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Defence Industry in Saudi Arabia

International Trade
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1. Introduction

This report has been produced by Arabian Enterprise Incubators (AEI Saudi) for Virginia Economic Development Partnership (VEDP). The purpose of this report is to provide the companies in the State of Virginia with an overview of the defence sector in the Kingdom specifically with regard to entering the market, engaging in the procurement process and understanding the current status of the transformation programme.

The report is structured as follows:

- Section 2: General Market Entry Strategy
- Section 3: Current Trends
- Section 4: Defence Procurement

The contents of this report have been compiled in good faith by consultants with significant experience and understanding of the Saudi market. However, information, insight and guidance contained herein should not be used in the place of formal professional advice (including but not limited to legal advice and tax advice) and AEI does not represent, warrant or guarantee that the use of the contents herein will lead to any particular outcome or result.

2. General Market Entry Strategy

In recent years the Saudi market has been opening up as the Crown Prince, Mohammed bin Salman (MBS), seeks to reposition the Kingdom with less reliance on oil and a more sustainable economic foundation for his country.

The process to open-up the Kingdom is not easy and has resulted in the largest transformation programme that the world has ever seen. Under the banner of Vision 2030, MBS has set out the priorities for the Saudi Government for the next 10 years and these focus on the diversification of the economy away from oil and the creation of jobs for huge, youthful Saudi national population.

We now see opportunities in all sectors that were previously difficult or impossible for foreign businesses to access such as in education, training, construction and the healthcare sector.

Defence, however, has always been ‘open’ to western suppliers and prime contractors to a certain extent. The security relationship between the Kingdom and the US (and other key defence partners such as the UK and France) has always been shored up by defence sector procurement contracts.

There are many examples of US companies that have successfully exported equipment and or services to the Kingdom over the years and the US remains of course the most strategic defence partner for Saudi Arabia. Accordingly, the routes to market for US companies supplying and servicing Saudi opportunities are fairly well tried and tested.

The preferred route to market is through a Government to Government arrangement. For US exporters this will be a Foreign Military Sales (FMS) programme but it is worth noting that US exporters may be able to access opportunities that arise under Government to Government arrangements with the UK, for example with the Royal Saudi Air Force.

There are two primary advantages of working under an FMS programme:

- Payment – suppliers are largely insulated from payment risk. Of course, suppliers must deliver but with the US Government as the customer, payment risk is greatly diminished.

- Acceptance – suppliers can generally rely on a US Government role in accepting goods or services and this diminishes the risk at test / handover / acceptance.

Additionally, suppliers benefit from being contracted under US law, contracts are typically in USD minimising exchange rate risk and, for the prime contractor community, FMS programmes tend to be large scale and long term tying the customer to a particular route to market for many years to come.

Of course there are disadvantages. FMS can be slow both from the perspective of securing US regulatory approvals and also from the Saudi side, signing off what might be a multi-billion dollar programme can take time. It is not uncommon for large defence campaigns to run for 5+ years before a contract is awarded. FMS can also be subject to the political 'ups and downs' of relations between the US and the recipient country.

On balance however, FMS is absolutely a preferred route to market, particular for first time exporters or smaller businesses who will face significant risks in the Direct Commercial Sale (DCS) environment.

The defence landscape in the Kingdom is fairly complex with a broad range of End Users often with limited inter-agency cooperation or communication. The initial 'target' customer for most US defence exporters is the Saudi Ministry of Defence (MOD) which comprises the traditional land, sea and air capabilities. These are knows as:

Royal Saudi Land Force (RSLF)	*Comprising the 'land' capability, the RSLF has historically been a US supported branch of the MOD. Wheeled and tracked vehicles fleets mainly from the US comprising M1 Abrams, M2 Bradley, M109, M113, M88, LAVs, 'humvee' and MATVs. Rotary fleets focus on Apache and Blackhawk.*
Royal Saudi Naval Forces (RSNF)	*Comprising the 'sea' capability, the RSNF is split into two fleets – the Western Fleet in Jeddah on the Red Sea has traditionally been supplied by France and the Eastern Fleet in Jubail on the Arabian Gulf has traditionally be supplied by the US and the UK.*
Royal Saudi Air Force (RSAF)	*Comprising the 'air' capability, the RSAF relies heavily on the UK for training with aircraft from both the UK and the US. Fast jets include Tornado, Typhoon and F15.*
Royal Saudi Air Defence Forces (RSADF)	*Comprising the 'air defence' capability, the RSADF is heavily reliant on the Patriot air defence system from the US*

Wherever there are largescale equipment programmes with the US, these are usually always FMS contracts.

An additional customer to consider in the Saudi defence landscape is the Saudi Arabian National Guard (SANG) now known as The Ministry of the National Guard (still referred to as SANG or MNG). The MNG is a separate, full time military force akin to the RSLF. It comprises approximately 200,000 personnel including 25,000 reservists and is traditionally drawn from a number of tribal groups that have been long standing allies of the House of Saud.

The traditional Concept of Operations (CONOPS) had been focused on internal security issues where law enforcement and the security services were unable to manage or resolve a crisis.

The MNG operate a very mixed fleet of land vehicles comprising LAV from the US, various French platforms including Aravis, Areva and Caesar from Nexter, Tactica from the UK and a substantial logistics and utility vehicle fleet from Steyr. There is also a large rotary capability, focused on Apache and Blackhawk.

The future of the MNG remains under review and it may well be the case that the MNG is somehow amalgamated with the RSLF given the overlap of capabilities.

Understanding the landscape and the End User community is crucial to building a pipeline of opportunities in the Kingdom. This will generally involve engaging the prime contractor community, leveraging existing relationships in the US with clients / customers / partners who have interests in the Kingdom as well as looking opportunities that may be releases publicly.

Qualifying an opportunity is essential and all the standard datapoints should be looked at such as customer budget, competition, requirements etc but suppliers to the Kingdom must also consider the customer's route to market – will the opportunity be contracted on an FMS or DCS basis? This is crucial as the customer's route to market will shape the entire campaign strategy.

Once an opportunity is identified, the supplier must consider how the project will be delivered. Delivering in Saudi can present some logistically challenges such as setting up an entity in the Kingdom, employment and deployment restrictions as well as broader compliance matters such as export controls and local tax regulations. Even under an FMS programme, suppliers must comply with local rules for work performed in the Kingdom.

One of the most common questions relates the requirement for a Saudi partner to support and enable both business development and project delivery. This topic is discussed further in section 4.

Looking at opportunities, determining a route to market and considering partnering options is generally wrapped-up in a Route To Market Strategy that a supplier will develop for the Saudi market. This is necessarily a 'living' document and will be kept alive with regular updates and changes.

In broad terms, most suppliers will end up with a market entry strategy for the Saudi market which is iterative thereby balancing risk and cost. Phases may include but are not limited the below and of course these may differ depending on the route to market, scope of supply and duration of project:

Market Assessment	*Understanding the market in terms of the defence landscape, the End User community and their requirements, competitor analysis as well as building a pipeline are all part of the initial phase of market engagement. This will require a budget to be allocated for a number of visits to the Kingdom as well as funds to support advice and guidance from trusted independent sources on the ground.*
Interim Operating Model	*It is not uncommon for suppliers to establish an interim operating model for the Kingdom, with a light touch footprint in the Kingdom. Typically this would involve a fly-in / fly-out Business Development effort, perhaps with a rented villa as a base. This phase is usually the ideal time to 'test' the Saudi market prior to further commitment, with BD efforts focused on market intelligence, customer engagement and understanding the partnering / supply chain opportunities.*
Partnered Approach	*In the case where a partner may be required, they can be engaged early as generally commitment tends to be limited to exclusivity rather than any financial or investment obligations. Of course exclusivity needs to be handled sensibly and can be limited to a specific project. Termination rights should*

	also be clearly stated and agreed. At this stage the relationship can be documented in a collaboration or teaming agreement.
Entity Registration	*It is becoming increasingly common for suppliers who are delivering projects in the Kingdom, whether goods or services, to be required to have an entity registered in the Kingdom. This is the stage where a firm commitment is being made to a legal and physical footprint in the Kingdom.*

Of course some of these phases may run concurrently for different campaigns or indeed different customers. A phased approach whether in an FMS or DCS environment is generally the most sensible way to land and expand in the Saudi market.

3. Current Trends

3.1. Context

In order to understand 'current trends' or the 'word on the street' with regard to the defence in the Kingdom of Saudi Arabia, it is first necessary to understand how Vision 2030 is being applied in the defence sector.

The transformation agenda of Vision 2020 is absolutely being applied in the defence but there is a slight change in focus. For defence, the priorities are:

Sovereign Capability	*This requirement is driving the localisation agenda. The Saudi are determined to spend more of their procurement budget on goods and services that are made in the Kingdom. Transfer of technology, transfer of production, the employment of Saudi Nationals and 'off-set' style arrangements are fundamental to all major procurements. Also, there is a strong view that in order to be considered a 'sovereign capability', assets, facilities, Intellectual Property, tooling etc must be in the Kingdom physically and 'owned' in whole or in part by the Saudi Government.*
Better Value For Money	*The Saudis have one of the largest defence procurement budgets in the world but it has not always been spent in an efficient manner. The old system of 'silo-ed' procurement which prevents volume purchases is being broken down and there is now a firm focus on joined-up procurement across the entire defence sector including MOD and MNG.*
More Capability	*Despite all the spending, the Saudi armed forces have struggled to deploy an effective capability in recent operations. This has come from the historic 'silo-ed' approach which was also taken for training restricting inter-operability and joint force deployment. Going forward, training and interoperability are a key focus to getting more out of the vast armed forces that the Kingdom possesses as well making sure that vital technologies and systems are updated.*

So the defence sector transformation has been launched. In fact it started back in 2017 and has already seen some of the largest consulting and project opportunities in defence anywhere in the world. For example, the design and delivery of the new Enterprise Resource Planning (ERP) system for the Saudi MOD is the largest project of its kind in the world currently.

To deliver the transformation, a number of new bodies and entities have been created. To deliver ***Sovereign Capability*** a new entity owned by the Public Investment Fund (PIF) called Saudi Arabian Military Industries (SAMI) has been formed. To push for ***Better Value For Money*** a new regulatory body called the General

Authority of Military Industries (GAMI) has been launched. And to achieve ***More Capability*** the Transformation Management Office (TMO) has been established.

Before looking at SAMI, GAMI and the TMO in more detail it is important to understand the role of the PIF.

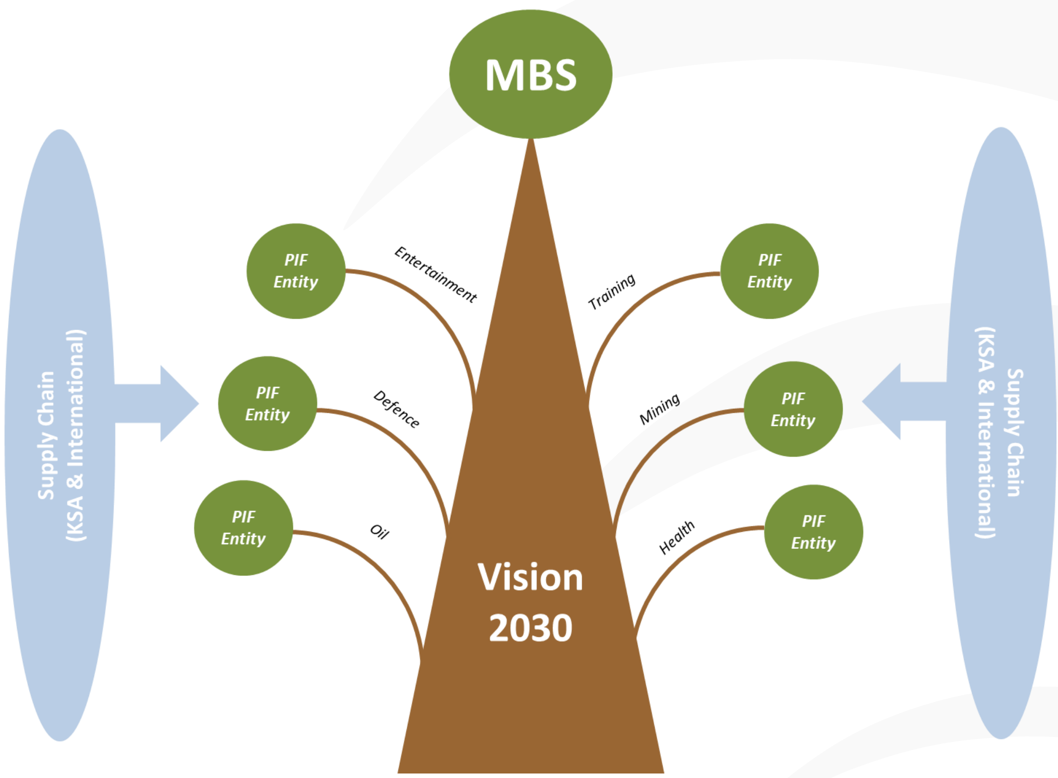
3.2. The Public Investment Fund

Although this is not a new body (the PIF was founded in the 1970s) and it is certainly not a TMO initiative, it is important to understand the role that the PIF is playing with regard to Vision 2030 in the defence sector.

In particular, the PIF has and continues to establish or acquire shareholdings in companies that it has identified as being central to the implementation of Vision 2030. It is of course therefore the case that if a PIF entity is involved in a bid for a particular tender, it *should* be viewed favourably by the procurement authority with regard to a Vision 2030 'tick in the box'.

This however must be assessed on a case by case basis and it does not mean that simply because of PIF ownership a particular entity is capable or credible to perform a particular scope of services.

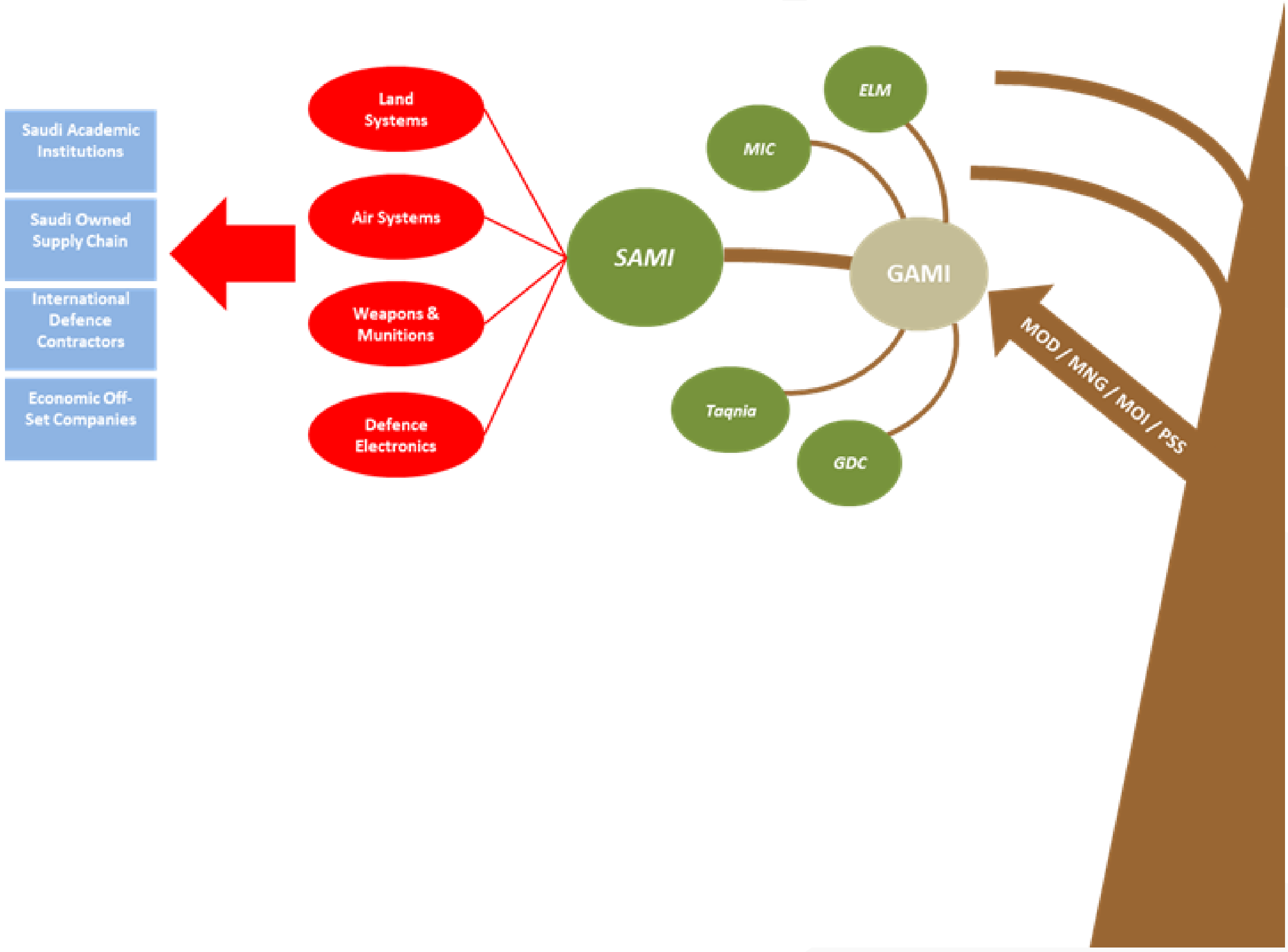
The PIF is being used as the delivery vehicle for Vision 2030 and in some ways has become the new, single patronage tree for the delivery of Government contracts in the Kingdom.



Illustrative structure showing interface between Vision 2030, the PIF and the supply chain

The key point is that in most cases only projects and proposals that are aligned to both Vision 2030 and the PIF will receive funding approvals.

The below image illustrates the 'defence branch' of the PIF including SAMI and the other defence sector PIF entities.



Currently, the entities within the defence portfolio are 100% owned by the PIF. In time, it is expected that these will be privatised, perhaps up to 80% floated through the Saudi stock market.

3.3. New Government Bodies

3.3.1. Transformation Management Office (TMO)

The TMO was the first initiative launched within the MOD under the banner of Vision 2030. It was formed in 2016 and is headed by Dr Sameer Al Tabib, a former VP Engineering Affairs at Aramco.

Since then, a large number of consultants have been used to develop a transformation plan for the MOD, most notably PWC and AT Kearney as well as a number of niche, smaller consulting companies. The vast majority of consultants have been either American or British.

However, it became clear early on that actually for the transformation to be successful and for the Vision 2030 objectives to be realised, particularly those relating to industrialisation, it would have to have a pan-defence sector remit.

Accordingly the focus of the TMO on areas such as training, procurement, organisation, CONOPS, HR / career management and operations all have a *joint* component signalling the end of the stove piped approach that has characterised the defence and security sector in the Kingdom for many years.

The creation of the Joint Force Commander and the Joint Operations Centre (JOC) is a TMO initiative and broadly follows the UK Permanent Joint Force Headquarters (PJHQ) model.

3.3.2. Saudi Arabian Military Industries (SAMI)

The creation of SAMI was announced by Royal Decree in 2017 and it is expected that SAMI will be within the top ten global defence prime contractors by 2030. SAMI is to be the principal beneficiary of the drive for ***Sovereign Capability***.

SAMI is managed by a Board of Directors chaired by Ahmed Al Khateeb, and currently sits as an independent entity, owned by the PIF. The CEO is Walid Abukhalid, a former senior executive at Northrop Grumman and BAE Systems.

SAMI is organised into 4 business units:

- ‘Air Systems’ – expected to cover the maintenance and repair of fixed wing aircraft and UAVs. It is expected to work closely with Taqnia Aeronautics but may well take over Taqnia in due course. It seems unlikely that Air Systems would compete with existing private sector companies like Al Salam, MIG or MEPC and the presence of Ghassan Shibl on the Board seeks to reassure the private sector that there is room for all in the Saudi defence landscape. The recent acquisition by SAMI of AEC and AACC has essentially launched the Air Systems business unit.

- ‘Land Systems’ – expected to focus on vehicles and particularly the elements of Military Industries Corporation (MIC) that currently represent the defence sector vehicle manufacturing capability in the Kingdom – what was Al Faris International in Dammam, now known as the Armoured Vehicle Factory (AVF) which has largely been dormant. It is expected that Land Systems will be the easiest part of SAMI to get going as there is so much opportunity, particularly with the RSLF tracked vehicle fleet (Bradley, M109, M88 and M113). However, internal challenges have delayed the planned integration of MIC into the SAMI business portfolio.

- ‘Weapons and Missiles’ – The existing MIC weapons, ammunition and munitions business has been expected to transfer to SAMI for some time but issues remain that are frustrating the process. A strategic review is currently underway within the TMO with regard to capability expansion and manufacturing capacity. SAMI Weapons and Missiles will inherit a close legacy relationship with Rheinmetall Denel and MBDA. A Joint Venture with MBDA will be announced soon.

- ‘Defence Electronics’ – according to media reports this business unit will focus on radars, sensors, EW and C4i. The large primes such as Raytheon and Northrop Grumman have been courting SAMI heavily in recent months as they expect the Defence Electronics business unit to lead the roll out of the long-awaited C4i programmes at the RSAF and RSLF. The acquisition of AEC has added significant capability with regard to sensors, pods and communications systems.

For the prime contractor community, SAMI is now the obvious candidate for a partnering approach and indeed most of the large defence contractors have signed statements of intent with SAMI to form a Joint Venture. However, all are holding fast that without a contract, the primes are not prepared to invest ‘speculatively’ in the Saudi market.

3.3.3. General Authority of Military Industries (GAMI)

With SAMI as the beneficiary of defence localisiaton, GAMI is very much the regulator setting rules and monitoring compliance. Additionally, GAMI will play a role in procurement and although nascent currently the intention is that GAMI will become a pan-defence sector procurement agency.

Announced in August 2017, GAMI is also a product of the TMO and is actually the first pan-defence sector body to be incorporated. As a General Authority, GAMI sits outside of any particular Ministry and is headed by Ahmed Al Khateeb (known as Khateeb).

Khateeb is one of MBS’s trusted acolytes and his name is found on the boards of various bodies and agencies across the defence and security sector. It can sometimes be difficult to understand which ‘hat’ Khateeb is wearing.

GAMI has one major priority which is the delivery of the industrialisation objectives for the defence sector. To that end, GAMI will take a pan-defence sector view with regard to procurement and look for common requirements that could be brought together in sufficient volume to justify in-Kingdom industrialisation.

Furthermore GAMI will also take a regulatory role by setting out and administering compliance with a formal set of Offset Regulations which have hitherto not existed in the Kingdom. The regulations themselves have been developed by Boston Consulting Group (BCG) and were expected to be ready before the summer break. It is now believed that they will be published by the end of the year and consequently major procurements may be delayed until these regulations can take effect.

Within the procurement process, suppliers can expect GAMI to be an independent agency supporting to the customer community to assess potential contracts from across the defence and security sector against 5 main criteria:

- Localisation / Industrialisation Review – what is the local content for manufacture / assembly, jobs, intellectual property, technology transfer and indigenous capability development / sustainment?
- Commercial Review – is the proposed solution value for money? What is the ‘should cost’ based on international benchmarking for similar products or services?
- Capability Review – what are the integration / engineering risks associated with the acquisition of the product or service?
- Legal Review – does the acquisition process and proposed contract conform to Saudi Government Tender & Procurement Law?
- Strategic Review – does the product or service ‘fit’ within the strategic direction of the particular customer?

3.4. Defence Sector News

It is fair to say that defence procurement has slowed in recent years in the Kingdom of Saudi Arabia. This might be unexpected given the high tempo of operations in Yemen before the pandemic but major procurements have been delayed whilst the transformation is embedded.

Of course war stocks and urgent operational requirements have been fulfilled (for example ammunition, munitions, body armour and air defence interceptors) but major equipment programmes have been pushed to the right.

There are a few notable exceptions however:

Freedom Class Multi Mission Surface Combatant	*An FMS programme for Lockheed Martin to supply 4 Littoral Combat Ships (LCS) to the RSNF. Estimated at $8bn+ this project includes the vessels and a significant package of shore facility upgrades.*
THAAD	*An FMS programme for Lockheed Martin to supply the next generation air defence system to the RSADF. Estimated at $3bn.*
Navantia Corvettes	*A DCS programme with Navantia from Spain for 5 corvettes, estimated $1bn.*

These projects represent a response to urgent and very apparent shortfalls in capability, largely borne out of the Yemen campaign.

The inability of the RSNF to maintain a naval blockade, recover downed pilots or indeed even to take on Somali pirates has left the Saudis questioning their longstanding relationship with the French navy in the Red Sea.

The ongoing air defence threat posed by the Houthis in Yemen has resulted in more investment in the RSADF than ever before and notably a very clear refusal to accept Russian, Chinese or indeed other western supplied air defence systems.

All these projects have received significant localisation objectives but all have been negotiated to be bespoke arrangements. For example, none of the corvettes will be 'made' in Saudi Arabia. Instead elements of the Combat Management System are being jointly designed by Navantia and AEC.

In terms of projects in the offing, there are a number of opportunities that are expected to see movement in 2022 and 2023:

Unmanned Surface Vessel (USV)	*The RSNF has a requirement for a next generation, USV capability to support mine warfare in both the Eastern and Wester fleets. It is believed that companies such as Lockheed Martin, Thales, Atlas and ST Engineering are being considered with Thales as the likely winner. An initial order is expected in 2022, for up to 12 systems with further orders and the supply of a number of 'mother ships' expected to attract a budget ultimately of c.$500.*
MNG and RSLF Light Armoured Vehicle (LAV) Fleet Upgrade	*Between the MNG and the RSLF there are over 3,000 LAVs of various generations in the Kingdom and there is a clear intent to make these wheeled vehicles the back-bone of infantry capability. A project to upgrade vehicles, probably through an FMS programme, starting with the MNG is expected to be awarded in early 2023.*

C4i Systems Upgrades – MOD	*There have been longstanding requirements for the upgrade of command and control systems across the MOD to improve overall C4i capability across land, sea, air and air defence. Likely to be awarded in separate contracts under an agreed system architecture, likely to be FMS which will favour Raytheon or Northrop Grumman. Estimated budget is $5bn+.*
Fast Jet Fleet	*There remains a requirement for 2 additional squadrons of fast jets. These had initially planned to be Typhoon but due to political issues there is consideration being given to Raphale from France. Estimate budget $5bn.*

Beyond equipment programmes, there are also significant opportunities for construction and facilities management within the defence sector. A considerable amount of these opportunities are awarded through the US Army Corps of Engineers (USACE).

For Small & Medium Enterprises (SME), accessing these opportunities can be difficult as it can be challenging to secure the attention of a prime contractor. The USACE tend to be far more open to SME participation.

Tender documentation may be made available through the websites of the US DSCA, USACE or government tender portal SAM.

4. Government & Defence Sector Procurement

4.1. Procurement Process

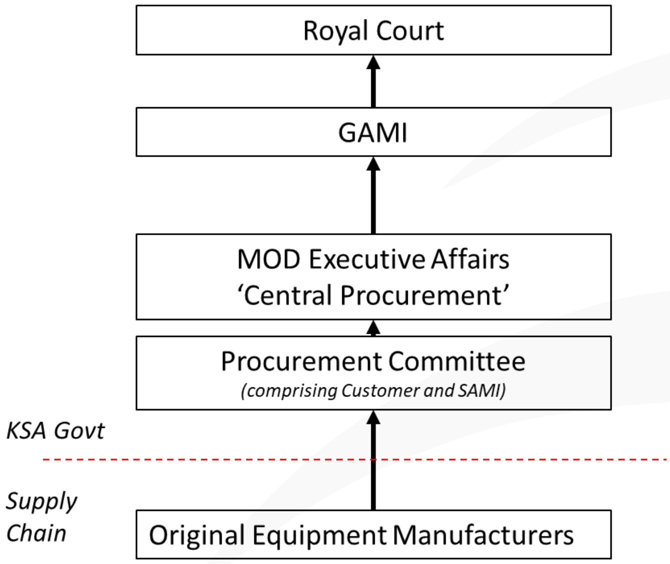
The procurement process has been a primary focus for transformation for the following reasons:

- There has been a very public drive to ‘clean-up’ government procurement in general and defence has been no exception with a number of high profile cases launched for corrupt procurement practices.
- The need to localise can only come from collating requirements from multiple end users to drive volume to justify the non-recurring costs associated with the transfer of technology or production.
- That volume will also be the only way to sustain a sovereign capability without significant government subsidy.
- And to harmonise requirements where possible to ensure the best value for money for the defence procurement budget.

It should be noted however that the transformation is very much still a work in progress and although it has moved from a strategy phase to an implementation phase there are significant and substantial challenges. This is of course always the case when dealing with large-scale change programmes.

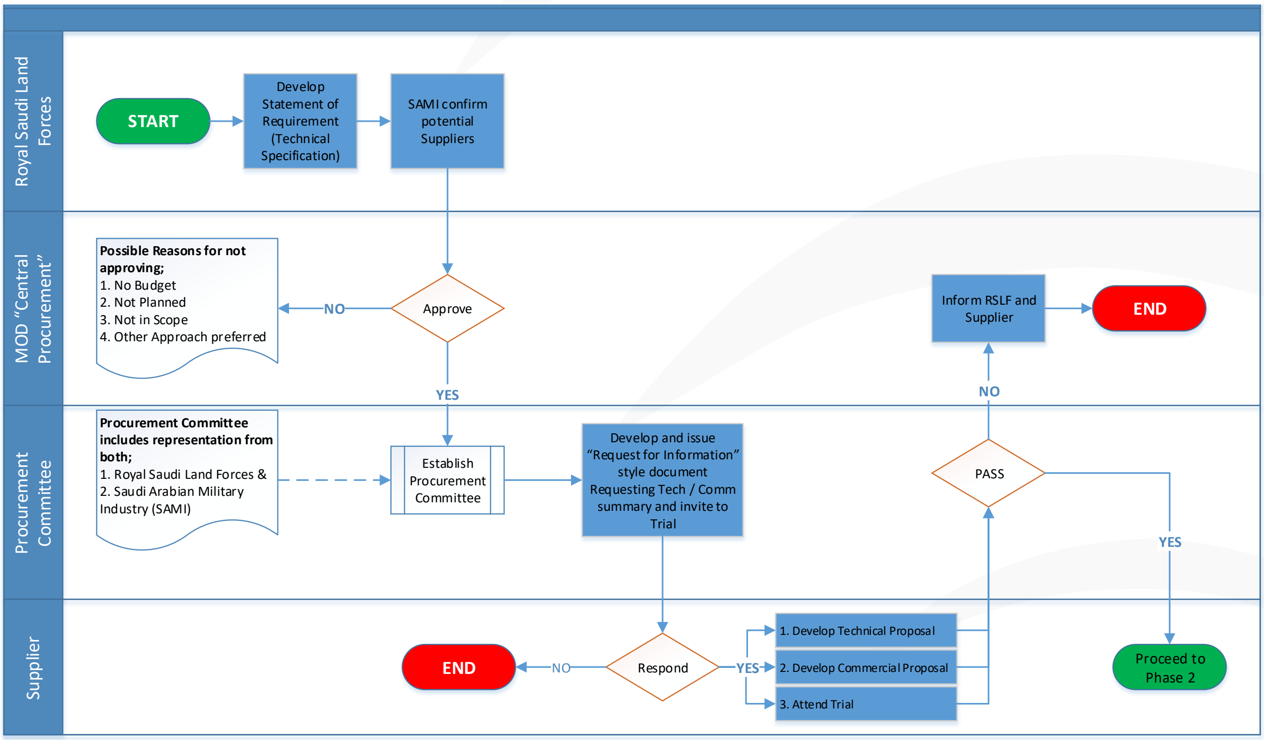
There are on-going ‘debates’ about who’s remit extends where and who has the ultimate say with regard to procurement. These debates are raging between all the stakeholders – TMO, SAMI, GAMI, non-uniformed personnel with the Ministries as well as the uniformed services themselves.

The below chart shows the expected approval process for MOD procurements:

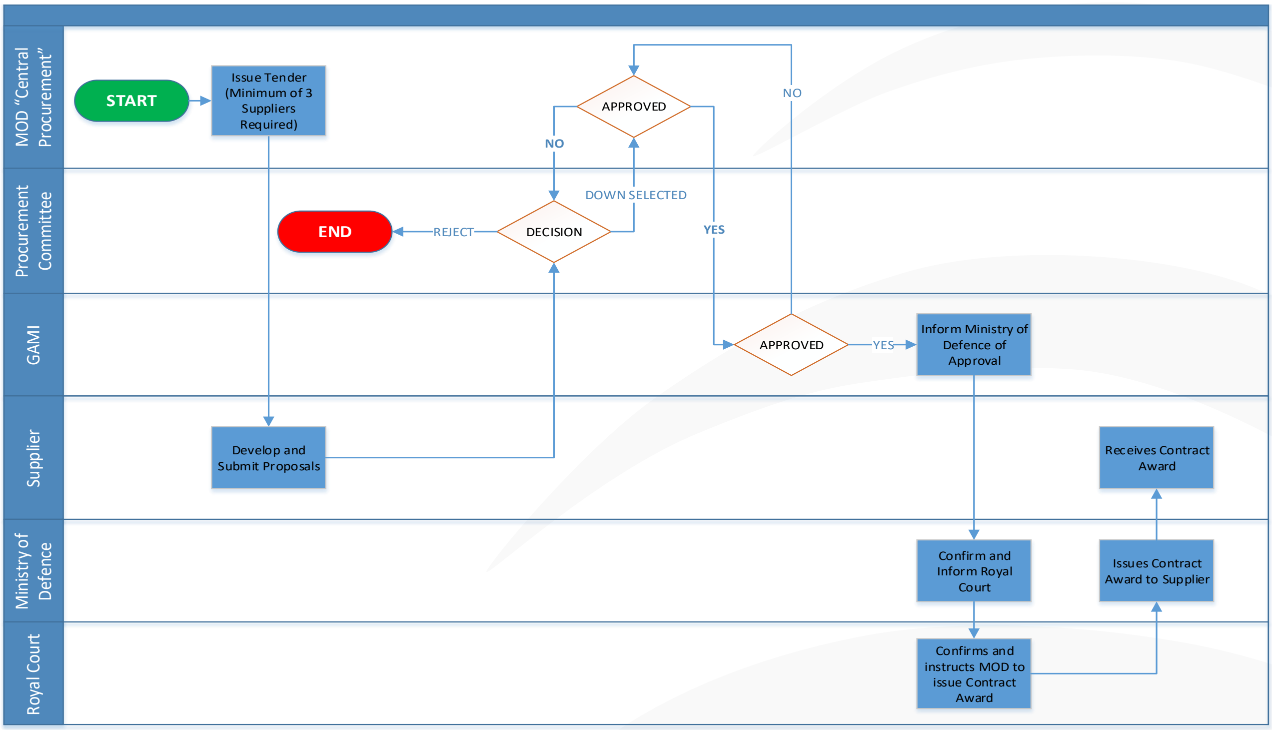


It will remain the role of the End User to set a requirement and then SAMI and GAMI will play their roles in running the procurement and evaluation bids.

It is still the case that an information gathering and trials phase will be common place as a Phase 1. The below chart shows the Phase 1 procurement process for the RSLF (as an example):



Phase 2 is the detailed tendering process which for defence equipment is usually an invite only approach for registered, prequalified bidders:



4.2. Partnering Options

4.2.1. Introduction

Strictly speaking the use of intermediaries or middlemen is forbidden under the Saudi Government Procurement regulations and it is important to understand what they mean by 'intermediary'. In this context an intermediary is typically characterised by as an individual taking a commission based on the sales value to support / enable business winning or a company that sits between the customer and the supplier which has no apparent workshare.

In such cases, the Saudis rightly view the intermediary as adding no value and indeed potentially undertaking nefarious activities.

It is however common for foreign companies, particularly the SME community to appoint a partner to help manage the market from both a business development and project delivery perspective.

4.2.2. Agent / Distributor

Typically the partner will take on the role of an agent or distributor and generally this applies most commonly to equipment suppliers.

For FMS programmes the Agent or Distributor will work as a subcontractor to the US supplier. In the DCS environment, the partner may sit between the foreign supplier and the customer in the contracting route so long a the partner has a sufficient workshare.

The sufficiency of the workshare can be difficult to determine but is typical activities such as:

- Warranty management

- Training delivery / support
- Spares / Repairs
- In-Kingdom procurement
- In-Kingdom assembly
- Provision of in-Kingdom resources or facilities

The partner may also be acting as an integrator, working with multiple overseas suppliers to produce a 'system' in the Kingdom.

4.2.3. Joint Venture

It remains a common assumption that a Joint Venture is somehow the preferred modus operandi in the Kingdom of Saudi Arabia; this is not the case and indeed nearly all the large foreign businesses in the Kingdom have been trying to extricate themselves from joint venture agreements in recent years.

In most cases, the same effect of a joint venture can be achieved a much more low risk way by engaging partners though a collaboration or teaming agreement. This approach could be adopted as a first step prior to moving to a formal equity partnership if deemed necessary.

A notable exception to this is the opportunity to do a joint venture with SAMI or another PIF owned entity. However, although this is acceptable do not expect it to be a easy route to sole-source contracts in the Kingdom. Such an arrangement will still carry significant risks and should be entered into after much thought and consideration.

For SMEs, a joint venture should only really be considered if the partner either has existing facilities or capabilities that the SME needs or if the partner is prepared to invest. In both cases extreme care must be taken.