

# Cummins India – SELL

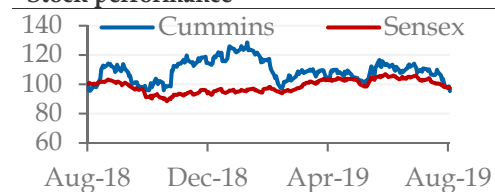
## Lackluster export outlook intensifies margin pressure

### Dismal performance on all front

Cummins India's (KKC) Q1FY20 revenue grew merely ~1% yoy, with domestic revenue (76% of sales) growing by ~16% yoy and exports (24% of sales) de-growing by 26% yoy. The domestic business was buoyed by strong demand from industrial (+37% yoy) and powergen (+9% yoy) segments whereas the exports business impacted by weak demand in low horsepower segment (-39% yoy). Gross margin came at 34% in Q1FY20, down 330bps yoy due to adverse sales mix, unfavorable currency movement and competitive pricing pressure. Though KKC has taken blended price hike of ~3% in Q1, EBITDAM nosedived 489bps yoy led by gross margin contraction and lower operating leverage.

### Cut earnings estimates by 22% as export outlook dampens

Despite of stronger domestic growth in Q1FY20, KKC has lowered its FY20 domestic sales growth guidance to 8-10% from 10-15% foreseeing demand slowdown from construction, powergen & marine segments. It has also slashed the export sales guidance with 12-15% dip in FY20 as export outlook remains weak and recovery looks elusive with uncertainties on the account of structural demand slowdown in Middle East, Asia (excl. China) & Africa markets. We expect KKC to face margin headwinds like unfavorable product mix (increasing share of industrial within domestic sales, lower export), pricing pressure due to stiff competition and rising other expenses owing to new product launches. Pricing pressure in India is worse than global levels so it would be difficult to control the material cost through price hikes. We are cutting our sales & EBITDA estimates by 9%/13% & 17%/19%, leading to EPS cut of 20%/22% in FY20/FY21 respectively. Hence, we downgrade the stock to 'SELL' with TP of Rs509 at 18x FY21E EPS.

CMP (Rs) 603		12-mths Target (Rs) 509		Downside 16%	
<b>Stock data</b> (As on August 8, 2019)		<b>Sector: Capital Goods</b>			
Sensex	37,327	<b>Stock performance</b>			
52 Week h/l (Rs)	884/603				
Market cap (Rs bn)	167	Aug-18 Dec-18 Apr-19 Aug-19			
Enterprise value (Rs bn)	166	<b>Shareholding pattern</b> (As of Jun'19 end)			
6m Avg t/o (Rs mn)	360	Promoter 51.0%			
FV (Rs)	2	FII+DII 36.9%			
Div yield (%)	2.6	Others 12.1%			
Bloomberg code	KKC IN				
BSE code	500480				
NSE code	CUMMINSIND				

### Exhibit 1: Result table (Standalone)

(Rs mn)	Q1FY20	Q1FY19	YoY (%)	Q4FY19	QoQ (%)
Net Revenue	13,430	13,280	1.1	13,404	0.2
EBITDA	1,514	2,147	(29.5)	1,718	(11.9)
EBITDA Margin (%)	11.3	16.2	(489.1)bps	12.8	(154.5)bps
Other Income	769	696	10.5	692	11.1
Depreciation	291	271	7.5	280	3.9
Interest	52	36	45.8	45	14.8
Profit before Tax	1,940	2,536	(23.5)	2,085	(6.9)
Tax	525	706	(25.6)	676	(22.3)
Reported PAT	1,415	1,830	(22.7)	1,409	0.4
Adjusted PAT	1,415	1,830	(22.7)	1,409	0.4
Net Margin (%)	10.5	13.8	(324.4)	10.5	2.3
Adjusted EPS	5.1	6.6	(22.7)	5.1	0.4

Source: Company, YES Sec - Research

## Exhibit 2: Cost analysis (Standalone)

As a % of net sales	Q1 FY20	Q1 FY19	bps yoy	Q4 FY19	bps qoq
COGS	66.0	62.7	325.3	65.8	20.5
Employee cost	10.2	9.5	71.6	10.0	19.8
Other expenses	12.5	11.6	92.2	11.4	114.2
Total costs	88.7	83.8	489.1	87.2	154.5

Source: Company, YES Sec – Research

### KKC cut domestic business growth guidance to 8-10%

While the domestic market has clearly shown signs of growth during Q1FY20 with 16% yoy growth, KKC's management seems less confident about domestic demand visibility in the rest of 9MFY20. Hence revised its domestic business growth guidance downwards to 8-10% from 10-15% earlier. In Q1FY20, compressor and railways steered 37% yoy growth for industrials. The power gen segment was supported by commercial realty, data centers and manufacturing industries, while residential realty remained weak as demand is mainly concentrated in affordable housing.

Management's long-term growth plans rest on the three pillars of market share, new products and emission norms. The company seeks to increase market share through better penetration and customer engagement. New product launches seek to offer innovation, better value and content growth. Stringent emission norms provide another significant opportunity as per the management. These efforts will likely increase R&D expenses of KKC for the next 2-3 years.

### Muted prospects for construction segment while compressor & rail segments expected to do well in FY20

KKC's industrial segment sales are directly linked to construction equipment sales. Therefore, strong growth momentum in construction equipment sales should translate into strong growth for the industrial

segment as well. Construction equipment sales volumes, in turn, are dependent on infrastructure awarding activities, hence a slowdown in core infra ordering leads to a decline in construction equipment sales volumes. Construction equipment sales typically peak one year after peak ordering, as this is the phase when contractors order equipment for the projects. Higher ordering activity leads to higher construction equipment sales and demand for back-up construction power. However, with a slowdown in awarding in recent quarters in key areas like highways, we expect muted prospects for KKC over FY19-FY21.

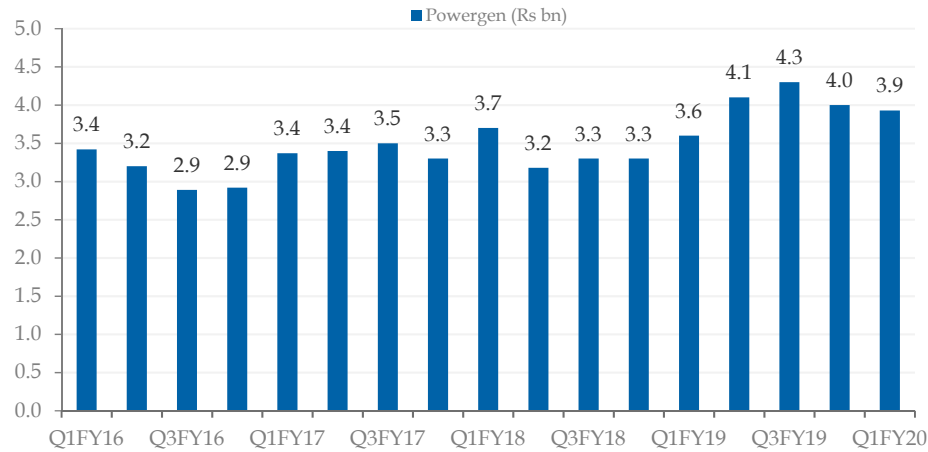
### Export demand recovery looks elusive

Export market demand recovery looks very difficult in medium term because prevailing uncertainties in various economies through the world & deteriorating macro conditions. LHP exports market size in ME and Africa have shrunk significantly from peak. Demand slowdown is visible across all geographies like Latin America, Asia excluding China and Middle east. We believe a pick-up in exports is very important for KKC considering its better margin profile.

### Price competition & cost headwinds to impact margins

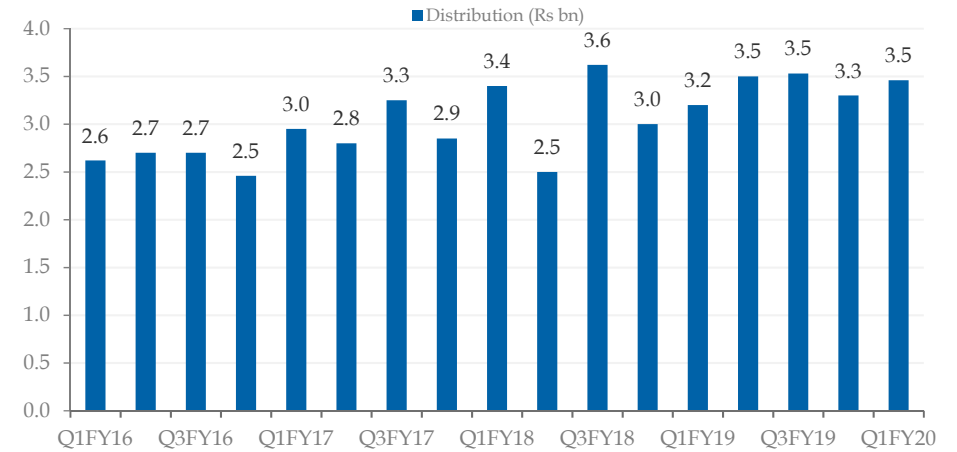
We believe that the industry has been facing pricing pressure at nearly all levels. However, this is not being seen globally, where although volume growth is substantially weaker than in India, pricing in USD terms has improved. We believe this can be attributed to weak volume growth in key segments (except HHP) as well as growing competition. With weak realization growth in recent years, we believe the industry may not have been successful at passing through cost increases to its customers; thus, squeezing EBITDA margins. While KKC has taken blended 3% price hikes across certain categories in Q1FY20, we believe the hike levels are inadequate to absorb the inflationary cost increases.

**Exhibit 3: Domestic Powergen revenue grew 9% yoy in Q1FY20**



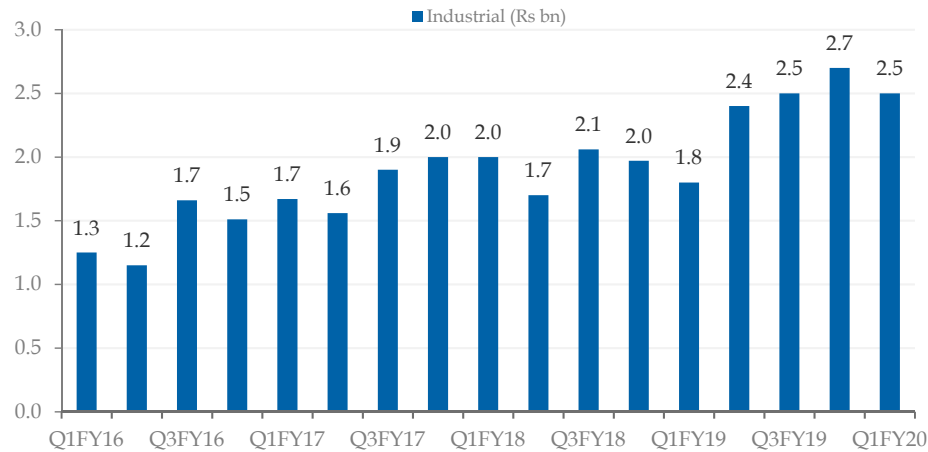
Source: Company, YES Sec - Research

**Exhibit 5: Distribution revenue grew 8% yoy in Q1FY20**



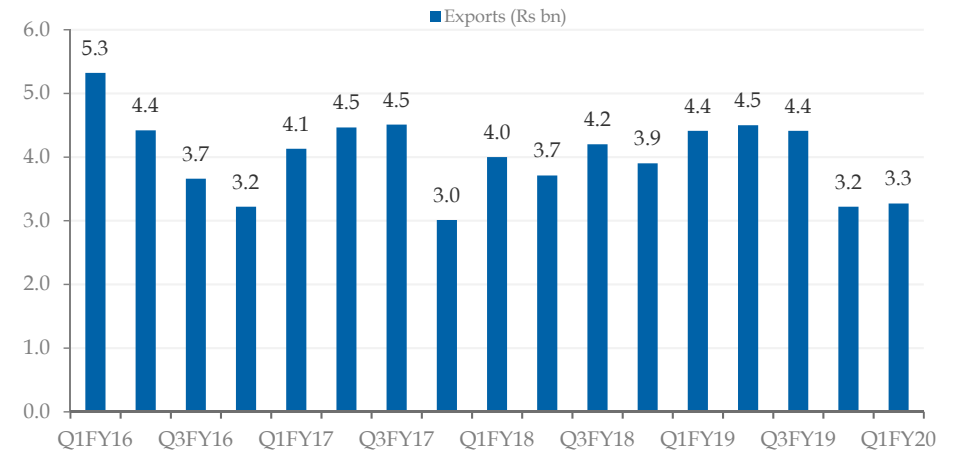
Source: Company, YES Sec - Research

**Exhibit 4: Industrial segment revenue grew 37% yoy in Q1FY20**



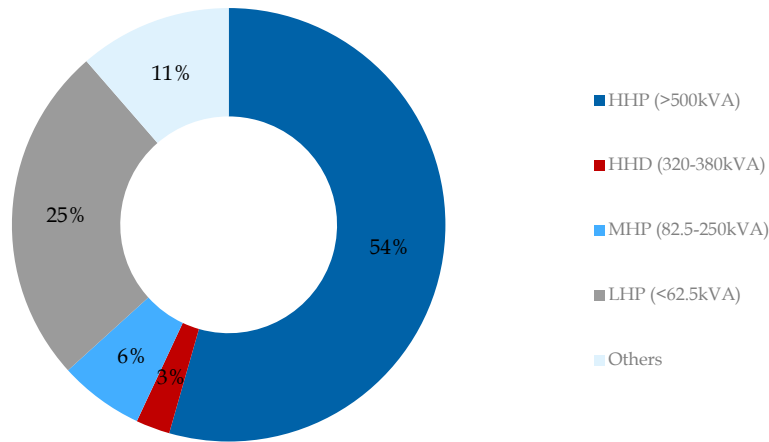
Source: Company, YES Sec - Research

**Exhibit 6: Export segment revenue dipped 26% yoy in Q1FY20**



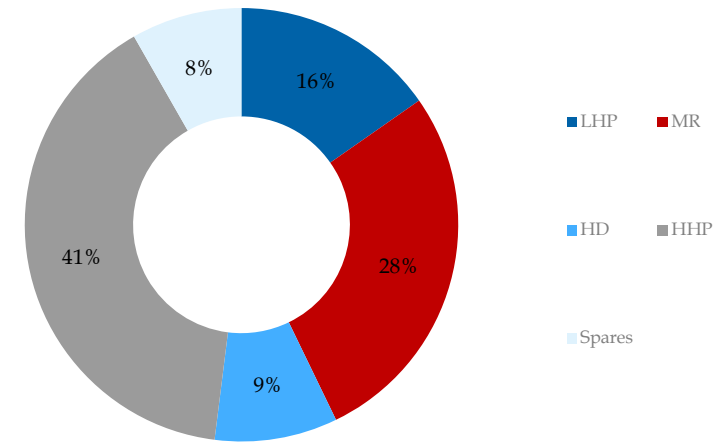
Source: Company, YES Sec - Research

**Exhibit 7: Powergen segment revenue mix in Q1FY20**



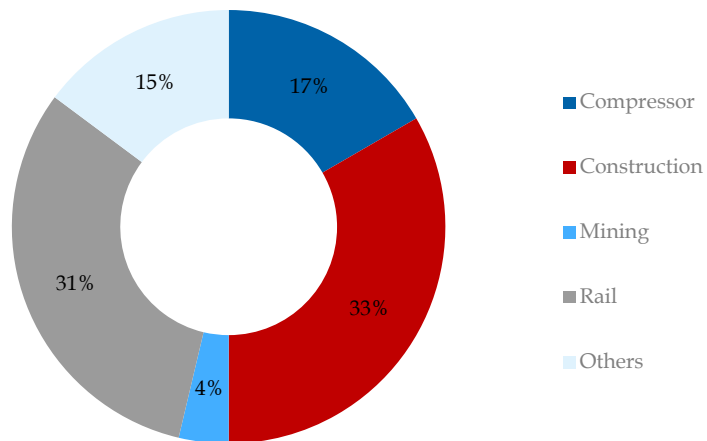
Source: Company, YES Sec - Research

**Exhibit 9: Export segment revenue mix in Q1FY20**



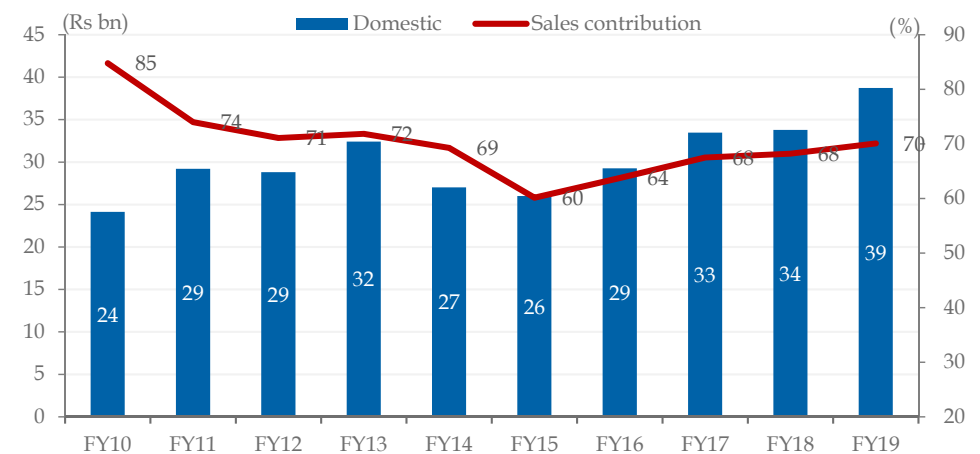
Source: Company, YES Sec - Research

**Exhibit 8: Industrial segment revenue mix in Q1FY20**



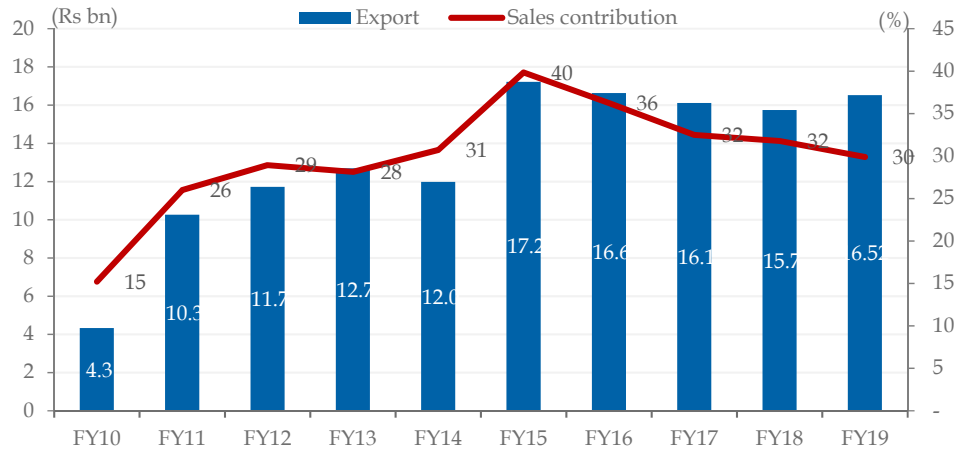
Source: Company, YES Sec - Research

**Exhibit 10: Domestic sales growth guidance at 8-10% in FY20E**



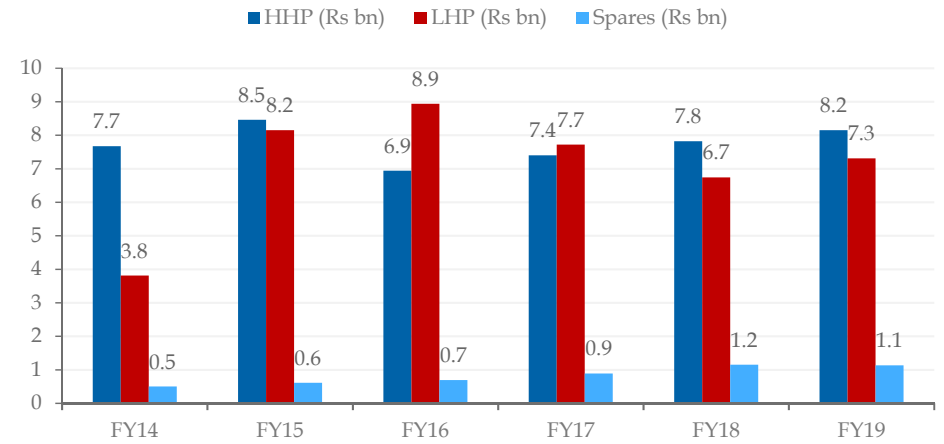
Source: Company, YES Sec - Research

**Exhibit 11: Export sales de-growth guidance at 12-15% in FY20E**



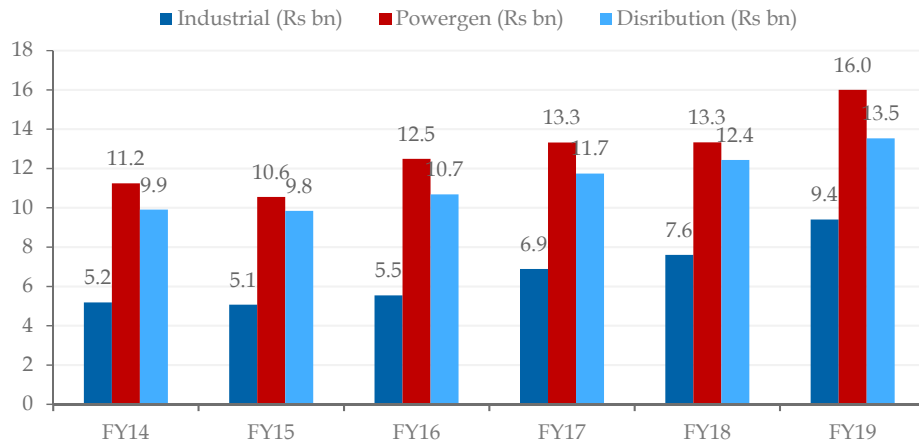
Source: Company, YES Sec - Research

**Exhibit 13: Export segments revenue growth trends**



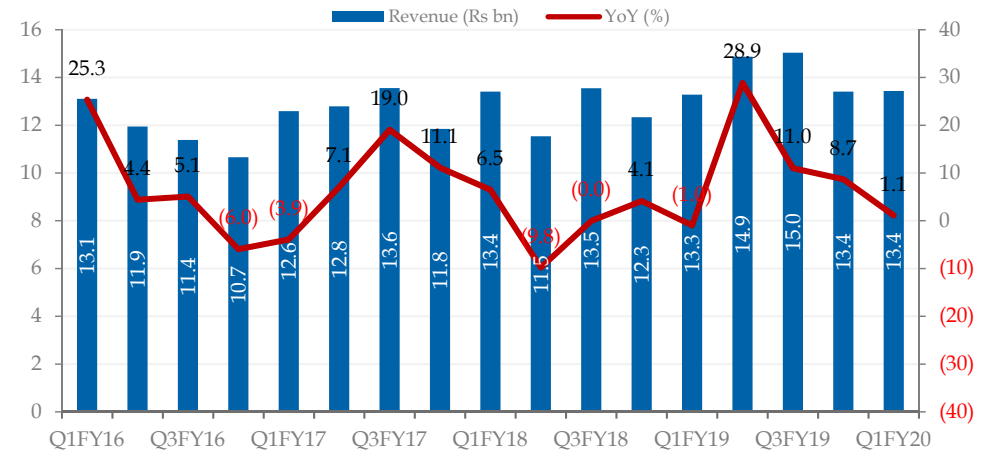
Source: Company, YES Sec - Research

**Exhibit 12: Domestic segments revenue growth trends**



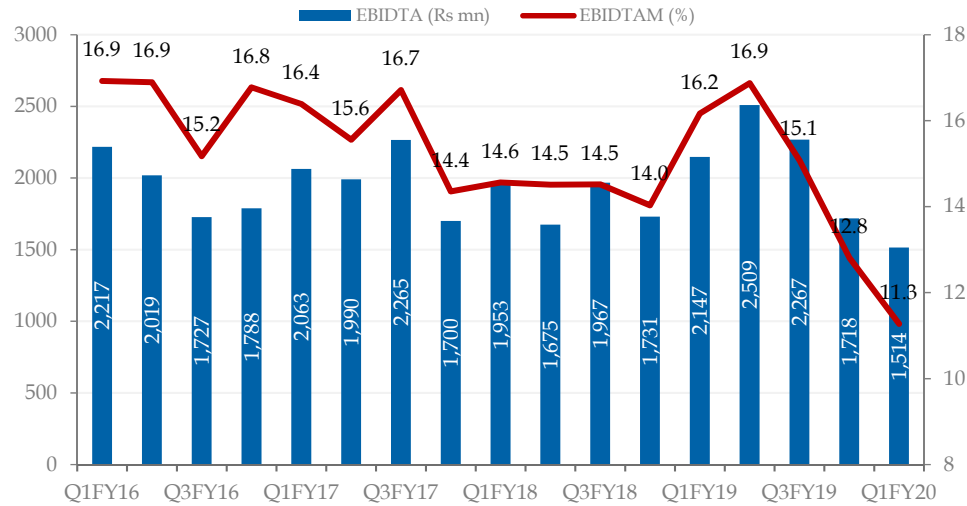
Source: Company, YES Sec - Research

**Exhibit 14: Q1FY20 revenues grew by 1.1% yoy**



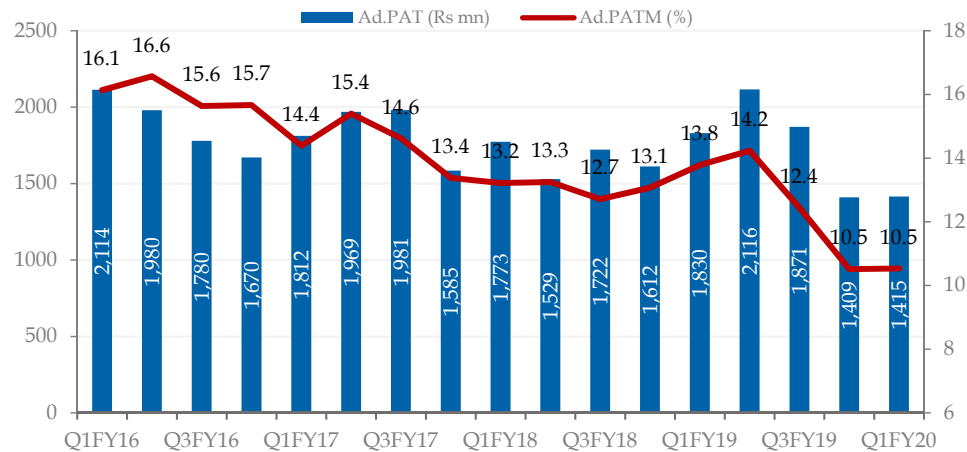
Source: Company, YES Sec - Research

**Exhibit 15: Unfavorable sales mix impacted Q1 gross margins**



Source: Company, YES Sec - Research

**Exhibit 16: Adjusted PAT decline by ~23% in Q1FY20**



Source: Company, YES Sec - Research

**Exhibit 17: Financial Summary**

Y/e 31 Mar (Rs mn)	FY17	FY18	FY19	FY20E	FY21E
Revenues	50,773	51,119	56,973	58,112	63,924
yoy growth (%)	7.8	0.7	11.5	2.0	10.0
EBITDA	8,018	7,329	8,691	8,136	9,141
EBITDAM (%)	15.8	14.3	15.3	14.0	14.3
Adjusted PAT	7,346	6,669	7,426	6,836	7,841
yoy growth (%)	(2.6)	(9.2)	11.3	(7.9)	14.7
EPS (Rs)	26.5	24.1	26.8	24.7	28.3
P/E (x)	28.5	31.4	28.2	24.5	21.3
P/BV (x)	5.6	5.3	5.1	3.6	3.2
EV/EBITDA (x)	20.7	22.6	19.1	20.4	18.1
Debt/Equity (x)	0.1	0.1	0.1	0.1	0.1
ROE (%)	20.3	16.9	17.8	17.0	17.8
ROCE (%)	24.4	21.1	23.5	17.3	18.5

Source: Company, YES Sec - Research

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