Stock Update

Sharekhan by BNP PARIBAS

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Cummins India

Operationally strong quarter, expect gradual business recovery

Capital Goods	Sharekhan code: CUMMINSIND	Result Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 434**	
Price Target: **Rs. 606**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

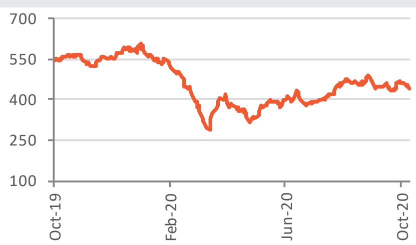
Company details

Market cap:	Rs. 12,026 cr
52-week high/low:	Rs. 282 / 653
NSE volume: (No of shares)	15.9 lakh
BSE code:	500480
NSE code:	CUMMINSIND
Free float: (No of shares)	13.6 cr

Shareholding (%)

Promoters	51.0
FII	8.2
DII	28.0
Others	12.8

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-3	9	15	-22
Relative to Sensex	-7	4	-3	-20

Sharekhan Research, Bloomberg

Summary

- We recommend Buy on Cummins India (Cummins) with a PT of Rs606, given high net earnings growth trajectory over FY2021E-FY2023E and discounted valuations.
- The company reported strong outperformance on OPM led by favorable mix , cost reduction measures and pricing impact. Export revenues rise 18% y-o-y while domestic revenues declined 22% y-o-y.
- Company is witnessing m-o-m and q-o-q recoveries pretty much in every segment. However, management remains cautiously optimistic and refrained from giving revenue guidance for FY2021
- Considering revival in its net earnings growth trajectory (23% CAGR) over FY2021E-FY2023E, strong balance sheet and steady cash flow generation, we remain optimistic on the company.

Cummins India (Cummins India) reported strong beat on OPM led by a favorable mix , cost reduction measures and impact of pricing. During Q2FY21, standalone revenue declined 11.3% y-o-y (marginally better than estimates) to Rs. 1,160 crore as domestic revenues declined 22% y-o-y to Rs. 743 crore. However, exports grew 18% y-o-y to Rs. 398 crore as it witnessed recovery in few export markets (viz. some Asia Pacific regions, Europe and Latin America). The OPM rose sharply by 278 bps y-o-y to 14.4% led by favourable mix, cost reductions (e.g. employee cost reduction due to lower headcount along with wage cuts) and pricing impact. Hence, operating profit grew 9.8% y-o-y to Rs. 167 crore. Lower other income and higher effective tax rate led by 20.6% y-o-y dip in net profit (although higher than our estimate). Currently, the company has been witnessing m-o-m and q-o-q improvement in almost all its segments. However, the management refrained from giving any guidance and maintained cautiously optimistic view for the near to medium term. On the exports front, H2FY2021 is expected to be at least as good as H1 but the second wave emerging in select countries pose uncertainties in predicting future outlook. Domestically, it has recovered to 80% of last year levels led by recovery in distribution, construction and mining segments. Overall, the company expects gradual recovery in demand in upcoming quarters. Cummins India is currently trading at 19.2x/16.3x its FY2022E/FY2023E net earnings, which is at a steep discount to its long-term historical average. Considering revival in its net earnings growth trajectory (23% CAGR) over FY2021E-FY2023E, strong balance sheet and steady cash flow generation, we remain constructive on the company and recommend Buy on the stock with a price target (PT) of Rs. 606.

Key positives

- Strong beat on OPM led by favourable mix, cost reduction and pricing impact .
- Exports grew strongly by 18% y-o-y.

Key negatives

- Domestic revenues dipped 22% y-o-y

Our Call

Valuation – Recommend Buy with PT of Rs. 606: Cummins, being the market leader, is in a sweet spot to leverage on gradual pick up in demand pick up in power generation segment (HHP and mid horse power diesel gensets), for sectors such as roads, real estate (residential and commercial), and data centres. Further, the industrial segment's sales will be driven by demand from railways, metro, road (compressors), and bottoming out of diesel generator demand for water well rigs. Improvement in core business and increased outsourcing of maintenance services by clients is expected to boost the distribution business. Cummins India is currently trading at 19.2x/16.3x its FY2022E/FY2023E net earnings, which is at a steep discount to its long-term historical average. Considering revival in its net earnings growth trajectory (23% CAGR) over FY2021E-FY2023E, strong balance sheet and steady cash flow generation, we remain constructive on the company and recommend Buy on the stock with a price target (PT) of Rs. 606.

Key Risks

Slowdown in the domestic macro-environment and higher loss funding in roads can negatively affect business outlook and earnings growth.

Valuations (Standalone) Rs cr

Particulars	FY20	FY21E	FY22E	FY23E
Revenue	5,158	4,587	5,198	5,747
OPM (%)	11.4	10.8	12.7	13.5
Adjusted PAT	643	488	628	737
% YoY growth	(11.0)	(24.2)	28.7	17.5
Adjusted EPS (Rs.)	23.2	17.6	22.6	26.6
P/E (x)	18.7	24.7	19.2	16.3
P/B (x)	3.1	3.1	3.0	2.8
EV/EBITDA (x)	21.1	24.6	18.3	15.3
RoNW (%)	15.5	11.6	14.6	16.3
RoCE (%)	17.2	14.1	17.7	19.8

Source: Company; Sharekhan estimates

Note: We now convert Cummins India into a Stock Update; It was earlier a 'Viewpoint' under our coverage

Operationally strong quarter, cost structure improving

The company reported strong outperformance on OPM due to a favorable mix , cost reduction and pricing impact and net profit along with double digit y-o-y growth in its export market providing cautious pessimism ahead. During Q2FY21, standalone revenue came in at Rs. 1160 crore, declined 11.3% y-o-y (marginally better than estimates) as businesses gradually gaining pace. Domestic sales in the current quarter at Rs 743 crore declined by 22% y-o-y and improved by 108% q-o-q. Exports for the current quarter at Rs 398 crore improved by 18% y-o-y with pent up demand and some recovery in few export markets. As for the cost structure, gross margin improvement was driven by select non-recurring factors. Higher margins in Q2FY21 were achieved due to a favourable mix (2.5% impact), cost reduction (1% or so) and pricing impact. The company had reduced headcounts and cut wages (~10-20%) and focused on increasing productivity with the remaining headcount. These initiatives led to EBITDA margin expand to 14.4% from 11.7% (up 278 bps y-o-y) in Q2FY20 (ahead of estimates). Accordingly, EBITDA was up 9.8% y-o-y to Rs. 167.4 crore. Further, lower interest cost offset by lower other income (down 37.4% y-o-y) and higher depreciation leading to 20% decline in net profit to Rs 145.6 crore (better than our estimates). Management continued its cost initiatives (not greatly on employee cost) across overheads/raw material, and sounded more constructive on incremental construction, compressors, mining and marine product demand.

Better QoQ commentary on growth; optimistic on mid-long term

Management sounded more optimistic on a sequential pickup, although a gradual one and highlighted that distribution, exports, domestic power generation, some industrial segments, data centres, healthcare, portion of residential & commercial sectors are witnessing growth while Large Infrastructure projects & Hospitality sectors are lagging. On the domestic industrial front, the rail division was affected as trains & metros did not become operational till October leading to nil procurement of power cars and other products. However, it continued to sell diesel products. However, the rail division is expected to get back to pre COVID levels in the medium term. On the global industrial front, it had been witnessing demand momentum building up in some Asia Pacific regions, Europe and Latin America. However due to the recent second wave emerging, it remains cautious. The company didn't provide any guidance, but remains optimistic due to m-o-m and q-o-q recoveries seen pretty much in every segment. Exports remains the outliner for the quarter witnessing 18% growth partially aided through pent up demand, but management expects it to more sustainable as it is witnessing demand momentum across the Asia Pacific region, Europe and Latin America. However the management remained cautiously optimistic due to the second COVID wave emerging but expects exports to be better in H2FY21 compared to H1FY21.

Conference call Highlights

- **No guidance for FY2021:** The company has seen m-o-m and q-o-q recoveries pretty much in every segment. However, it remains cautiously optimistic and would not be giving any revenue guidance for FY2021.
- **H2 exports outlook:** Difficult to predict exports due to the second wave of COVID emerging. It expects another six to twelve months to be turbulent. Generally Q3's are weaker than Q2 due to inventory correction by global clients due to calendar year ending. But it gets add up in Q4. So it expects H2 to be as good as H1 for exports if not better.
- **Higher margins in Q2:** Higher margins in Q2 were achieved due to favourable mix (2.5% impact), cost reduction (1% or so) and pricing impact. The company had reduced headcounts and cut wages (~10-20%) and focused on increasing productivity with the remaining headcount. It would not be adding people as volumes come back. It is expected to restore wage cuts in next quarter.
- **Rail vertical performance:** Within Industrial segment, rail division was affected as trains & metros did not become operational till October leading to nil procurement of power cars and other products. However, it continued to sell diesel products. However, the rail division is expected to get back to pre covid levels in the medium term.
- **Pricing environment:** Pricing pressure is expected to continue. Hence, it is looking ways to mitigate the impact on the company.

- **Sectors growing & lagging for power gensets:** Distribution, exports, domestic power generation, some industrial segments, data centres, healthcare, portion of residential & commercial sectors are witnessing growth. Large Infrastructure projects and hospitality sectors are lagging.
- **Global demand for Industrial segment:** Within the industrial segment, it had been witnessing demand momentum building up in some Asia Pacific regions, Europe and Latin America. However due to recent second wave emerging, it remains cautious.
- **MEIS incentives:** The company made Rs. 13 crore provision related to MEIS scheme in Q2. Generally, it books 3.75% incentives on exports of which major part is related to MEIS scheme incentive. The company is making provisions on account of stoppage of MEIS related incentives by government.
- **Royalty payments:** The company pays technology fee & royalties for brand new technology sourced from the parent and introduced for the first time in India. It pays for base technology and localizes as per Indian need.

Results (Standalone) Rs cr

Particulars	Q2FY21	Q2FY20	YoY (%)	Q1FY21	QoQ (%)
Revenues	1,160	1,308	(11.3)	498	132.9
Operating Expenses	785	909	(13.6)	303	-
Operating profits	167	152	9.8	3	-
Other Income	58	93	(37.4)	102	(43.3)
Interest	4	6	(27.2)	4	(6.7)
Depreciation	33	29	11.5	30	7.8
PBT	189	210	(10.2)	70	-
Tax	43	27	60.1	18	-
Adj PAT	145.6	183.3	(20.6)	52.6	-
Reported PAT	146	183	(20.6)	53	-
Adj EPS	5.3	6.6	(20.6)	1.9	-
			bps		bps
OPM	14.4%	11.7%	278	0.6%	-
NPM	12.5%	14.0%	(146)	10.5%	200
Tax rate	22.9%	12.8%	-	25%	-

Source: Company; Sharekhan Research

Outlook and Valuation

■ **Sector view - Continued government focus on infrastructure spending to provide growth opportunities:**

To make India a $5 trillion economy by FY2025 and to continue growing at an escalated trajectory until 2030, it is estimated that India would need to spend $4.5 trillion on infrastructure by 2030. In order to achieve the desired goal, the government drew up National Infrastructure Pipeline (NIP) through a bottoms-up approach wherein all projects costing more than Rs. 100 crore per project under construction, proposed Greenfield projects, Brownfield projects and those at conceptualization stage were captured. Consequently, the total capital expenditure in infrastructure sectors in India during FY2020-FY2025 is projected at ~Rs. 111 lakh crore. During the same period, sectors such as energy (24%), roads (18%), urban (17%) and railways (12%) amount to ~71% of the projected infrastructure investments in India. The huge outlay towards the infrastructure sector is expected to provide healthy growth opportunities for infrastructure companies.

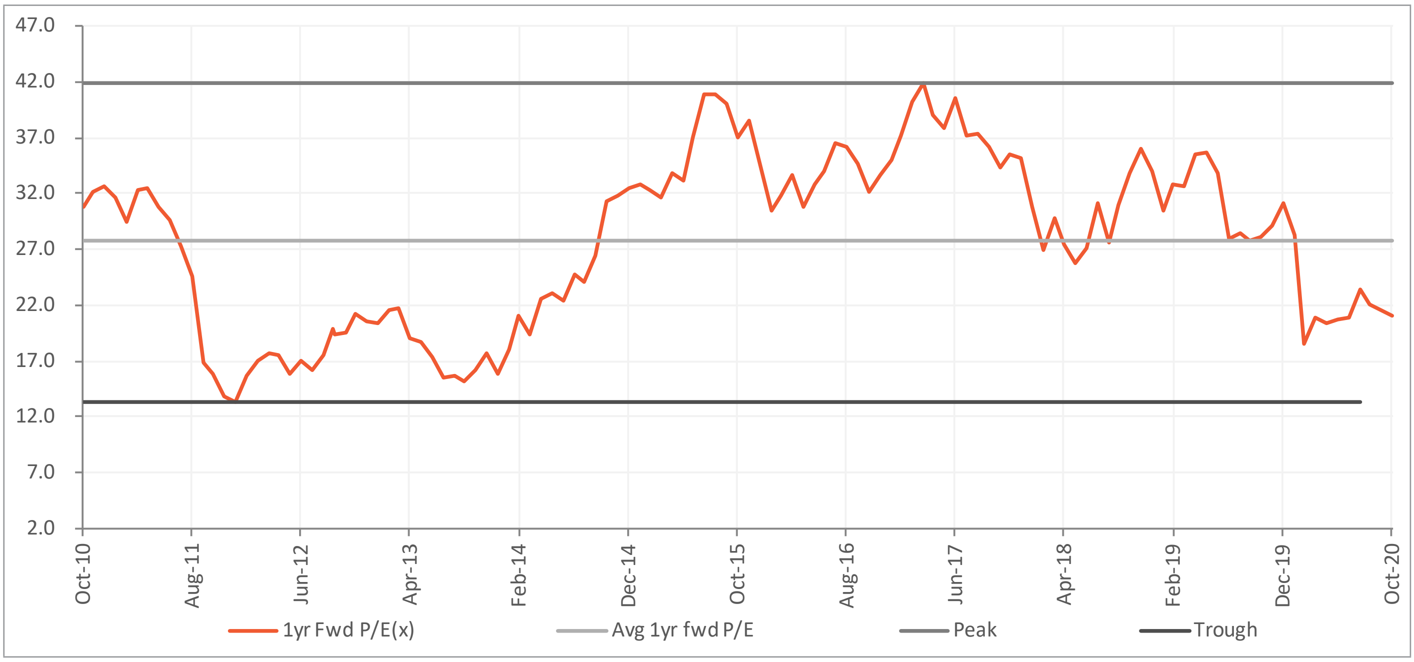
■ **Company outlook - Domestic market expected to perform well, exports to improve gradually:**

Cummins' strong parentage and technological capabilities give it an edge over competitors. The company's innovative products and solutions, market leadership particularly in HHP in the domestic market, rising optimism for export recovery, and margin expansion make us positive on its prospects. Favourable commentary regarding pick up in the manufacturing sector aided growth in the medium and HHP engines. The industrial segment is also expected to post a stronger growth trajectory, driven by robust demand from railways and construction segments arising because of sustained investments in infrastructure.

■ **Valuation - Recommend Buy with PT of Rs. 606:**

Cummins, being the market leader, is in a sweet spot to leverage on gradual pick up in demand pick up in power generation segment (HHP and mid horse power diesel gensets), for sectors such as roads, real estate (residential and commercial), and data centres. Further, the industrial segment's sales will be driven by demand from railways, metro, road (compressors), and bottoming out of diesel generator demand for water well rigs. Improvement in core business and increased outsourcing of maintenance services by clients is expected to boost the distribution business. Cummins India is currently trading at 19.2x/16.3x its FY2022E/FY2023E net earnings, which is at a steep discount to its long-term historical average. Considering revival in its net earnings growth trajectory (23% CAGR) over FY2021E-FY2023E, strong balance sheet and steady cash flow generation, we remain constructive on the company and recommend Buy on the stock with a price target (PT) of Rs. 606.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

Cummins is a subsidiary of Cummins Inc, USA – a global manufacturer of engines and other power generation products. The company comprises three businesses – Engine Business (serving the Construction and Compressor markets with Heavy, Medium and Light Duty engines), Power Systems Business (serving Mining, Marine, Rail, Oil and Gas, Defense, and Power Generation) and Distribution Business. Cummins has eight manufacturing facilities in Maharashtra and Gujarat. The company's product range primarily includes diesel engines/gensets from 15kVA to 2,000kVA for various power/industrial uses. Cummins also manufactures alternators, digital controls, transfer switches, etc. Cummins is the leader with 40% market share in the diesel engines/gensets industry. Further, Cummins has strong presence in high-value and high-margin HHP gensets. The company's domestic business is divided into power generation, industrial, and distribution segments, contributing 60% to its sales. Exports contribute around 40% to sales. The company exports to over 40 countries comprising Middle East and Africa, which contribute 90% to its exports.

Investment theme

Cummins India is the largest standby genset player in India with lead market share in medium and l arge gensets. The company has a strong technology/innovation track record, well supported by its parent, which helps it stay ahead of peers across changes in emission norms. The company's diversified business presence across power generation, industrial BU, exports, and distribution contributes reasonable long-term growth prospects with healthy return/cash flow profile. While the recent drop in demand both domestic and exports market has posed near-term challenges reflecting in recent earnings downgrades and valuation de-rating, we believe that the stock offers favourable risk-reward for long-term investors, given vast product offerings,management's focus on efficiency/cost, and a healthy potential scale from domestic infra and global market pick up.

Key Risks

- Slowdown in domestic macro-environment can result inslower-than-expected growth for the company.
- Global market demand weakness poses key downside risk to exports.

Additional Data

Key management personnel

Ashwath Ram	Managing Director
Rajiv Batra	Vice President – Finance Special Projects
Ajay Patil	Chief Financial Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Cummins Inc	51.00
2	SBI Fund Management Pvt Ltd	6.10
3	LIC of India	5.70
4	ICICI PruAmc	1.73
5	Aditya Birla Sun Life Trustee Co PVt Ltd	1.62
6	Sundaram AMC	1.54
7	Kotak Mahindra AMC	1.48
8	Franklin Resources Inc	1.37
9	UTI AMC	1.36
10	Aditya Birla Sun AMC	1.33

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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