



Turning Indian Offset Obligations Into a Strategic Advantage

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The Indian aerospace sector is booming. Building on the experience gained in the IT and engineering sectors, new and powerful actors are emerging with global ambitions.

Foreign companies that sign civil or defense contracts in India most often face offset obligations, i.e. they need to sub-contract / invest in India a pre-set proportion of the contract in India.

Beyond compliance, offset partnerships represent a strategic opportunity for Western Companies to build new capabilities and scale them out of India.

Rather than subcontracting marginal work, Western companies have an opportunity to leverage offsets to build and scale new capabilities from India.

How are the Indian aerospace industry and market developing?

With a projected investment of US\$300 billion over the next 25 years, the Indian aerospace industry is positioning itself as one of the fastest growing and most dynamic industries globally: The civil aviation has reached the 9th position in the world, with air passenger and freight traffics growing by 28% and 11% in 2007 and a projected order book of 850 new airplanes (US\$73bn) in the next 20 years.

Military expenses are projected to reach US\$35bn in the next 20 years, and India is one of the 6 countries in the world that perform space launches.

The Indian Government has been actively supporting the development of the aerospace sector which was largely liberalized in 2001: Private airlines represent 75% of the domestic market; Private-Public-Programs are implemented in many sectors such as Engineering, Manufacturing, MRO etc; Aero-parks and dedicated Special Economic Zones are being set-up; 100% Foreign Direct Investment are now allowed in activities such as MRO, Engineering, Airports, R&D activities, IT and IT-enabled services.

Why should your company look at taking positions in India?

The Indian Aerospace sector is buoyant and fast-growing and will largely benefit from the experience and best practice gained by the IT, IT-e, automotive and engineering sectors. You should expect the Indian Aerospace sector to grow rapidly:

Most global players are now in India.

With an order book of 347 aircrafts from Indian Airlines, **Airbus** announced in March 2009 its plans to have an Indian manufacturing base in the next 3-4 years. Airbus plans to double the capacity of its Bangalore design centre in the next few years and to outsource US\$ 5bn aerospace components, systems and software to India over the next 10 years.

Boeing announced in March 2009 the opening of a R&D centre in Bangalore. The centre will coordinate the work of more than 1,500 technologists from across India. Boeing also started outsourcing to India for the Dreamliner and F18 Super Hornet, involving technology transfer for sophisticated composite materials. Boeing also has a \$1bn partnership with **HAL** in the defence sector and will outsource \$600m aerospace structures and aviation electronics under the offset policy.

Helicopter players like **Sikorsky** and **Eurocopter** are also establishing manufacturing and engineering facilities in India, teaming up with local giants such as **Tata** in Special Economic Zones.

Among French companies, Thales, Safran, Dassault Systèmes, Cap Gemini, and Sogeti also have long-lasting Indian presence, often via Indian JVs, for R&D, manufacturing and Software development.

What is India's offset policy¹?

Any industrial defence contract between India and a foreign supplier worth over Rs. 300 crores (U.S. \$70 million) carries a minimum offset liability equal to 30% of the contract's value. No defence contract with India is effective unless the company fulfils its offset obligation.

¹ For in-depth analysis of the legal aspects of the Indian offset policy, please see "*The Do's and Don'ts of Offsets in India*" by Francois Montrelay (P2P Consultants) and Diane Mullenex (IMA Avocats). This article is available at <http://www.p2pconsultants.com/index.php/articles>

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In practice, the Defence Acquisition Committee often requires offset obligations up to 50%, depending on the circumstances.

Foreign companies may directly purchase products manufactured by Indian companies; perform export orders for Indian defense companies; invest directly in Indian defence companies; set up defense training facilities, source components, technology sharing, or provide Indian defense IT services; or invest in research and development organizations certified by the DOFA.

Civil offsets (also called “concessionary transactions”) are informal arrangements which the buyer and seller agree upon on a case-by-case basis.

How can you leverage your offset partnership to build a strategic advantage?

Many companies first look at offset obligations as lost revenues, potential difficulties to control IP, quality and delivery, or an administrative burden.

There is an element of all of this in an offset contract, but there is also much more to it:

An offset partnership offers your Company an opportunity to build new capabilities and scale them out of India while improving your profitability: By building Indian presence, many foreign companies have been able to build new capabilities, scale them, and market them globally: Cisco, Ford, Hyundai, GE, Honda, Honeywell, IBM, Accenture, Cap Gemini, Dassault Systèmes, are a few of them, among so many others. As it comes to aerospace offset contracts, a similar approach is possible, provided that some key strategic questions are clearly posed and answered:

- What part of your activity are you ready to perform in India? Your answer should reflect your strategic positioning and geographic expansion plans: An Indian presence is a definite asset to develop cost advantages and fast and efficient scale-up / scale-down capabilities. It also helps enter US and Anglo-Saxon markets. Subcontracting “what your company does not like to do” is different from building a long-term partnership. Your answer should also reflect the readiness of your organization to work with a partner and change its ways of working.
- What type of partner should you look for? The right partner for the right strategy is the key approach here. Some Indian players position themselves as pure price-based subcontractors.

They have little ability to absorb skills and technology transfers. Other players are eagerly looking for to go up the value chain and are ready to build very intimate partnerships in that end.

- Realistically, what skills are available today on the partner’s side, and how will you bridge the gap in the medium term?
- How will you effectively control the partnership? Different controls are required, depending on the nature of the partnership, the risks, and the complexity of the services / products delivered by the partner. A counter-intuitive rule here is, the deeper the partnership, the more the Indian partner will involve itself and allow and implement controls.

Which Indian players could your company partner with?

Building on lower labor and manufacturing costs, on a large and growingly qualified workforce and on offset opportunities, Indian players build capabilities in most fields of the Aerospace sector. Most of them have approvals to act as Global Offset Partners:

- Engineering Services Outsourcing: In 2020, India will own 25% of a total market estimated to US\$200bn. Some key players are Tata Technologies, Infotech, Quest, Cades, etc.
- R&D Centers and PPPs (Airbus, Snecma; Boeing+Wipro+HCL; HCL +Smith; Wipro+BAe...)
- Manufacturing (Tata Advanced Systems, HAL, Bharat Electronics, Mahindra Engineering...)
- MRO (HAL, Hamco, Airworks India, Max Aerospace...)
- HAL (33,000 employees) and Bharat Electronics (12,000) are the two main and Government-owned players in the defence sector. They have implemented several JVs and supply agreements with Indian and foreign partners to bring the right level of technology into the Indian Defence sector.

M&A, JVs and partnerships are now frequent in that space.

What type of partnership can you build?

Various options are available from pure subcontracting / offshoring contracts to JV, Greenfield operation and partial or full acquisition. There are pro’s and con’s for every option that can be as-

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sessed on a case-by-case basis. Some legal constraints apply (limitation of FDIs in certain sectors) and can be dealt with, once again on a per-case basis.

Practically, how can you look for an Indian Offset Partner?

Whatever type of partnership you are looking to build, having access and talking to the highest decision levels in the potential partner organization **in India** is critical.

Looking for an Indian partner will include several steps:

- Develop technical, financial and “soft” specifications to reflect your actual needs.
- Motivate candidate partners by making the prospect of collaborating with your Company

attractive. Indian players are over-solicited and tend to select their own partners...

- Implement tendering and evaluation processes, including meetings between the two organizations.
- Perform selection and contracting.
- Build and manage the partnership.

Along those steps, managing the cultural aspects of the relationship and the internal sensitivities within the Company will play a critical role.

When dealing with defence contracts, you should also include some regulatory aspects such as dealing with DOFA in the approach.

If you have further questions on the subject please feel free to contact us, and we will be glad to assist you.