

# Slowing down

## Downgrading to Underperform

Following 13% earnings miss in Q1 FY12E, we cut our PO 21%, to Rs600 and rating to Underperform, driven by (1) revision in EPS forecasts 8% in FY12E and 14% in FY13E, and (2) lowering of the target P/E from 17.5x to 16x FY13e. Post-revision, we expect profit growth of just 12%, owing to domestic slowdown.

## Q1FY12 disappointed on domestic sales

Cummins India Q1FY12 recurring net profit at Rs1.4bn was flat y-o-y and was 13% below our estimate. Key negative was domestic revenue growth of 8% compared to 25% sales growth expectation mentioned by the company in May 2011. The company has been affected by macro slowdown owing to sharp rise interest rate in last two months that has possibly led to deferral of large projects like shopping malls leading to weaker diesel genset sales.

## Margin has stabilized, but unlikely to improve

EBITDA margin at 17.8% in Q1FY12 though has fallen 350bp y-o-y, but has remained at around previous six-month level. However, company is comfortable with current margin level and does not see much improvement even though it will continue its cost reduction initiatives. Slower genset sales could in fact lead to lower margin owing to worsening of product mix.

## Valuation could de-rate on slower growth

Cummins India is currently trading at PE of 18.5x FY12e and 16.5x FY13e. The stock has traded at an average PE of 13x in the past during phases of such slower growth. At our PO the stock would trade at PE of 13.5x FY13e after adjusting for the value of its investment in associate companies.

## Estimates (Mar)

(Rs)	2010A	2011A	2012E	2013E	2014E
Net Income (Adjusted - mn)	4,439	5,910	6,595	7,391	8,351
EPS	22.42	29.85	33.31	37.33	42.18
EPS Change (YoY)	7.1%	33.1%	11.6%	12.1%	13.0%
Dividend / Share	12.00	15.00	18.00	22.00	25.00
Free Cash Flow / Share	32.80	19.43	14.53	22.57	29.04

## Valuation (Mar)

	2010A	2011A	2012E	2013E	2014E
P/E	27.42x	20.60x	18.46x	16.47x	14.57x
Dividend Yield	1.95%	2.44%	2.93%	3.58%	4.07%
EV / EBITDA*	23.08x	18.34x	16.94x	14.61x	12.80x
Free Cash Flow Yield*	5.34%	3.16%	2.36%	3.67%	4.72%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 7.

## Bank of America Merrill Lynch

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## Stock Data

Price	Rs614.75
Price Objective	Rs600.00
Date Established	4-Aug-2011
Investment Opinion	C-3-7
Volatility Risk	HIGH
52-Week Range	Rs587.10-Rs810.00
Mrkt Val / Shares Out (mn)	US\$2,747 / 198.0
Market Value (mn)	Rs121,721
Average Daily Volume	192,109
BofAML Ticker / Exchange	CUIDF / BSE
Bloomberg / Reuters	KKC IN / CUMM.BO
ROE (2012E)	33.7%
Net Dbt to Eqty (Mar-2011A)	-4.7%
Est. 5-Yr EPS / DPS Growth	20.0% / 20.0%
Free Float	49.0%

## Key Changes

(Rs)	Previous	Current
Inv. Opinion	C-1-7	C-3-7
Inv. Rating	BUY	UNDERPERFORM
Price Obj.	760.00	600.00
2012E EPS	36.20	33.31
2013E EPS	43.43	37.33
2014E EPS	50.18	42.18

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Refer to important disclosures on page 8 to 10. Analyst Certification on Page 5. Price Objective Basis/Risk on page 5. Link to Definitions on page 5. 11076361

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**iQprofile<sup>SM</sup> Cummins India****Key Income Statement Data (Mar)**

	2010A	2011A	2012E	2013E	2014E
<b>(Rs Millions)</b>					
Sales	28,449	39,454	45,146	51,798	59,486
Gross Profit	8,473	11,105	12,517	14,396	16,574
Sell General & Admin Expense	NA	NA	NA	NA	NA
Operating Profit	4,912	6,268	6,770	7,850	8,986
Net Interest & Other Income	1,197	1,755	2,143	2,166	2,330
Associates	0	0	0	0	0
Pretax Income	6,109	8,024	8,913	10,015	11,316
Tax (expense) / Benefit	(1,670)	(2,114)	(2,317)	(2,624)	(2,965)
Net Income (Adjusted)	4,439	5,910	6,595	7,391	8,351
Average Fully Diluted Shares Outstanding	198	198	198	198	198

**Key Cash Flow Statement Data**

Net Income	4,439	5,910	6,595	7,391	8,351
Depreciation & Amortization	361	366	415	480	520
Change in Working Capital	2,238	(1,054)	(669)	(1,402)	(1,621)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	65	65	534	0	0
Cash Flow from Operations	7,102	5,287	6,876	6,469	7,251
Capital Expenditure	(607)	(1,440)	(4,000)	(2,000)	(1,500)
(Acquisition) / Disposal of Investments	0	0	20	0	0
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(607)	(1,440)	(3,980)	(2,000)	(1,500)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(2,775)	(3,457)	(4,148)	(5,070)	(5,762)
Cash Flow from Financing	(2,775)	(3,457)	(4,148)	(5,070)	(5,762)
Free Cash Flow	6,495	3,847	2,876	4,469	5,751
Net Debt	(473)	(855)	(17)	(17)	(18)
Change in Net Debt	NA	NA	NA	NA	NA

**Key Balance Sheet Data**

Property, Plant & Equipment	3,337	4,411	7,996	9,516	10,496
Other Non-Current Assets	7,499	7,442	7,007	6,406	6,394
Trade Receivables	5,229	7,182	8,040	9,224	10,593
Cash & Equivalents	559	1,037	200	200	201
Other Current Assets	6,884	8,585	9,648	11,069	12,712
Total Assets	23,508	28,657	32,890	36,415	40,396
Long-Term Debt	86	183	183	183	183
Other Non-Current Liabilities	0	0	0	0	0
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	7,812	10,411	11,663	12,867	14,258
Total Liabilities	7,898	10,594	11,846	13,050	14,441
Total Equity	15,610	18,063	21,044	23,365	25,955
Total Equity & Liabilities	23,508	28,657	32,890	36,415	40,396

**iQmethod<sup>SM</sup> - Bus Performance\***

Return On Capital Employed	23.9%	27.2%	25.4%	25.9%	26.7%
Return On Equity	30.0%	35.1%	33.7%	33.3%	33.9%
Operating Margin	17.3%	15.9%	15.0%	15.2%	15.1%
EBITDA Margin	18.5%	16.8%	15.9%	16.1%	16.0%

**iQmethod<sup>SM</sup> - Quality of Earnings\***

Cash Realization Ratio	1.6x	0.9x	1.0x	0.9x	0.9x
Asset Replacement Ratio	1.7x	3.9x	9.6x	4.2x	2.9x
Tax Rate (Reported)	27.3%	26.3%	26.0%	26.2%	26.2%
Net Debt-to-Equity Ratio	-3.0%	-4.7%	-0.1%	-0.1%	-0.1%
Interest Cover	NM	NM	NM	NM	NM

**Key Metrics**\* For full definitions of iQmethod<sup>SM</sup> measures, see page 7.**Company Description**

Set up in 1962, Cummins India is India's leading manufacturer of medium and heavy duty diesel and natural gas engines for power generation, industrial and automobile application. US based Cummins Inc is the promoter of the company with 51% stake and a key customer for exports.

**Investment Thesis**

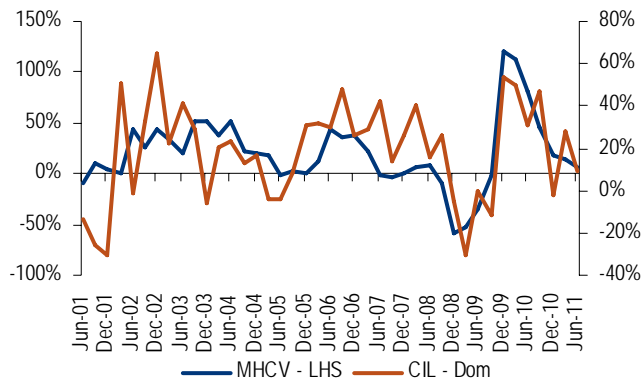
Cummins India is a holding in back diesel genset demand in India. CIL also leverages the low-cost manufacturing and global distribution network of its parent company, Cummins Inc., to achieve strong export growth. We expect the company to see cyclical slowdown in demand for back up power owing to adverse macro and improvement in grid power supply in India.

**Stock Data**

Price to Book Value 5.8x

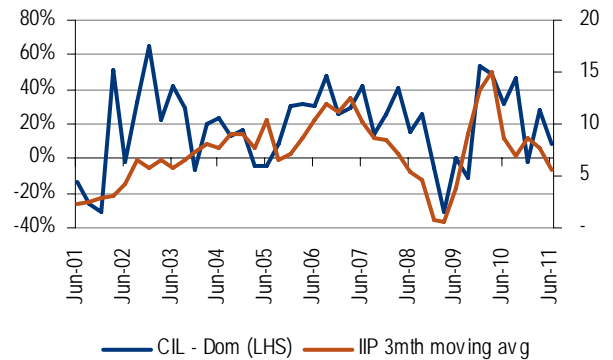
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Chart 1: Cummins India domestic sales growth slowing down along with Medium and Heavy commercial vehicle sales growth



Source: SIAM, Company

Chart 2: Slowing industrial growth hurting domestic sales growth



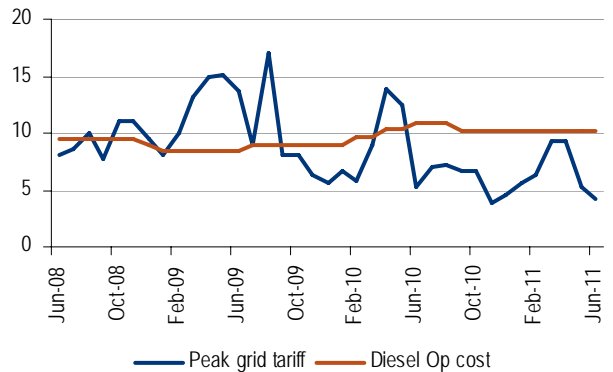
Source: Company, Bloomberg

Chart 3: Cummins India - PE one year roll forward



Source: Bloomberg, Company, BofA Merrill Lynch research estimate

Chart 4: Diesel genset operating cost now sharply higher than merchant thermal power tariff from grid



Source: India Energy Exchange, Mypetrolprice.com

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Table 1: Cummins India quarterly income statement

YE - 31-Mar (INRm)	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
<b>Net Sales</b>	<b>7,935</b>	<b>9,279</b>	<b>10,914</b>	<b>9,925</b>	<b>10,493</b>	<b>10,453</b>
Expenditure	6,325.60	7,304.60	8,741.90	8,128.80	8,644.30	8,596.70
Raw material	4,895	5,726	6,928	6,367	6,782	6,713
Staff Cost	509	530	672	643	701	698
Other expenses	921	1,049	1,141	1,119	1,161	1,186
<b>Operating profit</b>	<b>1,609</b>	<b>1,975</b>	<b>2,172</b>	<b>1,796</b>	<b>1,849</b>	<b>1,856</b>
Interest	3	4	4	3	8	4
Depreciation	97.60	93	93	91	89	94
Other income	138	96	205	103	213	159
<b>Profit before tax</b>	<b>1,645.8</b>	<b>1,973</b>	<b>2,281</b>	<b>1,805</b>	<b>1,964</b>	<b>1,918</b>
Tax	463	572	602	416	525	499
<b>Net profit</b>	<b>1,183</b>	<b>1,401</b>	<b>1,679</b>	<b>1,389</b>	<b>1,439.7</b>	<b>1,257.3</b>
Extra-ordinary income adjusted for tax						352
<b>Net profit -reported</b>	<b>1,183</b>	<b>1,401</b>	<b>1,679</b>	<b>1,389</b>	<b>1,440</b>	<b>1,772</b>
<b>Growth (%), YoY</b>	<b>Mar-10</b>	<b>Jun-10</b>	<b>Sep-10</b>	<b>Dec-10</b>	<b>Mar-11</b>	<b>Jun-11</b>
Net Sales	-25.9	45.0	73.8	19.9	32.2	12.6
Operating profit	-11.6	68.1	91.5	-5.3	14.9	-6.0
PBT	-1.0	58.3	91.2	-10.8	19.3	-2.8
Net Profit	0.1	56.2	91.3	-6.2	21.7	1.3
<b>Chg in Margin (bp), YoY</b>	<b>Mar-10</b>	<b>Jun-10</b>	<b>Sep-10</b>	<b>Dec-10</b>	<b>Mar-11</b>	<b>Jun-11</b>
RM/Net Sales	-397.2	-105.5	103.7	31.8	294.8	251.2
Operating Margin	328.4	292.0	183.0	-482.4	-266.3	-352.2
PBT Margin	522.4	177.7	189.3	-626.6	-202.2	-291.7
PAT Margin	388.1	107.9	140.7	-390.2	-118.9	-152.5
<b>Expenditure/ Net Sales (%)</b>	<b>Mar-10</b>	<b>Jun-10</b>	<b>Sep-10</b>	<b>Dec-10</b>	<b>Mar-11</b>	<b>Jun-11</b>
Raw Material	61.7	61.7	63.5	64.1	64.6	64.2
Staff cost	6.4	5.7	6.2	6.5	6.7	6.7
Other expenses	11.6	11.3	10.5	11.3	11.1	11.3
	28%	29%	26%	23%	27%	34%
<b>Margins (%)</b>	<b>Mar-10</b>	<b>Jun-10</b>	<b>Sep-10</b>	<b>Dec-10</b>	<b>Mar-11</b>	<b>Jun-11</b>
Operating profit	20.3	21.3	19.9	18.1	17.6	17.8
PBT	20.7	21.3	20.9	18.2	18.7	18.3
Net Profit	14.9	15.1	15.4	14.0	13.7	12.0
<b>Geographical mix</b>	<b>Mar-10</b>	<b>Jun-10</b>	<b>Sep-10</b>	<b>Dec-10</b>	<b>Mar-11</b>	<b>Jun-11</b>
Domestic	6,113	7,129	8,154	7,275	7,803	7,753
Export	1,822	2,150	2,760	2,650	2,690	2,700
Domestic growth	-20%	31%	47%	-2%	28%	9%
Exports growth	-40%	129%	282%	214%	48%	26%
Other operating income	159.20	179.30	239.10	341.70	397.20	233.80

Source: Company

## Price objective basis & risk

### Cummins India (CUIDF)

Our PO of Rs600 for CIL is based on PE of 16x our FY13E EPS of Rs37.33/share. The stock has traded between 10x-15x during period of slow growth in the past. Currently stock is trading at PE of 18.4x FY12e. Considering the slower earnings growth, we expect the stock to de-rate from current level. The company could get valuation support in terms of dividend yield which currently stands at around 3% for FY12e. The stock should trade 13.5x PE on FY13e at our If PO we adjust for the value of 50% stake in the Rs8bn lubricant company Valvoline Cummins, a 50% stake in Cummins Research Technology and a 48% stake in Rs5bn Cummins Generator Technology. These three companies had a combined profit of Rs1.8bn in FY11 and are likely to grow at 20% too. The downside risk is a sharp rise in steel prices and lower demand, owing to weaker-than-estimated economic growth. Key upside risk stronger export growth and successful launch of new products that would help boost marketshare.

## Link to Definitions

### Industrials

Click [here](#) for definitions of commonly used terms.

## Analyst Certification

I, Sanjaya Satapathy, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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## India - General Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
<b>BUY</b>				
	Aditya Birla Nu	ADYAF	ABNL IN	Reena Verma Bhasin, CFA
	Anant Raj Industries Ltd	XNRJF	ARCP IN	Gagan Agarwal
	Brigade Enterprises	XBDGF	BRGD IN	Gagan Agarwal
	Chambal Fertilisers & Chemicals	CHBZF	CHMB IN	Prasad Deshmukh
	Cummins India	CUIDF	KKC IN	Sanjaya Satapathy
	DLF Limited	XVDUF	DLFU IN	Gagan Agarwal
	Exide Indus Ltd	XEDRF	EXID IN	Sanjaya Satapathy
	Fortis Healthcare Limited	XFFTf	FORH IN	Prasad Deshmukh
	Havells	HVLIF	HAVL IN	Sanjaya Satapathy
	Indiabulls Real Estate Ltd	IBELF	IBREL IN	Gagan Agarwal
	Jaypee Infratech	XJAYF	JPIN IN	Gagan Agarwal
	Motherson Sumi	XMSUF	MSS IN	Sanjaya Satapathy
	Oberoi Realty Ltd	XRXOF	OBER IN	Gagan Agarwal
	Puravankara Projects Ltd	XPJVF	PVKP IN	Gagan Agarwal
	Renuka Sugars	SRNKF	SHRS IN	Sanjaya Satapathy
	SINTEX INDUSTRIES LTD	SIXDF	SINT IN	Prasad Deshmukh
	Sobha Developers	SBDRF	SOBHA IN	Gagan Agarwal
	Voltas	VTSJF	VOLT IN	Sanjaya Satapathy
<b>NEUTRAL</b>				
	Coromandel International Ltd	CMDFF	CRIN IN	Prasad Deshmukh
	Grasim	GRSJF	GRASIM IN	Reena Verma Bhasin, CFA
	Grasim -G	GRSJY	GRAS LX	Reena Verma Bhasin, CFA
	Housing Development and Infrastructure	XGHSF	HDIL IN	Gagan Agarwal
	Jain Irrigation Systems Ltd	JNIDF	JI IN	Prasad Deshmukh
	Shree Cements	SREEF	SRCM IN	Reena Verma Bhasin, CFA
	Unitech Ltd	UTKIF	UT IN	Gagan Agarwal
<b>UNDERPERFORM</b>				
	Ambuja Cements	AMBUF	ACEM IN	Reena Verma Bhasin, CFA
	APIL	ANSFF	APIL IN	Gagan Agarwal
	Assoc. Cement	ADCLF	ACC IN	Reena Verma Bhasin, CFA
	Bajaj Hindusthan	BJJHF	BJH IN	Sanjaya Satapathy
	Balrampur Chini	BMPRF	BRCM IN	Sanjaya Satapathy
	Container Corp	CIDFF	CCRI IN	Sanjaya Satapathy
	India Cements	INIAF	ICEM IN	Reena Verma Bhasin, CFA
	India Cements -G	IAMUY	ICEM LX	Reena Verma Bhasin, CFA
	Jet Airways	JTAIF	JETIN IN	Anand Kumar
	Jindal Saw	SWPFF	JSAW IN	Sanjaya Satapathy
	Nagarjuna Fertilizers & Chemicals Ltd	NFACF	NFCL IN	Prasad Deshmukh
	Omaxe Limited	XOMXF	OAXE IN	Gagan Agarwal
	SpiceJet Ltd	MDLFF	SJET IN	Anand Kumar
	Tata Chemicals Ltd	TTCXF	TTCH IN	Prasad Deshmukh
	UltraTech Cemen	XDJNF	UTCEM IN	Reena Verma Bhasin, CFA
	Welspun Corp Ltd	XUQRF	WLCO IN	Sanjaya Satapathy

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**iQmethod<sup>SM</sup> Measures Definitions**

**Business Performance**

Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization
Return On Equity	Net Income
Operating Margin	Operating Profit
Earnings Growth	Expected 5-Year CAGR From Latest Actual
Free Cash Flow	Cash Flow From Operations – Total Capex

**Denominator**

Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Amortization
Shareholders' Equity
Sales
N/A
N/A

**Quality of Earnings**

Cash Realization Ratio	Cash Flow From Operations
Asset Replacement Ratio	Capex
Tax Rate	Tax Charge
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents
Interest Cover	EBIT

Net Income
Depreciation
Pre-Tax Income
Total Equity
Interest Expense

**Valuation Toolkit**

Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Sales	
	Other LT Liabilities	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

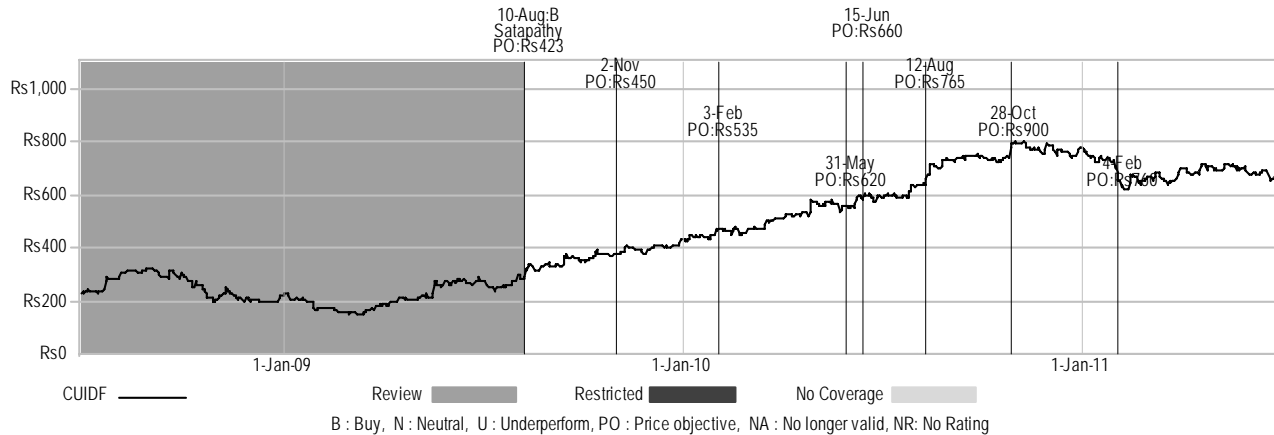
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## CUIDF Price Chart



The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of (June 30, 2011) or such later date as indicated.

## Investment Rating Distribution: Machinery/Diversified Manufacturing Group (as of 01 Jul 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	39	52.00%	Buy	21	56.76%
Neutral	25	33.33%	Neutral	8	38.10%
Sell	11	14.67%	Sell	2	20.00%

## Investment Rating Distribution: Global Group (as of 01 Jul 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	2024	53.94%	Buy	935	50.68%
Neutral	944	25.16%	Neutral	442	51.64%
Sell	784	20.90%	Sell	273	37.24%

\* Companies in respect of which BofA Merrill Lynch or one of its affiliates has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

**FUNDAMENTAL EQUITY OPINION KEY:** Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. **VOLATILITY RISK RATINGS**, indicators of potential price fluctuation, are: A - Low, B - Medium and C - High. **INVESTMENT RATINGS** reflect the analyst's assessment of a stock's: (i) absolute total return potential and (ii) attractiveness for investment relative to other stocks within its *Coverage Cluster* (defined below). There are three investment ratings: 1 - Buy stocks are expected to have a total return of at least 10% and are the most attractive stocks in the coverage cluster; 2 - Neutral stocks are expected to remain flat or increase in value and are less attractive than Buy rated stocks and 3 - Underperform stocks are the least attractive stocks in a coverage cluster. Analysts assign investment ratings considering, among other things, the 0-12 month total return expectation for a stock and the firm's guidelines for ratings dispersions (shown in the table below). The current price objective for a stock should be referenced to better understand the total return expectation at any given time. The price objective reflects the analyst's view of the potential price appreciation (depreciation).

Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

\* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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