Touchstone Partners

GREY MATTERS

Foreign Investment in Defence and Space

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The Government of India has identified the defence and space sectors as focal areas for the "Make in India" initiative and has accordingly been taking steps to promote the establishment of domestic manufacturing infrastructure backed by a robust research and development ecosystem in these sectors. Recently, as part of the wider stimulus package announced to revive the Indian economy, the Government further announced that (i) foreign investment of up to 74% will be permitted in the defence manufacturing sector without any prior Government approval, and (ii) steps will be will be taken to increase the participation of private companies in the space sector which has so far been dominated by the Government.

A. Background

In the absence of a strong domestic industry, India has historically been a large importer of defence equipment. Whilst a number of initiatives have been taken by the current Government since it first came to power in 2014 to reduce reliance on imports and strengthen the domestic defence industry, these have met with limited success.

Foreign investment in the Indian defence sector can at best be described as a missed opportunity so far. The sector was opened up for private participation as way back as 2001. However, India has so far failed to attract any significant foreign investment in the defence sector. The total amount of investment that has been received from 2001 till the end of 2019 has been short of USD 10 million! This is largely as a result of the stringent regulatory requirements on foreign investment and the difficulty in obtaining the necessary licences.

Currently, foreign investment of up to 49% is permitted in an Indian defence manufacturing entity under the automatic route, i.e. without requiring prior approval of the Government. Foreign investment in a defence manufacturing entity beyond 49% requires prior Government approval from the Indian Ministry of Defence (***MoD***) and is only allowed where such an investment is either likely to result in the inflow of "modern technology" into India or for "other reasons". The lack of guidance on the interpretation of these terms has meant that there are no well-known cases of foreign investment beyond 49% being permitted. As a result, foreign investors have been wary, and some would say, rightfully so, to consider a transfer of any meaningful technology to a joint venture which they could not control. The general lack of a culture of confidentiality in India and the delays and costs associated with litigating in India only exacerbated such concerns. Press reports suggest that it is for these reasons that Swedish company SAAB quit an Indian submarines project last year. Likewise, a deal with Dassault Aviation, the French manufacturer of the Rafale aircrafts, was also held up for a long time as they resisted having a Government undertaking – Hindustan Aeronautics Limited – as their partner. The deal ultimately fell through with the Government deciding to procure the Rafales under a Government- to-Government contract (which had its own share of controversy!).

The other major roadblock is the challenge in obtaining an industrial licence or an arms licence which is required for the manufacture of certain defence equipment and / or arms. Turf wars between various Government ministries / departments on which of them is ultimately responsible for granting such a licence resulted in significant delays. However, that has now been settled through a notification that was issued in 2019 which clearly set out the items that would require a licence and the Government ministry / department that would be responsible for issuing such a licence. Besides, the list of items requiring a licence has been significantly pruned over the last few years. The validity period of industrial licences has also been increased from three years to 15 years with a provision to further extend it by three years on a case-to-case basis. Until March 2019, over 400 industrial licences were issued to private entities for manufacture of defence items.

Defence manufacturing companies are also required to get a clearance (while applying for a foreign investment approval or obtaining an industrial licence) from the Indian Ministry of Home Affairs from a "national security" perspective. The process for granting clearance has historically been extremely slow and opaque, though an effort is now being made to clear such proposals in a time bound manner. Press reports suggest that it now takes approximately four to six weeks to obtain such a clearance.

With respect to the space sector, much like defence, the participation from private players has so far been very limited. Whilst the sector was opened up for private companies as early as 2000, their involvement has largely been limited to manufacturing and fabrication of rockets and satellites, and supply of components and sub-systems. It is understood that this is because in the absence of any meaningful foreign investment, such companies have found it difficult to mobilise resources and technology to handle independent space programmes.

Whilst foreign investment was permitted in companies engaged in the establishment and operation of satellites since when the sector was first opened up for private participation in 2000, such investment required prior Government approval. Further, satellite manufacturing companies are also subject to the requirement of getting a clearance from the Indian Ministry of Home Affairs from a "national security" perspective for receiving foreign investment. The limit for foreign investment was initially 74% in 2000 which was further liberalized to permit 100% foreign investment in 2016.

However, notwithstanding the regulatory regime, in practice there are no known instances of a Government approval having in fact been issued for investment in a satellite manufacturing company. Whilst US-based Hughes Networks had applied for an approval when the sector was first opened up to build a satellite communications system in India, the application is reported to have been still pending with the Indian authorities!

However, it is not all doom and gloom! As the spate of recent Government announcements suggest, liberalization may finally be on the way.

B. Recent announcements

<u>Increase in foreign direct investment limit in the defence sector</u>

Seemingly having recognized (*albeit* belatedly) that the only way of incentivizing foreign investors to meaningfully deploy their technology in India and, in turn, giving a push to the "Make in India" story, is by permitting foreign investors to exercise some control over such technology and also enjoy a significant portion of the economic returns that are generated in the process, the Government of India finally announced opening up the defence sector to up to 74% foreign investment under the automatic route. Foreign investments beyond 74% will likely continue to be subject to prior Government approval, though it is unclear at this stage if the requirement for this being allowed only if it results in the inflow of "modern technology" into India or for "other reasons" will continue.

Amongst a number of other measures, the Government expressed an intent to issue a list of defence equipment which will be banned for being imported into India – this would be equipment which can be manufactured domestically with the idea that this list be reviewed on a regular basis to add items that can be manufactured locally. This announcement was soon followed by an initial list of around 101 defence items (including weapons and military equipment and platforms) whose imports will be progressively curtailed over the next few years. Press reports suggest that within the next six to seven years, contracts worth almost INR 4 trillion (approx. USD 55 billion) are expected to be placed by the Indian armed forces in these categories with domestic manufacturers.

Separate provisions are also sought to be made in the annual budget for procurement of products from domestic manufacturers, with promotion of indigenisation of spare parts being a focal item. The Government is also aiming to privatise most Government undertakings. It announced that ultimately even in strategic sectors (which we assume would include the defence sector) the maximum number of the Government undertakings would not exceed four.

<u>Increasing private participation in the space sector</u>

With the intent to increase private participation in the space sector, the Government announced that a "level playing field" will be provided to private companies in satellites, launches and other space-based services. Further, private companies will be allowed to use the Indian Space Research Organisation's (***ISRO***) facilities and other assets to improve their capacities.

Lastly, in order to enable private companies to operate seamlessly, a "predictable" regulatory environment will be put in place by the Government.

The formal notifications giving effect to the announcements are yet to be issued.

C. Analysis of the announcements

The Finance Minister who announced the measures previously held the position of Defence Minister and, therefore, the overwhelming opinion is that the announcements are "grounded in facts". As such, the announcements relating to the defence sector, coupled with the fact that the licensing regime for the sector has now been significantly streamlined, is expected to overhaul the present dynamics and lead to the long-promised glut of foreign investment in the sector. It is also expected to have a cascading benefit across the employment and skill development spectrums backed by infusion of new technology. In addition, it could provide the much-needed push to Indian exports and help India's balance of payments position.

Based on the recent learnings from the US, it is only fair to say that the announcement for increasing private participation in the space sector is also a step in the right direction. Permission to use the facilities of ISRO will relieve private companies of the burden of going overseas to test equipment, perform launches, and access geospatial data. Besides, getting access to ISRO's team could be helpful for start-ups.

In addition, given the shift in regulatory thinking from public sector-focused to private sector-focused, ISRO, at its end, may also want to divert its attention to research and development and strategically important missions while contracting out most of its assembly related work and limiting its involvement in establishing and operating routine weather and communication satellites, thereby increasing the scope for involvement of the private sector further.

As is not atypical in the Indian context though, the announcements still leave much to be desired.

Is 74% foreign investment limit in the defence sector sufficient?

The threshold question is whether opening up the sector to 74% foreign investment under the automatic route is sufficient or was the need of the hour for the Government to have gone the whole hog in terms of liberalisation. The announcement means that foreign investors would still have to partner with an Indian private or Government undertaking and, therefore, the issues highlighted above would still continue to remain, albeit to a much lesser extent.

Ever since the defence procurement procedures of the MoD were overhauled in 2016, the Government has been promoting partnerships between domestic private sector players and foreign original equipment manufacturers (for the production of certain specified defence equipment which included submarines, aircrafts, helicopters and armoured fighting vehicles) by floating tenders under the "Strategic Partnership Model" (***SP Model***). The idea behind the SP Model was for a foreign original equipment manufacturer to set up a joint venture with a domestic player to which the original equipment manufacturer would then transfer its technology. However, one of the eligibility requirements under the model is for the joint venture entity to be "Indian owned and controlled"1. Whilst some tenders have been floated by the Government under the SP Model, there are no well-known examples of any contract having been concluded so far. In fact, the submarines project that SAAB quit last year was floated under the SP Model and (as discussed above) SAAB cited lack of control as the reason for quitting. Similar to the SP Model, several of the other procurement avenues under the defence procurement procedures of the Government impose conditions of Indian ownership and control to qualify as an eligible vendor.

Whilst raising of the foreign investment cap to 74% could be an implicit admission of the failure of the SP Model, it will need to be seen how far the announcement actually is able to evoke the interest of foreign investors given the requirement to still partner with domestic entities. The outcome could obviously be different if the Government alters its current stance and starts approving setting up of wholly owned subsidiaries by foreign investors more readily. Though, even in that case, foreign investor interest would surely depend on how favourably, or not, such wholly owned subsidiaries are treated by the MoD while placing orders. Interestingly, the draft of the latest defence procurement procedures that is currently in circulation introduces a new category of capital acquisitions by the MoD under the "Buy (Global – Manufacture in India)" category, which recognises foreign original equipment manufacturer setting up an Indian subsidiary to participate in the procurement process. These would be given preference over the "Buy (Global)" category which involve outright purchases from a foreign vendor and which rank the lowest in order of priority of acquisition by the MoD. It is worth mentioning that, for all other purposes, the draft procedure still continues to impose conditions of Indian ownership and control to qualify as an eligible vendor, though we expect this will be aligned with the liberalised foreign investment regime once the final notification giving effect to the increased foreign direct investment limits is in place.

Need for permitting foreign investment in the space sector

As mentioned above, in large part, the reason for limited involvement of private companies in the space sector has been the absence of foreign investment in the sector. Whilst a few of the big domestic players such as Godrej and L&T have shown interest in participating, the number of such domestic players is going to be limited. Accordingly, unless the Government alters its current stance and starts approving foreign direct investment proposals for investing in the sector, mere giving of a "level playing field" to private players is not likely to bear any significant results.

Land and labour issues persist

The historical problems around land and labour still continue to loom large on the head of investors looking to set up green field operations in India. Whilst the Central Government along with the various State Governments have been taking a number of initiatives to resolve these problems (which are indeed laudable in intent), these are often susceptible to legal challenge. Policies are often issued in India on a "trial and error" basis. The recent example of notifications being issued by a few State Governments

suspending the operation of some labour laws to promote "ease of doing business" in light of the pandemic (which were soon challenged before the courts) is one such case in point!

Enforcement of rights in India is still arduous

Contractual arrangements entered into with the MoD typically provide for arbitration under the Indian arbitration legislation with the seat of arbitration being in India, and enforcement of rights and obligations in India still remains difficult, time consuming (can take several years) and expensive. It is only reasonable to expect that any contracts that would be entered into by private players with ISRO will also provide for dispute resolution in India itself. Whilst the arbitration scene in India is improving, it will be a gradual improvement and is unlikely to compare with an overseas seated institutional arbitration in its efficiency and ease of process.

D. Conclusion

Whilst the Government has made some significant commitments to push the "Make in India" story, it will be interesting to see to what extent it is able to honour these, particularly in the event of an operational requirement. The recent example of orders for a number of the defence equipment required amid the rising tensions at the LAC border being placed with Russia clearly raises some (well-founded) concerns.

The Government had targeted that by the year 2025, India would be one of the top five defence manufacturers worldwide. Defence exports were also expected to be raised to USD 5 billion annually by 2025. Although it seems unlikely that all of these goals will be met (not least given the ongoing pandemic), it is being suggested that "some ground can be gained" if the recent announcements are implemented fully in spirit. Thus, we continue to wait and watch this space until the formal notification giving effect to the announcements is issued.

We are closely monitoring developments regarding this opportunity and if you require any further information about any aspects of the Projects, we would be very happy to assist with this.

This material is for general information only and is not intended to provide legal advice.
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