

# INVESTING IN INDIA'S DEFENCE SECTOR

## India's Defence Sector – An Overview

India is currently the second largest arms importer globally after Saudi Arabia<sup>1</sup>, and spends close to 2% of its GDP on defence related expenditure, with its defence budget rising from INR 58,587 crores in 2000 to INR 471,378 crores in 2020.

The Indian Government has announced plans to spend INR 130 bn on military modernization in the next 5 years. While India continues to rely heavily on foreign exports, with its main suppliers of defence equipment being Russia (56%), Israel (14%), and France (12%)<sup>2</sup>, major reforms have been announced in recent times to boost domestic purchases.

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**).

## Recent Policy Changes to boost Self-reliance and Make-in-India Initiative

Over the past few years, the Government has taken numerous steps to increase private sector participation and to boost the defence sector, some of which include<sup>3</sup>:

- A new category of procurement has been introduced in DPP-2016 to promote indigenous design and development of defence equipment. It has been accorded the highest priority for procurement of capital equipment. Besides this, preference has been accorded to 'Buy [Indian-IDDM (Indigenously Designed, Developed and Manufactured)', 'Buy (Indian)', 'Buy and Make (Indian)' & 'Make' categories of capital acquisition over 'Buy (Global)' & 'Buy & Make (Global)' categories. In effect, ensuring where Indian products are available, Ministry of Defence (**MoD**) only buys from Indian vendors and not foreign OEMs. As a result of the aforesaid initiatives, the Government in the last three years i.e. from 2016-17 to 2018-19 and current year till December, 2019, has accorded Acceptance of Necessity (**AoN**) to 138 proposals worth INR 2,69,465.26 crore approximately, under these categories of Capital Procurement which promote domestic manufacturing as per DPP-2016.<sup>4</sup>
- Industrial licensing regime for Indian manufacturers in Defence sector has been liberalized. Defence Products list requiring Industrial Licences has been rationalized and manufacture of most of the parts and components does not require Industrial Licence. 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.<sup>5</sup>
- In a significant move, FDI Policy has been revised and revised FDI permissible under automatic route up to 74% (earlier limit was 49%).
- 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.

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<sup>1</sup>[https://www.sipri.org/sites/default/files/2020-03/fs\\_2003\\_at\\_2019.pdf](https://www.sipri.org/sites/default/files/2020-03/fs_2003_at_2019.pdf)

<sup>2</sup> *Ibid*

<sup>3</sup> <https://pib.gov.in/Pressreleaseshare.aspx?PRID=1579736>

<sup>4</sup> <https://pib.gov.in/newsite/PrintRelease.aspx?relid=200276>

<sup>5</sup> <https://pib.gov.in/PressReleaseDetail.aspx?PRID=1606539>

- Separate procedure for ‘Make-II’ sub-category has been notified wherein a number of industry friendly provisions such as relaxation of eligibility criterion, minimal documentation, provision for considering proposals suggested by industry/individual etc., have been introduced. Till date, 36 proposals for development by industry have been given ‘In-principle’ approval under Make-II.
- Government has decided to establish two defence industrial corridors 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. These corridors are spanning across Chennai, Hosur, Coimbatore, Salem and Tiruchirappalli in Tamil Nadu and across Aligarh, Agra, Jhansi, Chitrakoot, Kanpur and Lucknow in Uttar Pradesh.
- An innovation ecosystem for Defence titled Innovations for Defence Excellence (**iDEX**) has been launched in April 2018. iDEX is aimed at creation of an ecosystem to foster innovation and technology development in Defence and Aerospace by engaging Industries including MSMEs, Start-ups, Individual Innovators, R&D institutes and Academia and provide them grants/funding and other support to carry out R&D which has potential for future adoption for Indian defence and aerospace needs.
- The Ministry has instituted a new framework titled ‘Mission Raksha Gyan Shakti’ which aims to provide boost to the IPR culture in indigenous defence industry.
- 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.
- Government has notified a Policy for indigenization of components and spares used in Defence Platforms in March 2019 with the objective to create an industry ecosystem which is able to indigenize the imported components (including alloys & special materials) and sub-assemblies for defence equipment and platforms manufactured in India.
- The process for export clearance has been streamlined and made transparent & online. A Defence export strategy has been formulated with a view of facilitating Defence Public Sector Enterprises (**DPSUs**) and private defence players in exploring business opportunities abroad.
- Government has set up the Technology Development Fund (**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.

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.

## Investing in India’s Defence Sector

### 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 MoD and revised every few years. Presently DPP 2016 is in force, however, a new DPP 2020 in draft version has been released for public comments and is likely to be notified soon.

The DPP lists out the various categories of procurement applicable to foreign vendors, which are:

Category	Description	Eligible Tender Participant	Indigenous Content (IC) requirement in DPP 2016 (presently in force)	IC requirement Proposed in Draft DPP 2020 (yet to be notified)	Remarks
Buy (Indian - IDDM)	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	Indian Vendor	Minimum 40%	Minimum 50%	
Buy (Indian)	Procurement of products from an Indian vendor having a minimum of 40% IC on cost basis of the total contract value	Indian vendor	Minimum 40%	Indigenous design – 40% Otherwise, Minimum 60%	
Buy & Make (Indian)	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.	Indian vendor with a foreign OEM tie-up	Minimum of 50% IC is required on cost basis of the Make portion of the contract	Minimum of 50% IC is required on cost basis of the Make portion of the contract	
Buy (Global – Manufacture in India)	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.	Foreign OEM, with subsidiary in India	-	Minimum of 50% IC on cost basis of the total contract value	New category of procurement introduced in the Draft DPP 2020

Buy (Global)	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.	Foreign OEM or Indian vendors	-	Minimum 30% IC for Indian Vendors	IC requirement introduced in Draft DPP 2020
Make I	Projects involving design and development of equipment, systems, major platforms or upgrades thereof by the industry	Indian vendor	To be designed, developed and manufactured by an Indian vendor	-	As per Draft DPP 2020, for Projects under Make-I sub-category, MoD will provide fund support maximum up to 70% of the prototype development cost, based on viability gap funding method.
Make II	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	Indian vendor	To be designed, developed and manufactured by an Indian vendor	-	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.
Make III	Includessubsystems/sub-assembly/assemblies/components/materials/ammunition, etc, which although not designed/developed indigenously, but are being manufactured in India as import substitution for product support of weapon systems/equipment held in the inventory of the Services.	Indian vendor may manufacture these either in collaboration or with ToT from foreign OEMs.	To be designed, developed and manufactured by an Indian vendor	-	New category introduced in the Draft DPP 2020

<p>Buy (leasing)</p>	<p>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).</p>	<p>Foreign OEM or Indian vendor</p>	<p>-</p>	<p>-</p>	<p>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 under-utilized 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.</p>
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## Key Compliance Requirements for an Investor specific to the Sector

### Foreign Direct Investment

In India, the Foreign Direct Investment Cap is 100%. Foreign Direct Investment (**FDI**) up to 74% is now 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. The Defence Industry shall be subject to Industrial License under the Industries (Development & Regulation) Act, 1951 and manufacture of small arms and ammunition under the Arms Act, 1959.

In a bid to boost the economy as a result of the ongoing Covid-19 pandemic, the Finance Minister announced that the Foreign Direct Investment (**FDI**) in the defence sector under the automatic route would be raised from the previously prevailing 49% to 74%. This move is viewed as a major step towards encouraging foreign OEM participation in India's defence sector, with the total FDI attracted in defence industries from April 2000 to March 2020 amounting to only USD 9.5 million.

This will plug the gap of knowledge transfer between foreign technology holders and Indian manufacturers. Foreign OEMs will duly see this is an incentive to Make-in-India for their global programs, spurring India into a likely candidate to be actively in their global supply chains by establishing manufacturing facilities in India through either FDI, Joint Ventures or the defence offset route. This move will particularly benefit the MSMEs which will find investment and flow of technology coming in at a faster pace and lower cost.

### Arms Act 1959 (Arms Act)

The Department of Industrial Policy and Promotion (**DIPP**) has vide Press Note No. 1 (2019 Series)<sup>6</sup> announced that the following defence items would require a license as under Section 51 of the Arms Rules 2016<sup>7</sup>, namely:

- Tanks and other armored 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

As per Section 53 of the Arms Rules, every manufacturer applying for a fresh licence under these rules shall be an Indian company incorporated under the Companies Act, 2013, provided that the applicant company is owned and controlled by resident Indian citizens or by Indian companies, owned and controlled by resident Indian citizens except in respect of a company having FDI beyond forty-nine percent. It is also provided that the Chief Executive of the company is a resident Indian and the management of the applicant company is in Indian hands with majority representation on the Board excluding nominee or independent directors except in respect of a company having FDI beyond forty nine percent.

As per section 54 of the Arms Rules, 2016, the license granted in Form VII shall be initially valid for a period of seven years within which the licensee shall be required to setup the facility for manufacture or proof test of arms and/or ammunition, recruit technical and administrative staff, develop and proof test proto-types of arms and ammunition, conduct trial runs and any other activity related to the setting up of the facility for the manufacture or proof-test of arms and ammunition, failing which the license shall lapse. Every subsequent renewal of the license under this rule shall be granted for a period of five years.

The licensee shall also preferably be self-sufficient in areas of product design and development and have maintenance and life cycle support facility of the product to be manufactured and the items to be

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<sup>6</sup> <https://dipp.gov.in/sites/default/files/PressNote12019.pdf>

<sup>7</sup> [https://dipp.gov.in/sites/default/files/Notification\\_ArmsRule\\_26May2017\\_3.pdf](https://dipp.gov.in/sites/default/files/Notification_ArmsRule_26May2017_3.pdf)

manufactured shall meet the International or Indian accredited quality standards and norms with special emphasis on indigenous designing.

#### ▪ **Industries (Development & Regulation) Act, 1951 (IDR)**

The DIPP vide Press Note 1 (2019 Series)<sup>8</sup> has also provided list of Defence items finalized 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.

As per Rule 7 of the Registration and Licensing of Industrial Undertakings Rules, 1952 (**RLIU**), an application for a license or permission for the establishment of a new industrial undertaking or the production or manufacture of any new article in an industrial undertaking must be made before taking any of the following steps:

- Raising from the public any part of the capital required for the undertaking or expansion (or the production or manufacture of the new article).
- Commencing the construction of any part of the factory building for the undertaking or expansion (or the production or manufacture of the new article).
- Placing order for any part of the plant and machinery required for the undertaking or expansion (or the production or manufacture of the new article).

Every such application must be made to the DIPP in accordance with the IDR Act. As per section 11 of the IDR Act, the license or permission under sub-section may contain such conditions, including, in particular, conditions as to the location of the undertaking and the minimum standards in respect of size to be provided therein as the Central Government may deem fit to impose.

#### ▪ **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**)<sup>9</sup>. Export of SCOMET items in India are only permitted against an export authorization 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<sup>10</sup>, any company interested in exporting a Munitions List item shall file an online application at [www.ddpmod.gov.in](http://www.ddpmod.gov.in) While filing such application, the exporter is required to provide:

- A brief write-up on their letter head regarding the intent of the application and relevant classification under the SCOMET Category 6;

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<sup>8</sup> <https://dipp.gov.in/sites/default/files/PressNote12019.pdf>

<sup>9</sup> <https://dgft.gov.in/sites/default/files/append3.pdf>

<sup>10</sup> [https://ddpmod.gov.in/sites/default/files/New%20SOP0001\\_2.pdf](https://ddpmod.gov.in/sites/default/files/New%20SOP0001_2.pdf)

- Copy of the Purchase Order/Supply Order/relevant documents like participation in Tender Enquiry/RFI/ Exhibition/Testing & Evaluation, as the case may be;
- Technical specification of the items intended to be exported; and
- End User Certificate signed and stamped by the appropriate authority.

### Licensing Regime in India

Manufacturing in defence sector is governed through industrial licensing under the Industries (Development and Regulation) Act, 1951 and Arms Act 1959/Arm Rules 2016. Prior to 2001, manufacturing in defence sector was limited to public sector companies only. The Industrial Licence applications received by the Ministry of Defence are examined by a Standing Committee on Private Sector Participation in Defence Production and comments are then accordingly sent to the licensing authorities. The licensees are required to follow the Security Manual notified by the Department<sup>11</sup> based on the product being manufactured and their categorization for which an industrial license is granted to a company.

As per Press Note 1 (2019 Series)<sup>12</sup>, the following Defence Products would require a license under the Industrial (Development and Regulation) Act, 1951 and the Arms Act, 1959:

IDR Act,  
1951

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

Arms Act,  
1959

- 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

### 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 has seen a growth of over five times in its order books in the last four years. According to the Ministry of

<sup>11</sup> <https://www.makeinindiadefence.gov.in/admin/writereaddata/upload/files/1403158012.pdf>

<sup>12</sup> [https://www.makeinindiadefence.gov.in/admin/writereaddata/upload/files/Press%20Note\\_1\\_2019.pdf](https://www.makeinindiadefence.gov.in/admin/writereaddata/upload/files/Press%20Note_1_2019.pdf)



Defence's Department of Defence Production dashboard, India's export of military equipment increased from INR 1521.86 crore in Financial Year 2016-17 to INR 8,620.59 crore in the last fiscal 2019-20.<sup>13</sup>

India's defence exports have increased in the last four years by more than 5-and-half 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. 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.<sup>14</sup>

With a view to revive the economy, Hon'ble FM as part of the Economy Stimulus Package<sup>15</sup> announced a number of reforms to the defence sector that addressed the long-standing need and desire of boosting domestic procurement in the country in a timely manner. Firstly, with a view to promulgate its much heralded 'Make-in-India' policy, the Government has now begun to limit the number of weapons and weapons systems that would be eligible for import. This would serve to progressively reduce dependence on foreign manufacturers and indigenously develop comprehensive capabilities in the defence sector. While essential weapons not produced here will be sourced from abroad, a negative list will be generated yearly and notified for which all imports that meet the required standards of the Armed Forces, will be banned. This list will be generated by the Ministry of Defence and will have year wise timelines to reduce import dependency. With this announcement, the ball is now in the Indian Industry's court to create the necessary products and platforms meeting the requirements.

The Finance Minister also announced the creation of a separate budget for domestic capital procurement. The defence capital budget in recent years has often being criticized for not providing sufficient budget for new acquisitions and more importantly for domestic new acquisitions. This announcement addresses this major consideration to incentivize Indian Industry to kick-start investments into the sector to build capability and capacity.

This initiative of indigenization is supplemented by major reform of increasing FDI limit in defence from the present 49% to 74% under automatic route. Thus, Foreign OEMs can now look to set up manufacturing hubs/joint ventures in India, without worrying about their confidential information and technology being controlled by its Indian partner. This was the major roadblock for entry of foreign OEMs into the Indian market and the same has now been removed by the Government, finally recognizing and understanding the need of the hour. India is primed and ready for a surge in investment into its Defence Industry, with the door now open for both domestic and foreign investors.

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<sup>13</sup> <https://zeenews.india.com/india/indias-defence-exports-rise-over-5-times-in-last-4-years-2277804.html>

<sup>14</sup> <https://www.livemint.com/industry/manufacturing/india-now-exports-defence-products-to-42-countries-11581332398457.html>

<sup>15</sup> <https://www.ndtv.com/india-news/nirmala-sitharamans-day-4-break-up-of-economic-package-highlights-2229888>



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