

CUMMINS INDIA

Q2 miss a temporary blip; growth positioning intact

India Equity Research | Engineering and Capital Goods

Cummins India (KKC) missed Q2FY18 estimates impacted by GST-related issues. Key highlights: a) Temporary, but significant GST hurdles impacted domestic revenues, while exports dragged due to sustained slow down in low KVA gensets in emerging countries; b) Management expects to recoup most of the lost sales in domestic market, while exports guidance was revised to 5-10% decline (from 0-5% decline earlier), despite some recovery in large engines to parent entity; c) Industrial BU grew at a reasonable 14% YoY in H1FY18 steered by railways and construction and is on track to post 20-25% CAGR over next 2-3 years. We pin hopes on KKC's sustained domestic positioning in large engines market (power gen), effective cost initiatives and high growth in industrial BU which coupled with its capex-ready status augurs well for RoE/free cash. Maintain 'BUY' with revised TP of INR1,005 (INR1,025 earlier) even as we trim FY18/19E earnings by 6/3% building in slow H1FY18.

Miss not a major worry; industrial BU, power gen growth intact

Despite the miss (impacted by GST) as customers (mainly PSUs) beefed up their systems, management expects most of the lost sales (mainly in distribution and PG segments) totaling excess of INR1.2bn to recoup in H2FY18 given that GST issues are now resolved. Even as industrial revenue declined (QoQ), management expects railways/construction (>65% of industrial BU) to drive 20-25% growth for the BU. While commentary for domestic market remained optimistic, exports was mixed with large engines showing improvement (single digit) and weak outlook for low KVA sets.

Road ahead in ensuing quarters

Management is currently focusing on value engineering which is evident from strong gross margins even as exports declined at a time when KKC is struggling to take a price hike due to tepid industry volumes and tough competition from the likes of KOEL. We believe strong prospects in industrial BU and after sales/spares and healthy growth in large/mid DG sets augurs well for KKC's capex-ready status.

Outlook and valuations: Cautious approach; maintain 'BUY'

KKC is trading carefully amid heightened competition and muted exports outlook. We expect KKC to record substantial FCF and RoE scale up over 2-3 years as volumes potentially improve. At CMP, the stock trades at 26x FY19E EPS. Maintain 'BUY/SO'.

Financials

(INR mn)

Year to March	Q2FY18	Q2FY17	% Chg	Q1FY18	% Chg	FY17	FY18E	FY19E
Net revenues	11,539	12,790	(9.8)	13,408	(13.9)	50,773	54,022	65,951
EBITDA	1,675	1,990	(15.8)	1,953	(14.2)	8,018	8,610	10,787
Adjusted Profit	1,529	1,969	(22.3)	1,660	(7.9)	7,346	8,004	9,859
Adjusted Diluted EPS	5.5	7.1	(22.3)	6.0	(7.9)	26.5	28.9	35.6
Diluted P/E (x)						34.4	31.6	25.6
ROAE (%)						20.3	20.2	22.0

EDELWEISS 4D RATINGS

Absolute Rating	BUY
Rating Relative to Sector	Outperform
Risk Rating Relative to Sector	Low
Sector Relative to Market	Overweight

MARKET DATA (R: CUMM.BO, B: KKC IN)

CMP	: INR 912
Target Price	: INR 1,005
52-week range (INR)	: 1,097 / 748
Share in issue (mn)	: 277.2
M cap (INR bn/USD mn)	: 253 / 3,881
Avg. Daily Vol.BSE/NSE('000)	: 306.9

SHARE HOLDING PATTERN (%)

	Current	Q1FY18	Q4FY17
Promoters *	51.0	51.0	51.0
MF's, FI's & BK's	21.8	21.8	21.5
FII's	14.6	14.3	14.3
Others	12.6	12.9	13.2
* Promoters pledged shares (% of share in issue)	:		NIL

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Capital Goods Index
1 month	0.5	6.0	7.0
3 months	(5.0)	3.0	2.6
12 months	7.3	19.8	23.7

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Q2FY18 conference call: Key highlights

- **Guidance:** Underlying tone was bullish despite the miss. Maintained domestic growth guidance of 5-10% amid GST disruption, but cut export guidance from 0-5 % drop to now 5-10% drop.
- **Strategy:** Hold and grow market share. KKC is witnessing strong competition in large engines, which is impacting its capability to take price hike.
- **Exports:** Many countries, including the Middle East and Africa, continue to struggle which impacts the company's low KVA exports. Management is optimistic on this product range for the next 2-3 years given KKC's global competence. Management expects current run rate in low KVA is close to bottoming out. On high HP exports, volumes started improving from Q1FY18 which is helping gross margins, though growth is still not significant.
- **Impact of GST/supply-side constraints:** Lost INR800mn sales on distribution side due to GST, as clients (mostly PSUs) were not ready, while it was a INR200mn miss on Powergen. Currently, most clients are now ready and management expects to recoup most of the lost domestic sales in ensuing quarters. The company's more than 200 suppliers were under stress in Q2FY18 impacting its shipments. However, in Q3FY18 till-date it has recovered substantially.
- **Profitability improvement:** KKC clocked 170bps expansion in gross margin YoY, most of the benefit was due to value engineering and cost initiatives, while export mix contributed 25% of these savings.
- **Industrial BU:** H1FY18 growth stood at 14%, with a decline in Q2FY18 mainly impacted by GST. Management expects industrial BU to lead the company's growth. Railway business moved up 44% YoY in H1FY18 for KKC and is one of the highest growing sub-sets of industrial BU. Other segments like marine, defense, compressors & construction are also witnessing strong traction. Overall, 20-25% is the sustainable growth for industrial BU over next 2-3 years, given strong demand across segments. There is strong focus by government on economic development with money flowing into railways/roadways. However, defence/ship-yards seem to be attracting lesser focus as per management. The government is moving away from L1 criteria and is giving tenders/projects to companies which are good in execution, which is a major change in trend.
- **Long term outlook/risk of disruption:** KKC focuses on the TCO (total cost of ownership) approach for its clients and does not want to rely on single product/platform. The company targets to play in all new/emerging technologies at parent level as and when demand comes for this and is justified on TCO basis.
- **Book keeping:** Tax rate & other income - Q2FY18 dividend from subsidiaries dropped sharply to INR150mn versus INR300mn in the corresponding quarter of previous year, which impacted other income. Tax rate was at 21.7%, up 200bps YoY due to sun-setting of 200% R&D tax benefit to 150% now, apart from the drop in shipment from the SEZ at Phaltan for low KVA gen-sets in FY18E.

Table 1: Segmental break up of revenue

Sector revenues	2,013	2,014	2,015	2,016	2,017	2018E	2019E	Remark
Power	16,000	11,600	10,556	12,667	13,427	14,770	18,462	We expect Power Gen revenues to pick up led by improving demand from commercial real estate/data center and improved infra spending.
% change	27.4	(27.5)	(9.0)	20.0	6.0	10.0	25.0	
Industrial	4,790	5,125	5,074	5,581	7,144	8,838	11,517	Growth in industrials on the back of improved spending in construction, railways, mining etc
% change	(9.1)	7.0	(1.0)	10.0	28.0	23.7	30.3	
Auto	1,590	1,352	1,081	703	870	-	-	
% change	(34.6)	(15.0)	(20.0)	(35.0)	23.8	-	-	
Distribution & others	13,557	12,470	13,194	14,048	15,544	17,876	21,808	Widening product applications with higher usage (railway, mining, etc.) apart from new product launches to launch higher distribution growth.
% change	18.4	(8.0)	5.8	6.5	10.6	15.0	22.0	
Total domestic revenues	35,937	30,547	29,905	32,999	36,985	41,484	51,788	
% change	13.3	(15.0)	(2.1)	10.3	12.1	12.2	24.8	
Exports	12,690	11,929	17,177	16,669	16,110	14,982	17,230	While structural drivers like rising product mandate from parent remains intact bottoming out of global commodities is likely to drive end demand for export zones like Middle East and Africa.
% change	6.6	(6.0)	44.0	(3.0)	(3.4)	(7.0)	15.0	
Total Gross revenueus	48,627	42,475	47,082	49,669	53,095	56,466	69,017	
% change	11.5	(12.7)	10.8	5.5	6.9	6.3	22.2	

Source: Edelweiss research

Financial snapshot

(INR mn)

Year to March	Q2FY18	Q2FY17	% change	Q1FY18	% change	YTD18	FY18E	FY19E
Net revenues	11,539	12,790	(9.8)	13,408	(13.9)	24,946	54,022	65,951
Raw material	7,282	8,285	(12.1)	8,722	(16.5)	16,004	34,667	42,544
Staff costs	1,257	1,125	11.7	1,226	2.5	2,482	4,695	5,101
Other operating expenses	1,326	1,390	(4.6)	1,507	(12.0)	2,833	6,051	7,518
Total expenditure	9,864	10,800	(8.7)	11,455	(13.9)	21,319	45,412	55,163
EBITDA	1,675	1,990	(15.8)	1,953	(14.2)	3,627	8,610	10,787
Depreciation	220	209	5.5	208	5.7	429	913	1,017
EBIT	1,454	1,781	(18.3)	1,744	(16.6)	3,199	7,697	9,770
Other income	536	692	(22.5)	583	(8.0)	1,120	2,660	2,907
Interest	38	43	(12.3)	42	(10.0)	80	168	168
Add: Exceptional items								
Profit before tax	1,953	2,430	(19.6)	2,286	(14.6)	4,239	10,190	12,510
Tax	424	461	(8.1)	625	(32.2)	1,049	2,185	2,651
Reported net profit	1,529	1,969	(22.3)	1,660	(7.9)	3,189	8,004	9,859
Adjusted Profit	1,529	1,969	(22.3)	1,660	(7.9)	3,189	8,004	9,859
Equity capital(FV INR 2)	554	554		554		1,108	554	554
Diluted shares (mn)	277	277		277		554	277	277
Adjusted Diluted EPS	5.5	7.1	(22.3)	6.0	(7.9)	11.5	28.9	35.6
As % of net revenues								
Raw material	63.1	64.8		65.1		64.2	64.2	64.5
Employee cost	10.9	8.8		9.1		10.0	8.7	7.7
Other operating expenses	11.5	10.9		11.2		11.4	11.2	11.4
EBITDA	14.5	15.6		14.6		14.5	15.9	16.4
Reported net profit	13.3	17.1		14.4		12.8	14.8	14.9

Change in Estimates

	FY18E			FY19E			Comments
	New	Old	% change	New	Old	% change	
Net Revenue	54,022	57,487	(6.0)	65,951	68,219	(3.3)	
EBITDA	8,610	9,085	(5.2)	10,788	11,030	(2.2)	
EBITDA Margin	15.9	15.8		16.4	16.2		
Adjusted Profit After Tax	8,004	8,389	(4.6)	9,859	10,055	(2.0)	Building in slow H1FY18
Net Profit Margin	14.8	14.6		14.9	14.7		
Capex	2,752	2,752	0.0	2,752	2,752	0.0	

Company Description

KKC is a subsidiary of Cummins, US, which holds 51% stake in the company. It is a leading manufacturer of medium-high HP range of diesel engines in India with manufacturing facilities in Pune and Daman.

Investment Theme

KKC is a play on the multiple segments of power requirement, rising mobile penetration across rural and suburban geographies, strong coal requirement (driving demand in mining), and continued growth in automobile sales on the back of large potential in environment friendly natural gas fuel-based engines. The company is a major outsourcing hub for its parent, especially in the LHP generators & High HP engines. We expect KKC to benefit from growth in the above segments.

Cummins has a strong co-relation to IIP growth & commercial capex which imparts confidence for an improved growth rate from FY18

CILs Phaltan mega-site is now a sole manufacturer of small kva gensets for global market. This will add peak sales potential of INR 12-14 bn for CIL over next 2-3 yrs.

Key Risks

Any major slowdown in the domestic market (70% of the total revenues) would pose a significant down side risk to our estimates.

Financial Statements

Key Assumptions

Year to March	FY16	FY17	FY18E	FY19E
Macro				
GDP(Y-o-Y %)	7.9	6.6	6.8	7.4
Inflation (Avg)	4.9	4.5	4.0	4.5
Repo rate (exit rate)	6.8	6.3	5.8	5.8
USD/INR (Avg)	65.5	67.1	65.0	66.0
Company				
Tax rate (%)	17.1	19.1	19.0	19.0
ICC	27,674	29,639	29,046	36,409
Sales volume	36,182	37,991	37,232	42,816
Avg. price realisation	764,844	780,141	780,141	850,353
Generating sets	360	-	-	-
Sales volume	1,108	-	-	-
Avg. price realisation	325,059	341,312	358,377	376,296
Capex (INR mn)	4,917	2,445	2,751	2,751
Dep. (% gross block)	4.3	4.3	4.0	4.0

Income statement

(INR mn)

Year to March	FY16	FY17	FY18E	FY19E
Income from operations	47,088	50,773	54,022	65,951
Materials costs	29,622	32,745	34,667	42,544
Employee costs	4,156	4,334	4,695	5,101
Other mfg expenses	5,559	5,677	6,051	7,518
Total operating expenses	39,337	42,755	45,412	55,163
EBITDA	7,751	8,018	8,610	10,787
Depreciation	810	848	913	1,017
EBIT	6,941	7,170	7,697	9,770
Add: Other income	2,258.6	2,079.8	2,660.31	2,907.3
Less: Interest Expense	96	168	168	168
Profit Before Tax	9,104	9,082	10,190	12,510
Less: Provision for Tax	1,561	1,736	2,185	2,651
Reported Profit	7,543	7,346	8,004	9,859
Adjusted Profit	7,543	7,346	8,004	9,859
Shares o /s (mn)	277	277	277	277
Basic EPS (INR)	27.2	26.5	28.9	35.6
Diluted shares o/s (mn)	277	277	277	277
Adjusted Diluted EPS	27.2	26.5	28.9	35.6
Adjusted Cash EPS	30.1	29.6	32.2	39.2
Dividend per share (DPS)	14.0	14.0	15.0	15.0
Dividend Payout Ratio(%)	61.7	63.3	62.3	50.6

Common size metrics

Year to March	FY16	FY17	FY18E	FY19E
Operating expenses	62.9	64.5	64.2	64.5
Materials costs	8.8	8.5	8.7	7.7
Staff costs	11.8	11.2	11.2	11.4
Other mfg expenses	83.5	84.2	84.1	83.6
Depreciation	1.7	1.7	1.7	1.5
Interest Expense	0.2	0.3	0.3	0.3
EBITDA margins	16.5	15.8	15.9	16.4
Net Profit margins	16.0	14.5	14.8	14.9

Growth ratios (%)

Year to March	FY16	FY17	FY18E	FY19E
Revenues	6.9	7.8	6.4	22.1
EBITDA	5.4	3.4	7.4	25.3
PBT	(2.9)	(0.2)	12.2	22.8
Adjusted Profit	(4.0)	(2.6)	9.0	23.2
EPS	(4.0)	(2.6)	9.0	23.2

Balance sheet		(INR mn)			
As on 31st March	FY16	FY17	FY18E	FY19E	
Share capital	554	554	554	554	
Reserves & Surplus	34,259	36,867	41,198	47,514	
Shareholders' funds	34,813	37,421	41,752	48,068	
Short term borrowings	-	2,508	2,508	2,508	
Total Borrowings	-	2,508	2,508	2,508	
Long Term Liabilities	1,021	887	887	887	
Sources of funds	35,230	40,040	44,370	50,686	
Gross Block	19,497	19,767	22,267	24,767	
Net Block	12,818	12,240	13,849	15,359	
Capital work in progress	75	82	162	237	
Intangible Assets	5,192	4,631	4,781	4,931	
Total Fixed Assets	18,086	16,954	18,792	20,527	
Non current investments	374	3,052	3,052	3,052	
Cash and Equivalents	4,235	8,447	12,562	16,317	
Inventories	6,003	5,621	5,951	7,168	
Sundry Debtors	9,381	9,557	10,399	12,451	
Loans & Advances	1,287	1,287	1,222	1,137	
Other Current Assets	4,808	4,692	4,458	4,146	
Current Assets (ex cash)	21,478	21,156	22,030	24,902	
Sundry creditors	7,170	7,470	7,908	9,954	
Provisions	1,773	2,099	4,158	4,158	
Total Current Liab	8,943	9,568	12,066	14,112	
Net Curr Assets-ex cash	12,536	11,588	9,964	10,790	
Net Deferred tax	(604)	(777)	(777)	(777)	
Uses of funds	35,230	40,040	44,370	50,686	
BVPS (INR)	125.6	135.0	150.6	173.4	

Free cash flow		(INR mn)			
Year to March	FY16	FY17	FY18E	FY19E	
Reported Profit	7,543	7,346	8,004	9,859	
Add: Depreciation	810	848	913	1,017	
Interest (Net of Tax)	79	136	136	136	
Others	(1,548)	(1,245)	(1,317)	(1,433)	
Less: Changes in WC	(33)	(371)	(1,624)	826	
Operating cash flow	6,917	7,456	9,361	8,753	
Less: Capex	4,918	2,446	2,752	2,752	
Free Cash Flow	2,000	5,010	6,609	6,001	

Cash flow metrics		FY16	FY17	FY18E	FY19E
Year to March					
Operating cash flow	6,917	7,456	9,361	8,753	
Investing cash flow	(2,121)	(4,860)	(1,092)	155	
Financing cash flow	(4,677)	(2,246)	(5,153)	(5,153)	
Net cash Flow	119	350	3,116	3,755	
Capex	(4,918)	(2,446)	(2,752)	(2,752)	
Dividend paid	(4,669)	(4,663)	(4,985)	(4,985)	

Profitability and efficiency ratios		FY16	FY17	FY18E	FY19E
Year to March					
ROAE (%)	22.6	20.3	20.2	22.0	
ROACE (%)	27.5	24.8	24.6	26.7	
Inventory Days	79	65	61	56	
Debtors Days	72	68	67	63	
Payable Days	91	82	81	77	
Cash Conversion Cycle	61	51	47	43	
Current Ratio	2.9	3.1	2.9	2.9	
Gross Debt/EBITDA	-	0.3	0.3	0.2	
Gross Debt/Equity	-	0.1	0.1	0.1	
Adjusted Debt/Equity	-	0.1	0.1	0.1	

Operating ratios		FY16	FY17	FY18E	FY19E
Year to March					
Total Asset Turnover	1.4	1.3	1.3	1.4	
Fixed Asset Turnover	3.7	4.0	4.1	4.5	
Equity Turnover	1.4	1.4	1.4	1.5	

Valuation parameters		FY16	FY17	FY18E	FY19E
Year to March					
Adj. Diluted EPS (INR)	27.2	26.5	28.9	35.6	
Y-o-Y growth (%)	(4.0)	(2.6)	9.0	23.2	
Adjusted Cash EPS (INR)	30.1	29.6	32.2	39.2	
Diluted P/E (x)	33.5	34.4	31.6	25.6	
P/B (x)	7.3	6.8	6.1	5.3	
EV / Sales (x)	5.3	4.9	4.5	3.6	
EV / EBITDA (x)	32.1	30.8	28.2	22.2	
Dividend Yield (%)	1.5	1.5	1.6	1.6	

Additional Data

Directors Data

Anant J Talaulicar	Managing Director	Antonio Leita	Director
Mark Smith	Director	Norbert Nusterer	Director
Suzanne Wells	Director	Nasser Munjee	Independent Director
P.M.Telang	Independent Director	P.S.Dasgupta	Independent Director
Rajeev Bakshi	Independent Director	Venu Srinivasan	Independent Director
Pradeep BHargava	Alternate Director	Nicole McDonald	Alternate Director

Auditors - S R B C & CO LLP

**as per last annual report*

Holding – Top10

	Perc. Holding		Perc. Holding
Cummins inc	51	Franklin resources	6.58
Life insurance corp	5.15	Pinebridge investmen	2.95
Axis asset managemen	2.49	Reliance capital tru	2.34
Birla sun life asset	1.52	Uti asset management	1.46
Templeton asset mgmt	1.44	Icici prudential ass	1.37

**in last one year*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
No Data Available				

**in last one year*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
No Data Available			

**in last one year*

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
ABB India	BUY	SO	L	Bharat Forge	BUY	SO	M
Bharat Heavy Electricals	BUY	SO	M	CG Power and Industrial Solutions	HOLD	SP	M
Cummins India	BUY	SO	L	Engineers India Ltd	BUY	SO	L
Greaves Cotton	HOLD	SP	M	Kalpitaru Power	BUY	SO	M
KEC International	BUY	SP	M	Larsen & Toubro	BUY	SO	M
Praj Industries	BUY	None	None	Ramkrishna Forgings	BUY	SP	M
Siemens	HOLD	SP	L	TD Power Systems	HOLD	None	None
Techno Electric & Engineering	BUY	SO	M	Thermax	REDUCE	SP	L
Triveni Turbine	BUY	None	None	VA Tech Wabag	BUY	None	None

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

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Coverage group(s) of stocks by primary analyst(s): Engineering and Capital Goods

ABB India, Bharat Heavy Electricals, Bharat Forge, CG Power and Industrial Solutions, Engineers India Ltd, Greaves Cotton, KEC International, Cummins India, Kalpataru Power, Larsen & Toubro, Praj Industries, Ramkrishna Forgings, Siemens, TD Power Systems, Techno Electric & Engineering, Thermax, Triveni Turbine, VA Tech Wabag

Recent Research

Date	Company	Title	Price (INR)	Recos
26-Oct-17	ABB India	GST-led spillover mars show; promising outlook; <i>Result Update</i>	1398	Buy
23-Oct-17	Havells India	Cost efficiency makes good for subdued volumes; <i>Result Update</i>	541	Buy
18-Sep-17	Kalpataru Power	Growth catalysts in place; rerating potential; <i>Visit Note</i>	355	Buy

Distribution of Ratings / Market Cap

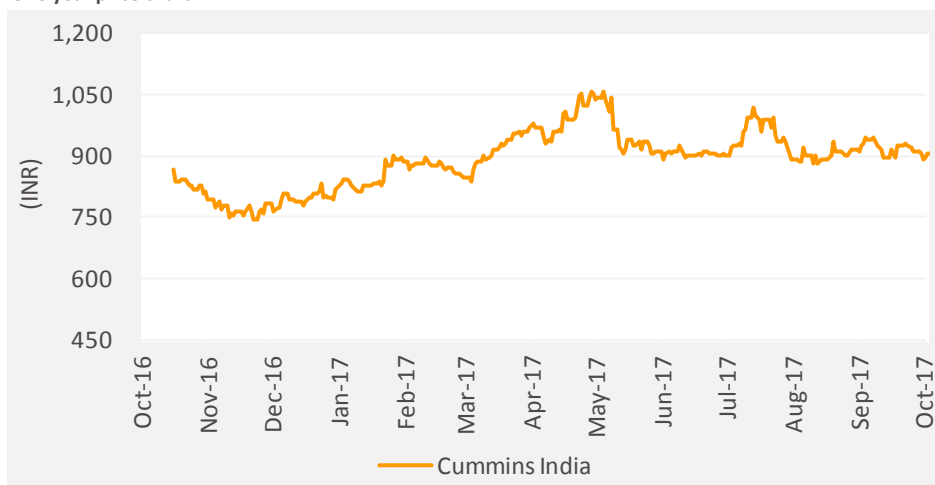
Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	161	67	11	240
* 1stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	156	62	11	

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

One year price chart



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