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MERGER OF PUBLIC SECTOR SHIPYARDS - A CRYING NECESSITY

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The Ship Building Industry in India today is in a state of flux. Given the vagaries of shipping cycles, commercial orders have all but dried up. As a consequence, private shipyards that had made substantial investments into infrastructure based on highly optimistic projections are now in dire straits. Many of them such as Bharati Shipyard Limited[1], ABG Shipyard Ltd[2] and Reliance Defence (now Reliance Naval and Engineering)[3] have either opted for closure or are in the midst of financial restructuring to relieve stress. Others such as Larsen and Toubro (L & T) have decided to ride out the maritime recession by focusing almost entirely on defence orders. A collateral impact of this is that Public Sector Undertaking (PSU) Yards, which have hitherto had a free run with defence orders, more often than not being allocated to them on nomination under 'cost plus' terms, have begun to feel the heat. Most low end platforms such as Offshore Patrol Vessels (OPVs), training ships, Fast Attack Craft (FAC) and Fast Interceptor Craft (FIC) are already being tendered competitively with private sector participation. Several of these contracts have even been won by private players such as Reliance Defence for Naval OPVs, and L & T for the Coast Guard OPVs and a Floating Dock (FDN) for the Navy.

A positive outcome of competitive bidding has been realistic price realization wherein contracted prices have occasionally been even lower than benchmarked values. Though this has been a godsend to a resource constrained Navy and Coast Guard, the savings so far have been modest as the value of these contracts have been relatively low. There is, however, a tremendous upside potential as private yards move up the value chain and start bidding for more complex platforms.

The PSU shipyards have watched these changes with varying degrees of concern. For some, such as Mazgaon Docks Limited (MDL) and Garden Reach Shipyard Limited (GRSE), sitting flush on Naval orders worth thousands of crores, a complacent attitude is understandable. For others such as Hindustan Shipyard Limited (HSL), a bad situation is progressively getting worse. In addition to getting orders on a nomination basis, some of the PSU yards have had the added advantage of having their infrastructure upgraded through naval budgetary support. Private yards on the other hand have done so either through debt, which requires being serviced at interest rates that are high when seen on a global basis, or through internal accruals. To compete in such an environment, which is far from a level playing field, and yet win contracts, speaks of considerable inefficiencies amongst the PSU shipyards. It would therefore be a reasonable assumption to make that as the private yards ramp up their technical competence and enter the frigate/destroyer market, the pressure on the PSUs will only increase. It is therefore essential that steps be taken at the earliest to ensure the long-term survival of these facilities as it would be in the interest of the Navy to have vibrant public sector undertaking coexist with private yards.

Inherent Inefficiencies

The PSUs have already undertaken major modernization drives and are progressively adopting modular construction techniques which have the potential to substantially compress build time-lines. They, however, still have inefficiencies that impair their profitability when seen on an aggregated basis. A summation of these issues is listed below: -

- **Unequal Loading.** While MDL and GRSE have their order books full, GSL's health is linked to the successful conclusion of the Minesweeper contract and Cochin Shipyard Limited (CSL) is fast reaching a point where an order for the second aircraft carrier (IAC 2) would become essential for its continued profitability. Consequent to the decision to allot the INS *Teg* follow-on frigates to GSL on nomination[4], HSL, which was hopeful of getting this order, faces the largest problem of all. With the contract for the Fleet Support Vessels still some distance away, the yard is staring at an order drought in the near term. Equitable distribution of work load amongst these facilities, which have been created at considerable public expense, could result in far more optimal utilization.

- **Infrastructure Deficiencies.** Each shipyard has a unique set of capabilities and limitations insofar as infrastructure is concerned. GRSE, for instance, has severe draught restrictions. The yard is therefore limited in the size of vessels it can build. Appendages such as sonar-domes often have to be installed at a different facility on the East coast. Once these have been attached, return of the vessel to Kolkata to attend to defects becomes a challenge. Conduct of trials requires an arduous voyage down the Hooghly, which is time consuming and invariably linked to tidal considerations. Further, if a major port were to be built on Sagar Island at the mouth of the river, the financial justification of spending enormous sums on dredging to keep the old port open could come under question. GRSE is therefore, already in search of a satellite facility to overcome the above deficiencies. While the situation in MDL is slightly better, draught limitation plagues this yard as well. The *Vishakhapatnam* class of destroyers is probably the largest size of vessel that can be launched from the facilities that currently exist. Even this is quite a challenge and requires a buoyancy assist from pontoons. Further, weight limitations at the time of launch limit the degree of outfitting that can be done pre-launch thereby going against the very grain of modular construction. Given the progressive rise in the tonnage of capital ships in the destroyer/frigate class, MDL is faced with a growing challenge in this regard.

- **Technical Expertise.** In contrast to MDL and GRSE, the challenges faced by other PSU yards are more related to technical expertise and experience. Though GSL has gained considerable proficiency in the construction of OPVs and FACs, they are yet to be tested in the far more complex frigate programmes which they are now about to enter. Similarly, HSL and CSL have largely focused on commercial vessels insofar as their construction activities are concerned, the first Indigenous Aircraft Carrier (IAC 1) being an exception for CSL. For these yards to get into the business of cost effectively manufacturing complex men-of-war would require a high degree of infusion of expertise from the more experienced players in the field.

A Workable Solution

What emerges from the above is that while the PSU yards compete with one another for award of contracts, either through competitive pricing for tendered projects or through intense lobbying for those that go out on a nomination basis, their capabilities are in many ways complimentary i.e. the shortcomings of some are the strengths of the others and vice versa. The potential benefits of collaboration are therefore tremendous. However, doing so under the present arrangement where each sees the other as a competitor would be difficult if not impossible. If, however, a solution were to be found to ensure collaboration, then the upside would be the unleashing of untapped potential. How best could we do so? To my mind, we have reached the point when we need to seriously consider the merger of PSU shipyards. If they were to be brought under a single management and operate as one company with different production facilities a.k.a. SAIL or IOC, there would be tremendous gains for all stakeholders. These could be summarized as follows:-

- **Optimization of Loading.** Rationalization on this count will do away with the present situation where you have unexecuted/ delayed deliveries at some overworked yards and facilities lying idle at others.

- **Infrastructure Deficit.** Some of the infrastructural bottlenecks mentioned earlier would get addressed without having to invest into green-field satellite facilities.

- **Workforce Mobility.** With a transferable and therefore relocatable work force, there would be unimpeded diffusion of skills and technology from one yard to the other. As a consequence, capability gaps that exist would rapidly get plugged. Experience sharing driven by the motive of profit maximization would result in an upward spiral in efficiency and build quality.

- **Pooling of Resources.** Overheads could be substantially reduced by the pooling of technical and human resources. Duplication of expensive pieces of equipment with unique, though limited, use could be avoided through sourcing all such requirements from a common facility. Undoubtedly this will have to be done after carrying out a cost benefit analysis factoring the logistics of doing so. Similarly gains would be realized through the pooling of human resources pertaining to ship design and associated software tools. This would be in addition to a far steeper learning curve where the lessons learnt from one programme are seamlessly applied to the other, unhindered by commercial firewalls that currently exist.

- **Reliable Vendor Base.** Given the size of a merged entity, it would be much easier to nurture a set of reliable vendors who would be willing to invest into creating capacities to fulfil the larger orders that they would now be competing for. The larger order quantities would also allow price reduction.

- **Standardization of Equipment.** Single point sourcing would result in standardization of equipment across different classes of ships. This would streamline logistics while simultaneously reducing the training burden for the Indian Navy.

- **Easier Disinvestment.** Lastly, as the government moves towards disinvestment of PSUs, while public offerings of MDL (like in the case of CSL) may find strong public support, the response for companies such as HSL would be expectedly tepid. However, valuations for a merged entity with overall profitability would still attract public interest. It would also be easier to disinvest a single entity as against the requirement to have multiple public issues if the process were to be undertaken piecemeal.

The Naysayer Argument

What then would be the argument put forward by the naysayers to such a proposition?

- **The Tyranny of Distance.** ***Geographically dispersed yards would find it difficult to leverage each other's strength.*** Undoubtedly this poses a problem but solutions already exist. For instance, insofar as our strategic programmes are concerned, we already have shipyards that ship sections of submarines over vast distances thereby seamlessly integrating widely dispersed production facilities.[5] In the U.S., fully outfitted sections of the Virginia Class submarine are built at Quonset Point, Rhode Island and then transported by barge to either Groton, Connecticut or Huntington Ingalls-Newport News Shipbuilding in Newport News, Virginia, for completion. In the U.K., the construction of the *Queen Elizabeth* aircraft carrier has been undertaken by four different companies with their shipyards spread across seven different locations.[6] The problem is therefore far from insurmountable.

- **The Throttling of Competition.** ***Merger would bring down the number of entities that compete for contracts.*** This too does not stand the test of reason. Getting two PSU yards to compete against one another may look good on paper but is impractical. Both are governed by boards which are dominated by largely the same set of government officials. Competition of this nature is incestuous and amounts to backdoor nomination for all practical purposes.

- **Irreconcilable Cultural Differences.** ***Culture of these entities is vastly different and would preclude gains from merger.*** This would certainly be a challenge but through deft management and HR practices, the synergies could be made apparent to one and all. A botched merger between Air India and Indian Airlines should not be used for the extrapolation that all consolidation will end in disaster. Lessons learnt need to be studied and mistakes need not be repeated. In any event, given the ongoing merger amongst PSU Banks, the government clearly feels that there is scope for unshackling value by bringing entities together.

What are Other Nations Doing?

We would not be breaking new ground in following such an approach. Most nations with large ship building industries have adopted varying degrees of consolidation of their yards to enhance efficiencies. Some of the steps taken are as listed below: -

- **China.** China consolidated all their government owned shipyards under one State Owned Enterprise (SOE), the China State Shipbuilding Corporation (CSSC) in 1982. On 01 July 1999, under a State Council initiative, the Chinese government split the top five Defence and Technology Corporations into ten new enterprises. The China Shipbuilding Industry Corporation (CSIC) was thus carved out of the China State Shipbuilding Corporation (CSSC) and both remain large SOEs today. There is, however, currently an ongoing debate on merging these two entities once again.[7]

- **United States.** In the U.S., consolidation driven by commercial considerations has resulted in the emergence of two large ship building conglomerates, these being General Dynamics and Huntington Ingalls. Each of these corporations has dispersed production facilities which are supportive of one another and function cohesively towards maximisation of profitability. General Dynamics for instance, apart from their yards at Groton and Quonset Point mentioned earlier, also runs large shipyards at Bath (Bath Iron Works) and San Diego (NASSCO) amongst other smaller facilities.

- **Russia.** On 22 March 2007, President Vladimir Putin signed a decree establishing the 'United Shipbuilding Corporation' that amalgamated about 40 agencies involved in the industry including design houses. The reasoning for doing so can best be derived from the statement made by the first deputy Prime Minister Sergei Ivanov on 27 April 2007, "Ninety-six percent of Russian cargo is transported by foreign ships, and ninety percent of new ships whose keels are laid in Russia's interests have orders placed abroad. That is an outrage."[8] It may thus be seen that while the primary motivation for the merger in this case was competitive civil shipbuilding, the move brought even the yards engaged in naval construction together thereby greatly increasing efficiencies.

Proposed Resolution

What then do we need to do to re-energise our PSU Shipyards and unleash their true potential? Consolidation undoubtedly is the way ahead but how do we chart our way through this process? There are three possible options: -

- **Option 1.** We bite the bullet and merge all the five PSU shipyards in one step. While this would be the most efficient, we run the risk of inter-ministerial bureaucratic delays as CSL comes under the purview of the Ministry of Shipping and Transportation (MOST) while the rest of the yards are with the Ministry of Defence (MoD).

- **Option 2.** We merge only the four MoD yards into a single entity.
- **Option 3.** Given the considerations of proximity and complementarities, some of which have been dwelt with in greater detail in earlier paragraphs, we adopt a measured approach and proceed with a marriage between MDL and GSL on the West Coast and between GRSE and HSL on the East Coast.

While these could be debated in greater detail, my recommendation would be the adoption of Option 2. It would circumvent the inevitable delays that inter-ministerial issues carry should Option 1 be exercised. In this case, there would also be an additional layer of complexity linked to the recent public issue of CSL. On the other hand, Option 3 would be hesitant and would not dispense with all the issues raised in the earlier paragraphs. Whatever be the approach finally adopted, it would need to be ensured that this merger is done with full commitment wherein seams between the merged entities are obliterated to the greatest extent feasible. This would preclude getting into a situation akin to the Air India and Indian Airlines union wherein several fences between the two entities persisted including issues such as divergent salary structures, terms and conditions of employment, etc. which resulted in the marriage going sour. In the interim, it is recommended that all public offerings of equity of individual shipyards be put on hold till the consolidation process is over. This decision could be revisited post merger.

Conclusion

In conclusion one may say that though crystal ball gazing is invariably a hazardous profession, over-capacity in shipyards within the country is likely to persist. Defence shipbuilding supported by the 'Make in India' environment is likely to remain the primary engine of growth to keep this sector afloat. Overcapacity will induce greater competition that will squeeze profit margins as shipyards compete with one another on defence orders. While PSU yards have hitherto enjoyed several advantages such as allotment of contracts on nomination basis and having their infrastructure upgrades partially funded through budgetary grants, these avenues of orders/resources are likely to dry up in the future. Under such conditions, it is imperative that these yards remain ahead of the curve and embrace innovative means to retain their profitability. Merger of complimentary yards would be a big step in this direction. The government is already resorting to such means in other sectors such as in banking and insurance and there is no reason why a similar approach will not find favour with regard to shipbuilding.

The Navy, as a key stake holder, would also like to witness the continued financial viability of these facilities which have been created at tremendous cost. So though '*combine or perish*' may sound alarmist at this juncture, our PSU shipyards could devote greater attention to reading the writing on the wall and adopt a proactive approach in this regard. This would be far better than being overrun by events and having a decision thrust on them without adequate preparation.

(Endnotes)

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