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To, **20th December, 2016**

Mr. Ramesh Kumar
Lt Colonel,
OSD, DOMW
Ministry of Defence, Government of India
South Block,
New Delhi 11001.

Sub: - <u>Venture Capital Fund - Working Group Report</u>

Dear Sir,

Thank you for your time to meet with the committee to discuss the VCF participation as a category in the Defence Offset Management. The working groups report is attached for your reference and the salient points which constitute the revised proposal, based on our discussion are mentioned below:

1. Offset multiplier of 3.5 at the time of OEM making investment in the fund

2. Offset multiplier of 2.5 on the cumulative incremental revenue generated by the 'DPP eligible' organizations in the Fund

3. Offset multiplier of 1 on the cumulative incremental revenue generated by the 'synergistic sector' organizations in the Fund

4. 35% of the capital invested must be with 'DPP Eligible' companies. Rest can be with companies in the 'synergistic sector'.

5. Irrespective of OEM buying from the companies in fund, the credits based on multipliers of 2.5 and 1 to be given to all OEMs who have invested in the Fund, since the investment has generated the ecosystem. (Note that if revenue of all the companies in the fund is 0, no credit is awarded to OEM)

6. The multipliers and time of award of credit is in-line with current norms in the commercial aviation offsets as well as offset policy of Turkey (examples provided in the paper)

7. Credits accrued after Period of Performance to be banked as per current banking norms.

8. OEMs can directly invest in OVF or MoD can nominate a public sector entity to manage the investment in all such funds. Similar arrangement exists for a fund of fund created by GoI for electronics and semiconductor MSMEs. All funds to be compliant with SEBI regulations.

9. The capital as well as profit invested by OEMs in the OVF will not be taken out by the OEM at any time. Therefore, over the course of time, the size of the fund may significantly increase and become a source of capital for MSME organizations.

We thank you once again for your assistance and look forward to your kind consideration.

Kind regards,

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Venture Capital Fund - Working Group Report

1.0 Background

The Defence Procurement Procedure (DPP) provides multiple avenues for discharge of offset obligations. OEMs can choose any one or a combination of these avenues. Though several avenues such as procurement of eligible products and services, FDI, Transfer of Technology (ToT) & Transfer of Equipment in 'kind' are available to OEMs to discharge offset obligation, majority of OEMs prefer procurement of eligible products and services as a preferred avenue.

It is estimated that approximately $7 Billion offsets are currently being executed by Foreign OEMs. Another $10 Billion to $15 Billion are in the pipeline to be executed till 2027. Significant structural changes need to happen in the Indian defence industrial base if it were to absorb huge amounts of offsets and move up the value chain to support defence indigenization objectives. Increased participation of Micro, Small, Medium Enterprises (MSMEs) in defence sector would represent one of the crucial structural shifts in the Indian defence industry. MSMEs contribute to more than 45% of manufacturing output in India and provide employment to about 80 million people. However their participation in the defence sector is limited due to constraints faced by MSME's in obtaining capital from the market, lack of formal management skills such as program management, sourcing, supply chain planning etc. and domain specific skills related to manufacturing including the necessary qualification and certifications etc. These constraints make the MSMEs in defence sub-scale and relatively non-competitive compared to defence organizations in other countries.

DOMW has floated a concept paper suggesting investments in MoD approved Venture Capital Funds (VCFs) as yet another avenue for offset obligations. It is envisioned that VCF would provide access to the capital and also support in upgrading the skills at MSMEs to make them more competitive.

Essentials of the 'Concept Note' were discussed by the MoD with the OEM fraternity in a meeting chaired by Additional Secretary (Defence Production) on 16 Sep 2016. It was decided to form a smaller 'Working Group' to examine the issue in detail and provide suitable recommendations to MoD.

2.0 DOMW Concept Note – Comments

The concept note sets up context for the Offset Venture Fund (OVF). However, we felt that certain proposed provisions in the concept note may not be practical considering the executions of offsets by the OEMs and working principles of a venture fund.

Specifically, the concept note envisages that offset credit to be given to OEMs only after the MSMEs use the fund to carry out offset eligible activity. As explained further in this paper, this proposition fails to take into account the timelines for an MSME to be competitive (typically 5 to 7 years depending on market factors). Also, in a typical venture fund, investors (in this case OEMs) have no control over the fund once these are invested. A fund manager invests the capital in several companies; many of these may not grow as per the expectations or may even go out of business. Thus OEMs are under taking substantial risks with their investment since factors such as capability of the MSME, its ability to scale its operations, market factors etc. are not in OEM's control. If the offset credit is to be given only after completion of end activity, the risks for OEMs for capturing credits further goes up and avenue of OVF becomes significantly less attractive compared to other avenues available to discharge offset obligation.

The concept paper does not provide adequate clarity on ways by which OEMs can mitigate the risks outlined above, such as by award of higher multiplier.

3.0 Working of a Typical Venture Fund (VF)

In a typical venture fund, investors or Limited Partners (LPs) commit certain amount of money to be invested into the fund. The fund manager acts as a trustee and invests the funds placed by the LPs in eligible organizations. The fund manager decides the amount to be invested and the organizations in which the investment is to be made after performing necessary due-diligence. Certain Funds invest only in organizations in particular sector or at particular stage of their growth cycle. However, sector focused funds tend to be managed by specialist managers with many years (often decades) of experience in similar investment strategies due to the concentration risk that such funds carry. Typically VFs invest in several organizations with an assumption that not all investments will provide handsome returns. In return for the equity invested by the VF, the VF receives certain stake in the organization. Percentage of the stake given to the VF is determined by the value of the organization which is agreed upon by the Fund Manager and the owner of the organization. Since Fund is now part owner of the organization, it typically negotiates seat at the board of the organization. More so, the Fund Manager provides value by mentoring and coaching the management of the company on business issues with an aim to grow the value of the organization.

At certain point in time (typically after 3 to 7 years of investment), the VF aims to sell its stake in order to generate the returns for the Limited Partners. This can happen either by listing the organization in the stock market or by selling the stake to another fund. Since the value of the organization may have increased (partly also due to the support provided by the VF), the value of the stake of the VF has also increased. Hence the same stake is worth lot more when the organizations are taken public than when the investment is made by the VF.

The profits that are made due to this transaction are returned back to the LPs as per their proportion of capital investment. Certain percentage of the profits also go to the Fund Manager based on agreed terms between the Fund Manager and the LPs. Fund Managers typically take a percentage of the capital as fees (typically 2% of the capital invested by the Limited Partners) for managing the fund, identification of the right organization to invest, for performing the financial due-diligence, for providing mentoring and coaching to the organization management.

The sole objective of the VF is to provide handsome returns back to its investors by investing in organizations that are expected to grow in value.

3.1 Key Stakeholders & their Interests:

It is important to understand the objectives and interests of the key Stake holders to develop a policy that creates a 'win-win' among all stakeholders. The key stakeholders in the VCF policy are:

The OEMs: This particular offset avenue requires the OEM to provide valuable cash. Unlike investments of ToT or 'equipment' in kind, this investment would invariably involve an additional financial burden on the OEM. The capital deposited by the OEMs in the Fund would be non-refundable. Depending on how the Fund performs OEM may or may not get any returns immediately. Therefore, in this investment the OEM would be looking for commensurately rewarding offset credit as soon as investment is made in the Fund. It is also important from OEM's point of view that the credits are approved with a reasonable multiplier and within a reasonable time frame.

OEMs are also financial investors in the fund. The long term success of any VCF depends directly on the ability of the fund manager to consistently make risk weighted returns for such investors over time. It is important to ensure that this VCF idea appeals to such investors (in order to secure an initial corpus) and enables the manager to consistently deliver returns over time (so as to ensure sustainability of the franchise).

MSMEs: MSMEs would be the main beneficiaries of this offset avenue. Many MSMEs are already IOPs (Indian Offset Partners) of OEMs in offset contracts and many more seek to become IOPs. Many MSMEs are constrained due to lack of funds. Capital infusion would enable the MSMEs to expand their infrastructure, hire & train talent, improve business processes which would result in better quality product. MSMEs also struggle in developing formal management practices and domain specific capabilities which the Fund manager with help from OEM can provide. World class MSMEs embedded in the global supply chain of foreign OEMs would boost the 'Make in India' programme as well as help the OEMs in executing their offset obligations.

The Venture Fund House: The fund manager seeks fund from various investors (in this case OEMs) and identifies organizations in which this investment can be made after necessary due diligence. The fund managers often mentor and guide the organization to scale-up and help increase their valuations with an aim to generate attractive returns on the investments. Generally, the Fund Manager gets a fee equal to certain percentage of the capital that is brought in. Venture funds 'exit' out of companies either by selling their stake to another fund at higher value or by listing the company in the stock market. The profit that is made due to this action is distributed among the investors and the fund house in a pre-determined ratio. Fund managers do not own the fund – they act only as 'trustee'. The VCF's sole objective is to generate profits from the investments received. Therefore, it would like to invest in any company which can generate maximum profits. A key consideration for Fund Managers in devising and executing their stated investment strategy is risk mitigation. This is ideally achieved through a combination of diversification across sectors, stage of company (early stage/ growth stage/ mature stage etc.) and geography

4.0 Proposed Working Mechanism:

4.1 Scope of the Offset Venture Fund (OVF) Policy:

The effectiveness of the OVF policy will depend on ability to develop significant corpus fund in short duration of time so that the Indian enterprises can start to receive the benefit sooner. Considering that approximately $7 Billion offsets are currently being executed, we recommend that this policy should be applied to all past offset contracts, irrespective of the DPP versions. This will provide significant incentives to OEM's currently executing these offset contracts to invest in the OVF.

OEMs should be allowed to obtain up to 40% of their offset obligation by using the avenue of Offset Venture Fund. This will provide significant incentives to rapidly build up the corpus for investment into Indian organization.

4.2 Eligibility Criteria for Offset Venture Fund House:

At present Securities & Exchange Board of India (SEBI) has developed regulations that focus on registration of funds, eligibility criteria, investment conditions, obligation and responsibilities that every venture fund in India needs to follow. We recommend that all Offset Venture Funds (OVF) should be registered with SEBI under the Venture Capital Fund Regulation of 1996. Also SEBI regulations should be applied to offset venture fund. These regulations can be found at: http://www.sebi.gov.in/acts/act19main.html

In order to ensure complete transparency, and on the same lines of a fund managed by Canara Bank for Electronic System Design & Manufacturing (ESDM) , a trustee in the form of a public sector undertaking such as a nationalized bank or a reputed private organization should be nominated as a single point of investment whose responsibility would be to identify the right funds and invest capital in these funds appropriately. There are several advantages of implementing such 'fund of funds' approach, such as:

a. Complete transparency in investment into fund houses, as the organization nominated as the 'single point of investment' is required to conduct necessary due-diligence to ensure that the investment happens only in the SEBI authorized funds.
b. Operationally it is easier for OEMs and MoD to work with a single entity as against multiple fund houses to capture all the information related to investments.
c. This is a proven model currently being utilized to grow the electronics manufacturing sector in India.

4.3 Criteria for Investors in the Offset Venture Fund:

Any foreign OEM irrespective of their current offset obligation should be allowed to invest in the OVF and bank the credits as per the existing banking procedures. Typically, in order to be compliant with the local regulations, OEMs use their subsidiaries which are registered in the local market, to infuse funds in joint venture and other business activities. Hence it is important that these fully owned subsidiary companies should be allowed to invest in the OVF on behalf of the OEM.

4.4 Criteria for Investees:

Any Indian organization operating in following sectors should be eligible to receive funding from the OVF.

1. Indian organizations that are manufacturing eligible products and providing eligible services as per DPP 2016 Annexure VI to Appendix D.
2. Indian organizations that are manufacturing products in sectors synergistic to defence manufacturing such as auto components, machine tools, electronics, telecommunication equipment, chemical equipment and industrial manufacturing.

Rationale for including organizations from the 'non-defence' manufacturing sector is as follows:

1. Majority of offsets today are executed by large Indian organizations. The participation of MSMEs is limited. With new incentives first introduced in DPP 2013 such as availability of 1.5 multiplier, MSME participation in defence is expected to slowly increase. Till such time, the MSME eco-system becomes mature to absorb the offsets and attractive for investments, OVF must have other avenues to invest OEM's money in organizations from the synergistic sectors.

2. Development of MSME organizations in other manufacturing sectors as outlined above would help improve overall competitiveness of the defence industry. The sectors identified have significant synergies with defence sector. For example manufacturing processes used in auto component and industrial manufacturing are often similar to aerospace & defence manufacturing. Similar machine tools as used in industrial sectors are used in aerospace sector. Electronics forms an integral part of any defence platform.

3. Based on OEM's experience in working with Indian suppliers, it is estimated that not more than 30 MSME organizations are currently executing defence offsets and performing satisfactory. Only few of these organizations would be eligible for receiving investments based on their business potential, need for capital, etc. Out of these even fewer organizations may grow and provide handsome returns on the investments. As per feedback received from IVCA (India Private Equity And Venture Capital Association) small number of MSMEs in the Defence & Aerospace sector may create constraints to invest capital with a reasonable risk adjusted returns.

However, one of the objectives of this policy is to develop defence MSME eco-system, hence we suggest that following conditions should be imposed on infusion of the capital.

1. During first three (3) years from the initiation of the OVF, at least 35% of the total capital invested in the organizations must go towards MSMEs in the defence sector manufacturing products and providing services as outlined by DPP 2016, Annexure VI to Appendix D.

2. After three years of implementing this policy, we suggest that a review of the policy outcome should be undertaken. Based on this review, this percentage can be increased to a higher or lower number.

4.5 Offset Credits:

Since it is important to link offset credits to the performance, we recommend that offset credit to be given to OEM based on following events.

A. At the time of infusing funds in the OVF by OEMs:

OEM's should receive offset credit as soon as they invest in the OVF. The OVF can provide the necessary supporting documentation to DOMW for collecting the offset credit.

It is important that the offset credit be provided at the time of investment because:

a) In our experience generally it takes 5 to 7 years to grow the capabilities of MSME defence organizations and embed them into OEM's supply chain. This period could be even higher for organization in sectors such as aerospace manufacturing. Thus if credit were to be given after the companies start delivering products and services to the OEMs, the offset credits may not be obtained during the Period of Performance of offset contracts which typically runs between 5 to 7 years. Banking of credits may not be preferred option for OEMs who currently have active offset obligation.

b) It is also to be noted that as per DPP, OEM's can obtain offset credits for FDI at the time the investment into a Joint Venture.

OEM's should also receive credit for the investment made in the OVF within 90 days of submission of supporting documents. We understand that it is DOMW's aspiration to provide credits for eligible offset transactions within 90 days. This request is simply in line with the objectives outlined by DOMW earlier in making the auditing process streamlined. Additionally, this provides time bound opportunity to respond and close any observations that DOMW may raise on the transaction.

We also recommend that a multiplier of 3.5 should be provided to the OEM for the capital that is infused in the OVF. For example, if the OEM invests $1 Million in the OVF, OEM will receive offset credit equal to $3.5 Million as soon as the necessary supporting documentation is submitted to DOMW.

A multiplier of 3.5 is recommended for the OEM's investment based on following rationale:

a) OEMs have no control over investment decisions made by the OVF or the functioning of the MSME organizations in which the investment has been made. In a typical venture fund scenario as outlined in Section 3.0, some investee organizations may go out of business and some may grow. Thus OEM's are undertaking significant risk by placing their valuable cash in the OVF.

b) The investment made by the OEMs cannot be repatriated back to OEMs. OEMs are parting with their cash and depending on how fund performs; they may or may not see any returns on their investment.

c) The risk for an investor is significantly higher in the defence sector as compared other sectors such as telecommunication, consumer retail and internet where significant investment has been made by the Venture Funds. Defence sector was recently opened up for the private participation and the capabilities are nascent but growing. Defence industry is a long gestation industry where significant investments are needed initially and pay out period is longer. In addition, the volume of business is mainly dependent on export orders through offset programs.

d) Ministry of Commerce which is monitoring civil aviation offsets related to purchase of aircrafts by Air India provides a multiplier of at least 5 when OEM makes equity investment in a joint venture.

B. Based on incremented business generated by the Offset Venture Fund (OVF):

Based on OEM's investment in the OVF, the organizations receiving the funds are expected to increase their revenue as they get embedded in the OEM's supply chain. We recommend that based on the incremental revenue of the investee organizations operating in areas as per 'eligible product & services' section of DPP 2016 Annexure VI to Appendix D, a multiplier of 2.5 will be given to the OEMs. Similarly, based on the incremental revenue of the investee organizations operating in 'non-defense' areas, a multiplier of 1.0 will be given to the OEMs.

Illustration:

Let's assume that there are 10 Indian suppliers in the OVF, who have received capital from the Fund. Three (3) of the Ten (10) suppliers are from 'DPP eligible' category while seven (7) are from other synergistic manufacturing sectors.

The fund was initiated in 2017 and at this point in time, the total revenue of all the 'offset eligible' suppliers in the fund was $10 M (~INR 70 Cr) while that of suppliers from the synergistic sectors was $50 M (~ INR 350 Cr).

In 2021, four years after the infusion of capital, the suppliers business grew because of the capital infusion, management support provided by the fund and inclusion of the suppliers in OEM's supply chain. In 2021 the total revenue of all the 'offset eligible' suppliers in the fund becomes $11 M (~INR 77 Cr.) Similarly the total revenue of all organizations from the synergistic sectors became $51 M (~ INR 357 Cr.)

All the OEMs who have contributed to the fund, irrespective if they have done business with the suppliers in the fund, are now eligible for receiving offset credit of $2.5 M (calculated as = ($11 M - $10 M) X 2.5) due to growth of 'offset eligible' suppliers and offset credit of $1 M (calculated as = ($51M - $ 50 M) X 1)

Even though the above example shows that theoretically for $ 1 M investment by OEM in the OVF, they can get offset credit of $3.5 M + $2.5 M + $1 M = $6.5 M, in reality, there are significant risks and uncertainties such as:

a) Incremental revenue of the organizations may grow at significantly lower rate during the offset period of performance
b) There may not be any revenue growth or negative growth. In such case OEM will not receive any offset credit for the revenue growth. Offset credit only for the initial investment will be provided.
c) The OEM's have no control over which organizations receive the capital infusion. Some of these organizations may not be relevant to OEM's offset plans, while others may not have developed necessary capabilities to be qualified by OEM during the offset period of performance. Some may be qualified by OEMs but could not be added in the offset contract in timely manner due to long decision cycle at DOMW. Hence linking offset credit to OEM procuring eligible products and services from the suppliers in the fund may not be practical.

The capital infusion by the OEM has resulted into creating an eco-system of capable 'offset eligible' suppliers and 'synergistic sector' suppliers, hence it is essential that OEMs be given the credit for the growth of this entire eco-system.

4.6 Objectives of the Offset Venture Fund (OVF):

In order to successfully devise a policy that will spur the growth of MSMEs in the Indian Aerospace & Defence industry, we propose that the Offset Venture Fund (OVF) policy should have following objectives:

1) Support development of vibrant industrial base of Micro Small, Medium Enterprises (MSME) by providing access to capital and world-class expertise to design, service and manufacture eligible products and services as defined per the offset policy and in synergistic sectors such as manufacturing.

2) Incentivize entrepreneurship in defence and other synergistic sectors such as civil aviation, manufacturing and internal security.

3) Ensure 'ease of doing business' by providing complete transparency, ease of reporting and approval of offset credits in all aspects of the Offset Venture

4.7 Responsibilities of the Offset Venture Fund :

OVF will play major role not only by providing the capital to the MSMEs but also by mentoring MSMEs so that they could successfully execute on OEM's requirement. Just like a typical Venture Fund, Offset Venture Fund generally will undertake following (but not limited to) activities.

1. Fund management – Manage the fund and be compliant with the SEBI guidelines. Provide necessary documentation to the OEMs and MoD regarding investment made in the MSMEs.
2. Link OEM's to Indian MSME organizations wherever necessary.
3. Assist MSMEs in contract negotiations and as appropriate in the fulfilment of the contracts obtained from the OEM's.
4. Arrange debt funding and work with banks for streamlined loan approval and disbursement process.
5. Assist in enhancing the business operation and management capabilities at MSMEs with a focus on following areas:
    - Management training on organization structure, roles & responsibilities, human resource policies, etc.
    - Globally acceptable accounting and financial management systems.
    - Information technology and cyber security systems.
    - Project management and risk identification and mitigation processes.
    - Productivity improvement systems such as lean manufacturing, strategic sourcing, vendor management, and cash flow management etc.
    - Intellectual property protection.
    - Identification and dissemination of best practices through industrial and manufacturing engineering interventions.
    - Linkages with educational and research institutes including vocational institutes for hiring talent.
    - Skilling systems that focus on engineering, frontline factory workers etc.
    - Quality Assurance system as per OEM's requirement.
    - Health, safety and environmental systems
6. Build a database of Indian and international domain experts that would be able to provide the necessary expertise when required to MSMEs.
7. Facilitating on-going R&D for technology enhancements.
8. Identify international companies that specialize in certain technologies that may be required by the MSMEs. Where necessary facilitate the process of technology licensing, formation of Joint Ventures, etc.
9. Develop a system for keeping the technology secure to comply with Government of India and OEMs security requirements.

4.8 Supporting Documents Submitted by OEMs to Claim the Offset Credits:

OEM will provide following supporting documents to claim offset credits

1. FIRC (Foreign Inwards Remittance Certificate) or eBRC (Electronic Bank Realization Certificate) that show funds have been invested legally in the OVF.

2. Any other supporting documents that act as proof of payment made by the OEMs such as bank statement etc.

4.9 Information Sharing & Monitoring:

We recommend that following documents can be requested by MoD in periodic manner from the OVF to assess the impact of the policy.

1) Details regarding list of investor's, and their respective stake in the fund
2) Details regarding the investment made by the OVF in the Indian organizations.

4.10 Repatriation to OEMs:

The capital as well as profit invested by OEMs in the OVF will not be taken out by the OEM at any time. Therefore, over the course of time, the size of the fund may significantly increase and become a source of capital for MSME organizations.

4.10 Comparison of Various Offset Avenues for Multipliers:

Based on following examples it is seen that in India for commercial offsets a minimum multiplier of 5 is provided for investment by OEM. Such investment may result into potential profit for OEM (such as when the investment is made in a joint venture) or not (such as investment in research institutes). Therefore, the multiplier of 3.5 at the time of investment, followed by a multiplier of 2.5 on the incremental revenue of the entire fund is in-line with current practices (See section 4.5 B).

a) Offset credit granted for Commercial Aviation Offset in India:

- Investment of equity in Indian organizations by OEM:
- Multiplier offered: Minimum: 5X – Maximum : Based on business transaction
- OEMs need to make equity investment
- Investment by OEMs subsidy is allowed
- Investment may or may not be in a joint venture
- Investment preferred to be in 'aviation sector'
- If it is in a JV, OEMs may get share of profits based on performance of the joint venture

b) Direct foreign investment (DFI) by OEM in Turkey by Foreign OEMs:
- Multiplier of 4X on the DFI
- Offset credit provided at the time of investment.
- Investment has to be in defence, aerospace and homeland security
- If it is in a JV, OEMs may get share of profits based on business condition of the joint venture

c) Investment made by OEMs in Research Universities in India for Commercial Aviation Offsets:
   a. Multiplier offered: Based on impact generated by the investment. Historically 5X multiplier was provided

b. Investment preferred to aid aviation & defence sector.
c. No monetary returns for OEM other than offset credits
d. Offset credits provided yearly based on the impact generated by the project.

d) Machines and capital equipment provided by OEMs to Indian supplier

a. Multiplier offered: Based on impact generated by the investment. Historically 5X multiplier was provided
b. Equipment supplied is expected to aid aviation & defence sector.
c. No monetary returns for OEM other than offset credits
d. Offset credits provided when machines and capital equipment accepted by supplier.

5.0 Recommendation:

Investment by OEMs, in Venture Capital Funds, for use by MSMEs towards production and provision of eligible products/services per DPP, is considered a viable avenue of offset discharge; provided OVF investment is also permitted in synergistic sectors, the offset credit is given on deposit of the fund and a '3.5 X' multiplier is granted at the time of investment and '2.5 X' multiplier on the incremental cumulative revenue of the organizations receiving the investment from the OVF. It is recommended that the above suggested methodology be incorporated as an additional avenue of offset discharge applicable to all contracts irrespective of the DPP version. If all the suggested provisions suggested in this paper are accepted, Offset Venture Fund policy can have long term and significant impact on the MSME base in India. It is also to be noted that Venture Fund industry is regulated by Securities & Exchange Board of India (SEBI) and potential use of this regulatory framework for Offset Venture Fund (OVF) will provide transparency for all the stakeholders.

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