India’s Aerospace & Defense Markets

Bloomberg Conference: New York, NY

April 26, 2012

Robert S. Metzger
750 Ninth Street, N.W., Ste 710
Washington, D.C. 20001
rmetzger@rjo.com www.rjo.com

ROGERS JOSEPH O’DONNELL
EXPERIENCE TIPS THE BALANCE

Where are the markets? What is their size?

- Defense
  - Defense spending has risen from $11B ($4B capital) in 2002 to $37B in 2012-13 (of which $15B is for capital items)
  - Some **project** a 2011-15 spend of $54B from foreign vendors
  - SIPRI now reports India as the world's largest arms importer; weapons imports increased by 38% from 2007-2011
- Homeland Security
  - India's homeland security **expected** to double to $16 billion by 2018
- Civil Aviation
  - KPMG **projects** domestic passenger throughput of 293M by 2020, up from 105M in 2011 and 51M in 2006
  - India **predicted** to be world's 3[d] largest aviation market by 2020
  - Boeing in 2011 **forecast** a $150B market for 1,320 aircraft over 20 years
  - Bombardier in 2012 **forecasts** a market of 1,300 20-149 seat aircraft

Behind the Statistics: Defense

- Fiscal restraints on new defense purchases
  - Almost 70% of the capital budget is already committed.
  - Adjusted for Inflation and currency fluctuation, the 2012-13 capital budget is no greater than 2011-12.
  - $12B MMRCA contract execution (?) w/ Dassault adds further stress.
  - Induction of new systems puts pressure on revenue (O&M) budget.
  - Multiplicity of recent scandals further impairs decision-making.
  - Pressure to reduce fiscal deficit (5.9% of GDP) will constrain spending.
- Offset requirements may deter participation
  - Questions about absorption of available capacity.
  - Limited existing private sector base; questionable public sector.
  - Very difficult process for review and approval.
  - “Hazardous” offset contract terms.

So far, offsets have not accomplished indigenization

- Problematic Transfer of Technology Objectives

Companies question “risk-adjusted return”

Access to the Defense Market - I

- Distinct markets selling to the Government of India
  - FMS (USG ↔ GOI) or other IGA
    - GOI prefers direct sales and views FMS w/ suspicion
    - Many US firms are unfamiliar
    - Can be slow and suffer from bureaucratic diffidence
    - Best opportunity: equip purchased platforms
  - Direct Commercial Sale (DCS) under the DPP
    - Buy – Make – Buy and Make – Buy and Make (Indian)
    - Single Stage, 2-Bid System
    - Lowest price ("L1") ordinarily determines winner
    - Rule-driven; little flexibility
    - Expensive to participate ("NCNC" Trials) and often very slow
    - Partnering may be best strategy

US Export Controls May Impair Opportunities

Access to the Defense Market - II

- Buy & Make (India)
  - Newest DPP category – introduced 2009 Revision
  - RFP only to Indian industry (either DPSU or private sector)
  - 50% indigenous content on a cost basis
  - Opportunities to partner in support (ToT?) of Indian lead
  - Resolution needed of private sector opportunity vs. DPSUs

- The Offset Submarket
  - ≥30% requirement on all sales (FMS, IGA and DCS)
  - Contractual obligation with penalties
  - Liberalization of "banking" expected
  - >$3.3 billion of signed offset contracts + $10B in pipeline

"Offset Obligors" are a real and addressable market

ROGERS JOSEPH O'DONNELL
EXPERIENCE TIPS THE BALANCE

Critical Problems Confront Defense Market Exploitation

- The DPP
  - Very complex, slow, rule-bound, uncertain results (if any); vulnerable to manipulation or disruption
  - Suitable only for already developed systems; no provision for qualitative distinction
  - Carries exposure to accusation, investigation, reputational damage
- Uncertain role and opportunity for private industry
  - Announced objectives of Defence Production Policy have yet to be actualized through private sector participation
  - DPSUs and Ordinance Factories enjoy continued preference / deference
  - New system development largely the domain of DPSUs
  - Leading Indian companies reluctant to make major commitments
  - FDI limit of 26% a major constraint on foreign partner participation

Leadership and Policy Issues

- Leadership Issues
  - Uncertain ability of M.O.D. to execute pending procurements
  - Recent regional elections suggest uncertain authority of Coalition
  - Continuing difficulties in resolution of internal differences within MOD
  - Scandals and concerns about integrity, transparency, fairness
- Bureaucratic obstacles
  - Getting FDI approval is problematic (even with 26% limit)
  - Getting Offset package approval is problematic
  - "Unusual" tax initiatives and uncertain allocation of decision authority
  - Potential new scrutiny of JVs with foreign partners
- Export controls
  - Can US firms timely offer and assure delivery of necessary technology?
- Foreign Investment
  - Will foreign partners commit key technology with 26% FDI limit?
  - Can offset eligible Indian defense JVs to conform to global standards?

Behind the Statistics: Civil Aviation

- **Civil aviation faces many and serious challenges**
  - Absence of airports and supporting infrastructure (only 45% of major city pairs have direct air connectivity)
  - Poor economic condition of carriers
  - Over-regulation and excessive taxation
  - FDI climate at best uncertain
  - Essentially no current civil aeronautics industrial base
- **Questions despite growth in passenger demand**
  - Can passenger growth continue without more airports?
  - Will demand fall as prices rise and delays mount?
  - Can India's carriers afford new airliners?
  - Can India afford or accept only foreign sources for aircraft?
- **Homeland Security**
  - Absence of central purchasing authority
  - Uncertain priority and budget at states

India's domestic air traffic is 1/5th that of China

Execution Opportunities – Civil Aviation

- The basic proposition is that India should, can and will develop a domestic civil aviation industry.
  - Necessary technical talent is present
  - Continued GDP growth depends on aviation
  - Fiscal deficit considerations demand domestic participation
  - India has private sector concerns up to the task
- A coherent national policy will emerge that looks to the private sector and necessarily encourages foreign investment.
- US firms now can partner with India S/MEs
  - Short-term: sell to offset obligors, enter their supply chain
  - Long-term: sell worldwide, grow system capabilities

Net Assessment

- The markets for aerospace, defense and homeland security in India are not so attractive as they may have appeared just a year or two ago.
- Absence of strong national leadership and political and policy uncertainty have caused concern to prospective foreign partners
- Nonetheless, real opportunities are present – both short-term and long-term

Short Term Strategies – Directed by Realism & Restraint

The potential market opportunity in India, for defense, internal security and civil aviation, is enormous. Access to that market, and success in business ventures, will be very difficult. More than patience and persistence are required. Companies are urged to approach the market with great care and selectivity.

For the near term, the best advice is to think <u>necessary</u>, <u>small</u>, <u>close</u> and <u>demonstrable.</u>

Necessary: Produce and sell "must haves" of the national of state governments.

Small: initial deal size large enough to commit participants but small enough to exit.

Close: Foreign investors should stick to what they know and do best and should acquire necessary operational authority by contract.

Demonstrable: the driving business proposition should be achievable (or not) within one to three years.

Long Term Strategies – Driven by Requirements

India must have a robust defense to balance potential external threats from China and Pakistan. Its regional role necessarily increases as the U.S. exits Afghanistan. Internal security remains a pressing concern. Maturation of the civil aviation sector is essential if India is to sustain its overall economic growth.

Allowing for existing capital demands, India will continue to spend on tac air, readiness and support for land forces, on ISR and on maritime capabilities.

States and cities will need improved tactical equipment and communications for domestic security requirements.

India will look to the private sector to improve its airport infrastructure.

A national aerospace policy can be expected that will actually encourage private sector growth of a domestic aerospace industry. But … when?

ROGERS JOSEPH O'DONNELL
EXPERIENCE TIPS THE BALANCE

Where These Strategies Converge

① Identify core capabilities aligned with India's needs

② Find capable, motivated partner (and .. Know Your Partner)

③ Develop product plan for accessible, funded markets

④ Form JV and Secure FDI approvals as required

⑤ Contractual surrogates for necessary operational authority

⑥ Seek strategic partnering/ sourcing deals with OEMs

⑦ ToT as necessary to enable Indian venture

⑧ Operate to global standards and grow sales

CONCLUDING OBSERVATIONS

- India has important choices to make. It has a dynamic population, high ambitions and important regional responsibilities. There are natural affinities with the U.S. that should be exploited for mutual benefit. Great progress has been made in the aerospace and defense relationship.
- Recent events evidence policy fluctuation, hostility to foreign investment, and unpredictable tax and regulatory environment. These make many U.S. companies wary of investment.
- Actions within the authority of Indian national leadership can restore the promise. Until there is clarity in national policy, U.S. firms should approach India's markets for aerospace, defense and homeland security with great care and patience.

SPEAKER CONTACT

Robert S. Metzger
Head of DC Office
202-777-8951
rmetzger@rjo.com

Counseling on India Defense Opportunities

- Strategic Business Counseling
- Policy & Regulatory Assessment
- Knowledge of U.S. and India Procurement Practices
- Assurance of FCPA Compliance + Coordination w/ India Counsel
- Transaction Counseling
- Offset Strategies & Compliance

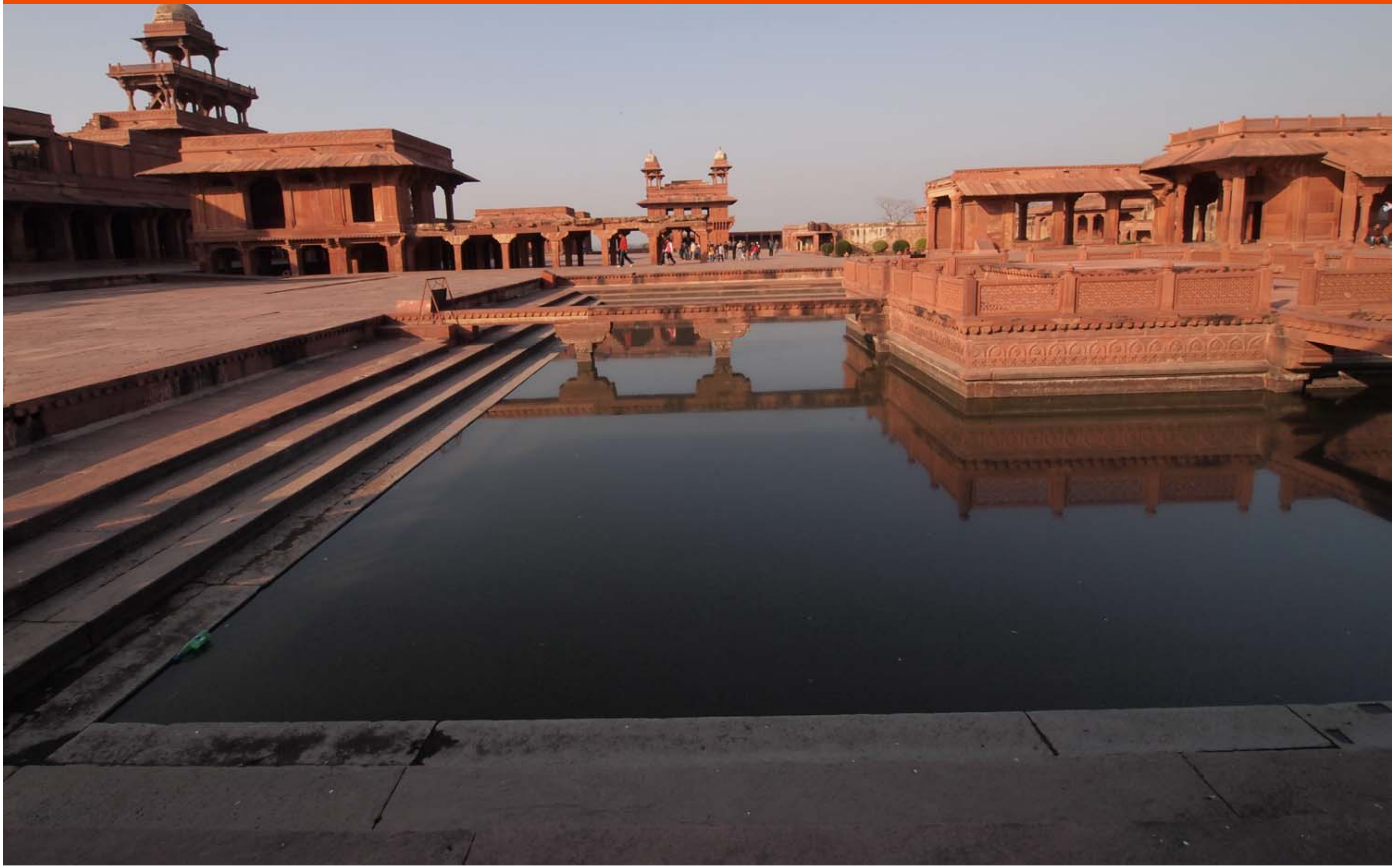
ROGERS JOSEPH O'DONNELL
EXPERIENCE TIPS THE BALANCE

About RJO -- GOVERNMENT CONTRACTS

- San Francisco (1981)
- Washington, DC (2011)
- Chambers USA
  - GovCon Tier 2 (top 8 nationally)
  - 3 ranked GovCon Partners
- 14 GovCon Attorneys
- Experience across the spectrum
- Impressive clients
- Thought leadership
- Cleared attorneys, SCI capable

ROGERS JOSEPH O'DONNELL
EXPERIENCE TIPS THE BALANCE

Backup Slides



U.S. Participation in India Defense Market

- U.S. is now the largest defense supplier to India
- India has awarded American companies ~$12B in defense contracts since 2007 (34% share)
- Notable U.S. successes include C-17, P-8I, C-130, Sensor Fuzed Weapon; Ultra-Light Howitzer; prospects include Jaguar Re-engine
- Disappointments include MMRCA, RAW Air Surveillance, MH-60
- India has shown it respects U.S. military hardware, <u>but</u>
  - Most sales (by $) are platforms (P-8, C-17, C-130)
  - Most sales (by $) are through FMS (C-17, C-130, SFW)
  - Boeing dominates, followed by Lockheed Martin, GE
  - Broad representation of U.S. industry is not present
  - Few U.S. firms have secured DCS award under the DPP

India now is the <u>third</u> largest purchaser of US arms. The U.S. Defense Security Cooperation Agency reported sales contracts worth $4.5 billion in FY 2011.

The View of U.S. Firms on India Defense

- Few firms have succeeded (and mostly by FMS)
- Those who have concluded sales worry about offsets
  - There are real questions about “absorption” of capacity
  - Offset rules do not allow gestation of new partners
  - New ventures face challenges of quality and supply assurance
  - FDI limits impair confidence of U.S. firms in partner output
- The DPP is seen as unwieldy and unpredictable
  - “Rule bound” with little “play in the joints” for sound discretion
  - Risk of being gamed by end-game withdrawal, artificial prices
  - “NCNC” trials are expensive but without outcome assurance
  - Actual awards seen as few, process cost & duration high
- There is fatigue with the process
- There are concerns about reputation exposure
- Questions are asked about risk-adjusted return

India's Defence Procurement Procedure (DPP)

- 2001: India opened its defence industry sector to 100% Indian private sector participation, with Foreign Direct Investment (FDI) allowed to 26%.
- 2005: DPP released to increase accountability and transparency and to promote free competition and impartiality.
- 2006: DPP establishes formal guidelines for capital procurement and sets offset guidelines including 30% offset requirement.
- 2008: DPP introduced three principal categories of defence acquisition:

  "Make" – high technology systems designed, developed and produced indigenously

  "Buy" – outright purchase including **" Buy (Indian)"** (≥30% Indian) & **" Buy (Global) "**

  "Buy and Make" – purchase from a foreign vendor followed by licensed production and/or indigenous manufacture in India

- 2009: **"Buy and Make (India)"** added – RFP issued only to Indian industry -- may be issued to both DPSUs and private sector companies; requires 50% indigenous content on a cost basis.

DPSUs are not subject to the D.P.P.	D.P.P. not used for system development

Key Features of the DPP

- Principles: Self reliance – Transparency –Expeditious –Fair competition
- Types of Procurements: "Normal," "Fast-Track" and "IGAs"
- Categories: Buy (Global | Indian); Buy & Make (B&M| B&M (Indian); Make
- RFP is key event: includes specifications and requirements, contractual obligations, price and delivery terms, offset requirements
- "Single-stage, Two Bid" System: requires two fully compliant tenders
- Three evaluation stages (technical, field, staff) precede the Commercial phase. Only the lowest bidder (L1) proceeds to Contract Negotiations
- Offsets:
  - Commitment to Offset compliance – due at RFP response
  - Separate Technical Offset and Commercial Offset Proposals
  - Offset Offer evaluate in two stages: Technical Offset Offer first, to assure compliance, then Commercial Offer Offset Proposal, opened along with main offer, can be revised at this stage
  - Commercial Offset Offer has no bearing on L1 selection

ROGERS JOSEPH O'DONNELL
EXPERIENCE TIPS THE BALANCE

Offset Requirements - Introduction

- Since 2005 the DPP has required offsets for major defense contracts.
- The requirement applies to all "Capital Acquisitions" in the "Buy (Global)" and "Buy and Make (Global)" for acquisitions > Rs. 300 crores (~$60M).
- Uniform offset of 30% of acquisition cost (for "Buy Global") and 30% of foreign exchange component (for "Buy and Make").
- Defence Acquisition Council (DAC) has power to waive or vary.
- 2011 Amendments
  - 1- expanded eligible products to include civil aviation and homeland security
  - 2 – allows Tier-1 sub-vendors to discharge offset obligations for their workshare

Role of Defense Offset <u>Facilitation Agency (DOFA)</u>

- Facilitate implementation
- Assist vendor interface
- Monitor offset provisions
- Interact, consult with Indian Armed Forces, DRDO and MOD

Revisions are pending – may be released soon

Offset Requirements – Basic Mechanics

- How are offset requirements satisfied?
  - Direct purchase/execution of export orders for <u>eligible products</u>
  - Purchase of <u>eligible services</u> provided from Indian industry
  - Investment for infrastructure for service, co-development, JVs and co-production of eligible products and services
- What are eligible <u>products</u>?
  - Defense products, products for internal security, **civil aero**
- What are eligible <u>services</u>?
  - Maintenance, overhaul, upgrades, life-extension, engineering, design, testing services, QA and training
- Other key features
  - Co-terminus with main contract
  - Surplus credits can be banked for 2 years (but not transferred)
  - Penalties of 5% of unperformed annual obligation

Offsets: Questions

- How well has India's offset policy worked?
- What are the principal restraints on success?
- Is India's capability to partner or satisfy offsets already absorbed?
- How much will it help to include sub-tier supplier?
- Should multipliers be granted for ToT? For SME participation?
- Should the "credit sphere" be expanded outside A&D and homeland security?
- Do current FDI limits operate against achievement of offset goals?
  - Why exclude offset credit if 100% U.S. owned firms are: in India, licensed, using Indian employees and operating under Indian laws?
  - As to FDI, should not the Government distinguish between companies in India which do civil aeronautics and those key for national defense?
- Are offsets worth their price?
- What could India learn from "best practices" of other countries?

Offsets: Recommendations & Prospects

- Policy
  - ☒ Expand Eligible Purchases & Services to other national objectives
  - ☒ Increase allowable FDI > 26% for new ventures
  - ☒ Grant credit to U.S. firms using existing India aerospace subsidiaries
  - ☑ Incentivize ToT by using multipliers earned by technology delivery
  - ☑ Encourage use S/MEs w/ multipliers and allow banking for "gestation"
- Administration ?
  - ? Increase staffing and increase authority of DOFA
  - ? Establish "cycle times" for bureaucratic action
  - ? Confirm vendors may rely on DOFA rulings (certainty of actions)
  - ? Assure transparency through disclosure and regular reporting
- Implementation
  - ☒ Cap offset contractual liability with reasonable max penalties
  - ☒ Enable DOFA to grant relief for changed circumstances
  - ☑ Extend period of performance for offsets to 7-10 years