

Indian defence sector offers investment opportunities



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INDIA BELIEVES IN A FOREIGN POLICY that promotes peace and international co-operation. Historians have acknowledged first Indian president Jawaharlal Nehru's policy of non-alignment as an attempt to place India 'beyond and above the rivalries of great powers.' The country continues to be major participant in the non-aligned movement (NAM) – an international organisation of countries that consider themselves to be politically unaffiliated with any major global power.

However, the country has a land frontier of 15,200km, a coastline of 7,516.6 km and an exclusive economic zone of 2.2 million sq km, as well as island territories, vital offshore installations and airspace to defend. The armed forces, therefore, have to be kept prepared and well equipped to repel any external threat.

India is also a major participant in international peacekeeping missions with the UN, sending its troops into conflict zones around the world.

THE DEFENCE SECTOR

The Indian Ministry of Defence (MoD) is in charge of all defence-related activities

spanning the army, navy and airforce. The focus of its defence planning is on increasing indigenous capacity to meet the needs of the armed forces and a reliable mechanism of inter-service, inter-departmental and multi-level co-ordination. The current strategic and technological scenarios, as well as future projections are taken into consideration in preparing the defence plan. Periodic review addresses any unexpected developments or new threats to security.

Defence spending

India is among the world's top ten countries in terms of defence expenditure and it is the third-largest importer of defence hardware. Indian defence procurements include strategic defence capabilities on land, sea and air.

The areas of focus for the future are on:

- long range, lethal and precision guided munitions;
- merger of the delivery system and warhead into one integrated or cohesive unit;
- mobile weapons systems;
- reconnaissance, surveillance and target acquisition systems;
- the ability to operate at night and in bad conditions; and
- communications and information management systems to optimally link sensors to missile-shooting equipment.

The defence budget estimate for the year 2006-07 is £10bn, an increase of £559m over 2005-06. The Indian military budget is expected to grow by 7% annually over the next five years. The country's military spend amounts to roughly 2% of GDP, which is without accounting for expenditure on defence pensions, paramilitary forces and the defence ministry itself as part of budgeted defence spending. India's imports of military hardware and software are expected to be worth £15bn by 2012.

GOVERNMENT CONTROL

Production of defence equipment has always been under the purview of the government. India has kept defence production in the public sector since its first industrial policy, outlined in the Industry Policy Resolution of 1948. The Industries (Development & Regulation) Act 1951 gave statutory base to that policy. As a consequence, a large infrastructure for defence production was created in India, consisting of:

- 39 ordnance factories (OFs);
- eight defence public sector undertakings (PSUs); and
- 50 research and development (R&D) laboratories.

(See 'Defence infrastructure' on pXX for further details.)

LIMITED PRIVATE SECTOR INVOLVEMENT

The private sector has played a significant role in the defence industry as sub-contractors and ancillary industry, although until recently its participation was largely restricted to the supply of raw materials, semi-finished products, parts and components to:

- defence PSUs;
- OFs;
- the base workshops of the army;
- the base repair depots of the airforce; and
- the dockyards of the navy.

OPENING UP THE DEFENCE SECTOR

In its quest for self-reliance in the crucial sector of defence, the Indian government has been continuing its efforts to indigenise the production of defence equipment wherever technologically feasible and economically viable. It originally planned to source 70% of its defence requirements from indigenous suppliers by 2010.

In May 2001, the Indian government decided to open the defence industry for private sector participation up to 100%

of equity, with foreign direct investment (FDI) permissible up to 26%. Both were subject to licensing restrictions.

Following the policy change, all defence-related items have been removed from government's reserved category and transferred to the licensed category. As a result, the private sector can now manufacture all types of defence equipment after obtaining a government licence.

LICENSING REQUIREMENTS

In 2002, the Department of Industrial Policy & Promotion (DIPP), in consultation with the MoD, issued the following guidelines (see 'Press Note No2 (2002 Series)' available from www.dipp.nic.in) for licensing the production of arms and ammunitions:

- Licence applications will be considered and licences given by the DIPP in consultation with the MoD.
- Cases involving FDI will be considered by the Foreign Investment Promotion Board (FIPB) and licences given by the DIPP in consultation with the MoD.
- The applicant should be an Indian company or partnership firm.
- The management of the applicant company or partnership should be in Indian hands – with majority representation on the board, as well as the chief executive of the company or partnership firm being resident Indians.
- Full particulars of the directors and the chief executives should be provided along with the applications.
- The government reserves the right to verify the antecedents of the foreign collaborators and domestic promoters – including their financial standing and credentials in the world market. Preference would be given to:
 - original equipment manufacturers or design establishments;
 - companies with a good track record of past supplies to the armed forces, space and atomic energy sectors; and
 - companies with an established R&D base.
- There would be no minimum capitalisation for the FDI. A proper assessment, however, needs to be done by the management of the applicant company, depending on the product and the technology. The licensing authority would satisfy itself about the adequacy of the net worth of the foreign investor, taking into account the category of weapons and equipment that are proposed to be manufactured.
- There would be a three-year lock-in period for transfer of equity from one foreign investor to another foreign investor (including non-resident Indians (NRI) and overseas corporate bodies with 60% or more NRI stake) and such transfer would be subject to prior approval of the FIPB and the Indian government.
- The MoD is not in a position to give purchase guarantee for products to be manufactured. However, the planned acquisition program for such equipment and overall requirements would be made available to the extent possible.
- The capacity norms for production will be provided in the licence – based on the application, as well as the recommendations of the MoD, which will look into existing capacities of similar and allied products.
- Import of equipment for pre-production activity, including development of prototypes, by the applicant company would be permitted.
- Adequate safety and security procedures would need to be put in place by the licensee once the licence is granted and production commences. These would be subject to verification by authorised government agencies.
- The standards and testing procedures for equipment to be produced under licence from foreign collaborators or from indigenous R&D

DEFENCE INFRASTRUCTURE

Ordnance factories

India's 39 ordnance factories (OFs) are government units producing armaments under five categories:

- ammunition and explosives;
- weapons;
- vehicles and equipment;
- armoured vehicles; and
- ordnance equipment (other military supplies, including general stores).

They were built to meet the growing needs of India's armed forces over the past 60 years.

Defence public sector undertakings

The eight defence public sector undertakings (PSUs) are public-sector corporations managed by the Indian government. They are:

- Bharat Dynamics Ltd;
- Bharat Earth Movers Ltd;
- Bharat Electronics Ltd;
- Hindustan Aeronautics Ltd;
- Garden Reach Shipbuilders and Engineers Ltd;
- Goa Shipyard Ltd;
- Mazagon Dock Ltd; and
- Mishra Dhatu Nigam Ltd.

The defence PSUs produce a range of defence equipment. They also provide overhaul and maintenance facilities.

Defence research and development

India also has a defence research and development (R&D) capability: the Defence Research and Development Organisation (DRDO). The DRDO draws on the work of the 50 R&D laboratories/establishments.

will have to be provided by the licensee to the government nominated quality assurance agency under appropriate confidentiality clause. The nominated quality assurance agency would inspect the finished product and would conduct

surveillance and audit of the quality assurance procedures of the licensee. Self-certification would be permitted by the MoD on case-by-case basis, which may involve either individual items, or groups of items manufactured by the licensee. Such permission would be for a fixed period and subject to renewals.

- Purchase preference and price preference may be given to the public sector organisations as per the guidelines of the Department of Public Enterprises (available at www.dpe.nic.in).
- Arms and ammunition produced by the private manufacturers will be primarily sold to the MoD. These items may also be sold to other government entities under the control of the Ministry of Home Affairs and State Governments with the prior approval of the MoD. No such item should be sold within the country to any other person or entity. The export of manufactured items would be subject to policy and guidelines as applicable to OFs and defence PSUs. Non-lethal items would be permitted for sale to persons or entities other than the central or state governments with the prior approval of the MoD. The licensee would also need to institute a verifiable system of removal of all goods out of their factories. Violation of these provisions may lead to cancellation of the licence.
- The government decision on applications to FIPB for FDI in defence industry sector will normally be communicated within a time frame of ten weeks from the date of acknowledgement by the Secretariat for Industrial Assistance in the DIPP.

CHANGING ROLE OF THE PRIVATE SECTOR

It was hoped that the involvement of the private sector, with its world-class expertise and high technology, would augment India's indigenous defence production capability. In-built advantages of the private sector that the government intended to harness were its reservoir of management, scientific and technological skills, and also its ability to raise resources.

After the announcement of the industrial policy changes, there has been a shift in the role of the private sector in the field of defence indigenisation. From being suppliers of raw materials, components and sub-systems, private sector companies have now become partners in the manufacture of complete advanced equipment and systems.

After defence production was opened up to the private sector, the industry has shown keen interest in the opportunities on offer. Many large industries have shown definite inclinations to assume the role of system integrators by investing both in R&D and infrastructure to develop capabilities in defence production.

By mid-2007, there were about 5,200 companies supplying around 20-25% of components and sub-assemblies to state-owned contractors in the defence sector. Leading corporate houses like the Tata Group, Satyam Computer Services Ltd, the Mahindra Group, Kirloskar Brothers Ltd, Larsen & Toubro Ltd and many other companies can now make defence equipment to suit and meet the domestic defence requirement.

DEFENCE PROCUREMENT PROCEDURE 2006

The MoD has documented defence acquisition procedure in 'Defence Procurement Procedure - 2006' (DPP). This has increased levels of transparency and accountability in the defence acquisition process. The DPP 2006 reviewed and revised the earlier 'Defence Procurement Procedure - 2005', along with the 'Fast Track Procedure - 2006' and the 'Procedure for Indigenous Naval Ship Building'.

The procedure now includes an 'make' category, as well as the existing 'buy' and 'buy and make' categories. This new category, applicable to defence products designed and made by Indian companies, bridges a critical gap that existed hitherto, and provides the requisite framework for increased participation of Indian industry in the defence sector.

Some of the important features of the DPP 2006 include:

- a) all major decisions on to the procurement process to be taken simultaneously to reduce the time frame for acquisitions;
- b) enhanced transparency to be achieved by placing the generic requirements of the services on the MoD website and generating vendor registration through the internet;
- c) increased transparency in the conduct of field trials;
- d) an 'integrity pact' to be made compulsory for all contracts above 1bn rupees (£12.9m), to eliminate corruption; and
- e) an 'offset' obligation for all contracts above 3bn rupees (£38.8m) to ensure that a minimum of 30% of the value of the contract would have to be sourced from Indian companies.

The DPP 2006 provides comprehensive policy guidelines for all capital acquisitions for the armed forces. This document, along with the 'Defence Procurement Manual', is available at the MoD website: www.mod.nic.in/dpm/welcome.html.

Two major initiatives of the policy are:

'Offset' policy

This applies to all capital acquisitions categorised as:

- 'buy (global)' - ie, outright purchase from a foreign or Indian vendor; or
- 'buy and make with transfer of technology' - ie, purchase from a foreign vendor followed by licensed production,

where the indicative cost in the request for proposal is 3bn rupees (£12.9m) or more.

Under the offset policy, foreign suppliers are obligated to purchase directly, or execute export orders for, defence products and components manufactured (or services provided) by Indian defence industries - ie, defence PSUs, the Ordnance Factory Board and any private defence industry manufacturing these products or components under an

industrial licence granted for such manufacture. As stated above, at least 30% of the value of the contract must be sourced from Indian suppliers.

'Raksha Udyog Ratna' – champions in defence production

There are various levels of participation for the private sector in defence production. These include supplying:

- 1) major systems;
- 2) assemblies;
- 3) spare parts; and
- 4) components.

To ensure effective participation by the public and private sectors at various points of interaction, and subsequent long-term association in product development and supplies, the MoD has introduced its 'Raksha Udyog Ratna' policy.

Under this policy, firms of proven excellence that are capable of contributing to the defence sector are granted status as 'Raksha Udyog Ratna' (RURs) – champions of defence production. These RURs are essentially platform producers and system integrators – the companies at the top level of the defence industry.

The RURs should be treated on a par with defence PSUs and have similar rights to bid for defence contracts, access foreign technology, collaborate with foreign partners and make use of FDI.

DEFENCE CO-OPERATION

India co-operates on defence projects with many other countries.

Russia

All bilateral issues relating to defence co-operation are addressed and resolved under the India-Russia Inter-governmental Commission on Military Technical Co-operation (IRIGC-MTC). In 2007, an agreement for India to produce precision Aero engine components at Hindustan Aeronautic Ltd (HAL) was signed at IRIGC-MTC.

Europe

In 2006, the European Aeronautic Defence and Space Company (EADS)

announced that it was going to invest £1.5bn in India over the next 15 years in production and R&D facilities.

Indian defence production units are currently involved with a joint venture with companies in France for the Scorpene submarine project, which is currently proceeding to schedule at Mazagon Dock Ltd.

Israel

Following the opening up of the defence sector, an agreement between India and Israel on joint production of several items, including various types of ammunition, at India's OFs led to the first defence FDI project in 2006.

UK

BAE Systems agreed to supply 66 Hawk advanced jet trainers to India – 24 are to be made in the UK, with a further 42 to be manufactured under licence by HAL.

US

The 2005 New Framework Agreement for the US-India Defence Relationship outlined a strategic relationship in the field of defence production, co-production and technology collaboration arrangements.

THE PATH AHEAD

India is forging a reputation as a manufacturing hub for world corporations wanting to exploit the sector's proven skills in product design, reconfiguration and customisation with creativity and assured quality. With its defence sector now more accessible for foreign investment, India is poised to become a key outsourcing hub for global defence majors.

The US-based defence and aerospace company, Lockheed Martin, has begun 'putting meaningful work' in India, independently of any sales contracts. The company has also set up an Indian subsidiary to market all its operating systems in the country.

European defence company Thales International said in 2006, 'There has been no slow down in our interest in India. On the contrary, we are very keen to step up contracts with New Delhi,

DEVELOPMENTS IN 2008

Most countries with a significant defence sector produce guidance for manufacturers on what is considered to be a 'defence product'. India did not need to officially state what it considered to be a defence product when its defence sector was closed to private sector and foreign involvement.

However, since the sector has been opened up a listing of defence products is needed to determine where manufacturing licences will be required and where foreign participation will be restricted to 26%.

Consequently, the Indian Ministry of Defence is expected to release a 'Munitions List' in 2008 that will contain the country's official list of defence products.

both in the defence and civil sector'. In 2007, the company put in a formal bid for upgrading the Mirage 2000 fighters of the Indian Air Force.

CONCLUSION

The Indian government is fully committed to the development of a vibrant and proactive defence industry. Its objective is to ensure that the resources, capabilities and infrastructure, including intellectual capital, available both in the public and private sector are treated as national assets and harnessed to the fullest extent.

For a foreign company, the benefits are twofold. On the one hand, equity investment in an Indian defence company will appreciate rapidly, while on the other, the Indian company can act as a manufacturing base to supply high-quality components in a cost-effective manner.

A strong and healthy partnership between the public and private sector will be critical in delivering the defence capability the country needs and in sustaining a powerful domestic industrial base for the future.

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