7 July 2020

Update | Sector: Capital Goods

Cummins

BSE SENSEX	S&P CNX
36,675	10,800

CMP: INR430 TP: INR330 (-23%) Downgrade to Sell

All hopes on CPCB-IV, but will end markets support?

Stock Info

Bloomberg	KKC IN
Equity Shares (m)	277
M.Cap.(INRb)/(USDb)	119.1 / 1.6
52-Week Range (INR)	766 / 282
1, 6, 12 Rel. Per (%)	5/-15/-34
12M Avg Val (INR M)	482
Free float (%)	49.0

Financials Snapshot (INR b)

Y/E Mar	2020	2021E	2022E
Sales	51.6	44.4	55.5
EBITDA	5.9	4.7	7.1
PAT	6.4	4.3	6.1
EBITDA (%)	11.4	10.6	12.8
EPS (INR)	23.3	15.4	22.1
EPS Gr. (%)	(10.8)	(33.6)	43.1
BV/Sh. (INR)	150.6	156.8	163.0
Ratios			
Net D/E	0.0	(0.0)	0.0
RoE (%)	15.4	9.8	13.6
RoCE (%)	14.0	9.0	12.3
Payout (%)	90.3	60.0	72.0
Valuations			
P/E (x)	18.5	27.9	19.5
P/BV (x)	2.9	2.7	2.6
EV/EBITDA (x)	20.4	25.0	16.9
Div Yield (%)	3.8	1.7	3.0
FCF Yield (%)	3.0	1.6	0.4

- **CPCB-IV related opportunity the best (only) bet:** The transition from CPCB-II to CPCB-IV (4th phase of emission standards proposed by Central Pollution Control Board) is touted to be beneficial for Cummins India, led by its access to technology as well as its first-mover advantage. On account of this transition, price hikes are likely to be >20% and may even be higher for certain categories. However, we note that: **(a)** technology access may not be as big a barrier to competitors (KOEL, Mahindra, and Perkins), **(b)** end markets may not be strong enough to absorb such steep price hikes (similar learning from the earlier transition from CPCB-I to CPCB-II), **(c)** the implementation date is set as July 2021, which may be pushed by six to nine months, especially given the COVID-19-led disruption.
- **Input costs to rise, but end markets may not be supportive:** The shift to CPCB-IV would imply higher input cost, necessitating price hikes. However, the key end markets – Manufacturing, Real Estate, Retail, and Hospitality – are likely to remain under pressure, with a sluggish growth outlook over the next two years. Private capex is expected to be weak given the low capacity utilization witnessed even prior to the COVID-19 situation. In such a scenario, the ability to pass on the input price hikes may prove challenging, in our view.
- **Precisely how it panned out last time:** Even the transition to CPCB-II met with a similar fate, with an anticipation of pre-buying, followed by price hikes, and hope of earnings growth. While pre-buying was limited to just 5–10%, weakness in the end markets eventually outweighed the same. Cummins did take a price hike of 10–15% to start with, only to reverse it later. The ultimate conclusion is that end-market fundamentals remain the key driver for margins over the longer run. Given the weak outlook for the end markets and limited pricing power in the Gensets industry, we refrain from being bullish on CPCB-IV opportunities.
- **Core business on structural downtrend until macro supports:** While we acknowledge Cummins' strong parentage and access to superior technology, the company finds itself operating in an industry driven more by macro fundamentals. Currently, macro headwinds remain too strong for the industry to witness double-digit growth on a sustainable basis in the domestic market. Exports (down to 25% of revenue from 30% in FY19) remain too volatile to predict the growth trajectory. Such strong macro headwinds are resulting in sharp deterioration in the core business' return ratios. Cummins' RoEs have almost halved over the past five years to 15.5% in FY20, showing maximum erosion in our coverage universe. The core business' RoIC stood at just 11% in FY20, much lower than Siemens (26%) and ABB (16%), which have worked toward transforming their business models to adapt to changing realities.
- **Other income forms 43% of PBT in FY20:** Other income, largely driven by dividend and rental income, constituted 43% of PBT in FY20 and supported the company's overall RoEs. Adj. for the same, RoEs fell to 8.7% in FY20 from a reported 15.5%, indicating the pain in the core business.

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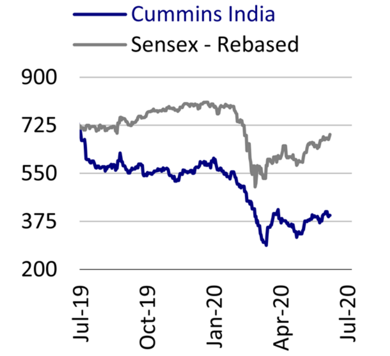
Shareholding pattern (%)

As On	Mar-20	Dec-19	Mar-19
Promoter	51.0	51.0	51.0
DII	30.4	31.8	27.2
FII	7.5	6.3	9.1
Others	11.2	10.9	12.7

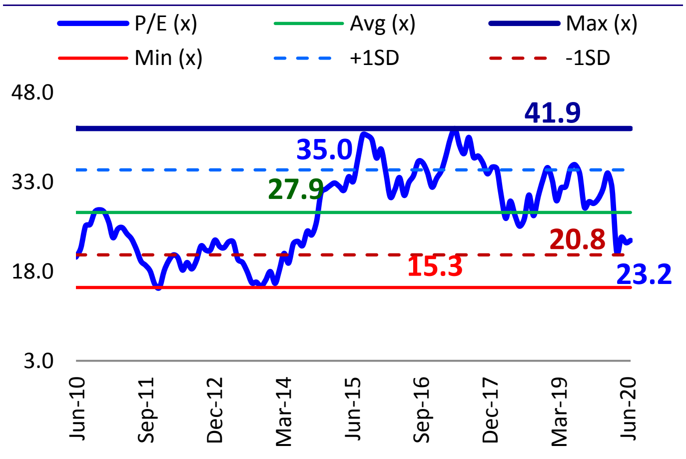
FII Includes depository receipts

Stock Performance (1-year)



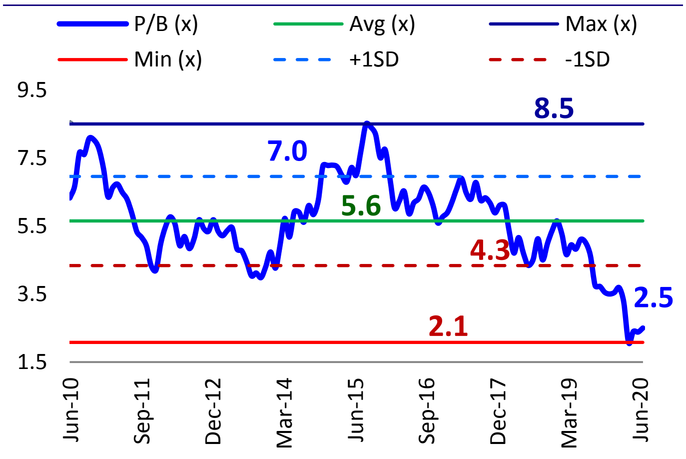
- **Historical valuation may be meaningless if EVA declines:** With core RoICs of 11–12% and core RoEs of <10%, we believe the stock deserves to trade at a significant discount to its historical trading multiples from the perspective of economic value addition. In fact, a comparison of Cummins, Siemens, and Thermax on core RoICs v/s core PE multiples suggests that while the core RoIC differentials of both Cummins and Thermax have deteriorated against Siemens', the same trend is yet to be witnessed in the PE differentials.
- **Downgrade to Sell, with lower TP of INR330:** We downgrade Cummins to Sell with lower TP of INR330 (from INR360) as we lower our target multiple to 15x from 16x earlier. We acknowledge that despite macro headwinds, the company has done a commendable job in FCF conversion, resulting in a strong balance sheet. Rental and dividend incomes have enabled the company to significantly increase dividend payouts over the years, owing to which it has one of the best payout ratios in the Capital Goods sector. However, the lack of growth drivers is yet to be fully factored in the valuations, in our view.

Exhibit 1: P/E band (x)



Source: Company, MOFSL

Exhibit 2: P/B band (x)

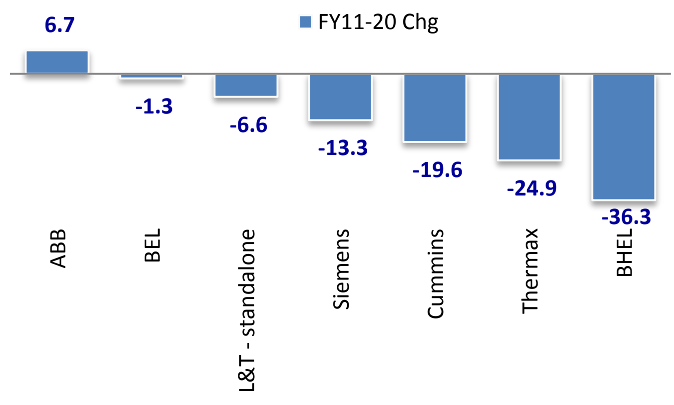


Source: Company, MOFSL

Deteriorating business fundamentals, driven by strong macro headwinds

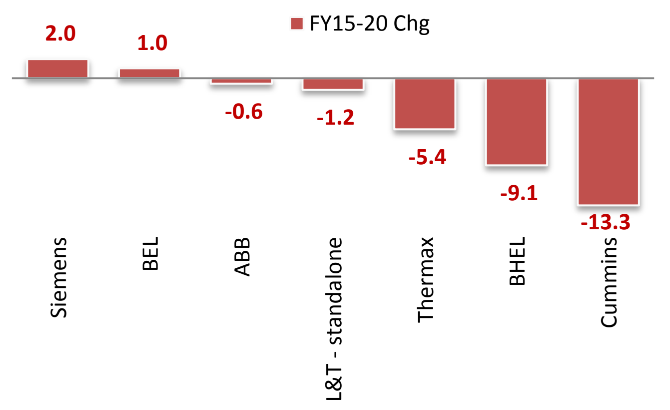
- Notably, while many companies in the Capital Goods space have seen a downward trajectory in return rations, Cummins' problems have started over the past few years rather than in the early part of the decade. Thus, while it ranks the third worst in terms of RoE decline from a 10-year time frame, **it ranks the worst when seen from a five-year time frame**. **We believe the company has a long struggle ahead before there is any revival in sight.**

Exhibit 3: RoE trend analysis – BHEL, Thermax, Cummins see maximum deterioration over past 10 years



Source: MOFSL, Company

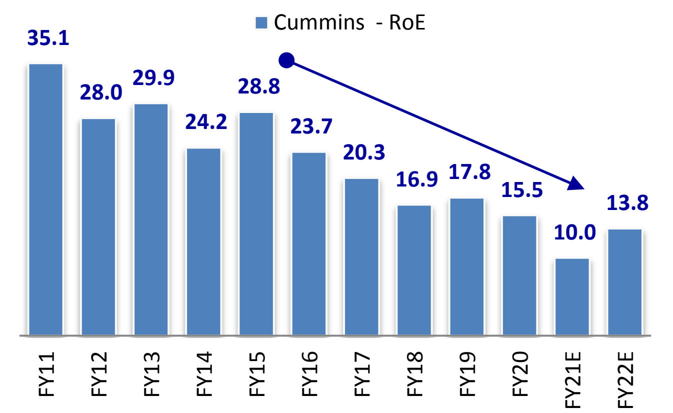
Exhibit 4: Cummins' RoE deterioration started lately as it ranks lowest v/s peers over past five years



Source: MOFSL, Company

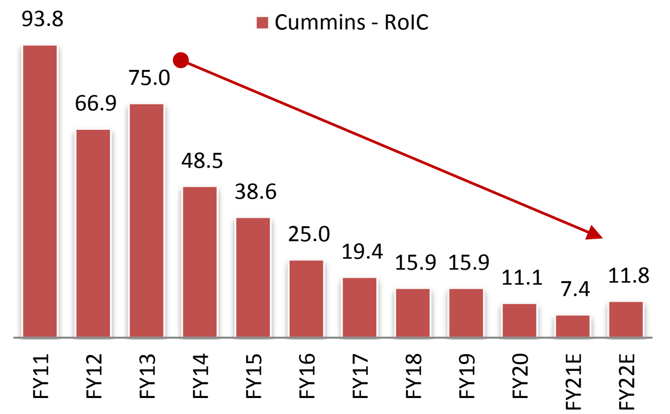
- Even after factoring a weak capital cycle, Cummins fairs poorly v/s peers on return ratios, suggesting structural deterioration in the business fundamentals. Not only have RoEs deteriorated to 15% currently from a range of 25%+, RoICs (which present a better picture on core returns) have come down to 11%. **From the perspective of economic value addition, we believe the core business is now generating lower returns than the expected CoE of 12–13%.**

Exhibit 5: Cummins' RoEs have almost halved over the past five years to 15.5% in FY20



Source: MOFSL, Company

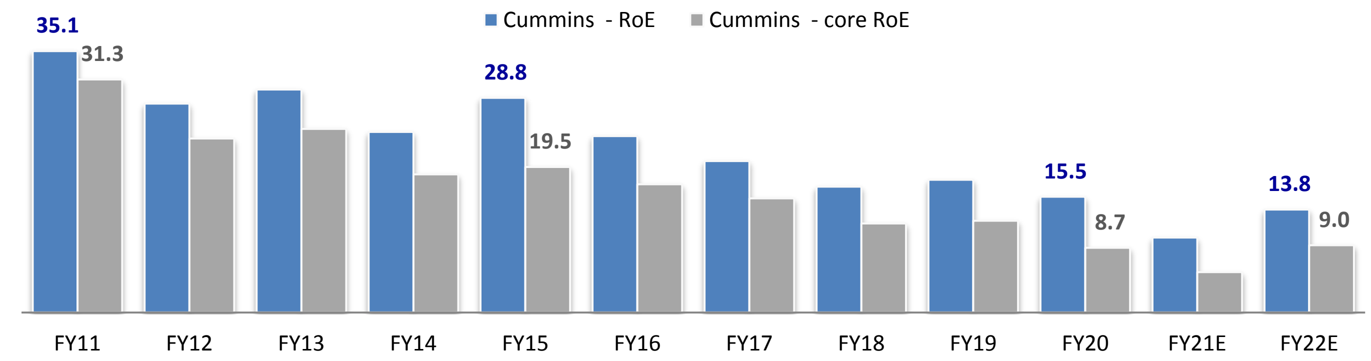
Exhibit 6: RoIC erosion even higher, suggesting issues with core business performance



Source: MOFSL, Company

- Earnings growth is entirely supported by other income. Excluding this, RoE deterioration has been even more severe (<10%).

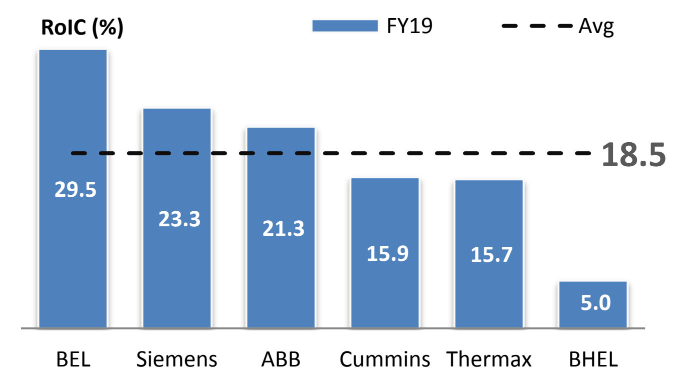
Exhibit 7: Reported RoEs supported by other income; core RoEs fall to just 8.7% v/s overall RoE of 15.5% in FY20



Source: MOFSL, Company

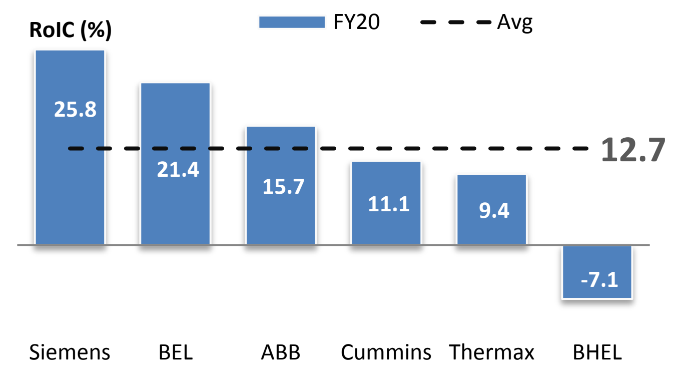
- Cummins' RoIC ranks lower than sector-average core RoICs. Although FY20 was impacted by COVID-19, the reading was the same for FY19 as well.

Exhibit 8: RoIC comparison (FY19)



Source: MOFSL, Company

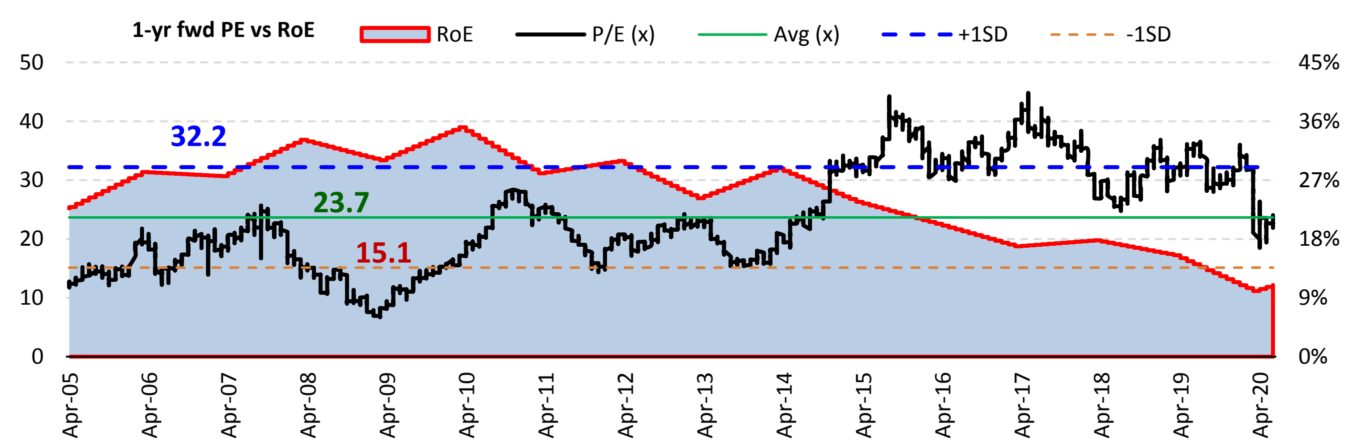
Exhibit 9: RoIC comparison (FY20)



Source: MOFSL, Company

- The stock trades at long-term average one-year forward PE. If evaluated on core PE v/s core RoE, the PE multiples are yet to factor deterioration of core RoE, as indicated by the gap between the two.

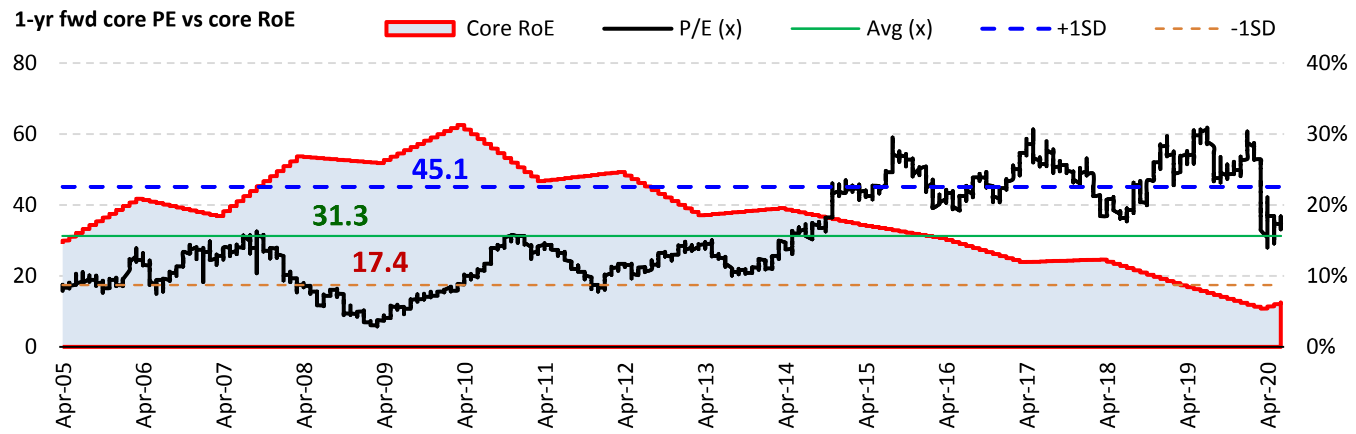
Exhibit 10: Despite absolute stock price correction, valuations have not followed deteriorating RoE profile



Source: MOFSL, Company

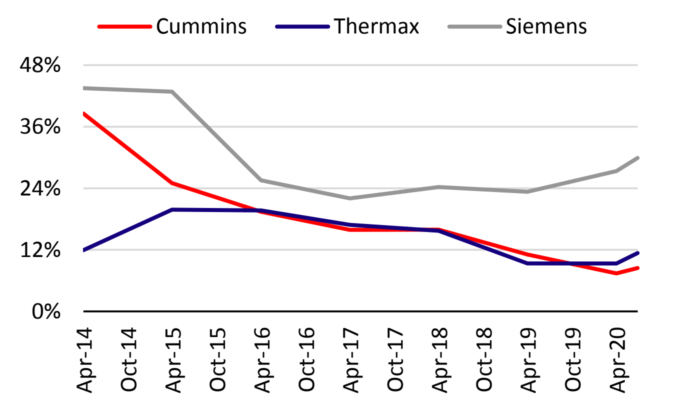
- **Also, a key point to note is that in the earlier cycle, when RoEs were higher, the stock's max PE = the current average PE multiple.**

Exhibit 11: Core PE higher than maximum PE over FY04–14 despite core RoE dropping to single digits



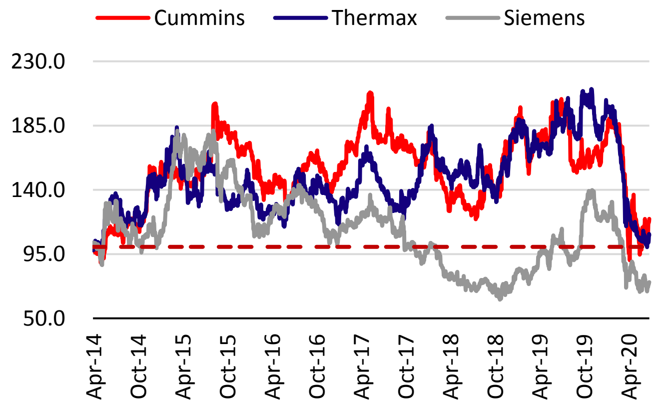
Source: MOFSL, Company

Exhibit 12: RoIC trend analysis – Cummins and Thermax witness material RoIC erosion, while Siemens' RoIC stabilizes…



Source: MOFSL, Company

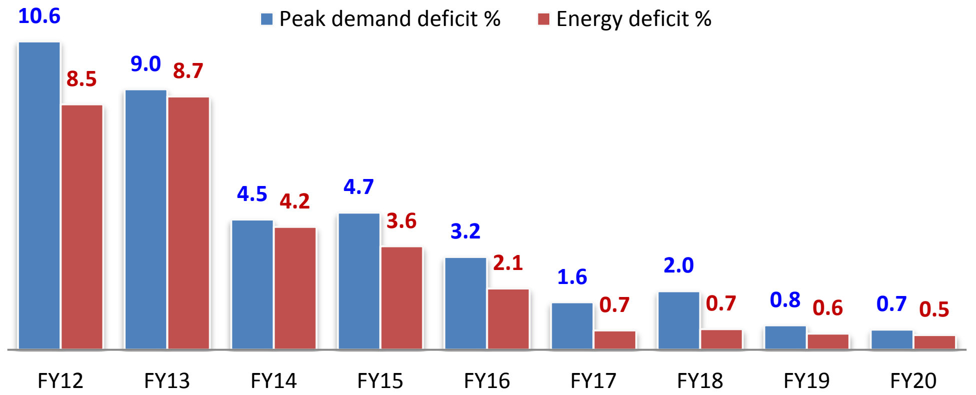
Exhibit 13: …however, worsening of RoIC profile not reflected in relative valuations; Siemens has witnessed de-rating, but Cummins and Thermax have not



Source: MOFSL, Company

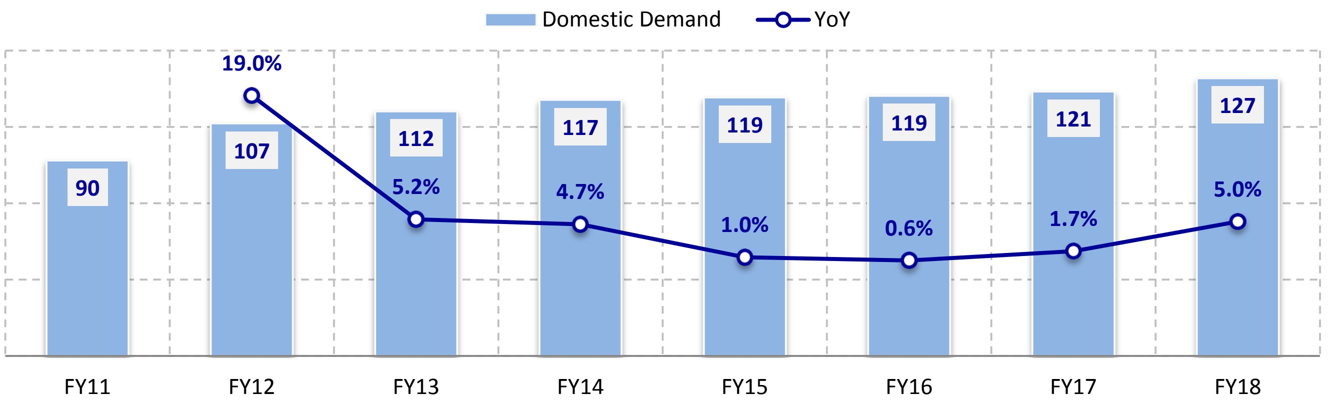
Key industry trends

Exhibit 14: India's power deficit reduces drastically over past decade; power gensets now play more of standby emergency role than substitute for power shortage



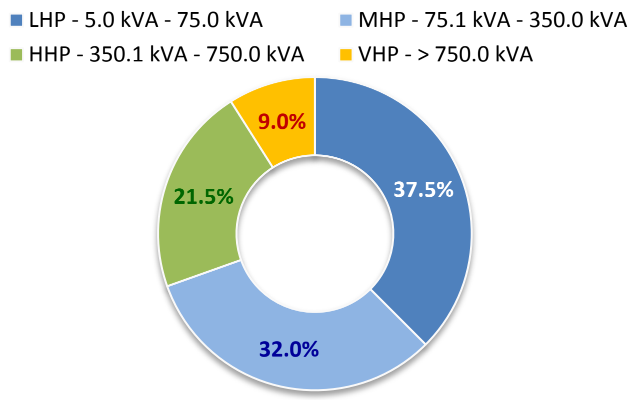
Source: MOFSL, Power Ministry

Exhibit 15: Domestic demand (in '000s units) rises at 5.1% CAGR over FY11–18



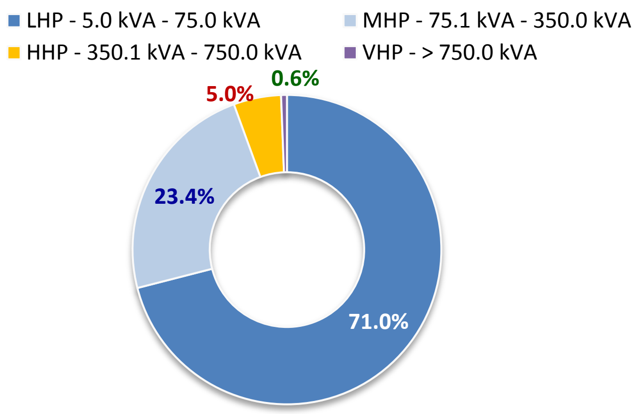
Source: MOFSL, Powerica RHP

Exhibit 16: Rating-wise breakup, by value (FY18)



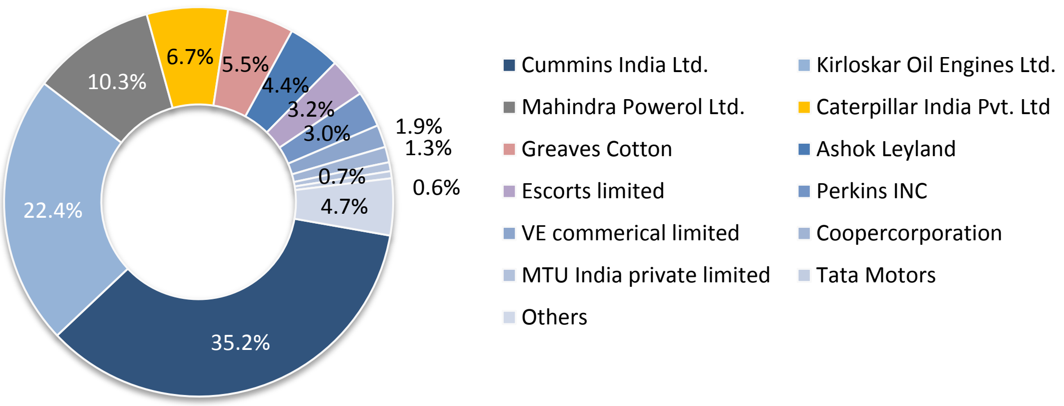
Source: MOFSL, Powerica RHP

Exhibit 17: Rating-wise breakup, by volume (FY18)



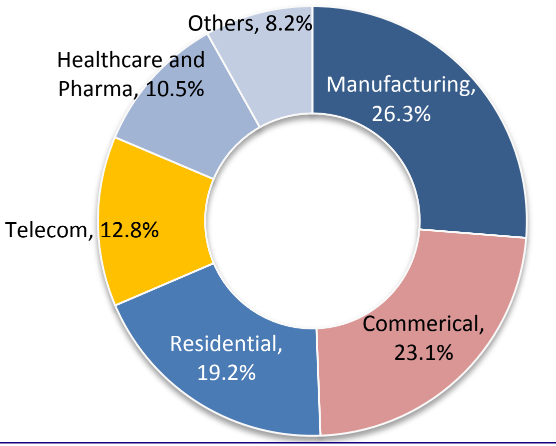
Source: MOFSL, Powerica RHP

Exhibit 18: Market share, by value (FY18)



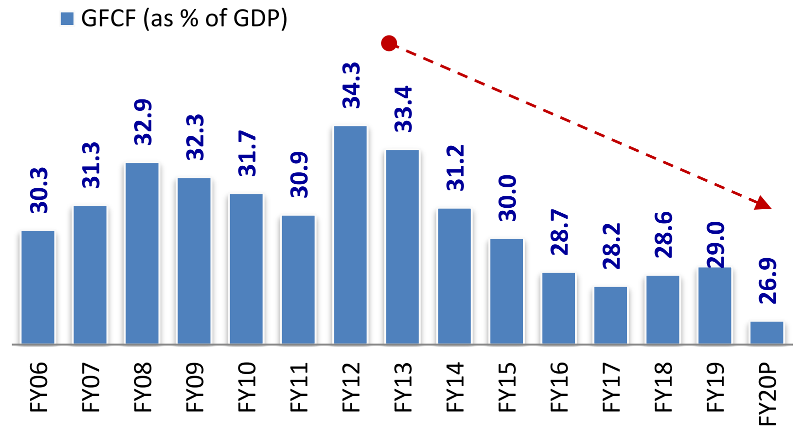
Source: MOFSL, Powerica RHP

Exhibit 19: End-market breakup of Powergen industry – Manufacturing, Real Estate, Retail form bulk of demand



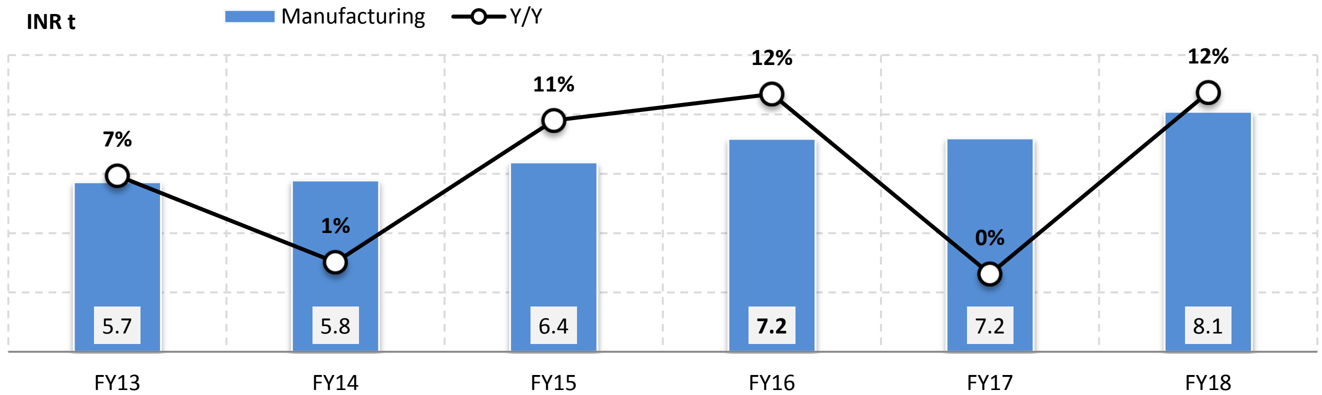
Source: MOFSL, Powerica RHP

Exhibit 20: Declining GFCF suggests challenges for capex-related domestic demand for power gensets



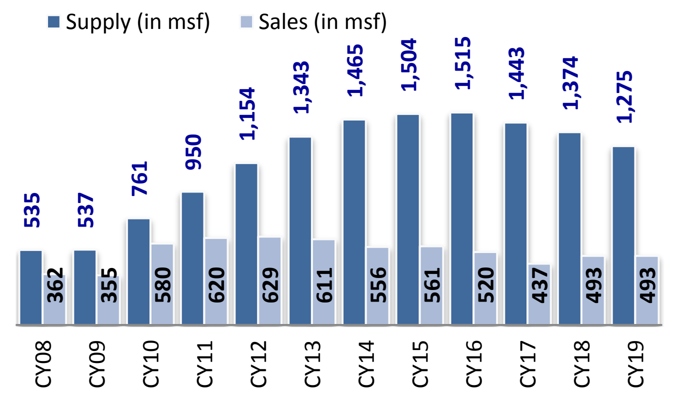
Source: MOFSL, RBI

Exhibit 21: Manufacturing sector forms >1/4th of end market, but has risen at just 7% CAGR over FY12–18



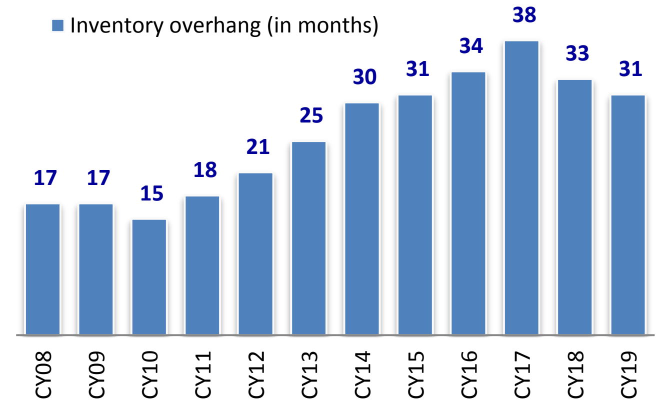
Source: MOFSL, MoSPI

Exhibit 22: Residential supply outpaces absorption rate…



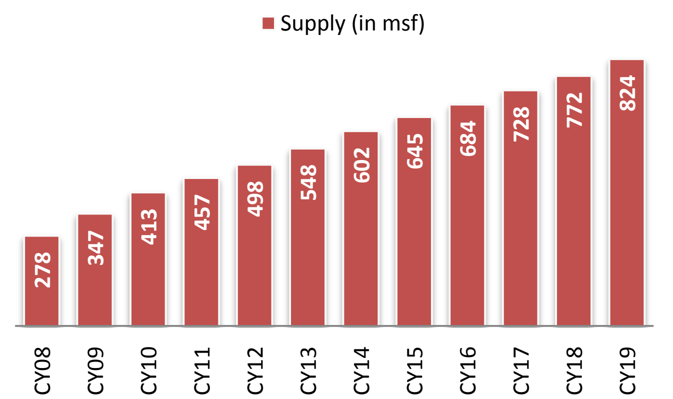
Source: MOFSL, Company

Exhibit 23: …leading to rising levels of inventory over CY08–19



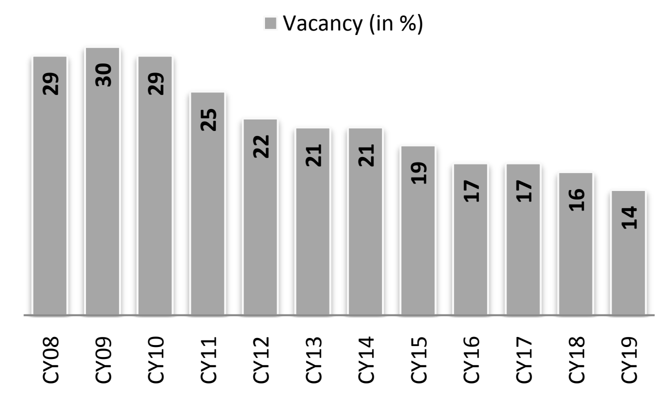
Source: MOFSL, Company

Exhibit 24: Supply steadily rises for commercial real estate (office spaces)



Source: MOFSL, Company

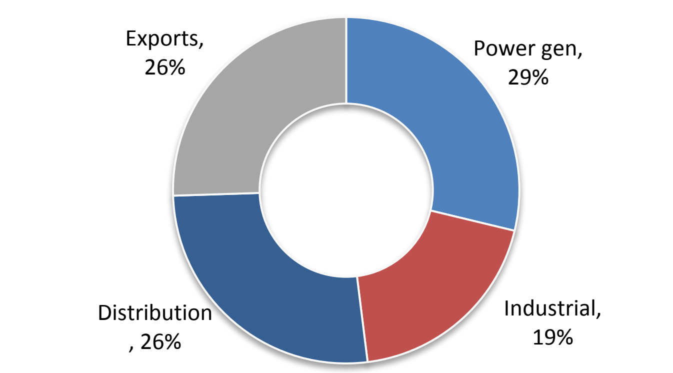
Exhibit 25: Though vacancy rates have improved off late, the scenario may change drastically due to COVID-19



Source: MOFSL, Company

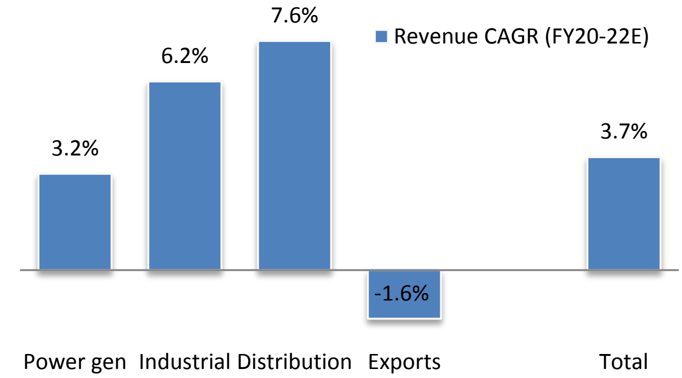
Story in charts

Exhibit 26: FY20 share of revenue



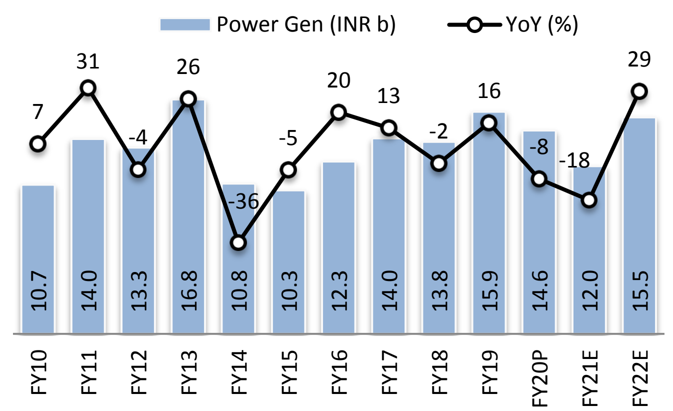
Source: MOFSL, Company

Exhibit 27: Revenue CAGR over FY20–22E



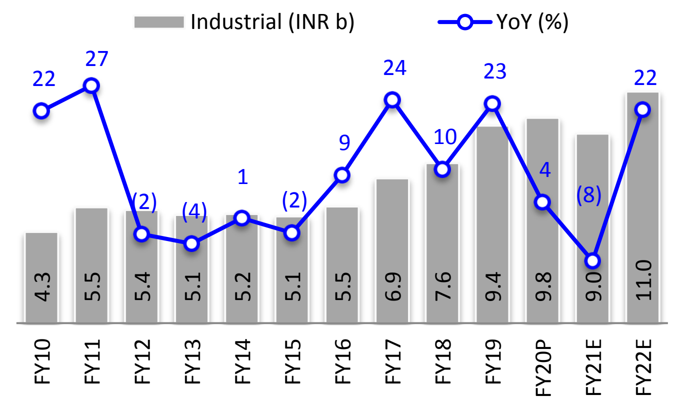
Source: MOFSL, Company

Exhibit 28: Powergen segment is expected to rise at a 3.2% CAGR over FY20–22E v/s 3.1% CAGR over FY10–20



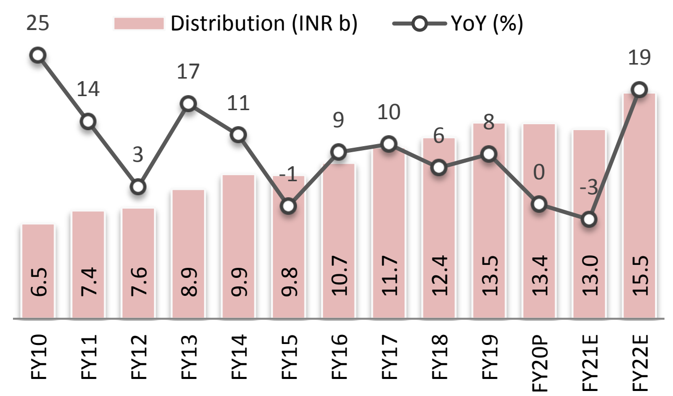
Source: MOFSL, Company

Exhibit 29: Industrial segment would grow at 6.2% CAGR over FY20–22E v/s 8.5% CAGR over FY10–20



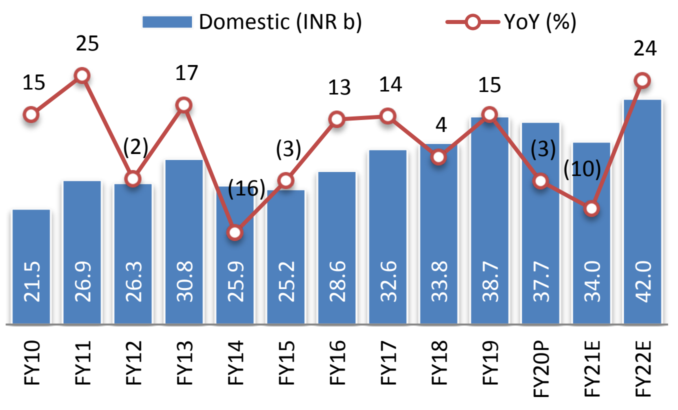
Source: MOFSL, Company

Exhibit 30: Distribution segment would grow at 7.6% CAGR over FY20–22E v/s 7.5% CAGR during FY10–20



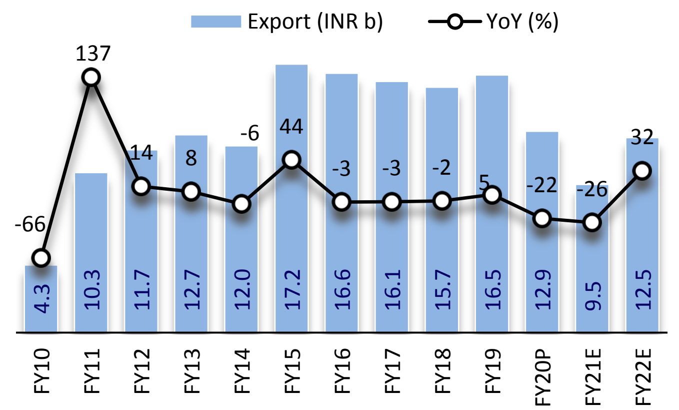
Source: MOFSL, Company

Exhibit 31: Domestic segment would grow at 5.5% CAGR over FY20–22E v/s 5.8% CAGR during FY10–20



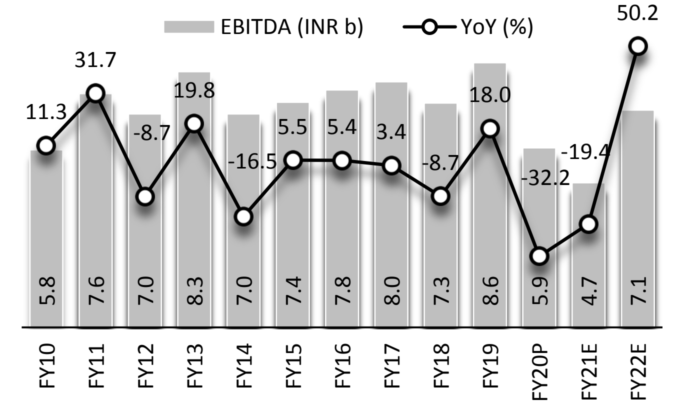
Source: MOFSL, Company

Exhibit 32: Exports would de-grow at 1.6% CAGR over FY20–22E v/s 11.5% CAGR growth over FY10–20



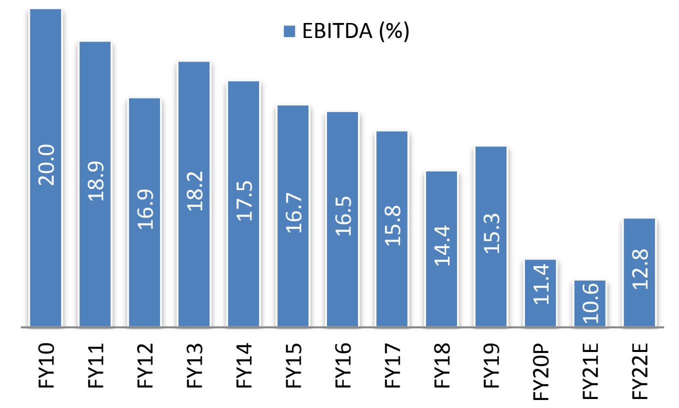
Source: Company, MOFSL

Exhibit 33: EBITDA would grow at 10% CAGR over FY20–22E v/s flat growth over FY10–20



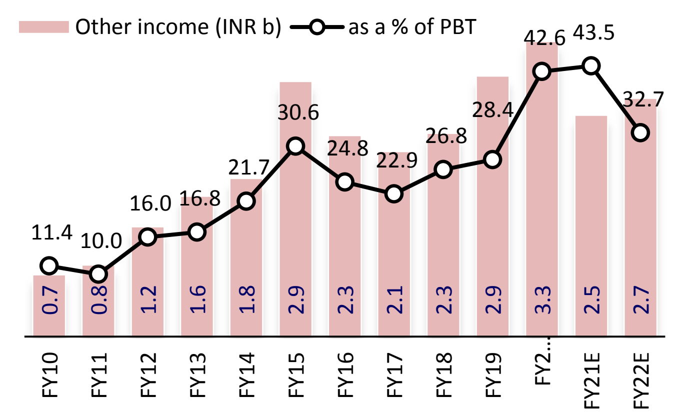
Source: Company, MOFSL

Exhibit 34: Declining EBITDA margin trend attributable to weak pricing power in India and declining share of exports



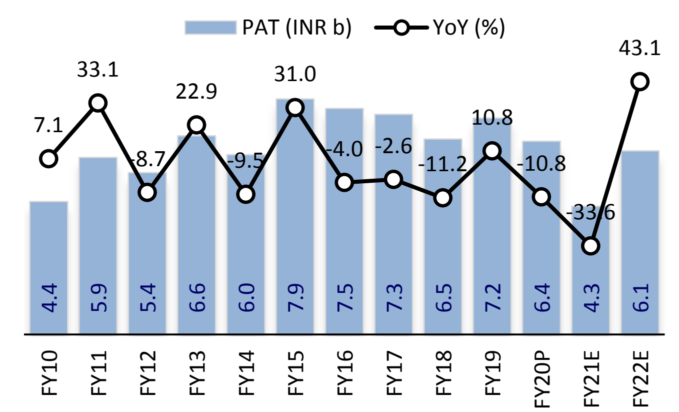
Source: Company, MOFSL

Exhibit 35: Other income formed 43% of PBT in FY20 and has grown at 17% CAGR over FY10–20



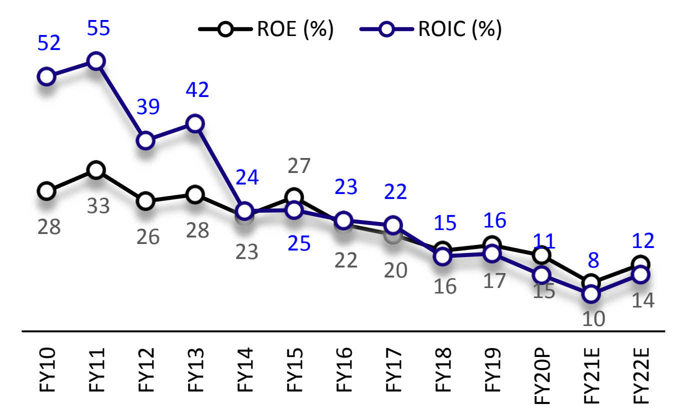
Source: Company, MOFSL

Exhibit 36: PAT would de-grow at 2.5% CAGR over FY20–22E v/s 3.8% over FY10–20



Source: Company, MOFSL

Exhibit 37: RoE/RoIC have gradually declined over FY10–20, and are expected to remain under pressure

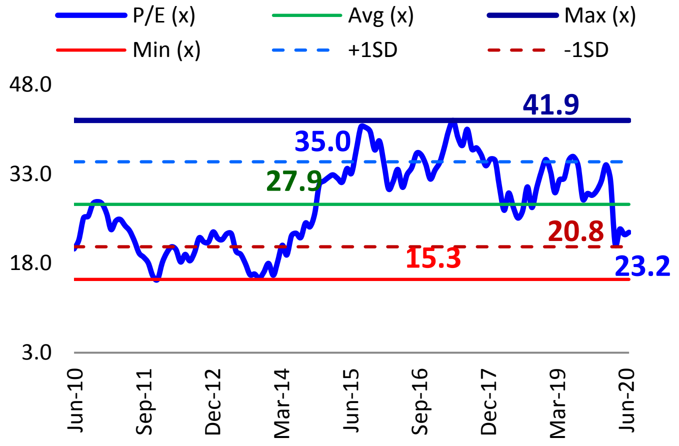


Source: Company, MOFSL

Valuation and view

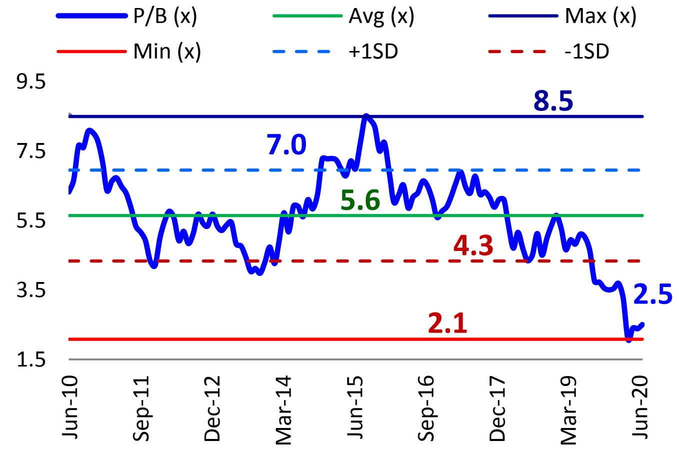
- We downgrade Cummins to Sell, with lower TP of INR330 (from INR360), as we lower our target multiple to 15x from 16x earlier. We acknowledge that despite macro headwinds, the company has done a commendable job in FCF conversion, resulting in a strong balance sheet. Rental and dividend incomes have enabled the company to significantly increase dividend payouts over the years, owing to which it has one of the best payout ratios in the Capital Goods sector. However, the lack of growth drivers is yet to be fully factored in the valuations, in our view.

Exhibit 38: P/E band (x)



Source: Company, MOFSL

Exhibit 39: P/B band (x)



Source: Company, MOFSL

Financials and valuations

Income Statement						(INR m)
Y/E March	**2017**	**2018**	**2019**	**2020**	**2021E**	**2022E**
Total Revenues	**50,773**	**50,825**	**56,590**	**51,577**	**44,365**	**55,495**
Change (%)	7.8	0.1	11.3	-8.9	-14.0	25.1
Raw Materials	32,745	32,581	36,135	33,679	28,969	36,237
Staff Cost	4,334	4,979	5,458	5,602	4,994	5,506
Other Expenses	5,677	5,940	6,356	6,434	5,679	6,659
EBITDA	**8,018**	**7,325**	**8,641**	**5,863**	**4,723**	**7,093**
% of Total Revenues	15.8	14.4	15.3	11.4	10.6	12.8
Depreciation	848	938	1,103	1,187	1,289	1,385
Other Income	2,080	2,285	2,928	3,315	2,486	2,678
Interest	168	148	162	203	200	200
PBT	**9,082**	**8,523**	**10,304**	**7,789**	**5,720**	**8,186**
Tax	1,736	2,000	3,078	1,341	1,440	2,060
Rate (%)	19.1	23.5	29.9	17.2	25.2	25.2
Adjusted PAT	**7,346**	**6,524**	**7,226**	**6,448**	**4,280**	**6,126**
Extra-ordinary Income	0	561	0	-155	0	0
Reported PAT	**7,346**	**7,085**	**7,226**	**6,293**	**4,280**	**6,126**
Change (%)	-2.6	-3.6	2.0	-12.9	-32.0	43.1

Balance Sheet						(INR m)
Y/E March	**2017**	**2018**	**2019**	**2020**	**2021E**	**2022E**
Share Capital	554	554	554	554	554	554
Reserves	36,867	39,306	40,750	41,195	42,907	44,622
Net Worth	**37,422**	**39,861**	**41,305**	**41,750**	**43,462**	**45,177**
Loans	2,508	2,515	3,092	4,854	4,854	4,854
Deferred Tax Liability	24	299	988	800	800	800
Capital Employed	**39,953**	**42,675**	**45,384**	**47,404**	**49,116**	**50,831**
Gross Fixed Assets	22,705	28,665	29,676	32,837	34,837	37,837
Less: Depreciation	7,703	8,445	9,548	10,499	11,789	13,174
Net Fixed Assets	**15,001**	**20,193**	**20,128**	**22,338**	**23,048**	**24,663**
Capital WIP	4,631	380	1,585	800	800	800
Investments	7,074	5,487	2,853	8,240	8,240	8,240
Curr. Assets	**23,702**	**29,253**	**33,970**	**28,163**	**27,467**	**30,186**
Inventory	5,621	5,375	6,254	5,729	4,928	6,164
Debtors	9,557	13,263	12,727	11,316	10,696	12,163
Cash & Bank Balance	1,291	4,709	7,379	4,538	6,183	4,779
Loans & Advances	1,287	1,287	0	0	0	0
Other Assets	5,948	4,621	7,610	6,579	5,659	7,079
Current Liab. & Prov.	**10,455**	**12,637**	**13,152**	**12,137**	**10,440**	**13,059**
Current Liabilities	9,036	11,114	11,450	9,650	8,300	10,383
Provisions	1,419	1,523	1,702	2,487	2,139	2,676
Net Current Assets	**13,247**	**16,616**	**20,818**	**16,026**	**17,027**	**17,127**
Application of Funds	**39,953**	**42,675**	**45,384**	**47,404**	**49,116**	**50,831**

Financials and valuations

Ratios						
Y/E March	**2017**	**2018**	**2019**	**2020**	**2021E**	**2022E**
Basic (INR)						
Adj EPS	**26.5**	**23.5**	**26.1**	**23.3**	**15.4**	**22.1**
Cash EPS	29.6	28.9	30.0	27.0	20.1	27.1
Book Value	135.0	143.8	149.0	150.6	156.8	163.0
DPS	14.1	14.0	16.4	16.4	7.4	12.7
Payout (incl. Div. Tax.)	63.5	65.5	78.6	90.3	60.0	72.0
Valuation (x)						
P/E	16.3	18.3	16.5	18.5	27.9	19.5
Cash P/E	14.6	14.9	14.3	16.0	21.5	15.9
EV/EBITDA	15.1	16.0	13.3	20.4	25.0	16.9
EV/Sales	2.4	2.3	2.0	2.3	2.7	2.2
Price/Book Value	3.2	3.0	2.9	2.9	2.7	2.6
Dividend Yield (%)	3.3	3.2	3.8	3.8	1.7	3.0
Profitability Ratios (%)						
RoE	19.6	16.4	17.5	15.4	9.8	13.6
RoCE	18.7	15.6	16.2	14.0	9.0	12.3
RoIC	19.1	15.7	15.0	11.2	7.4	11.3
Turnover Ratios						
Debtors (Days)	69	95	82	80	88	80
Inventory (Days)	40	39	40	41	41	41
Creditors. (Days)	44	54	53	49	49	49
Asset Turnover (x)	1.3	1.2	1.2	1.1	0.9	1.1
Leverage Ratio						
Net Debt/Equity (x)	0.0	-0.1	-0.1	0.0	0.0	0.0

Cash Flow Statement						(INR m)
Y/E March	**2017**	**2018**	**2019**	**2020**	**2021E**	**2022E**
PBT before EO Items	**9,082**	**9,084**	**10,304**	**7,634**	**5,720**	**8,186**
Depreciation	848	938	1,103	1,187	1,289	1,385
Interest & other	-1,912	-2,136	-1,205	-1,366	-2,286	-2,478
Direct Taxes Paid	-1,736	-2,000	-2,361	-1,609	-1,440	-2,060
(Inc)/Dec in WC	666	49	-2,341	144	644	-1,504
CF from Operations	**6,948**	**5,935**	**5,500**	**5,990**	**3,927**	**3,528**
(Inc)/Dec in FA	-2,227	-1,709	-2,734	-2,366	-2,000	-3,000
Free Cash Flow	**4,721**	**4,226**	**2,766**	**3,624**	**1,927**	**528**
Investment & Others	-1,659	3,872	5,103	-2,392	2,486	2,678
CF from Investments	**-3,885**	**2,163**	**2,369**	**-4,758**	**486**	**-322**
(Inc)/Dec in Debt	2,508	8	576	1,762	0	0
Interest Paid	-168	-148	-121	-154	-200	-200
Dividend Paid	-4,663	-4,639	-5,681	-5,681	-2,568	-4,410
CF from Fin. Activity	**-2,323**	**-4,779**	**-5,226**	**-4,073**	**-2,768**	**-4,610**
Inc/Dec of Cash	**740**	**3,319**	**2,643**	**-2,841**	**1,645**	**-1,404**
Add: Beginning Balance	897	1,291	4,709	7,379	4,538	6,183
Closing Balance	**1,291**	**4,709**	**7,379**	**4,538**	**6,183**	**4,779**

NOTES

Explanation of Investment Rating	
Investment Rating	**Expected return (over 12-month)**
BUY	>=15%
SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

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