

Peek into A'n'D

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Aerospace & Defence

"War never pays its dividends in cash on the money it costs."

- Sir Winston Churchill

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Listed Indian DPSUs (as on 10 th Feb 2021)	Share Price (INR)	Market price (INR cr)
Hindustan Aeronautics Limited	1009	33,974
Bharat Dynamics Limited	340	6,295
BEML Limited	979	4,036
Mishra Dhatu Nigam Limited	186	3,520
Garden Reach Shipbuilders and Engineers Ltd	193	2,255
Bharat Electronics Limited	139	33,613
Mazagon Dock Shipbuilders Ltd	224	4,438

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Our Take

2021 has begun on solid footing for the indigenous industry in India.

A \$6.5bn contract for 83 LCA Tejas aircraft (73 Tejas Mk1A and 10 Mk1 trainer aircraft) - the largest order for indigenous procurement was signed during Aero India 2021 earlier this month. A \$20mn order for an undisclosed number of indigenous SWITCH tactical drones was awarded to an Indian company. Policy regulations have been relaxed including performance guarantee rules for defence contracts. Aero India 2021 also witnessed a display of India's combat air teaming system (CATS) with an internal weapons bay deploying a DRDO SAAW - a very significant development that could enable a multiple fold jump in capabilities.

That said, while there was a lot to cheer about in terms of orders and capabilities the defence sector again found no mention during the entire Union Budget speech.

The allocations while on the face of it when comparing BE numbers appear to be a significant YoY increase, a deep dive brings forth the reality that the RE of last year and the BE of this year are almost similar - nominal increase and almost flat.

Last year witnessed two significant causes for drain of resources - Covid-19 and China. Last year's revised budget reflected significant emergency investments to counter China aggression in border areas. A possible fact is emergency purchases may still continue if the situation does not improve on the LAC. While imminent procurements cannot be stopped, it is again imperative to point out that indigenous sourcing requires investment in R&D which in turn requires investment of time, money and trust. Make Projects were proposed with the intention to do just that. However, the trends indicate a reduced emphasis on Make projects. The Government would need to come forward and invest along with the industry in order to push R&D and manufacturing.

The year 2020 saw some significant measures including progress on the OFB corporatization and the DTIS project. 2021 brings a new decade - one that arguably is the most critical for India from an aerospace and defence sector perspective. There are too many opportunities and too many catalysts for the private industry to step up. It is for the government to support and collaborate via PPP or other means and it is up to the private industry to prove their mettle again.

Maj Gen Rohit Gupta, SM (Retd)
Head - Aerospace and Defence
Primus Partners

Key take-aways

1	The overall defence expenditure planned for FY22 is INR 3,62,345.62cr, an increase of INR 24,792.62cr over FY21 BE. In FY21, MoD expended an additional INR 20,776cr for buying new weapons and equipment over and above the funds allocated. Should the problem at the LAC be resolved amicably, given that the FY22 BE is almost at par with the RE of FY21, the additional allotment can be fruitfully used for planned capability building and modernisation rather than adjusting it in piecemeal emergent procurement. For this judicious expenditure would be required.
2	Given the declared plans for corporatization of OFBs and disinvestment of PSUs, the funds generated can be utilised effectively for creation of a corpus for defence modernisation. This may come as an additionality at RE Stage.
3	The capital allocation for the DRDO has been increased by 8% (INR 11375.50 cr) and for Border Roads by 7.5% (INR 6004.08 cr), indicating the Government's intent for advancements in research and much needed development of infrastructure including roads and bridges in forward areas.
4	Allotment of greater allocation will lead to underutilisation unless accompanied by enabling provisions to ensure its optimum expenditure. Hitherto fore, it is also our inability to align defence budgets to acquisition plans, which has contributed to slow pace in modernisation. Defence capability development is an expensive and lengthy process. The challenge is to assess the requirement for deterrence levels and what should be the optimum defence budget allocation to ensure it. Given the circumstances, the Government has done a reasonably satisfactory job in the defence budget 2021-22. The key issue remains to be able to expend it and create room for more in-flow at RE stage.

Insights and Analysis

- Defence Budget 2021-22



For 2021-22, the Ministry of Defence has been allocated INR 4.78 lakh crore, a 1.4% increase vis-a-vis the previous year's budget which stood at INR 4.71 lakh crore. This includes revenue, capital, civil and pension expenditures.

If we look at the break up between the 4 heads in the budget, ex pensions, the budget is 1.63% of GDP and the total capital and revenue component of the budget reported a ~7% increase. Allocation for capital procurements increased by ~19%. However, a ~13% decrease in pensions resulted in a flat total budget YoY.

Comparing the budgeted estimates of the current and last year, the increase is significant for capital procurement budget. However, last year was different than other years. Last year saw significant emergency purchases to counter the Chinese offensive on the LAC - resulting in a revised FY20-21 budget which was almost INR 21,000 cr more than the BE. Hence, comparing that with the BE of FY21-22 results in an almost flat budget

Army is the largest of the three forces, both in terms of budget as well as number of personnel. Army has been granted a capital outlay of INR 36,481 crore as against the RE of INR 33,213 crore in 2020-21. This includes a 100% increase in allocation for Heavy and Medium Vehicles along with a ~40% increase in allocation for Rashtriya Rifles. Aircraft and aero engines for the army saw a ~6% increase in allocation vs BE FY21 but the RE was lower than the BE last year indicating that allocated funds were not fully utilized for the purpose.

Navy is arguably the most indigenized when it comes to Indian defence forces. The BE for FY22 shows a ~25% increase YoY with Other Equipment and Naval Fleet accounting for a major share of the increase. The BE FY22 however shows a decline compared to the RE specifically in the aircraft and aero engine category probably also accounting for the lease contract for the armed UAVs.

The Air Force forms the largest chunk of capital expenditure allocations. Justifiably so given that the entire aerospace fleet

including aircraft and helicopters is being modernized. The land component of the Air Force witnessed a ~250% increase probably accounting for the infrastructure build up. 'Other equipment' and 'Special Projects' also had higher allocations from last year.

The allocations for Research and Development are 8% more in the current year compared to BE of last year. However, the reduced allocations as per RE of last year indicate that the allocated funds were not completely utilized for R&D. Hence, the current allocations to R&D although slightly higher than BE of last year still do raise concerns. Further, allocations for Make projects continue to get subdued attention possibly due to few projects moving out from Make-I category which requires government funding.

The current capital allocations in FY22 budget, at almost similar levels as RE of last year falls short of the requirement to address new procurement purchases. In light of a possible two front war being considered, emergency purchases (especially from foreign companies) may still continue for a while before the planned assembly lines and facilities are ready with the indigenous industry

- We expected an announcement to further increase allocation of funds for defence procurement beyond the INR 52,000 cr announced during the Atmanirbhar Bharat campaign.
- A long outstanding demand of the Services for a non-lapsable fund being created has also probably not been considered.
- A higher allocation to R&D has been done but it is also critical to utilize all available funds completely for the same purpose
- The private industry needs to be further incentivized for investing in R&D
- The OFB corporatization and the DTIS projects need to be followed up to completion so that the existing and the new infrastructure can be efficiently utilized

News & Announcements



Some buzz on the industry

India relaxes performance guarantee rules for defence contracts

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Indian Coast Guard is reviewing manpower, assets, infrastructure, maintenance and repair facilities requirement to meet emerging challenges. ICG aims to have 200 ships, 100 aircraft soon

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DRDO and Army develop India's first indigenous machine pistol. The machine pistol fires the in-service 9mm ammunition and is likely to have production cost under INR 50,000 each

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Government set to divest stake in Defence PSUs GRSE and MIDHANI

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India building economic, defence corridors to take infrastructure to global standard: PM Modi

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Order for 83 Tejas fighter aircraft signed during Aero India 2021. First batch of deliveries to begin in 36 months.

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Some buzz on the industry players

HAL revealed the Combat Air Teaming System family of loyal wingmen or manned-unmanned warriors with mock-ups at Aero India 2021

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Thales, Bharat Dynamics ink deal to work on air defence system

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'Idea Realization'— a unique approach to examine futuristic ideas required for the growth of an organization or a sector or geography, from the perspective of assured on ground implementability.

India is and will continue to be a complex opportunity. Private and Public sector need trusted advisory partners in order to tap into this opportunity. Primus Partners is your go-to trusted Advisory for both public and private sector organizations involved intricately with nation building, and the creation and growth of robust corporations as engines of progress.

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Primus Partners brings experience of working in more than 30 countries with private and public sector, including working with Government of India, building and leading large consulting teams at the leadership level, and creating one of the largest public sector consulting practice in India. They also represent 200 person years of experience in leading global and Indian consulting firms and the public sector.

The founding team is supported by a distinguished advisory board that includes experts with leadership experience across government, large corporate and notable civil society organisations.

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