

## INDIA AEROSPACE & DEFENSE: MARKET ASSESSMENT FOR U.S. FIRMS

India will be spending an estimated \$54 billion over the next five years on defense procurement from foreign vendors. Even in the aftermath of the recently announced selection of the Dassault *Rafale* in the MMRCA competition, India represents an important market opportunity for U.S. companies.

There are two levels to the opportunity. U.S. companies will have the opportunity to sell to the Government of India (GOI), either through the Foreign Military Sales (FMS) process or by direct commercial sale (DCS). Opportunity also is presented to address the requirements of prime contractors (U.S. and otherwise) who have entered into offset contracts with the Government of India (GOI).

### *Prospective FMS Opportunities*

FMS has accounted for most U.S. sales to India. FMS is well suited for sales of existing systems or platforms, in the U.S. inventory, of a non-developmental character. The well-publicized sales of the C-17 (\$5.8 billion) and C-130J (\$1.2 billion), for example, were accomplished by FMS. The GOI has resorted to FMS where there is a compelling need, advocated vigorously by a military service, to use an "Inter-Governmental Agreement" (IGA) in lieu of an acquisition via the Defence Procurement Procedure (DPP), and where it has determined to acquire supplies or services from U.S. contractors.

FMS has resulted in sales by U.S. companies worth billions of dollars even though the GOI has communicated an aversion to FMS. The GOI considers FMS non-responsive to its objective of competition. Further, there is a perception, apparently with some cause, that the U.S. bureaucracy is slow and may be untimely in production of Price and Availability (P&A) data or an FMS Letter of Offer and Acceptance (LOA) sales offer. The FMS process does not align well with DPP. FMS is priced to include life cycle costs (LCC). Many procurements have proceeded under the DPP without requesting that information and without means to assess or compare LCC. (The MMRCA competition was an exception, however.) It can be difficult for a U.S. company to compete with an FMS offer in a DPP competition where the LOA price includes elements not sought by the GOI, including the FMS administrative charge imposed by the U.S.

Nonetheless, FMS will continue to be a primary channel for future opportunity for U.S. firms. *There are advantages for all concerned.* For the GOI, an FMS agreement is supported by the "full faith and credit" of the United States. The U.S. Government exercises its contractual leverage over the U.S. supplier. Fair price is assured by U.S. competition rules, cost and price analysis techniques, and rigorous accounting and compliance rules. The GOI would further benefit where it obtains "dependable undertaking" status, as it can pay incrementally while the U.S. supplier can rely on being paid by the U.S. Government. Moreover, FMS sales get done. While DPP procurements have proven exceedingly slow, FMS transactions, as evidenced by the C-130, can be executed between the two countries with timely supplier performance to follow.

By dollar value, FMS Sales have been dominated by platforms such as the C-17 and C-130. However, there is evidence that the Indian military can motivate the GOI to seek FMS buys of munitions, systems, electronics and other equipment. The Defense Security Cooperation Agency (DSCA) has notified the U.S. Congress of intended FMS sales of such items as Mk-54 Lightweight Torpedoes (\$86 million), AGM-84L Harpoon missiles (\$200 million), M777 155 Light-Weight Towed Howitzers (\$647 million) and CBU-105 Sensor Fuzed Weapons (\$375 million). Where India has purchased platforms from U.S. suppliers – whether by FMS or by direct commercial sale (DCS) – it can be expected to purchase munitions and other equipment necessary to utilize and exploit the platform. U.S. companies who can support such platforms as the C-17, C-130, P-8 and (prospectively) the AH-64, may wish to work with U.S. officials in Security Assistance and Security Cooperation programs, in the U.S. and in India, to promote their products and the availability of the

FMS mechanism. Recent Pentagon announcements suggest high-level recognition of the benefit to the U.S. of encouraging and facilitating FMS sales.

U.S. firms also can propose cooperative research and development as a form of “defense service” under FMS procedures. Where India has acquired platforms without all electronics, subsystems or munitions packages, FMS can accommodate technology transfer which includes “follow-on development or improvement of U.S. equipment.” Where the U.S. Government negotiates directly for the sale to the Government of India, U.S. companies need not deal with the uncertain and often frustrating process of the DPP and can limit their exposure to the potential risks of direct business dealings in India. (That said, however, every company selling defense supplies or services to India, whether by FMS or DCS, will be obligated to satisfy these offset obligations imposed by contract between the GOI and the supplier. As a matter of policy, however, the U.S. Government is not a party to any offset contract.)

Compared to DCS transactions, FMS presents fewer uncertainties related to export control and technology release. (In some cases, particularly involving sensitive military technology, the U.S. Government insists on sale by FMS. ) India continues to have a “trust deficit” as concerns the U.S. as a supplier. Doubts as to the process and outcome of U.S. export controls figure in this “deficit.” While the FMS process can be slow and suffer from its own bureaucratic constraints, the decision-making process within the U.S. Government resolves export control and technology release considerations, in the context of overall U.S. security policies. From the standpoint of the customer, when the U.S. Government offers P&A data for an FMS sale, there can be high confidence that the technology offered will be approved for delivery.

There are many good business reasons to look for more FMS opportunities. A U.S. company may be troubled by the “risk adjusted return” of the investment necessary to sell directly to the GOI by the DPP. By comparison, the FMS channel is very attractive. Where the U.S. Government is enlisted to advocate the sale, there is higher assurance of the result, and the ultimate sale contract (but not offset agreement) is with the U.S. Government and follows the known format and terms of U.S. government contracts.

For these reasons, it is recommended that U.S. aerospace and defense suppliers at all tiers examine where they might propose equipment or services, to be sold by FMS, to support U.S. platforms already sold or in the works, to meet stand-alone priority requirements of the Armed Forces of India, or to support systems and platforms acquired from non-U.S. sources. Opportunities may be present for smaller value sales for modern equipment which India can buy FMS from the U.S. which will upgrade existing assets, improve their reliability and reduce costs of operation. The U.S. Government can help advocate these sales.

### ***Prospective DCS Opportunities***

There is no escaping the facts that direct sale to the GOI under a DPP procurement is slow, uncertain in outcome, and sometimes vulnerable to manipulation. Nevertheless, U.S. companies have realized some success in DPP procurements, such as P-8I Poseidon, and several prospects are pending, such as the sale of F124 engines to re-equip the IAF’s Jaguar aircraft and the sale of AH-64D Block III Apache helicopters. More to the point, the GOI has determined to rely upon the DPP for much of its military requirements. Each invitation to tender under the DPP potentially represents prospective business for U.S. companies. And, to incorporate lessons learned from experience, the GOI has committed to periodic revision of the DPP.

Where India proceeds with a DPP, it selects among three basic modes – “Make,” “Buy” and “Buy and Make.” Opportunity is presented for U.S. companies in the second and third categories. “Buy” procurement can be specified as “Buy (Global)” meaning that tenders will be accepted from non-Indian suppliers. (Offset requirements apply.) More likely, in reflection of announced policies, India will use the

DPP to procure by “Buy and Make,” which permits purchases from a foreign vendor followed by licensed production and/or indigenous manufacture in India, or “Buy and Make (India),” where the RFP is issued only to Indian industry, and where 50% of the content must be of Indian origin on a cost basis.

There are a number of practical observations that flow from these methods and their requirements. First and foremost, companies looking to participate in DPP procurements will need to “invest” in acquiring expertise and understanding of the India procurement rules and in creating relationships within India. These relationships will include, for many, engagement of professional service firms and Indian law firms and tax advisors. Creation of an Indian operating unit may be necessary. Since most forms of DPP procurements can be expected to require substantial work performed in India, and limits on foreign ownership apply, U.S. companies also will be well-counseled to seek partnering relationships with established Indian companies. (FMS business requires similar investment to create entities in India that can satisfy offset requirements.)

Not every U.S. company will have the means or patience for these investments. But those who can forecast large sales, sufficient to justify the investment, are most likely to make the commitment to bid on a DPP procurement as prime. Where the demand is less certain, companies might be deterred by the costs and process of market entry and the long sales cycle.

There is another way to approach the DPP opportunity, however. It is to take a longer view of the Indian marketplace, focusing not on what the MOD may issue in a solicitation over the next year or two but on what India will require over a 10 – 20 year period. Looking toward the far horizon, one can identify certain compelling needs to enhance military power and for improved domestic security. One also can predict that India eventually will create indigenous aerospace and defense capabilities – in manufacturing as well as design and development – and that new or existing Indian companies will emerge as credible players in the global supply chain. Investing in new ventures today, and forming new partnerships, can create capabilities in the private sector where there will be future sales opportunities in both the public and private sector.

U.S. firms can position themselves to do business with India through DPP procurements through a combination of market *intelligence* – to assess where India’s needs will coincide with their capabilities – and market *commitment*, as expressed by formation and growth of in-country capabilities and relationships. The Government of India will employ the DPP, for all its limitations, for billions of dollars worth of purchases over the next decade and beyond. For that reason alone, U.S. firms will need to accommodate and support the DPP or limit their participation to FMS or the offset “submarket” (as described below).

The GOI, no doubt, is aware of limitations of the DPP. It is widely characterized as a “work in progress” since first introduced in 2005. Its evolution is paced by complex considerations, including the influence of DPSUs and Ordinance Factories over acquisitions from the private sector, the size and skill of the acquisition workforce and concerns within India that changes to the DPP rules should be made to serve *India’s* interests, not those of any particular country or individual suppliers. This last point bears emphasis for prospective U.S. suppliers to India. Some facets of the DPP, seen as limitations by Western suppliers, are seen as advantages from the Indian perspective. Because it is rule-based, with selection of “L1” purely on the basis of price, the DPP is believed to be less susceptible to corruption or favoritism. It has transparency of process and uses objective measurements of technical adequacy and price superiority.

No doubt, external analysts will continue to offer constructive suggestions for future improvement of the DPP. Today, India does not have the means, either regulatory or in human assets, to fully support more complex procurement mechanisms as have evolved over years in other countries. Moreover, India’s goals may differ from the norm in the U.S., as India may be content to acquire “sufficient” capability, if demonstrated through trials, at the lowest bid price, even if the offer would not be the “best value” under

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U.S. practices. Performance superiority, or technological advantage, may not have the same importance to India, in its acquisition equation, as to the U.S. In proposing under the DPP to India, U.S. firms should take care not to apply expectations as to competitive discriminators derived from U.S. practices or preferences.

As to timing, excluding those exceptional cases that result in “fast track” procurements or “buy” accomplished through IGAs such as FMS, the GOI may be content with a “slow” process just as it may accept that the DPP does not differentiate for qualitative differences above the bar set by mandatory technical requirements. U.S. firms, to succeed, must choose their opportunities carefully and be patient. U.S. firms also should enter into a DPP procurement with the expectation that India’s rules, as exist and apply at the time of a procurement, will not later be changed to relax requirements to or otherwise improve the bargain. With few exceptions, the present evidence is that changes to the DPP are prospective only. The GOI will expect companies to live up to the contract according to the rules by which it was awarded.

### ***The Offsets “Submarket”***

A separate market is presented by the offset obligations already imposed on U.S. and other foreign OEM primes. For many U.S. companies, small and large, this may be the “best addressable” portion of the Indian aerospace and defense market. It is big – an official Indian government estimate, early in 2012, asserted that foreign companies (the offset “obligors”) had signed defense offset contracts worth \$3.3 billion – and that was *before* the MMRCA award, which may put as much another \$6 billion, or more, into the offset “pipeline.” The offset obligations of just two U.S. primes (Boeing and Lockheed Martin), for just two of the platforms they have sold (C-17 and C-130), exceed \$2 billion.

The offset obligors must purchase eligible supplies or services from Indian sources or make qualifying investment in Indian ventures. (In both cases, foreign ownership is permitted, but limited.) Each offset obligor signs a binding contract with the GOI. These contracts are backed up by bank guarantees, penalties for non-performance and the risk of debarment if offset commitments are unmet at the close of a contract.

There are opportunities for a broad group of U.S. companies to partner with Indian companies to satisfy the offsets sub-market. The customers for these new ventures will be neither the Government of India (as for DCS under the DPP) nor the U.S. Government (as for FMS) – but rather the “prime” level commercial firms who are the offset obligors. This is a reduced challenge from a contracting standpoint, and anti-corruption risks are less difficult because the primary interaction is with a business, not with government officials.

Today, India imposes a limit of Foreign Direct Investment (FDI) of 26% in defense ventures. Many U.S. firms object to that limit. They contend that minority ownership means they lack operational control as necessary to assure product quality or timely production. Many also maintain that the risk of FCPA or other anti-corruption violation increases where the U.S. company has just a 26% stake and may not be able to avoid improper acts of venture employees or agents. Another cited concern is that the minority position means that precious Intellectual Property (IP) may be at risk of diversion or compromise. The FDI limit, nonetheless, is the “law of the land” and U.S. firms either must find a way to accommodate this restriction or choose not to participate (at least as to supplies or services for which offset credit is sought under defense contracts).

While there are many challenges to setting up a successful venture in India, these can be managed with a long view to the market, discipline and skill in execution, and patience for realization. First and foremost is the importance of choosing the right partner. Traditionally, offset obligors have favored Defence Public Sector Undertakings (DPSUs) as business partners, and in some cases they have been forced to by the “Make” elements of procurement awards. There are reasons today, however, for concern over “absorption”

of the DPSU capabilities, and this is only aggravated by the MMRCAs award with the expectation that various DPSUs will co-produce the Rafael aircraft and many of its subsystems. In contrast, India's *private sector* is relatively under-represented in aerospace and defense design, development and manufacturing. There are capable companies who operate with integrity, and their numbers extend beyond the leading family-dominated firms. If smart decisions are made on the product or service objective, and sufficient time is allowed for necessary technical and operational gestation, U.S. firms can find sound partners and infuse them with IP and other "know-how" to create supply sources to answer the demands of the offsets submarket and become global supply chain participants.

Choosing the right partner begins with necessary diligence on integrity and technical competence. It includes assistance of lawyers and professional service firms to assure that India's laws are respected in the creation of new ventures and in their documentation. That documentation can include contractual agreements to provide assurance on such subjects as quality and to protect against improper acts. A combination of such agreements can act as effective "surrogates" for ownership and control while remaining faithful both to the letter and spirit of the FDI limitations.

There are many good reasons to believe that India's offset policies and practices will change over time. However, the "offsets submarket" already exists and is sizable, and the rules are in place and unlikely to change as to those offset contracts already signed by obligor OEMs. U.S. firms should look to the "inventory" of offset obligations owed by those primes and identify where they can co-produce or supply equipment, devices, systems, structures, services or training that the OEM can purchase (on competitive terms) and will use. As India awards future contracts to foreign sources – under the DPP or as IGAs (such as FMS) – this offsets submarket will grow. As India's offset rules evolve, again the opportunities may grow as well. For example, the present rules are that offset commitments must be satisfied within a contract's period of performance. India has been urged to extend the period, to give more time for formation of new ventures. More flexible rules for "banking" of offset credits also are recommended. Either step would facilitate the business opportunities for joint ventures created to satisfy the offsets submarket. While present experience indicates that India has been inflexible in the *application* of offset rules that are in place, the evolution of offset guidelines (and the DPP more generally) shows that India is willing to make *policy changes* to achieve practical results consistent with the long term national interest.

### ***Managing Expectations***

The opportunity for U.S. firms in India is moderated by many factors, including the overall status and direction of the U.S.-India relationship, uncertain application of export controls and restrictive technology release policies, the internal politics of India, concerns of U.S. companies about transparency and integrity in contracting, the presence of strong and sometimes less-than-scrupulous foreign competitors, doubts as to the willingness of India to truly open defense requirements to its private sector, India's sovereign intentions to distribute its business among many nations, and India's national objective of indigenization. Yet, today the United States is the largest defense supplier to India. That fact alone speaks volumes to the reality of the opportunity, and the contracts already awarded create opportunities for U.S. firms, in the offsets submarket at least. As the Armed Forces of India come to appreciate the quality, performance and value of U.S. equipment, it is reasonable to posit that the demand will grow for products and services from many tiers of the U.S. supply chain. India's procurement rules, and the operation of offset requirements, will produce opportunities for technical and industrial collaboration at many levels.

U.S. companies with vision, selectivity and patience should have great prospects working with and in India as its aerospace and defense industry grows.