COMPANY UPDATE

CUMMINS INDIA

In a sweet spot

India Equity Research| Engineering and Capital Goods

Edelweiss
Ideas create, values protect

We recently interacted with Cummins India (KKC) management to get a sense on long-term business opportunities and key trends in the DG set industry. The company expects its domestic power gen business to sustain 15-20% volume growth given weak power availability and exports to surge in FY14. Further, its ability to successfully pass on costs and a moderating pig iron price scenario lend margin comfort. Building in better operating leverage and favourable cost-price dynamics we revise up KKC's FY13E and FY14E earnings by 2 and 7 %, building in 30bps and 100bps margin improvement. Maintain 'BUY' with a revised TP of INR 580

Powergen key earnings driver; new launches impart scalability

KKC is confident of the current domestic PG market growth rate sustaining on back of weak power availability in India. With an expected uptick in construction and mining, the company's industrial segment has the potential to grow 15-20% plus in FY14E. Also, it expects launch of QSK series (Pune), LHP generators plant (Phaltan, mainly to cater to global demand) and Urja gensets to spur revenue materially over FY13-16E.

Favourable cost-price dynamics add to margin comfort

The company announced two price hikes—June 2012 and w.e.f. January 2013E—across its DG sets portfolio upto 3%. It raised prices, despite intense competitive pressure from other MNC players like Perkins and MTU, solely to pass on the surge in pig iron and copper prices. Also, pig iron prices have moderate future outlook; this, we believe, lends KKC incremental margin comfort.

Outlook and valuations: Positive; maintain 'BUY'

We believe, KKC has the potential to spring a positive surprise on the Street over the next two years with superior operating leverage as utilisation levels for newly introduced products. Also, with its ability to successfully pass on costs, the company is slated for an improved margin in a moderating pig iron price scenario. We raise our target price to INR580 (from INR541). The stock currently trades at a P/E of 21.6x & 17.8x its FY13E & FY14E EPS respectively. Maintain **'BUY/SO'** recommendation /rating.

Financials

Year to March	FY11	FY12	FY13E	FY14E
Revenue (INR mn)	39,454	41,172	44,984	53,175
Rev. growth (%)	*38.7*	*4.4*	*9.3*	*18.2*
EBIDTA (INR mn)	6,635	6,973	7,876	9,699
Net profit (INR mn)	5,910	5,912	6,514	7,882
Shares outstanding (mn)	277	277	277	277
EPS (INR)	21.3	19.5	23.5	28.4
EPS growth (%)	*33.2*	*(8.7)*	*20.7*	*21.0*
P/E (x)	23.8	26.0	21.6	17.8
EV/ EBITDA (x)	20.0	19.0	16.8	13.6
ROAE (%)	35.1	28.0	29.9	31.4

EDELWEISS 4D RATINGS

Absolute Rating	**BUY**
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Low
Sector Relative to Market	Overweight

MARKET DATA *(R: CUMM.BO, B: KKC IN)*	
CMP	: INR 507
Target Price	: INR 580
52-week range (INR)	: 538 / 322
Share in issue (mn)	: 277.2
M cap (INR bn/USD mn)	: 141 / 2,563
Avg. Daily Vol.BSE/NSE('000)	: 301.3

SHARE HOLDING PATTERN (%)

	Current	Q1FY13	Q4FY12
Promoters*	51.0	51.0	51.0
MF's, FI's & BK's	21.9	21.6	21.0
FII's	12.5	12.8	13.3
Others	14.7	14.6	14.7

** Promoters pledged shares (% of share in issue) : NIL*

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Capital Goods Index
1 month	5.8	3.4	12.5
3 months	11.0	5.4	2.5
12 months	50.2	23.4	(14.2)

Amit Mahawar
+91 22 4040 7451
amit.mahawar@edelweissfin.com

Rahul Gajare
+91 22 4063 5561
rahul.gajare@edelweissfin.com

Swarnim Maheshwari
+91 22 4040 7418
swarnim.maheshwari@edelweissfin.com

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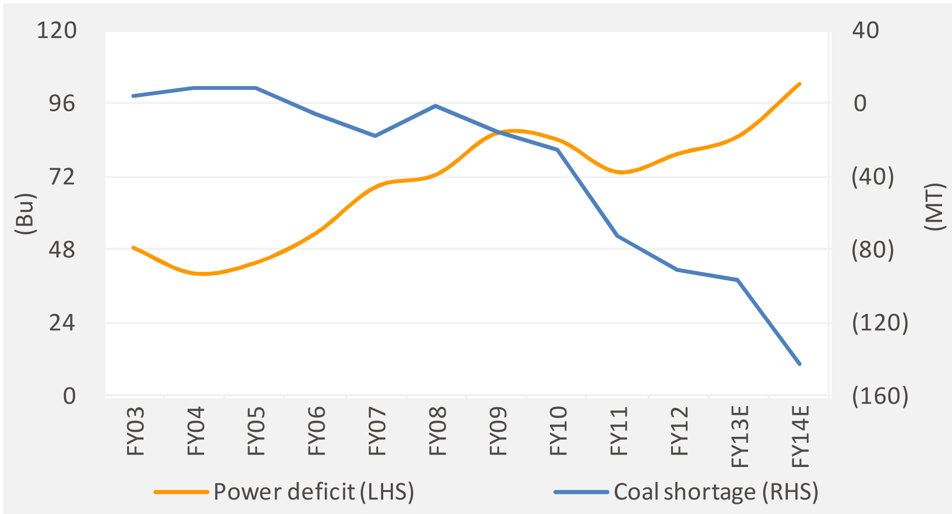
Key growth drivers

- **Weak power availability to drive Power Gen demand in near to medium term**

  Coal demand from the power sector continues to be robust due to huge investments in power capacity addition over the past few years. Coal India is finding it difficult to scale up production on account of delays in environmental clearances, land acquisition problems, etc. As a domino effect, India's power deficit is likely to remain high. The country is facing acute power shortage, primarily in South, and lately in North and East India, which has catapulted demand for DG sets (20% growth in FY13 YTD). This augurs well for KKC, given its exposure to the power gen market segment (50% of the total Engine revenues).

Chart 1: Power deficit to sustain



Source: Ministry of Power & Coal, Edelweiss research

- **Growth in Office space and multiplexes to remain healthy**
  - AS per Jones Lang Lassale, commercial space is expected to post a robust uptick in CY13E after an expected sharp dip in CY12.
  - As per FICCI KPMG research, the multiplex industry is expected to double multiplex screens over the next five years, implying a CAGR of 14% per annum. It entails business opportunity for DG sets market.

Chart 2: Multiplex screens to double over the next 4 years

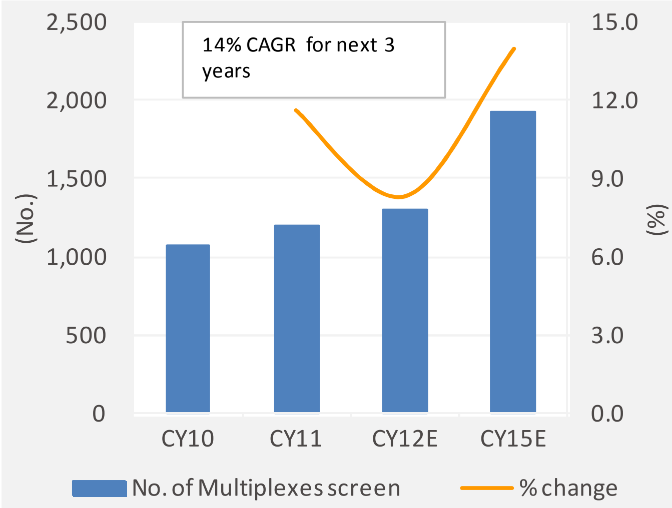
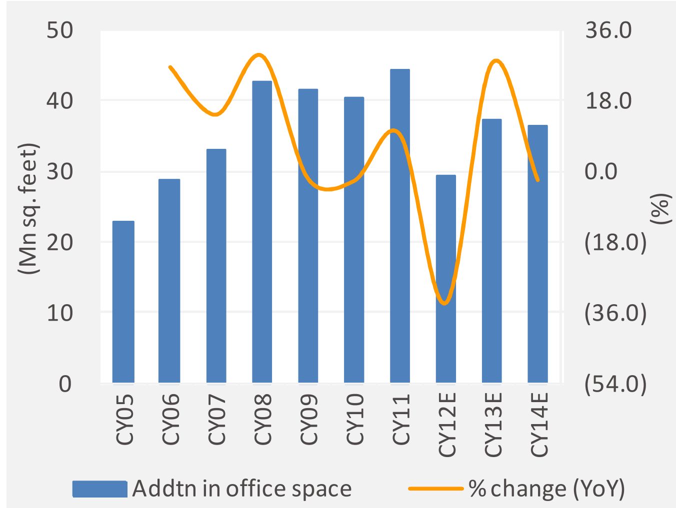


Chart 3: Office space expected to grow by 30% next year

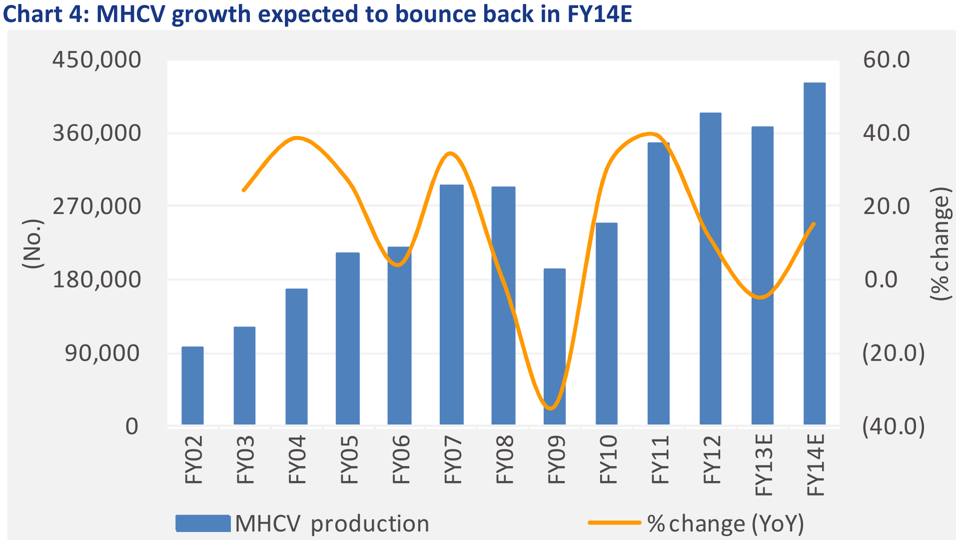


Source: Jones Lang Lassalle, FICCI-KPMG & Edelweiss research

- **MHCV growth to pick up in FY14E**

  Structural changes like rising trading activities, continuous gain of market share from railways and improving profitability of truck operators can spurt demand of MHCV segment positively. Our auto team expects 15% growth in FY14E after an expected 5% decline in FY13E.

Chart 4: MHCV growth expected to bounce back in FY14E



Source: Edelweiss research

- **Better equipped to cater to changing industry demand trends**
  - CPCB II norms are expected to come into effect from H2FY14 for engines up to 800 kw, with significant reductions targeted in emission levels (see table below).
  - KKC is better equipped to comply with the changing emission norms and also proactively launch new improved engine models in tandem with market trends (see table below).
  - Manufacturing of QSK series at Kothrud (Pune) is to comply with CPCB II norms and also to address increasing shift in demand from mechanical to electronic engines.

Table 1: DG Sets Emission Regulations in India

	Exising norms (g/kW-hr)			Future Norms : CPCB 2(g/kW-hr)			
Applicable for Engines below 800 kWm	Nox + HC	CO	PM	Nox + HC	CO	PM	Smoke
0-19KW	10.5	3.5	0.3	7.5	3.5	0.3	0.7
19-36KW	10.5	3.5	0.3	4.7	3.5	0.3	0.7
37-75KW	10.5	3.5	0.3	4.7	3.5	0.3	0.7
75-129KW	10.5	3.5	0.3	4.0	3.5	0.2	0.7
130-560KW	10.5	3.5	0.3	4.0	3.5	0.2	0.7
561-800KW	10.5	3.5	0.3	4.0	3.5	0.2	0.7

Source:CPCB

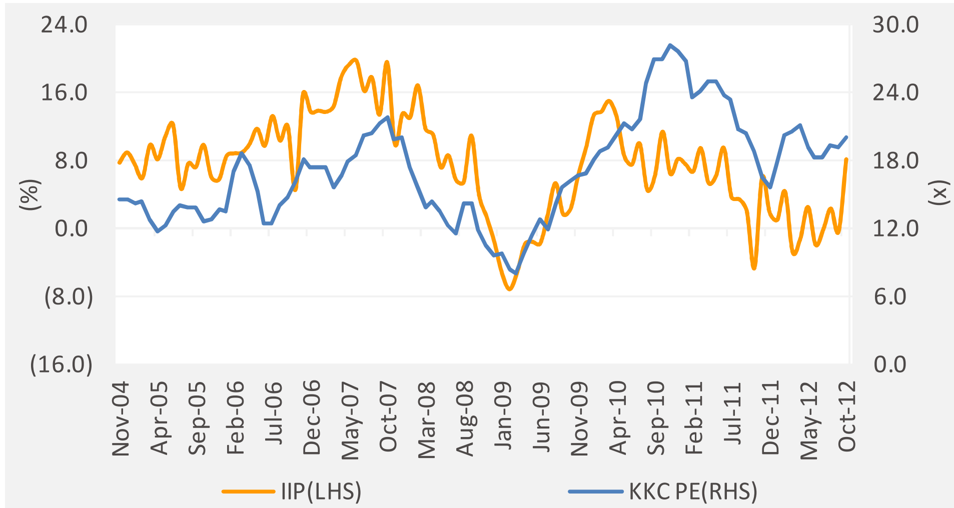
Table 2: Strong parentage equips KKC to proactively respond to changing industry trends

Segment	Introduction
Power Gen (FY09)	X-3.3 ltrs (Engine)
Power Gen	QSK23 - 750KVA (Engine)
Power Gen (FY10)	7.5/10KVA (DG Set)
Power Gen	40KVA -160KVA for Exports (DG Set)
Power Gen (FY11)	QSK50 - For Exports (Engine)
Power Gen (FY12)	S3.8 Series - 40to 75KVA 9DG Set)
Power Gen	6BTA5.9 Series - 90-125KVA (DG Set)
Industrial	14ltr & 19 ltr - high pressure water well drilling segment
Power Gen	QSK50G - For Exports (DG set)

Source: Company, Edelweiss research

- **Key comparisons for KKC**
  - With DG sets and internal combustion engines having application across broad basket of industrial, mining, construction, auto, manufacturing etc., KKC is a play on broad-based recovery in investment.

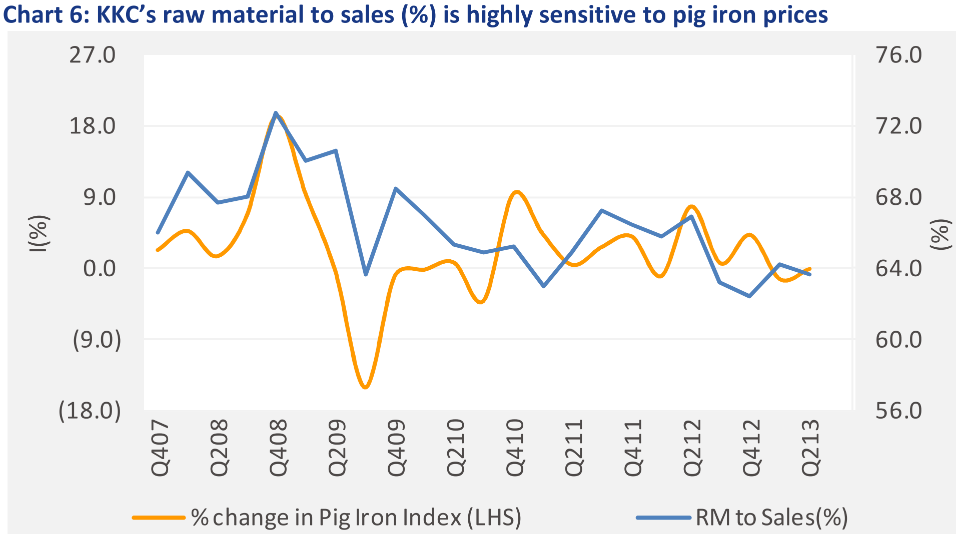
Chart 5: KKC has a strong co-correlation with IIP data



Source: Edelweiss research

- KKC's raw material to sales is directly linked with pig iron price movement. With a moderate outlook on pig iron prices and price hike effected by the company, we expect KKC's margin to further improve by 30bps & 100bps in FY13E to FY14E.

Chart 6: KKC's raw material to sales (%) is highly sensitive to pig iron prices



Source: Bloomberg & Edelweiss research

Table 3: Key assumptions

Sector revenues	2009	2010	2011	2012	2013E	2014E	Remark
Power	9,970	10,461	13,495	12,562	15,074	18,089	Sustained power shortages in the country will continue to drive Power gen reveneues
% change		*4.9*	*29.0*	*(6.9)*	*20.0*	*20.0*	
Industrial	3,550	4,400	5,588	5,268	5,005	6,006	We expect a pick up on rate sensitives industrial segment on the back of rate cuts and demad pick up over the next 1year
% change		*23.9*	*27.0*	*(5.7)*	*(5.0)*	*20.0*	
Auto	1,060	2,600	2,600	2,431	2,309	2,725	Our auto team expects a recovery in the MHCV cycle in FY14E.
% change		*145.3*	*-*	*(6.5)*	*(5.0)*	*18.0*	
Distribution	7,590	8,860	10,116	11,450	12,824	15,132	Sustained growth in the installed capacity of DG's and ICE's to drive distribution revenues
% change		*16.7*	*14.2*	*13.2*	*12.0*	*18.0*	
Total domestic revenues	**22,170**	**26,321**	**31,799**	**31,711**	**35,212**	**41,952**	
% change		*18.7*	*20.8*	*(0.3)*	*11.0*	*19.1*	
Exports	13,129	4,883	10,604	11,908	12,503	14,378	Expected to pick up in F14 on the back of demand revival in MEENA , Europe & South America . Also LHP Gen sets from Phaltan to contribute start contributing materially from FY14E
% change		*(62.8)*	*117.2*	*12.3*	*5.0*	*15.0*	
Total reveneus	**35,299**	**31,204**	**42,403**	**43,619**	**47,715**	**56,331**	
% change		***(11.6)***	***35.9***	***2.9***	***9.4***	***18.1***	

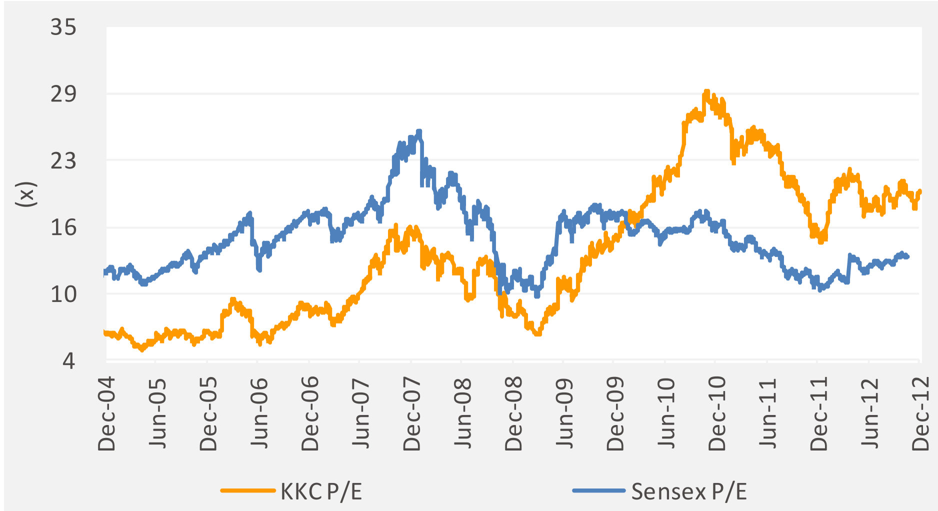
Source: Edelweiss research

Outlook & valuation: Improving visibility to sustain premium valuations

KKC's dominant positioning in the DG set market (especially in mid and high HP) makes it an optimal play on the weak power availability story. The company has exhibited strong operating leverage on improving volumes and has also shown its ability to take price hikes to pass on cost rises (especially pig iron). We believe, KKC's superior EBIDTA margin will be maintained given sustainable volume growth in domestic high HP power generation with contribution from high margin QSK series engines, moderate outlook for pig iron prices and impact of price hikes. Also, LHP generator exports could add INR12-14bn by FY15-16E, which imparts scalability over and above current export volumes.

We maintain our **'BUY/Sector Outperformer'** recommendation/rating on the stock with a revised target price of INR575/share, assigning 20.0x PE on FY14E earnings (premia to historical average PE of 15.2x). Dominant business positioning, long-term scalability and superior return ratios, we believe, justify KKC's premium valuations. (Show exhibit: KKCs PE vs Sensex)

Chart 7: KKC vs Sensex 1 year fwd P/E



Source: Edelweiss research

Table 4: Change in Estimates

	FY13E			FY14E			
	New	Old	% change	New	Old	% change	Comments
Net revenue	44,984	44,984	*0.0*	53,175	53,175	*0.0*	
EBITDA	7,876	7,732	*1.9*	9,699	9,134	*6.2*	.
EBITDA margin	*17.5*	*17.2*		*18.2*	*17.2*		Improved utilization levels, moderate outlook of pig iron prices and price hike taken in DG sets.
Core profit	6,514	6,395	*1.9*	7,882	7,390	*6.7*	Due to improvement in EBITDA margins.
PAT margin	*14.5*	*14.2*		*14.8*	*13.9*		
Capex	2,600	2,600	*0.0*	2,600	2,600	*0.0*	

Company Description

KKC is a subsidiary of Cummins, US, which holds 51% stake in the company. It is a leading manufacturer of medium-high HP range of diesel engines in India with manufacturing facilities in Pune, Phaltan, Daman etc.

Investment Theme

KKC is a play on the multiple segments of power requirement, rising mobile penetration across rural and suburban geographies, strong coal requirement (driving demand in mining), and continued growth in automobile sales on the back of large potential in environment-friendly natural gas fuel-based engines. The company is a major outsourcing hub for its parent, especially in the LHP generators & High HP engines. We expect KKC to benefit from growth in the above segments. Furthermore, KKC will benefit from Phaltan expansion which should cater to KKC's growing business demands over the next 5-6 years.

Key Risks

- Any major slowdown in the domestic market (70% of the total revenues) would pose a significant down side risk to our estimates.
- Significant improvement in overall power availability in India could impact overall power generation demand for Cummins India over medium term.
- Increased competitive intensity, particularly in HHP segment which contributes more than 55% to KKC's power gen revenues.

Financial Statements

Key Assumptions

Year to March		FY10	FY11	FY12	FY13E	FY14E
Macro -	GDP(Y-o-Y %)	8.4	8.4	6.5	5.5	6.5
	Inflation (Avg)	3.6	9.9	8.8	7.8	6.0
	Repo rate (exit rate)	5.0	6.8	8.5	7.5	6.8
	USD/INR (Avg)	47.4	45.6	47.9	53.5	52.0
Company -	Domestic sales growth (%)	9.4	13.6	(0.8)	12.0	16.0
	Export sales growth (%)	(62.8)	117.2	12.3	5.0	15.0
	Change in realisation in ICE (%)	(13.4)	7.8	2.0	3.0	5.0

Income statement (INR mn)

Year to March	FY10	FY11	FY12	FY13E	FY14E
Income from operations	28,449	39,454	41,172	44,984	53,175
Materials costs	18,555	26,291	26,454	28,618	33,587
Employee costs	1,953	2,546	3,039	3,274	3,849
Other manufacturing expenses	2,667	3,983	4,706	5,216	6,040
Total operating expenses	23,174	32,820	34,200	37,108	43,476
EBITDA	5,274	6,635	6,973	7,876	9,699
Depreciation & Amortization	361	366	420	549	662
EBIT	4,914	6,268	6,553	7,327	9,037
Other income	1,216	1,774	1,233	1,649	1,841
Interest expenses	21	19	54	53	81
Profit before tax	6,109	8,024	7,732	8,924	10,797
Provision for tax	1,670	2,114	2,334	2,409	2,915
Net profit	4,438	5,910	5,398	6,514	7,882
Extraordinary income/ (loss)	192	-	514	-	-
Profit After Tax	4,630	5,910	5,912	6,514	7,882
Shares outstanding (mn)	277	277	277	277	277
Diluted EPS (INR)	16.0	21.3	19.5	23.5	28.4
Dividend payout (%)	53.8	50.3	56.5	51.1	42.2

Common size metrics - as % of net revenues

Year to March	FY10	FY11	FY12	FY13E	FY14E
Operating expenses	65.2	66.6	64.3	63.6	63.2
EBITDA margins	18.5	16.8	16.9	17.5	18.2
Net profit margins	15.6	15.0	13.1	14.5	14.8

Growth ratios (%)

Year to March	FY10	FY11	FY12	FY13E	FY14E
Rev. growth (%)	(13.9)	38.7	4.4	9.3	18.2
EBITDA	10.5	25.8	5.1	13.0	23.1
Net profit	7.1	33.2	(8.7)	20.7	21.0

Balance sheet					(INR mn)
As on 31st March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Equity capital	396	396	554	554	554
Reserves & surplus	15,214	17,667	19,877	22,526	26,543
Shareholders funds	15,610	18,063	20,432	23,080	27,097
Secured loans	86	183	-	300	600
Borrowings	86	183	-	300	600
Deferred tax (net)	169	187	70	70	70
Sources of funds	**15,696**	**18,245**	**20,432**	**23,380**	**27,697**
Gross block	7,776	9,144	9,703	12,203	14,703
Depreciation	4,440	4,734	5,054	5,603	6,265
Net block	3,337	4,411	4,649	6,600	8,438
Capital work in progress	-	-	497	597	697
Total fixed assets	3,337	4,411	5,146	7,197	9,135
Investments	7,329	7,255	5,976	5,976	5,976
Inventories	4,099	5,190	5,676	5,880	6,901
Sundry debtors	5,229	7,182	8,436	9,178	10,826
Cash and equivalents	559	1,037	2,235	2,940	3,715
Loans and advances	2,695	3,297	3,429	3,601	3,781
Other current assets	92	99	50	99	99
Total current assets	12,674	16,804	19,826	21,697	25,321
Sundry creditors and others	5,178	7,109	6,849	8,232	9,478
Provisions	2,634	3,303	3,736	3,326	3,326
Total current liabilities & provisions	7,812	10,411	10,585	11,559	12,804
Net current assets	4,862	6,393	9,241	10,138	12,517
Uses of funds	**15,696**	**18,245**	**20,432**	**23,380**	**27,697**
Book value per share (INR)	56.3	65.2	73.7	83.3	97.8

Free cash flow					(INR mn)
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Net profit	4,630	5,910	5,912	6,514	7,882
Depreciation	361	366	420	549	662
Deferred tax	61	(17)	-	-	-
Others	(1,528)	(610)	(1,082)	53	81
Gross cash flow	3,524	5,648	5,250	7,116	8,625
Less: Changes in WC	(2,236)	1,355	825	193	1,604
Operating cash flow	5,759	4,293	4,425	6,923	7,021
Less: Capex	362	1,479	2,281	2,600	2,600
Free cash flow	**5,397**	**2,814**	**2,144**	**4,323**	**4,421**

Cash flow metrics					
Year to March	**FY10**	**FY11**	**FY12**	**FY13E**	**FY14E**
Operating cash flow	5,759	4,293	4,425	6,923	7,021
Investing cash flow	(3,368)	(1,326)	77	(2,600)	(2,600)
Financing cash flow	(2,155)	(3,049)	(3,506)	(3,618)	(3,646)
Net cash flow	236	(82)	997	705	775
Capex	(362)	(1,479)	(2,281)	(2,600)	(2,600)
Dividends paid	(2,775)	(3,002)	(3,452)	(3,865)	(3,865)

Profitability & efficiency ratios

Year to March	FY10	FY11	FY12	FY13E	FY14E
ROAE (%)	30.0	35.1	28.0	29.9	31.4
ROACE (%)	32.9	36.9	33.9	33.4	35.4
Inventory day	81	72	78	75	75
Debtors days	67	66	75	74	74
Payable days	102	99	94	105	103
Fixed asset turnover (x)	6.9	7.4	6.6	5.2	4.8
Average working capital turnover	4.9	7.0	5.3	4.6	4.7
Net Debt/Equity	(0.5)	(0.4)	(0.4)	(0.4)	(0.3)

Operating ratios

Year to March	FY10	FY11	FY12	FY13E	FY14E
Total asset turnover	2.5	3.4	3.1	2.8	2.8
Fixed asset turnover	8.9	10.2	9.1	8.0	7.1
Equity turnover	1.9	2.3	2.1	2.1	2.1

Valuation parameters

Year to March	FY10	FY11	FY12	FY13E	FY14E
Diluted EPS (INR)	16.0	21.3	19.5	23.5	28.4
Y-o-Y growth (%)	*7.1*	*33.2*	*(8.7)*	*20.7*	*21.0*
CEPS (INR)	17.3	22.6	21.0	25.5	30.8
Diluted PE (x)	31.7	23.8	26.0	21.6	17.8
Price/BV (x)	9.0	7.8	6.9	6.1	5.2
EV/Sales (x)	4.7	3.4	3.2	2.9	2.5
EV/EBITDA (x)	25.2	20.0	19.0	16.8	13.6

Peer comparision valuations

			PE (x)		P/BV (x)		ROE (%)	
Name of the companies	CMP	Market cap (USD mn)	2013E	2014E	2013E	2014E	2013E	2014E
Kirloskar Oil Engines	192	532	13.8	12.9	2.0	1.7	15.6	16.7
Greaves cotton	74	332	10.2	11.7	2.2	1.9	22.3	22.8
Cummins India	507	2,555	21.6	17.8	6.1	5.2	29.9	31.4

Source: Bloomberg, Edelweiss research

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
ABB India	REDUCE	SU	L	Bajaj Electricals	HOLD	SP	M
BGR Energy	REDUCE	SU	M	Bharat Electronics	BUY	SO	H
Bharat Heavy Electricals	HOLD	SP	L	Crompton Greaves	HOLD	SP	M
Cummins India	BUY	SO	L	Havells India	HOLD	SP	M
Jyoti Structures	HOLD	SP	M	Kalpataru Power	HOLD	SP	M
KEC International	BUY	SO	M	Larsen & Toubro	BUY	SO	M
Siemens	HOLD	SO	L	Sterlite Technologies	HOLD	SP	H
Techno Electric & Engineering	BUY	SO	M	Thermax	REDUCE	SP	L
Voltamp Transformers	REDUCE	SU	M	Voltas	HOLD	SP	L

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

Edelweiss Securities Limited, Edelweiss House, off C.S.T. Road, Kalina, Mumbai – 400 098.
Board: (91-22) 4009 4400, Email: *research@edelcap.com*

Vikas Khemani	Head Institutional Equities	vikas.khemani@edelweissfin.com	+91 22 2286 4206
Nischal Maheshwari	Co-Head Institutional Equities & Head Research	nischal.maheshwari@edelweissfin.com	+91 22 4063 5476
Nirav Sheth	Head Sales	nirav.sheth@edelweissfin.com	+91 22 4040 7499

Coverage group(s) of stocks by primary analyst(s): Engineering and Capital Goods

ABB India, BGR Energy, Bharat Electronics, Bharat Heavy Electricals, Bajaj Electricals, Crompton Greaves, Havells India, Jyoti Structures, KEC International, Cummins India, Kalpataru Power, Larsen & Toubro, Siemens, Sterlite Technologies, Techno Electric & Engineering, Thermax, Voltamp Transformers, Voltas

Recent Research

Date	Company	Title	Price (INR)	Recos
14-Dec-12	**Thermax**	In search of broad-based revival; *Visit Note*	604	Reduce
14-Dec-12	**Larsen and Toubro**	Urea investment policy to spur business opportunity; *EdelFlash*	1,626	Buy
26-Nov-12	**Engineering & Capital Goods**	Woes intensify; Policy traction holds the key; *Result Review*		

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution* * - stocks under review	118	46	17	181

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	117	57	7

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

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