Investing in India’s Defence Sector

- India is currently the **second largest arms importer** globally.
- India’s defence budget rising from INR 58,587 crores in 2000 to **INR 4,71,378 crores** in 2020.
- India spends close to **2% of its GDP** on defence related expenditure.
- Key **countries which India relies upon for imports** include Russia (56%), Israel (14%), and France (12%) with imports from US falling recently but expected to pick up.
Recent Policy Changes to boost Self-reliance and Make-in-India initiative

Over the past few years, the Government has taken numerous steps in order to increase private sector participation and to boost the defence sector, some of which include:

**Draft DAP 2020**

The Draft Defence Acquisition Procedure ("DAP") 2020 which governs capital procurement of defence equipment in India and heavily focuses on indigenisation and introduces new categories of procurement such as Buy Global (Manufacture in India), Buy (Leasing) and Make III.

**Foreign Direct Investment**

While the present policy allows FDI upto 49% under the automatic route, a recent announcement made by the Finance Minister alludes to an increase in FDI to 74% under the automatic route. Official notification of this change in FDI Policy is still awaited.

**Doing away with Offsets**

The Draft DAP 2020 also envisions doing away with offsets in cases progressed through Inter-Governmental Agreements such as Foreign Military Sales, India-Russia Intergovernmental Commission etc.

**Offset Guidelines made flexible**

Offset guidelines have been made flexible by allowing change of Indian Offset Partners (IOPs) and offset components, even in signed contracts. Foreign OEMs are now not required to indicate the details of IOPs and products at the time of signing of contracts. ‘Services’ as an avenue of offset discharge have also been re-instated.

**Licensing regime liberalized**

Industrial licensing regime for Indian manufacturers in Defence sector has been liberalized. The total number of defence licences issued has more than doubled from 215 as on March 31, 2014 to 460 on December 31, 2019, covering a total of 275 Companies.²

Government has notified the Strategic Partnership (SP) Model

Government has notified the ‘Strategic Partnership (SP)’ Model which envisages establishment of long-term strategic partnerships with Indian entities through a transparent and competitive process, wherein they would tie up with foreign OEMs to seek technology transfers to set up domestic manufacturing infrastructure and supply chains.

Defence Industrial Corridors

Government has decided to establish two defence industrial corridors across several cities, to serve as engines of economic development and growth of defence industrial base in the country, which ensures a mature manufacturing ecosystem for investments and innovation in India.

Testing facilities made available to private sector

The Testing facilities/infrastructure available with the various Government agencies have been made available to private sector with the objective of assisting them in design and development of defence systems.

Technology Development Fund (TDF)

Government has set up the TDF to encourage participation of public/private industries especially MSMEs, through provision of grants, so as to create an eco-system for enhancing cutting edge technology capability for defence applications.
Categories of Capital Procurement

The acquisition of capital defence equipment in India is governed by the Defence Procurement Procedure (DPP), a document published by the Ministry of Defence (MoD) and revised every few years. Presently DPP 2016 is in force, however, a new re-christened Defence Acquisition Procedure (DAP) in draft version had been released for public comments recently and is likely to formally notified and effective from 1st September 2020.

The DPP lists out the various categories of procurements by Ministry of Defence and a quick comparison with the new Draft DAP is set out below –

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
<th>Eligible Tender Participant</th>
<th>Indigenous Content (IC) requirement in DPP 2016 (presently in force)</th>
<th>IC requirement Proposed in Draft DAP 2020 (yet to be notified)</th>
<th>Remarks</th>
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<tbody>
<tr>
<td>Buy (Indian - IDDM)</td>
<td>Procurement of products from an Indian vendor meeting one of the two conditions: products that have been indigenously designed, developed and manufactured with a minimum of 40% Indigenous Content (IC) on cost basis of the total contract value; Or products having 60% IC on cost basis of the total contract value, which may not have been designed and developed indigenously</td>
<td>Indian Vendor</td>
<td>Minimum 40%</td>
<td>Minimum 50%</td>
<td></td>
</tr>
<tr>
<td>Buy (Indian)</td>
<td>Procurement of products from an Indian vendor having a minimum of 40% IC on cost basis of the total contract value</td>
<td>Indian vendor</td>
<td>Minimum 40%</td>
<td></td>
<td></td>
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<tr>
<td>Buy &amp; Make (Indian)</td>
<td>Initial procurement of equipment in Fully Formed (FF) state in quantities as considered necessary, from an Indian vendor engaged in a tie-up with a foreign OEM, followed by indigenous production in a phased manner involving Transfer of Technology of critical technologies as per specified range, depth and scope from the foreign OEM.</td>
<td>Indian vendor engaged in a tie-up with a foreign OEM</td>
<td>Minimum of 50% IC is required on cost basis of the Make portion of the contract</td>
<td>Minimum of 50% IC is required on cost basis of the Make portion of the contract</td>
<td>Minimum of 50% IC on cost basis for the ‘Make’ portion of acquisitions under ‘Buy and Make’ category. In Buy and Make cases where the vendor achieves minimum 30% IC as per cost of base contract value of the entire procurement i.e. Buy plus Make, such vendor will not require to discharge offsets. In case the vendor</td>
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### Category Description

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<td>Buy (Global – Manufacture in India)</td>
<td>Outright purchase of equipment from foreign vendors, in quantities as considered necessary, with a minimum of 50% Indigenous Content (IC) on cost basis of the total contract value which can be achieved in the manufacturing of either the entire equipment or spares/assemblies/sub-assemblies/Maintenance, Repair and Overhaul (MRO) facility for the entire life cycle support of the equipment, through its subsidiary in India.</td>
<td>Foreign OEM, with subsidiary in India</td>
<td>–</td>
<td>Minimum of 50% IC on cost basis of the base contract price</td>
<td>Achieves only partial IC requirement i.e. less than the 30%, offset waiver will not be applicable.</td>
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<tr>
<td>Buy (Global)</td>
<td>Outright purchase of equipment from foreign or Indian vendors. In case of procurement through foreign vendors, Government to Government route/Inter Government Agreement may also be adopted, for equipment meeting strategic/long term requirements.</td>
<td>Foreign OEM or Indian vendors</td>
<td>–</td>
<td>Minimum 30% IC for Indian Vendors</td>
<td>New category of procurement introduced in the Draft DPP 2020</td>
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<td>Make I</td>
<td>Projects involving design and development of equipment, systems, major platforms or upgrades thereof by the industry</td>
<td>Indian vendor</td>
<td>To be designed, developed and manufactured by an Indian vendor</td>
<td>–</td>
<td>As per Draft DPP 2020, MoD will provide fund support maximum up to 70% of the prototype development cost or a maximum 250 crores per Development Agency.</td>
</tr>
<tr>
<td>Make II</td>
<td>Projects under Make-II category will include prototype development of equipment/system/platform or their upgrades or their sub-systems/subassembly/assemblies/components/materials/ammunition/software, primarily for import substitution/innovative solutions by the Private industry, for which no Government funding will be provided</td>
<td>Indian vendor</td>
<td>To be designed, developed and manufactured by an Indian vendor</td>
<td>–</td>
<td>In Make-II cases, where innovative solutions have been offered even by a single individual or a firm, the cases would be progressed as a Resultant Single Vendor.</td>
</tr>
<tr>
<td>Make III</td>
<td>Includes subsystems/sub-assembly/assemblies/components/materials/ammunition, etc, which although not designed/developed indigenously, can be manufactured in</td>
<td>Indian vendor may manufacture these either in</td>
<td>To be designed, developed and</td>
<td>–</td>
<td>New category introduced in the Draft DPP 2020</td>
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Leasing provides means to possess and operate the asset without owning the asset and is useful to substitute huge initial capital outlays with periodical rental payments. Leasing would be permitted in two sub categories i.e. Lease (Indian), where Lessor is an Indian entity and is the owner of the asset, and Lease (Global).

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<td>Buy (leasing)</td>
<td>Leasing provides means to possess and operate the asset without owning the asset and is useful to substitute huge initial capital outlays with periodical rental payments. Leasing would be permitted in two sub categories i.e. Lease (Indian), where Lessor is an Indian entity and is the owner of the asset, and Lease (Global).</td>
<td>Foreign OEM or Indian vendor</td>
<td>—</td>
<td>—</td>
<td>New category introduced in Draft DPP 2020, Cases where lease of equipment may be preferred are:- (a) Where procurement is not feasible due to time constraint. (b) Where the asset/capability is needed for a specific time or would be underutilized if procured. (c) Where smaller numbers of assets are needed and administrative/maintenance infrastructure expenditure would be high. (d) When service life lease rentals are a better option compared to a one-time acquisition cost. (e) To gain experience for operational exploitation of equipment. (f) Due to operational necessity.</td>
</tr>
</tbody>
</table>
Key Compliance Requirements for an Investor specific to the Sector

01 Foreign Direct Investment
As per the current policy, Foreign Direct Investment Cap is 100% with FDI up to 49% being allowed through automatic route and above 49% under government route wherever it is likely to result in access to modern technology or for other reasons to be recorded. However earlier in May 2020 this year, as part of Economic Stimulus Package, India’s Finance Minister has announced an increase in FDI upto 74% under automatic route. A formal notification to that effect is awaited.

02 Arms Act 1959 (Arms Act)
The Department of Industrial Policy and Promotion (DIPP (now DPIIT)) has vide Press Note No. 1 (2019 Series) announced that the following defence items would require a license as under Section 51 of the Arms Rules 2016, namely:

- Tanks and other armoured fighting vehicles
- Arms and ammunition and allied items of defense equipment; other than small arms of caliber 12.7mm and above as defined under clause (51) of sub-rule (1) of rule 2 of the Arms Rules, 2016

A license for the manufacture, proof test or transfer of all categories of Arms & Ammunition under Schedule I of the Arms Rules, 2016 would be required in accordance with Section 5 of the Arms Act.

03 Industries (Development & Regulation) Act, 1951 (IDR)
The DIPP vide Press Note 1 (2019 Series) has also provided list of Defence items finalised by the MoD that would require a license under the IDR Act, namely:

- Defence Aircrafts
- Warships of all kinds
- Allied items of defence equipment such as electronic, jamming, radio equipment etc.

04 Export Control - SCOMET
In India’s Foreign Trade Policy, dual-use items have been given the nomenclature of Special Chemicals, Organisms, Materials, Equipment and Technologies (SCOMET). Export of SCOMET items in India are only permitted against an export authorisation issued by the concerned department or ministry. Category 6 of the SCOMET list contains the list of munitions items eligible for export and the licensing authority for the same is the MoD. As per the Standard Operating Procedure issued by the DDP, any company interested in exporting a Munitions List item shall file an online application at www.ddpmod.gov.in
Future of India’s Defence Industry

From one of the world’s biggest importer of defence hardware and equipment, India is slowly emerging as an exporter now and India’s defence exports have increased in the last four years by more than 5.5 times mainly due to the country’s emphasis on ‘Make in India’, with India now exporting to about 42 countries worldwide including the US, Australia, Finland, France, Germany, Israel, South Africa and Sweden.

According to the Ministry of Defence’s Department of Defence Production dashboard, India’s export of military equipment increased from INR 1521.86 crores (~USD 200Mn) in FY 2016-17, to INR 8620.59 crores (~USD 1.1Bn) in the last fiscal 2019-20. In lieu of India’s ever-improving defence sector, the Prime Minister has announced a target of exporting USD 5 billion worth of military hardware which is about INR 35,000 crore.9

The Indian Government has also announced plans to spend USD 130 bn on military modernization in the next 5 years. At the same time, in order to meet it’s stated objective of achieving self-reliance in the sector, Government has consistently been opening up the Defence industry for private sector participation to provide impetus to indigenous manufacturing. This also paves the way for foreign original equipment manufacturers (OEMs) to enter into strategic partnerships with Indian companies, as against in the older days, when such tie-ups were only encouraged with Public Sector Undertakings (PSUs).

8 https://zeenews.india.com/india/indias-defence-exports-rise-over-5-times-in-last-4-years-2277804.html