

Defense Contracting in Saudi Arabia: Launching Saudi Arabia's Military Manufacturing Sector under Vision 2030

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I. Introduction

Saudi Arabia, a bedrock of stability in the Middle East, has in recent years been surrounded by conflict and unrest. To the north, Iraq and Syria have descended into armed conflict, with substantial portions of their territories having been occupied by insurgent groups. To the south, Yemen's civil war between the government and Houthi rebels has triggered the greatest humanitarian crisis on the Arabian Peninsula. To the east, Saudi Arabia's arch-rival Iran is laying the groundwork for acquiring nuclear weapons. To the west, armed conflict in the Sudan has divided the nation, and piracy at the horn of Africa has disrupted Saudi trade.

In light of conflict throughout the region and Saudi Arabia's commitment to maintain stability within its borders, the Kingdom has sought to build up a world-class military. Saudi Arabia recognizes that a strong military is a key deterrent to growing threats to Saudi national security posed by ISIS across Saudi Arabia's northern border in Iraq and the threat posed by Iran-backed Houthi rebels across the southern border. In response, the Saudi government has appropriated more than USD 50 billion in defense spending in 2017 and over USD 55 billion in 2018.

Saudi Arabia has also begun aggressively partnering with the world's leading defense contractors in developing an indigenous defense manufacturing sector. Saudi Arabia's Vision 2030 and the National Transformation Program 2020 present unprecedented opportunities to military contractors to invest in Saudi Arabia. Crown Prince Muhammad bin Salman has committed to make Saudi Arabia, which is currently a top-four military spender globally and the world's second largest importer of armaments and other military supplies, a leader on the world stage and to localize over 50 percent of military equipment spending by 2030. Led by the Crown Prince's pioneering vision for a local military manufacturing sector, the Saudi government is actively seeking partnerships with the world's leading defense, security and technology firms. Vision 2030 offers these companies unprecedented investment opportunities in Saudi Arabia.

II. Traditional Limitations

Traditionally, opportunities for military contractors in Saudi Arabia have been limited to the sale of armaments and other military equipment to the government of Saudi Arabia and ancillary services relating to those sales, such as:

- Maintenance, repair and overhaul (**MRO**);
- Training Saudi Arabia's officers and enlisted on the operation of military equipment;
- Providing spare parts;
- Mounting and installing equipment;
- Technical support;

- Fitting out military vehicles.

The sphere for military contractors has been further restricted by:

- Regulations prohibiting military contractors from engaging agents on a commission basis in sales of armaments and military equipment to the Saudi Arabian government;
- Supreme Economic Council ban on foreign investment in manufacturing military equipment, devices and uniforms.

III. Paradigm Shift

These restrictions are undertaking a shift with the introduction of Saudi Arabia's Vision 2030 and the National Transformation Program 2020, which seek to incubate an indigenous military manufacturing industry. Vision 2030 states in part:

As we continue to give our army the best possible machinery and equipment, we plan to manufacture half of our military needs within the Kingdom to create more job opportunities for citizens and keep more resources in our country.

...

The benefits of localizing our own defense industries are not limited to solely reducing military spending. It also stimulates other industrial sectors such as industrial equipment, communications and information technology, which in turn creates more job opportunities. Although the Kingdom is the world's third biggest military spender, only 2 percent of this spending is within our Kingdom. The national defense industrial sector is limited to only seven companies and two research centers.

Our aim is to localize over 50 percent of military equipment spending by 2030. We have already begun developing less complex industries such as those providing spare parts, armored vehicles and basic ammunition. We will expand this initiative to higher value and more complex equipment such as military aircraft. We will build an integrated national network of services and supporting industries that will improve our self-sufficiency and strengthen our defense exports, both regionally and internationally.

Localization will be achieved through direct investments and strategic partnerships with leading companies in this sector. These moves will transfer knowledge and technology, and build national expertise in the fields of manufacturing, maintenance, repair, research and development.

IV. Tensions

While Vision 2030 may not lift the ban on foreign investment in the military manufacturing industry, it will without doubt bring other opportunities for partnership between the Saudi Arabian government and the world's leading and most innovating military contractors.

At the same time, however, there will be several tensions at play:

- The Supreme Economic Council has traditionally sought to limit foreign investment in the military manufacturing sector. This restriction was *not* established with protectionism in mind. After all, foreign investment is permitted in manufacturing of civilian goods and products. Rather, the restriction aims to strengthen Saudi national security, since foreign control over

Saudi Arabia's military manufacturing capabilities could potentially threaten Saudi security in the event relations between Saudi Arabia and the countries of foreign investors break down. Saudi Arabia has thus sought autonomous control over its military manufacturing sector.

- On the other side of the equation, US security concerns restrict the types of security technology and military intellectual property that can be exported. On the one hand, the US government is eager to promote US industry and investment abroad. At the same time, the US government must balance its economic interests with the demand to protect US national security. As a result, there will be a tension between, on the one hand, granting all required permits in order to transfer knowledge and technology to the Saudi sector and, at the same time, to hold back critical intellectual property that, if fallen into the wrong hands, can threaten US national security interests. The US might not, in the end, grant full waivers and exceptions to permit the transfer of sensitive intellectual property to Saudi Arabian Military Industries (**SAMI**) and other potential joint venture partners.

V. What Vision 2030 Means for Defense Contractors

Under Vision 2030, the Saudi government is seeking to develop self-sufficient industries with an emphasis on the defense, healthcare and education sectors. Developments in the defense sector will lead to wide-ranging opportunities for foreign investors. In navigating what Vision 2030 means for defense contractors, we explore the following questions:

A. Opportunities Available for Partnership with Saudi Arabian Military Industries

What opportunities are available for partnership with Saudi Arabian Military Industries (SAMI), Saudi Arabia's national military industries company created by the Public Investment Fund in 2017?

Vision 2030 promises foreign defense firms opportunities in establishing Saudi Arabia's local military and defense capabilities, beginning with manufacturing spare parts and culminating with the in-Kingdom manufacture of sophisticated aircraft and weapons systems. Yet it is not clear whether there will be a formal lift on restrictions on foreign ownership in local defense manufacturing, which the Saudi Arabian General Investment Authority (**SAGIA**) continues to impose. However, opportunities will abound for foreign companies through joint ventures, technology transfers and local employment and training in support of Vision 2030's stated goal of transferring "knowledge and technology, and [building] national expertise in the fields of manufacturing, maintenance, repair, research and development."

At a minimum, foreign companies will be given a place in consulting with local industry and transferring knowledge and technical expertise as Saudi Arabia develops an indigenous manufacturing sector. Saudi Arabia's stated goal of shifting from 2 percent to 50 percent local military equipment manufacturing will depend on concluding agreements with foreign defense firms whose focus is on higher-value equipment and innovative technology.

B. What Partnering with Saudi Arabian Military Industries Means for Winning Contracts

What does Vision 2030 and partnering with Saudi Arabian Military Industries mean for winning contracts from the Royal Saudi Land Forces, the Ministry of Defense, the Ministry of the Saudi Arabian National Guard and the Ministry of the Interior?

Vision 2030, through partnering with SAMI and other joint venture partners, will grant foreign defense firms “most valuable player” status in the Saudi defense sector. Foreign defense firms will likely find opportunities to procure contracts not only with the Ministry of Defense and its branches (the Royal Saudi Arabian Land Forces, the Royal Saudi Navy, the Royal Saudi Air Force), but also with the Ministry of the National Guard, the Ministry of Interior and state-owned enterprises such as the Military Industries Corporation (MIC), which will oversee major facets of the development of the Vision 2030 local defense industry. We anticipate that before foreign companies undertake the major investment required to establish in-Kingdom manufacturing entities, their joint venture partners, whether SAMI or otherwise, will need to guarantee a minimum sales threshold over a certain number of years.

C. What Types of Joint Ventures Will Be Formed?

What rules and regulations will govern joint ventures established between military contractors, Saudi Arabian Military Industries and private defense companies in Saudi Arabia?

1. Overview

Most likely, we are going to see myriad joint ventures between SAMI and foreign investors incorporated. We would expect to see these formed as limited liability companies (LLCs), each owned by two shareholders—SAMI, acting as a passive investor, and a foreign defense contractor, which will likely operate the local entity and transfer its knowledge and technical knowledge to the operation of the entity. Most likely, we would see the companies formed with a majority shareholding held by the foreign investor, who will take decisions as to the strategic direction of the LLC.

2. Manufacturing Joint Ventures in the Private Sector

We will also likely be seeing joint ventures being formed between foreign companies and Saudi companies in the military manufacturing field. For example, the joint venture between Lockheed Martin and TAQNIA Aeronautics, known as “Rotary Aircraft Manufacturing Saudi Arabia” (RAMSA), is reported to be advancing in Saudi Arabia. The parties signed a letter of intent in May 2017 to build *Black Hawk* helicopters in Saudi Arabia.

Alan Chinoda, the chief executive of Lockheed Martin’s Saudi business, revealed the job creation package in an interview with Arab News prior to the Armed Forces Exhibition for Diversity of Requirements and Capabilities (AFED). He stated that Lockheed Martin “created a joint venture to produce 150 Blackhawks in the Kingdom, which is a tremendous opportunity. It will create a whole new technology eco-system and will involve the transfer of technology as well as jobs. The infrastructure to support that in Saudi Arabia is good.”

We expect that one of the following will occur:

- SAGIA will relax its restrictions on foreign investment in the military manufacturing sector; or
- The role of foreign companies will be limited to merely advising local companies and providing training through unincorporated JVs, rather than actually owning shares in JV companies.

D. Vision 2030 Implementation

How is Vision 2030 being implemented?

Following the announcement of Vision 2030 in 2016, the Saudi government took steps to begin to implement the plan's goals and vision. In its goal of localizing over 50 percent of military equipment spending, the Saudi government initially focused on the local manufacture of spare parts, equipment and fittings. With this in mind, the government has launched the General Department for Local Manufacturing Support (الإدارة العامة لدعم التصنيع المحلي), whose website (<https://www.gdis.gov.sa/Portal>), published in 2017, announced the Department's goal of implementing the government's manufacturing localization strategy by forging public-private partnerships between the Saudi armed forces and private sector actors. The Department is actively working towards the goal of locally-manufactured parts that meet the same standards, specifications and quality as those that had formerly been manufactured abroad. As an example of progress made to date, the 2018 Armed Forces Exhibition for Diversity of Requirements and Capabilities (AFED) in Riyadh showcased an armored vehicle with the words "Made in KSA" prominently displayed on the windshield.

Steps to localize defense manufacturing can also be seen in the realm of supply contracts between the Ministry of Defense and defense contractors. Today, less than two years after the formal launch of Vision 2030, the Ministry of Defense is requiring defense contractors to provide for the local manufacture of certain elements of supply contracts. This means defense contractors and suppliers may be required to visit Saudi Arabia to identify partners that can manufacture spare parts and other elements of supply contracts that meet the standards and specifications of the defense contractor.

Defense contractors may additionally be required to participate with the General Department for Local Manufacturing Support in the prequalifying process of national companies that will be engaged in local manufacturing in accordance with the approved local manufacturing standards. If a local manufacturing requirement is imposed, defense contractors must produce a Certificate of Local Manufacturing countersigned by the General Department for Local Manufacturing Support and submit it along with their supply contract before they can receive full payment from the Ministry of Defense.

In cases in which suppliers are required to undertake a local manufacturing obligation, the initial percentage of local manufacture may be low. For example, the Ministry of Defense may impose a requirement that 5 to 15 percent of spare parts be locally manufactured. However, as we approach the 2030 target for 50 percent of local manufacturing, these thresholds are likely to increase. It is probable that the Saudi government will implement a tiered approach, with supply contractors being initially required to manufacture spare parts in-Kingdom and later transition to producing ammunitions and small arms before shifting to more sophisticated weapons systems. In all cases, the Ministry of Defense will likely require that defense contractors and suppliers certify that local manufacturing quotas have been met as a precondition to the receipt of the full payment of underlying supply contracts and as a precondition to winning future supply contracts.

E. Military Manufacturing Investment Licenses

Will foreign defense contractors be granted military manufacturing investment licenses in Saudi Arabia?

Given the rhetoric we have seen from the Crown Prince, the language of Vision 2030, which states that the localization of the military manufacturing sector “will be achieved through direct investments and strategic partnerships with leading companies in this sector” and SAMI’s active pursuit of joint ventures with the world’s leading military manufacturers, the answer to this question appears to be “yes.” At the same time, however, SAGIA continues to maintain military manufacturing on its Negative list of prohibited activities, and this does not appear to be changing any time soon. The latest edition of the SAGIA Investment Manual, published in December of 2017, bans foreign investment in military manufacturing, and subsequent inquiries we have made with SAGIA have confirmed that military manufacturing will remain off-limit.

Despite these restrictions on foreign investment, we expect that given Saudi Arabia’s ambitions in the military manufacturing sphere and the recognition that SAMI can achieve world-class status as a leading manufacturer of military supplies if it partners with leading defense companies, SAGIA will either relax its restrictions on military manufacturing foreign investment or exceptions will be granted on a case-by-case basis. SAMI will likely play an important role in obtaining these exceptions.

F. Joint Venture Pitfalls and Best Practices

What are the pitfalls to joint ventures and how can they be avoided?

1. Avoiding Incorporating a Company

Avoid incorporating a JV if you can. In the event the Ministry of Defense or SAMI directs a defense contractor to enter into a joint venture, the defense contractor should, to the extent possible, establish such a joint venture through a joint venture agreement without incorporating a new entity with mixed ownership. The foreign contractor can leverage its local partner’s expertise, marketing skills and knowledge of the local market without formally incorporating an entity. An incorporated entity may reduce the foreign contractor’s independence and organizational control.

We generally advise foreign contractors against incorporating a joint venture with a local partner so as to maximize this independence and organizational control. Foreign contractors should focus on finding a local partner that is licensed in manufacturing and that could import spare parts and supplies and then enter into a cooperative agreement, teaming agreement or joint venture agreement with that partner. Approaching a joint venture in this way (i.e., as an unincorporated joint venture) will save the costs and administrative burden of having an on-the ground entity whose annual filings, certificates and regulatory requirements entail a large financial and administrative cost and whose benefits can be derived without the need to incorporate a new entity.

2. If Required to Incorporate, Choose the Limited Liability Company

If the foreign contractor is required by the Ministry of Defense or by SAMI to enter into an incorporated joint venture with a local Saudi partner, the parties will need to form a company. The LLC is the most commonly preferred option in Saudi Arabia because it entails a streamlined incorporation

process and allows foreign investors to establish a permanent presence in the Kingdom. Moreover, it permits a great deal of flexibility with respect to management and control. For example, beginning in 2016, sole-shareholder LLCs were permitted, and they may be wholly-foreign owned.

3. Carving Out the Company's Purpose and Licensed Activities

One of the more important, and often overlooked, strategies in forming a JV is ensuring that the description of the company's purpose in its articles of association is certain, definite, unambiguous and does not fall within one of the statutorily proscribed items falling within the Negatives list. If it is foreseen that the entity will engage in manufacturing, then the activities stated on the SAGIA license and commercial registration certificate should state this from the start to avoid the cost and delay of needing to amend the constitutional documents at a later time.

4. Control

A foreign contractor should structure the company's articles of association to retain as much power over the operations and management of the company as possible, especially if the foreign investor is undertaking an operation role. In particular, we recommend that the articles of association provide the majority shareholder, which is normally the foreign investor, with the power to appoint the general manager of the LLC, including the right to determine what powers and authorities the GM will have.

5. Anti-Corruption Regulations

Ensure the joint venture agreement obligates the parties to comply with pertinent anti-corruption regulations, including the Saudi Combatting Bribery Law and, if applicable, the U.S. Foreign Corrupt Practices Act and the UK Bribery Act. In this regard, we recommend that the JV agreement contain a clause requiring the parties to agree to comply with the foreign contractor's relevant anti-corruption legislation. This is important because foreign anti-corruption laws often hold parties to a higher standard than Saudi law. The local entity and partner should thus be bound by provisions at least as rigorous as those government the foreign partner. This is key because a US or UK entity can be held liable for the actions of its Saudi partner under these Acts.

6. Intellectual Property

Foreign contractors must insist on strict protections of all of their intellectual property, particularly if their Saudi counterparts in turn enter into JVs with competitors of the foreign contractors. The failure of the Saudi partner to put in place firewalls between each of the JV partners can lead to trade secrets or sensitive intellectual or industrial property being shared with or leaked to competitors. Foreign contractors should, at a minimum, insist on the following safeguards to ensure the security of their intellectual property and trade secrets:

- The local partner must agree to set up information barriers between employees of the JV partner that are working with the contractor and employees of the JV that are working with the contractor's competitors.

- The local partner must agree that sensitive intellectual property will only be disclosed to employees on a need-to-know basis.
- The local JV must take all practical action to secure sensitive information received from the foreign contractor by ensuring, at a minimum: two-point verification and access; encryption of all hard discs and servers storing such information; daily full or incremental backups of all data; the ability to remote wipe hard drives that fall into the possession of unauthorized persons.
- Protecting confidential information can be challenging in Saudi Arabia. For any foreign company doing business in Saudi Arabia, this is an ever present business risk with respect to the company's proprietary business information. It is difficult to prove breach of a confidentiality clause and equitable remedies such as specific performance and injunctive relief are generally not available in Saudi Arabia. In addition, it is also difficult to establish damages even if it can be proven that the representative breached its confidentiality undertakings. The foreign company may consider including a **liquidated damages** provision in the event the representative violates the confidentiality terms of the agreement.

VI. Conclusion

Under Crown Prince Muhammad Bin Salman's Vision 2030, defense contractors now have an unprecedented opportunity to partner with the Saudi government and local partners in transferring know-how and expertise. Defense contractors looking to invest in Saudi Arabia should meet with officers of the Ministry of Defense or SAMI to explain what their companies can contribute, how their military equipment and technology can play a role in strengthening Saudi Arabian security and why the Ministry of Defense should support their applications for foreign investment licenses and ensure that their commercial registrations include the broadest array of licensed activities possible. With the Ministry of Defense's support, defense contractors will act as partners in forging Saudi Arabia's future as a key player in the maintenance of peace, stability and security in the Middle East.

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