Cummins India (CUMM.BO)

Maintain Sell – Too Early to Bottom-Fish

- **PAT down 23% YoY** — PAT at Rs1.28bn was 23% below CIRA at Rs1.68bn. Domestic sales declined 5% YoY, while exports were up 15% YoY. EBITDA margins at 14.5% were down 358bps YoY on the back of (1) inflation in raw materials and (2) poor product mix with the upper end experiencing a bigger slowdown vs the lower end of the range.
- **Sales guidance cut as expected** — Export growth guidance maintained at 5-10% but domestic growth guidance has been cut to 5-10% from 10-15% earlier. Competitor KOEL has also revised down sales growth guidance for FY12E twice this year from 15-20% (Post FY11 results) to 10% (Post 1Q12 results) to 0% (Post 2Q12 results).
- **Margin expectations lowered** — PBT margins could contract 100bps over next two quarters from ~ 17% end 2Q12: (1) inflation seems to be leveling but pig iron continues to climb and (2) mix could be poor, similar to what it was in 2Q12, over the next two quarters. The impact of price increases in earlier part of the year is already baked into numbers now and hence cannot provide upside to margins.
- **FY12E-14 EPS cut by 17-20%**— This is to factor in ***5-8% lower sales.*** For FY12E we factor in domestic growth of 5% (vs guidance of 5-10%) and export growth of 10% (vs guidance of 5-10%). ***57-138bps lower margin.*** We assume EBITDA margins will contract from 14.5% in 2Q12 to 14.1% in 3Q12 to 13.6% in 4Q12. We also factor in 99bps and 66bps improvement in FY13E and FY14E.
- **Too early to bottom fish - Maintain Sell** — Though we believe CIL is a quality company with sustained +ve CFO and dividend yield of 3%+, we believe it might be a little to early to bottom-fish this name, as we believe there are significant downside risks to consensus expectations (our EPS estimates are 14-22% below consensus for FY12E-14E). We revise down target price to Rs334 (Rs387 earlier) to factor in (1) 17-20% EPS cut and (2) roll forward of target P/E multiple of 15x to Mar13E from Dec12E.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2010A	4,439	16.01	6.6	22.2	6.3	30.0	2.4
2011A	5,877	21.20	32.4	16.7	5.4	34.9	3.0
2012E	5,031	18.15	-14.4	19.6	5.0	26.5	3.2
2013E	6,176	22.28	22.8	15.9	4.5	29.7	3.7
2014E	7,421	26.77	20.2	13.3	4.1	32.2	4.4

Source: Powered by dataCentral

- Company Update
- Target Price Change
- Estimate Change

Sell	**3**
Price (11 Nov 11)	Rs355.05
Target price	Rs334.00
from Rs387.00	
Expected share price return	-5.9%
Expected dividend yield	3.2%
Expected total return	**-2.7%**
Market Cap	Rs98,420M
	US$1,969M

Price Performance
(RIC: CUMM.BO, BB: KKC IN)

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Fiscal year end 31-Mar	2010	2011	2012E	2013E	2014E
Valuation Ratios					
P/E adjusted (x)	22.2	16.7	19.6	15.9	13.3
EV/EBITDA adjusted (x)	17.9	14.1	15.4	12.6	10.5
P/BV (x)	6.3	5.4	5.0	4.5	4.1
Dividend yield (%)	2.4	3.0	3.2	3.7	4.4
Per Share Data (Rs)					
EPS adjusted	16.01	21.20	18.15	22.28	26.77
EPS reported	16.01	21.32	19.82	22.28	26.77
BVPS	56.31	65.16	71.57	78.69	87.39
DPS	8.57	10.71	11.50	13.00	15.50
Profit & Loss (RsM)					
Net sales	28,449	39,454	41,940	48,231	56,023
Operating expenses	-23,535	-33,186	-36,251	-41,236	-47,534
EBIT	**4,914**	**6,268**	**5,688**	**6,994**	**8,489**
Net interest expense	-21	-19	-18	-18	-18
Non-operating/exceptionals	1,216	1,774	1,498	1,722	1,981
Pre-tax profit	**6,109**	**8,024**	**7,168**	**8,699**	**10,452**
Tax	-1,670	-2,147	-2,138	-2,523	-3,031
Extraord./Min.Int./Pref.div.	0	33	463	0	0
Reported net income	**4,439**	**5,910**	**5,494**	**6,176**	**7,421**
Adjusted earnings	4,439	5,877	5,031	6,176	7,421
Adjusted EBITDA	5,275	6,635	6,087	7,476	9,055
Growth Rates (%)					
Sales	-13.9	38.7	6.3	15.0	16.2
EBIT adjusted	13.8	27.6	-9.3	23.0	21.4
EBITDA adjusted	10.5	25.8	-8.3	22.8	21.1
EPS adjusted	6.6	32.4	-14.4	22.8	20.2
Cash Flow (RsM)					
Operating cash flow	**7,098**	**5,205**	**5,849**	**6,595**	**7,593**
Depreciation/amortization	361	366	399	482	566
Net working capital	2,238	-1,054	-44	-63	-394
Investing cash flow	**-3,944**	**-1,366**	**-2,500**	**-2,500**	**-2,500**
Capital expenditure	-607	-1,440	-2,500	-2,500	-2,500
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**-2,918**	**-3,361**	**-3,717**	**-4,202**	**-5,010**
Borrowings	-126	96	0	0	0
Dividends paid	-2,775	-3,457	-3,717	-4,202	-5,010
Change in cash	**236**	**478**	**-368**	**-107**	**83**
Balance Sheet (RsM)					
Total assets	**23,508**	**28,657**	**31,243**	**34,680**	**38,988**
Cash & cash equivalent	559	1,037	669	563	646
Accounts receivable	5,229	7,182	7,634	8,340	9,687
Net fixed assets	3,337	4,411	6,512	8,530	10,464
Total liabilities	**7,898**	**10,594**	**11,404**	**12,866**	**14,763**
Accounts payable	3,768	6,129	6,603	7,504	8,676
Total Debt	86	183	183	183	183
Shareholders' funds	**15,610**	**18,063**	**19,839**	**21,814**	**24,225**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	18.5	16.8	14.5	15.5	16.2
ROE adjusted	30.0	34.9	26.5	29.7	32.2
ROIC adjusted	30.0	35.3	24.9	26.7	28.0
Net debt to equity	-3.0	-4.7	-2.5	-1.7	-1.9
Total debt to capital	0.6	1.0	0.9	0.8	0.7

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Powered by: dataCentral

Disappointing 2Q12 – PAT down 23% YoY

- That macro economic headwinds in India have started taking a toll on Cummins India (CIL) is very evident from the fact that domestic sales declined 5% YoY while exports were up 15% YoY. Overall sales at Rs10.7bn were flat YoY but well below CIRA at Rs11.7bn.
- EBITDA margins at 14.5% were down 358bps YoY and down 135bps QoQ on the back of (1) inflation in raw materials and (2) poor product mix with upper end of range experiencing a bigger slowdown v/s lower end of range.
- PAT at Rs1.28bn was down 23% YoY, which was 23% below CIRA at Rs1.68bn.

Figure 1. CIL 2QFY12 Results Review

Year End Mar31 (Rsmn)	1QFY11	1QFY12	YoY	2QFY11	2QFY12	YoY	2QFY12E
Net sales	**9,100**	**10,219**	***12.3%***	**10,675**	**10,698**	***0.2%***	**11,700**
- Exports	2,155	2,719	*26.2%*	2,760	3,179	*15.2%*	3,200
- Domestic	6,945	7,501	*8.0%*	7,915	7,519	*-5.0%*	8,500
Raw materials	(5,726)	(6,713)		(6,928)	(7,158)		(7,699)
% of net sales	62.9%	65.7%		64.9%	66.9%		65.8%
Employee Cost	(530)	(698)		(672)	(750)		(748)
% of net sales	5.8%	6.8%		6.3%	7.0%		6.4%
Other expenditure	(1,049)	(1,186)		(1,141)	(1,236)		(1,381)
% of net sales	11.5%	11.6%		10.7%	11.5%		11.8%
EBITDA	**1,796**	**1,623**	***-9.6%***	**1,933**	**1,554**	***-19.6%***	**1,873**
Margins	**19.7%**	**15.9%**		**18.1%**	**14.5%**		**16.0%**
Depreciation	(93)	(94)		(93)	(98)		(100)
EBIT	**1,702**	**1,529**	***-10.2%***	**1,840**	**1,456**	***-20.9%***	**1,773**
Margins	**18.7%**	**15.0%**		**17.2%**	**13.6%**		**15.2%**
Interest	(4)	(4)		(4)	(5)		(4)
Other Income	97	159		205	163		265
Other Operating Income	179	234		239	205		299
PBT	**1,974**	**1,918**	***-2.8%***	**2,281**	**1,819**	***-20.2%***	**2,334**
Margins	**21.7%**	**18.8%**		**21.4%**	**17.0%**		**19.9%**
Tax	(572)	(609)		(602)	(534)		(654)
Rate %	29.0%	31.8%		26.4%	29.3%		28.0%
Recurring PAT	**1,402**	**1,309**	***-6.7%***	**1,679**	**1,286**	***-23.4%***	**1,680**
Margins	**15.4%**	**12.8%**		**15.7%**	**12.0%**		**14.4%**
Exceptional	0	515		0	0		0
Tax Adjustment	0	(51)		0			0
Reported PAT	**1,402**	**1,772**	***26.3%***	**1,679**	**1,286**	***-23.4%***	**1,680**

Source: Company and Citi Investment Research and Analysis estimates

Figure 2. CIL 2QFY12 Segmental Sales

Year End Mar31 (Rsmn)	FY10	1Q11	2Q11	3Q11	4Q11	FY11	1Q12	2Q12
Power Generation	10,460	3,367	3,958	3,640	2,495	13,460	3,577	3,166
Growth						*29%*	*6%*	*-20%*
Industrial	4,330	1,274	1,385	1,040	1,801	5,500	1,226	1,302
Growth						*27%*	*-4%*	*-6%*
Automotive	2,590	364	792	520	654	2,330	654	1,187
Growth						*-10%*	*80%*	*50%*
Distribution	6,520	1,940	1,781	1,733	1,966	7,420	2,044	1,864
Growth						*14%*	*5%*	*5%*
Exports	4,330	2,155	2,760	2,650	2,686	10,260	2,719	3,179
Growth						*137%*	*26%*	*15%*
Parent Net Sales	**28,230**	**9,100**	**10,675**	**9,584**	**10,096**	**38,970**	**10,219**	**10,698**

Source: Company and Citi Investment Research and Analysis

Domestic sales growth and margin guidance revised down

- Though CIL has maintained the export growth guidance at 5-10%, the company has revised down the domestic growth guidance to 5-10% from 10-15% earlier.
- CIL's close competitor Kirloskar Oil Engines (KOEL) has also revised down sales growth guidance for FY12E twice this year from 15-20% (Post FY11) to 10% (Post 1Q12 results) to 0% (Post 2Q12 results)

Figure 3. CIL – Poorer Mix in 2Q12

kVA	Past	2Q12
< 160	20 - 25%	35%
160 - 380	20%	20%
400-625	15%	15%
750	45%	30%

Source: Citi Investment Research and Analysis

Figure 4. Cummins Sales Growth Guidance

	Post FY11	Post 1Q12	Post 2Q12
Domestic	25%	10-15%	5-10%
Exports	15%	5-10%	5-10%

Source: Company and Citi Investment Research and Analysis

- Management also believes that PBT margins could contract by 100bps over the next two quarters from the 17% levels at the end of 2Q12 as: (1) inflation seems to be leveling but pig iron continues to climb and (2) mix could be poor, similar to what it was in 2Q12 over next two quarters
- The impact of price increases in the earlier part of the year is already baked into the numbers now and hence cannot provide upside to margins. Management does not expect prices to come down.

Industry outlook remains muted

- Slowdown is clearly end-market related due to multiple rounds of interest rate hikes causing projects to get deferred, and a slowdown in real estate & infra projects.
- Base-load applications are smaller than stand-by applications (~65%), although the number of hours in stand-by applications can be quite significant (compared to American standards of 200 hours/year).
- Most segments are growing, albeit the rate of growth is coming off. The power generation segment has been impacted the most, followed by mining and construction. Telecom was high growth segment in the past but is now declining 15% (CIL has an exposure of only 10% to this segment). Retail and IT datacenters remain strong and are growing at 10%. Commercial realty has slowed down, but is still growing 3-4%, down from 10-15%. Infrastructure, which

was growing at 15%, is now growing at 6%. Auto, which was growing at 12%, is now growing at 8%. Hospitality continues to grow at 10%. Banking continues to grow at 5%.

- The water-well rig segment has gone into a cyclical decline. Generally it grows for three or four years and then corrects for two or three years. In mining, it did not see many tenders come to fruition this quarter

- Exports have grown faster than domestic orders in the short term. But one needs to be cautious (they tanked significantly in FY10). We expect here will be some downward pressure due to the global slowdown.

EPS revised downwards

We revise down our FY12E-14 EPS estimates by 17-20% to factor in:

- **5-8% lower sales:** For FY12E we factor in domestic growth of 5% (vs guidance of 5-10%) and export growth of 10% (vs guidance of 5-10%).

- **57-138bps margin contraction:** We assume EBITDA margins will contract from 14.5% in 2Q12 to 14.1% in 3Q12 to 13.6% in 4Q12. We also factor in 99bps and 66bps improvement in FY13E and FY14E.

Our estimates are 14-22% below consensus for FY12E-14E.

Figure 5. CIL – EPS Revision Table

	FY12E	FY13E	FY14E
Net Sales			
New	41,940	48,231	56,023
Old	44,000	51,578	61,107
Change	-4.7%	-6.5%	-8.3%
EBITDA Margins			
New	14.5%	15.5%	16.2%
Old	15.9%	16.4%	16.7%
Change	-138	-86	-57
PAT			
New	5,031	6,176	7,421
Old	6,250	7,463	8,958
Change	-19.5%	-17.2%	-17.2%
EPS			
New	18.1	22.3	26.8
Old	22.5	26.9	32.3
Change	-19.5%	-17.2%	-17.2%

Source: Citi Investment Research and Analysis estimates

Figure 6. CIL EPS – CIRA vs Consensus

Year End Mar31 (Rsmn)	FY12E	FY13E	FY14E
EPS	18.1	22.3	26.8
Consensus EPS	23.2	27.0	31.2
Difference	-21.7%	-17.4%	-14.1%

Source: Consensus data, Citi Investment Research and Analysis estimates

Cummins India

Company description

Cummins India Limited (CIL) is a 51% subsidiary of Cummins Inc., USA, the world's largest independent diesel engine designer and manufacturer above 200 HP. Set up in 1962, CIL is India's leading manufacturer of diesel engines with a range from 205 HP to 2365 HP and value packages serving the power generation, industrial and automotive markets. CIL also caters to the growing market for gas and dual fuel engines.

Investment strategy

We rate Cummins India as Sell given: (1) High inflation, interest rates hikes, diesel price hikes and Government policy inaction has led to a significant slowdown in infrastructure capex and industrial activity in the country. (2) Management has cut their growth guidance for FY12E twice already. Further, the economic outlook for the US and Europe has deteriorated post 1Q. (3) Competitor KOEL has also cut its sales growth guidance for FY12E twice. Domestic genset suppliers suggest 1Q/2Q FY12 was weak for sales and new inquiries have come down.

Valuation

Our target price of Rs334 on CIL is based on a target P/E multiple of 15x Mar-2013E, set in line with the average 15-year P/E of 15x (the stock has traded in a band of 7x to 26x over the same period). We believe our target P/E multiple is well supported by EPS CAGR of 8% over FY11-14E with average RoEs of ~ 29%.

Risks

Key upside risks that could prevent the stock from attaining our target price include: (1) Significant rebound in infrastructure and industrial capex; (2) Higher than expected sourcing by Cummins Inc. from CIL; (3) Significant rebound in the global economy; (4) Significant fall in diesel, pig iron and copper price and INR depreciation; and (5) Open offer by Cummins, similar to what happened in Siemens and Crompton.

Key downside risks to our target price include: (1) Price competition from unorganized segments; (2) Low-cost imports from China; (3) High diesel prices; (4) Alternative backup power sources like UPS and inverters; and (5) INR appreciation.

Appendix A-1

Analyst Certification

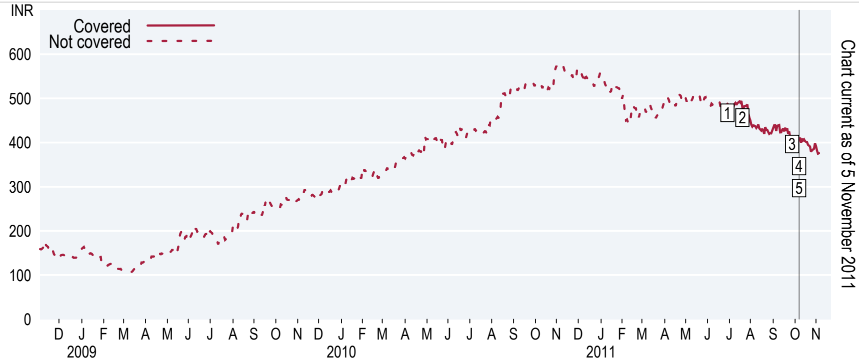
The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Cummins India (CUMM.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Venkatesh Balasubramaniam
Covered since June 29 2011



	Date	Rating	Target Price	Closing Price
1	29-Jun-11	*3L	*486.43	488.11
2	20-Jul-11	3L	*488.57	479.82

	Date	Rating	Target Price	Closing Price
3	28-Sep-11	3L	*387.00	412.95
4	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
5	7-Oct-11	*3	387.00	406.25

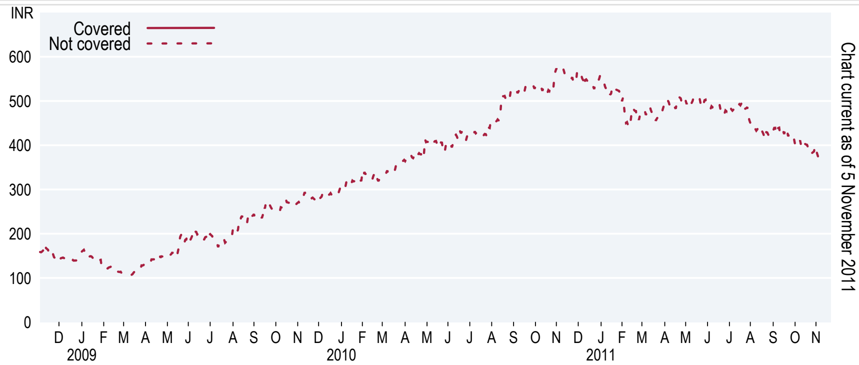
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Cummins India (CUMM.BO)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Venkatesh Balasubramaniam
Covered since June 29 2011



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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	12 Month Rating			*Relative Rating*		
Data current as of 10 Oct 2011	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Investment Research & Analysis Global Fundamental Coverage	59%	34%	7%	10%	79%	10%
% of companies in each rating category that are investment banking clients	45%	42%	37%	50%	43%	46%

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Prior to October 8, 2011, the firm's stock recommendation system included a risk rating and an investment rating. **Risk ratings,** which took into account both price volatility and fundamental criteria, were: Low (L), Medium (M), High (H), and Speculative (S). **Investment Ratings** of Buy, Hold and Sell were a function of CIRA's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating. Additionally, analysts could have placed covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and/or trading in the company's securities (e.g. trading suspension). Stocks placed "Under Review" were monitored daily by management and as practically possible, the analyst published a note re-establishing a rating and investment thesis. For securities in developed markets (US, UK, Europe, Japan, and Australia/New Zealand), investment ratings were:Buy (1) (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold (2) (0%-10% for Low-Risk stocks, 0%-15% for Medium-Risk stocks, 0%-20% for High-Risk stocks, and 0%-35% for Speculative stocks); and Sell (3) (negative total return). For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings were:Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).

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