Cummins India Limited

Gaining traction from revival in key domestic segments

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. 667**	
Price Target: **Rs. 765**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

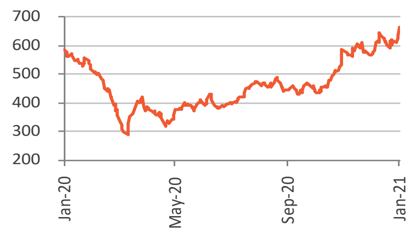
Company details

Market cap:	Rs. 18,477 cr
52-week high/low:	Rs. 687/282
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	9.0
DII	27.5
Others	12.5

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	16.6	50.9	67.5	14.1
Relative to Sensex	19.6	34.5	44.8	0.9

Sharekhan Research, Bloomberg

Summary

- We retain Buy on Cummins India Limited (Cummins) with a revised PT of Rs. 765, as we see further room for upside considering strong earnings growth potential led by domestic economic revival.
- The company reported yet another strong quarterly performance, led by better-than-expected OPM, driven by largely sustainable cost-reduction measures.
- The company is witnessing strong uptick in key segments such as power generation, construction, and mining, which are expected to do well going ahead. Management remains optimistic but has refrained from giving guidance for FY2021.
- The company continues to carry out new product initiatives, cost rationalising, and conserving cash. The company is expected to maintain its technologically driven market leadership across all business segments.

Cummins India Limited (Cummins) reported yet another strong quarter, led by improving OPM, majorly led by cost-reduction measures at both employee and other expenses level. During Q3FY2021, standalone revenue declined by 2.0% y-o-y (largely in-line with estimates) to Rs. 1,424 crore as domestic revenues declined by 3% y-o-y (up 38% q-o-q), while exports showed marginal growth of 1% y-o-y (down 6% q-o-q). Strong sequential recovery in domestic revenue was primarily driven by the power-generation segment (revenue up 11% y-o-y, 64% q-o-q) and the industrial segment (revenue up 51% q-o-q, down 4% y-o-y). Within the industrial segment, the company witnessed strong traction in construction and mining segments, while railways continued to lag. The company's cost-reduction initiatives especially in terms of reduction in manpower across the board along with lower other expenses led to better-than-expected OPM at 17% (up 213bps y-o-y, 254bps q-o-q). Consequently, operating profit rose by 12% y-o-y to Rs. 242 crore. Strong OPM along with higher other income (up 75% y-o-y) led to adjusted net profit growth of 15.7% y-o-y to Rs. 234 crore, which was much higher than our estimates. Management seemed optimistic of the demand environment, although some domestic segments are yet to recover, while key geographies (US and Europe) are sluggish, affected by subsequent COVID-19 waves. Consequently, management has not given guidance for FY2021. The company would be eyeing opportunities in upcoming demand from data centers as its global parent has a leadership position globally. It is customising products for multiple segments and increasing power density for its products. On the CTIL front (investor's concern on new technologies products getting in the unlisted entity), the company is looking at options to resolve the issue (one of which can be merging the unlisted entity with itself), although there is no concrete plan in the short term. Cummins is currently trading at 30.4x/26.2x its FY2022E/ FY2023E net earnings, which we believe provides further room for upside, considering strong growth potential in end-user industries, strong balance sheet, and steady cash flow generation. Hence, we retain Buy on the stock with a revised price target (PT) of Rs. 765.

Key positives

- Strong beat on OPM and net profit continues, led by cost-reduction initiatives.
- Strong rebound in growth seen in power generation, construction, and mining segments.

Key negatives

- The industrial rail segment continues to lag.
- Export revenue remains soft due to impact of COVID-19 pandemic in key geographies, Europe and Latin America.

Our Call

Valuation – Retain Buy with a revised PT of Rs. 765: Cummins has started to witness the benefits arising from strong revival in key segments such as power generation, construction, and mining, which is expected to sustain going forward. The cost initiatives undertaken by the company have been yielding benefits in terms of improved OPM. We have fine tuned our estimates for FY2021-FY2023, factoring higher OPM during FY2021, led by its cost-reduction measures. We remain constructive on Cummins and expect 15% net earnings CAGR over FY2021E-FY2023E, as it continues to benefit from healthy demand led by domestic economic revival. Cummins is currently trading at 30.4x/26.2x its FY2022E/FY2023E net earnings, which we believe provides further room for upside considering strong growth potential in end-user industries, strong balance sheet, and steady cash flow generation. Hence, we retain Buy on the stock with a revised PT of Rs. 765.

Key Risks

Slowdown in the domestic macro-environment and key global geographies affects growth outlook.

Valuation (Standalone) Rs cr

Particulars	FY20	FY21E	FY22E	FY23E
Revenue	5,158	4,390	5,000	5,501
OPM (%)	11.4	12.7	12.7	13.3
Adjusted PAT	643	532	608	706
% YoY growth	(11.0)	(17.2)	14.1	16.2
Adjusted EPS (Rs.)	23.2	19.2	21.9	25.5
P/E (x)	28.7	34.7	30.4	26.2
P/B (x)	3.1	3.1	3.0	2.8
EV/EBITDA (x)	21.1	21.8	19.0	16.1
RoNW (%)	15.5	12.6	14.1	15.6
RoCE (%)	17.2	15.3	17.0	18.9

Source: Company; Sharekhan estimates

Better-than-expected operational performance continues

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Optimistic on domestic revival

Cummins has started to witness the benefits arising from strong revival in key segments such as power generation, construction, and mining, which are expected to sustain going forward. The cost initiatives undertaken by the company have been yielding benefits in terms of improved OPM. Management seemed optimistic of the demand environment although some domestic segments are yet to recover, while key geographies (US and Europe) are sluggish, affected by subsequent COVID-19 waves. Consequently, management has not given FY2021 guidance. The company would be eyeing opportunities in upcoming demand from data centers as its global parent has a leadership position globally. It is customising products for multiple segments and increasing power density for its products. On the CTIL front (investor's concern on new technologies products getting in unlisted entity), the company is looking at options to resolve the issue (one of which can be merging the unlisted entity with itself), although there is no concrete plan in the short term.

Conference Call Highlights:

- **Demand and guidance:** Management has not provided FY2021 guidance. Management is seeing gradual recovery over the next two to three months. The company is overall optimistic going ahead. The power generation segment has recovered better than expectations due to strong recovery in end-user segments, data centres, infrastructure, rentals, and industrial. Growth has been slower in medium horse power due to muted demand from hospitality, retail, and commercial segments.
- **CTIL concerns:** There have been concerns with investors with respect to CTIL (unlisted entity Cummins Technologies Pvt.Ltd.) getting investments for new technologies from the global parent. The company is looking at ideas for the long term, such as merging CTIL with itself, but nothing is planned in the short term. As per the company, hydrogen technologies for rail, construction, marine (segments where Cummins is already present) will remain with the company.
- **Data centres:** Globally, Cummins is the largest player in data centres. High-speed diesel is absent in competitors. Cummins has the right technology to grow in India.
- **Construction segment:** The construction segment is expected to remain strong for atleast a year or so.
- **Realty demand:** Pre-COVID commercial projects are getting completed, although new projects are not much seen. The residential market is seeing green shoots of recovery, which is helping drive DG genset sales.
- **Rail, mining, and marine:** The segment has been lagging and will take couple of quarters to come back. The mining segment has come back strongly, led by demand in coal and metal industries. In marine, the company has introduced new products to capture market share and will grow well.
- **BS-IV norms:** Pre-buy demand is strong. The company is already ready with products and expects good sales and profit.
- **CPCB-IV:** CPCB-IV norms are expected to be delayed for six months (originally during July-August 2021). The new norms are most likely expected in April 2022. The industry has been asking for relief due to COVID-19. Cost of products as per the new norms will be higher. So,selling price is expected to be higher, but the price hike cannot be said right now. Although it would be significant compared to other industries.
- **New product launches:** The company is developing customised products for multiple segments such as data centres. The companyis also increasing power density for products.

- **Global markets:** Europe and Latin America are sluggish on account of subsequent waves of COVID-19 pandemic. Asian markets are stronger. Middle East and Africa are in the middle.
- **Commodity impact:** Rise in key commodity prices such as copper andsteel would be hitting the company in the next quarter. The company would be increasing prices next year depending on products and segments to partially mitigate the impact of commodity rise.
- **Other income:** Higher other income is on account of Rs. 38 crore dividend received from its subsidiary, Valvoline Cummins, and exchange gains.
- **Other expense:** Other expense during the quarter looks lower y-o-y as compared to Q3FY2020.The company had booked impairment charges of Rs. 23 crore.
- **Employee costs:** The company did workforce reduction across the board, the benefits of which have been seen in the previous quarters.

Results (Standalone) **Rs cr**

Particulars	Q3FY21	Q3FY20	y-o-y (%)	Q2FY21	q-o-q (%)
Revenues	1,424	1,453	(2.0)	1,160	22.8
RM cost	8,614	8,716	(1.2)	7,572	13.8
Staff cost	125	142	(11.6)	119	5.2
Other Exp	141	150	(5.9)	155	(8.9)
Operating Expenses	888	901	(1.4)	785	13.2
Operating profits	242	216	12.0	167	44.4
Other Income	98	56	75.0	58	69.8
Interest	5	5	(1.5)	4	13.9
Depreciation	32	30	8.2	33	(2.2)
PBT	304	238	27.7	189	60.9
Tax	70	52	34.9	43	61.2
Adj PAT	234.1	202.3	15.7	145.6	60.8
Reported PAT	234	186	25.7	146	60.8
Adj EPS	8.4	7.3	15.7	5.3	60.8
			bps		**bps**
OPM	17.0%	14.8%	213	14.4%	254
NPM	16.4%	13.9%	252	12.5%	389
Tax rate	22.9%	21.7%	123	23%	5

Source: Company; Sharekhan Research

Outlook and Valuation

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

It is estimated that India would need to spend $4.5 trillion on infrastructure by 2030to make India a $5 trillion economy by FY2025 and to continue growing at an escalated trajectory until 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 conceptualisation stage were captured. Consequently, total capital expenditure in the infrastructure sector 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.

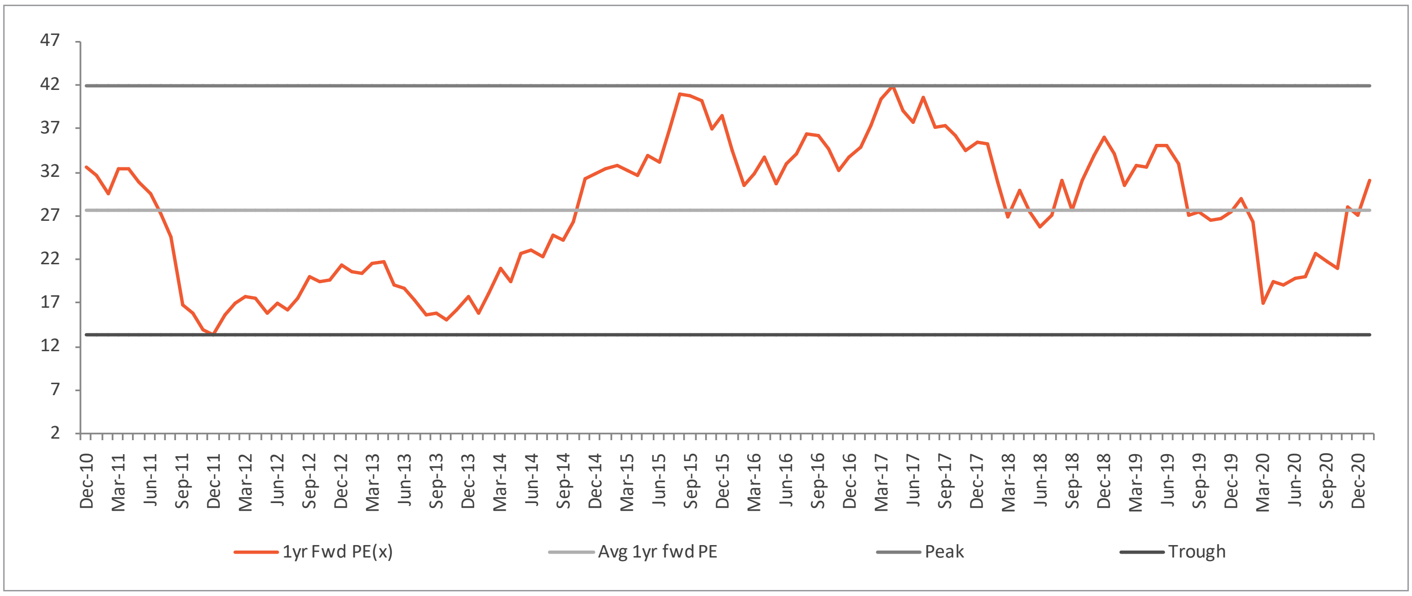
■ Company outlook - Domestic market expected to perform well, exports to improve gradually

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. The company has started to witness the benefits arising from strong revival in key segments such as power generation, construction, and mining, which are expected to sustain going forward. Cost initiatives undertaken by the company have been yielding benefits in terms of improved OPM.

■ Valuation - Retain Buy with a revised PT of Rs. 765

Cummins has started to witness the benefits arising from strong revival in key segments such as power generation, construction, and mining, which are expected to sustain going forward. Cost initiatives undertaken by the company have been yielding benefits in terms of improved OPM. We have fine tuned our estimates for FY2021-FY2023, factoring higher OPM during FY2021, led by its cost-reduction measures. We remain constructive on Cummins and expect 15% net earnings CAGR over FY2021E-FY2023E, as it continues to benefit from healthy demand,led by domestic economic revival. Cummins is currently trading at 30.4x/26.2x its FY2022E/FY2023E net earnings, which we believe provides further room for upside, considering strong growth potential in end-user industries, strong balance sheet, and steady cash flow generation. Hence, we retain Buy on the stock with a revised PT of Rs. 765.

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, and transfer switches, among others. Cummins is the leader with 40% market share in the diesel engines/gensets industry. Further, Cummins has a strong presence in high-value and high-margin HHP gensets. Thecompany'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 is the largest standby genset player in India with leading market share in medium andlargegensets. The company has a strong technology/innovation track record, well supportedby its parent, which helps it stay ahead of peers across changes in emission norms. The company's diversifiedbusiness presence across power generation, industrial BU, exports, and distributioncontributes 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-termchallenges reflecting in recent earnings downgrades and valuation de-rating, we believethe 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 andglobal 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: Bloomberg

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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