This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
Governance: Corporate Governance Issues

Cash Flow Concerns Grow While Insiders Cash Out
Cummins Inc. (NYSE:CMI)

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Cummins Inc. designs, manufactures, distributes and services diesel and natural gas engines, electric power generation systems and engine-related products, including filtration and emissions solutions, fuel systems, controls and air handling systems. It is organized into four business segments. The Engine segment produces engines and parts for sale to customers in automotive and various industrial markets. The Power Generation segment is a provider of power systems, selling engines, generator sets and alternators. It also offers rental of power equipment for both standby and prime power uses. The Filtration and Other segment is engaged in the sale of filtration products, exhaust systems and turbochargers. The International Distributor segment includes Company-owned distributorships engaged in selling engines, generator sets and service parts, performing service and repair activities on the Company's products and maintaining relationships with various original equipment manufacturers.

Summary of 3DAdvisors Findings for CMI

- **Accounting:** Lots of reasons to be concerned about cash flow
- **Insider Trading:** 10b5-1 used as an excuse for big holdings reductions
- **Insider Trading:** Company admits buying shares directly from insiders
- **Accounting:** Contingent liabilities and limited financing options
- **Accounting:** FIN 46 effects add to debt levels

Discussion of 3DAdvisors Findings

Our analysis designed to identify specific anomalistic insider trading behavior planted Cummins Inc. near the center of our radar screens last week, prompting us to highlight their unusual and significant selling in our most recent *Insider Research Bulletin* (5/07/04). The next step in our research process, a thorough examination of accounting and governance behavior, revealed a company that continues to grapple with significant cash flow issues while facing very limited financing opportunities. There are a number of problems and contingencies that could come into play should an anticipated upturn in sales and revenue not provide adequate cash generation. In the face of these concerns and certain related behaviors, we have found it extremely interesting that, adding spice to the insider selling, the Company acknowledges it is buying shares from employees outside of its authorized share repurchase program.

Accounting: Lots of reasons to be concerned about cash flow

Cummins struggles to get its financial ratings back up to "Investment Grade" and although S&P recently upgraded the Company's BB+ rating outlook from "Negative" to "Stable", the caveat seems to be that the upgrade is "based on improving operating performance and recovering industry fundamentals that should result in stronger earnings and cash generation." In the May 3rd upgrade announcement, S&P goes on to explain that "anticipated sizable free cash flow generation is expected to be largely earmarked for debt reduction, enabling the firm to reduce its overall debt and debt-like burden."

Of course, this all causes one to wonder what the picture would be like should the expected turn-around in cash flow prove illusory. With regards to this possibility, Cummins' management faces a number of concerns: First, it is quite evident that a big portion of the Company's earnings contribution is non-cash, being derived from Cummins' equity portion of its various Joint Ventures and other investments. Indeed, $54 million (60%) of the Company's $90 million pretax 2003 net came from non-cash income from such entities. Though this improved some in Q1 of 2004, where 12% of net came from these entities, the "improvement" may be illusory as Q1's (of 2004) $9 million non-cash income recorded from Joint Ventures and other investments tracked closely to the $7 million booked for the Q1 of 2003, only to pick up dramatically in subsequent quarters.

But there's more to the Cummins cash flow picture. The pension fund, where the Company provides no advance funding for Other Postretirement Benefits (read: there are no established Plan Assets for the postretirement benefit plans) continues its "pay as you go" practices, which continue to require large amounts of cash. Pension contributions, which drained $118 million from Cummins cash balances in 2003, will not abate in 2004 as the Company contributed $23 million to the plan in Q1 plus an additional $8 million in retirement benefits. The Q1 10-Q discloses that the Company will contribute an additional $102 million to the Pension for the year (a $5 million increase over the estimate given by the Company at 12/31/03), plus an additional $55 million in claims and premiums for postretirement benefits during the remainder of the year.

Then there's the big increase in Q1 payables, which jumped to $765 million vs. $557 (37% increase) million at year-end. This was much higher than the payables increase for the same period of 2003, which were up 23% from Y/E 2002. In fact, day's payables, which had been averaging 35 to 40 days for the prior four quarters, jumped to 48 days in Q1 of 2004.

Adding to the mix is the large $225 million debt repayment due in March of 2005 which some analysts tried to get the Company to reveal if it will be required to sell stock in order to make the payment.

Insider Trading: 10b5-1used as an excuse for big holdings reductions

As we stated above, the recent insider picture at Cummins jumped out at us. First off, their selling was off the charts based on the Company's past selling history. In all, from March 17th through April 6th, eight insiders sold 329,650 shares between $55 and $65. Though the amount may not look large, "prima face", the number takes on new meaning when compared with the 191,536 shares sold, in total, by Company insiders between 1995 through 2003. We found it rather unusual that the Company attempts to explain the selling in an April 6th 8-K filing, the same filing where it had disclosed increased guidance. The shares, which closed at $64 that day, are down 13% since then.

The Company's explanation that the insider sales were part of a series of 10b5-1 plans only added to our curiosity. The release was worded to imply that shares were sold "as pre-determined market prices of the Company's Stock are attained." The release goes on to imply that the 10b5-1's, when properly structured, "provide the officers with an opportunity to diversify their beneficial ownership of Common Stock, in a systematic manner…". Diversify indeed! Company CFO **Jean Blackwell**, V.P., President-Power Generations Business **Thomas Linebarger**, and V.P., Group President-Filtration **Rick Mills** dumped 66%, 40%, and 54% of their actionable positions (common stock plus exercisable options) in the early stages of their 10b5-1 selling.

There are a handful of reasons that these reductions are especially telling. After not granting any stock options or medium-term performance bonuses (cash payments) in 2002, only a very small amount of options were granted in 2003. The three above-mentioned execs, that sold large percentages of their stock, received less than 8,000 options each. The sales not only wiped out nearly all of their exercisable options, but also left them with only the unexercisable options granted during 2003. This grabbed our attention because the Company has stock ownership guidelines in place, which requires senior execs to hold three times their base salary in Common Stock by 2006. Blackwell currently is below her requirement while the other two are barely meeting theirs. Should they continue to sell, they will not only be short of complying with the terms of the guidelines but also will not have sufficient options vesting to replenish their holdings. Company directors also have ownership guidelines, which require them to hold Common Stock equal to three times their annual retainer fee ($94,000). They have six years to meet this requirement.

Finally, there are interesting board relationships with Chairman and CEO **Theodore Solso** and Irwin Financial CEO William Miller. Each sits on the other's board, and they also sit together on the boards/committees of a handful of funds and partnerships. There are a few membership fees and donations that have gone back and forth between the two. Not to mention, Irwin Financial has an ownership stake in Cummins' business aircraft, which they make payments to the Company for. Solso also is a board member at Ball Corp. (NYSE: BLL), and he and Ball's CEO both sit on the board at Irwin Financial.

- **Jean Blackwell (49)** – V.P., CFO, Chief of Staff. From March 18th through April 6th, Blackwell cleared out six series of non-expiring options (expiration dates: 4/07, 9/08, 2/09, 2/4/10, 2/8/10, 1/11) to acquire shares to sell. She then sold the underlying 52,150 shares as the stock leapt from $56 to $65. The exercising of multiple series tells us that there might be a sense of urgency to sell. That she **sold 66% of her holdings** in the process supports the assumption. However, Blackwell, like most of the Company's execs, entered into a 10b5-1 trading plan. She made her first 10b5-1 sales in January 2004 when she sold 700 shares. Trading plans (read: 10b5-1's) usually imply a more consistent pattern of selling than 700 one month and 66% of one's ownership stake in another. Finally, it should be noted that prior to the January selling, Blackwell's most recent prior activity since joining the Company in 1997 was a 7,300-share open-market sale on March 14, 2002. A very timely sale as the shares dropped over 50% in the next six months. One final note: Blackwell is required to hold three times her base salary in Common Stock, which at the close on 3/4/2004 ($61.33) should have been worth $1.25 million. After the recent sale, her common stock holdings totaled just $1.16 million. As an interesting footnote to Blackwell's behavior, Chief Accounting Officer **Susan Carter (45)** disposed of 15,000 shares for $60 each on April 4th, her largest sale on record.

- **Theodore Solso (57)** – Chairman, CEO. Over the past seven years, the only time we've seen Solso cross our screens was when he bought shares (19,687) between October 1997 and September 2001. In fact, over the past few years, Solso, who has a seat on the boards of Irwin Financial (NYSE: IFC), Ball Corp. (NYSE: BLL) and Ashland Inc. (NYSE: ASH), had only purchased 6,000 shares ($323,000 investment) of Ball in March 2003. It wasn't until March 18th and April 6th that he finally decided to sell Cummins stock, dumping 62,050 shares and grossing $3.9 million. Solso exercised six series of non-expiring option series (expiration dates: 9/04, 12/04, 12/05, 7/06, 9/08, 2/10) to acquire the shares to sell. After the sale, he still holds just over 400,000 shares.

- **Thomas Linebarger (41)** – V.P., President, Power Generations Business. Like Solso, Linebarger hadn't sold since becoming a Section 16 filing insider back in 1998. However, he also entered into a 10b5-1 trading plan in the past couple months. He recently sold 500 shares as part of the trading plan on March 17th, and then as the stock climbed $9 to $65 by April 6th, he dumped an additional 33,700 shares. In order to acquire the shares to sell, he cleared out six series of non-expiring option series (expiration dates: 12/05, 7/06, 2/10/07, 2/11/07, 9/08, 1/11), and then **sold 40% of his actionable position** (common stock and exercisable options). Before the recent sales, Linebarger's only prior transactions were a 1,153-share open market purchase in June 2001 at $43 and an 8,529-share open market buy in September 2001 at $29.

- **Rick Mills (55)** – V.P., Group President, Filtration. Since filing in 1996, Mills' only prior sale before he established a 10b5-1 plan in early 2004 was a 6,730-share disposition in August 1999 at prices higher than current levels. That sale preceded a three-month, 40% slide. Since setting up the trading plan, he sold 2,600 shares in January 2004 and then recently increased his aggressiveness when he dumped 51,300 shares between March 19th and April 6th, grossing $2.9 million. **The sale reduced his holdings by 54%.** And like his peers, he exercised a large amount of options series, five in all, with expiration dates between 7/06 and 1/11.

- **Steven Chapman (49)** – V.P., International, and President, International Distributor Business. Chapman displayed the most aggressive option activity of the group. **He cleared out twelve series of non-expiring options** with expiration dates between 12/05 and 9/11. A majority of the options he cleared out had at least three years left before expiration. Equally as troubling, he exercised one option series at $60.84 and sold the underlying shares at $65, accepting a mere 6% profit on the sale. Since filing as an insider back in February 2002 his only prior transaction was a 10,235-share sale in May 2002 as the stock was under pressure and continued to slide to 10-year lows.

Insider Trading: Company admits buying shares directly from insiders

Cummins original share repurchase program dates back to 1994. The plan authorized Cummins to repurchase up to 8 million shares in the open market. As of 12/31/03, 5.5 million shares had been purchased under the plan, with the last buying occurring in 2000. There is clear evidence that since 2000, Cummins has bought shares from its own executives outside of the plan on at least two separate occasions.

The Company's Key Employee Stock Investment Plan, last amended in 1994, allowed for installment purchases of Company shares by Cummins' executives. The Company is careful not to use the term "loans", instead referring to "installment purchases" that were made and the fact that the underlying shares were held as collateral. Although the 1994 amended copy of the Plan does not spell out details, the Plan is obligated to buy shares back from employees: The following terse disclosure was contained in the itemization under the "Certain Agreements" section (Schedule 3.09 (c)) of Cummins' 2003 10-K, (filed 8/04/03):

> "The Company's Key Employee Stock Investment Plan under which the Company must repurchase its common stock from the employees".

Evidence of such repurchases exists in 2002 when, in the Proxy for that year (and in no other document) indicated "During 2002, four current executive officers sold shares to the Company pursuant to this policy. No such transactions have occurred during 2003." And now, in Q1 of 2004, employees have again sold shares back to Cummins as the Company has disclosed that it had purchased 32,665 shares during the quarter, from employees, in connection with the Company's Key Employee Stock Investment Plan, for an average price of $53.25 each.

It is extremely rare to find companies buying shares directly back from insiders, and rarer still to see them admit doing so. Governance experts and financial analysts are rightly concerned about such transactions given the obvious conflicts of interest, especially in situations like Cummins' where the executives were also given the opportunity to use "purchase installments" (i.e. loans) to acquire the shares. Typically, there is no way to determine when such transactions have taken place (between a company and its own executives), as insiders will file such distributions as an "Open Market Sale" on a Form 4.

Accounting: Contingent liabilities and limited financing options

Some very interesting contingent liabilities are revealed in the operating agreement with Citicorp Leasing where the Company has made significant payment guarantees to help secure financing for its distributors. Cummins has agreed to guarantee revolving loans, equipment term loans and leases, real property loans and letters of credit to its independent Cummins and Onan distributors in the U.S. Under the terms of the agreement, Cummins' guarantees are limited "to the amount of the financing in excess of a particular distributor's "borrowing base". The "borrowing base" for any distributor being equal to the amount that Citicorp Leasing would have allowed the distributor to borrow absent the guarantee. As "borrowing base" is defined, it seems that it could be zero as the amount that the distributor could borrow, that is without the Cummins guarantee.

The most interesting aspect of the agreement with Citicorp, however, is the following clause:

> "In the event that any distributor is in default under any financing or we default on one of our financial covenants under our $385 million revolving credit agreement, then we will be required to guarantee the entire amount of each financing under the terms of the operating agreement. In addition, by January 31, 2004, we are required to issue a letter of credit or purchase credit insurance covering the amount of distributor borrowings in excess of their borrowing base; otherwise, we will be subject to a ratings trigger. Under the ratings trigger, we could be required to guarantee the entire amount of each financing if the rating on our long-term senior unsecured debt from Standard & Poor's is less than "BB" or from Moody's is less than "Ba2". Also, in the event the rating on our long-term senior unsecured debt falls below the thresholds described above, we will also be required to pay to Citicorp Leasing, Inc. a monthly fee equal to 0.50% on the daily average outstanding balance of each financing arrangement under the operating agreement. Further, in the event that any distributor defaults under a particular financing arrangement, we will be required to purchase the assets of that distributor that secure its borrowings under the financing arrangement."

To alleviate the trigger, Cummins issued letters of credit, to Citicorp Leasing, totaling $30 million, and covering distributor borrowings in excess of their "borrowing base". The letters must be renewed annually. As of 3/31/2004, Cummins had $25 million of guarantees and $30 million of letters of credit outstanding under the agreement.

Additional evidence of Cummins' tight financing picture are abundant. Restrictive covenants in the latest new credit facility, entered into this past quarter, call for tight limitations on any additional debt, issuing preferred stock, entering into sale/leaseback transactions and dividend payments, among others.

Given the current debt picture at the company, Cummins is more than likely faced with the prospect of selling more shares when it comes to paying off the $225 million in long-term debt coming due in March of 2005. Even without potential stock sales, however, one must wonder whether the current dividend level can be maintained without the significant improvement in cash flow expected by the rating agencies. Maintaining the dividend level after the sale of new shares will be that much more difficult.

Accounting: FIN46 effects add to debt levels

Cummins significant debt burden became heavier upon the adoption of FIN 46 between Q4 and Q1 of this year. The initial adoption caused the reversal of a leaseback agreement, causing a $0.09 charge in 2003 plus the addition of $92 million to the Company's long-term debt picture. Further Fin 46 consolidations will add another $106 million to long-term debt in Q1, with the line-by-line income statement consolidation of the three entities not showing up until Q2. The timing of the second consolidations interested us. While a case could be made for not consolidating them at the end of 2003, little justification would appear to exist for not doing so as of 1/1/2004. It would seem that the auditors, in reviewing the Q1 release, may have agreed to let the related line-by-line income statement detail go until Q2, but insisted on the Q1 consolidation of the balance sheet items.