Decoding the Indian Aerospace and Defence sector

Domestic and foreign investments and offset obligations

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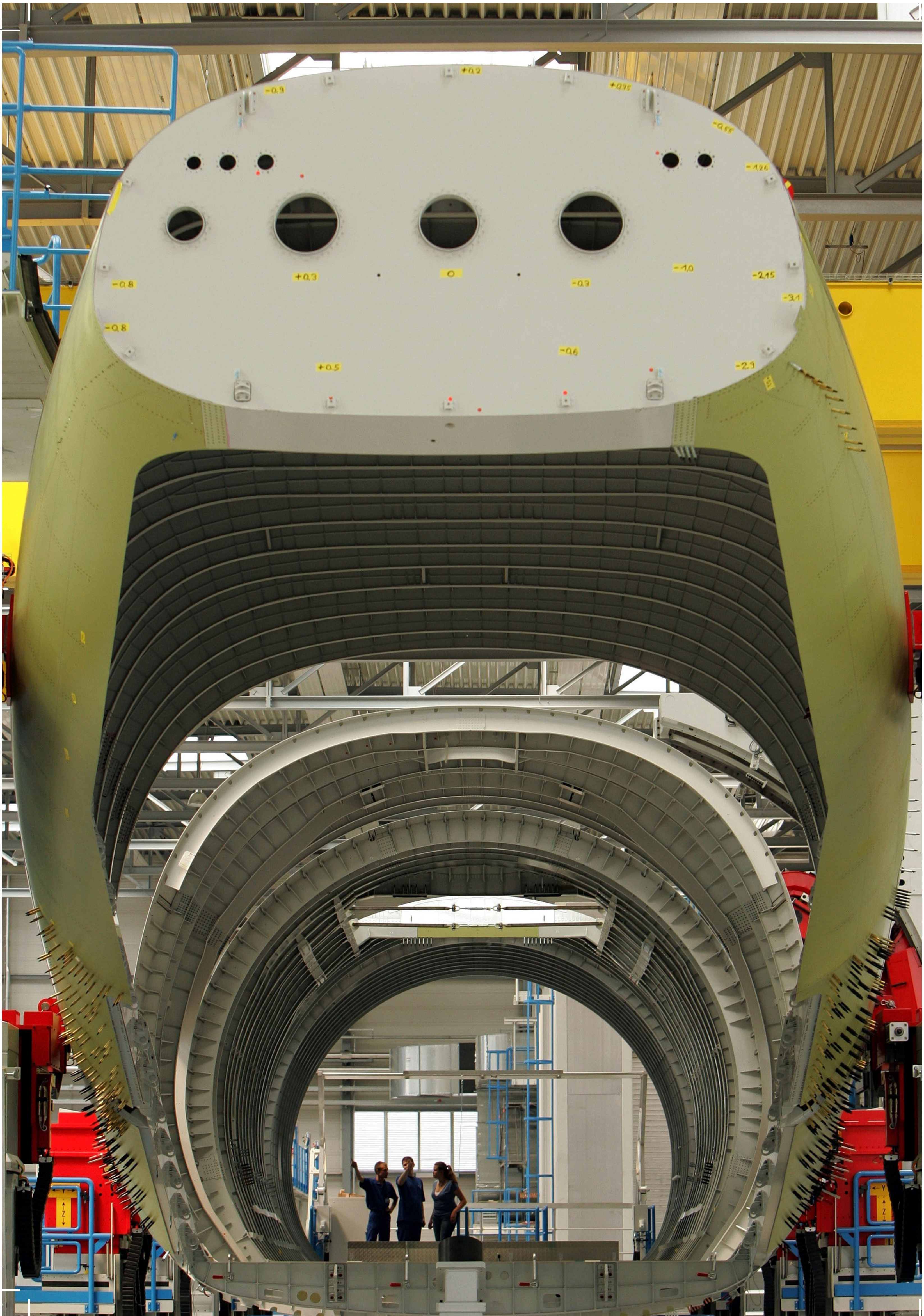

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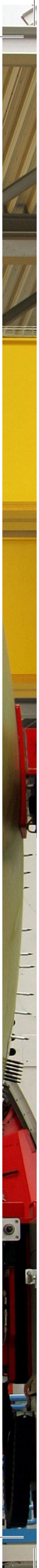


Big Opportunity

- Budget expected to grow to 50 billion USD in 3 years
- Largely import-dependent procurement
- DPP: Transparent global bidding procedure; revised annually
- Liberalised offset policy

Aerospace and Defence market in India

Investing in the Indian aerospace and defence sector

The Indian aerospace and defence market presents an attractive and significant opportunity for Indian and foreign companies across the supply chain. India has the third-largest armed forces in the world, and its defence budget is about 1.90% of its GDP. India is one of the largest importers of conventional defence equipment and spends about 40% of its total defence budget on capital acquisitions. About 70% of its defence requirements are met through imports.

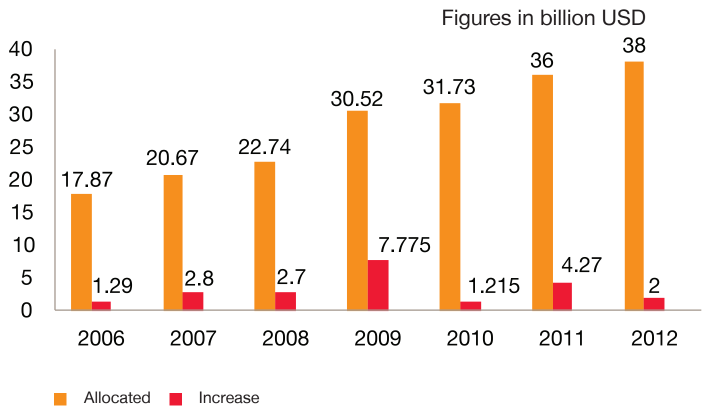
Market attractiveness driven by large and growing defence budget

Between 2006 and 2010, India surpassed China as the world's largest importer of weapons systems, reflecting the nation's intent to modernise its armed forces and replace obsolete equipment. India's defence spending has grown tremendously to 38 billion USD in 2012 as against 30.52 billion USD in 2009 at a compounded annual growth rate (CAGR) of 7.58%. The defence expenditure of the government accounts for about 13% of its total expenditure.

The government opened this sector to private and foreign investment in 2001. Further, it has sought to build a domestic industrial base and has set itself a challenging target of achieving 70% indigenisation. To broad base the acquisition, the Government has made transparent global bidding guidelines in the Defence Procurement Procedure (DPP), which is revised annually. The DPP also lays out the Defence Offset Policy.

To fully exploit this opportunity and fulfil offset obligations, original equipment manufacturers and their suppliers should leverage India's competitive advantages in manufacturing and information technology by setting up units in India. A large number of Indian private companies and publicly funded research laboratories are looking for international partners. India has emerged as a global R&D hub with 150 of the Fortune 500 setting up R&D labs in India. A liberal special economic zone (SEZ) policy creates a competitive eco-system for exports by providing attractive fiscal incentives. Such a strategy would allow companies to fully participate in the Indian market, using India's competitive advantages to create a low-cost regional or global manufacturing hub, as has been done successfully in the auto sector.

Growing trend in defence budget allocation 2006-2012



Source: Indian Budget 2006-12

Domestic and Foreign Investment

Until the turn of the century, India's defence sector had been exclusively reserved for the government and Defence Public Sector Undertakings (DPSUs). In May 2001, the government liberalised the manufacture of defence equipment in India, permitting 100% investment by the domestic private sector and up to 26% foreign direct investment (FDI) by approval from the Foreign Investment Promotion Board (FIPB) and subject to the Indian company obtaining an industrial license from the Department of Industrial Policy and Promotion (DIPP). There a number of conditions for FDI in the defence sector. These include a stipulation that ownership and control of the company must lie with resident Indian citizens with at least 51% of the shares vesting with a resident Indian shareholder. The licensing conditions require, inter alia, that the management of the applicant Company or partnership should be in Indian hands, with the majority representation on the Board and the Chief Executive being resident Indians. There is also a three-year lock-in-period for foreign equity[1].

To provide further impetus to building a domestic industrial base, in 2006, the government announced a defence offset policy that mandated a minimum 30% plough-back of foreign outflows from defence procurement exceeding INR 30 billion into the Indian defence industry. The policy allows foreign suppliers to choose their Indian offset partner—in either the private or public sector—in discharging their offset obligations. This offset policy has been revised in 2008 and 2010. In August 2012, the defence ministry announced a slew of keenly anticipated modifications to its defence offset policy. Transfer of technology (ToT) has been made eligible for offsets, multipliers allowed; banking provisions liberalized, and time frames for the discharge of offsets relaxed. Moreover, the objectives of the offset policy have been spelt out clearly, making it easier for vendors to structure their offsets.

These changes are likely to make the offset burden less onerous and encourage technology transfers and setting up of production units in the country.

Guidelines for establishing joint venture (JV) companies by DPSUs

The Ministry of Defence, on 17 February 2012, released the guidelines for establishing JV companies by DPSUs.

The salient features of the guidelines are listed below:

- The proposed partnerships could be of various kinds, such as outsourcing, subcontracting, formation of consortia, project-specific special purpose vehicles (SPVs), formation of JVs, etc.
- DPSUs may enter into JVs only in cases where the complementary capacities, infrastructure, technology or capability available with the partners require engagement for a longer term and result in achieving lower costs, better risk management, greater efficiency or shorter timeframes for delivery.
- The JV company should be restricted to specific product(s) or service(s) that are required to achieve the objectives of the company.
- The DPSU should retain the right of prior approval of the key decisions of the JV Company and should clearly be mentioned in the shareholders' agreement of the JV Company.

The procedure for the formation of a JV company by a DPSU and the exit provisions are given in the guidelines.

Procurement policy

Defence procurement is governed by the Defence Procurement Procedure (DPP). First enumerated in 2006, the latest policy on defence procurement (DPP 2011) was released on 6 January 2011. The government has now decided to revise the DPP every year.

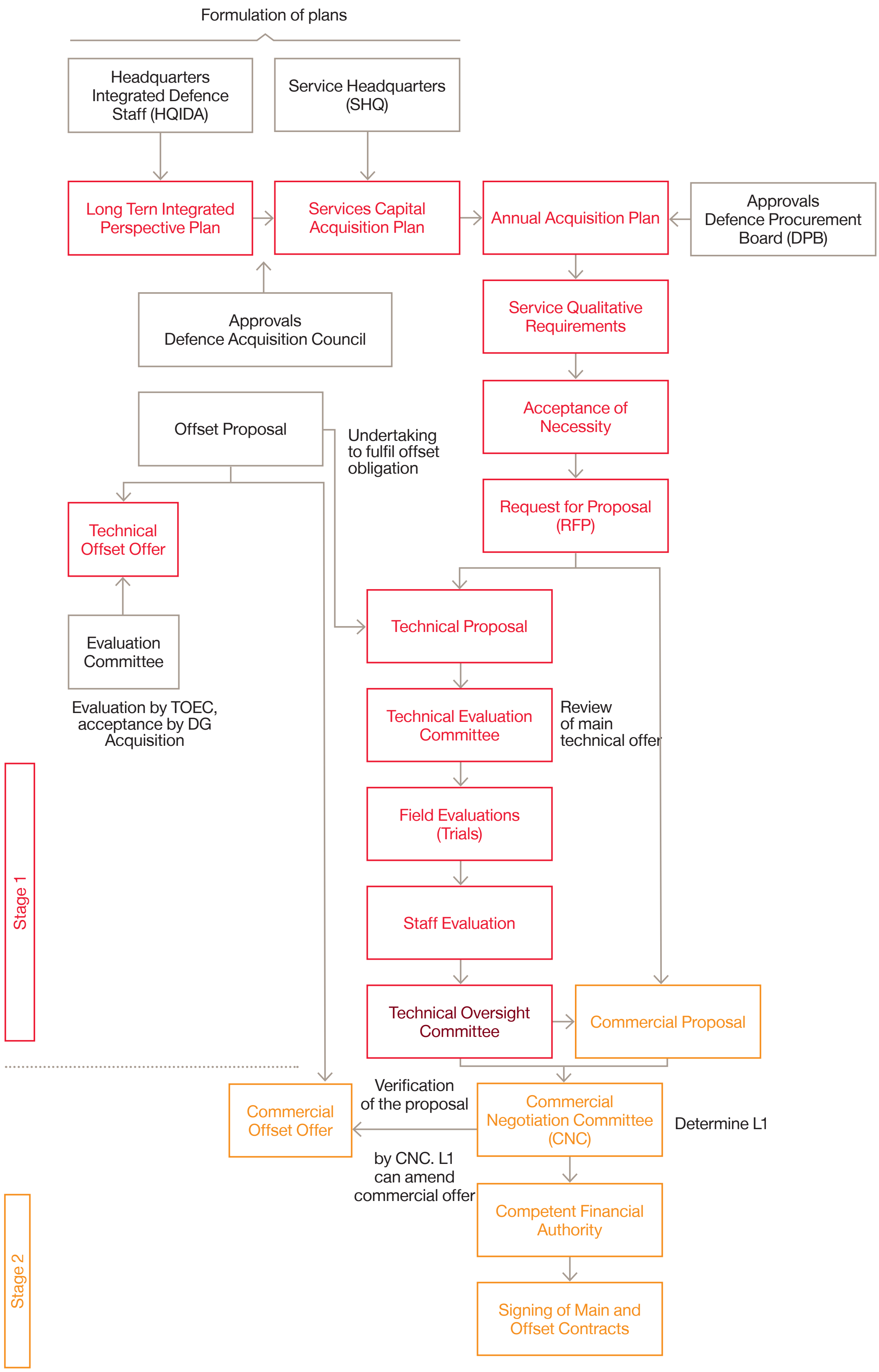
Key features of DPP 2011 are listed below:

- ***Categories of defence procurement:***
  - Buy:

    (Global): Outright purchase of equipment from a foreign vendor
    (Indian): Outright purchase of equipment from Indian vendor with minimum local content of 30%
  - Buy and make: Purchase from a foreign vendor followed by licensed domestic manufacture through transfer of technology (ToT)
  - Buy and make (Indian): Purchase from an Indian company or Indian JV with minimum local content of 50%
  - Make: Indigenous design, development and production of equipment

1. "Details of FDI and Licensing Policies are given in the Consolidated FDI Policy revised annually and Press Notes issued by DIPP. The latest policy is contained in Press Note 1 of 2012"

Summary of bidding process



- ***Naval ship building procedure has been divided into two different streams:***
  - Acquisition by nomination to defence public sector undertakings (DPSUs)
  - Acquisition on a global competitive basis
- ***Fast-track procedure:***
  - Formulated to ensure quick procurement during crisis situations
  - Requirement to emanate from the concerned service chief
  - Exempt from offset obligations
- All details of trail methodology are disclosed in respective request for proposals (RFPs)
- Single-stage two-bid system to be followed and the technical and commercial proposals submitted separately to be valid for 18 months
- Offset offers to be submitted three months after the submission of main bids
- Field trails to be conducted on 'no cost, no commitment' basis
- Broad time frame for planning purposes from issue of RFP to contract finalisation is approximately two and a half years

'Make (High-tech)' Procedure

HQ IDS obtains approval of DAC with Acceptance of Necessity & Quantity Vetting

Integrated Project Management Team (IPMT), constituted by Acquisition Wing and headed by service officer, evolves Project Definition Document

IPMT seeks EoI from companies recommended by Department of Defence Production

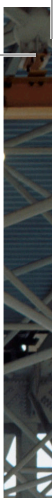
IPMT analyses responses, assesses capabilities and sends names of short-listed companies to Defence Production Board (through Acquisition Wing) which selects two companies

Both submit Detailed Project Report (DPR) including role of foreign technology provider, if any

IPMT analyses DPR and forwards to Acquisition Wing for approval, especially the exit criterion.

IPMT monitors progress and reports to Defence Production Board through Acquisition Wing

User trials and staff evaluation of prototypes carried out under Service HQ. MoD accepts staff evaluation. Commercial evaluation and contract negotiation done by Acquisition Wing as per normal 'Buy' procedure



Offset Guidelines – Amendments in 2012

- Policy objectives elucidated
- Credit for ToT and equipment allowed
- Banked Offset credit to remain valid for a period of seven years
- Introduction of multipliers
- List of critical defence technology areas and test facilities for acquisition by DRDO included
- Overall penalty capped at 20%
- Defence Offset Management Wing (DOMW) to be formed
- Clear demarcation of role and responsibilities between Acquisition Wing and the DOMW

Key concerns

- Definition of Indian enterprises
- Definition of second-hand equipment
- Valuation of technology

Offset policy

The key objectives of the defence offset policy are to leverage capital acquisitions to develop the Indian defence industry by:

i. Fostering development of internationally competitive enterprises

ii. Augmenting capacity for research, design and development related to defence products and services

iii. Encouraging development of synergistic sectors like civil aerospace, and internal security

Key features of the updated policy:

- Mandatory offset requirement of a minimum of 30% for procurement of defence equipment in excess of 3 billion INR
- Categories of schemes in which offsets are applicable:
  - 'Buy (Global)'
  - 'Buy and Make' with ToT

Offsets obligations can be discharged by any combination of the following methods:

a. Direct purchase of, or, executing export orders for eligible products manufactured by, or services provided by Indian enterprises

b. FDI in joint ventures with Indian enterprises for manufacture or maintenance of eligible products and provision of eligible services

c. Investment in 'kind' in terms of ToT to Indian enterprises for manufacture or maintenance of eligible products and provision of eligible services (through joint ventures or through the non-equity route). Offset credit for ToT shall be 10% of value of buy back.

d. Investment in 'kind' in Indian enterprises in terms of provision of equipment through the non-equity route for the manufacture and/or maintenance of eligible products and provision of eligible services. Vendor to buy back minimum 40% of eligible products and services.

e. Provision of equipment and/ or ToT to government institutions and establishments engaged in the manufacture and/or maintenance of eligible products and provision of eligible services, including the Defence Research and Development Organisation (DRDO)

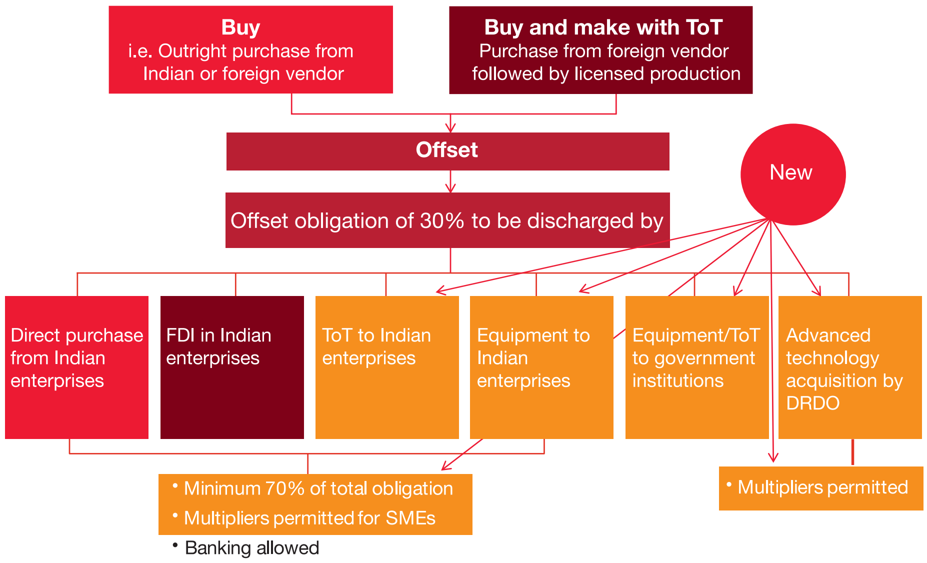
f. Technology acquisition by DRDO in areas of high technology

Minimum 70% of the offset obligation shall be discharged by (a) to (d) above

- Multipliers of 1.5 permitted where MSMEs are Indian offset partners and a multiplier of up to 3 permitted for high technology acquisition by DRDO.
- Indian enterprises and institutions and establishments engaged in manufacture of eligible products and/or provision of eligible services, including DRDO, are referred to as the Indian offset partner (IOP). IOP to comply with all guidelines of DIPP.
- Time frame for discharge of offset obligations can extend beyond the period of the main procurement contract by a maximum period of two years
- Defence Offset Management Wing (DOMW) would replace DOFA and would be responsible for all matters related to offsets management, monitoring, policy formulation and banking.
- Banked offset credits to be valid for a period of seven years from the date of acceptance by the DOMW.

- Transfer of credits is allowed between an OEM and its Tier 1 supplier within the same programme, with a 50% cap on using banked credits.
- List of products eligible for the discharge of offset obligations are defence, internal security, civil aerospace products and services related to eligible products.
- Offset implementation reports to be submitted every six months during the implementation stage
- Overall penalty capped at 20% of total offset obligation
- Re-phasing and change in offset partners or offset components is allowed by DOMW in exceptional circumstances provided the value of offset obligations remains unchanged.
- ToT and supply of equipment to private industry are eligible for discharge of offset obligations subject to buyback by the OEM. ToT should be provided without licence fee and there should be no restriction on domestic production, sale or export. The offset credit for ToT shall be 10% of the value of buyback by the OEM during the period of the offset contract, to the extent of value addition in India. 40% buyback of the eligible product or service is mandatory in case of supply of equipment.
- ToT and supply of equipment to Government institutions and establishments engaged in the manufacture and/ or maintenance of eligible products and provision of eligible services does not have a buy back condition.

Increase in number of avenues for discharge of offset obligations



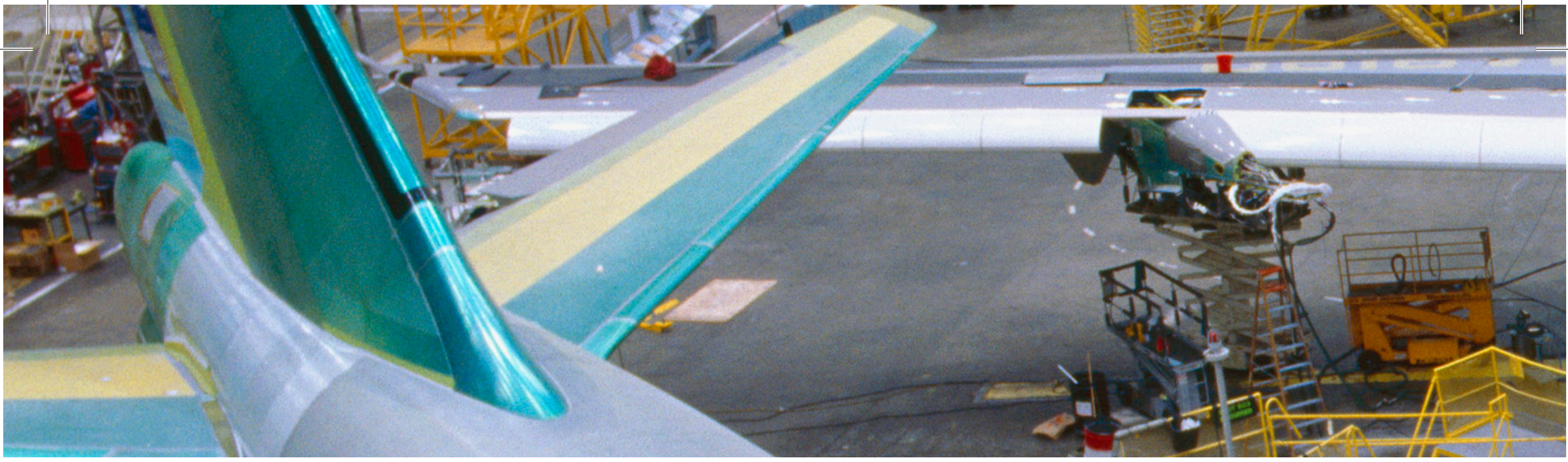
Offset bid-evaluation process

- Separate technical and commercial offset proposals to be filed
- Technical offset offer to contain details of the products, services and investment proposals indicating relative percentages and proposed Indian partners for the offset investment, along with details of banked offset credits as discharged offset obligations
- Technical offset offers to be scrutinised by a technical offset evaluation committee constituted by the Technical Manager with approval of DG Acquisition. The Technical Offset Evaluation Committee (TOEC) will include representatives of the Service Headquarters, Defence Finance, DRDO and DOMW. The TOEC report is forwarded by the Technical Manager within 4 to 8 weeks to the DG Acquisition for acceptance
- Offset Proposals relating to technology acquisition by DRDO will be assessed by a Technology Acquisition Committee (TAC) constituted by the Defence Research and Development Organization with the approval of Scientific Advisor to the Defence Minister
- Commercial offset offer must specify the absolute amount of the offset with a break-up of the details, phasing, name(s) of the Indian partner(s) and banked credits as discharged obligations
- Commercial offset offer will be opened with the main commercial offer. The Contract Negotiating Committee (CNC) would verify that the offer meets the stipulated offset obligations. Lowest bidding (L1) vendor can amend the commercial offset offer at this stage. For evaluation of commercial offset proposals, the CNC includes a representative of DOMW as member. Representatives of DRDO, DPSUs, OFB or other Government institutions are also co-opted as members
- Commercial offset offer have no bearing on the determination of L1 vendor. All offset proposals will be processed by the Acquisition Wing
- Clarifications regarding offset proposals will be made by the Acquisition Wing in the pre-contract stage and by the DOMW after the contract is signed. There will be mutual consultation between the two

Regulatory Framework in the A&D sector in India

Any company doing business in the A&D sector in India needs to comply with five key policies. These are:

- DPP and Offset policy
- Industrial licensing policy
- FDI policy
- Foreign Trade policy
- Tax Policies



Industrial licensing policy

Under the Industries (Development and Regulation) Act 1951, an industrial licence (IL) is required for manufacturing defence equipment. The applicant must be an Indian company or partnership and has to apply to the Department of Industrial Policy and Promotion (DIPP). The application is considered by an inter-ministerial committee and the process takes about six months. There are a number of conditions imposed and there is no clarity on the definition of defence equipment.

Foreign Direct Investment Policy

FDI up to 26% is allowed in an Indian company manufacturing defence equipment subject to the company obtaining an IL from DIPP. The approval is given by the Government through an application filed before the Foreign Investment and Promotion Board (FIPB) in the Ministry of Finance. This too is an inter-ministerial committee and approval takes about six months.

Detailed guidelines with respect to the FDI and Licensing Policies are given in the Consolidated FDI Policy revised annually and Press Notes issued by DIPP. The latest policy is contained in Press Note 1 of 2012

Foreign Trade Policy

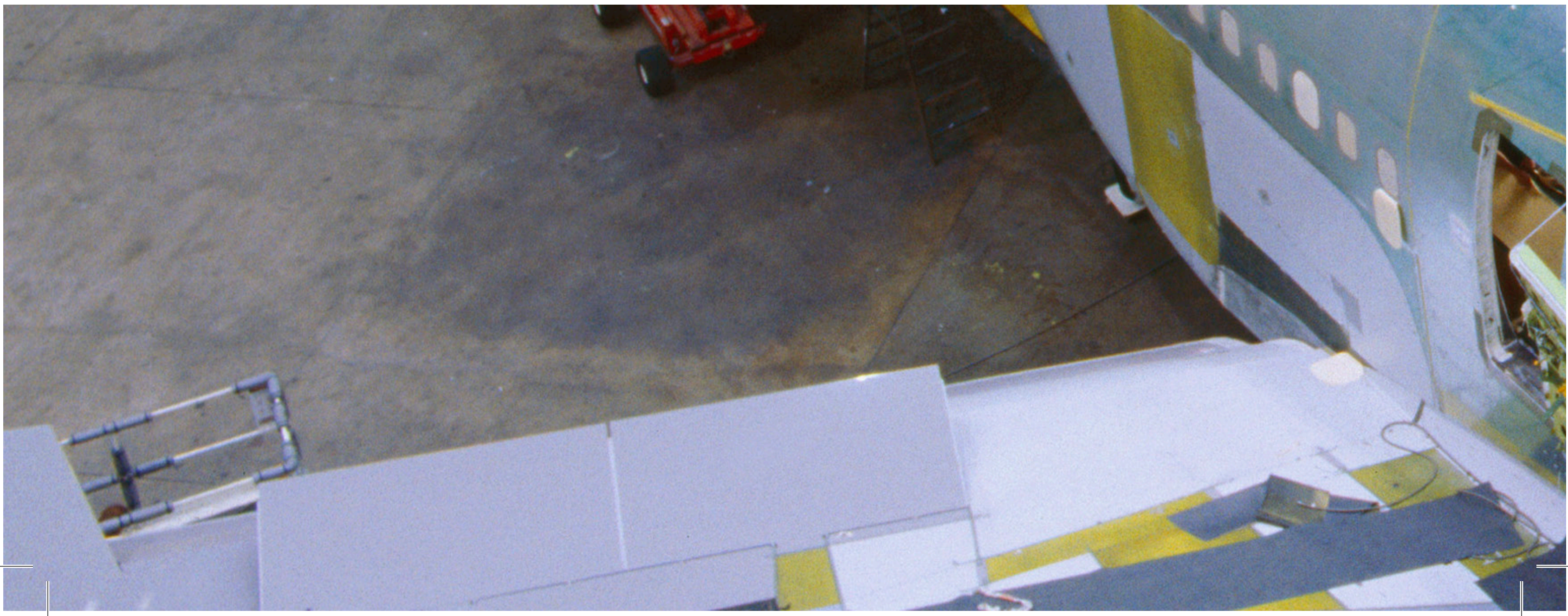
Import and export of defence equipment is governed by the Director General of Foreign Trade (DGFT) in the Department of Commerce. Barring select items that are banned, defence equipment can be exported either after obtaining a licence from the DGFT for items in the SCOMET list or after obtaining a NOC from the Ministry of Defence.

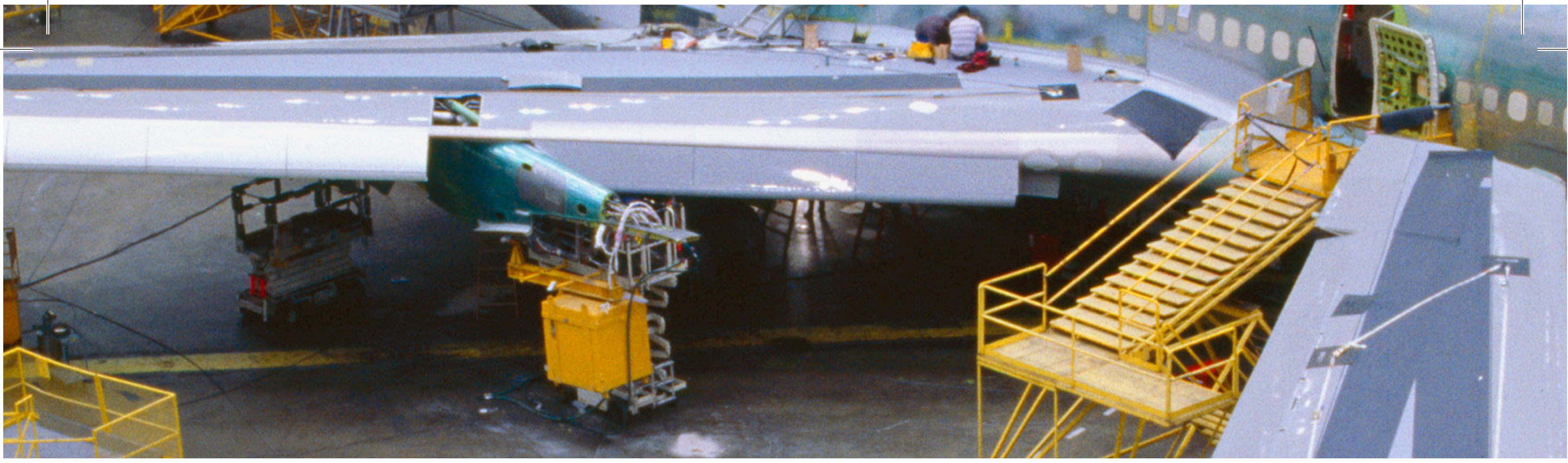
Overview of tax framework in India

India has a federal set up of tax administration under which the government levies taxes on income, custom duties, central excise and service tax, whereas the state government levies taxes like value added tax, works contract tax, etc.

Corporate income-tax

- Permitted business presence in India for a Foreign Company includes project office, branch office, liaison office and subsidiary or JV company. Limited liability partnerships (LLPs) can also be incorporated for carrying out activities where 100% FDI is allowed, through the automatic route (such as rendering marketing or other similar services).
- Effective corporate tax rate for domestic companies is 32.445%; 30.9% for LLPs and 42.024% for foreign companies.
- While dividend income received from domestic company is exempt in the hands of the shareholder, dividend distribution tax (DDT) at 16.22% is levied on the companies declaring dividends. Presently, LLPs are not subject to DDT.
- Minimum alternate tax (MAT) or alternate minimum tax (AMT) is applicable at 20.01% (companies) and 19.05% (LLPs) of book profits when tax liability under normal tax provisions of the Income Tax Act, 1961, is less than 18.5% of book profits.
- India has entered into comprehensive treaties for avoidance of double taxation ('tax treaties') with over 82 countries. Tax treaties can be invoked by taxpayers, wherever their provisions are more beneficial over the domestic tax laws of India. However, in order to obtain any benefit under a tax treaty, it is necessary for the non-resident taxpayer to furnish a certificate





containing prescribed particulars from its government.

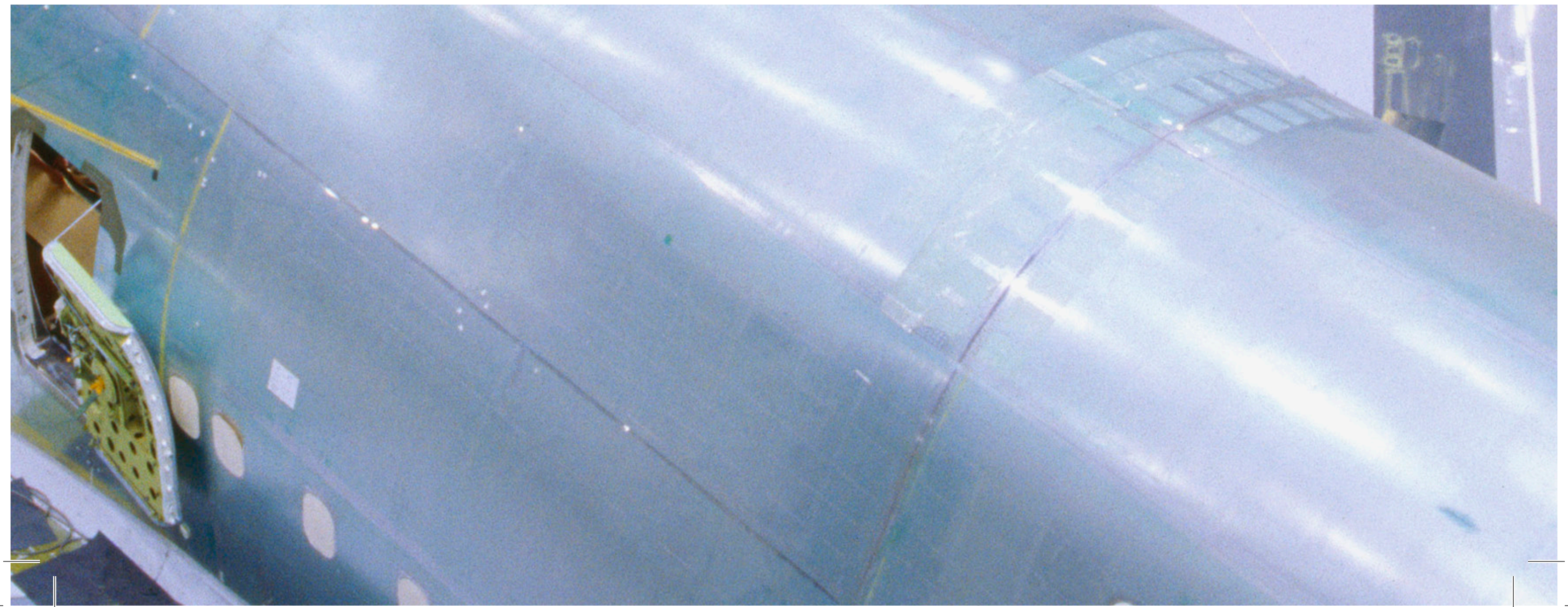
- India has also entered into Tax Information Exchange Agreements with over 21 countries.
- A well established withholding tax regime exists in India. The payer is required to withhold tax on all payments to non-residents, which are taxable in India. Further, certain payments made to residents also attract tax withholding provisions.
- Fees for technical services and royalty are taxable in India, on source basis and attract a tax withholding of 10.506%.
- Tax losses can be carried forward for eight years, while tax depreciation can be carried forward indefinitely.
- Foreign companies, especially those in the aerospace and defence (A&D) sector, should carefully structure their Indian operations and cross border movement of personnel, to mitigate chances of constituting a permanent establishment.
- Direct Taxes Code, proposing to revamp the existing legislation is under consideration. However, there is no clarity on the date of its enactment.

Transfer pricing

- International transactions with associated companies need to be at arm's length price and comply with transfer pricing regulations. Transactions with domestic related parties also need to comply with transfer pricing provisions, where the aggregate value of such transactions exceeds 50 million INR.
- Taxpayers can up-front approach the Authority for Advance Ruling to determine income-tax implications of any proposed or current transactions. The Indian government has also introduced advance pricing arrangements (APAs). APA is an agreement between a taxpayer and a taxing authority on an appropriate transfer pricing methodology for a set of transactions over a fixed period of time in the future.

Indirect tax implications for defence sector

- Effective customs duty rate on import of goods is 28.85 % based on peak rate of customs. Exemption is available to imports by the Ministry of Defence and its contractors, subject to conditions.
- Effective excise duty rate on manufacturing activity is 12.36 % [inclusive of education cess (EC) and secondary and higher education cess (SHEC)]. Exemption available to goods manufactured by DPSUs along with other product-specific exemptions.
- While inter-state sale of goods is subject to levy of CST, intra-state sale of goods are subject to levy of VAT. CST rate is 2% against submission of statutory forms by the purchaser else VAT rate of the originating state would apply. For most of the goods, VAT rate is either 4% or 15.5%. No general exemptions or concessions available on sale of goods made to defence; VAT legislation should be examined.
- With effect from 1 July 2012, the system of levying service tax has been changed from a positive list (wherein certain specified services are leviable to service tax) to a negative list pursuant to which only 17 specified services shall remain outside the purview of service tax and the remaining services shall be taxable.

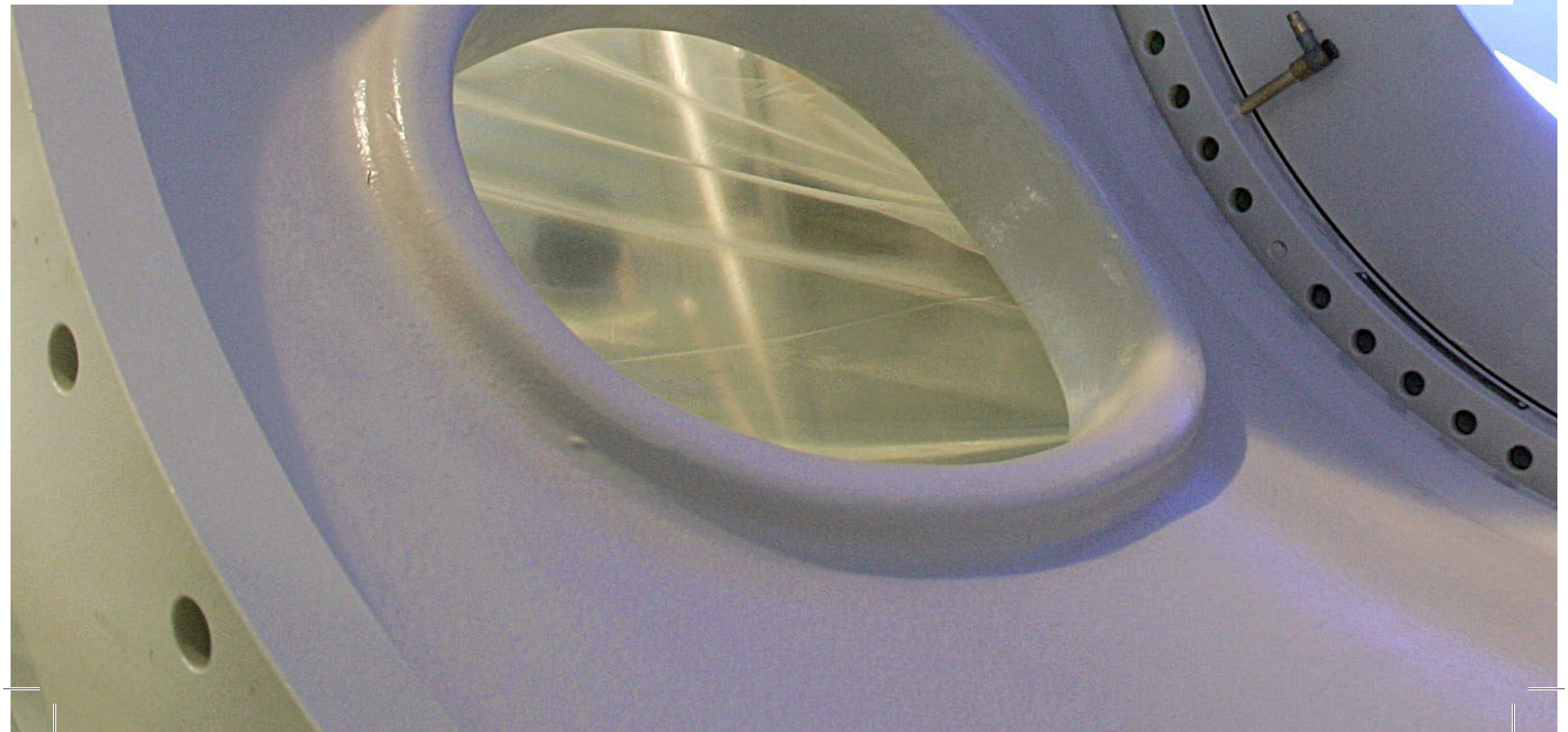


Typically, service providers are liable to charge service tax on the invoices and deposit the service tax so collected with the government exchequer. However, under certain specified circumstances, where the service provider is located outside India, the service recipient in India is liable to pay service tax under the reverse-charge mechanism. Currently, service tax is leviable at the rate of 12.36% including EC and SHEC. Further, specified services provided by or to the government are not subject to service tax.

- The states are also authorised to levy other local taxes such as entry tax. Furthermore, local authorities and municipal corporations impose local taxes.
- R&D cess at 5% is applicable on import of technology into India by an industrial concern under a foreign collaboration. However, the cess paid can be adjusted against service tax liability accruing under certain service categories.
- Indirect tax incentives are available to SEZ units for their authorised operations.

Tax incentives

- Units set up in a SEZ enjoys 100% tax holiday on profits on exports for five years and 50% tax holiday for the next 10 years (subject to specified conditions), but they are subject to MAT provisions.
- SEZs are deemed to be located outside the customs frontier of India and units located inside the SEZ can import goods without payment of customs duty. In addition, local procurement of goods can be made without payment of excise duty and services procured by the SEZ enjoy exemption / refund of input service tax. The benefits on State levies vary based on the State Laws.
- Income earned by a foreign company by way of fee for technical services or royalty, pursuant to an agreement with central government, for providing services on projects concerning security of India is exempt from tax, provided the same is notified in the official gazette.
- Undertakings manufacturing specified goods located in north-eastern states enjoy 100% tax holiday up to March 2017.
- Deduction of 200% is available for scientific research expenditure incurred by a company engaged in manufacturing or production of any article (subject to certain exceptions), on in-house R&D facility (up to 31 March 2017). Subject to specified conditions, deduction of 125% of payments made for research in scientific R&D is also available to an Indian company.



About PwC Aerospace and Defence team and our services

We are a multi-disciplinary team of professionals with diverse background and experience cutting across our lines of service. Our people and culture, promoting knowledge sharing and best practices have been our greatest strengths. This is reflected in our strong global Aerospace and Defence practice that serves most of the leading global and Indian Aerospace and Defence companies. As part of this global network, we leverage the global connects and capabilities of PwC's global A&D practice. Further, our deep understanding of Government regulations and industry issues in India helps us understand clients needs better and deliver greater value.

To provide high quality service, our partners and consultants invest considerable time in developing our industry expertise. Our team maintains strong yet independent relationships with the Government and constantly shares knowledge with players in the defence sector and Government. We also conduct research, arrange workshops and conferences to deliberate upon important issues for the development of the industry.

Your requirements	Our service offerings
Regulatory Advice/ Approvals	• Policy advisory • Advice on necessary regulatory approvals – Industrial License, FIPB, RBI • Assistance in obtaining clarifications/approvals from the relevant regulatory authorities • Assistance in making representations to the regulatory authorities • Offset related assistance - structuring offset and banking proposals, regulatory review of bids. • Managing offset programme
Tax and Regulatory Structuring	• Advice on creating a tax efficient business and capital holding structure keeping in view regulatory restrictions relating to level of returns, repatriation, exchange control and other related issues under the Indian Companies Act, DPP/Offset, FDI and licensing policies • Providing implementation assistance • Tax advice in relation to various transaction taxes, corporate tax, transfer pricing, tax • Suggesting an appropriate business and entity structure, joint venture, contract manufacturing, consortium arrangements etc. to undertake the proposed operations. • Agreement review – assist in review of transaction documents, joint venture agreements from a tax and regulatory perspective • International assignment tax services for expatriates, both consulting and compliance, covering structuring of assignments including review of employment contracts, tax equalization policies, employees stock plans, fringe benefit tax, Indian Social Security applicable to International Workers
Advisory Services	• Supply Chain Management – assistance in selecting offset partners • Performance Improvement • Risk and compliance management: Institutionalizing risk and compliance monitor process that enables tracking and stakeholder reporting of compliance to offset guidelines • Business controls advisory - collaborating with management to develop standard operating procedures / policies that enable strengthening of the offset management process • Internal audit - Perform periodic internal audits to assess compliance to internal policies and procedures and compliances requirements • Strategy & Research – Market Entry & Growth Strategies; Market size, scope and mission identification, Gauge competition, strategic business planning, developing a target operating model and partner assessment. • Joint Venture partner search : financial/strategic • Joint venture partner due diligence • Transaction support including structuring, valuation, negotiations, fund mobilization and shareholders agreements • Assistance in acquisitions

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