

COMPANY UPDATE

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CUMMINS INDIA LTD

PRICE: RS.724

TARGET PRICE: RS.862

RECOMMENDATION: BUY

FY20E PE: 21.9x

We expect Cummins India to be able to deliver growth at c.16.4% CAGR (against flat YY growth in FY18E) between FY18-20 given the continued momentum in industrial demand and potential benefits arising from improving economic outlook in exports market (business impact yet to be confirmed by the management). Continued efforts towards cost rationalization (maintain Gross margins through value engineering efforts) and operating leverage will be able to offset the cost inflation to a large extent. We see margins reverting towards FY15-16 levels (still far from previous peaks levels of over 18%), consistent with management's view.

Recovery in high end real estate projects and projects like airports, high rise complexes is critical for Power Generation segment. However, our FY18-20 earnings estimates are based on uptick in the Industrial and Distribution segments and operating leverage led margin resurrection.

After the recent correction in the stock price (stock fell c.15% since February and over 26% YY), the valuations have become attractive at 21.9x FY20 earnings. We believe that the downside could be limited from the current levels and Cummins India can surprise a rather skeptical market on the margin (and subsequently on earnings) front, making a plausible case for re-rating. We value Cummins India at 26x FY20 earnings and move recommendation to 'BUY' from 'ACCUMULATE' with revised target price of Rs 862 (Rs 897 earlier).

Company Highlights

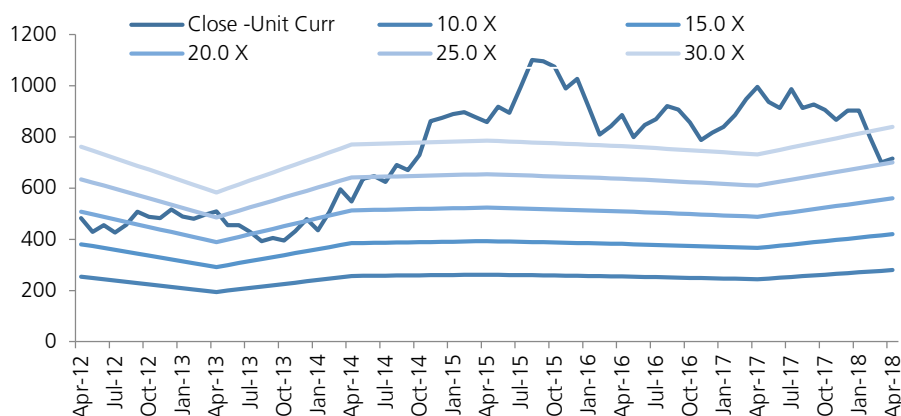
At current valuation metrics- PER 21.9x FY20 and 25.5x FY19, Cummins India stock is trading attractive (below last six years average 1 Yr-forward PER of 29.4 x).

Summary table

(Rs mn)	FY18E	FY19E	FY20E
Sales	50418	55090	61933
Growth (%)	1.6	9.1	12.2
EBITDA	7545	8740	10358
EBITDA margin (%)	14.6	15.5	16.7
PBT	8685	9965	11774
Net profit	6774	7772	9183
EPS (Rs)	24.4	28.0	33.1
Growth (%)	(7.8)	14.7	18.2
CEPS (Rs)	27.7	31.8	37.0
BV (Rs/share)	141.4	150.2	162.8
Dividend/share (Rs)	15.0	16.0	17.0
ROE (%)	17.7	19.2	21.2
ROCE (%)	16.5	17.8	19.7
Net cash (debt)	2410	1975	1901
NW Capital (Days)	33	31	32
EV/Sales (x)	3.8	3.5	3.1
EV/EBITDA (x)	25.4	21.9	18.5
P/E (x)	29.6	25.8	21.9
P/Cash Earnings	26.2	22.8	19.5
P/BV (x)	5.1	4.8	4.4

Source: Company, Kotak Securities – Private Client Research

1 Year forward PER

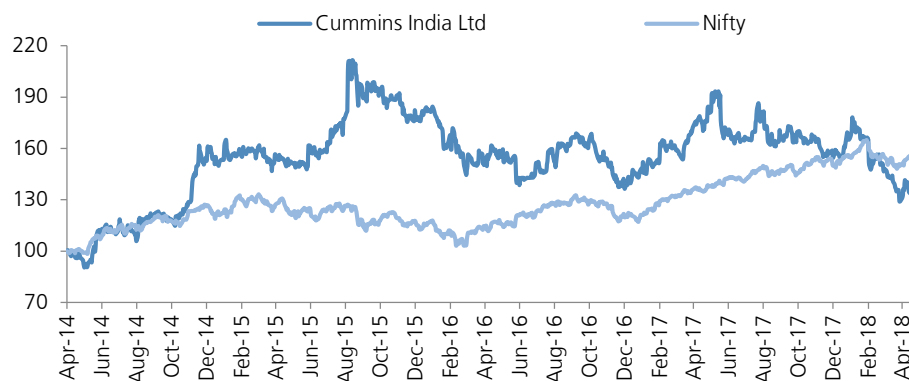


Source: Bloomberg

Cummins India stock has underperformed the broader index (over 40% deviation vis-à-vis benchmark index) in the last six quarters. Contraction in valuations is largely explained by diminishing ROE trend over the past few years. ROE has halved from 29% in FY13 (c.18% in FY18E) levels due to 1/ adverse business climate in India and abroad in last two years and 2/ increased equity base driven by productive and unproductive assets including India office campus.

We believe that current valuations largely discounts the above mentioned negatives and there could be potential case of re-rating on first sight of earning recovery (street has turned negative on earnings disappointment in past six quarters). Rising volumes in industrial business and bottoming out of Powergen & exports would help Cummins India restoring profitability going ahead.

Cummins India Vs Nifty



Source: Bloomberg

Margins could have bottomed out and could expand driven by volumes and cost saving measures

Domestic business: In 9MFY18, Cummins India has reported sales at Rs 38 Bn (down 1% YY). However, EBITDA margins at 14.5% contracted sharply to the lowest level in past several quarters, despite 53 bps rise in gross margins. We note that Cummins India has demonstrated its ability to maintain gross margins in the input price inflationary scenario over the past one year (and even historically), on back of dedicated/ongoing cost reduction efforts. This provides us confidence for FY19/20 when we forecast positive price-cost spread.

The contraction in EBITDA margins to 14.5% (despite improvement in gross margins) in 9MFY18, is largely explained by 1/ 16.4% increase in employee expense (bulk of it came in as payment of variable PAT to employees in Q3FY18), reported at Rs 3.7 Bn and 2/ 11.8% increase in other expenses, reported at Rs 4.5 Bn driven by higher R&D expenses and charged paid to parent for various services availed in 2HFY18. Further management has maintained that unfavourable product mix has also contributed to the margin decline.

On positive side, we believe that the momentum in the industrial business (22-25% of Cummins India revenue pie) would last into FY19/20, driven by strong tailwinds in construction, mining and railways. The management has stated in the Q3FY18 earnings call that the company has been able to push price hikes (in the range of steady 1-2%) to offset inflation impact. While price hikes do not necessarily 'stick', we believe that the trend is sufficiently supported by buoyant market conditions. Cummins India is well poised to benefit from this trend as it enjoys leadership position- commanding over 57% market share in the construction segment within the industrial segment and similar dominant positioning in most of the product categories it is present into.

Further, we also highlight that the higher growth in Industrial sales, would likely pull the distribution sales (38-40% of revenue pie) upward as longer the engines run would require more spare-parts/maintenance. GST led disruptions (prevalent in Q1-Q2FY18) seems to be behind and we believe that the distribution segment would report steady growth going forward.

In Powergen (40% of revenue pie, challenging area as of now) recovery appears to be elusive and pricing pressure might continue to persist over the next two to three quarters. Recovery in high end real estate projects, large projects like airports, hospitals etc is critical for the growth in Powergen segment. We note that in the domestic Powergen market, Cummins India enjoys healthy market share of over 62% in HHP and 54% in Mid-KVA.

Bears might argue that 1/ with the reducing statistics of power deficit (vis-à-vis 3 or 4 years ago) and 2/ with alternate sources of green backup power technology (mainly solar energy based) demand for power generator sets could face (rather already facing) structural headwinds. However, we believe (counter argument put forth by the management) that the Indian power generation market is not under fundamental pressure. The medium to long term prospects would be proportional to the increase in overall economic activity, including revival in high end real estate, high rises etc, and coming back of the manufacturing segment. On renewable backup power front, the storage technology is still struggling (but evolving) to offer credible substitute for diesel generator sets especially on higher loads.

Exports business: Despite positive outlook shared by other capital goods companies, Cummins India management has maintained cautious (but directionally optimistic) view on exports. Exports have been on the declining trend in last two years. We expect FY18 exports revenues are headed for decline of c.9.5% YY (in line with management guidance). However, do not expect the company to face similar proposition in FY19/20 on back of 1/ bounce back in oil price could potentially revive demand from Middle East/Africa for Low KVA engines which was down over 40% in FY18 and 2/ modest recovery reported by Europe (confirmed by other capital goods companies, adequately exposed to exports viz. Thermax, Triveni Turbine etc, Elgi Equipment, yet to be confirmed by Cummins India though).

In our forecasts we do not build sharp recovery in exports in FY19 and would rather wait for management commentary to turn positive. We note that the management earlier have mentioned about introducing new value added products in the exports market which has helped the company in outpacing the market growth. We note that the recovery in exports could further boost margins.

Company to report growth in profits in FY19/FY20 on account of continued momentum in domestic industrial and distribution segments; margins are expected to recover led by operating leverage

We update our earnings model and build 1/ bottoming out of Powergen business and showing modest recovery and 2/ continued momentum in industrial and distribution business driven by infrastructure sector. Exports could potentially surprise, given the bounce back in crude oil prices leading to the recovery in Middle East & Africa market and Europe recovery. We build revenue growth at 11.1% CAGR between FY18-20. Our assumptions are presented in the table below.

Key assumptions

Revenues Rs mn	FY17	FY18E	FY19E	FY20E
Power generation	13600	13192	13984	15662
YY	9.3%	-3.0%	6.0%	12.0%
Industrial	7100	7952	9383	10884
YY	25.7%	12.0%	18.0%	16.0%
Distribution	11485	12748	14278	15991
YY	16.6%	11.0%	12.0%	12.0%
Exports	16140	15333	16253	18203
YY	-2.8%	-5.0%	6.0%	12.0%

Source: Company, Kotak Securities – Private Client Research

We highlight that our forecasts are still factoring margins below the historical peak. We build higher operating leverage assumption and favourable product mix, leading to reversal in margins. We expect company to expand operating margins to 16.7% in FY20, which at first might look demanding in light of 14.5% reported in 9MFY18. However, we keep in mind the impact of GST led disruptions, unfavourable product mix and severed exports in the last few quarters.

We also note that company is better placed vis-à-vis peer group in terms of technology, brand perception and distribution in the marketplace and this would benefit in the medium to long term.

Revenues/EBITDA



Source: Company. Kotak Securities – Private Client Research

Valuation and Recommendation; Rs 862 TP suggests 19% upside

We believe that the downside could be limited from the current levels and Cummins India can surprise a rather skeptical market on the margin (and subsequently on earnings) front, making a plausible case for re-rating. We value Cummins India at 26x FY20 earnings and move recommendation to 'BUY' from 'ACCUMULATE' with revised target price of Rs 862 (Rs 897 earlier).

We recommend BUY on Cummins India Ltd with a price target of Rs.862

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BUY	– We expect the stock to deliver more than 12% returns over the next 12 months
ACCUMULATE	– We expect the stock to deliver 5% - 12% returns over the next 12 months
REDUCE	– We expect the stock to deliver 0% - 5% returns over the next 12 months
SELL	– We expect the stock to deliver negative returns over the next 12 months
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NA	– Not Available or Not Applicable. The information is not available for display or is not applicable
NM	– Not Meaningful. The information is not meaningful and is therefore excluded.
NOTE	– Our target prices are with a 9-month perspective. Returns stated in the rating scale are our internal benchmark.

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