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Innovating Offset Programmes to Support Local Economic Development & Achieve a Company's Business Targets

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ROUND TABLE DISCUSSION:
INNOVATING OFFSET PROGRAMMES TO SUPPORT LOCAL ECONOMIC DEVELOPMENT & ACHIEVE A COMPANY'S BUSINESS TARGETS

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OFFSET SUCCESS – CHANGING MINDSETS, SETTING STRATEGIES & PENETRATING NEW MARKETS

Offset – the industrial compensation required by a government from a non-domestic customer as a condition of buying goods and services – is now a C-suite reality of aerospace and defence business. The scale of the potential is huge with a Financial Times survey, carried out in conjunction with IHS Jane's, identifying that between now and 2025 there will be about US $500 billion worth of offset obligations that will either be incurred or discharged*. Yet despite the potential, many OEMs and suppliers are losing out through old 'legacy' mentality and the inability to draft offset strategies and start "thinking it through, instead of thinking it up at the end," according to experts.

Although offset obligations have made great strides over recent years – the UAE's Tawazun Precision Industries (TPI), for instance, has reported a doubling in its business every two years since 2012 and predicts the trend will continue for the next six years – too many suppliers still regard it as a burden instead of seizing the 'opportunity.' Some even shy away from meeting obligations, fearful of playing a role in their future demise, believing the new money customers, largely emerging market governments, are using their buying power to create future competition.

LEGACY OR OPPORTUNITY?

Addressing the issue at the Global Aerospace Summit 2016 in Abu Dhabi, Dr. Phil Lewis, the CEO of TPI, which is a subsidiary of Emirates Defence Industries Company, said there are largely two current prevailing views on offset – one the legacy approach, the second a more productive, progressive attitude, and the latter will win out every time because customers take them very seriously. Increasingly governments rely on the local offset investments to justify capital expenditures on defence upgrades and to rebalance foreign trade and often give offset proposals equal or greater weight than procurement costs in bid evaluation.

"One view is that an offset obligation is a contractual obligation that is a burden on the company or supplier and it's only there to be done because it's compulsory; that it's there just to be managed and thought about once the contract is awarded – that is if the contract is awarded, because in this day and age, you're less likely to win the contract with this approach," cautioned Lewis. "Certainly it's a view of the world where people see offset as a form of taxation that is part of just the penalty you have to pay to be in game. And it's effectively a source of increased risk, whether reputational risk or any other type of risk. This is the legacy view but even so in our conversations we still see people who take the view that this is something they have to get over rather than see it as an opportunity."

The alternative approach, according to Lewis, requires a change of mindset, though it is gaining momentum. "It is one of looking at offset as the ability to engage, creatively, with offset as a source of differentiation, a competitive weapon, a way of winning in the marketplace." Lewis said the second approach is gaining momentum with countries such as the UAE using it as part of its capital justification and assigning it high weighting in contract awards. But, he added, there were even more benefits to offset: "It can provide access to new markets and it can also help create new relationships, particularly in regards to the supply chain. So it's an important mindset change to make."

THE RISKS

Offset obligations do carry risk, often in the form of penalties for non-compliance. The most likely penalty, according to Lewis, is about timescale. "If you didn't discharge to the baseline programme you committed to, then there are penalties associated with that. Now sometimes if you made an effort to discharge, but just failed in the amount, then the penalties are sometimes reduced. The other types of penalties are if you just don't do it and these are important to understand. I think in the UAE the penalty clause is 8.5% of total contract value so you would have to put down a bank guarantee of 8.5% of the total contract value for the total timescale of the baseline programme which are not insignificant penalties if you don't deliver."

Sometimes suppliers build penalties into their proposals, intent from the get-go not to fulfil, though this, warns Alan Culver of Flir, is risky in itself, with the non-compliant companies running the risk of long-term blacklisting.

"You run tremendous professional risk if you flat out price the penalties into the proposal and just don't do it," said Culver. He warned that there were examples of companies being blacklisted for non-delivery and that in some cases the

*www.ft.com/intl/indepth/defence-offsets end user simply increases the obligation, by as much as 10% a year, until the obligations are met. These, however, were rare, he said.

"Are there companies out there that just pay the penalty and walk? I'm sure there are and they probably don't ever do business with that country again," he says. "For the big obligations, and most of these obligations kick in at big, you can price in the risk. The 8.5% risk here in the UAE for instance, does drive some pricing, but every company has the intent to perform at least most of the obligation. And most countries want an out, they want their customers to be successful, so they are not going to leave you hanging if you have made a reasonable effort to perform it."

LOOKING BEYOND THE NORM

Another huge mindset change facing offset operators is the ability to look beyond traditional core markets which are now losing momentum, according to Dr. Lewis. "The historical markets that companies had either now have minimal growth, no growth or slow growth, while many of the countries that have a large addressable market, such as those in the Middle East, Asia and South America are investing in defence modernisation requiring offsets so it's pretty much important to get involved in those."

OFFSETS: THE A-Z

Offset largely comes in two different forms – direct and indirect. Direct are agreements which centre around a particular project under discussion. "For example, if a country is buying tanks, then the direct offset will be involved in that product, whether it be the turret or the weapons system, so some kind of co-production or sub-contracting, some sort of manufacturing will be involved on that side of things," explained Dr. Lewis.

Indirect can be a number of things unrelated to the particular project, such as purchases or export assistance. "Then there's a bit of work in the middle which can be direct or indirect such as training - TPI for example has been the recipient of a lot of training input - some form of licensed production or FDI, foreign direct investment - again TPI has been the recipient of significant FDI."

Other distinguishing factors of offset proposals and projects, particularly in the UAE, is the difference between inputs and outputs. "Inputs are enablers - training and knowledge transfer and outputs are typically direct manufacturing and production," explained Dr. Lewis.

A prime example of a successful offset project would be if a supplier sells 300 tanks and is required to make some offsets direct and indirect. If the selling price is, for example, US $400 million and a multiplier for the offset obligation is 120% the offset obligation is US $480 million.

Dr. Lewis said this type of contract would typically work with some direct offset co-production of around US $70 million. "So let's assume that the US $70 million is for turret production. Multipliers are very prevalent in offset so obviously if you have a purchase of US $400 million and 120% of offset, it doesn't make any sense whatsoever unless there's the notion of multipliers that you get extended benefits for particular items of offset. In this particular instance, we are saying US $70 million in direct offset in co-production with a multiplier of three. If you look at the multipliers you will see that it's one of the lowest, which tells you that in this particular instance the customer is rating the co-production quite low, so that would be worth US $120 million in credits. In terms of indirect offset, in the form of investment, whether it's equity, capital equipment or technology transfer assistance, you will see that in this particular example the technology transfer element has a multiplier of seven, which means that the customer rates the technology transfer element of this package strongly and that the US $20 million of input is worth US $140 million of credit. We end up with US $128.5 million of input effectively equalling US $480 million of credit and this is where you end up with offset making economic sense. Sometimes these policies are published, other times they are not because they're the subject of highly sensitive negotiations."

LIVE THE VISION

Sellers need to fully understand offset, the customer's short and long term visions and how to align with them to build a successful offset strategy – an essential pre-requisite to successful negotiations these days, according to Dr. Lewis. "We want to see people who have thought it through, rather than think it up at the last minute." The UAE's offset policy set in 2010, for instance, focusses on technology transfer, employment of Emirati nationals, and a system of credits that values net profitability of export sales in preferred fields such as advanced materials, prevision manufacturing and electronics.

Dr. Lewis said there are various key guiding elements of offset. The first is the threshold. "This is the level at which offset kicks in and it varies from jurisdiction to jurisdiction," he said. Saudi Arabia's threshold kicks in at around US $110 million; India's at US $65 million and the UAE's at anything above US $10 million. India, though a growing market for offset, does have its challenges, warns Dr. Lewis. "Probably what is particularly difficult here is that if the offset obligation is above US $700 million, it requires at least 30% of production to be indigenised so it has to take place in India which is quite significant."

Another typical element is obligation: that is the percentage of the contract a company is obligated to offset. Typically in Saudi Arabia the obligation weighs in at 35%, the UAE at 60% and India at 30%. The range gap between, for instance the UAE and India, is often linked to how the multipliers are used.

Discharge timescale is also key – that is how long sellers have to fulfil their offset obligations. "So, companies need to consider is it a long, thin programme or a shorter, fatter programme and what are the challenges associated with that?" advises Dr. Lewis.

Then there's a mix of direct and indirect offset. The mix of inputs and outputs in the UAE is in the public domain and clearly outlined on the Tawazun Economic Council (TEC) website. "There's a maximum of 30% of the obligation that can be discharged through input – so what can be done with training and technology transfer is limited to 30% of input. And for output, things like production, it's a minimum of 70% in the UAE, which I think tells you something about the priorities in the UAE about what they desire – outputs are a big driver here. And actually if you read the TEC guidelines you will see it's linked to net profitability of outputs rather than revenue. At TPI all of our arrangements are contract driven rather than JV in nature."

And with all those elements in place, comes decisions on the required structure of generating credits. "It's not unusual for JVs to be a requirement, but it's also not unusual for there to be contractual arrangements which are non-JV in nature but contract driven, and the UAE allows for both mechanisms," said Dr. Lewis.

Then the precise multipliers have to be determined – in other words, how do sellers get the credits for the value they have put in – and the multipliers change depending upon priorities. "If the country's priority is the creation of infrastructure, or generating manufacturing output, they will have a high multiplier," explained Dr. Lewis. "It really depends on the objectives of the customer."

Sellers should look for 'win-win' scenarios when trying to create technology benefits to meet customer requirements while at the same time looking to generate their own profits, according to Osama Amir Fadhel, TPI's Strategy Director. He says from the local company's perspective, effort has to be made to foresee the relationship and build in a level of sustainability. "One of the challenges and gaps that we have noticed in the market is that suppliers often have difficulty in finding a proper offset project." TPI tries to overcome this dilemma by proactively seeking out OEMs and presenting TPI's own strategy and vision to them to create greater understanding and focus from the outset – and the approach appears to be paying dividends. In 2009 there was no manufacturing of aero components in the UAE and now fabrication and assembly are part of the road map for the future.

THE SUPER SIX

TPI believes any offset strategy will have six key element. They are:

Context: What offset obligation can a company most effectively meet?

Alignment: Being present in the market. "If you're not here, you're not here," should be the guiding mantra according to Dr. Lewis.

Preferences: This is often dictated by multipliers and involves understanding customer preferences.

Regulation policies: Which in the UAE are transparent and include JVs and industrial co-operation.

Engagement: How to best engage the stakeholders.

Differentiation: How the company differentiates itself.

TPI recognises that there are still inherent challenges in meeting offset obligations but in the Emirates these are actively being addressed. "Human capital remains the UAE's largest challenge. However, it is receiving strong governmental support to address it," says Osama Amir Fadhel. "The dependency on overseas staff for blue and white collar work continues but will lessen in the future through education and training initiatives."

THE REALITY

Accepting offsets are here to stay, creating strategies to maximise mutual returns are, say the experts, the only way forward for those looking for international business portfolios. Further, the signals from customers are clear, with several nations reforming their offset policies to boost contractors' industrial participation and laying down heightened success criteria for offset fulfilment and enforcement. India now has the Defence Offset Monitoring Wing, which oversees uniform offset performance reporting including more multipliers to incentivise contractors to spread investments into the SME sector. The UAE's TEC has a detailed set of multipliers targeting priority investment areas, as well as penalties for underperforming programmes including payment of damages for partially fulfilled or unfulfilled obligations.

At the Global Aerospace Summit 2016 the consensus emerged that sellers that create a cooperative and structured approach to their offset strategies will find them less of a burden and more a sharp competitive weapon in an increasingly competitive global landscape.