

MSMEs' access to Defence sector: A two pronged approach

Besides accounting for almost 40% of India's Industrial production, the MSME sector is also a life line to the most advanced sectors of the country such as Auto, Engineering, Electricals and Electronics, IT & BT among others. However, so far as the Defence sector is concerned, they have remained at periphery.

Why MSMEs' access to Defence sector is strategically critical? There are three reasons,

Firstly, it helps generate additional business for local industry / MSMEs and also create positive externalities of additional employment and resource generation. Secondly, it helps build deeper supplier base and build indigenous capabilities. Thirdly, and most importantly, with intelligent use of procurement policies and offsets, it can facilitate development of or access to critical and cutting edge technologies which hold potential of creating economy wide impact.

Following a brain storming session with top OEMs supplying to India Defence sector (6th May 2015, New Delhi) and a larger seminar with all major stake holders including OEMs, Indian large companies, MSMEs and associations, DPSUs and defence experts-which was inaugurated by Hon'ble Raksha Mantri himself (11 June, 2015 New Delhi), FISME has identified a set of interventions that could break-open the Defence sector for MSMEs. The approach has the following prongs:

1. Orders and Mandates for R&D, Production and Supplies
2. Institutional support and capacity building

1. Orders and Mandates for R&D, Production and Supplies

- i. The Defence Procurement DPP 2015 should mandate that minimum 20% of the contract value must be procured from the MSME sector. To make it effective the policy must have a clause of reasonable financial penalty in case of non-compliance (say 10% of the PO value) with provision of disbarment from participation in the MoD tenders for certain period (say 5 years).
- ii. To ward off predatory pricing by large companies, the L1 condition if any should be considered within the MSME suppliers only in Public Procurement Policy for MSEs to Defence PSUs and Ordinance Factory Boards following 20% of procurement from MSMEs.



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- iii. Under the “Make” category, the Prime contractor should be mandated to offload at least 50% of the material cost by value on to the Indian industry and of that minimum 50% i.e. 25% of the orders must go to MSMEs. The clause will ensure that a supply chains gets created in the country involving MSMEs.
- iv. **Single vendor issue:** To encourage MSMEs to work with Defence institutions in developing new equipment, upon successful development and deployment, bulk orders/or a committed order quantity must be placed within a defined time frame and such cases would not fall under “Single Vendor” case if the vendor is an MSME Unit. Secondly, in case of repeat order, the commercial RFP should be given only to the “approved vendors” who have developed the equipment if the GSQR remains the same. Further, if the vendor happens to be an “MSME Vendor” the case should not be treated as a single vendor case.
- v. Deviation from General Financial Rules (GFR) in terms of multi-vendor procurement may be allowed if the OEM is ready to participate in Make in India.
- vi. **Offsets:** The Offset Policy must be made flexible and MSME friendly. At present MSMEs are unable to take advantage of the 1.5x multiplier offered by the MoD. Following policy interventions can be very effective:
- Minimum 50% of the Offset obligation must be reserved for the MSME sector.
 - MSME Sector should be given benefits of Direct Off-sets in areas such as Spares production and support, Simulators, Ground support equipment and infrastructure including installation.
 - The MSME sector should be given subsequent maintenance upgrades and Logistics supplies including consumables for major weapon systems be entrusted to MSME sector (This will benefit the country in acquiring 'know-why' of designs and it should be part of the System approach when negotiating major projects for end to end solutions. This will also avoid prolonged unserviceability of imported systems due to lack of timely product support within the country).
 - The Foreign Vendors may submit their Offset discharge plan on a yearly basis naming the Indian Offset Partner and their work share. This should be applicable on all contracts under execution and in the pipeline and the Foreign vendor would be free to choose his IOPs afresh.
 - The entire supply chain of the foreign vendor wherein the product technology resides consists of small units. To draw maximum benefits through the Offset policy, the foreign vendor should have the flexibility to discharge his offset obligation through his supply chain with no restriction on value.
 - The abeyance order on ‘Services’ must be lifted as it is an important route for transfer of technology/ know-how and other critical services such as in country repair and maintenance, MRO, software, design, training, documentation etc.



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2. Institutional Support and Capacity Building

- i. There is a need for setting up an **MSME interface in MoD** to coordinate various policy interventions and their compliances with regards to MSMEs reporting directly to the RM. Special focus is needed for Transfer of Technology from DRDO to MSMEs.
- ii. **An institutional mechanism** is needed either as a separate Department of MoD (on the lines of US DoD Small Business) or a preferably a professional agency as a Programme Manager which would be required to do:
 - Building Data bases of:
 - Potential MSME suppliers who could be made defence ready
 - Possible products to be sourced from MSMEs
 - Specific requirements of OEMs/ Tier-I and II suppliers
 - Preparing an Action Plan to bridge the demand and supply gaps in areas such as Technology, Quality/ standards, Skills and Management Systems and execute specific projects
 - Organizing awareness programmes for MSMEs about opportunities
 - Facilitating interaction between the supply chain of the foreign OEM with the Indian MSMEs
 - Running a dedicated portal
- iii. **MSME consultation:** FISME- as a representative body of MSMEs, should be allowed to participate during the MoD discussions in 'Make' or 'Buy and Make' projects to ensure Tier-II/ Tier-III involvement.
- iv. **Strategic Defence Clusters:** The cluster development approach can yield quick and large dividends in terms of scaling up the contributions of MSMEs to Indian defence production. To create fully functional eco-system for defence manufacturing in MSMEs, 10 locations could be identified to develop Defence Clusters. The clusters could be fortified with common facilities such as specialized facilities like the JSS 55555 testing facilities, Warehousing facilities, R&D and Technology upgradation and training institutions, 'Plug and Play' high tech infrastructure facilities specially meant for systems, electronics and other niche areas of manufacturing to support the production ecosystem. A few such clusters with supporting infrastructure for aero structures, landing gear, engine components, avionics etc. to attract global investments. The Central government needs to work in tandem with States and global OEMs for developing such clusters.
- v. **Skill:** India's distinct competitive advantage lies in its human capital and this is also true for the defence sector. The skill gap in defence production is found to be acute. Therefore there is a need to integrate National Skill Mission goals with priorities in the defence manufacturing sector as well as a need for curriculum development in engineering colleges and other vocational centres.



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- The ITIs may be allowed to be adopted and to be converted into defence focused skill development centres using offsets. Capex could be borne out of funding available with the MSME ministry and training cost could be borne out of Govt schemes (Ministry of Entrepreneurship and Skill Development)
 - In addition templates such as the mentor-protégé programmes followed by the DOD in the US, can act as catalysts for skill development.
 - Special 'systems integration' skilling programmes at the level of the various vocational institutions as well as key engineering institutions in India are needed.
 - Government should form a cross functional team comprising of industry bodies such as FISME, OEMs along with NSIC, Ministry of MSME, MoD, MoCA to come out with an action plan to develop aerospace skill development centres across the country.
- vi. **Finance:** MSMEs participating in Defence business are handicapped by the peculiar financial needs of the sector.
- a. There is a need to create a new class of capital for the Defence MSME Units to fulfil the need of the both fund based and non-fund based requirement, provide collateral free guarantees, project/program financing, technology development or acquisition and Infrastructure upgrade to the SMEs operating in the defence sector at low cost. The "Defence SME fund" can be created by any of the following or a combination thereof:
- Allowing offset obligor to invest a part of his obligation in the fund and this deposit will be deemed to have fulfilled his offset obligation. The fund may pay interest at international rates say at 2% and the tenor is proposed to be 5-6 years. (Similar on lines of RBI's Priority Sector Lending policy where Banks who cannot fulfil their obligations of lending to MSMEs are required to deposit the equivalent amount with SIDBI).
 - Or a Cess of 1% can be levied for all defence imports and revenue generated can be transferred to this fund.
 - An initial budgetary support of say Rs.1000-2000 Cr could be made to kick starts the activity.
 - SIDBI already has experience of managing such Funds and has an exposure of more than 84,000 cr. A separate window for the "SME Defence Fund" may be established.
- b. The cost of acquiring and maintaining a bank guarantee is crippling for MSMEs. The requirement of the Bank Guarantee for the MSME units should be waived and in lieu thereof an indemnity bond should suffice. Only in case of advance, a Bank Guarantee may be asked to be furnished by the MSME unit.



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- c. Milestone payments should be made to the MSME unit on the same lines as being followed for the DPSU Units without the requirement of matching Bank Guarantee.
- vii. **Taxes and levies:** Domestic suppliers should be given the level playing field and Tax exemptions should also be available to Defence industry as those are available to Infrastructure, Civil aviation or Shipping industry. By not doing so we would discourage Defence sourcing from and manufacturing in India. The Government should consider 'infrastructure' status to the Aerospace and Defence industry and providing various concessions/benefits in the form of tax incentives to A&D manufacturers, both from direct and indirect tax perspectives, so as to augment domestic production.
- viii. **Organisational Integrity:** The benefits asked for above are for the MSME units to enable them grow in capabilities, revenue and capacity. MSME units that are an 'Associate' or a "Subsidiary" or a JV of a non-MSME company, they would not be deemed to be "MSME Unit" eligible to avail the above benefits.
- ix. Government should encourage MSMEs to achieve aerospace **certifications** and approvals like Industrial licenses and AS9100 to build components for global OEMs.



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