



Defence Industry
Leadership Program

Growth of Small to Medium Sized Businesses

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Executive Summary

Australia's defence industry landscape has several large, multi-national Prime organisations and thousands of small or very small businesses. Currently, there is a void in the number of medium-sized businesses bridging the gap between these two extremes. This paper examines the impact of this void on defence programs and procurement and then provides a series of recommendations to support the growth path of small businesses into medium-sized businesses.

This paper analyses this question from the perspectives of small-medium sized enterprises (SMEs), Primes and the Commonwealth of Australia. Responses from representatives from defence industry and the Department of Defence are summarised here, with resultant recommendations developed. Broadly, these recommendations are:

- CoA having the financial support systems readily available and look to simplifying security accreditation pathways.
- Primes clearly articulating capability growth opportunities to the commercial industry and provide ongoing SME support and relationship sustainment, even during quiet periods.
- SMEs believing in themselves, having a longer-term strategic vision and investment in an ability to articulate a business proposition that clearly demonstrates capability and a solid value proposition.

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List of Acronyms

AIC	Australian Industry Capability
CDIC	Centre for Defence Industry Capability
CoA	Commonwealth of Australia
DILP	Defence Industry Leadership Program
DISP	Defence Industry Security Program
DSTG	Defence Science and Technology Group
DSVS	Defence Security and Vetting Service
DTC	Defence Teaming Centre
IP	Intellectual Property
ISO	International Standards Organisation
SICP	Sovereign Industrial Capability Priority
SME	Small to Medium Enterprise

Disclaimer

The contents of this report are the opinions and conclusions of the authors and do not necessarily represent the views of the author's organisations, the contributors, the contributors' organisations, the Defence Industry Leadership Program (DILP) or the Defence Teaming Centre (DTC).

Contributors

As part of our research for this concept paper, we engaged with representatives from the Defence industry and the Government through a series of interviews and discussions. We would like to acknowledge the contributions from the following organisations:

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Introduction

The Australian defence industry landscape has a wide range of organisations, including the Australian Government, large international organisations (the Primes), and small to medium enterprises (SMEs). This report focuses on the challenges faced by SMEs, the reasons for the lack of a healthy number of medium-sized businesses, and its impact on Defence projects and procurement decisions. We interviewed all segments of industry to capture their experiences and challenges.

This concept paper summarises the responses and provides recommendations to assist SMEs with growth, value propositioning, and how to win long term contracts within the Defence industry.

SME Perspective

The void of medium-sized businesses raises the question of what barriers prevent SMEs from growing larger. A business is underpinned by sustainable cash flow and requires opportunities to grow. Additional issues reported by SMEs are gaining recognition and credibility by the Primes and Defence.

Any business needs to maintain a sustainable cash flow. For SMEs in the defence industry, a common challenge has been finding a way to support themselves while waiting on defence procurement bids and activities because of the long lead times on decisions. It is also possible for contract schedules to be significantly postponed or even cancelled at short notice. This uncertainty discourages a company to expand, invest or even submit a tender response for Defence work altogether.

Many SMEs rely on Primes to provide them business and this relationship can be difficult to cultivate and manage. It is not easy for an SME to gain initial exposure or identify the key decision makers. Maintaining a presence at events and other forms of engagement, while important, can be costly in terms of personnel and funding the activity. Sometimes, international recognition is needed before an SME gets any attention. In addition, the mechanisms to register with a Prime do not always reach the right decision makers within the Prime. A relationship might not be long-lived since it is based on the Prime looking for surge capacity and not a unique capability. It is also possible that a Prime is protecting its in-house knowledge and capability. Finally, Primes have been criticised for not following the Australian Industry Capability (AIC) and Sovereign Industrial Capability Priorities (SICP)ⁱ content requirements^{ii,iii}.

SMEs tend to have a limited budget and staff performing multiple roles. They typically have a low level of administrative support and hence a weak skill base to seek out and respond to Defence-related tenders. There might also not be enough resources to follow procedures rigorously and comply with the complex procurement processes. As a result, SMEs miss out on growth opportunities.

While good for establishing credibility and reducing risk, the accreditation requirements placed on SMEs are burdensome. Defence and the Primes look for membership in the Defence Industry Security Program (DISP)^{iv} and compliance with ISO 9001 and ISO 27001, among others. Attaining compliance usually takes multiple costly iterations and maintaining accreditations has an ongoing and non-trivial cost in terms of time and money.

There are also factors that are not related to working with Defence or Primes. An enduring and complex issue is the lack of available talent for hire, especially expert domain knowledge. The business could also still be establishing its business proposition. Government support has not been a

strong barrier in establishing a business, since SMEs are aware of tax support^v and the Centre for Defence Industry Capability (CDIC) in the form of grants^{vi} and its advisory and facilitation service^{vii}.

One strategy is to encourage mergers among the SMEs. This approach would work if it benefits all parties, their cultural values align, and the businesses offer complementary skills. However, this strategy is not a suitable for all businesses and there can be complexities regarding profit splits and intellectual property (IP).

Prime Perspective

To describe the impact the void of medium-sized businesses has on the industry's Primes, one must define what is considered important to these Primes. The priorities for Australian defence industry Primes include:

- Demonstrable healthy business growth and project delivery performance;
- Hit targets for revenue and cash flow;
- Healthy profit margins and reinvestment in research and development and return to shareholders; and
- Minimise risk to company profits, reputation and program execution.

The primary source of revenue for defence Primes is from direct contracts with the Commonwealth and hence the dearth of medium-sized defence businesses does not directly impact them. However, this gap does have a credible impact on defence Primes' business growth, profit margin and risk profile if the reduction of compatible SMEs gets to a point where the Primes are required to increase their own capacity or capability to fill a short-term gap requiring expensive contractors or overseas products or support.

Business Growth

The defence industry landscape is dominated by a few large Primes and thousands of small businesses, which means these Primes often rely on engaging small, or even very small, organisations to include in their supply chain or to provide services to their programs.

One common issue in many SMEs is that business development and bid strategy management are undertaken by individuals who either lack experience in winning new business or have multiple competing tasks. The result is that SMEs struggle to develop proposals or tender responses that appropriately demonstrate their capability. As an organisation grows to medium size, it would be able to take on specialised business development staff who are experienced in winning new business.

Another issue with the large number of small businesses is that often each business is specialised in a very niche area so Primes need to engage multiple SMEs in parallel in order obtain the required solution. Primes often find that it is not worth subcontracting out such a small element of scope and instead either develop the capability in-house or find a larger business (often another Prime) to subcontract out a greater portion of the activity. A greater number of medium-sized businesses would mean that Primes would be able to subcontract out a greater portion of the solution rather than relying on several small businesses to obtain each niche capability.

Profit Margin and Risk

Primes are focused on maximising their profit margin by minimising cost and risk. SMEs present risk if they do not have accreditations such as DISP or strong processes in anti-corruption, health and safety, export control management, quality management, or risk management. This sometimes

means that Primes are unable to engage these organisations, either due to defence or Government legislation or their own internal processes, necessitating them engaging other Primes or developing the capability in-house, which takes time and can be a significant investment. Medium sized businesses are more likely to have these accreditations and processes developed already.

Additionally, SMEs will often not have a strong history of past performance that they can promote. Strong past performance is often an effective risk mitigation technique that Primes leverage when selecting suppliers. Similarly, Primes often look at their subcontractors' financial status and strength because a poor financial position presents risk to the Prime.

Commonwealth of Australia Perspective (Defence)

Apart from sustaining, growing or requiring a new Defence capability, the CoA also has an ongoing responsibility to create jobs to stimulate and sustain the economy. Any increase in employment and consumer spending results in overall growth in revenue for the CoA to spend across all sectors, including investing back into Defence.

Increasing Sovereignty and Australian Industry Capability (AIC) is a very important aspect as Australia's products, service capability and capacity has been eroded as we import more and more goods and services, resulting in a loss of critical skills and experience. Growing sovereignty and AIC will also allow the CoA to be more independent in times of crisis and will also increase export opportunities to increase revenue and global positioning.

Value for money is an important focus for the CoA as they assess each tender response for commercial viability as well as looking at where the money is being spent, whether it supports or utilises existing infrastructure and local jobs that provide resilience to an in-country supply chain, plus considerations for what Intellectual Property and access rights can be offered. Thus, more commercial focus helps with increasing Australia's defence capability with a lower cost basis, ultimately getting more for less.

With specific regard to SMEs, for major acquisitions, CoA will generally lean towards a Prime with an expectation that it will engage and manage the SMEs as part of their supply chain, which reduces direct technical and schedule risk. For smaller procurement activities, they may directly target Australian SMEs with a unique capability, product or value proposition. These SMEs are normally identified through Defence Innovation Hub, DSTG Next Generation Technology Funding, or Request for Information activities.

Current CoA initiatives to support SMEs

Three Australian Government initiatives to support the defence industry are^{viii}:

- Centre for Defence Industry Capability
- Next Generation Technologies Fund
- Defence Innovation Hub

These initiatives provide funding for either developing capabilities or the business and have already been mentioned above or in previous sections.

In addition, the government also introduced the AIC Plan Audit Program^{ix} that threatens non-compliance with a reduced chance of winning future contracts.

Recommendations

CoA

- Financial support to provide backing during the lengthy procurement processes, such as a low interest rate loan arrangement or deferred payments until a successful outcome.
- Further refinement of the DISP requirements so that the required standard has as little ambiguity as possible. Training could be offered to help SMEs understand the implementation of these requirements.

Primes

- SMEs are often looking to expand their capabilities to grow their business base but are mostly unaware of the areas useful to the Primes. To address this gap, a capability gap assessment of future needs could be performed by the Primes and then published.
- Primes should review their supplier portal processes to ensure that the capabilities of registered SMEs are brought to the attention of the right people within the Prime.

SMEs

- SMEs should invest in their business processes, such as becoming ISO 9001 accredited and DISP registered, which would be a significant advantage to winning Defence contracts. They could then build from there as the contracts start to be forthcoming.
- As an SME grows, it should invest in specialised business development employees experienced with successful bid writing. Being able to articulate a product, service or capability is a significant advantage and would help with dealing with Primes as it will be contributing to the total value proposition. This especially includes SMEs that could be deemed as having a Sovereign capability and clearly demonstrating they contribute to AIC.
- SMEs should also work on developing and then maintaining a relationship with Primes, which will allow them to understand the industry in general and what the CoA is looking for, which is not just increasing capability but also value for money, aligned business ethics, considerations for environmental sustainability, and so on.
- SMEs should keep a watchful eye on emerging CoA initiatives and grants that support SMEs with developing key skills and capability growth to support the Defence industry.
- SMEs should look at their current products, services, and capabilities and adapt them for Defence rather than creating new ones. This will minimise investment and provide a continuation income when Defence work is low.
- Once in a Defence-related contract, SMEs should work with the Primes and CoA to explore potential markets to 'sell' the SME capability as exports or as part of a global supply chain which will help SMEs further grow their customer base, strengthen business and help Primes and CoA build strategic alliances. This in turn will significantly help grow and maintain relationships between SMEs, Primes, and CoA.
- Where commercially viable and strategically aligned, SMEs can adopt merger, acquisition or collaboration models with other businesses. It will reduce overheads, increase financial security and capability offerings, increase IP, and enable them to leverage on each other's strengths.

Previous SADILP Concept Papers

In 2010, a SADILP concept paper "A pathway that maximises the involvement and return for Small to Medium Enterprises in South Australia from Future Shipbuilding Projects including New Submarine"^x proposed similar recommendations.

The 2010 paper recommended the following:

- SMEs should establish best practice general business principles, including: safety, quality, risk management, security, intellectual property, financial performance and project management, environmental, industrial relations.
- SMEs should seek and use assistance from either Primes or CoA initiatives that were available at the time
- Establish relationships with Primes

When compared to the 2021 investigation, the 2010 recommendations are very similar and it should be investigated further as to why the same situation exists today.

However, our thinking is that some SMEs still work ‘hand to mouth’, driven by annual profit, and do not think strategically enough about long-term future growth and self-investment. A longer-term strategy will secure a revenue base, but only if the value proposition is evident and maintained.

Finally, SMEs find it difficult to sustain or grow when the workload is sporadic because of the time lag between winning, delivering and then waiting for the next opportunity. This in turn presents further issues with maintaining relationships with the Primes as internal changes constantly happen from contract to contract.

Conclusion

Whilst the Defence industry continually makes significant improvements to help and support the growth of SMEs, there is still a need to revisit these steps and tailor them to address current challenges. This was evident when comparing the outcomes of two SADILP concept papers more than a decade apart.

There is no simple solution to a sustainable outcome and it is not the sole responsibility of the CoA to ensure SME growth occurs. The solution needs to include a multi-faceted and fully committed approach with the following as a high-level example:

- CoA having the financial support systems readily available in addition to simplifying security accreditation pathways.
- Primes clearly articulating capability growth opportunities to the commercial industry and ongoing support and sustainment of SMEs, even during quiet periods.
- SMEs investing and believing in themselves and investing in their ability to articulate a business proposition that clearly demonstrates capability and a solid value proposition.

ⁱ Commonwealth of Australia, 2019, “Defence Policy for Industry Participation”,

<https://www1.defence.gov.au/sites/default/files/2020-08/Defence-Policy-for-Industry-Participation.pdf>

ⁱⁱ Tillett, A, 2019, “Audit looms for defence companies amid anger over local jobs snub”, Financial Review, <https://www.afr.com/politics/federal/audit-looms-for-defence-companies-amid-anger-over-local-jobs-snob-20191212-p53j94>

ⁱⁱⁱ Tillett, A, 2021, “Big defence companies must ‘do better’ on local content promises”, Financial Review, <https://www.afr.com/politics/federal/big-defence-firms-need-to-do-better-on-local-content-promises-20210404-p57gdl>

^{iv} Australian Government Department of Defence, 2020, “Control 16.1 DISP in the Defence Security Principles Framework”, <https://www1.defence.gov.au/sites/default/files/2020-12/DSPF-OFFICIAL-Principle-16-Control-16.pdf>

^v Australian Taxation Office, 2020, “Research and development tax incentive”, <https://www.ato.gov.au/Business/Research-and-development-tax-incentive>

^{vi} business.gov.au, 2021, "Grants for defence industry", <https://business.gov.au/cdic/grants-for-defence-industry>

^{vii} business.gov.au, 2021, "Defence Industry Advisory and Facilitation Services", <https://business.gov.au/grants-and-programs/defence-industry-advisory-and-facilitation-services>

^{viii} Commonwealth of Australia, 2016, "2016 Defence Industry Policy Statement", https://www.defence.gov.au/sites/default/files/2021-08/2016-Defence-Industry-Policy-Statement_0.pdf

^{ix} Price, M, 2020, "Leading the development of a sovereign industrial defence capability", <https://www.minister.defence.gov.au/minister/melissa-price/speeches/leading-development-sovereign-industrial-defence-capability>

^x Suter, R, Evans, G, O'Donnell, V, and Candetti, A, 2010, "A pathway that maximises the involvement and return for small to medium enterprises in South Australia in future shipbuilding projects including new submarine", Defence Teaming Centre