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CONCEPT PAPER

How can Australian companies, especially small to medium businesses, capitalise on the indirect benefits of the major defence acquisition programs now and into the future?

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1. Executive summary

South Australia's defence industry is about to embark on a new era of investment, development, growth and opportunity. It is hoped the major defence acquisition programs now and into the future will create a sustainable, long-term naval shipbuilding industry in South Australia. Construction of naval ships and boats in South Australia has benefits, not just for the shipbuilding industry, but also for the broader economy, including small business and community groups. For local small to medium enterprise companies (SMEs) to capitalise on the indirect benefits of these programs it is necessary for them to appreciate the complexities of the defence industry, ensure they develop realistic strategies, and work with government policies to leverage opportunities. This paper explores the barriers that SMEs may face now and into the future, strategies for capitalisation, the potential benefits they may realise, and initiatives such as government assistance, specialised grants, strategic planning and specialist consultancy services are needed to create an environment in which SMEs can flourish.

Concept Paper

1. Introduction

South Australia's defence industry is about to benefit from a new era of investment, development, growth and opportunity. The South Australian Government Defence Strategy: 2030 outlines how the state can accelerate defence investment, create export opportunities and grow its highly-skilled defence workforce. It is hoped that these major projects will create a sustainable, long-term naval shipbuilding industry in South Australia and boost advanced manufacturing opportunities. Growth is also anticipated across other defence domains, including systems and cyber, aerospace, and science and technology. These evolving areas will generate opportunities for current and prospective researchers, engineers and tradespeople.

Construction of naval ships and boats has benefits not just for the shipbuilding industry but also for the broader economy. The benefits go beyond the direct employment shipbuilding generates. It is estimated that for the \$90b shipbuilding program, SA will gain an additional \$134b over the life of the program [6]. The supplies and services from other industries that support the major programs contribute to economic activity in those sectors, and the flow down of employees spending their income further supports the local economy. It is clear that a major factor for economic success relies not only on the direct benefits, but also the indirect benefits of major programs [1].

The tiers of defence industry companies are shown in Figure 1. Defence procures most of its major capabilities through global defence companies and these are the prime contractors in Tier One. At Tier Two are many of the other large defence companies, sometimes the prime in other projects. They support the major project. The small to medium enterprise companies (SMEs) are at Tier Three. Some will work directly with Defence; others may not and be in a support role, but they will often still exist in the supply chain of the major defence companies. Many of the new opportunities for Australian SMEs will exist in domestic supply chains creating a network of subcontractors. In this model a forth Tier is included. This is to show companies that provide niche capabilities. We also show the community groups who will also benefit from the major defence acquisition programs.

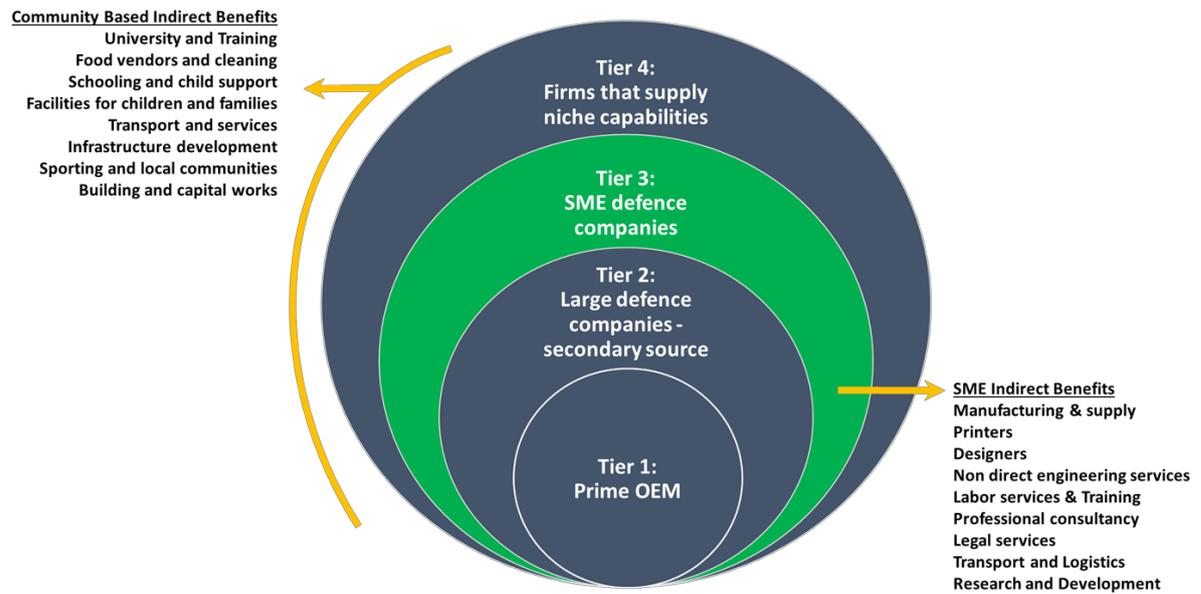


Figure 1. Model of defence industry tiers

2. Barriers for Small Business

Reports from defence based small businesses in South Australia indicate some significant obstacles often faced by small business when competing for work on major defence programs: benefit

- High costs required to rapidly grow business and support program; cost of tendering;
- Time consuming in resource and human capital;
- Research and development costs can be high;
- Often requires 'inside' or specific capability knowledge that is difficult to acquire;
- Resource limitations due to Defence clearances, nationalities, dual citizenships;
- ISO 9001 and similar accreditations can be onerous;
- Ability to hold information securely (accredited);
- High risk exposure when breaking into new areas of business;
- The timescales between tendering and contracts being awarded are often long;
- Major defence acquisitions are not constant steady state.

This should be a caution to growth of SMEs based from major acquisition programs, as these programs are often very large, but short lived. SMEs are particularly exposed to seemingly lucrative

opportunities, and must not only ensure they navigate the risks of rapid growth, but also must ensure they have a sustainable strategy beyond the major program.

Perhaps then, the appetite for SMEs to take on the direct benefits of major programs should be established first, and businesses must have a realistic strategy for capturing the benefits of development [5]. This includes an available skilled workforce or business that can meet the needs of the project, otherwise benefits will be less than expected as goods and services will be sourced elsewhere.

3. Current strategies

Large defence acquisition programs are an opportunity to not only develop Australia's capabilities but also provide economic benefit to local community. SMEs are a significant source of job creation and contribute significantly to GDP growth. However, this cannot be done at any cost and there can be a premium when building defence assets in Australia. In order to realise the benefits the full range of mechanisms should be evaluated.

There are already a range of government policy mechanisms in place that endeavour to spread as much of the expenditure to SMEs as possible. One major policy in place to ensure skills, expertise and employment are retained is the Australian Industry Capability (AIC) program. Another example is the Indigenous Procurement Policy (IPP), which aims to leverage the Commonwealth's annual procurement expenditure to drive demand for indigenous goods and services.

The AIC policy is designed to meet the objectives of the 2016 Defence and Industry Policy Statement (DIPS), which aims for major programs to include as much Australian content as possible, thereby encouraging domestic investment and supply. The plans for AIC are required at the time of tendering and describe the Contractor's plans, procedures, commitments and responsibilities for the management of the AIC program for the period of the Contract.

These plans typically include evidence of market testing which involves providing the maximum opportunities for competitive Australian Industry. They must demonstrate if work or supplies come from overseas why it cannot be performed by Australian Industry. AIC Plans include opportunities for transfer of technology, intellectual property and knowledge to Australia.

To facilitate the integration of an AIC to a program the following strategies are recommended:

- Technology Transfer – Embedding Australian Engineers and technologists in foreign companies, and then bringing them back to Australia with the knowledge gained.
- Engagement with the supply chain to pass on knowledge and the associated supply requirements and manufacturing methods involved, including roadshows such as Naval Group on SEA1000 and BAE on SEA5000;
- Appropriate systems are in place to successfully deliver and sustain equipment;
- Work with suppliers to define infrastructure requirements;
- Employment strategies to maximise local skills and training programs
- Consider the use of the Industry Capability Network (ICN) gateway – a mechanism for primes and SMEs to connect and interact.

If AIC can be leveraged to allow Australian business to gain the foreign expertise, transfer of new technologies, working methods and Intellectual Property (IP) to Australia; not only will there be greater Australian involvement at all stages of the program but Australian Businesses will have the opportunity to become international leaders.

4. With so many barriers, what are the benefits for SMEs?

The motivation for SMEs to capitalise on major programs is a balance between profit and growth. A small company's primary objective should be at very least to maintain profitability, and at best to increase market share and financial performance. SMEs are particularly important in any economy to take advantage or supply indirect benefits such as increases in employment; supply of goods and services; and wider benefits which are spending by employees or upstream service providers. South Australia has over 140,000 SMEs which comprise about 98 per cent of all businesses. They employ over a third of the state's workforce and contribute over \$34b to the economy annually [3], and for every \$10m in expenditure undertaken in SA directly, there is a total of \$24m in additional Gross State Product [6].

Some of the biggest advantages of SMEs are their smaller size and flexibility, with the ability to react to market conditions whilst employing a wide array of people across many demographics. When the larger economy does better as a whole, SMEs thrive; however, when the economy is volatile, there are many risks to SMEs, due in part to their small budgets and lower levels of reserve [11]. Major defence acquisitions offer a potential lucrative opportunity to cash in on the flow down economy of work through many industries, therefore affording small business an avenue to greater

capitalisation. The benefits extend not only directly, but indirectly to the wider community and state, affording potentially many options for a small business to capitalise on some of this wealth.

5. Capitalisation Strategies

Small business that feeds off the indirect benefits of large scale programs is wide and diverse, from schools and education facilities, to food outlets, restaurants and takeaway, to lower level supply chain, to transport, infrastructure, and many more. Therefore suggesting a single strategy for small business is never going to work. Neither can a single support strategy be governed by state or federal governments. There is however, a wide range of offerings that can benefit many companies.

For the small businesses, they must start with having a realistic strategy for capturing the benefits of programs or development [5]. This includes realising they need access to communities that have the required and available skilled workforce or business that can meet the needs of the project, otherwise benefits will be less than expected as goods and services are sourced from another community and from competing business elsewhere. Entrepreneurs need to take charge of their own prospects [4] and choose how they model their business strategy.

The strategy of the business must be complemented by the attitude of its owners and managers to embrace new business and entrepreneurship. The growth attitude is an important factor in small business growth, and how the manager and leaders operate has a direct positive effect on small business growth [7]. Having an 'Entrepreneurial Orientation' [7] has a positive effect on its growth to a substantial degree. It involves a willingness to innovate to rejuvenate their market product, take risks and be more proactive than competitors. However, entrepreneurial orientation as a successful growth strategy must be cognisant of specific context.

Once strategy, attitude and resourcing are taken care of, the cost barriers become important. Adequate access to finance, enhancement of productivity and boosting the internationalisation of SMEs are all crucial for these businesses to survive and grow [10]. It is also noted [7] that access to more financial capital facilitates the pursuit of resource-intensive growth strategies that in turn lead to higher growth. This in turn allows greater research and development which support entrepreneurial orientation.

The government play a role in this too, from policy that demands SME involvement, to incentive schemes. A possible avenue for Australia (in a similar way to other countries) is to develop and offer formal offset policies. Greater defence offsets (government-to-business compensation

arrangements) are largely believed to provide for the government industrial benefits in the form of jobs, technology transfer, and support for the defence industrial base; however, it is also noted they may inhibit the government's flexibility in negotiating deals and result in inefficient procurement [9].

Also, indirect benefits for SMEs are highly dependent on the Government, both state and local, to provide project specific infrastructure and services required by the development. An existing successful example is the Techport precinct in Osborne, South Australia, whereby the government invested in significant infrastructure for the construction of the Collins Class submarines. This is an area where government can plan significant support to SMEs, not only in allowing greater business opportunity (such as increased utilities and transport networks) but also in the employment of skilled workers to build and maintain the infrastructure.

6. Government and SME strategies

The following strategies are proposed to assist in the capitalisation of indirect benefits to major defence programs. These are further explored in the section following.

How can Governments help?

- a) Continue the federal Centre for Defence Industry Capability (CDIC) which provides specialist support for business entering and navigating the defence market.
- b) Encourage SMEs to set up in the precinct of the major project to retain spending in that local community, through financial incentives
- c) Set up training institutes that directly feed skills required for future technologies and programs
- d) Export grants, finding programs, offset programs
- e) Tax incentives for start-ups
- f) Instruct policy that mandates local content in support from local SMEs
- g) Mobilise SA industry to work with prime contractors.

How can SMEs capitalise?

- a) Fundamentally by running their business well;
- b) Develop a realistic strategy and seeking good advice;
- c) Be aware that a large program may be in their backyard and focus energy to targeting that revenue and potential business;
- d) Mobilising and targeting the program that is creating the revenue;

- e) Having an Entrepreneurial Orientation, and understanding environmental dimensions;
- f) Access available financial capital from government;
- g) Embrace a growth attitude.

Exploration of novel options to assist SMEs

Tax benefits for start-ups to encourage local content

- Tax incentives related to setting up a small to medium enterprise will likely encourage those wanting to reach into the defence sector within South Australia by reducing start-up costs which can often be a deterrent for small to medium enterprises.
- Savings realised can be reinvested within the small to medium enterprise allowing the business to invest in advanced technologies, business support mechanisms and employees (more attractive salary packages and training)
- There is risk to the State and Federal tax income, which has a flow on effect to funding for services required by the Australian public (education, hospitals, infrastructure)
- Increased risk to the SME not being able to sustain their business once it is no longer deemed a start-up, leading to increased organisational costs.
- There is risk that with tax benefits the market could become saturated with SME's this could lead to greater competition within and possibly the only way to succeed is to merge with other SMEs which is not the intended purpose.

Use of offsets used in other countries

- Australia should consider procurement strategies such as used in Canada and the UK, to increase the industrial benefits and providing SMEs economic growth and benefits.
- Offset strategies assist SMEs through industrial considerations (termed "Value Propositions") which are rated and weighted as part of the bid evaluation process.
- Possibility of dealing with countries that Australia doesn't have a trade agreement with or are not considered international allies; this could potentially put national security at risk.
- Risk associated with some countries' customs due to history of accepting/offering bribes to obtain business
- When dealing with an international supplier/partner, there is risk to potential delays or ceased dealings due to instability in international relationships.

Special grants for SMEs

- Encourages SME's that may already be working in the required technology fields to invest in and expand into the defence sector, where they may not have had the opportunity prior to the government grants.
- Potential to expand the defence supplier base that may not have existed previously before the government grants.
- SME's are more likely to engage local services and suppliers which in turn expand the South Australian business growth both directly and indirectly.
- Risk of saturating the industry with potentially short term suppliers and service providers.
- With the increased competition, some SME's to ensure success or longevity may potentially start using substandard services and or supplies to keep up with demand, presenting the defence sector a threat to quality.

7. Recommendations

1. Consolidate Government assistance

Consolidate Government assistance through specialist centres or hubs specific for defence acquisition. An example of centralised assistance is the CDIC, and an example of centralised services is the 'landing pad' on North Terrace, Adelaide. Currently the focus is on supporting international business; however this concept could be expanded to focus the support towards South Australian SMEs connecting to the major defence programs. This will provide an accessibility point for SME to understand the breadth of policy, grants and assistance available, and lead to an increase of Australian Industry Content, and enable SMEs to develop world class capability.

2. SMEs must develop a realistic business strategy

The SME must develop a realistic business strategy to take charge of their own prospects and choose how they model their business strategy. This should be developed through good advice and research, and must be complimented by the attitude and leadership of their owners to flow down through the business.

3. Specialised grants that focus on the lower tier SME's of Defence programs

This paper was unable to identify any clear grants in South Australia for defence sector SMEs. In NSW for example the state government has recently announced specific grants of up to fifty thousand dollars for the purpose of tender applications. For a small company this is a great strategy

to soften the financial burden of tendering. This recommendation proposes access to specific grants for SMEs to remove competitive barriers, ease tendering, and importantly to motivate innovation and technology. Government must ensure it continues support through existing policy that focus on extracting the indirect benefits from major defence programs.

4. Engage a specialist connection agency

Engage the services of a specialist consultancy that focuses on the connection between SME and Defence acquisition programs. Although agencies exist in various forms, such as the Defence Teaming Centre; or the Centre for Defence Industry Capability; these types of services are poorly integrated and often misunderstood by SMEs. There is space for either a private service, or a consolidated or improved government service to provide the means for an entrepreneurial SME to identify and use assistance programs and connect to a major acquisition program. Likewise, an agency has the unique ability to facilitate this connection for the benefit of both parties, helping also the government and defence program to fulfil its desire to support local business.

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