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The Rise of the Indian Defence Sector



VQ Deep Dive

May 2025

Authored by :

Aniket Dharamshi

Arvind Ananthanarayanan

Vishrut Bubna

The Rise of the Indian Defence Sector

► Introduction:

The last five years have seen significant increase in the valuations of defence companies, particularly the large Defence Public Sector Undertaking (DPSU) companies, while earnings growth has been a surprise. This has been a period of increasing private sector participation in the Indian defence sector, and exports are also showing encouraging signs. With Government (GoI) support and increasing demand from the services, the outlook for the sector remains buoyant. In this article, we explore the rise of the Indian defence sector, briefly highlighting the historic aspects of India's complex relationship with her armed forces, and the resulting consequences for procurement. Also highlighted is the overall trend in defence spending and important themes within the defence megatrend. The aim is to understand the role of India in terms of exports, in the context of recent US diplomacy as we look forward to opportunities in Indian defence.

We reiterate that defence is an important method for any country to develop, nurture and sustain high technology manufacturing. The Indian geopolitical situation places an even greater impetus on this endeavour. To present our lens of investing in this sector, we discuss the history, geopolitics and regulations around this sector and distil the qualities of value creators in this space.

► The role of the armed forces in India

The relationship of the Republic of India with her armed forces has been complex. Indeed, this has led to the long acquisition processes and an armed force that is reactionary in doctrine. To understand the cause of such a relationship, we delve into the history of the Indian armed forces, which were created from the structures of the British Indian army at independence in 1947.

It is noteworthy that the British armed forces were a garrison guard to protect the administrative core of the empire in India from local unrest and quell uprisings decisively if needed. Therefore, the powers of the armed forces were more extensive, and they occupied a more central role in the power dynamics of colonial India. For example, under British rule, the military commander-in-chief was the de facto defence minister. Military leaders could also hold the position of Viceroy of India, as was the case with Field Marshall Archibald Percival Wavell in 1943.

In contrast, the armed forces of the Republic of India would protect the country from external threats but would always be under the robust scrutiny of civilian bureaucrats to ensure that their powers were adequately controlled. The first prime minister of India, Pt. Jawaharlal Nehru took the symbolic step of taking over Teen Murti Bhavan, the former British commander-in chief's residence as the new prime ministerial residence. At the same time, he altered the status of the army in the warrant of precedence and limited the wearing of uniforms in public, ensuring that the armed forces were subservient to the state. Nehru's policies ensured that the armed forces would never be able to make a lunge to control the country as would happen time and again in most former British colonies. The armed forces were also an engine for employment creation.

Therefore, the virtues of a numerically larger army was extolled time and again as a method to create employment.



The social position of the army was cemented by the second prime minister of India, Lal Bahadur Shastri. He rallied the country in 1965 with the famous slogan “Jai Jawan, Jai Kisan” as a response to Pakistani aggression on the western front while India was facing a shortage of food grains¹.

The push towards a larger army was ingrained in the system and even presently, the Indian army remains the second largest in the world numerically. It also is an important employment generator across the country, especially in northern states (Exhibit 1). The promise of secure employment and pensions mean that army placements are coveted, and recruitment is highly competitive. At the same time, army generals were graded on their effectiveness at raising a large army and this practice has led to a large pension outgo for that service as discussed in detail subsequently.

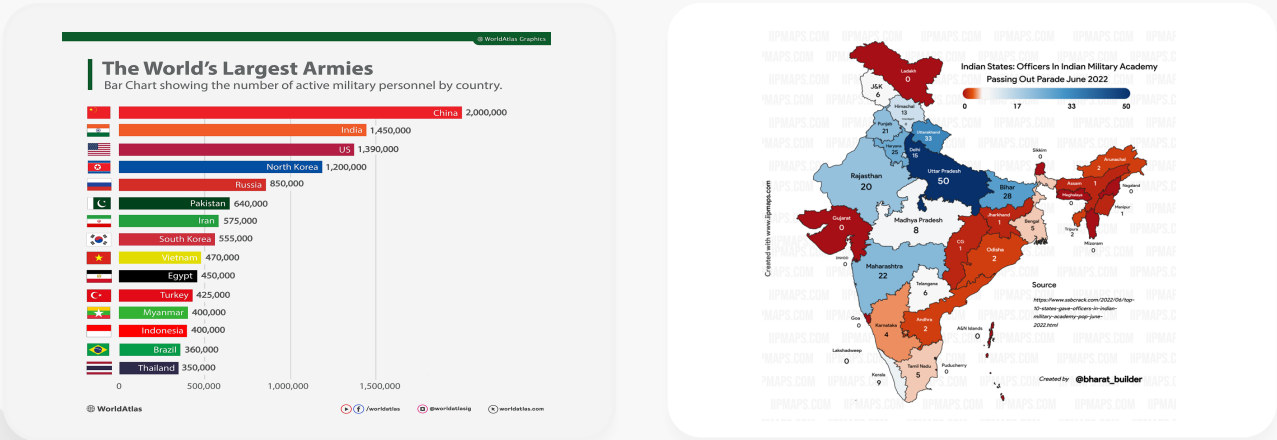


Exhibit 1: The Indian army is the second largest in the world and an important employment generation engine (Source: worldatlas.com)

The Indian policy of creating an armed force under tight bureaucratic control has meant that India has never had to endure military rule like many other former colonial states, including Pakistan. However, it has also ensured that the armed forces would remain focussed on numerical strength and have a reactionary nature in doctrine and procurements, compromised by layers of bureaucracy. Simultaneously, demands of the services meant that most defence requirements were met through imports leaving little impetus for a local defence ecosystem to emerge.

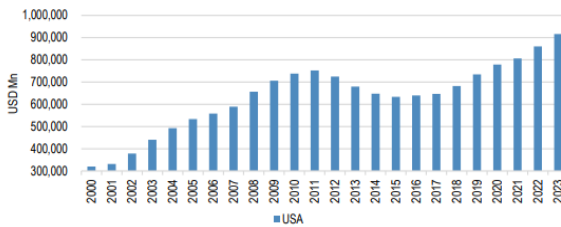
► **Geopolitics and adversaries:**

Where India has grown steadily in defence procurements, China has been advancing at a much more rapid pace. With a view to achieve parity with the USA, Chinese military expenditure has grown at more than twice the growth rate for the USA (Exhibit 2).

¹The soft-spoken, Nehruvian socialist Shastri became the prime minister of India on the 9th of June 1964, following Nehru’s demise in office on the 27th of May 1964. On the 19th of October 1965 at a gathering in Uruwa, Allahabad, he gave the slogan “Jai Jawan, Jai Kisan” to encourage valour in soldiers and to urge farmers to increase production and reduce import dependence.

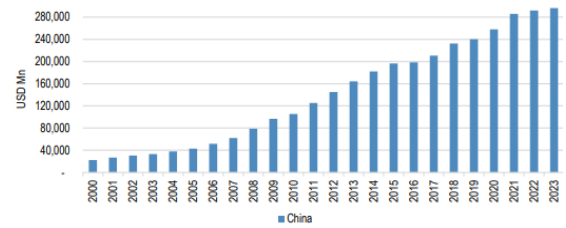


Between 2000-2023, USA's military expenditure has grown at a CAGR of c.5%



Source: SIPRI, J.P. Morgan.

Between 2000-2023, China has ramped up on its military expenditure, recording a growth of almost 12%.

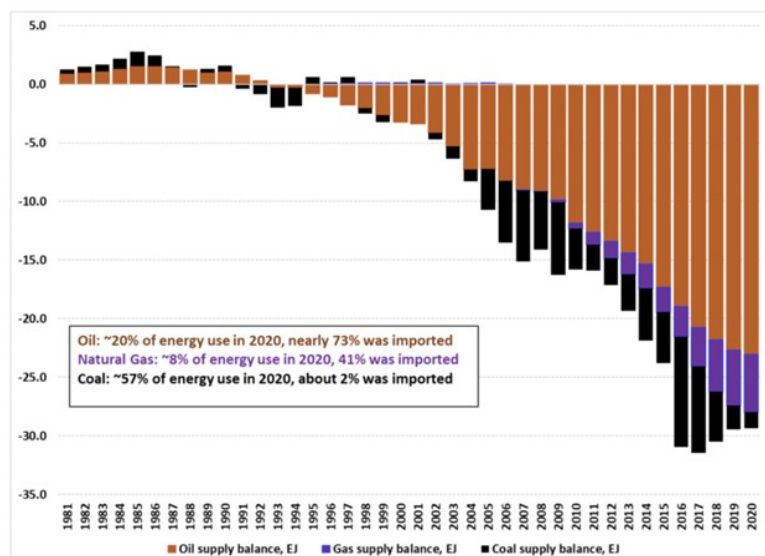


Source: SIPRI, J.P. Morgan.

Exhibit 2: A comparison of US (left) and Chinese (right) military expenditure since 2000. The Chinese have increased military expenditure at a rate of 12% versus 5% for the USA.

The first two decades of the 21st century have marked a shift in the capability spectrum of the Chinese defence forces as well. For example, the People's Liberation Army Airforce (PLAAF) has a total of 1600 aircraft of which ~68% are 4th or 4++ generation. The PLAAF is also the second air force after the USA to field 5th generation fighters (J-20 and FC-31/J35)².

This is also a period when US ambitions as a global sea faring force seem to be waning as they are more self-sufficient in oil than at the beginning of the 21st century. In contrast, China still imports most of its fuels by sea (Exhibit 3). Therefore, the onus of keeping sea lanes open now lies on China.



Source: China General Customs Administration

Exhibit 3: China still imports oil and gas, mostly by sea.

²China is also willing to supply advanced 4th generation fighters such as the J-10 and some 5th generation types such as the J-35 to Pakistan to maintain pressure on the Indian western borders, despite Pakistan lacking the financial capability to field or operate 5th generation types.



Most of the shipping channels are likely to lie in the Indian Ocean and pass-through areas of strategic interest to India (Exhibit 4).

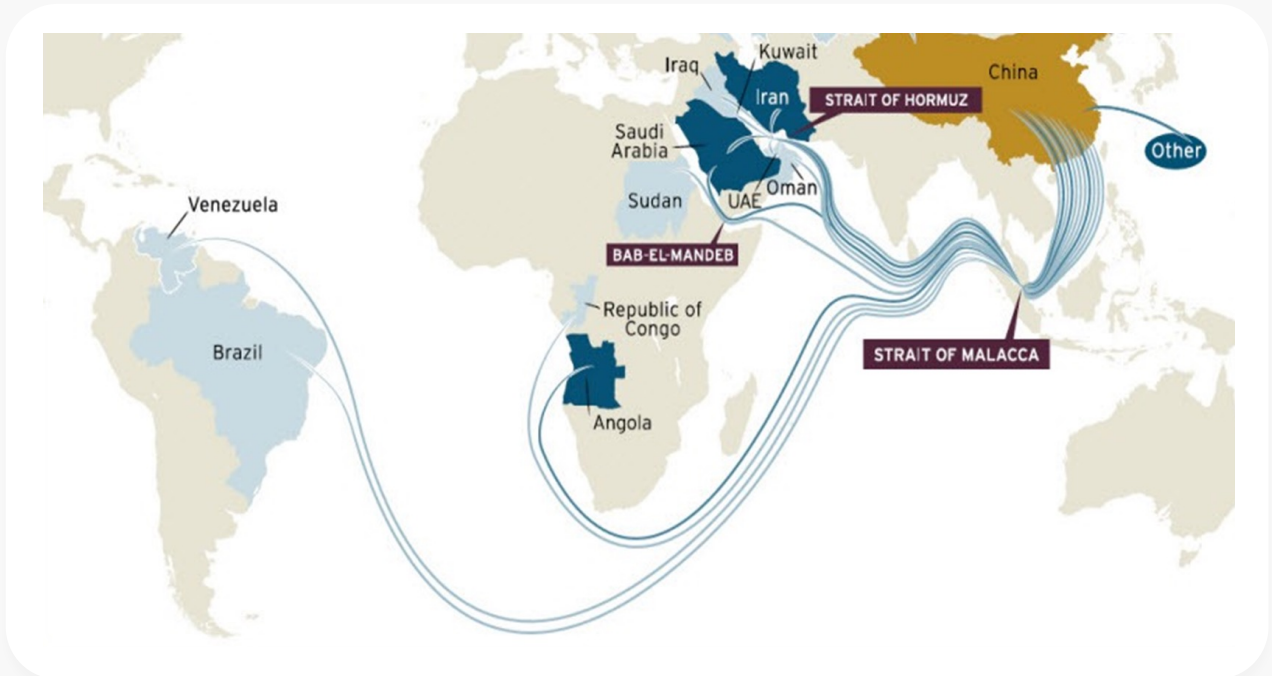


Exhibit 4: Chinese trade routes will lie on the Indian doorstep. (source: fas.org)

In the Indian Ocean and nearby seas, Indian forces are facing an increasingly numerous and sophisticated Chinese adversary force. **In this situation, the army has limited use, and the emphasis lies of naval and air power.**

With the ever-present concern of Islamic extremism, nuclear armed Pakistan constitutes a potent threat on the western border despite their presently impoverished circumstances. In this context, the Indian army is a strategic counterbalance, but more recently, the role of air power has emerged to the fore in this theatre as well. China has been using Pakistan as a counterbalance to India and has been arming the latter with various weapon systems. In the event of hostilities, India can expect a two-pronged war.

► The defence budget and spending patterns:

Indian defence spending has increased in lockstep with the GDP, growing at a CAGR of 6.6% versus the GDP CAGR 7.2% since 1960 (Exhibit 5). Since the liberalization of 1990, defence spending has declined to ~2.5% of GDP versus ~4% for the previous three decades.

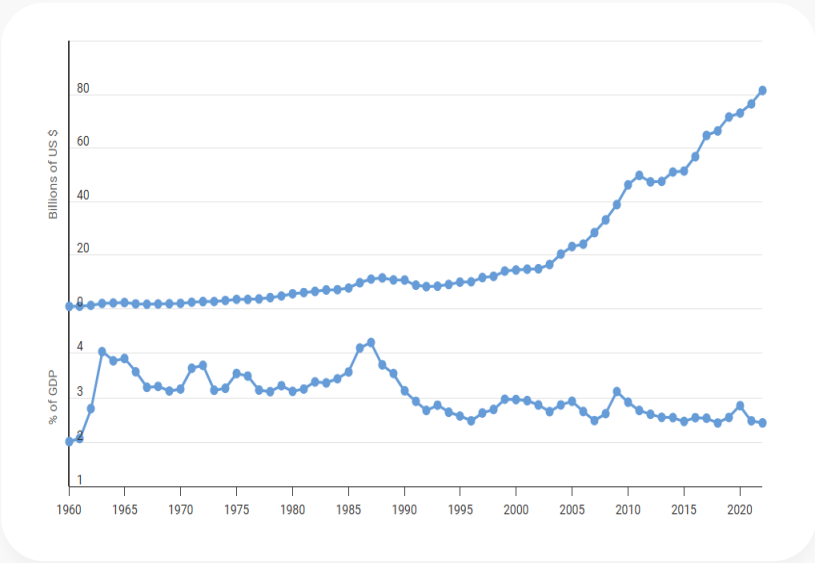


Exhibit 5: Indian defence spending (above) and spending as a % of GDP (below) (source: VQ research)

While the pre-2020 spending trends were marked by ups and downs, most spending was reactionary, often in response to aggressive overtures by Pakistan and more recently China³.

In more recent times, while defence expenditure has increased steadily, defence spending as a percentage of government expenditure has seen a downward trend. Also, as evident in Exhibit 6, non-pension spending is ~1.5% of GDP and trending downward.

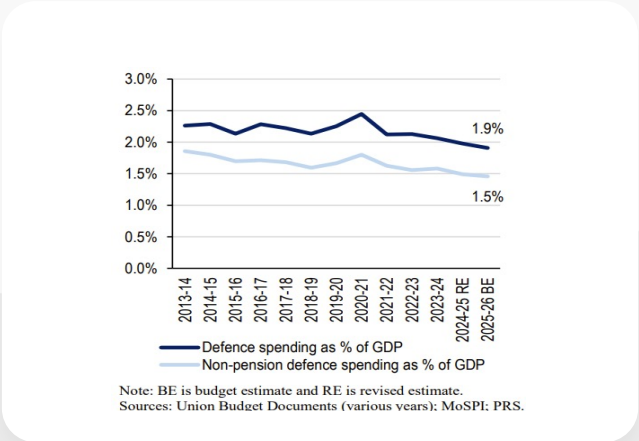
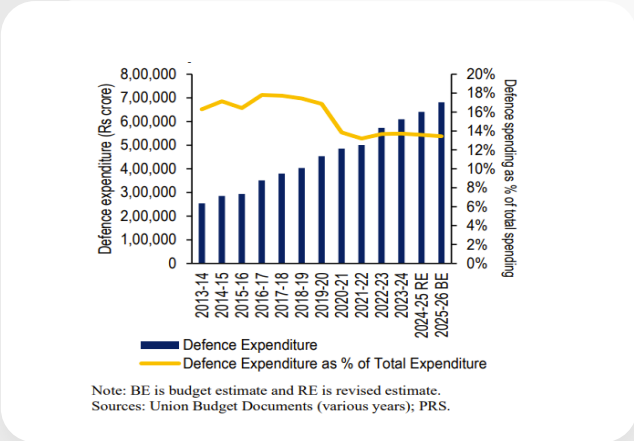


Exhibit 6: Defence spending has decreased as a percentage of government spending (left) and as a percentage of GDP (right) even as overall defence spending continues to increase

A comparison of the budgeted expenditure (BE) for 2025-26 versus the revised (RE) and actual expenditure for 2023-24 is presented in Exhibit 7.

³The reactionary spending is often evident in emergency procurements (EP) to fill gaps in capability, often with little to no price negotiations. Once the emergency procurement is complete, further procurements follow due process and competitive tendering as maybe the case.



Major Head	Actuals 2023-24	RE 2024-25	BE 2025-26	% change 2024-25 RE to 2025-26 BE
Army Revenue	3,15,849	3,35,295	3,51,345	5%
Navy Revenue	45,420	48,320	52,290	8%
Air Force Revenue	66,803	65,744	71,254	8%
Capital Outlay	1,44,259	1,48,386	1,68,565	14%
Other	37,173	43,315	37,756	-13%
Total	6,09,504	6,41,060	6,81,210	6%

Note: Army includes Jammu and Kashmir Light Infantry and Navy includes Coast Guard. Capital Outlay includes capital spending on coast guard. RE is revised estimate and BE is budget estimate.
Sources: Expenditure Budget, Union Budget 2025-26: PRS

Exhibit 7: Budget allocation for the armed forces (INR Cr.)

The defence budget has seen an overall increase of 6% in BE 2025-26 versus RE 2024-25. Noteworthy is that over half the budget is devoted to salary and pensions, but the salary component for National Cadet Corps (NCC), Rashtriya Rifles and Agnipath is not disclosed implying that the salary expenditure could be higher overall. Indeed, the actual capital outlay in 2023-24 was 6% lower than RE due to poor procurement planning. It is unclear which service was responsible for this since the government has stopped releasing these figures service wise. Finally, Exhibit 7 suggests that the efforts to reduce pension and salary expenditure through the Agnipath and associated schemes has not been as successful as originally anticipated.

It may also be noted that despite the largest budget allocation, the army gets only ~10 – 15% of the modernization budget while the Navy and the Airforce take the remaining ~90% equally between themselves (Exhibit 8).

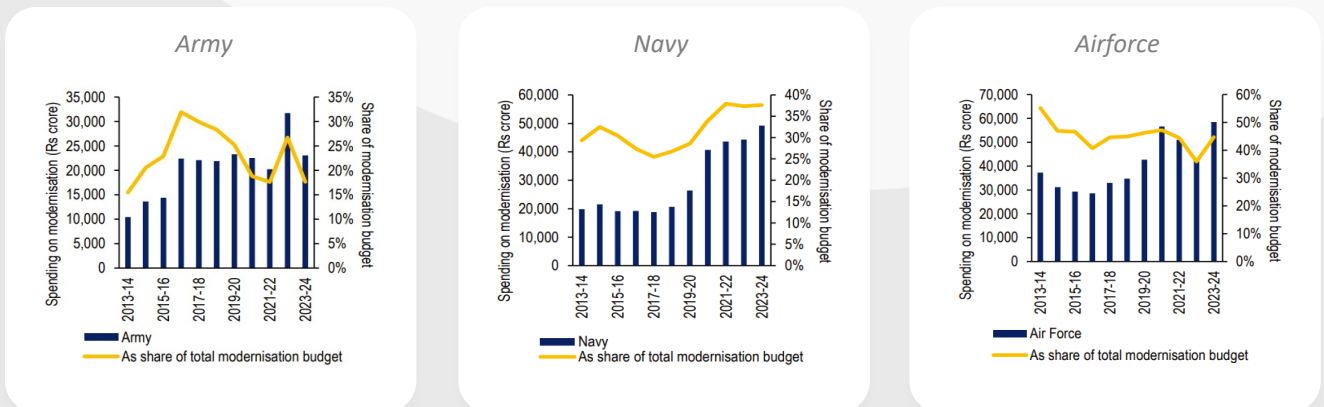


Exhibit 8: The army gets a small share of the modernization budget as compared to the Navy and Airforce. This reflects the higher cost of the systems used by those services, but also points to the personnel heavy nature of the army

Sources - <https://prsindia.org/budgets/parliament/demand-for-grants-2024-25-analysis-defence>

Despite the higher allocation to the Navy and Airforce, the cost of modern weapon systems (especially ships and aircraft) mean that **en masse** new acquisitions are unviable. In view of this, deep modernization, and upgrades are being pushed to increase competitiveness. It is also of concern that overall R&D spend as a percentage of the defence budget remains below 5% (Exhibit 9).

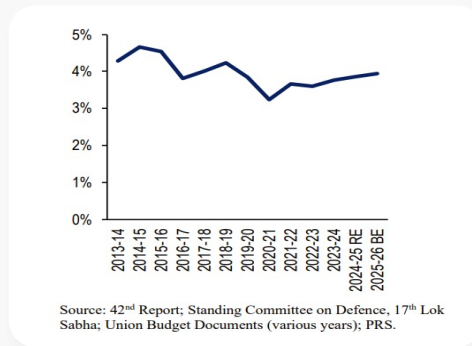


Exhibit 9: Defence R&D as a percentage of the total defence budget paints a sobering picture

The push toward electronics and upgrades along with a small R&D allocation implies that the private sector is expected to step forward and drive R&D. The consolidation of the DRDO and their reducing role in R&D is also expected to increase R&D contribution from the private sector.

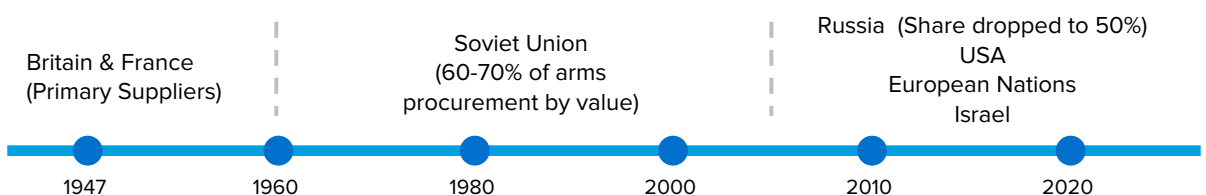
In summary, the Indian defence budgets have been constrained by high salary and pension expenditure leaving little room to expand R&D or modernization budgets. Of the three services, the army has the smallest modernization budget and is often mired by poor project definition in the limited modernization endeavours funded. Therefore, based on the budgets and financial realities, we prefer Navy or Airforce facing projects in the domain of electronics and systems.

► Acquisitions, modernization, DAP 2020 and the path forward for Indian defence:

A bureaucratic procurement process with the budget limitations common to a young and often impoverished country meant that early acquisitions were made only when necessary and often piecemeal from any country willing to sell. This method of procurement was suitable to a personnel heavy military, where forward thinking initiative was also viewed with suspicion by the leadership in Delhi⁴. The effect of such a piecemeal acquisition strategy means that the armed forces have a motley collection of varied weapon systems supplied by different countries and suppliers, each with their own support and logistics requirements and little to no commonality.

Over the past decades, India has remained a large importer of weapon systems.

Weapons Sourcing



⁴Despite his willingness to use the army if needed (1948 in Kashmir and in 1960 for the liberation of Goa), PM Nehru was more in favour of disarmament, non-alignment and non-violence. While on good terms publicly with Gen. K. S. “Timmy” Thimayya, Nehru undermined his position in concert with his defence minister V. K. Krishna Menon, fearing the rise of the charismatic officer. These actions set up an opportunity for China in 1962 and pushed India into a war she was not prepared for, where India endured a bitter defeat. Nehru and Menon allegedly engineered a scandal surrounding the resignation of Thimayya, allowing the rise of Gen. B. M. “Bijji” Kaul.



However, till the mid-2000s, defence acquisitions were ad-hoc, opaque and often riddled with allegations of irregular practices. There was also increasing concern that despite the large imports, there was no technology transfer and capability build-up in the Indian system.

The first steps of change were taken with the creation of the Defence Procurement Procedure (DPP) in 2005 where standardized terms, timelines and pricing guidelines for Request for Proposals (RFPs) were laid out.

This was followed by the DPP of 2006, which mandated the following:

- 30% offset for defence contracts exceeding INR 300 Cr, with a three-year offset obligation period and an indigenous content requirement was established.
- The aim was to encourage JVs with foreign OEMs and allow the development of an indigenous technology base through the domestic content and offset obligation.
- This also introduced the L1 – T1⁵ methodology to bidding and enhanced Foreign Direct Investment (FDI) limits from 24% to 49%, then to 74% and even 100% in specific cases.

While noble in conception, the offsets aspect of DPP 2005 and 2006 was plagued by unintended consequences like:

- Foreign OEMs were wary about transferring technology and preferred to add minimum value to pass the offset checklist while giving away little of technological significance.
- This was also the birth of the pure-play defence offset companies in India. These were the hand maidens of the foreign OEMs who helped the OEMs discharge their offset obligations and allowed them to profitably participate in one of the largest arms procuring countries in the world. The offset partners (Indian companies) would get a small percentage of the revenue earned by the OEM as a fee to enable doing business in India.
- Most damagingly, most offset obligations were enabled by this method through the purchase of goods and services, seldom through technology investments. Additionally, the process was slow and decision making cumbersome, meaning that most strategic requirements were often fulfilled by direct imports.
- It may also be noted that Israeli companies were significant beneficiaries of the offset engagements, especially given the rising role of these companies in electronics and Electronic Counter Measures (ECM).
- Nevertheless, these OEMs have also been reluctant to share source codes, repair manuals or provide access/know-how for field repairs or upgrades.

The matter came to a head in 2020, when the Defence Acquisition Procedure 2020 (DAP 2020) was unveiled. DAP – 2020 would focus on indigenization and mandated the procurement of Indian designed, developed and built systems.

⁵The L1 – T1 methodology was created to allow competitive prices and timely deliveries. To minimize false bids, which then delayed the process or led to re-tendering, bank guarantees were subsequently mandated. The L1 – T1 methodology in concert with a technical bid evaluation is still used in DAP-2020.



New buying categorization was created, and a prioritization list was also made as seen in Exhibit 10. Central to the indigenization theme were the positive indigenization lists which were populated with increasing number of items. Once an item was placed on the indigenization list, it had to be procured from India.

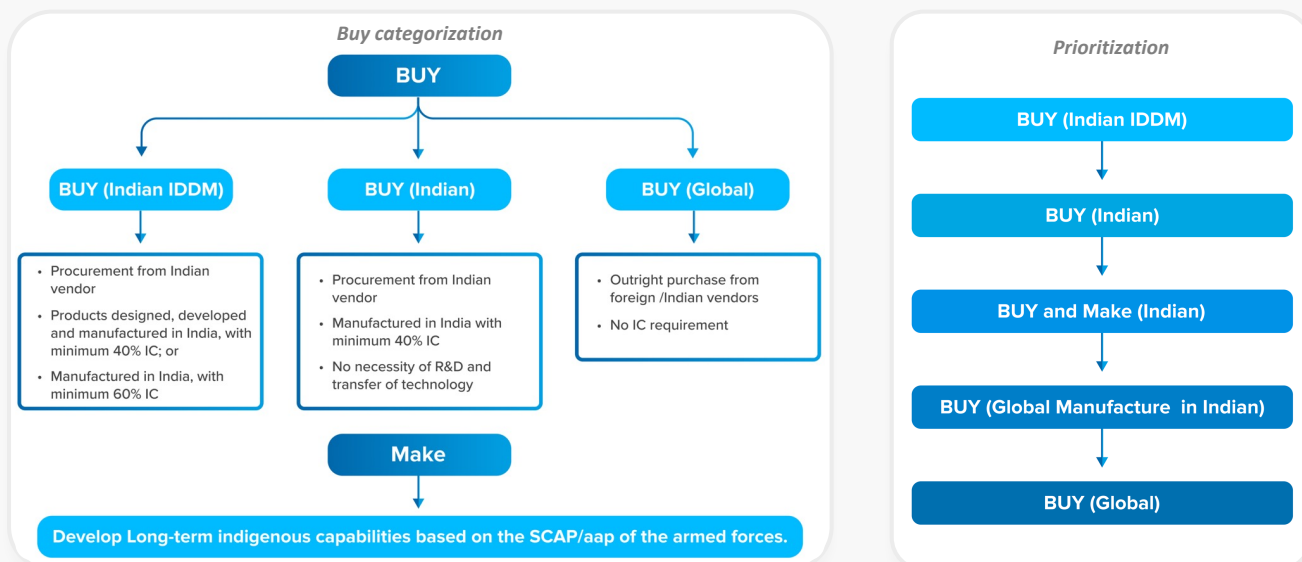


Exhibit 10: The DAP-2020 buying categorization and prioritization

Source: VQ research

The DAP – 2020 also made it mandatory for foreign OEMs coming in through the “Buy and Make” route to have a partnership with an Indian company, where the latter would hold 51% in the joint entity. At a fell swoop, the Ministry of Defence (MoD) had rendered the pure play offset model obsolete, while ensuring that order flow would be assured for the large DPSUs. The effect this had on the financials of selected DPSUs is illustrated in Exhibit 11.

INR crore	Pre- DAP (FY14-FY21)			Post-DAP (FY22-FY24)		
	PAT (FY21)	PAT CAGR %	AVERAGE ROCE %	PAT(FY24)	PAT CAGR %	Average ROCE %
HAL	3,239	4	25	7,621	22	30
BEL	2,099	12	23	3,985	29	29
BDL	258	-5	35	613	11	18

Exhibit 11: DAP-2020 and the indigenization focus resulted in substantial PAT growth for the DPSUs. The dividend paying, high RoCE cash cows had turned into growth stars

Source - VQ Research, The stocks discussed herein are for illustration purpose and should not be construed as buy/sell recommendation.

The capital markets concomitantly re-rated in terms of valuation of these equities, once again highlighting that growth is value and value is growth.

► The creation of a tiered defence ecosystem:

With order visibility increasing in the DPSUs, a defence eco-system with the DPSUs as lead integrators and supported by various private companies from systems down to components was created as shown in Exhibit 12.

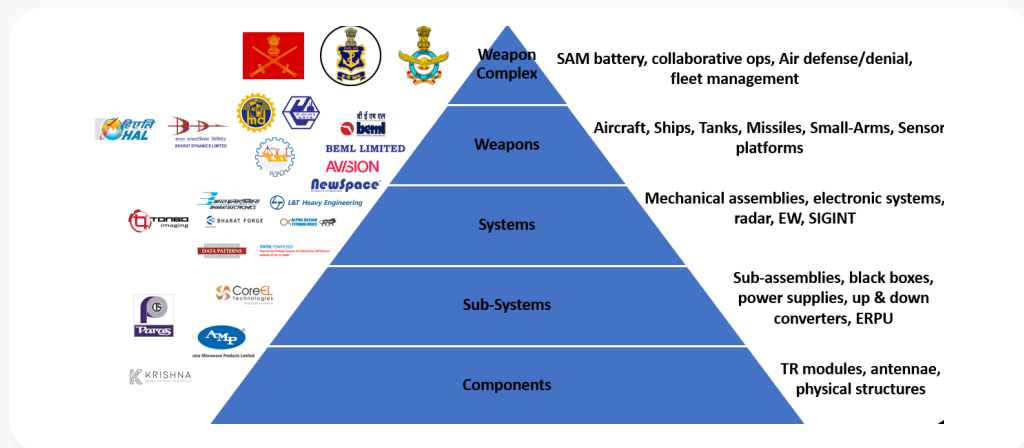


Exhibit 12: DAP – 2020 allowed the creation of an indigenous defence eco-system

Source - VQ Research, The stocks discussed herein are for illustration purpose and should not be construed as buy/sell recommendation.

While order flow and growth were assured, balancing growth with high returns (RoCE is the relevant metric here since most defence companies are debt free with net cash balance sheets) has proven to be more challenging for the private sector since they must balance growth, R&D expenses and project selection judiciously (Exhibit 13).

INR crore	PAT (FY24)	PAT CAGR/%	Average ROCE/%
DPSUs			
HAL	7,621	22	30
BEL	3,985	29	29
BDL	613	11	18
BEMIL	282	38	11
Private			
Data Pattern	182	39	18
AMPL	121	79	14
DCX	76	7	10
Apollo Microsystem	31	46	9
Paras	30	9	11

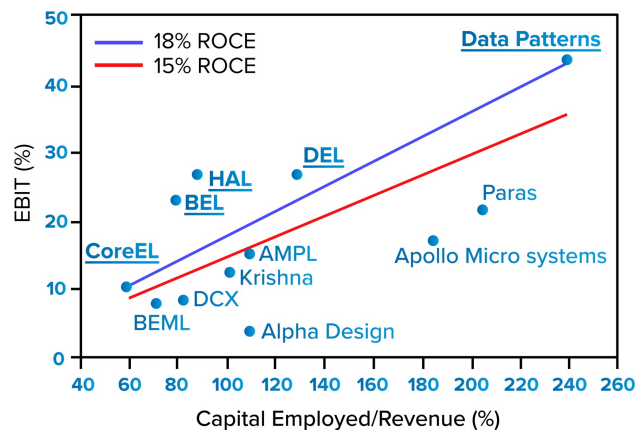


Exhibit 13: Despite the large number of private defence companies, those that combine growth with high return ratios are few.

Source - VQ Research, The stocks discussed herein are for illustration purpose and should not be construed as buy/sell recommendation.

DAP – 2020 was the creation of the defence eco-system in India, with Tier – 2 and 3 capabilities built up under the umbrella of the invigorated DPSUs. Despite their size, the DPSUs enjoy substantial benefits including R&D carried out by DRDO laboratories, favourable terms of payment, advances, waivers on liquidated damages and priority on pre-dispatch inspections.

In all intents and purposes, the Gol has created a top-down defence eco-system arrayed under the DPSUs. Project selection, margins and the resultant return ratios are not as easy to come by for private companies in the defence eco-system as for the protected (ex mandato) DPSUs.

In passing, we also reflect that ~ INR 12,00,000 Cr. is earmarked for capital expenditure over the coming five years. As previous, we expect nearly 90% of this to be carried out by the Navy and the Airforce with modernisation, electronics, radars, EW and sensors likely to form a bulk of these expenses.



At present, the growing schism between the US and her European allies, with calls for the rearmament of Europe following recent comments by US president Trump can be an opportunity for exports for the Indian defence industry. At the time of writing this article, such opportunities are in their nascent stages but can be important for the private sector with the correct set of capabilities.

► Possible directions and future outcomes:

The future of warfare, technologies and enablers remain uncertain. However, based on recent conflicts in Ukraine, Yemen, Syria and Israel, it can be assumed that asymmetric warfare, drones, unmanned systems, cyberwarfare and information warfare will assume an increasing role. At the same time, connected battlespaces as shown in Exhibit 14 will allow fielded units superior information and the ability to act decisively. Optional lethality will also be a concept of importance, and the focus will shift towards battlespace dominance versus system superiority.

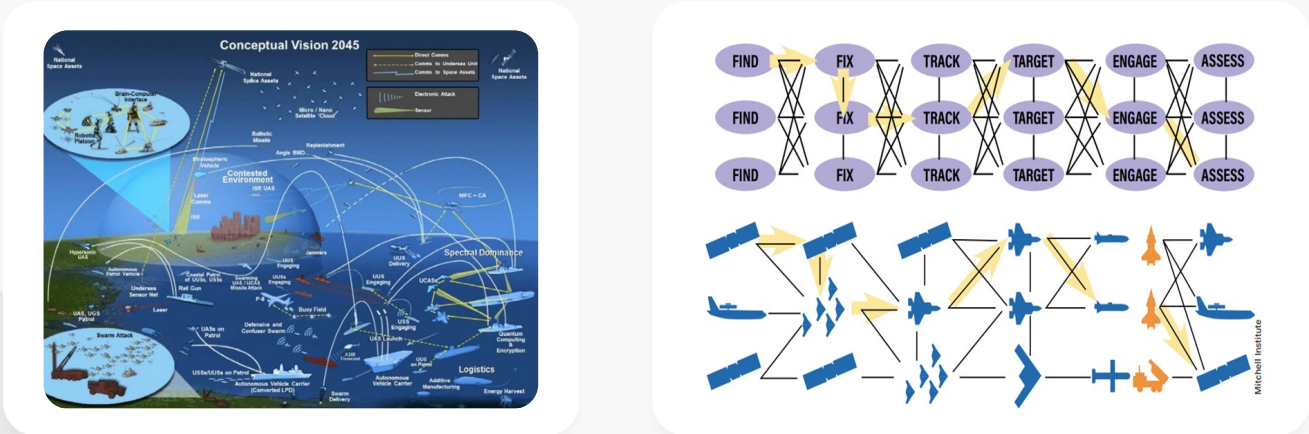


Exhibit 14: The future battlespace is information driven. It is networked, sensor fused and optionally lethal. The emphasis lies on dominating all aspects of the digital battlespace (Source: fas.org)

Exhibit 14 also shows the future battlespace relies on the exchange of massive quantities of data across information webs. The “kill chain” has evolved into an “effects web”. Platforms on the network can exchange data seamlessly in network centric capability. It maybe mentioned that new systems (nodes) can then enter the network allowing substantial upgradation potential.

The signal processing, data handling and digital architectures that will enable such multi-spectral, multi-dimensional battlespace dominance must be underpinned by indigenous technologies, an area where we see substantial opportunities. The emphasis on indigenous battlespace networking and communication technologies derives from the needs of security and upgradability even as the “fog of war” degrades networks. Depending upon foreign OEMs for such critical infrastructure can be tactically sub-optimal, and strategically unviable⁶. Sensor fusion at a platform level will then take advantage of the battlespace network to deny, degrade or destroy adversary capabilities as needed.

⁶The signals, waveforms and communication protocols involved in these applications increasingly derive from civilian technologies including 5G. Where radar relies upon power, communication systems are defined by their fidelity. In the future, blending of radar, communications and electronic warfare (EW) into a single system is likely.



We also feel that futuristic technologies such as drone swarms, networked munitions, sensor fused weapons and unmanned combat air vehicles (UCAVs) to name a few would be most effective only in a fully networked battlespace.

In the Indian context, the Defence Research Development Organization (DRDO) would be the leader in the development of advanced concepts such a networked battlespace. However, DRDO lacks the speed and agility to develop such novel concepts and partnerships with the private sector and leading academia would be needed. Indeed, the Vijayraghavan committee has recommended sweeping changes to the structure of the DRDOs as shown in Exhibit 15 since the present mechanisms have led to 23 high priority projects out of about 55 falling behind schedule.

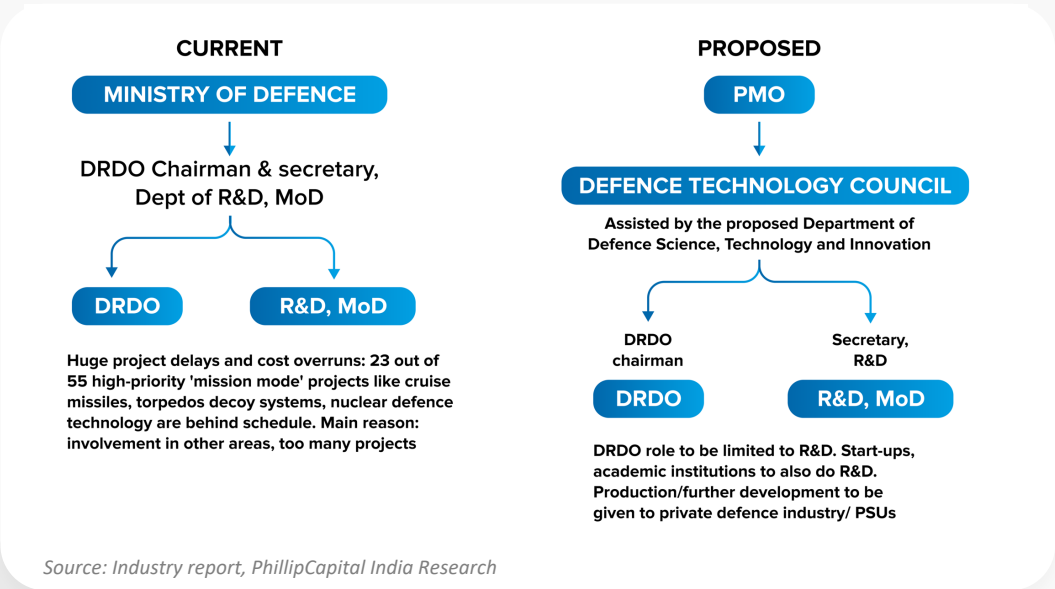


Exhibit 15: Revised structure of DRDOs as proposed by the Vijayraghavan committee to repurpose the organization into an incubator for defence R&D while production trials and prototyping will move to the DPSUs and private sector

The proposals of the Vijayraghavan committee are expected to create broad changes to the DRDO as illustrated in Exhibit 16.

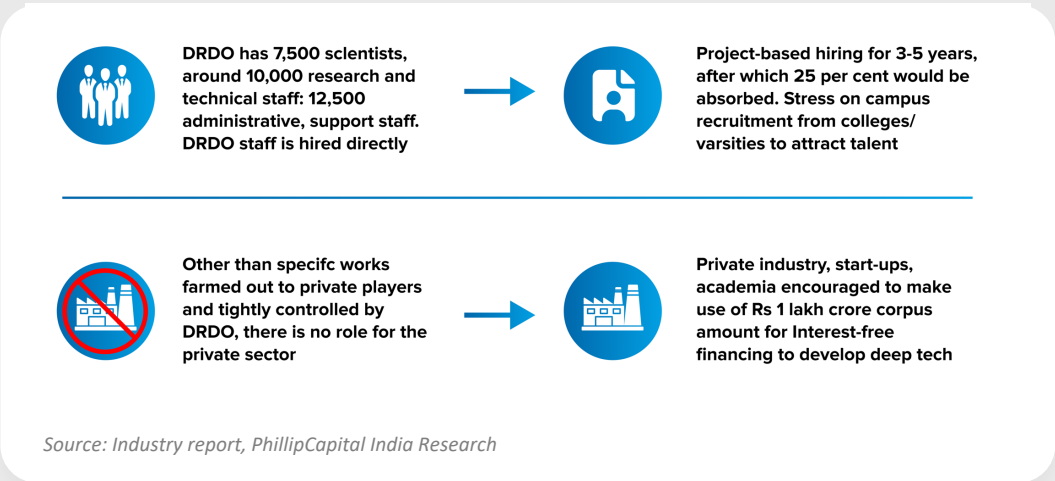


Exhibit 16: From ~30,000 staff overall, the DRDO will reduce in size with project-based hiring and the private sector, start-ups and academia will be encouraged to develop deep technology for defence applications



While the initiative of a leaner DRDO seems laudable, it is important to remember that DRDO placements are coveted due to the permanent nature of employment and a host of other benefits (“Government job”). The project-based, temporary hiring bereft of the benefits of permanent placements with compensations well below private sector wages mean that the DRDO will be unable to attract the best human capital. The private sector will be able to provide higher remuneration for the best talent, shifting the human capital advantage away from the DRDOs precipitously.

We opine that these otherwise well-meaning changes will fundamentally erode the DRDOs hold on defence research and allow migration of these activities to the private sector. In turn, the private sector will provide the technological base for integration by the DPSUs.

► Our lens to view developments:

Considering the hype and news flows, it is important to understand which technologies can lead to actionable investments in a reasonable timeframe. In this context, we present in Exhibit 17, our lens to scope out the sector.

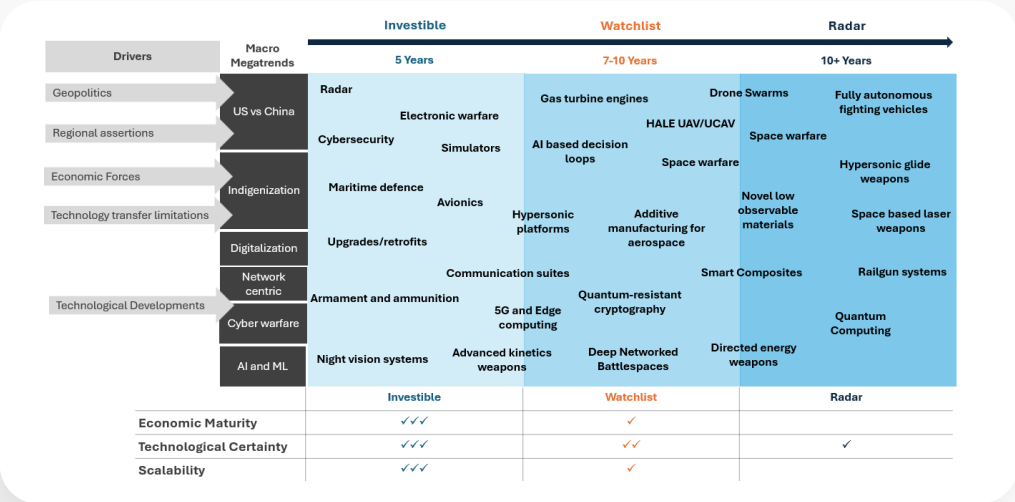


Exhibit 17: The VQ framework for time-based view of various ideas in the defence eco-system
Source -VQ Research

The drivers of the defence megatrend are presented on the left, leading to macro trends. These are areas we keep remain cognizant opportunities that we bucket into timeframes. Those in the five-year horizon have high economic maturity and are backed by a developed industrial base and confirmed order books, there is ample evidence of technological maturity and the ability to scale up. It is here that we look for actionable investment ideas.

Ideas further out on the seven-to-ten-year range have reasonable technological maturity, but economic maturity and scalability of these ideas are yet to be demonstrated with order flow. These ideas are leaving the drawing boards to become prototypes. This is an area we keep revisiting to find the next ideas that are crossing over into the investible horizon.

Even further in the future are ideas with a visibility around technology, but no clarity on economic maturity or scalability. These can also include revolutionary, but presently nebulous concepts. These are areas we keep remain cognizant of but cannot action as an investment idea.



► Indian defence, and the rise of investible opportunities in private companies:

In the Indian context, the policy shift of DAP – 2020 has energised the sector with assured order flows. While for the present, the DPSUs remain the lead system integrators, large private sector companies/conglomerates such as Tata, Adani, L&T, Mahindra etc. will also increasingly take up the lead integrator roles. Smaller private companies will then step in as suppliers of components, sub-systems and assemblies for the lead integrators, public or private. With the weakening of the DRDO as discussed previously, the R&D initiatives in a rapidly changing landscape will be borne increasingly by the private sector (large and small). The domestic focus created by the DAP – 2020 (and the subsequent indigenization lists) means that there is substantial confidence in the private sector to undertake such R&D, without fear of it being orphaned by imports. The announcements of various ambitious projects such as the Advanced Medium Combat Aircraft (AMCA), indigenous tanks such as the Zorawar, indigenous artillery, cybersecurity, indigenous communication protocols etc., paint a rosy future for the Indian defence sector and private participants in it.

The global turmoil with the Russia-Ukraine conflict, the increasingly remote stance by the US on European defence also position India well as a reliable supplier of weapons systems. The recently announced increases in EU defence spending as a reaction to US stance on defence will also be an opportunity to Indian defence companies to allow rapid manufacturing and scale-up of European defence, which has hitherto been neglected. It is also important to note that circumstances at present will allow India to rise as a defence supplier in addition to China in the region. While present capabilities still lag China in several aspects, private sector participation is allowing India to catch-up across the board.

While the rise of Indian companies, across the defence sector is encouraging, and exports are ramping up, most revenue is so far realised domestically. Although rationalized, Indian defence procurement processes are still long drawn, as evident in Exhibit 18.

Key Stages		Timeline/ months				
Abbreviation	Full form	Emergency	Foreign	Command	MHA	MoD
RFP	Request for Proposal	-NA-	0	0	0	0
FET	Field Evaluation Trial	-NA-	1 - 2	1.5 - 2	1.5 - 2	12.5
CNC	Contract Negotiations Committee	-NA-	-NA-	3.5 - 4	3.5 - 4	17.5
PO issue	Purchase Order	0	3 - 4	5.5 - 7	5.5 - 7	22.5 - 25
Delivery	-	1.5 - 2	4 - 7	7 - 9	7 - 9	25 - 27
Final release of payment	-	3 - 4	5 - 10	9 - 11.5	9 - 11.5	27.5 - 30
Time from PO to payment	-	3 - 4	2 - 6	3.5 - 4.5	3.5 - 4.5	5+
Time from Delivery to payment	-	1.5 - 2	1 - 3	2 - 2.5	2 - 2.5	2.5 - 3+

Exhibit 18: Common procurement processes in India can take nearly two to three years

Source - VQ Research



It is important to re-iterate that emergency procurements (EP), while allowing higher margin and curtailed timelines, are not a recurring line of business. Any EP based procurement cannot therefore be used prudently to assess margins or capital intensity. Other than this it is important to emphasize that pre-dispatch inspections can be time consuming with finished articles waiting as inventory. Over 80% of capital employed by private defence companies is in working capital mostly toward inventory. Additionally, there are substantial bank guarantee (BG) clauses which necessitate the maintenance of cash reserves on the balance sheet.

Unlike global peers, Indian defence companies are unable to use borrowings as effectively, relying almost entirely on equity funding due to the nature of the industry.

There have been recurring reports about a rationalization of the acquisition processes even further and the setting up of a non-lapsable fund for acquisitions. The latter would ease continuity of projects if yearly delivery targets were not met, or inspections were delayed. At present, the funds would lapse, and fresh funding sought in the next financial year to allow the project to continue creating significant uncertainty. Nevertheless, with high capital employment and the added responsibility for R&D will put the emphasis on capability, promoter ability and the ability to select the right projects. The sector is on the rise with many opportunities for the private sector. Growth is certain, but value accretive growth needs a more nuanced lens to identify and a disciplined approach to invest in. The development of an export market will aid the maturity of the sector and allow growth of the right players.

► Conclusions:

- Innovative capability and the ownership of technology or manufacturing know how an important quality for high capability defence companies, especially in the private sector
- The role of DRDO is expected to wane as the sector develops, and the onus of R&D will fall on the private sector, placing emphasis on innovation
- Growth is not a problem as there is a significant supply demand mismatch in terms of weapons systems and capabilities
- While efficient use of capital can drive return ratios, the high inventory holding of defence typically lends itself to high margins as a reliable route to high return ratios
- Despite the large number of private companies in this sector, very few combine high return ratios with sustained growth, and investing in the sector requires backing these companies. We prefer to invest bottom-up after scoping the opportunity top-down.
- Electronics and upgrades will form a large part of the capital expenditure
- The army lacks the modernization budget for large systems but small items that address key pain points can be valuable



- Growth areas include Make – 1 and 2 projects and exports. Strategic reinvestment into these areas is critical to maintain growth momentum
- Offsets or similarly low value add businesses to be avoided as even a small increase in capital employment due to inventory build-up or extension of receivables can hamper return ratios. This situation is exacerbated by the low margins inherent in these businesses
- Global changes mean that an attractive export opportunity is opening. Participating in the journey as investors can be rewarding if the company has the correct combination of capability, proven technology and execution capability helmed by a strong promoter
- Finally, after many wrong turns the Indian defence sector is finding its feet. As it grows, the private sector will also develop in strength and capability while contributing robustly to exports. This is a phase that will favour innovators who are prudent in selection of projects across the board, to ensure high margins. These margins will in turn protect against any inadvertent increases in capital intensity and allow consistently high return ratios.

We also mention that the changes that have swept through the defence manufacturing sector are unprecedented. Government mandate and geopolitical events have given Indian defence businesses to rise to global importance in capability and execution. Since we are at the inflection of this sector, picking the correct company combining technology, execution and financial prudence will be wealth accretive. The journey of the Indian defence sector has only started.



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