Making investments in the defence sector

Need for a synergistic policy regime

March 2012

ASSOCHAM INDIA

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Contents

Message

On behalf of ASSOCHAM, I am pleased to announce the 5th ASSOCHAM International Conference on Indian Defence on 30th March 2012 at Hotel Shangri La, New Delhi.

Assocham Defence Council has been very active in promoting the Indian Defence Industry and has been submitting substantial inputs and recommendations to the Ministry of Defence from time to time.

The Industry is aware that since 2001 the Government has allowed private sector participation in Defence production along with FDI up to 26 percent, subject to licensing and security clearance. The liberalization of the Industry was with a view to enhance India's Self-reliance in Defence production. However, nearly a decade since opening of the Defence Production sector, India continues to be one of the largest arms importers .It is estimated that during the next decade close to USD 100 Billion worth of Defence imports are likely. Though it is difficult to reach a clear estimate on the value of offsets which will be involved with this huge Defence Imports, never the less the offsets figures could well be above USD 30 Billion . The implementation of this value of offsets is both a challenge and an opportunity for the Foreign and Indian Defence Industries.

The ASSOCHAM has organized this seminar during the period of Defence Expo 2012, for the primary reason to enable the foreign and the Indian Defence Industry to meet and discuss the problems being faced by the two parties to undertake Defence work in India as per the Defence procurement procedure promulgated by the Government. An opportunity has therefore been created during this seminar for the Industry to interact with the users and the Ministry of Defence In a free and frank atmosphere.

I wish all the participants great success and useful discussions.

Vice Admiral (R) PC Bhasin, PVSM, AVSM, VSM
Chairman,
ASSOCHAM Defence Council

Message

India, with its Defence spending & Civil Aviation market growth rate of (CAGR) 18%, would put the country, in very near future, among one of the top five Defence & Civil aviation markets in the world.

Opportunities in Defence; Buy-Make & Make Programs supported by government's Defence Production policy and evolving Defence Procurement Procedures - bringing in Civil Aviation products into Offset play, provide further impetus for global A & D players to engage with Indian industry.

Raising to the occasion; SME's , ME's and large business houses, if can collaborate to build an Indian Defence eco-system, will not only help meet domestic demand, supporting self-reliance but at the same time create a mark in Global market by offering competitive products & services to Global majors. With government's thrust on creating level playing field to accelerate the process of self reliance, it's time for both government owned Defence and Private players to work together and be an integral part of Domestic and Global Supply Chain.

It's a beginning of a journey & an opportunity for the Indian industry to be a part of Global Aerospace and Defence system.

Wishing team ASSOCHAM a success.

Kamesh Gupta
Co-Chairman
ASSOCHAM Defence Council

Message

We are pleased to present the discussion paper on **Making investments in the Indian defence sector: Need for a synergistic policy regime** at the 5th ASSOCHAM Conference on Aerospace and Defence. Characterised by a high growth potential, India's aerospace and defence industry is important to the country's strategic and economic interests.

The government has initiated the process of transformation and there are encouraging signs of the industry developing the capability and capacity to provide world-class equipment, not only for the domestic market but also for exports. This discussion paper aims to capture opportunities and challenges that investing in this sector presents to both foreign as well as domestic players and offers suggestions for synergising policy changes. However, keeping in mind the fact that this is a capital-intensive and cyclical industry vulnerable to long lags between investment decisions and implementation, we have tried to present a holistic and long-term view of the opportunities available.

Now is the right time to invest and build infrastructure in this strategic sector. We trust this paper will provide valuable insight to existing and prospective investors. We also thank ASSOCHAM for giving us this opportunity to present the perspectives and opportunities for the sector in India.

Mathur

Dhiraj Mathur
Executive Director
Leader, Aerospace and Defence Practice
PwC India

Message

The recent media reports of India becoming the largest buyer of defence equipments in the world not only highlights the Government's concern for the nation security, but also the Government's quest for providing latest technology to our armed forces.

ASSOCHAM India's leading Apex Chamber of Commerce and Industry has been articulating the views that Indian armed forces deserve the best technologies keeping in mind the threat perception.

ASSOCHAM has taken the thought leadership position by inviting the industry leaders and the decision makers on various forums for creating a better understanding about the Sector.

ASSOCHAM believes that there is a significant business opportunity for the India companies particularly the Small and Medium Enterprises who are known to develop niche technologies for the Defence and Home Land security.

Any defence program success or failure is because of supply chain execution and it is precisely here that the Indian Small and Medium companies will play a critical role in the entire supply chain for the Aerospace and Defence sector.

It is heartening to know that the Ministry of Defence has announced a dedicated Fund through their Defence Production Policy 2011 and also in the recent announcement in the Annual Budget a special allocation of fund has been made for the SME sector in India.

We thank the Ministry of Micro, Small and Medium Enterprises, Government of India, for Officially Supporting this Conference. We are very confident that the 5th ASSOCHAM International Conference on Aerospace & Defence would provide an excellent opportunity for the industries and other stakeholders in further strengthening the domestic supply chain and local manufacturing in the A & D sector in India.

D. S. Rawat
Secretary General
ASSOCHAM

Introduction

The Indian defence market presents an attractive opportunity for Indian as well as foreign manufacturers. With the world's third largest armed forces, the country's defence budget is 2.14% of its GDP. In 2012-13, the Budget for defence has increased by almost 17% to reach US$ 38 billion. India is one of the largest importers of conventional defence equipment and spends about 40% of its total defence budget on capital acquisitions. Around 70% of our defence requirements are met through imports. In 2001, the government opened this sector to private and foreign investors and set a challenging target of achieving 70% indigenisation.

The Department of Industrial Policy and Promotion (DIPP) has issued over 178 industrial licences (IL) till November 2011. However, anecdotal evidence suggests that few of these have fructified. There is no official or reliable data on the implementation of ILs available in the public domain. Besides, the inflow of foreign direct investment (FDI) in this sector has not been very encouraging. Till December 2011 (a decade since the 2001 opening-up),the sector has attracted a meagre investment of US$ 3.72 million.

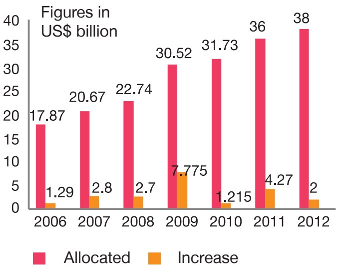
There are a number of reasons for this poor progress towards indigenisation. Most of them are rooted in the policy structure– both in terms of inconsistencies as well as lack of a proactive approach. The defence industry is in a nascent stage of growth and requires support from the government. Historically, if we analyse the growth of most developed countries, the most recent example being that of the 'Asian tigers', it is evident that the government policies of these countries protected its infant domestic industry from foreign competition. Called the 'infant industry protection' argument in economic literature, it consists of high tariff barriers to make imports uncompetitive and support for domestic industry with various fiscal and monetary incentives. Unfortunately in India, this argument has turned upside down. There are no tariff barriers as imports by the Ministry of Defence (MoD) are duty-free and there is no incentive for domestic investment. In fact, the complex policy regime creates very high entry barriers.

This paper evaluates the reasons for the low levels of investment and the poor progress in indigenisation. It also highlights inconsistencies in the regulations that govern domestic and foreign investment in the defence sector. It also contains suggestions to streamline the regulatory framework to attract domestic and foreign investment.

Growth in the defence budget

Between 2006 and 2010, India surpassed China as the world's largest importer of weapons systems, reflecting the nation's intent to modernise its armed forces and replace obsolete equipment. Since 2001, the country's defence spending has grown significantly to reach US$ 38 billion (2012) from US$ 30.52 billion (2009), representing a compounded annual growth rate (CAGR) of 7.58%.

Defence budget allocation (2007-2012)

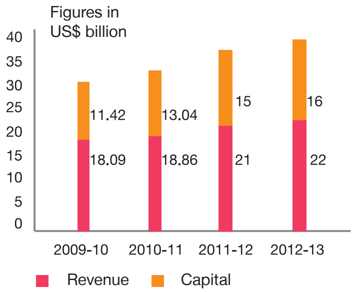


Source: *The Indian Budget 2006-12*

This trend has continued as the Budget for 2012-13 has allocated a sizeable US$ 16 billion towards capital expenditure. This is to modernise the armed forces, and replace and acquire weapons to meet security challenges of the country.

India's defence budget is broadly divided into two categories- revenue expenditure and capital expenditure, with the former accounting for nearly 60% of the total budget. The revenue expenditure mainly caters to the running or operating expenditure of the defence services, while the capital expenditure is incurred on creating long-term assets.

Capital and revenue expenditure



Source: *The Indian Budget 2009-12*

Over the last four years, the share of capital expenditure has increased to 42% (2012) from 38% (2009), highlighting the government's focus on increasing physical military capability.

Factors driving growth in the military spending include India's foreign policy objectives, real or perceived threats, policies contributing to multilateral peacekeeping operations and the availability of economic resources.

In summary, the country's defence expenditure has been increasing with big-ticket deals and massive modernisation programmes. The large scale of the market provides a significant opportunity for foreign original equipment manufacturers (OEMs), Indian industries and SMEs. Also, the Ordnance Factory Board and Defence Public Sector Units have laid the foundations for developing a robust industrial base in the aerospace and defence (A&D) sector. The government has been pushing towards indigenisation and attracting foreign investment for capital and technology. However, over the last decade, indigenisation levels have stayed below 30% and there is a yawning technology gap in terms of what our armed forces need and what is available in the developed nations.

Regulatory framework

The Indian defence market is a monopsony market where a single buyer(the government), follows a strict L1 system for defence purchases. Hence, it will not be possible for any business to depend only on government orders for sustenance. Therefore, exports need to form an integral part of any viable business plan. For a new entrant in the Indian defence sector, the regulatory framework is highly restrictive, ambiguous and often conflicting.

The sector is primarily regulated and affected by the following five policies (other laws of the land also apply, e.g., the Companies Act, etc.).

The defence offset policy

As per Defence Procurement Policy (DPP) 2011, at least 30% of the contract value (those exceeding 300 crore INR) has to be ploughed back into the Indian defence industry as offsets. This can be either in the form of direct purchase of components from the Indian industry, equity investment in a joint venture in the defence sector or investments in R&D. It is important to note that the government actually pays for the offsets as no OEM can or will be able to bear the programme cost. The policy exists to build a defence industrial base in the country. Given the massive acquisition programmes India has embarked upon, the offset policy presents an excellent opportunity to build a defence manufacturing base in the country. It requires foreign OEMs to collaborate with an Indian partner to plan sourcing, joint ventures, co-production arrangements, technical collaborations, etc. However, a review of the experience suggests that the country has a long way to go before it can utilise the opportunity that the policy has opened up. As with other policies in this sector, there exists ambiguity in implementing the offset policy by investors.

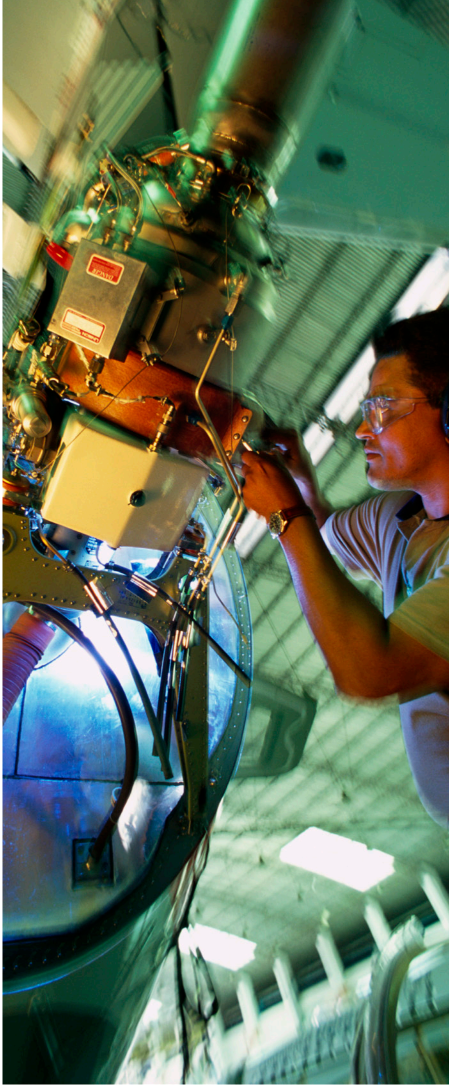
The policy states that a foreign OEM can fulfil its offset obligations through direct purchase or by facilitating exports to Indian industries. However, the term 'Indian industry' is not defined under the offset policy and the MoD has taken a stand internally that companies with FDI exceeding 26%, whether in the manufacturing or services sector, do not qualify as a valid Indian offset partner. This is contrary to the provisions of the policy stipulating that the Indian offset partner needs to comply with the licensing regulations and FDI policy enumerated by the DIPP. This is because there is no licensing requirement for the services sector and most services are allowed on the automatic route with up to 100 % FDI. OEMs are also concerned that no credit is given for technology transfers involving considerable time and costs.

Industrial licence (IL)

Under the Industries (Development and Regulation) Act, 1951 (the Act), an IL is required to manufacture arms and ammunition and allied items of defence equipment, parts and accessories. The licence is granted under Rule 15(2) of the Registration and Licensing of Industrial Undertaking Rules, 1952. These rules have been issued under section 30 of the Act. This is also a mandatory requirement under the FDI policy for the defence sector.
The licence applications are considered by the DIPP, Ministry of Commerce & Industry, in consultation with the MoD.

Following are the key issues faced by companies in this area:

- Absence of a definition of 'defence equipment' in either the policy or the Act causes confusion among investors and reduces the effectiveness of the regulations as they become open to arbitrary interpretation. For instance, it is not clear which sub-systems, components and parts are included in the list of items requiring compulsory licensing.
- Clarity is needed on 'dual use' items for civil and defence application. For instance, last year the government made items of civil aerospace and homeland security eligible for offsets. Most of these do not require an IL and are also allowed on the automatic route for 100% FDI. Despite the position taken by the MoD, it is not clear how they will be treated.
- It can take four to six months to obtain an IL and there is no certainty that an approval will be granted even after the delay. Most private investors find it challenging to invest money and resources in such an uncertain environment.



The FDI policy

In 2001, the Indian government opened up the defence sector to private participation, permitting Indian firms to invest up to 100% and foreign companies up to 26% in the sector.

Under the prevailing FDI policy, foreign investment is allowed up to 26% in the defence manufacturing sector under the approval route subject to provisions of industrial licensing under the Act. The licence under the Act is provided to manufacture arms, ammunitions and allied items of defence equipment as well as parts and accessories. The FIPB approval and licence is granted in consultation with the MoD.

Following are the key issues faced by companies under this policy:

- There is no definition of a 'defence industry' under the Policy. The policy states that the FDI in manufacturing for the defence industry is subject to 26% cap under the government route. However, the term 'defence industry' or 'defence equipment' is not defined under the policy.
- The cap of 26% has deterred the inflow of FDI. OEMs are not keen to invest and share critical technology in a JV where they have only 26% stake with no significant control over their intellectual property, strict capacity and product constraints, no purchase guarantees, no open access to other markets (including exports) and a perceived unfair advantage to the public sector.
- The policy stipulates that an Indian defence company has to be owned and controlled by resident Indian citizens or companies. For this, the equity held by the largest Indian shareholder will have to be at least 51%. In case of multiple Indian shareholders, they have to enter into a legally binding agreement to act as a single unit in managing the matters of a JV company. This is a significant concern for a widely-held public limited company whose shareholding is liberally dispersed and changes frequently.
- There is no cap on the time taken by the Foreign Investment Promotion Board (FIPB) to convey its decision to the foreign investor. In the past, it has taken four to six months to convey its decision. Combined with the time taken for an IL, the total time before the start-up can extend to 10 to 12 months. This is clearly an area that needs improvement.

The Export and Import Policy

The Directorate General of Foreign Trade (DGFT) is the authority that regulates India's export policy. Under the Foreign Trade Policy (FTP), export of defence equipment falls under the restrictive Special Chemicals, Organisms, Materials, Equipment and Technologies (SCOMET) list and requires an export licence. Similarly, an import licence is required from the DGFT to import restricted items covered under the FTP. The licence is granted for specific defence items and comes with a fixed tenure.

Following are the key issues faced by companies under this policy:

- The policy does not provide any clarity on whether an export or import licence will be required for a 'dual use' item. This is a major concern not only for the foreign investor but also for the Indian private industry.
- The time lag for obtaining an import or export licence varies between three-to-five months depending on the nature of the equipment. Further, there is no certainty that the licence will be forthcoming even after such a long wait.
- The approval is granted for export of certain equipment to an identified buyer based out of a 'friendly country'. This list has not been published.
- An end-user certificate is mandatory for obtaining such a licence. It is a major cause of concern for Indian defence industry as an approval has to be obtained each time one proposes to export or import defence equipment from a particular buyer or supplier or from a different country. It creates uncertainty and causes delay.

Tax regime

The ultimate objective of the government should be to facilitate the creation of an A&D value chain in India that is part of a global supply chain. For this, it is important to have a level playing field for all players. In this context, the tax policy, particularly the indirect tax regime, plays a critical role.

The following three scenarios (two of procurement and one of implementing offsets) depict how indirect taxes can render domestic manufacturers uncompetitive. Recommendations for each issue are also present.

Buy global: The Indian private sector vis-à-vis foreign OEMs

Foreign OEMs are able to minimise the input cost on account of export benefits available in foreign countries. However, input taxes are added and loaded on bids for the domestic private sector as there are no exemptions to the sub-contractors.

Particulars	Private sector	Foreign OEM
Input transaction taxes	Added to the bid price as no exemption available	Likely refundable or exempt as finished goods are exported
Recommendation	Grant full exemption to sub-contractors and contractors State level taxes (e.g., VAT, Entry Taxes, etc.), if not exempted, should be refunded by MoD on actual.	-

Buy Indian: The Indian private sector vis-à-vis DPSU

Contrary to the above situation, the sub-contractors for the Defence Public Sector Undertaking (DPSU) are entitled to customs duty exemption. Similarly, excise duty exemption is claimed in terms of customs and excise duty certification issued by the DPSUs. However, the excise duty exemptions claimed by sub-contractors are being disputed by the authorities on the basis that notifications do not specify sub-contractor as in customs regulations.

Particulars	Private sector	DPSU
Input transaction taxes	Added to the bid price as no exemption available	Exempt
Recommendation	Grant full exemption to sub-contractors and contractors. State level taxes (e.g., VAT, Entry Taxes, etc.), if not exempted, should be refunded by MoD on actual.	Clarify that sub-contractors are eligible for excise duty exemption (as available in customs law). State level taxes (e.g., VAT, Entry Taxes, etc.), if not exempted, should be refunded by MoD on actual.

Offset: Sourcing from India vis-à-vis manufacturing in India

The present tax and duty structure treatment of offsets, limits offsets to supply of parts and systems by Indian industry to OEMs by way of physical exports and thus misses out on system integration / manufacture within the country. As an Indian offset partner is entitled to export benefits on inputs and tax free export of goods, it becomes uneconomical to carry out system integration in India or deliver assemblies and sub-assemblies to OEMs in India.

The tax regime for the defence sector should offer a level playing field to all the suppliers in this sector.

Particulars	Sourcing from India	Manufacturing in India
Input transaction taxes	Refundable or exempt as finished goods are exported	Available as offset (credit) against output taxes
Output transaction taxes	Exempt as exports	Applicable
Recommendation	-	Grant full exemption to offset partners and its sub-contractors from taxes or duties including those at state level. In addition, waiver from compliances granted to offset partners.

Future outlook

A number of measures are needed to maximise opportunities presented by the acquisition programme and the Offset Policy for building indigenous capability in defence production. There is an urgent need to reconcile contradictions and align all relevant policies. There needs to be clarity on what a defence product is and the definition should cover the final product (not components) and have a direct link with lethality or high-end technology. Moreover, if a product or service is allowed foreign investment under the FDI Policy, it should not be disallowed or have a different cap imposed on it under the Offset Policy.

Greater transparency along with simple procedures should be introduced in the offset approval process. There is little justification in asking for a background check of the Indian offset partner by the Intelligence Bureau in a proposal for banking offsets.

Also, it is necessary to restructure the DOFA. The organisation regulating offsets should be a separate department or division under MoD but not part of department of defence, DDP or the Acquisition Wing. The staffing requirements should be such that it can carry out its responsibilities effectively. It should be headed by a special secretary or an additional secretary reporting to the defence secretary or directly to the Raksha Mantri. As this entity will support both the Acquisition Wing and the Department of Defence Production, it should be separate from both to ensure objectivity. Moreover, being outside the Acquisition Wing will allow greater access to the industry, officials in this body and will enable them to better perform their advisory and advocacy functions.

The offset approval process should be centralised in one permanent committee in DOFA, set up on the same lines as the FIPB. It should have representation not only from the various defence wings, but also from the DIPP and the Finance Ministry. Having one permanent committee will ensure that an institutional memory is built up and there is consistency in the approval process.

Defence production is a capital and technology intensive sector and requires foreign capital and technology to develop a domestic industrial base. The 26% cap on FDI has kept away both. The cap must be reconsidered. In fact, there is no reason not to allow 100% FDI. The nascent industry protection comes from high tariff barriers and investment incentives and not the other way round. Manufacturing within the country, through foreign capital, with full transfer of state-of-the-art technology is a far better option than importing the equipment from abroad.

Finally, the defence sector is like no other–it has a single buyer that invariably buys through competitive bidding and a long product development and procurement cycles. Both viability and competitiveness will be achieved if exports are allowed and encouraged. India has an excellent SEZ law that should be utilised to make the country an important hub in the global supply chain in aerospace and defence production.

Notes

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About Aerospace and Defence

PricewaterhouseCoopers (PwC) has a strong global Aerospace and Defence (A&D) practice that serves most of the leading global companies. We set up our practice in India in 2007 to assist our domestic and international clients in making the most of this exciting growth phase in the country. With deep understanding of government regulations and industry issues, PwC is a one-stop shop for clients and is competent to assist in various aspects of their businesses.

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To provide the highest possible level of service, we invest the time of our consultants in developing industry expertise. The team maintains strong yet independent relationships with the government and constantly shares knowledge with players in the industry and government.

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ASSOCHAM acknowledged as Knowledge Chamber of India has emerged as a forceful, pro-active, effective and forward looking institution playing its role as a catalyst between the Government and Industry. ASSOCHAM established in 1920 and has been successful in influencing the Government in shaping India's economic, trade, fiscal and social policies which will be of benefit to the trade and industry.

ASSOCHAM renders its services to over 4,00,000 members which includes multinational companies, India's top corporate, medium and small scale units and Associations representing all the sectors of Industry. ASSOCHAM is also known as a Chamber of Chambers representing the interest of more than 400 Chambers & Trade Associations from all over India encompassing all sectors.

ASSOCHAM has over 100 National Councils covering the entire gamut of economic activities in India. It has been especially acknowledged as a significant voice of Indian industry in the field of Corporate Social Responsibility, Environment & Safety, Corporate Governance, Information Technology, Agriculture, Nanotechnology, Biotechnology, Pharmaceuticals, Telecom, Banking & Finance, Company Law, Corporate Finance, Economic and International Affairs, Tourism, Civil Aviation, Infrastructure, Energy & Power, Education, Legal Reforms, Real Estate, Rural Development, etc. The Chamber has its international offices in China, Sharjah, Moscow, UK and USA. ASSOCHAM has also signed MoU partnership with Business Chambers in more than 75 countries.

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