Gulf countries: recent trends in the defence sector

January 2019

Gulf countries[1] are amongst the largest purchasers of defence products globally, with Saudi Arabia and the UAE allocating the largest military budgets in the region, both in absolute terms and in percentage of their GDP[2].

Over recent years, a number of geopolitical factors have led Gulf countries to increase their military spending: the war in Yemen, the perception of Iran and its regional proxies as a threat, the perceived disengagement by the US[3], and the diplomatic discord between Qatar and certain of its neighbours.

Whilst the US remains the long-standing partner of the Gulf monarchies[4], there is a clear trend amongst them to diversify their partnerships and to try to promote self-sufficiency.

This article provides high-level thoughts from the point of view of a legal professional living in the Gulf and advising international defence contractors on some of the recent trends in the defence sector in the region[5].

A clear push towards industrialisation and local content

Gulf countries have been trying to develop their respective defence industries for years, with offset programmes being promoted formally or informally[6]. Despite these efforts, there is a perception that the results have been modest, resulting at best in low value-added activities being localised in-country[7]. Only the UAE has so far managed to develop a real, although limited, manufacturing defence base[8].

For the reasons detailed below, there has been a clear push, in particular in Saudi Arabia and in Qatar, to promote local manufacturing capacities. Although these two countries are very different in size, population, industrial base and geopolitical orientation, it is striking to see that each has created, almost contemporaneously, a legal corporate vehicle aimed at developing joint ventures with foreign partners in the military field.

[1] The Gulf peninsula is composed of seven countries: six are members of the Gulf Cooperation Council (Saudi Arabia, the UAE, Qatar, Kuwait, Bahrain and Oman), and Yemen stands apart.

[2] In 2015, Saudi Arabia spent USD 87 billion on defence products (13,3% of its GDP) while the UAE spent USD 23 billion (6,7%) in "*The Emerging GCC defence market*", a paper published by Strategy& in July 2017.

[3] Prior to the election of Donald Trump, the *rapprochement* of the US with Iran and the non-interference during the Arab Spring to defend long term allies like General Mubarak in Egypt have created a great cause for concern in the Gulf capitals. The election of Donald Trump has somehow modified this perception without however changing the long-term analysis that Gulf countries cannot entirely rely on the US for their own security.

[4] The US remains by far the largest supplier of all Gulf countries and maintains major military installations in particular in Qatar, Bahrain, Oman, Kuwait and Abu Dhabi.

[5] The author would like to thank all his defence clients and contacts who have provided feedback on some suggested ideas or proofread this article.

[6] For a historical perspective on the Saudi and UAE offset programmes, please refer to Bilal Saad's article: « *The Gulf Rising: Defence industrialization in Saudi Arabia and in the UAE* », May 2014, The Atlantic Council.

[7] Mainly assembly, licenced production and MRO (Maintenance, Repair, Overhaul) activities, see Strategy&'s "*The Emerging GCC defence market*".

[8] The UAE offset programme, later renamed Tawazun Economic Council (TEC), started as early as 1992 and was progressively enhanced through the establishment of Tawazun Holding in 2007. TEC has developed very stringent offset guidelines whereby defence contractors have the obligation to generate offset credits in consideration of the UAE government entering into a supply contract. Penalties are applied in case of a failure to reach an offset credit milestone. Tawazun Holding has been one of the designated partners for foreign defence contractors to set up industrial JVs in the UAE. In parallel of their offset policy, the UAE government set up EDIC (Emirates Defence Industries Company) in 2014. EDIC controls several companies (most of them are not JVs with foreign partners) which have manufacturing capacities in respect of land, air and marine equipment. Its aim is to be the integrated manufacturing and services platform able to provide high-level products and services to the UAE armed forces.

Saudi Arabia Military Industries (SAMI) was set up in May 2017 as a 100% subsidiary of the Public Investment Fund. It has already set up joint venture companies with Boeing of the US and Navantia of Spain, and is currently in discussion with various defence contractors from Russia, France and other nations. SAMI has been heralded as the "*national State company for arms manufacturing to produce thousands of jobs in the Kingdom*"[9].

Barzan Holdings (Barzan) was set up in December 2016 but only publicly announced in March 2018. It is a 100% subsidiary of the Ministry of Defence of Qatar branded as "*the first defence and security company responsible for empowering the military capabilities of the Qatar Armed Forces*"[10]. It has already set up joint ventures with Beretta of Italy, Kongsberg of Norway and Qinetiq from the UK, and is in discussions with several defence contractors, including from Turkey and France, to develop various programmes[11].

Both SAMI and Barzan have put forward very ambitious objectives in terms of ensuring self-sufficiency in certain areas, allowing meaningful transfers of technologies, holding strategic partnerships or even exporting their products to outside markets.

Especially from a Saudi perspective, there were clear messages sent that the Kingdom wants local investments and local jobs being created for their nationals instead of one-way transfers of money to foreign contractors manufacturing from abroad[12].

There are also rumours that the UAE could soon introduce in 2019 an updated version of the current offset rules (the 2015/2016 Tawazun Guidelines) that could become even more stringent. This relative instability (the rules tend to be changed every four to five years) is a sign that it is difficult to find the right recipe to produce meaningful offsets.

[9] "*Saudi Cabinet sets up General Authority for Military Industries*" in Al Arabiya Newspaper, 14 August 2017. As mentioned in this article, SAMI should not be confused with GAMI (the General Authority for Military Industries) which is meant to become the final customer for many defence programmes in the Kingdom as well the agency regulating the national military industry.

[10] "*Barzan Holdings officially launched*" in Gulf Times newspaper dated 13 March 2018.

[11] Barzan and its joint-ventures with foreign partners have been set up as commercial companies in the Qatar Science & Technology Park (QSTP) which is raising a number of legal issues given the current QSTP regulations do not cover defence or industrial activities.

[12] The Saudi Vision 2030 even requires that 50 percent of the country's defence procurement be sourced onshore (quoted in Strategy&'s paper).

Defence professionals contacted as part of the drafting of this article were unanimous in saying they perceive a real change of nature in the way Gulf states are pushing for industrialisation and local content. This is a material trend and one to stay for the foreseeable future.

Several contractors we spoke to were hoping for SAMI and Barzan to show flexibility in pushing their industrialisation agenda, in order to avoid the very formalistic and rigid process currently prevailing in the UAE.

The reasons behind this push

In the current geopolitical context, the drive of several Gulf countries towards industrialisation can be seen as the result of several factors.

First, as explained above, there is an intention to depend less on the US, but also to depend less on other traditional European defence suppliers.

Defence products are historically subject to strict export control restrictions in their country of origin: authorisations are not always given and sometimes only for less sophisticated '*export versions*'. The war in Yemen has sparked controversy in the West as to whether arms should be sold to Saudi Arabia[13].

From the point of view of Gulf countries, being able to manufacture their equipment means they can depend less on a green light from others, in order to equip themselves.

Even if there is a long way to go, there is an intention for several countries in the region, at least in certain areas, to become defence producers rather than defence consumers.

More generally, building military manufacturing capacities is also a question of prestige, credibility and diplomatic leverage[14].

Finally, this push is also driven by domestic considerations: in all Gulf countries, there is an intention to diversify the economy away from oil and gas, and in Saudi Arabia more than in any other country of the region, to provide jobs for a growing local workforce.

[13] See in particular "*Why more and more countries are blocking arms sales to Saudi Arabia and the UAE*", article by Dominic Dudley published in Forbes magazine on 7 September 2018. The killing of Saudi journalist Jamal Khashoggi in October 2018 added further controversy to this sensitive subject.

[14] See more developments in Bilal Saad's « *The Gulf Rising* » article.

Defence budgets, if structured correctly, are seen as a way to fuel economic growth, create jobs, and develop more industrial and technological sectors in the Gulf region[15].

What it means for international defence contractors operating in the Gulf

Defence contractors have to adapt to this new reality and adjust their traditional delivery model, whereby products were manufactured in their home country with limited activities being generated in the recipient country, apart from commissioning, training and MRO activities.

Arguably, international defence contractors still want to be represented in Gulf countries in an autonomous manner, without interference from a local partner. There are legal possibilities in each country to allow for such an independent representation at a group level[16]. As a matter of fact, Gulf countries do not require a joint venture to be set up for each and every defence programme; international defence contractors may still deliver certain projects independently, typically through a branch.

However, there are a number of defence programmes where defence contractors need to be prepared to provide more local content and to set up a joint venture company with a designated partner such as SAMI, Barzan, Tawazun Holding or others, with detailed commitments in terms of producing in-country value[17].

International defence contractors have understood this trend and a number of MOUs have been signed in the past few months, although they have not all translated into concrete projects.

[15] See Strategy&'s paper, « *The Emerging GCC defence market* ».

[16] In KSA, permanent branches or fully-foreign owned subsidiaries are possible. In the UAE, certain free zones such as the Dubai Airport Free Zone are hosting a number of international defence contractors. In Qatar, the Qatar Financial Centre has opened its doors to defence contractors, usually operating under the umbrella of a 'project management' company, which provides a useful addition to the more traditional representative office or project branch set up. For more details on establishment options in Qatar, please refer to the 2019 edition of *"Defence & Security Procurement in Qatar"*, an article prepared by Arnaud Depierrefeu and to be published by legal editor "*Getting the Deal Through*".

[17] In addition to usual subjects to be discussed in any joint-venture context (such as governance in particular), industrial joint ventures raise specific issues such as the availability of industrial land, the construction of facilities, the contribution of equipment and know-how to the capital, ownership of IP rights developed through local manufacturing activities and the definition of the export markets the JV will serve.

Acquiring defence companies abroad as an alternative strategy

Another trend which we have seen is the willingness by certain Gulf countries to acquire defence companies based abroad. Such a strategy means being able to acquire immediate manufacturing capacities. The obvious downside is that it does not "tick the box" of boosting local content and creating local jobs and is therefore likely to remain a less preferred option.

This does not go without its own challenges as well, not least because most Western countries have legislation in place protecting strategic sectors. Western States are in principle reluctant to allow a foreign country to access key industrial and technological capacities in the defence sector. Therefore, it is often when a defence contractor needs financial rescue that the funds from Gulf countries are considered as an option.

The most obvious and recent example is the bid by SAMI to acquire a minority stake in a South African company called 'Rheinmetall Denel Munition', which is a joint venture between State player Denel and Germany's Rheinmetall. Interestingly it appears that Qatar's Barzan would have made a similar overture to South Africa[18]. The South African government is yet to make a decision on whether to accept the sale of a stake to a foreign State or not, and if so, to whom.

Another example is the acquisition of assets of distressed French munitions equipment manufacturer Manurhin by EDIC in August 2018. The takeover was approved by a French commercial court as Manurhin was under a safeguard procedure.

In that sense, it is apparent that the severe liquidity crisis of companies like Denel or Manurhin and the ambitious industrialisation programmes of several Gulf countries, are creating some common ground.

Other similar situations may follow in the future as such investments represent an alternative and a complement any way for Gulf States to develop their own home-grown defence industries.

[18] African Defence Review, « *Denel, Saudi Arabia, Qatar: what we know* », article by Darren Olivier on 23 October 2018.

The challenges raised by the blockade imposed on Qatar by its neighbours

Finally, one should mention the diplomatic crisis which erupted in early June 2017 between Qatar and some of its neighbours (Saudi Arabia, the UAE and Bahrain) and Egypt as an interesting case study for the defence sector in the Gulf.

This crisis is proving detrimental to the unity of the GCC and in particular to the modest coordination attempts on the military front[19]. Each country is now pursuing its own strategy whilst new alliances emerge, with Saudi Arabia and the UAE working together whilst Qatar can count on the support of Turkey, its key regional ally[20].

Several major military powers such as the US, the UK and France have military personnel in, defence treaties with and sometimes their own military bases inside several of the protagonist countries, thus making the situation uncomfortable for them.

The crisis has obviously incentivised Qatar, which was lagging behind Saudi Arabia and the UAE in terms of military spending[21], to confirm and accelerate its campaign to purchase new military equipment[22], in a bid to modernise its equipment, deter potential hostile neighbours and also to cement strong relations with the major defence players.

This crisis is also an example of a new form of conflict called "*hybrid warfare*"[23].

This new form of *blitzkrieg* began with a cyberattack on the Qatar News Agency and was followed by a multitude of initiatives which stopped short of military action to put Qatar under maximum pressure: blocking all direct road, sea and air links between Qatar and its neighbours, promoting *Qatar bashing* – including accusing Qatar of supporting terrorism – through an intense media campaign by newspapers from the blockading countries but also by newspapers and think-tanks based in the West, withdrawing capital invested in Qatari banks and attacking the Qatari Riyal, spreading rumours on the shifting of the US military base outside of Qatar or the withdrawal by FIFA of the rights to hold the 2022 World Cup, allowing a pirate channel called BeOutQ to undermine BeINSports including during the World Cup in Russia etc.

Qatar has also responded with hybrid forms of counterattacks such as engaging with the US on major investments and on fighting terrorism, using media and influence campaigns[24] and initiating legal actions (a strategy known as "*lawfare*") [25].

The field of homeland security is also subject to changes

Whilst the security of energy and infrastructure assets was the traditional subject to be dealt with, homeland security is also undergoing change due to new threats.

New disciplines are emerging, such as food security (especially from a Qatar perspective given the current crisis), major events security (in the context of Expo 2020 in Dubai and of the 2022 World Cup in Qatar) as well of course as cybersecurity (for which States and companies are spending increasing amounts of money).

Arnaud Depierrefeu
Partner

T +974 4409 6725

E arnaud.depierrefeu@simmons-simmons.com

[19] Such as the creation of a Joint Military Command amongst the GCC States. There was some coordinated action in the past in respect of Yemen, on the fight against ISIS, but no real cooperation and planned sharing of resources to jointly defend the block against a third-party attack.

[20] Turkey's parliament approved the additional deployment of soldiers on a Turkish military base in Qatar only days after the blockade commenced (the Turkish military base in Qatar had started to be set up in April 2016 as part of a bilateral defence treaty between Turkey and Qatar).

[21] In 2015, Qatar spent 3.7 billion USD on defence equipment, only 2% of its GDP (see '*The emerging GCC defence market*' article), to be compared with the much higher figures for KSA and the UAE mentioned under footnote 2.

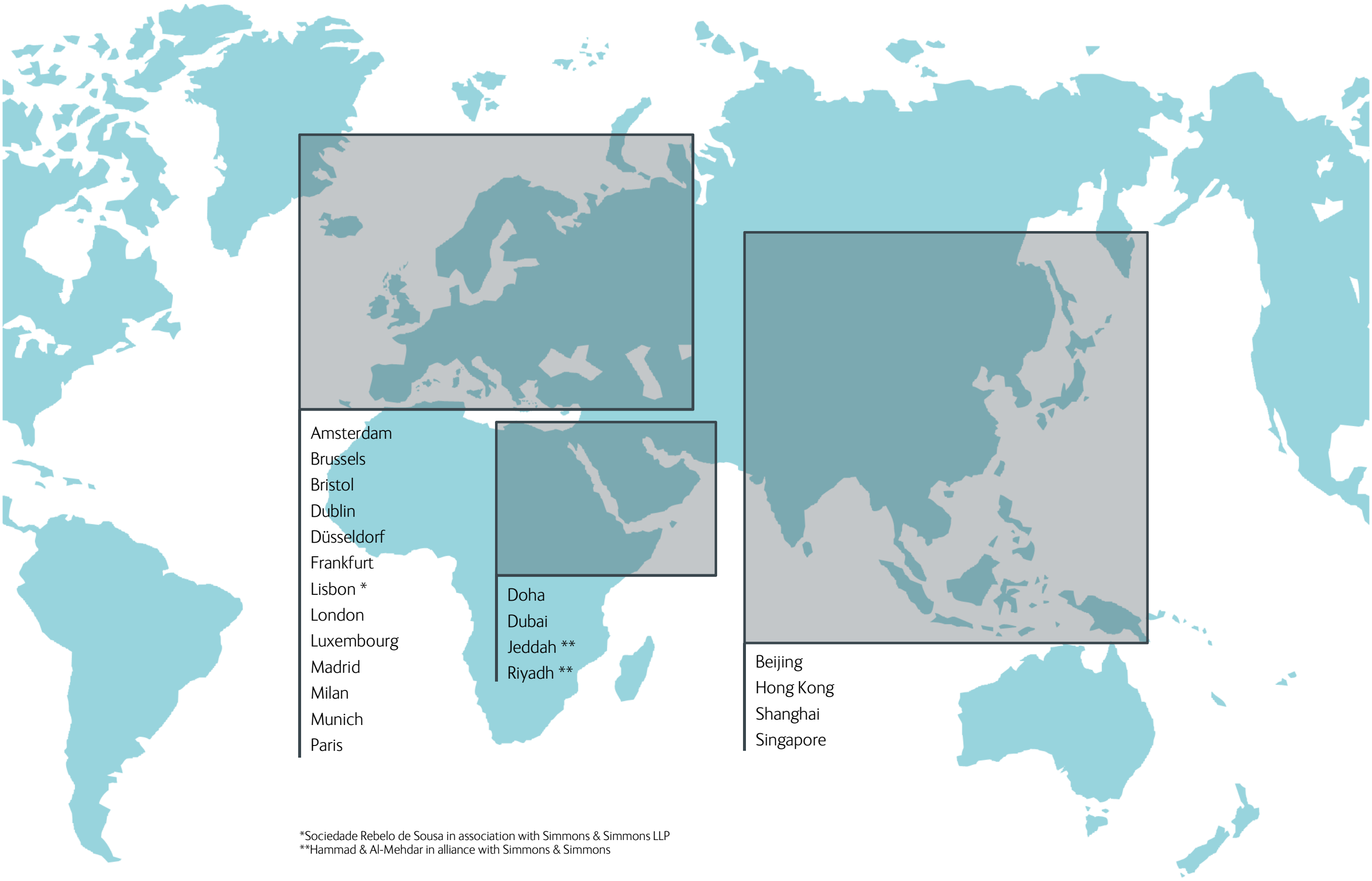
[22] Qatar for example purchased 36 F15 from the US in June 2017, a few days after the crisis erupted. This followed other major transactions such as the purchase of 24 Rafale aircraft from Dassault Aviation in May 2015 and several warships from Italy's Fincantieri in June 2016. Other defence deals were made with the US, the UK, France and Turkey after the crisis erupted. However, it is fair to say that almost all the deals concluded after June 2017 were already well under way before the crisis because Qatar had already identified, several years ago, that it needed to renew its military equipment for all its forces. In that sense, the crisis might have accelerated certain decisions but has not fundamentally changed what Qatar had already planned to purchase.

[23] See article by S.D. Bachmann: « *The current crisis in the Persian Gulf in the context of hybrid warfare* » published in the Australian Defence Force Journal, issue 204 of 2018. French readers can also refer to the book by General F. Chauvancy published in September 2018 under the title "*Blocus du Qatar: l'offensive manquée*" (Qatar Blockade: the Failed Offensive). It provides for a very interesting and detailed analysis on the historical and geopolitical context of the crisis, on the various steps of the offensive against Qatar and on how Qatar responded to it.

[24] See New York Times' article dated April 2018: "*In Charm Offensive, Qatar Pushes for a Comeback in Washington*".

[25] For example, Qatar initiated proceedings against the UAE in front of the International Court of Justice in June 2018. This followed other legal actions initiated in front of the ICAO (International Civil Aviation Organization) and the WTO (World Trade Organisation).

Our locations



Simmons & Simmons is a leading international law firm with more than 900 legal staff in offices situated in key business and financial centres across Europe, the Middle East, and Asia. We believe it is who we are and how we approach our work that sets us apart from other firms. We set the highest standards for the work we do and pride ourselves on our client focus.

In building our international business, we have created a closely knit and cohesive network of lawyers who seek to balance local business needs with the delivery of a global service. Our current client base includes a significant number of the current FTSE 100 and Fortune Global 500 companies and we advise the world's leading investment banks, many of the world's largest financial conglomerates and more than half of the top 50 European hedge fund managers. We provide services from locations based in Europe, the Middle East and Asia. We work across core practice areas including corporate, dispute resolution, EU, competition & regulatory, employment, pensions & employee benefits, financial markets, intellectual property, projects, real estate, information, communications & technology and tax.

A key commercial advantage for our clients is our focus on specific sectors, including asset management & investment funds; financial institutions; technology, media and telecommunications (TMT); and life sciences. We also focus on the energy and infrastructure market, in particular through our international projects and construction teams.

For additional information on our firm, please visit our website at simmons-simmons.com.