

# New opportunities for foreign defence contractors in Saudi Arabia

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## Introduction

Saudi Arabia is currently attempting an ambitious reorientation of its economy. The Saudi Arabian Vision 2030 and the National Transformation Programme 2020 comprise the most comprehensive strategy shift in Saudi Arabian economic policy since oil was found in the country. The envisaged reforms also present opportunities for defence contractors to invest in Saudi Arabia and take a larger role in the market. Saudi Arabia is implementing a new strategy for their local military manufacturing sector. While this sector has traditionally been reserved for Saudi Arabian nationals, the Saudi government is now seeking partnerships with foreign security and defence companies to enhance their capabilities and establish a sophisticated defence manufacturing industry. In particular, Vision 2030 offers opportunities for joint ventures, technology transfers, consultation and training to foreign defence investors. The \$100 billion defence deal concluded by the United States on Donald Trump's recent visit to Saudi Arabia is one of the first steps in this direction.

It is to be expected that under the Saudi Arabian Vision 2030 and the National Transformation Programme 2020 existing restrictions will be eased and the market will be liberated to foster development of a domestic defence manufacturing industry.

## Existing regime

The Supreme Economic Council maintains a so-called 'negative list' of sectors in which foreign investors may not carry out investment. Within the manufacturing sector, this list includes the manufacturing of defence equipment, devices, technology and uniforms, as well as restrictions on producing civilian explosives. As far as services are concerned, the negative list comprises providing services catering to the military sector as well as security and detective services. Non-Saudi companies that are registered in other countries of the Gulf Cooperation Council (GCC) may in some cases obtain licences to undertake restricted activities in Saudi Arabia. In rare instances, non-Saudi companies with no presence or registration in GCC countries have been granted permission to engage in activities included in the negative list. However, in general, the negative list is strictly observed by the competent authorities.

Hence, under the existing regime, foreign investors have been barred from engaging in manufacturing armament and equipment, devices or other products relating to the defence sector in Saudi Arabia. This restriction not only includes security-sensitive goods such as armament and classified military equipment, but also less sensitive items such as uniforms. When doing business with or in Saudi Arabia, defence contractors have been limited to:

- issuing licences for the production of their products to businesses, the economic beneficiaries

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- of which are Saudi Arabian nationals only;
- selling defence-related items produced or technology developed outside Saudi Arabia to Saudi Arabia; and
- providing ancillary services such as installation, maintenance and training.

Foreign businesses selling defence products or technology to Saudi Arabia cannot handle import and delivery to the customer in Saudi Arabia. Unlike in other GCC countries, foreign investors may participate in companies engaged in import to and distribution in Saudi Arabia. Still, in the defence sector, foreign investors may not be involved in import and distribution in Saudi Arabia. In most transactions, it is the local client – typically the government – that handles import and customs clearance as part of the sale and purchase of armaments and other defence equipment. Alternatively, foreign defence companies may engage a whole Saudi-owned agent. Where the local content of sales of defence-related products or technologies is concerned, foreign defence contractors have been limited to providing ancillary services such as the installation and maintenance of equipment or technology, technical support and training activities.

Further, doing business in Saudi Arabia has been particularly difficult for small and medium-sized defence companies due to regulations forcing them into expensive practices. For instance, defence contractors may not engage agents on a commission basis in sales of armaments, defence equipment and technology to the Saudi Arabian government.

### **New developments under Vision 2030**

As part of the Saudi Arabian efforts to diversify its economy and reduce its dependence on oil, many of the restrictions in the defence sector will undergo changes. Vision 2030 fosters the development of self-sufficient domestic industries and specifically promotes the defence, healthcare and education sectors. The resulting changes in the defence sector will create promising opportunities for foreign investors. However, the new focus on the defence industry can be seen in more in the context of economic diversification. Growing threats to Saudi Arabian national security posed by ISIS and other terrorist organisations operating in the region and the threat posed by the ongoing conflict in Yemen, as well as a new role taken by Saudi Arabia as a military power in the region by actively engaging in local conflicts, create a need for a more sophisticated military and reduce spending. In response, the Saudi Arabian government has appropriated more than \$50 billion in defence spending to localise the industry for 2017 alone.

### **Development in local manufacturing sector**

Vision 2030 includes ambitious plans to localise manufacturing in the Saudi Arabian defence sector. This will require a shift in the Saudi Arabia approach to foreign engagement in the defence industry – in particular, since Saudi Arabia will rely on foreign know-how to effectively grow its defence industry.

Vision 2030 considers the benefits of localising Saudi Arabia's defence industries. It states that establishing a domestic defence industry will not only result in reducing military spending, but will also stimulate other industrial sectors by increasing demand for sophisticated communication and information technology, machinery and industrial equipment as well as raw material production. This comes at the realisation that although the country is the world's third biggest military spender, only 2% of this spending relates to investments in Saudi Arabia. Therefore, the Saudi Arabian government is aiming to localise over 50% of military equipment spending by 2030. The first steps have been taken to develop less complex industries, such as the production of spare parts, armoured vehicles and basic ammunition. This initiative will be expand to higher value and more complex equipment and technologies. Vision 2030 specifically refers to military aircrafts in this respect.

To foster localisation of defence spending and grow domestic capacities in the defence industry, Saudi Arabia is seeking to entice direct investments and strategic partnerships with leading defence companies. Through these measures, the country seeks to foster the transfer of knowledge and technology and build national expertise in manufacturing, maintenance, repair, research and development for the defence sector. Saudi Arabia also plans to build its capacity to train military and security staff and set up state of the art complexes and facilities for the defence industry.

The engagement of foreign defence contractors under Vision 2030 promises the emergence of new opportunities in the Saudi Arabian defence sector. However, it will have to be seen how the strategies for foreign participation in building the Saudi Arabian defence industry will be translated into legislation and administrative regulations. While there may not be a formal lift of restrictions on foreign participation in local defence manufacturing, opportunities will abound for foreign companies committed to Saudi Arabia through joint ventures, technology transfers and local employment and training. Considering the ambitious goal to establish a domestic industry that will receive 50% of Saudi Arabia's defence spending, as well as increased defence spending appropriated for this goal, foreign defence firms will find opportunities to procure not only with the Saudi Arabian military, but also key entities such as the Military Industrial Corporation, which will oversee large parts of the defence goals identified under Vision 2030.

In turn, since the country is seeking to localise defence spending, defence contractors will have to rethink their approach to Saudi Arabia and the way they are doing business therein. Established models focused mainly on the sale of equipment produced abroad may prove less lucrative in the future.

### **Implementation of Vision 2030**

Shortly after the announcement of Vision 2030 in April 2016, the Saudi government took steps to begin implementation of the vision. In its goal to localise 50% of military equipment spending, the Saudi government is initially focusing on the local manufacture of spare parts, equipment and fittings. To oversee this effort, the Saudi government has established the General Department for Local Manufacturing Support. The department recently announced its goal to implement the government's strategy for manufacturing localisation by establishing public-private partnerships between the Saudi armed forces and private sector actors. Further, the department is seeking to ensure that locally manufactured equipment and parts meet the standards and specifications of those formerly procured from abroad.

Steps to localise defence manufacturing can already be seen in the way the Ministry of Defence and Aviation approaches supply contracts with defence contractors. Less than a year after the formal launch of Vision 2030, the ministry compels defence contractors to have certain elements of the products supplied manufacture locally. Thus, foreign defence contractors and suppliers wishing to conduct business Saudi Arabia will have to find suitable partners that can manufacture spare parts and other elements for their products that meet the ministry's standards and specifications. This may prove difficult. Development of the Saudi Arabian defence industry is at its beginning. Thus, sophisticated manufacturers that can produce according to the standards and specifications required by the ministry may be difficult to find. Consequently, foreign defence companies must closely cooperate with and supervise their local partners. Since foreign investment in Saudi Arabian defence business is (still) prohibited, they will not be able to form joint ventures to execute local manufacturing content. Thus, other strategies will have to be found. Foreign businesses may, for instance, second key staff to their subcontractors supplying locally manufactured parts. Where these components are more complex and the foreign company must license their local partners to rely on the foreign company's intellectual property, such secondment will be particularly important to safeguard know-how and intellectual property. It may also be feasible to set up a branch office or subsidiary in Saudi Arabia to supervise and coordinate local suppliers and partners.

Further, the General Department for Local Manufacturing Support may require foreign defence contractors and suppliers to prepare plans for establishing local spare part manufacturing capacities for the products supplied. This may involve cooperating with the department in designing and operating a prequalifying process for Saudi Arabian companies for local manufacturing. Initially, local manufacturing obligations may require only a low percentage of local manufacturing – for example, the Ministry of Defence and Aviation may demand that 5% to 15% of spare parts be locally manufactured. However, as 2030 comes nearer, these thresholds are likely to increase.

### **Comment**

Saudi Arabia's plans to establish a local defence manufacturing industry offers considerable opportunities for defence contractors. However, the shifting strategy for the defence sector will also create challenges for defence contractors. Established practices relying on direct sales to the Saudi

Arabian armed forces will have to be revised to comply with localisation requirements. Further, closer relationships with local partners in the private sector will have to be forged and strategies for ensuring quality standards and protecting intellectual property and know-how will have to be developed. At the same time, existing relationships with decision makers in the Ministry of Defence and Aviation and the armed forces will have to be maintained for defence contractors to present themselves as reliable partners for the development of a sophisticated Saudi Arabian defence industry.

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