2017 Aerospace and Defense Trends

Contractors as local businesses around the world
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About the authors

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Military budgets continue to tighten in the traditional big markets. Emerging nations seek to protect themselves and their growing economies. Thus defense contractors — most of which have roots in the United States or Western Europe — are looking in new places for customers. Instead of, for example, familiar territory like the North Atlantic Treaty Organization (NATO) allies, the growth arena for weapons manufacturers is mostly in places such as Saudi Arabia, India, South Korea, and Japan. This shift, in turn, requires landmark changes in the way defense companies approach new business and manage their customer relationships.
Closer relationships

Perhaps the most notable challenge is that defense contractors must increasingly negotiate on a country-by-country basis. In a multipolar world, the U.S. and its largest allies are no longer the arbiters of who buys weapons and how much equipment they can stockpile. Individual nations are now making these decisions for themselves as they find their footing in the geopolitical maze, which means that the rules and etiquette that defense contractors must navigate are much more unwieldy than ever before. These empowered countries have unique histories, politics, alliances, threats, economic goals, and ways of awarding contracts — and they are using their clout as military equipment purchasers to put their own imprint on contract negotiations.

Exhibit 1
Growth in traditional defense markets has slowed

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>577.5</td>
<td>3.5%</td>
<td>-19.8%</td>
</tr>
<tr>
<td>France</td>
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<td>2.2%</td>
<td>-4.8%</td>
</tr>
<tr>
<td>U.K.</td>
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<td>2.2%</td>
<td>-12.7%</td>
</tr>
<tr>
<td>Canada</td>
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<td>1.0%</td>
<td>-10.9%</td>
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<tr>
<td>Germany</td>
<td>46.6</td>
<td>1.2%</td>
<td>-6.0%</td>
</tr>
</tbody>
</table>

Source: PwC Global Defense Perspectives
To thrive in this environment, defense contractors can no longer rely on a classic arm's-length framework, in which a U.S.-based defense company, for instance, does business with a foreign country only as an exporter of products. Instead, defense contractors will be building closer relationships with more countries: assessing each market individually, deciding which are appropriate to do business with, and designing programs tailored to each country for business development, industrial participation by local businesses, and long-term investment. This is particularly important for U.S. contractors, which are somewhat hamstrung by the strong dollar. As U.S. products become more expensive than similar equipment produced in non-dollar denominated countries, American defense companies will have to “sell” cooperation and collaboration as a valuable benefit that makes it worthwhile and affordable for foreign customers to access U.S. military devices and technology.

Defense ministries are relaxing foreign direct investment constraints and asking defense contractors from outside their borders for commitments to their countries that go well beyond traditional short-term, relatively mild offset agreements (contract-related givebacks in the form of minimal intellectual capital transfers and the use of local suppliers, among many other things). The ministries now want broad-

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**Exhibit 2**

Defense contractors must seek out new channels to expand their business

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<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>73.7</td>
<td>10.4%</td>
<td>54.0%</td>
</tr>
<tr>
<td>Japan</td>
<td>59</td>
<td>1%</td>
<td>0.1%</td>
</tr>
<tr>
<td>India</td>
<td>50</td>
<td>2.4%</td>
<td>1.7%</td>
</tr>
<tr>
<td>South Korea</td>
<td>33.1</td>
<td>2.6%</td>
<td>1.1%</td>
</tr>
<tr>
<td>UAE</td>
<td>21.9</td>
<td>5.1%</td>
<td>23.9%</td>
</tr>
</tbody>
</table>

Source: PwC Global Defense Perspectives
based, explicit, and often extensive skills and knowledge transfer to build up their own industrial and military capabilities and diversify their economies. Their goal is to evolve from being an importer of technology to having the indigenous capability to develop and export their own defense products and services.

One example of this type of deal is the joint venture between Boeing and Tata Advanced Systems in India. The companies have agreed to co-produce Boeing AH-64 Apache helicopter fuselages and other aero structures. The Hyderabad-based production facility will eventually be the sole global producer of AH-64 fuselages. In a similar vein, a Northrop Grumman joint venture in Saudi Arabia is designing systems and technology for high-end security systems to protect critical infrastructure in the area. In this arrangement, U.S.-derived technology and staffers are augmented by Saudi engineers and selected partners from other Saudi defense-related enterprises. In Japan, Lockheed Martin, Mitsubishi, and Sampa Kogyo K.K. have formed a joint venture that will work with government military experts to design combat systems for the Japan Maritime Self-Defense Force (JMSDF). And another Saudi arrangement involves Britain’s BAE Systems, which has a wide-ranging deal to provide electrical engineering know-how, IT systems, and training for both military and industrial development in Saudi Arabia.
Winning lucrative international defense contracts will increasingly require these long-term, knowledge-sharing commitments, including technology transfer, intellectual property licensing, co-production arrangements, local sourcing, and training of local workers in skills that allow them to handle engineering and production responsibilities. Consequently, extensive industrial cooperation with governments and other contractors will become the price of entry into the game for all defense companies. The potential benefits to defense contractors go beyond merely gaining access to new customers. Strong, localized relationships in developing markets could ultimately help defense contractors lower global supply chain costs, improve competitiveness, and play a role in determining where defense capabilities can spread.

To succeed in framing their approach to a diverse landscape of multiple local markets, we believe defense contractors should focus on the following six critical rules.

1. **Think long-term**

   Investment and partnerships in the local economy are now a cost of doing business long before any defense contract is signed. Gone are the days when a company could simply show up and bid on a lucrative contract. For access, companies need to demonstrate commitment to the military and industrial base and a willingness to transfer technology and skills beforehand. Given that the return on this kind of investment might be 10 years or more, some companies will struggle to justify the expense. But at least a few contractors see this as a winning strategy. For example, Rolls-Royce has established an engineering center in India to train 1,500 locals, just one part of a deep involvement in the country that the company believes will bolster its defense aviation business. As India places more emphasis on its “Make in India” campaign, it will “allow companies like us to further support the country’s modernization needs,” said Kishore Jayaraman, Rolls-Royce president for India and South Asia, in an article on the website Aviation & Defence Universe.
2. Study history

A fine-tuned appreciation of the political and economic terrain is essential. This includes a broad understanding of a country’s history — its colonial past, wars, rivals, and alliances — and how this “burden of history” guides a country’s current political and military decisions toward new threats or conflicts, such as the fight against terror or, for Asian countries, the increasing assertiveness of China in the South China Sea. Because of the complex array of geopolitical and military considerations that each government confronts, it’s often necessary for defense contractors to enlist officials from their home government to offer guidance — and to speak on behalf of the company to counterparts in the other country. This kind of government-to-government communication can be critical to assure the buyer that the provider will be able to continue supplying weapons in the event of war.

3. Know whom to know

It’s very important to develop the right relationships in each country in order to understand when the RFIs (requests for information) are coming and how the procurement process works. Which staff in the Ministry of Defense or the Finance Department are the best touch points? And who are the unofficial influencers (rarely named in the official negotiated document, but holding sway nonetheless) who must be cultivated or at least taken into account? In India, for example, defense contractors ignore the impact of the state-owned Defence Research and Development Organisation (DRDO) at their peril. This past summer, India’s Ministry of Defence rejected the plans of France shipbuilder DCNS to develop a local, fully owned subsidiary to manufacture air-independent propulsion submarine systems on the advice of DRDO, which is developing similar equipment, according to Defense News.

4. Develop relevant capabilities

Evolving from an export and transactional business model to a “localization” approach requires defense companies to improve some of their skills and develop new ones. For example, defense contractors need to be able to cooperate with and train local companies they partner with to make sure that components and parts procured locally are built to the same specifications and standards that the defense contractor is accustomed to in other parts of its supply network. In some cases, this is extraordinarily hard work; many local businesses are starting from scratch and must be taught every aspect of production systems to meet A&D cost, quality, and delivery expectations.
5. Decide what intellectual property to share and what to develop

There is a natural tension between foreign governments’ desire for defense contractors to transfer technology skills and knowledge and defense contractors’ desire to maintain control over their intellectual property. Each defense contractor must decide how much access it will grant to these technological secrets, which are potentially the most valuable assets it owns. Both parties need to look at these arrangements as long-term partnerships and not one-time transactions. In other words, for defense contractors, sometimes sharing more than is instinctual is a good business practice with substantial rewards, and it can be good public policy as well.

One compelling reason to share intellectual property could be to improve a country’s capability to manage threats, particularly if that country is an ally of the company’s home country, such as, for U.S. companies, Japan, South Korea, or Israel. This may help ensure that the market remains stable and advantageous for defense contractors. For example, the U.S. and Israeli militaries have a long history of working together to jointly finance, develop, test, and use advanced weapons systems — a boon for defense contractors in both countries. In addition, for Western defense companies, codeveloping intellectual property facilitates the transfer of skills and knowledge to industrial partners in other countries and, in some cases, allows Western contractors to export technology that might otherwise be prohibited by trade restrictions.

6. Control costs

Although defense contractors can still turn to developing countries for new contracts, lower commodity prices and shrinking government coffers are pinching military budgets from these regions. This means that defense contractors must be cost competitive wherever they seek new markets. As long as most of their factories remain in Western countries, this will be difficult, though. An aging workforce in the West is creating a scarcity of skilled A&D workers and driving up costs. Because of this, forming meaningful joint ventures in developing nations and localized procurement strategies is a quick and relatively painless way to lower labor costs and sustain savings across the supply chain. Achieving this, companies must view emerging countries not just as markets but also as an avenue for talent arbitrage, a newly expanding and thus far less expensive labor force. However, when the required skills are lacking in developing countries, joint ventures will not instantly supply the sophisticated labor pool that A&D companies are seeking. In those cases, companies must be willing to help develop and train these local employees to achieve higher standards.
Defense contractors must wrestle with their own identity in this new environment. Will they continue to view themselves as exporters engaged in transactional relationships, or will they evolve to become long-term partners and active players in the development of local economies? In our view, success depends on a smart migration into this new, less transactional role — and, importantly, their survival depends on having a clear strategy to adopt the six strategic rules covered in this article. This is a serious challenge, and contractors must develop fresh operating models that can adapt to compete as emerging markets continue to evolve and develop their own capabilities. It is essential to have a long-term blueprint to become a local competitor globally and an industrial participant around the world.
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