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Rethinking oil-field partnerships in Saudi Arabia

Changing roles for the new era

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Contacts

Beirut

Georges Chehade
Partner
+961-1-985-655
georges.chehade
@strategyand.ae.pwc.com

Dr. Yahya Anouti
Principal
+961-1-985-655
yahya.anouti
@strategyand.ae.pwc.com

Dubai

David Branson
Executive advisor
+971-4-436-3000
david.branson
@strategyand.ae.pwc.com

Hitesh Chelawat
Manager
+971-4-436-3000
hitesh.chelawat
@strategyand.ae.pwc.com

About the authors

Georges Chehade is a partner with Strategy& Middle East, part of the PwC network. He is based in Beirut and is a member of the energy, chemicals, and utilities practice in the Middle East. He previously led the practice in the Middle East and has extensive experience in energy, including midstream and downstream oil and gas. He has led numerous transformation programs for large international and national oil companies, including corporate and business unit strategies, restructurings, and operating model redesigns.

David Branson is an executive advisor with Strategy& Middle East. Based in Dubai, he is a member of the firm's Middle East energy, chemicals, and utilities practice. He has over 30 years of experience in oil and gas operations, and specializes in strategy, organization, and processes, for oil and gas companies, national oil companies, and oil-field service and equipment companies.

Dr. Yahya Anouti is a principal with Strategy& Middle East. Based in Beirut, he is a member of the energy, chemicals, and utilities practice in the Middle East. He specializes in resource-based economic development and energy economics. He advises governments and oil and gas companies on sector strategies, operating models, and performance improvement programs.

Hitesh Chelawat is a manager with Strategy& Middle East. Based in Dubai, he is a member of the energy, chemicals, and utilities practice in the Middle East. He has over eight years of experience in the oil and gas and chemicals sectors, and specializes in advising companies on corporate strategy, business unit strategy, and mergers and acquisitions.

Executive summary

Changes in the oil-field services and equipment sector in Saudi Arabia mean that both multinational corporations (MNCs) and their local partners need to review their strategies and approaches to partnerships. On the one hand, greater transparency and the easing of foreign investment regulations have made it easier for MNCs to do business in Saudi Arabia without the local partners that have traditionally acted as agents, distributors, or passive joint venture partners. On the other hand, a renewed focus on the localization of manufacturing and services presents an opportunity for local companies to support MNCs in establishing efficient manufacturing operations, or to position themselves as vertically integrated oil-field services and equipment suppliers.

The starting point is for local companies and MNCs to redefine their vision and strategy for engagement in the sector. They should take into consideration the characteristics of potential investments in the sector and assess how well their current portfolio and capabilities are aligned with the evolving requirements of the sector along two dimensions — localization potential and economic attractiveness. Local companies should then seek to determine how their existing marketing, supply chain, and support service capabilities can be further developed to enable the localization of manufacturing. In addition, local companies that wish to play a more active and sustainable role in the oil-field services sector need to ensure that they have the financial wherewithal to co-invest with their MNC partners or to invest in their own capabilities.

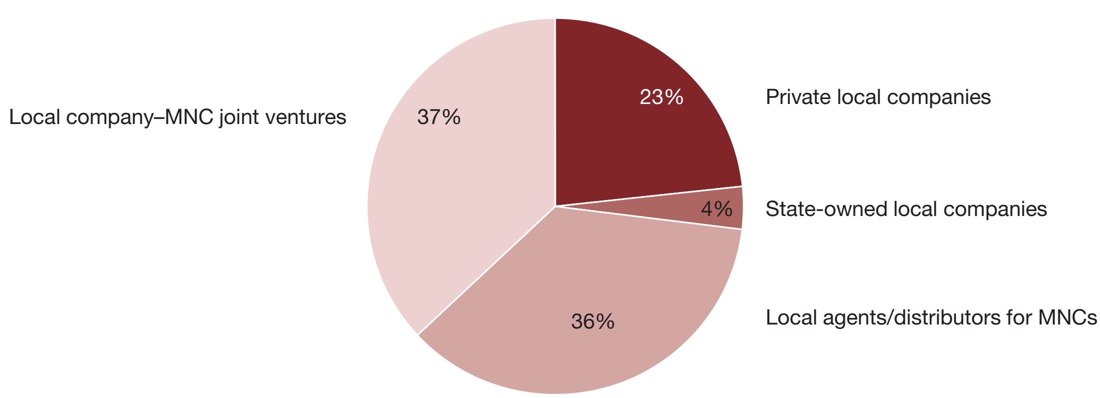
Local companies that proactively develop and adapt their capabilities will be best positioned to retain their existing partnerships and attract new MNC partnerships. Alternatively, they can become independent suppliers of oil-field services and equipment.

An industry built on partnerships

Partnerships between MNCs and local companies dominate the oil-field services and equipment sector in Saudi Arabia (*see Exhibit 1*). These partnerships result from how the oil-field services and equipment sector developed in Saudi Arabia. Although MNCs initially acted alone, local regulations eventually required the participation of local companies and stipulated that trading activities be restricted to Saudi individuals and companies. To meet the requirements of the new regulations, many MNCs that entered Saudi Arabia in the 1970s did so in partnership with strong, family-led industrial conglomerates, with the local firms acting as the agents and distributors for goods manufactured overseas. Although some of these partnerships retain their original supplier–distributor relationship, many have developed into joint ventures. This has particularly been the case when the volume of equipment sales has encouraged the localization of elements of the manufacturing value chain.

Exhibit 1

The oil-field services and equipment sector is dominated by partnerships between MNCs and local companies



Note: Based on a survey of 134 companies.

Source: Strategy& analysis

A more open investment regime

Increased transparency and greater openness to foreign investment are making it easier for MNCs to do business in Saudi Arabia without local partners. Saudi Arabia has progressively relaxed foreign investment regulations since 2000. These changes have included revisions of key pieces of legislation, along with the formation of the Saudi Arabian General Investment Authority (SAGIA), whose mission is to "develop and attract investments by improving the investment environment." The accession of Saudi Arabia to the World Trade Organization in 2005 further reflected Saudi Arabia's commitment to reforming and liberalizing its economy.

In particular, recent changes have the potential to make partnerships redundant, especially for large, well-established companies. In September 2015, SAGIA announced that non-Saudi entities would be permitted to own 100 percent of wholesale and retail operations, subject to certain conditions. These conditions include commitments on inward investment, the training and employment of Saudi nationals, manufacturing 30 percent of distributed products locally within five years, investing 5 percent of gross sales revenues in local research and development, and establishing Saudi-based logistics and after-sales support operations. In response, a number of large foreign companies, such as Dow Chemical, Pfizer, and 3M, have obtained licenses to conduct trading activities through wholly owned companies.

Of course, partnerships remain an important option for smaller foreign companies that have less international experience or for new entrants to the Saudi market. For such companies the establishment of an agency or distributorship is common practice because it allows them to understand market dynamics and mitigate risks.

A renewed focus on localization

Saudi Arabia has long had a policy to localize manufacturing activities and create employment, a policy whose recent renewal provides an incentive for MNCs to seek local partners or for local firms to become independent oil-field services and equipment suppliers. There have been previous initiatives, such as *Nitaqat* from the Ministry of Labor, which was introduced in 2011 to encourage the employment of Saudi nationals through incentives and penalties. However, official efforts at localization have often met with limited success because of the absence of a cohesive national strategy for local content development; uncoordinated local content development efforts lacking a single, empowered coordinating entity driving the agenda; incomplete monitoring, regulations, and enforcement of local content objectives; and, procurement practices that limit the ability of local companies to participate and compete.

The decline in oil prices since mid-2014 has provided a new urgency to diversify the Saudi economy away from oil. Saudi Vision 2030, announced in April 2016, emphasizes the maximization of local content, job creation, and private-sector participation. To support these objectives, a Local Content and Private Sector Development Unit was formed within the Council of Economic and Development Affairs in December 2016. This unit's task is to increase local content, support the development of the non-oil private sector, and improve the balance of payments. The unit plays an important role addressing barriers to localization across different industries, such as through the establishment of industrial zones and reviewing import tariffs.

For oil-field services and equipment specifically, the key localization initiative is Saudi Aramco's In-Kingdom Total Value Add (IKTVA) program, launched in December 2015. IKTVA is solely focused on the oil sector and so can have an important effect on oil-field services and equipment partnerships. As the sole buyer for the majority of oil-field services and equipment, Saudi Aramco is in a unique position to directly influence the localization strategies of key suppliers. IKTVA's objectives are to:

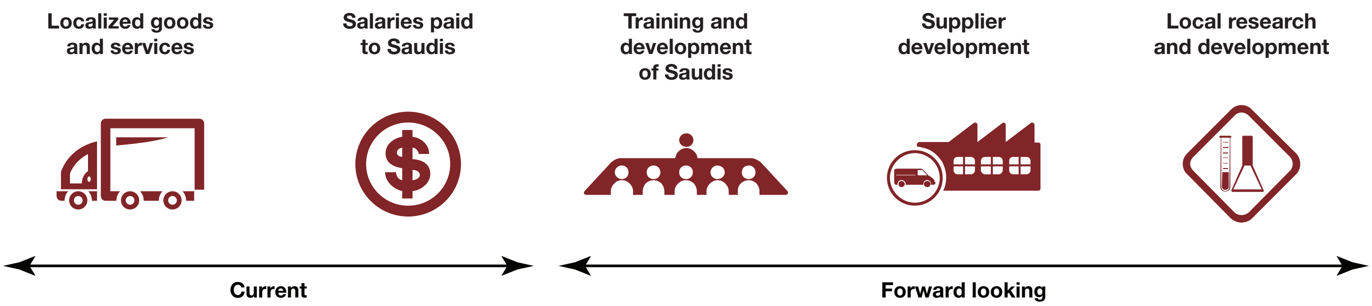
- Double the percentage of locally produced energy-related goods and services from 35 percent in 2015 to 70 percent by 2021
- Export 30 percent of output from the local energy goods and services industry

- Create half-a-million direct and indirect jobs for Saudi nationals

Saudi Aramco is placing increasing emphasis on IKTVA in the award of major contracts. The company's top 100 suppliers are subject to an audit procedure that generates an IKTVA score based on measures of current localization (expenditure on local goods and services, and salaries paid to Saudi nationals) and forward-looking measures that demonstrate how the supplier is supporting future localization (training and development of Saudi nationals, supplier development, and local research and development) (*see Exhibit 2*). Saudi Aramco works with suppliers to ensure that actions taken are aligned with national objectives. The resultant IKTVA score is used to determine the contract award.

Exhibit 2

The IKTVA score includes measures related to current and future localization



Source: Saudi Aramco

Although the IKTVA program is still developing, it is already having an impact. Saudi Aramco reports that locally produced energy-related manufacturing accounted for 43 percent of the total in 2016, up from 37 percent in 2015. In addition, the IKTVA score was a key component in the process to select suppliers for contracts that could total over SAR 60 billion (US$16 billion).[1] Meeting IKTVA targets to remain competitive is forcing companies to rethink their supply chain operations so that they switch to local suppliers and develop the local supply chain wherever economically justified.

Companies do not have the luxury of waiting to see how the final IKTVA approach develops. They need to take action now. Indeed, Saudi Aramco, through the agency of IKTVA, requires that MNC suppliers deliver a clear road map for increased localization. In developing these road maps, MNCs will need to consider their existing partnerships, and consider the roles that current and future local partners may play in helping them to achieve cost competitiveness and profitability for localized manufacturing operations.

New roles for old partners

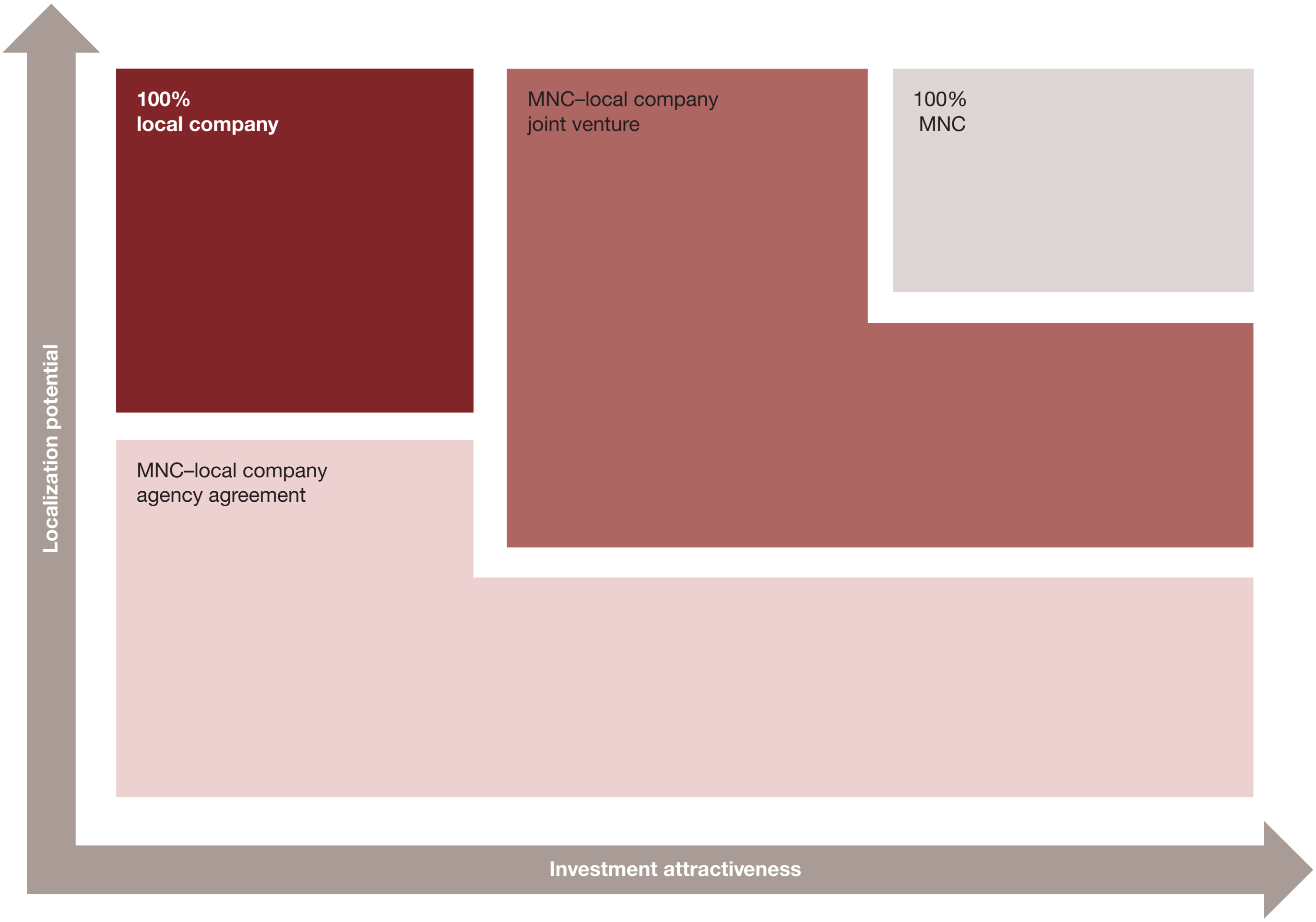
The new environment raises questions about the prospects for existing partnerships between MNCs and local companies. MNCs may ask why they need their local partners given relaxed investment regulations. They should instead ask how local partners can help them meet the challenges of increased localization. Conversely, local companies need to ask what will make them more attractive and valuable for MNC partners, or whether they should consider establishing their own independent operations. Addressing these questions is a matter of urgency. In the words of one major Saudi oil-field investor, “we are hanging on to the tail of this business.”

The starting point for local companies and MNCs is to review and redefine their vision and strategy for participation in the oil-field services and equipment sector. In developing this vision, companies need to take into account the characteristics of potential investments in the sector and compare their portfolio to the opportunities (*see Exhibit 3*). They should then apply this vision to their own investment strategy so that it includes the local content dimension in the evaluation of investment and growth opportunities.

The nature of potential investments will influence how partnerships develop. For example, it may be in the best interests of an MNC and a local company for the local partner to have an agency agreement to sell and distribute products in the Saudi market for activities that cannot be commercially localized, whether due to small market size or supply chain limitations. By contrast, a larger MNC possessing sophisticated approaches and capabilities to manage increased localization requirements may opt for 100 percent ownership for attractive investment

Exhibit 3

The characteristics of investment opportunities will influence approaches to partnership



Note: MNC = multinational corporation. Investment attractiveness is market size, market growth, and profitability margins. Localization potential is ease of localization and socioeconomic impact.

Source: Strategy&

prospects with high localization potential. Similarly, local firms may also go it alone for less-attractive, commoditized investment opportunities with no significant barriers to entry. Indeed, local companies operating independently are already a small component of the Saudi landscape.

Although MNCs and local companies acting independently may become more common, joint ventures will remain a feature of the industry. Just because companies can proceed independently, does not mean that they will, particularly for joint ventures that are still seen to serve the ambitions of both parties.

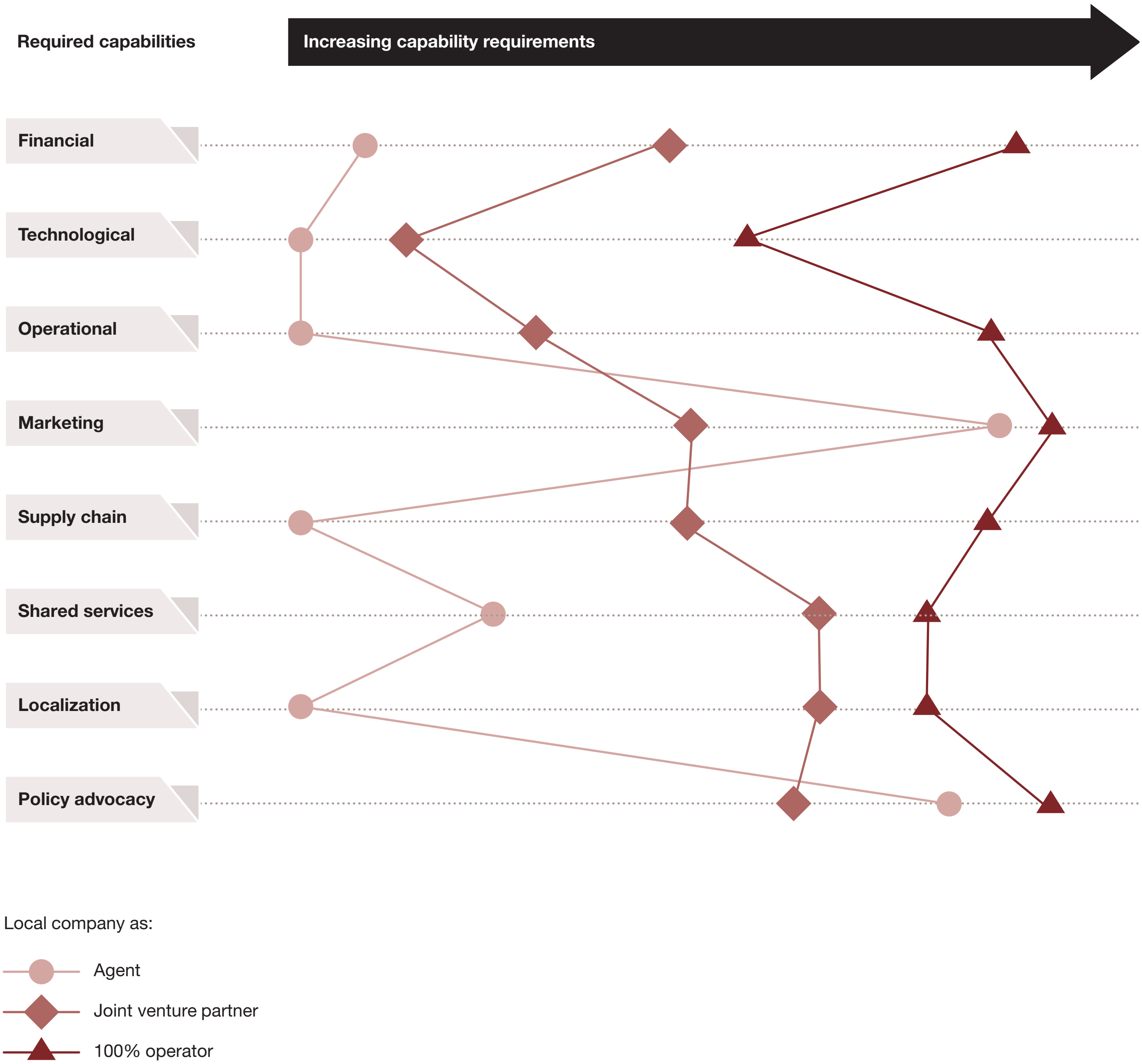
Building the capabilities to succeed

The challenge for local companies is to build the capabilities required to support greater localization of activities, whether they do so within a partnership or as independent suppliers. After local companies have developed their vision and strategy for participation in the oil-field services and equipment sector, they then have to build capabilities accordingly. For companies whose vision and strategy is to maintain the traditional role of an agent, the capability requirements are not onerous. Local companies with a greater ambition to expand their role as a joint venture partner with MNCs, or to conduct their own operations independently, will need to build on their existing capabilities to maximize value creation for their shareholders, and for their joint venture partners (*see Exhibit 4*).

Some companies may already possess many or all of these capabilities. Other companies will need to build these capabilities over time or acquire them. These capabilities will be in the eight following areas:

Financial: Local companies will need to be able to access sufficient financing to meet their share of new investments, whether for independent operations or as part of a joint venture in local manufacturing. Large industrial conglomerates that have a broad portfolio may find meeting such investment requirements straightforward, although it implies significant capital expenditure in a smaller number of ventures. Other companies may have to rely on external financing, which demands more sophisticated financing capabilities. Such capabilities are in contrast to the traditional role of the agent/distributor that required minimal up-front investment from the local company because the MNC partner made the bulk of investment in manufacturing facilities outside of Saudi Arabia.

Exhibit 4
Local companies will need to build a range of capabilities for longer-term success



Source: Strategy&

Technological: Local companies need technological capabilities sufficient to allow them to make decisions on investment in new technology. These investments are required even though it is primarily the role of the MNC in many partnerships to provide the technology and technological capabilities. Those local companies aspiring to conduct independent operations, such as to become vertically integrated oil-field services and equipment suppliers, will need sophisticated technological capabilities. They can acquire these potentially through the licensing of required technologies or through technical service agreements.

Operational: Local companies should be able to review operational plans and practices in joint venture operations on the basis of their knowledge of the Saudi operating environment. Although core technical operations may be led typically by the MNC, a local company could support the joint venture by providing its experience in non-core operations derived from other ventures and sectors — for example in power and water management.

Marketing: Local companies need to ensure that they maintain and strengthen the capabilities to complement MNC-led marketing efforts. MNCs typically lead marketing efforts based on their in-depth knowledge of products and services in a joint venture structure. Such local company capabilities may include cultivating key relationships and contributing to the understanding of the competitive landscape. This is in addition to the existing role of an agent or distributor of maintaining relationships with customers (especially Saudi Aramco), remaining abreast of important service and equipment requirements, and marketing services and products developed outside of Saudi Arabia.

Supply chain: Local partners need the capabilities to support their MNC partners in developing local suppliers and supply chains, which IKTVA encourages. Local partners may already be able to identify local suppliers that can contribute goods and services to their joint ventures through established activities. In some cases local companies may take a more active role in developing suppliers by directly investing in these supply companies to achieve the scale or quality required by the joint venture.

Local companies need to ensure that they maintain and strengthen the capabilities to complement MNC-led marketing efforts.

Shared services: Local companies should develop shared service capabilities that can support the cost performance and efficiency of newly localized ventures. These capabilities can mitigate any negative impact that new localized operations may have on joint venture profit margins. Such shared services may include the provision of manpower and staffing solutions because of the challenges that MNCs can face in dealing with visa and labor requirements. In some cases, local companies may already possess, or can readily develop, logistical capabilities that support the import and export of required equipment and support the distribution of products throughout Saudi Arabia.

Localization: Local companies should build capabilities to identify and secure human resources based on their existing knowledge and relationships with entities such as local universities and training institutes. This can help their MNC partners in accessing the often hard-to-find local skills and corporate resources needed for localization.

Policy advocacy: Local companies should build their capabilities to actively participate in ongoing debates occurring at all levels of government and within Saudi Aramco around the future of the oil-field services and equipment industry, as well as the broader debate on increased local participation. Although MNCs are already engaged in these discussions, local firms have more influence. In so doing, local companies should ensure that future policy actions are informed by the practical challenges that their MNC partners have faced during localization.

Conclusion

Although the investment landscape in Saudi Arabia may seem worrisome for local companies, the current changes herald the start of the next phase of development of the oil-field services and equipment sector. In this new era for partnerships, success will come to MNCs that can leverage local partnerships to drive increased localization, and to those local companies that can offer the capabilities to support this process. The changing environment offers important opportunities to those local companies that proactively align their strategy and capabilities to meet the new requirements. Local companies that succeed in developing their capabilities will emerge as partners of choice for MNCs or as independent local suppliers.

Endnotes

[1] In-kingdom Total Value Add (iktva) — program in motion, Saudi Aramco, 2016 (https://www.iktva.sa/wp-content/uploads/2017/01/17-0141-IKTVA-in-motion-RA-15-Jan-17.pdf).

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