Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Cummins India

Strong Q2, growth outlook bright

Capital Goods	Sharekhan code: CUMMINSIND
Reco/View: Buy ↔	CMP: **Rs. 1,335** / Price Target: **Rs. 1,550** ↑

↑ Upgrade ↔ Maintain ↓ Downgrade

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		↔	

ESG Disclosure Score NEW

ESG RISK RATING 29.69
Updated OCT 08, 2022

Medium Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

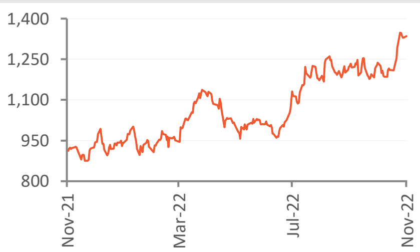
Company details

Market cap:	Rs. 37,006 cr
52-week high/low:	Rs. 1,380/842
NSE volume: (No of shares)	5.7 lakh
BSE code:	500480
NSE code:	CUMMINSIND
Free float: (No of shares)	13.6 cr

Shareholding (%)

Promoters	51.0
FII	10.4
DII	26.7
Others	11.9

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	9.5	13.0	31.3	48.0
Relative to Sensex	4.5	8.5	21.8	46.5

Sharekhan Research, Bloomberg

Summary

- We reiterate Buy on Cummins India (Cummins) with a revised PT of Rs. 1,550 given its strong performance during H1FY23 and optimistic management commentary.
- Cummins reported strong standalone revenues with ~13%/15% y-o-y revenue/PAT growth driven by both domestic and export markets with a strong beat on OPM estimate.
- The demand outlook is robust in domestic market from data centers, mining, healthcare, realty and infrastructure. Further, products catering to CPCB-4 norms would drive future growth. Exports growth would be driven by market share increase through new product offerings.
- Cummins has a strong pedigree, healthy balance sheet, constantly evolving product portfolio to meet the changing emission norms and improving earnings trajectory. We expect revenue/PAT CAGR of ~18%/19% over FY22-25E.

Standalone results exceeded our estimates. Total revenues grew by ~13% y-o-y to Rs. 1,951 crore (vs our estimate of Rs. 1,882 crore). Domestic sales increased by 11% y-o-y to Rs. 1,391 crore. Exports were rose 21% y-o-y to Rs. 531 crore. Operating profit grew by 12% y-o-y to Rs. 291crore (vs our estimate of Rs. 258 crore). OPM came in at 14.9% down12 bps y-o-y but higher than our estimate of 13.7% as other expenses and employee cost declined y-o-y on a proportionate basis. Net profit was up by 15% y-o-y to Rs. 252 crore.

Key positives

- Revenues from domestic PowerGen/Distribution/Industrial rose by 6%/22%/10% y-o-y.
- Exports sales were primarily driven by 49% y-o-y growth in LHP (low horse power) sales.
- Other income grew by 23% y-o-y to Rs. 85 crore; thereby contributing to net profit growth.
- GPM improved 74 bps q-o-q to 31.8%. OPM came in at 14.9% (down 12 bps y-o-y) but improved substantially by 221 bps on sequential basis.

Key negatives

- In the powergen segment, compressors and construction segments have not been performing as per expectations since the past few quarters.
- In international markets, Europe has started to slowdown.
- Shortage of raw materials especially in HHP domain still persist.

Management Commentary

- Cummins has seen robust demand across most of the segments in both domestic and export markets.
- Demand remains robust in Powergen from data center, biotechnology, pharmaceuticals, real estate and manufacturing.
- The company expects export growth would be driven by market share gain through the launch of new products.
- CPCB-4 Plus is the tightest emission norms and therefore product prices are expected to be significantly higher than earlier.
- Complete normalisation of the supply chain has not happened as yet and it has not improved meaningfully from the last quarter.
- Current average capacity utilisation is 70-80% as some demand is unmet due to supply side constraints.

Revision in estimates – We have introduced FY2025E estimates and tweaked our estimates for FY2023-FY2024E to build in better-than-expected H1FY2023 performance.

Our Call

Valuation – Retain Buy with a revised PT of 1,550: Cummins is well geared to gain from increasing demand from data centers, healthcare, infrastructure, real estate; etc. In exports as well, the company has been continuously revamping its product portfolio and offering fit-for-market products in exports. However, a slowdown in Europe could affect exports growth. Cummins would benefit from emergence of alternative and green fuels and would play a crucial role in India's transition to a zero-carbon country by 2070 by offering products in alternative and green spaces. Cummins' industry-leading margins, product depth and strong parentage give us further comfort. We expect revenue/PAT CAGR of ~18%/19% over FY22-25E. Hence, we retain a Buy on the stock with a revised PT of Rs. 1,550.

Key Risks

- If the supply side issues persist for a long time, it can negatively affect the business outlook and earnings growth.
- Global market demand weakness due to the current geopolitical crisis between Russia and Ukraine poses a key downside risk to exports

Valuation (Standalone) Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
Total Revenue	6,140	7,595	8,837	10,143
OPM (%)	14.4	14.1	14.9	15.5
Adj Net profit	794	930	1,141	1,349
Adj. EPS (Rs.)	28.6	33.6	41.2	48.7
PE (x)	46.6	34.9	32.4	27.4
P/B (x)	7.6	7.0	6.3	5.5
EV/EBIDTA (x)	40.0	33.1	26.6	22.0
RoE (%)	17.2	18.4	20.5	21.5
RoCE (%)	21.1	22.7	25.6	27.3

Source: Company; Sharekhan estimates

Strong overall growth

Standalone results exceeded our estimates. Total revenue grew by ~13% y-o-y to Rs. 1,951 crore (vs our estimate of Rs. 1,882 crore). Domestic sales increased by 11% y-o-y to Rs. 1,391 crore. Exports rose by 21% y-o-y to Rs. 531 crore. Operating profit grew by 12% y-o-y to Rs. 291crore (vs our estimate of Rs. 258 crore). OPM came in at 14.9%, down 12 bps y-o-y but higher than our estimate of 13.7% as other expenses and employee cost declined y-o-y on a proportionate basis. Net profit was up by 15% y-o-y to Rs. 252 crore.

Sanguine demand outlook backed by new product launches

Cummins expects demand momentum to continue from data centers, healthcare, commercial realty, pharmaceutical, biotech, and manufacturing industries in domestic powergen segment. Further, it is seeing a demand revival from construction and residential housing segments. Cummins is a significantly large player in data centers and well placed to tap demand. Further, implementation of CPCB -4 plus norms should lead to robust demand for the company's products in the domestic market. The company can also tap export markets as the technology is equivalent to US tier-4 emission standards. The industrial segment's sales will be driven by demand from railway electrification, mining, marine, oil & gas, defense; etc. Distribution business would be driven by increasing demand for maintenance and the company is improving its offerings in this segment. The company has been continuously revamping its product portfolio and offering fit-for-market products in exports.

Key Conference call takeaways

- **Segment-wise revenue break up:** All the segments in both domestic and exports markets performed well. In the domestic segment - Powergen sales stood at Rs. 675 crore (up 6% y-o-y, up 36% q-o-q), distribution came in at Rs. 446 crore (up 22% y-o-y/ 7% q-o-q). Industrial sales were at Rs. 250 crore (up 10%/5% y-o-y/q-o-q). The industrial break up was as follows: compressors – Rs. 13 crore, construction – Rs. 93 crore, mining - Rs. 38 crore and oil & gas, defence, marine and other smaller segments had sales of Rs. 60 crore. In exports – HHP was at Rs. 234 crore (down 3% y-o-y/+1% qoq), LHP was at Rs. 242 crore (up 49% y-o-y/20% qoq).
- **Exports' region wise sales break up:** Latin America – Rs. 116 crore, Asia Pacific – Rs. 143 crore Middle East – Rs. 109 crore, Europe – Rs. 70 crore and Africa had sales of Rs. 40 crore.
- **Supply chain issues persist:** Supply chain has improved a bit but critical parts particularly for HHP products, electronics-based parts and castings are short in supply.
- **Gross margin to further improve sequentially:** Price hikes taken in the past few quarters (as Cummins has not rolled back any prices) and a consistent decline in commodity prices would result in further improvement in gross margins, sequentially.
- **Capacity Expansion:** The current average capacity utilisation is 70-80% as some of the demand is unmet due to supply side constraints. With the present capacity, the company can increase the production with manpower recruitment (ball park figure of 400-500 employees to achieve 100% utilization) and bringing some changes in the processes through automation. Hence, major capacity expansion is not in the pipeline currently.
- **Capex:** Cummins' capex plan is in line with last year and the company expects Rs. 200-220 crore capex for the next two years driven by maintenance capex, expenses towards development of new products and value engineering.
- **International market outlook:** Demand is good in Latin America, Asia Pacific and Middle East. Europe has started to witness a slowdown and Africa is also subdued. As payments are difficult to realize in Africa, the company does not want to increase its exposure to Africa. However, the company is confident of strong growth in overall exports led by market share gain and introduction of fit to market products for these regions.

- **CPCB-4 norms to be applicable from July 2023 onwards:** The company said that there would be substantial increase in pricing for CPCB-4 compliant products. As per the past trend, whenever the emission norms are changed, there is a lot of pre-buying before the norms are implemented. Hence, post the new launches, there is a demand slowdown for 12-18 months, however, the long-term demand is not impacted.
- **Industrial segment outlook:** Rail is gradually improving as the company is getting into electrification space. The company expected construction segment to post 13-15% CAGR on long-term basis, however, spends have not happened and markets have contracted. The other areas such as mining, defence and marine are expected to perform well.
- **Domestic market outlook:** If the Indian economy continues to grow at 6-7% then the domestic growth will be faster than the exports. Data centre, pharmaceuticals, biotechnology, realty and manufacturing have had strong sales in Q2 and will not slowdown for couple of years. However, exports could outperform domestic business if company is able to increase its market share substantially through new products in the long-term.
- **Meritor Inc acquisition by parent may help combine product offerings:** Cummins' US parent's acquisition of Meritor- (a leading global supplier of drivetrain, mobility, braking, aftermarket and electric powertrain solutions) may not have a meaningful impact on Cummins business. The company added that, however, now in construction and other heavy-duty applications, the entity can contemplate to offer entire power drill solutions rather than just an engine.
- **Distribution segment:** The company is focused on growing this segment as it believes that India distribution business is lagging behind as compared to other Cummins entities.

Results (Standalone) Rs cr

Particulars	Q2FY23	Q2FY22	YoY (%)	Q1FY23	QoQ (%)
Total Revenue	**1,951**	**1,727**	**13.0**	**1,687**	**15.7**
RM Cost	1,330	1,157	14.9	1,162	14.4
Staff Cost	161	157	2.5	151	6.3
Other Expenditure	170	154	10.2	159	6.6
Operating Expenses	1,661	1,468	2.8	1,473	12.8
Operating Profit	**291**	**259**	**12.1**	**214**	**35.9**
Other Income	85	69	23.1	100	(14.6)
Interest	5	2	107.7	2	137.6
Depreciation	35	34	5.1	34	4.8
PBT	**336**	**293**	**14.8**	**264**	**27.3**
Tax	84	73	14.8	65	28.4
Adjusted PAT	**252**	**220**	**14.8**	**213**	**18.4**
Exceptional items	-	-		(14)	
Reported PAT	252	220	14.8	199	27.0
Adj. EPS (Rs.)	**9.1**	**7.9**	**14.8**	**7.7**	**18.4**
Margins (%)			**bps**		**bps**
GPM	31.8	33.0	(118)	31.1	74
OPM	14.9	15.0	(12)	12.7	221
NPM	12.9	12.7	20	12.6	30
Tax rate	24.9	24.9	1	24.7	21

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. To achieve the desired goal, the government drew up National Infrastructure Pipeline (NIP) through a bottom-up approach, wherein all projects cost more than Rs. 100 crore per project under construction, proposed Greenfield projects, Brownfield projects and those at the conceptualization stage were captured. Consequently, 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.

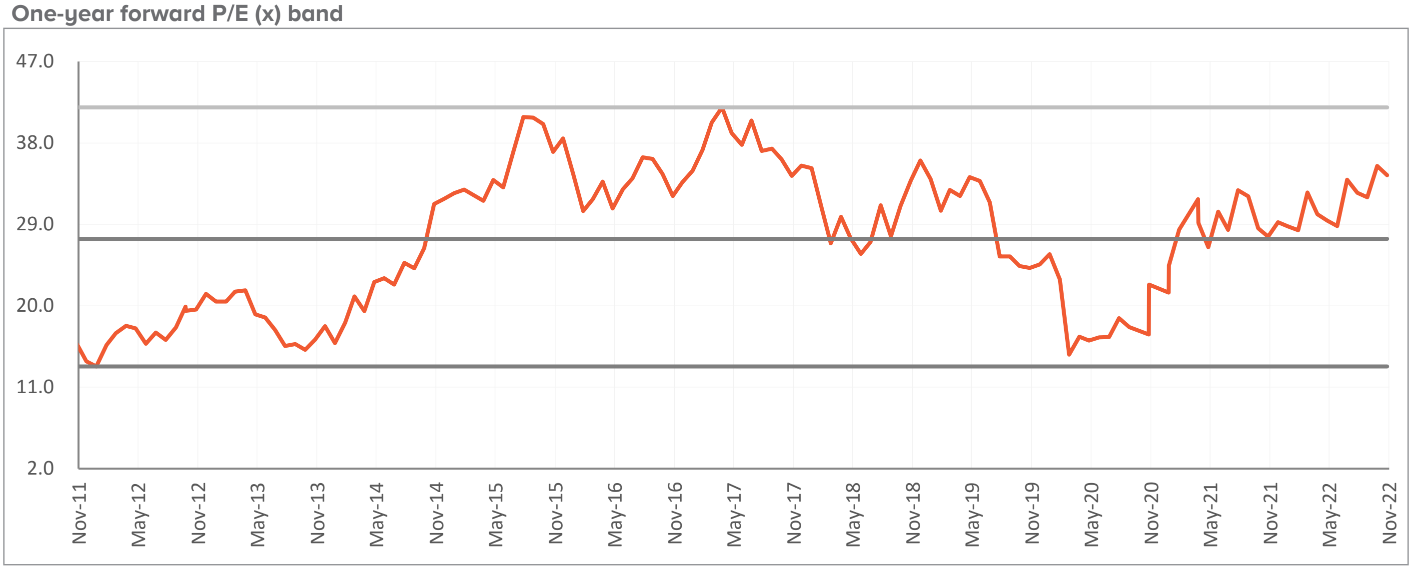
■ **Company Outlook – Domestic and exports markets expected to perform well**

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, and expectations of robust growth in exports and margin expansion make us positive on its prospects. The company has begun to witness the benefits arising from a 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 from the low levels.

■ **Valuation – Retain Buy with a revised PT of 1,550**

Cummins is well geared to gain from increasing demand from data centers, healthcare, infrastructure, real estate; etc. In exports as well, the company has been continuously revamping its product portfolio and offering fit-for-market products in exports. However, a slowdown in Europe could affect exports growth. Cummins would benefit from emergence of alternative and green fuels and would play a crucial role in India's transition to a zero-carbon country by 2070 by offering products in alternative and green spaces. Cummins' industry-leading margins, product depth and strong parentage give us further comfort. We expect revenue/PAT CAGR of ~18%/19% over FY22-25E. Hence, we retain a Buy on the stock with a revised PT of Rs. 1,550.

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 a 40% market share in the diesel engines/gensets industry. Further, Cummins has a 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 70% to its sales. Exports contribute around 25-30% to sales. The company exports to over 40 countries comprising the Middle East and Africa, which contribute 90% to its exports.

Investment theme

Cummins is the largest standby Genset player in India with a lead market share in medium and large 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 contribute reasonably long-term growth prospects with a healthy return/cash flow profile. While the recent drop in demand, both domestic and exports market, has posed near-term challenges reflected in recent earnings downgrades and valuation de-rating, we believe the stock offers favorable risk-reward for long-term investors, given vast product offerings, management's focus on efficiency/cost, and a healthy potential scale from domestic infrastructure and global market pick up.

Key Risks

- If the supply side issues persist for a long time, it can negatively affect the business outlook and earnings growth.
- Global market demand weakness due to the current geopolitical crisis between Russia and Ukraine poses a key downside risk to exports

Additional Data

Key management personnel

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

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Kotak Mahindra AMC	3.94
2	SBI Fund Management Pvt. Ltd	3.71
3	Norges Bank	1.81
4	ICICI Pru AMC	1.65
5	LIC of India	1.62
6	SBI Life Insurance	1.60
7	Vanguard Group Inc.	1.51
8	Franklin Resources Inc,	1.51
9	Aditya Birla Sun Life Asset Management 9	1.28
10	HDFC AMC	1.14

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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