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India and U.K. in defence

A 'new special relationship'

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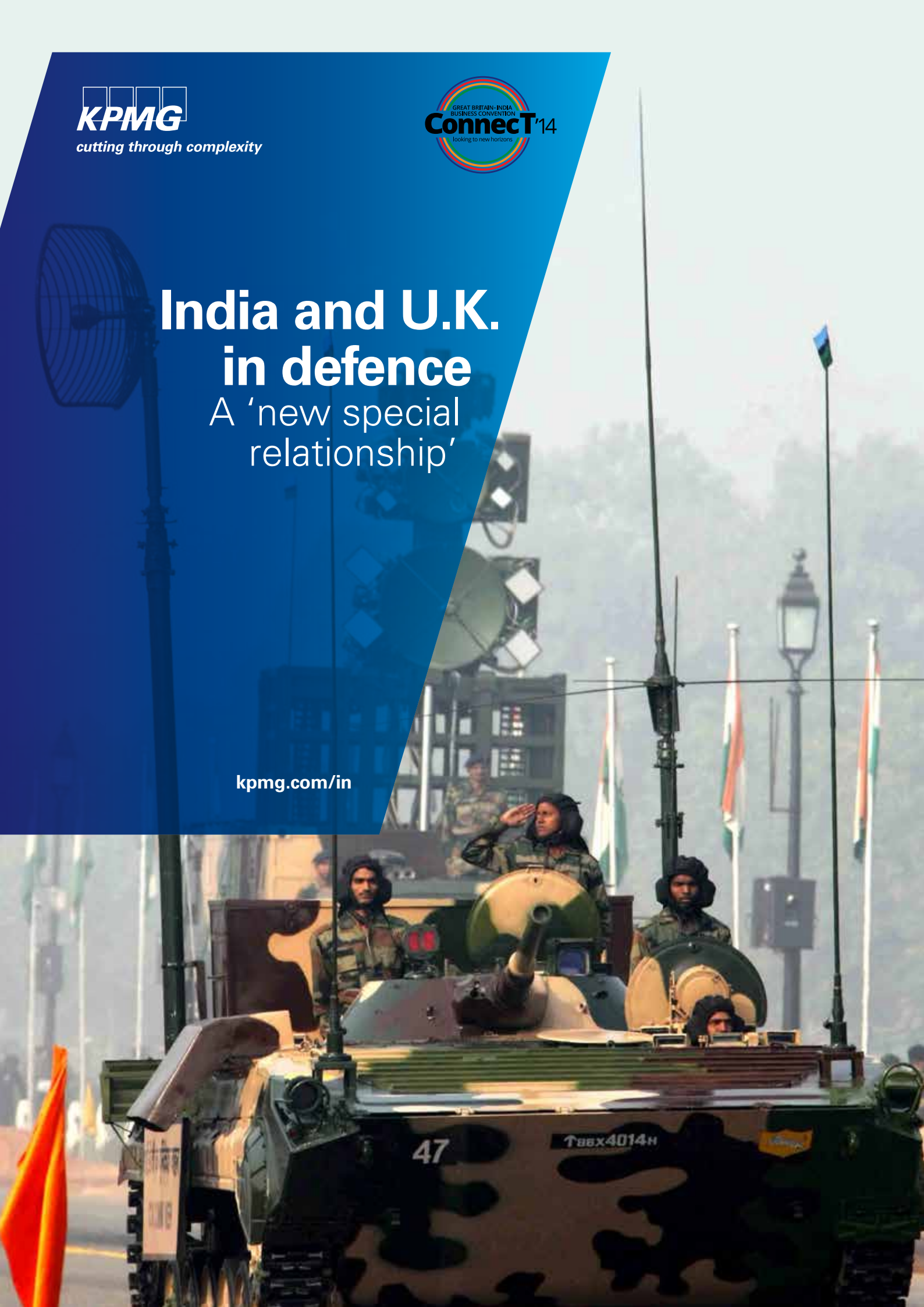


A new India is emerging

India has the world's third largest military force and is the ninth highest defence spender.[1] Nearly half of the defence equipment is approaching obsolescence and the government is heavily dependent on imports. The Government of India (GoI) has therefore made the growth of an indigenous aerospace and defence sector a high priority. Keeping this in mind, the government has liberalised the FDI limit in defence sector from 26 to 49 per cent.[2] It has also allowed Foreign Institutional Investors (FIIs), Foreign Portfolio Investors (FPIs), and venture capital firms to invest upto 24 per cent in defence companies which hitherto was not allowed at all.

U.K. is among the leading countries supplying defence equipment to India. The coming decade therefore can provide a significant opportunity to strengthen the U.K.-India relationship further, for mutual benefit.

Keeping with the decisive mandate from the electorate, the new government has ambitious plans to improve India's standing within the global aerospace and defence supply chain. More than USD250 billion worth of equipment is expected to be procured over the next decade, both for the armed forces and the para-military forces.[3]

Given the ample presence of engineers, scientists, and low-cost skilled manpower in India, expectations are that Indian companies will play a key role across the defence value chain including in research, design, development, manufacturing, maintenance, quality control, and training.

By the end of 2014 we expect to see the government approve long-awaited capital acquisitions programmes – for fighter jets, artillery guns, helicopters, submarines, amphibian planes, etc. The government recently removed 60 per cent items from the list of defence equipment that require a mandatory industrial license. Licenses are now required only for arms and ammunitions; defence aircrafts and spacecrafts; tanks and other armoured fighting vehicles; and warship equipment.[4]

The GoI also allowed the Indian ownership of 51 per cent equity to be split among many Indian companies – which means that a foreign OEM with 49 per cent equity could actually be the single largest shareholder. Earlier, the largest shareholder had to be an Indian company with at least 51 per cent equity share.[5]

These programmes, along with business-friendly reforms have the potential of making India a major global defence player within the next 10 to 15 years. Defence companies from the U.K. are participants in these programmes and can play a significant role in developing India's defence capabilities.

[1] Stockholm International Peace Research Institute (SIPRI) Military Expenditure Database 2014

[2] Union Budget 2014-15, Ministry of Finance, Republic of India

[3] KPMG Global Aerospace and Defence Outlook 2014

[4] Government of India, Ministry of Commerce and Industry, DIPP, Press Note No. 3 (2014 Series)

[5] Ibid., Press Note No 7 (2014 Series)

Priority for India: A robust defence industrial base

Nearly 70 per cent of India's defence procurement is met through imports, giving it the dubious distinction of being the world's largest importer of defence equipment.[6] This sounds ironical given India's success in complex nuclear and space technologies.

The balance 30 per cent of the capital equipment is supplied by Defence Public Sector Undertakings (DPSU), the Ordnance Factory Board (OFB), and the nascent private sector. Even for these equipment, a significant number of components are imported. Despite their efforts to boost indigenous R&D, the DPSUs have not been able to keep pace with the requirements of modern day warfare.

Out of the total defence equipment held by the Indian armed forces, only 15 per cent is considered 'state of the art' and nearly 50 per cent has become obsolete.[7] This is a major deterrent to the operational capability of the armed forces.

India's northern neighbour, China has a GDP (nominal) of about USD9 trillion, over 2.3 million troops, and a military spend of over USD188 billion in 2013. China's defence budget is over four times that of India.[8] Interestingly, in 1985, China decided to shift focus and create a fighting force that can 'hit early, strike hard and fight a nuclear war'. It reduced its armed forces by 1 million in 1987, by 500,000 in 1997 and by another 200,000 in 2003.[9] Higher budgets were allocated to modernise the navy and air force as well as focus on space, cyber and non-conventional Nuclear-Biological-Chemical (NBC) warfare.

Over the years, China acquired weapons systems from Russia, including Sukhoi Su-30 aircraft, Kilo-class submarines, and Sovremenny class destroyers.[9] It also focussed on developing its indigenous defence industry that has now developed J-10 fighter aircraft, Jin class nuclear submarines, destroyers, and frigates.[10] China today has become the third largest defence exporter in the world with exports in 2013 valued at USD1.8 billion by the Stockholm International Peace Research Institute (SIPRI).

The Indian government is aware of the growing capability gap between China and India. It plans to bridge the same through imports and indigenous development for which it would need support from friendly countries that are ahead in the technology game, today.

[6] A Vibrant Indian Military Industrial Complex for Self Reliance', Vivekananda International Foundation

[7] 'Foreign Direct Investment in Defence Sector, Discussion Paper of the DIPP, May 2010

[8] Stockholm International Peace Research Institute Military Expenditure Database 2014

[9] 'The Political Economy of China's Defence Modernisation', Bhartendu Kumar Singh, Institute for Defence Studies and Analyses, Strategic Analysis, Vol. 29, No. 4, Oct-Dec 2005

[10] 'Fortifying China: The Struggle to Build a Modern Defense Economy', Tai Ming Cheung

India's restrictive policies could have harmed itself

Many of the U.K.'s defence companies are keen to enter the Indian market, given its high demand potential and availability of quality manpower, but are dissuaded by its restrictive policies and onerous defence procurement processes. It was felt in some quarters that with the increase in the FDI cap to 49 per cent global majors may hand over their critical technologies. The fact however is that handing over critical technologies to India is restricted by their home country regulations.

According to government sources, the total FDI inflow in defence between April 2000 to March 2014 amounts to a meagre USD5 million. The defence industry ranks one of the last among the 62 identified sectors where FDI has flowed in, behind components of the FMCG sector such as soaps, cosmetics, and toiletries among others.[11]

Pragmatism perhaps demands that India acknowledges its strengths and weaknesses and waits for the opportune time to seek a dominant role. The state of India's defence capabilities in terms of design, development, manufacturing, training, and maintenance of cutting-edge defence equipment is significantly lower than the best. It may be time to be receptive to new ideas and to make it easier for global players to come in and develop India as a global defence supplier over a 10 to 15 year horizon.

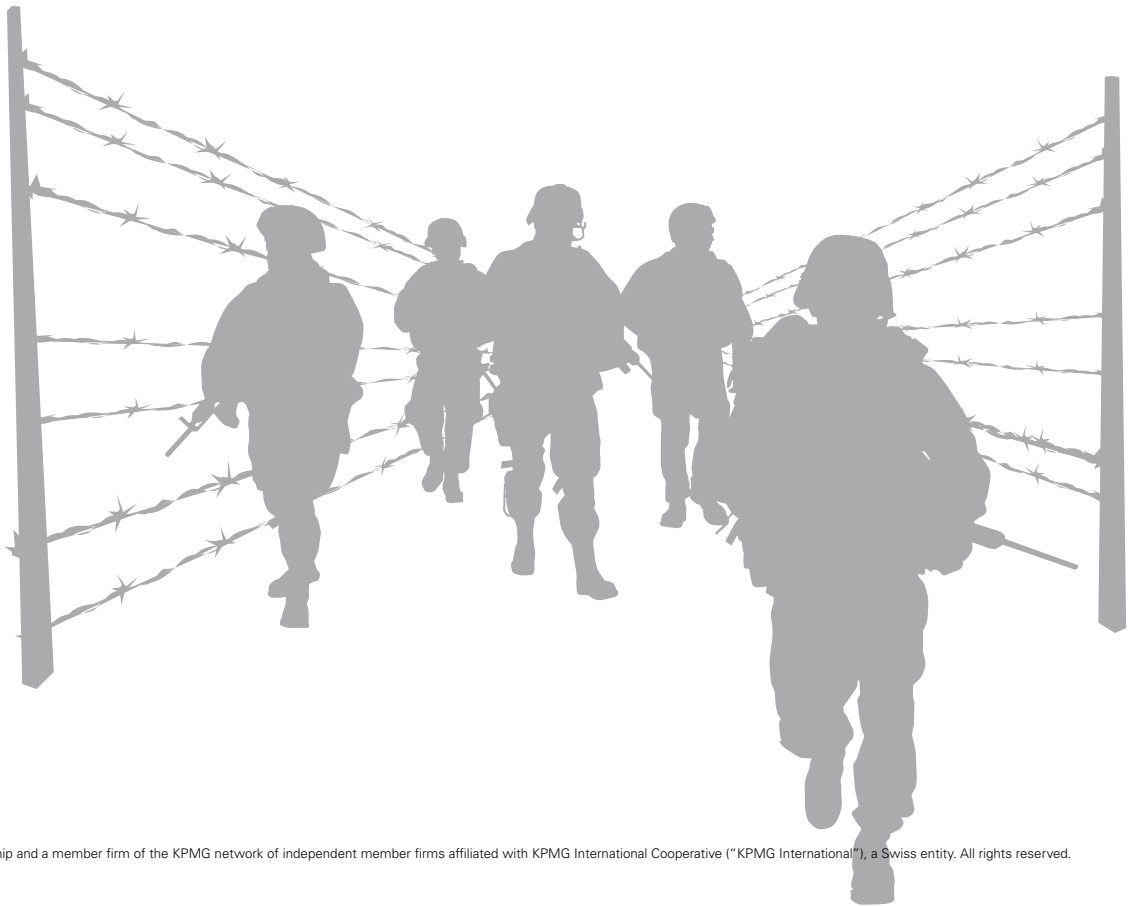
Percolation effect of defence technologies

Over a period of time, Indians working in the subsidiaries of global defence majors are expected to gain the knowledge, experience, and confidence to set-up their own entrepreneurial ventures and become part of the global supply chain. Collaboration between global majors, the Indian corporate sector, and the DPSUs is expected to lead to the spread of knowledge. A time may come when India itself may be known as a leading producer of certain defence equipment. Global leaders like U.S., U.K., Russia, France, Israel, and China have taken decades to get there.

With slowing economies in the west and increasing pressure on defence procurement budgets, global defence majors are keen to expand their presence in Asia. The continuing rise of China as the next industrial-financial-military superpower increases India's stature as a credible counter-balancing force. India needs to leverage this geo-political situation to its advantage.

Further, improvement in the FDI limit and procurement policies could promote defence manufacturing in India, leading to multiplier effects in terms of economic growth, employment generation and development of ancillary industries. Some Indians trained in cutting-edge defence technologies may move to other sectors, carrying their skills in R&D, materials science, precision manufacturing, electronics, telecom and IT. This could be considered as a better situation than India being perennially dependent on imported equipment, fearful of when the foreign supplier or its government may pull the plug.

[11] 'A Case for Increasing FDI up to 100 per cent in India's Defence Industry', Dr. Lakshman Kumar Behera, IDSA



Expectations from Government of India

Some of the key initiatives expected from the Government of India include the following:

Policy

- The government's immediate focus should be to come out with a comprehensive vision and roadmap for India's aerospace and defence sector. The vision should specify where India sees itself in the global world order 10 to 20 years down the line. It should also highlight critical defence technology areas where India should develop complete self-reliance.
- Small and Medium Enterprises (SME) form a critical part of the supply chain of countries with a strong Defence Industrial Base (DIB). The GoI needs to create a focussed action plan for encouraging the entry and growth of SMEs in India's defence sector.
- The existing version of India's Defence Procurement Procedure (DPP) is generic and does not lay down a clear roadmap on how private sector participation and foreign collaboration will be harnessed to build India's indigenous capability. The policy document needs to be revised with more specific action points.
- The Technology Perspective and Capability Roadmap (TPCR) document of the Ministry of Defence (MoD) should be made more specific to help industry and foreign participants to plan their long-term investments in the sector. It can also help in aligning the R&D initiatives of OEMs with the actual needs of the defence forces, and could provide clarity to the component manufacturers in planning their production capacity.
- The role of defence offsets as a means of developing a DIB is often limited to providing components that the Indian offset partner is anyway good at. The offset order quantity is limited to the orders placed on the global OEM by the MoD. The government should work with the industry to identify key technologies for which India can become a global production hub, and then tailor policies and procedures to support that. Companies from the U.K. can invest in these Indian companies to broad-base their supply chain, discharge offset obligations, and also to drive down their production costs.
- The current policy bottlenecks that prevents export of defence equipments manufactured in India need to be addressed. Global players may not be encouraged to set-up manufacturing facilities in India with only GoI as its customer. Using India as a global supply base for friendly countries could provide the necessary critical mass for viable operations.

Infrastructure

- India should adopt a cluster-based approach, with each aerospace and defence cluster focussing on a particular sub-system or technology area. This could help in creating a focussed ecosystem and capability building across three to four defence clusters spread around the country.
- The government should work with the global OEMs and Tier 1 suppliers to set-up Centres of Excellence and vocational training centres at the proposed clusters.

Global collaboration

- The Indian government should take a leaf out of U.S. government's Defence Advanced Research Projects Agency (DARPA) model. DARPA has roughly 200 employees about half of whom are technical experts. They work closely with the private sector, universities, government laboratories and talented individuals to come out with cutting-edge defence technologies.[12] It has no laboratories of its own as compared to the 52 laboratories of India's Defence Research and Development Organisation (DRDO.)[13]
- The Joint Strike Fighter (JSF) program is a good template for military competitive programmes. Several countries including the U.S., U.K., Canada, and other allies were involved in the program which aimed to update and replace a large variety of old aircrafts in their fleets. Two companies were shortlisted and were given USD750 million to develop prototypes of the JSF and the better one was given the manufacturing contract.[14] Indian defence programmes are more conservative and any concept development by the private sector is on the basis of NCNC (No Cost-No Commitment). This is an onerous responsibility to place on the private sector which is often ill-equipped to handle the high costs and uncertainties of India's procurement process. A joint approach and funding by the government is extremely important.
- Collaborations and joint ventures should be encouraged between DPSUs and global companies to promote indigenous manufacturing.

Raise FDI limit in defence to 74 per cent

The enhanced FDI limit of 49 per cent may be no better than 26 per cent in terms of ownership and control. It is not expected to lead to a significant increase in global investments in India. The FDI limit should be enhanced to 74 per cent to create an ideal balance between India's national interests and those of global OEMs.

[12] 'DARPA Reaches Beyond Technological Frontiers for Warfighters' – Caludette Roulo, American Forces Press Service

[13] www.drdo.gov.in

12. The Joint Strike Fighter (JSF) Program – www.jsf.mil

Clarity required regarding 'state of the art technology'

The GoI announced its intent to allow 100 per cent FDI in case of 'state of the art technology' (SOAT). More clarity is needed on the definition of this term, else it may lead to subjective interpretation, bureaucratic delays, and legal challenges.

Some of the parameters that define SOAT could be: technical superiority, rarity, exclusivity (through patents), market dominance, etc. These need to be defined, in order to create a level playing field.

Eliminate loopholes which can lead to unethical practices in the defence procurement process

The U.K. is cracking down on unethical practices in defence procurement as illustrated in the case of a well-known supplier of helicopters. The investigation of the company started in Italy, and India started investigating only after the news hit the headlines. Subsequently, the Serious Fraud Office of the U.K. commenced investigations.

The Bribery Act 2010 of U.K. has been described as the 'toughest anti-corruption legislation in the world.' India needs to collaborate with the U.K. government to ensure that transparent procedures are put in place that allow U.K. firms to operate freely in India without the large administrative cost attached to compliance with the Bribery Act.

India needs to resolve its SCOMET priorities

Special Chemicals, Organisms, Materials, Equipments and Technologies (SCOMET) is the nomenclature given in India's foreign trade policy for dual-use items. India is planning to enter into a number of international treaties such as the Nuclear Suppliers Group, Wassenaar Agreement, Missile Technology Control Regime and the Australia Group to improve its stature among countries when it comes to responsible use of nuclear technology.[15] Hence, the government is tightening controls on the export of dual-use technology. Any export of 'military stores' requires an End User Certificate (EUC) from the country to which the stores are exported.[16]

Although the SCOMET list does not explicitly mention the items which are under export control, the items which come under the Wassenaar Agreement can be taken as the proxy. Items which come under Transfer of Technology and offsets will require EUC even if exported out of India as an intermediate step.

The requirement of EUC could create a burden for companies planning to use India as an export hub. The GoI seems to feel EUC helps it project India as a responsible nuclear power, hence is unlikely to do away with it. The government may consider making the EUC process digital and simple.

Strengthen intellectual property protections

India would need to strengthen its Intellectual Property (IP) protection regime to give confidence to defence sector investors. The Global Intellectual Property Centre of the U.S. Chamber of Commerce has scored India a very low 6.95 on a scale of 30 for IP protection, while the U.K. has a score of 27.59.[17] India scored the least among the 25 countries surveyed and highlights the amount of catching up India needs to do. India has good IP protection laws, but their enforcement needs to be improved to a 'zero-tolerance' level.

[15] The Economic Times, 1 October 2014

[16] Guidelines for Export of SCOMET Items – Directorate General of Foreign Trade, Ministry of Commerce and Industry, Government of India

[17] The Global Intellectual Property Centre International IP Index 2nd Edition

Expectations from the Government of U.K.

U.K. has termed its relationship with India as the, 'new special relationship': it could be time to 'walk the talk'

With the Prime Minister of U.K. calling the U.K.-India relationship as the 'new special relationship', it is imperative that it translates into visible actions. A first step could be the establishment of a U.K.-India Defence Cooperation Program comprising leading companies from U.K. and India and representatives of the two governments as members. The members should meet quarterly and identify specific programmes where the defence industries of the two countries could collaborate on developing cutting-edge technologies.

Easier grants of visas to students, scientists and experts to visit and work in the U.K. could help strengthen relationships. Tax breaks for Indian companies to set-up operations in the U.K. and non-critical components manufacturing outsourcing to India would be other notable steps which the U.K. can take to ensure the new special relationship grows.

Relentlessly reduce costs to win India's defence contracts

U.K. is currently behind the U.S., Russia, and Israel in terms of value of defence exports to India.[18] U.K. companies need to become more cost competitive given India's 'lowest bidder wins' approach.

The unsuccessful bid for India's MMRCA procurement program is a case in point where despite not being the lowest bidder, U.K. tried to sweeten the deal by continuing to offer monetary aid to India.[19] India's defence procurement program is scrutinised closely by an aggressive media and any deviation from the procurement norm creates controversies. U.K. companies should therefore relentlessly focus on cutting costs while meeting the minimum requirements of the bid.

Relentlessly reduce costs to win India's defence contracts

Indian armed forces continue to use British equipment like Jaguar and Hawk. During the mid-1960s, India was keen to build a submarine arm and presumed U.K. support. However, under U.S. pressure, U.K. turned down India's request to supply submarines. India turned to the erstwhile USSR and relations between Moscow and Delhi blossomed. U.K. also joined the international community in passing sanctions against India after India carried out nuclear tests in 1998.[20] Events such as these may have played a part in U.K. having a low share in India's defence purchases. The Government of U.K. may have to go an extra mile to jettison its image of being a 'fair-weather friend'.

Initiate co-development programmes

The BrahMos missile program is a shining example of the joint development of defence technology. This missile co-developed by Russia and India is now in demand globally. Another example of successful co-development is the Barak 8 missile where more than 70 per cent of the missile components would be Indian.[21]

U.K. can offer to co-develop programmes such as Type 26 frigates and MBDA missile programmes with high British content – where the U.K. can benefit from Indian engineering skills and cost efficiencies. Co-development programmes can also help build confidence about U.K.'s long term commitment to India, rather than having a simple buyer-seller relationship.

Conclusion

Given U.K.'s historical connect with India there is significant scope for improvement via co-operation in the aerospace and defence space. The latest breakthrough likely has come during the visit of U.K.'s Deputy Prime Minister, Mr. Nick Clegg, to India. He spoke about the shared values of democracy and the common threat of extremism faced by both countries.

India has embarked on a massive defence modernizing program as most of its equipment face obsolescence. The Government of U.K. should step up its engagement with India and take advantage of this opportunity.

U.K. companies need to relentlessly focus on cost competitiveness. Setting up a U.K.-India Defence Cooperation Program under the auspices of U.K. Trade and Investment (UKTI) could be a good first step.

The GoI needs to raise the FDI limit in defence production to 74 per cent. It needs to define the term 'state of the art technology' for allowing 100 per cent FDI on an exceptional basis. India's defence procurement procedures need to be aligned with leading global practices. India also needs to simplify its Export Control Policy.

It is time now to walk the talk for both U.K. and India.

[18] SIPRI Arms Transfers Database

[19] The Telegraph, February 4, 2012

[20] 'The Russian Connection' – Admiral J G Nadkarni (Retd) writing in the website Rediff.com

[21] Aviation Week http://aviationweek.com/awin/india-test-fire-barak-missile-year-0

Key contacts:

Nitin Atroley
Partner and Head
Sales and Markets
T: +91 124 307 4887
E: nitinatroley@kpmg.com

Amber Dubey
Partner and Head
Defence and Aerospace
T: +91 124 3074 146
E: adubey@kpmg.com

kpmg.com/in

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