



**Study on the Competitiveness  
of European Small and Medium  
sized Enterprises (SMEs) in  
the Defence Sector**

**Executive Summary  
to the  
Final Report**

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## Introduction

- 1 This study was commissioned by DG Enterprise, in order to describe the situation of SMEs<sup>1</sup> in the European defence sector, to highlight the factors that impede them from competing internationally, and to recommend ways in which their international competitiveness could be improved. It is hoped that this would help to bring about a more dispersed distribution of defence procurement in the European Union.
- 2 The context of the study is the fragmented state of the European defence market, and the Defence Package which has been introduced by the European Commission to address this. Two key elements of the package are the Defence Procurement Directive and a Directive on Intra-community Transfers. Their adoption into national laws by 2012 has the potential to generate significant structural changes within Europe's defence equipment industries.
- 3 These changes can be expected both to present a competitive threat to Europe's defence-related SMEs, and to open up opportunities for them. Some of these SMEs may not survive, but others may prove capable of exploiting the opportunities that will be created by this more integrated EU defence market. This is the motivation for this study of policies that could complement these market-opening measures.

### *The study's approach*

- 4 In order to make it manageable to represent the position in 27 Member States, six were selected to form the focus of the study:
  - (a) two of the three major EU defence equipment producers, France and the UK, with relatively high proportions of public expenditure allocated to defence;
  - (b) two second-division EU defence equipment producers, Italy and the Netherlands (the former with a distinctive and SME-orientated business culture), with relatively low proportions of public expenditure allocated to defence; and
  - (c) Two transitional economies with significant defence equipment industries, Poland and Romania.
- 5 Defence-related SMEs were identified via national defence trade associations. We were then able to conduct online questionnaire surveys (circulated by the trade associations to their members), to establish a descriptive profile of defence-related SMEs (e.g. turnover, employment, R&D), and to understand their concerns.
- 6 In addition to the surveys, interviews were conducted with seven trade associations (and their SME working groups where such groups existed). The focus here was the policy environment; the effectiveness of existing policies; and views on additional initiatives. Three Prime contractors were also interviewed.

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<sup>1</sup> Enterprises employing between 10 and 249 employees and with an annual turnover not exceeding €50 million, or an annual balance sheet total not exceeding €43 million.



- 7 Having identified the main challenges facing defence-related SMEs, we considered whether and to what extent existing policies help these SMEs to meet them. We then offer some recommendations for additional policies and initiatives, at EU, national and regional levels.

## **The EU's Defence Industrial Landscape**

- 8 The study sought first to describe the current situation of European SMEs in the defence sector – their numbers, economic importance, dependence on defence, and location. This is a broad remit, and most of it is uncharted territory. It was tackled by a combination of desk-based research, questionnaire surveys of defence-related SMEs, and interviews with trade associations and Prime contractors.
- 9 The study considered first why most of the European defence production (estimated here to be 87 per cent of the EU production that could be identified) is located in just six countries – the Letter of Intent (LoI) nations – France, Germany, Italy, Spain, Sweden and the UK. It is, of course, the case that the geography of defence equipment production has been shaped by Member States' political choices (how much to spend on defence, the extent that supply is organised by the state, the openness of defence procurement and the degree of preference that is accorded to domestic contractors, the insistence on offset arrangements). But it has been shaped also by the same economic forces that are evident in other industries (large economies trade less in relation to their size than small countries, countries with abundant skills export products such as defence equipment). For these reasons, the concentration of production in the LoI countries should not be viewed as some form of market failure, but in part as a response to economic forces.
- 10 Some powerful defence clusters reinforce the concentration of defence equipment production in the six LoI countries: because the Primes are concentrated in these countries, so, too, are the SMEs that depend upon them. Overall, however, the defence-related SMEs tend, in their modest way, to disperse, rather than to concentrate, equipment production. The LoI countries play host to 87 per cent of the EU's production of defence equipment, but to only 52 per cent of defence-related SMEs. This could be explained by the fact that SMEs play a larger role, generally, in non-LoI economies. An alternative interpretation is that LoI countries are uncompetitive in defence in part because their companies are, on average, too small to exploit the available economies of scale and scope.

## **SMEs' Economic Role in the Defence Sector**

- 11 In manufacturing, SMEs accounted for 45 per cent of value added and 39 per cent of turnover in the EU27 in 2006. There is no corresponding figure available for defence-related SMEs, because the bulk of the goods and services supplied to defence are buried within industries that supply both civil and military markets. By combining official statistics (Eurostat's Structural Business Statistics) with results of our survey, we concluded that SMEs account for between 11 and 17 per cent of the EU's estimated sales of defence equipment – significantly lower than SMEs' 39 per cent share of the sales of the EU27's manufacturing sector in 2006.



- 12 There are four main levels at which companies operate in defence supply chains: Prime contractors, which act as system integrators, Tier 1, Tier 2 and Tier 3 contractors (subcontractors). SMEs operate typically at the Tier 2, Tier 3 or higher levels.
- 13 The survey helped to construct a portrait of the defence-related SME. Its average annual turnover is €9 million, of which about one-third is accounted for by defence. Many “defence-related SMEs” appear not, in fact, to be strongly related to defence. It is worth noting, however, that responses were only received from seven per cent of the SMEs registered with national trade associations in the EU27, and were primarily from SMEs based in France, Germany, Greece, Italy, the Netherlands, Poland, Romania, Sweden and the UK.
- 14 Subcontracting, in the domestic market, rather than supplying national defence authorities directly, appears to be the most important source of defence business for SMEs. Nearly two-thirds of the SMEs that reported received less than 10 per cent of their defence business directly from their national defence authorities. For the respondents as a whole, their respective national defence authorities provided 21 per cent of their defence business. Exporting was negligible.
- 15 These findings focussed our attention on the SMEs’ strengths (flexibility, inventiveness and specialised skills) and weaknesses (scale disadvantages, dependence on Primes, cash flow problems) and raise the question whether SMEs’ comparatively modest role in defence equipment markets reflects fundamental disadvantages on their part, or a market failure in those markets. It may well be the case that there are exceptional economies, and advantages, of scale in defence, that are reflected, for example, in the recent consolidation in some national defence sectors. Many defence equipment items are hugely expensive and highly complex. One would not expect an SME to take responsibility for supplying them, any more than one would expect a house building company to tackle an Olympic stadium. A competing explanation is that there are inefficiencies in defence markets – inefficiencies that might be reduced by appropriate policies.

### **Factors Affecting the Competitiveness of Defence-Related SMEs**

- 16 We identified four types of challenges for SMEs:
  - (a) Information problems — too much information on the one hand and a lack of targeted accessible information for SMEs and potential clients on the other means that SMEs are less aware than they might be of future capability requirements and upcoming business opportunities, especially in other Member States. Because Prime and Tier 1 companies find it difficult to identify reliable suppliers, they prefer existing suppliers, subsidiaries or suppliers located close to the contractor.
  - (b) Problems accessing finance — defence-related SMEs may have particular difficulty accessing finance.
  - (c) The scope for Prime and Tier 1 contractors to exercise market power — national procurement authorities’ growing reliance on Primes and Tier 1 companies confers greater buying power to them.



- (d) Regulatory failure — offset policies and export regulations that favour domestic SMEs, excessive administrative burdens and the costs associated with IPR protection and user rights, create inefficiencies in the defence market and undermine the competitiveness of SMEs.
- 17 These hypotheses were tested against the evidence from the questionnaires, from interviews with trade association representatives and large downstream companies, as well as any empirical evidence that we could find on these issues.
- 18 A surprising result from the survey of SMEs is that so few SMEs responded to an opportunity to air their concerns, and of those SMEs that did so, less than a third reported that they faced major obstacles such as insufficient information, and difficulties gaining access to national procurement authorities and to Primes. Taken as a whole, our survey results do not convey a sense of seething frustration in the defence SME community.
- 19 We surmise that part of the reason for this is that the SMEs that are embedded into defence supply chains are reasonably comfortable. They are typically subcontractors, and have longstanding relationships with their customers. This view was consistent with the feedback received from the large downstream companies.

#### *Information problems*

- 20 The evidence indicates that the challenge for SMEs is not so much their ability to respond to demands, but to find out about and actually win business. Independent SMEs appear to be at a clear disadvantage to subsidiaries, in finding opportunities to subcontract and in building relationships with Primes and Tier 1 companies.
- 21 There appear to be substantial barriers to entry to supply chains, both within and across countries, particularly with respect to more specialised products. Downstream companies prefer to rely on established supply chains. Geographic proximity is important only for more generic products; for niche products, what matters is the relationship between customer and supplier. The risks associated with using untested suppliers are likely to be higher here. Larger companies find it difficult to identify SMEs with the appropriate skill sets: they prefer to improve the efficiency of existing suppliers rather than searching for more efficient ones.

#### *Accessing finance*

- 22 There is some evidence that access to finance is a particular challenge for those SMEs engaged in defence-specific R&D. In some Member States, those SMEs that are embedded in a supply chain may actually find finance easier to obtain than SMEs in other sectors.

#### *Abuse of market power by Primes*

- 23 On the other hand, we found very little evidence that downstream companies abuse their market power, at least in terms of the type of contracts that they offer to their suppliers.

#### *Regulatory failure*

- 24 If a Prime is required to find offsets for an export order, SMEs in its own domestic supply chain stand to lose. On the other hand, offsets for imports into their own country are



positive opportunities by SMEs. The net impact on SMEs is therefore unclear. SMEs themselves did not generally raise offsets as an issue. Evidence from the EDA's Electronic Bulletin Board (EBB), however, suggests that countries with regulated policies on offsets tend to allocate a greater proportion of public contracts to domestic suppliers, and to domestic SMEs.

- 25 The replies to our survey of SMEs indicate that their involvement in exporting is negligible. That said, it is likely that export regulations do affect the ability of SMEs to export, but more fundamental barriers to export exist, such as the economies of scale required to export, problems in identifying appropriate markets, and the fact that it is difficult to export sub-systems independently of the system of which they form a part.
- 26 The protection of intellectual property rights does not feature as a serious concern for SMEs. Nor does the evidence suggest that concerns over IPR protection play a role in determining whether SMEs collaborate or not. Co-financing programmes and R&D/R&T contracts more generally, however, do raise concerns for SMEs in terms of IPR protection and user rights. As discussed in a recent report commissioned by the European Defence Agency on increasing SME participation in defence R&D/R&T, the insistence upon user rights by national authorities can reduce the incentives for SMEs to engage in R&D/R&T.

#### *Conclusions*

- 27 Overall our analysis provides some evidence that inefficiencies in defence markets do exist, to do with information, gaining entry to supply chains, accessing finance, exports and administrative burdens associated with tendering. It is therefore in these areas that we considered measures to improve the competitiveness of defence-related SMEs.

### **A Review of Existing Policies**

- 28 There are four broad categories of policies, each with its own mechanisms, strengths and weaknesses, that may be considered in order to improve the competitiveness of defence-related SMEs:
- (a) Market-opening policies led by the European Parliament, the Council of Ministers and national governments - pursued either through legislation, or on a voluntary basis – seek to make defence markets more transparent and better informed;
  - (b) Imposing requirements on Primes to involve SMEs;
  - (c) EU and State support for R&D by SMEs, seeking to improve SMEs' competitiveness in an area in which they are believed to have distinctive strengths;
  - (d) Industry initiatives to make defence markets function better, and to improve SMEs' capabilities.
- 29 It is difficult, in general, to determine the impacts of existing policies. Data on SMEs' involvement in defence is limited, and even where data exists, it is rarely possible to compare the situations before and after policy interventions. The UK provides one such case. Following the adoption of more SME-friendly policies by the UK Ministry of Defence, the proportion of its direct business that was placed with SMEs increased by over 75 per cent between 2004-05 and 2007-08, from 3.1 per cent of total procurement expenditure to 4.6 per cent.



30 Drawing on the material available - data, feedback from stakeholders, and an assessment of the mechanisms through which the different types of policies work – the report commends the types of policies set out below.

**“Best Practices”**

Issue	Type of policy	Examples
Information	Market-opening policies led by governments	Conference de Lancement
		Atelier R&T
		EDA CoC – EBB
		CDE
	Industry initiatives	Conference Fournisseurs
		AeroPortal
		Met
	Communities of interest	
Access to public contracts	Market-opening policies led by governments	Procurement directive
		Reduction in thresholds for advertising contracts
		Service d’achat
Access to foreign markets	Market-opening policies led by governments	Transfers directive
		Portail soutien export PME
		UK Trade & Investment’s Defence and Security Organisation (DSO)
	Industry initiatives	Trade fairs etc.
		NIDV informs members of all foreign defence projects
Access to finance	Market-opening policies led by governments	RAPID
		CDE
		SBIR
Cost of bidding	Market-opening policies led by governments	Espace PME
		Simplification of contracts etc (CDE)
		Turnaround time on bids
	Industry initiatives	Advice on procedures

**Conclusions and Recommendations**

31 There appear to be aspects of defence markets where initiatives can improve both the efficiency of the supply chain as well as the competitiveness of SMEs. Such measures have already been adopted, by the Commission, by the EDA, by some national governments, and by the defence industries themselves. As noted above, there is evidence that such policies can be effective.



- 32 At the EU level, the Defence Package and the EDA's Code of Conduct (CoC) should help improve the competitiveness of defence-related SMEs. The Directive on defence procurement, in particular, should help to address one of the two most frequently mentioned obstacles facing SMEs: access to national defence authority contracts.
- 33 If the Directive is implemented as intended, it would make defence markets more accessible for SMEs and ensure that, as subcontractors, they would be treated in an equal and non-discriminatory way. It will allow Member States, if they choose, to open up contracts to inject competition into supply chains and / or allow a greater degree of subcontracting. The subcontracting provisions of the Directive would also make it impossible to continue with offset practices, thereby removing a very significant distortion in European defence markets.
- 34 SMEs who have traditionally benefited from offsets may consider this as a major challenge, since they will have to face more cross-border competition for contracts awarded at home. However, at the same time, the same SMEs will gain additional business opportunities when subcontracts are awarded in other Member States. There is thus a potential opportunity for competitive SMEs to benefit from the market-opening effects of the Directive's provision's on sub-contracting.
- 35 Because subcontracting would have to be conducted on a non-discriminatory basis, it could not be used to engineering particular outcomes, such as, for example, a greater share of defence work for SMEs. In any case, it seems questionable to us whether a policy based on such targets would address the fundamental reasons why SMEs are not more competitive. If Member States choose to insist on specified levels of subcontracting, it is possible that subcontractors would have to bear greater technical risks than they could cope with. However, the drawbacks that might arise here, if any, would be vastly outweighed by the discontinuation of offset practices.
- 36 The focus of our recommendations is on facilitating the implementation of the Defence Package and promoting existing policies, to ensure that these initiatives are as effective as possible. Their general spirit is that SMEs depend on institutional structures, for information, advice and representation. There is therefore a case for strengthening these institutions. In this sense, the recommendations favour “soft measures”, in contrast to “hard”, rules-based approaches.
- 37 **At the EU level** we recommend that institutions such as the EDA and ASD, supported by the Commission, play a greater role in coordinating the activities of the national and industry trade associations. This would encourage the dissemination of best practice, as well as ensuring that these channels are used more effectively to disperse information across the whole of the EU. The Commission and the EDA are important as providers of a coherent EU wide approach – in so far as this is possible – and drive forward EU wide initiatives, including the promotion of trade associations and the participation of national trade associations in interactions with institutions such as the EDA and ASD.
- 38 **At a national level**, defence authorities should improve the flow of information to SMEs about their future requirements, directly with SMEs and through the promotion of and active engagement with trade associations. Good examples of such approaches include: the DGA's Espace PME in France; the Centre for Defence Enterprise in the UK; and in



export market, the “Portail soutien export PME” in France and the Defence and Security Organisation (DSO) in the UK.

- 39 **Trade associations** should be encouraged by the authorities, and should take a role in:
- (a) Monitoring and providing a picture of the numbers and nature of SMEs operating in the defence sector – this is currently done on an annual basis by a number of Trade Associations, such as GICAN, GICAT and GIFAS in France;
  - (b) Improving the flow of information about public procurement opportunities (both foreign and domestic) for SMEs – as currently is done by the EDA's EBB, the NIDV in the Netherlands, the SBAC and DMA in the UK, for example;
  - (c) Assisting companies to identify subcontracting opportunities with Primes – particularly useful examples include the Conferences Fournisseurs organised by GICAN, the ASD's AeroPortal, Pacte PME in France's Met programme; and
  - (d) Offering support and advice on procurement processes and administrative and legal issues – as is already done by a number of trade associations.

#### **Topics for further consideration**

- 40 Aside from these immediate priorities, three other initiatives warrant further consideration: intensifying efforts to promote exports by defence-related SMEs, supporting defence clusters, and recognising quality assurance procedures.
- 41 **Export promotion.** Member states might consider the merits of giving greater priority to helping defence-related SMEs to become exporters, as the Defence Package begins to take effect. There are several topics on which such enterprises, in particular, may need advice; on national export control policies, the impact of customer countries' offset policies, and local business cultures. Such policies may not be appropriate for all Member States; to conduct them effectively requires a background and expertise that takes many years to develop, and there needs to be a volume of business in prospect to justify the additional resources required..
- 42 **Supporting defence clusters.** The Commission is developing a range of policies to promote clusters. Questions for further consideration here concern the existence and strength of defence clusters, and how could they be encouraged, noting their distinct features and dynamics. For example, defence technologies might be considered as a candidate for a transnational cooperation initiative under the Europe INNOVA TM initiative that supports innovative SMEs by arranging matchmaking events and preparing partnership agreements. The comparative weakness of defence clusters in the Eastern European countries invites the thought that they, in particular, should be better supported by national and regional initiatives.
- 43 **Recognising quality assurance procedures.** Accreditation was considered as either quite important or extremely important by over half of those that responded to the study's longer questionnaire. This not surprising: formalised quality assurance originally derived from the defence industry's need for them. This, highly technical subject, is beyond the scope of this study. The topics that might be usefully explored here concern the types of accreditation that carry particular weight with Contracting



Authorities and Primes, and the extent to which these are mutually recognised across the EU.