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Cummins Inc. (CMI) CEO Thomas Linebarger on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-29-19 Earnings Summary

Press Release SEC *10-Q* *Slides*

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Earning Call Audio

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Cummins Inc. (NYSE:CMI) Q3 2019 Earnings Conference Call October 29, 2019 10:00 AM ET

Company Participants

James Hopkins - Executive Director of Investor Relations

Thomas Linebarger - Chairman and Chief Executive Officer

Mark Smith - Vice President and Chief Financial Officer

Tony Satterthwaite - President and Chief Operating Officer

Conference Call Participants

Joseph O'Dea - Vertical Research Partners LLC

Jerry Revich - Goldman Sachs & Co.

Andrew Casey - Wells Fargo Securities, LLC

Jamie Cook - Credit Suisse Securities LLC

Ross Gilardi - Bank of America Merrill Lynch

Joel Tiss - BMO Capital Markets

David Raso - Evercore ISI

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Q3 2019 Cummins' Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speaker presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded. [Operator Instructions].

I would now like to hand the conference over to your speaker, Mr. James Hopkins, Executive Director of Investor Relations. Mr. Hopkins, you may now begin.

James Hopkins

Thank you. Good morning, everyone, and welcome to our teleconference today to discuss Cummins' results for the third quarter of 2019. Participating with me today are Chairman and Chief Executive Officer, Tom Linebarger; our Chief Financial Officer, Mark Smith; President and Chief Operating Officer, Tony Satterthwaite; and retiring Chief Operating Officer, Rich Freeland. We will all be available for your questions at the end of the teleconference.

Before we start, please note that some of the information that you will hear or be given today will consist of forward-looking statements within the meaning of the Securities Exchange Act of 1934. Such statements express our forecasts, expectations, hopes, beliefs and intentions on strategies regarding the future. Our actual future results could differ materially from those projected in such forward-looking statements because of a number of risks and uncertainties.

More information regarding such risks and uncertainties is available in the forward-looking disclosure statement in the slide deck and our filings with the Securities and Exchange Commission, particularly the Risk Factors section of our most recently filed Annual Report on Form 10-K and any subsequently filed Quarterly Reports on Form 10-Q.

During the course of this call, we will be discussing certain non-GAAP financial measures, and we refer you to our website for the reconciliation of those measures to GAAP financial measures.

Our press release, with a copy of the financial statements and a copy of today's webcast presentation, are available on our website at www.cummins.com under the heading of Investors and Media.

With that out of the way, we'll begin with our Chairman and CEO, Tom Linebarger.

Thomas Linebarger

Thanks, James. Good morning. I just want to start one correction of James remarks. Retiring Chief Operating Officer, Rich Freeland, has said he will not be available for questions after the call, unless it's about how cute his grandchildren are or about golf.

I'll start with a summary of our third quarter results and finish with a discussion of our outlook for 2019. Mark will then take you through more details of both our third quarter financial performance and our forecast for the full-year.

Revenues for the third quarter of 2019 were $5.8 billion, a decrease of 3% compared to the third quarter of 2018. EBITDA was $958 million or 16.6% compared to $983 million or 16.5% a year-ago. Positive pricing, lower variable compensation, material cost reduction activities and lower warranty expense partially offset the impact of lower volumes and increased investments in research and engineering.

Engine business revenues declined 11% in the third quarter compared to a year-ago. Revenues in North America decreased by 6% as we began to see the impact of OEMs preparing for lower production of heavy-duty trucks in North America, as well as declines in shipments to construction markets. International revenues declined by 25% primarily as a result of lower demand in China light-duty truck and construction markets.

EBITDA margin for the quarter was 14.1% compared to 14.9% for the same period in 2018, and included a $33 million charge related to ending production of our 5-liter ISV engine for the U.S. pickup market. Improved pricing and lower material costs partially offset the impact of lower volumes, reduced joint venture income and the $33 million charge.

Sales for our Distribution segment grew by 4% year-over-year driven by higher demand for power generation equipment in North America. Third quarter EBITDA was a record $186 million or 9.3% of sales compared to 8% in the third quarter of 2018. EBITDA margins benefited from higher volumes, positive pricing and lower variable compensation costs.

Third quarter revenues for the Component segment declined by 6%, sales in North America increased 2% driven by higher demand in the U.S. pickup market, while revenues in the international markets declined by 18% as a result of lower truck demand in Europe, India and China. EBITDA for the third quarter was $286 million or 17.3% compared to 16.4% in the same quarter a year-ago.

The increase in EBITDA percent was primarily due to lower warranty costs and the benefit of material cost reduction programs, which offset increased investment and the development of new products to meet advancing emission standards in China and India as well as the impact of lower volumes.

Power Systems sales in third quarter increased by 2%. Demand in industrial markets increased 3% with lower sales to oil and gas markets offset by increased sales to marine, rail and mining customers. Power Generation sales increased 8% in North America, driven by continued strength in data center markets, offset by a 4% decline in international markets, mainly in Europe and the Middle East.

While sales increased compared to a weak third quarter last year, sales declined 6% sequentially with lower demand in power generation, oil and gas and mining markets. EBITDA in the third quarter was 14% compared to 14.7% a year-ago. The decrease in EBITDA percent was largely due to the impact of higher material costs, including tariffs, and lower sales of industrial engines.

In the Electrified Power business, EBITDA was a loss of $36 million in the third quarter and in line with our expectations. We completed the acquisition of Hydrogenics, a leading producer of fuel cells and electrolyzers for the production of hydrogen, on September 9. Our third quarter results included $2 million EBITDA loss related to Hydrogenics.

Now I will comment on the performance in some of our key markets for the third quarter of 2019 starting with North America, and then I'll cover some of our largest international markets. Our third quarter revenues in North America were flat at $3.6 billion. Increased sales of power generation equipment, especially the data center customers were offset by lower shipments of heavy-duty truck and construction engines.

Industry production of heavy-duty trucks increased 3% in the third quarter of 2019 compared to a year-ago and decreased 4% compared to the second quarter of this year with low truck orders, a declining industry backlog and historically high levels of new truck inventory driving lower industry production.

While industry truck production increased compared to last year, our shipments declined as OEMs prepared to ramp down production in Q4. Our market share through September was 32%. Production of medium-duty trucks increased 4% in the third quarter. A growing U.S. economy, coupled with high levels of consumer spending, low unemployment and low interest rates continues to drive demand for medium-duty trucks.

Our market share in the medium-duty truck market was 78% through September compared to 81% a year-ago. Total shipments to our North American pickup truck customers increased for the third consecutive quarter to over 41,000 units supported by strong demand for the Ram 2500 and 3500 pickup trucks.

Engine demand for construction equipment in North America decreased 30% in the third quarter. While non-residential construction spending remains high, we are seeing industry participants take steps to reduce their equipment inventory, which currently stands at a historically high levels.

Revenues for power generation grew by 8% due to higher demand in data center markets partially offset by lower sales to recreational vehicle OEMs. Demand for engines in oil and gas markets declined by 86% due to continued low purchases of new fracking equipment.

Our international revenues decreased by 8% in the third quarter of 2019 compared to a year-ago. Third quarter revenues in China, including joint ventures were $1.2 billion, a decrease of 2% over the prior year. Lower demand in construction and light commercial vehicle markets was partially offset by increased demand in medium- and heavy-duty truck markets.

Industry demand for medium- and heavy-duty trucks in China increased 1% compared to a year-ago and was positively impacted by a prebuy of natural gas engines, ahead of the move to NS VI standards. We estimate the impact of this prebuy to be approximately 27,000 units this quarter, increasing market size by 10%. This increase, in addition to the 20,000 unit prebuy that occurred in the second quarter.

Our market share improved to 16.1% this quarter from 15.6% a year-ago as we increased our share at Foton and saw a shift towards over-the-road trucks versus construction-related dump trucks. Industry sales of light-duty trucks declined by 3% in the third quarter and 15%, sequentially.

Our engine market share was 7.4%, 0.2 percentage points higher than a year-ago. We continue to be impacted by increased enforcement of loading regulations where truck models that has historically been registered as light-duty trucks are now to be classified as medium-duty trucks, which limits access to urban areas and requires additional licensing for drivers. OEMs did begin to launch new light-duty vehicles in the third quarter, resulting in higher industry productions than we had originally forecasted.

Third quarter demand for excavators in China increased 16% from a year ago. Our market share also increased from 15% to 15.4% driven by the strong performance of our local partners. While industry sales and our market share increase compared to a year-ago, our sales for the quarter including joint ventures declined 29% due to OEMs and dealers reducing inventory built primarily in the second half of last year.

Demand for power generation equipment was flat in the third quarter with lower demand for standby power, partially offset by growth in demand for data center markets.

Third quarter revenues in India including joint ventures were $344 million, a reduction of 29% in the third quarter a year-ago with lower demand in all of our major end markets.

Industry truck sales decreased 52% year-over-year and even larger decline than we'd expected, driven by continued lack of credit availability. Credit availability also started to impact other markets during the third quarter with construction revenues down 75% as companies struggle to finance construction projects, placing pressure on equipment purchases.

Now let me provide our overall outlook for 2019 and then comment on individual regions in end markets. We now expect company revenues to be down 2% for the year compared with our prior guidance of flat. We are lowering our forecast for industry production of heavy-duty trucks in North America. Hopefully, we’re off mute now. Okay. More concerning, the industry backlog declined 31% or 61,000 units [technical difficulty] to 133,000 units from its peak of over 300,000 units a year-ago.

Inventory remains elevated at 81,000 units and third quarter orders of 34,000 units were the lowest since 2009. Industry production decreased monthly as we [technical difficultly] third quarter and we expect monthly declines to continue through the end of the year. We expect our market share for the year to be at the low end of our forecast range of 32% to 34%. Market share is being negatively impacted by lower shipments to OEM's ahead of truck production cuts.

Demand in our parts and remanufacturing business remain stable in the third quarter. As we continue to see the impact of increased capacity of fleets and lower freight demand resulting in lower utilization of available equipment in the industry. We continue to expect parts demand to be relatively weak through the end of this year as dealers reduced parts inventory and anticipation of lower market activity.

In the medium-duty truck market, we're lowering our forecast for industry production to 138,000 units are up 5% compared to our prior guidance of 140,000 units are up 6% year-over-year. While retail sales of medium-duty trucks remained strong, up 13% year-to-date, industry truck production has now been above order intake for seven months, lowering the industry backlog to levels that will result in lower build rates.

We continue to expect our market share to be in the range of 74% to 76% unchanged from our prior guidance. We expect our engine shipments for pickup trucks in North America to be flat for 2019, compared to a very strong 2018 and unchanged from our expectations three months ago. Shipments of construction engines are now expected to decline 5% compared to our prior expectations of 10% growth as OEMs and dealers reduce inventories from historically high levels.

In China, we now expect domestic revenues including joint ventures to be down 1% in 2019 and improvement compared to our prior guidance of down 2%. We are increasing our outlook for medium- and heavy-duty truck market demand to 1.23 million units or down 7% compared to our prior guidance of down 10% due to the additional prebuy of natural gas trucks that occurred in the third quarter.

In the light-duty truck market, we now expect a 7% reduction in demand compared to our prior guidance of down 12%. This improvement is driven by OEMs launching new truck models in light of the more stringent enforcement of overloading regulations that began in the second quarter.

We expect our market share and the medium- and heavy-duty truck market to be in the range of 13% to 14% and in light-duty we expect our market share to be 8% to 9%, both in line with our prior guidance. We now expect industry sales of excavators in China to increase 8% from the record levels achieved in 2018, compared to our prior guidance of flat. While industry sales are expected to increase this year, we are expecting lower levels of industry production in the second half of 2019, compared to 2018 as the industry prepares for lower demand in the spring 2020 selling season.

In India, we now expect total revenue including joint ventures to be down 20% [technical difficultly] compared to our prior guidance of down 5%. We anticipate – industry demand for trucks to be 30% lower than the record levels experienced in 2018 compared to our prior guidance of down 17%.

We now expect construction demand to decline 40%, compared to our prior outlook of 5% to 10% growth with a lack of financing for construction projects lowering demand for new equipment. Demand for power generation equipment is now expected to be flat compared to 5% to 10% growth.

In Brazil, we are now projecting truck production to be flat in [technical difficultly] down from our forecast of 2% growth three months ago. While domestic demand in Brazil continues to increase from levels experience in [technical difficultly] truck production in Brazil for export markets is expected to decline 50% compared to 2018 – primarily due to weak demand for trucks in Argentina. We continue to project total revenues for Brazil to be down 10% this year.

We now expect our global high horsepower engine shipments to be down 10% this year, compared with our prior guidance of down 5%. Demand for new oil and gas engines is now expected to decline 50%, compared with our prior guidance of just down 40%.

We now anticipate sales in North America will decline by 85%, compared to our 75% expectations three months ago with lower demand for new equipment in the Permian Basin as well as reduced demand for engine rebuilds. The deterioration in our outlook for North America is partially offset by growing sales [technical difficultly] which have represented 61% of our oil and gas engine sales to-date.

Demand from mining engines has moderated [technical difficultly] three months as commodity [technical difficultly] and capital budgets have been cut. We now expect mining engine sales down 7% lower than the prior guidance of down 5%. Demand for power generation equipment increased 2% compared to the low levels experience in the third quarter of last year and declined 3% sequentially [technical difficultly] primarily due to lower demand in India.

We now expect full-year revenues to be down 2% compared to our primarily due to lower demand in India. For the full-year growth in data centers is being offset by lower sales of [technical difficultly] lower demand in backup power applications in China and India, and a drop in large prime power applications in Europe.

In summary, we are now expecting revenues to be down 2%, for the year lower than our prior guidance of flat. This revenue decline is driven by lower demand and domestic international truck markets, weakness in Indian end markets and lower demand in several off-highway markets.

Lower sales reduced joint venture income in India and the acquisition of Hydrogenics will impact our EBITDA for the year, which we now projected at 15.9% to 16.3% of sales, down from our prior guidance of 16.25% to 16.75% of sales.

Strong execution across all of our businesses resulted in record revenues being translated into record EBITDA and operating cash flow in the first nine months of this year. Our strong and consistent cash flow generation continues to support our plans, return cash to shareholders and we returned $910 million of cash in third quarter [technical difficultly] 2.9% of outstanding shares.

While we were pleased with our operating performance in third quarter, we've been working to prepare the company for what lies ahead in the fourth quarter and in [technical difficultly]. As we have discussed before, several of our end markets have been above replacement level for some time and we are now expecting cyclically reduced demand.

Our third quarter revenues declined 7% sequentially and our guidance projects that they would decline another 8% in the fourth quarter. This steep level of decline resulted in a number of actions to align costs with production levels including a recently announced voluntary retirement package in United States, which we [technical difficultly] reduced headcount by 400 to 450 people. We are in the process of making additional structural changes in several areas of the business and we'll continue to drive actions to improve costs.

As always, we will capitalize on the downturn period to improve our company and merge as a stronger and more profitable Cummins. We will also maintain our investments in the key [technical difficulty] and product development programs that will ensure leadership and sustainable growth in the future.

During the third quarter, we announced new [technical difficulty] powertrains and launched an updated ISX15 engine for the North American heavy-duty truck market. These actions demonstrate our commitment to lead both in alternative powertrain technologies and continue to lead in traditional powertrains.

We closed on our acquisition of Hydrogenics, one of the world's premier fuel cell and hydrogen production technology providers in September. Their expertise and innovative approach will strengthen fuel cell capability. This is another step forward as we continue to invest in a broad range of clean, fuel efficient and high-performing products and technologies that will deliver value to customers.

[Technical difficulty] who designed manufacturer fuel cell range extenders and announced the partnership with Hyundai to jointly evaluate opportunities to develop and commercialize electric and fuel cell powertrains. While we increase investments on alternative powertrains, we continue to enhance our diesel and natural gas products delivering more fuel efficiency, power and lower emission.

At the North American Commercial Vehicle show in Atlanta, we are currently showing our new ISX15 Efficiency Series. [Technical difficulty] an endurance transmission will provide up to 5% improvement in fuel efficiency for [technical difficulty] meeting 2021 greenhouse gas standards one-year early.

Now let me turn it over to Mark.

Mark Smith

Thank you, Tom, and good morning, everyone. I'll start with a quick summary of our financial performance in the [technical difficulty] for the full-year. Third quarter revenues were $5.8 billion, a decrease of 3% from a year-ago. Sales in North America were flat and international revenues [technical difficulty] 8%. Currency movements negatively impacted revenues by 1%.

Earnings before interest and tax depreciation and amortization were $958 million or 16.6% for the quarter, compared to $993 million or 16.5% of sales a year-ago. EBITDA decreased by $25 million driven by the negative impact of [technical difficulty] reduced joint venture income and [technical difficulty] partially offset by material cost reduction activities, lower warranty and decreased variable compensation expenses.

Gross margin of $1.5 billion or 25.9% decreased by $57 million or 20 basis points. Benefits from favorable pricing actions, material cost reductions, lower warranty and variable compensation expenses mitigated the negative impact of lower volumes [technical difficulty] charges incurred to cease production of certain unprofitable product lines and higher tariffs.

Our selling, administrative and research costs of $842 million, increased by $9 million year-over-year, driven primarily by new product development in the Engine, Components, and Electrified Power segments, partially offset by lower variable compensation expense.

Joint venture income declined by $22 million due to weaker demand for light-duty trucks in China and lower truck production in India. Other income of $61 million increased by $34 million, driven primarily by $35 million of gains related to closing out certain derivative contracts associated with the Company's foreign exchange hedging program.

Net earnings for the quarter was $622 million or $3.97 per diluted share compared to $692 million or $4.28 from a year-ago. Third quarter results were positively impacted by $23 million or $0.14 per diluted share and discrete tax items and the after-tax gains of $28 million or $0.18 from closing out the foreign exchange hedging contracts I referred to earlier.

During the quarter, we also incurred after-tax expenses of $35 million or $0.23 per share related to actions taken to cease development and production of certain products. These actions will benefit future financial performance. The effective tax rate in the quarter was 18.4%. Excluding discrete tax items, the tax rate was 21.5% in the third quarter and in line with our full-year forecast.

Operating cash flow in the quarter was a record in flow of $1.1 billion. That's $208 million higher than last year. Year-to-date, we've generated a record $2.3 billion of cash from operating activities, up $955 million from the same period last year, driven by higher earnings and a much slower pace of working capital expansion.

I will now comment on our revised guidance for 2019. For the Engine segment, we expect full-year revenues to be down between 5% and 6% compared to our previous guidance of flat at the mid-point. The reduction in sales is driven by declines in heavy-duty engine shipments in North America, weaker demand for construction equipment in North America or India, and the lower outlook for medium-duty truck engines in North America, Europe and Brazil.

We revised our forecast for EBITDA margins for the engine business to be in the range of 14.3% to 14.8%, down from our prior guidance of 15% to 15.5%, driven primarily by the impact of lower volumes, weaker joint venture incomes and the costs incurred in the third quarter associated with ending production of one engine platform.

For the Distribution segment, we now expect revenues to be up 2% to 3% compared to our previous guidance of 1% to 5%, due to lower sales of construction engines in North America and lower engine rebuild volumes with oil and gas and mining customers.

We are raising our outlook for EBITDA margins by 35 basis points to be in the range of 8.4% to 8.8% as continuous solid operating performance and lower variable compensation expense more than offset – the slightly lower outlook for sales.

For 2019, we now expect components revenues to be down between 4% and 5% compared to our prior projection of flat at the mid-point and this decline is – being driven by reduced truck demand in North America, India, Europe, and Brazil.

As a result of the lower sales outlook, we've revised our focus for EBITDA margins to be in the range of 15.6% to 16.1%, down from our prior guidance of 15.75% to 16.25%.

Power Systems revenues are forecast to be down 3% to 4% lower than our previous guidance of flat at the midpoint, due to lower demand for power generation equipment in international markets and weaker demand for engine rebuilds and new engine shipments in mining and oil and gas markets. We're also revising our forecast for EBITDA margins to be in the range of 12.5% to 13% down from our prior forecast 13.25% to 14%.

In the Electrified Power segment, we now expect a net expense of $145 million at the high-end of our previous guidance range due to the completion of the acquisition of Hydrogenics. The net impacted the changes to Individual segment projections is that we now forecast total company revenues to be down 2% and company EBITDA margins to be between 15.9% and 16.3. This compares to our prior guidance of flat sales and the EBITDA in the range of 16.25% to 16.75%.

Full-year operating cash flow is projected to be a record $3 billion due to the strong full-year earnings and lower working capital. Capital expenditures for the third quarter were $153 million, bringing our year-to-date total investment to $395 million. We expect our full-year capital investments will be in the range of $700 million unchanged from our prior guidance.

In the third quarter, we returned a record $910 million to shareholders. We repurchased 4.6 million shares after a total of $706 million. And for the first nine months, we have returned $1.4 billion through dividends and share repurchase activity. We still plan to return 75% of operating cash flow to shareholders this year while maintaining a strong balance sheet.

To summarize, we delivered a solid set of results in the third quarter, including record quarterly operating cash flow and in response to a slowing global economy driving weaker demand in a number of our end markets. We have taken a number of actions to reduce costs and address some underperforming parts of our business.

Consistent with prior downturns, we will continue to identify additional opportunities to drive efficiency and cost reduction whilst maintaining investment in the products and services that will deliver a stronger future.

Finally, I want to remind everyone of our upcoming Analyst Day on November 21 of the New York Stock Exchange. I look forward to seeing you all there. Webcast of our presentation will also be available on our Investor Relations section our website. Thank you for your interest today, your patience with a difficult phone call.

Now let me turn it back over to Tom before we move to Q&A.

Thomas Linebarger

Mark, with all the challenges we have in fuel cells and electrification, I did not expect to be flooded by a phone. There you have it. Just to conclude our prepared remarks. As you will remember, we announced on April 29 and then discussed in our first and second quarter earning calls that we are initiated an internal review of our emission certification and compliance processes for our pickup truck applications as a result of conversations with the EPA and the California Air Resources Board.

Our review continues and we are proactively working with EPA and CARB as well as with the Department of Justice and SEC to address their questions and information requests. During conversations with regulators, they raise concerns that certain aspect of our emission system on the model year 2019 Ram engine may reduce the effectiveness of our emission control systems and thereby act as defeat devices. Based on these discussions, we've developed a new calibration for the engines in model year 2019 Ram 2,500 and 3,500 trucks that has been included on all engines shipped since September.

During our discussions, the agencies have asked us to look at other model years and other engines that the primary focus of our review has been the model year 2019 Ram. Consistent with the values and the history of our Company, which include a strong commitment to compliance, we will work with regulators and other agencies to address the issues identified in our internal review and develop future technologies that will advance our industry.

We are already making changes to our process and organization structure as a result of our review. However, it's too soon to know what the response of our regulators or agencies will be to our review or to determine any potential financial consequences.

Now let me turn it back to James for Q&A.

James Hopkins

Great. Thank you, Tom. Out of considerations to everybody on the call to ask that you limit yourself to one question and a related follow-up, and if you have any additional questions, please rejoin the queue.

With that operator, we're ready for questions.

Question-and-Answer Session

Operator

[Operator Instructions] Our first question comes from Joe O'Dea with Vertical Research.

Joseph O'Dea

Hi, good morning.

Thomas Linebarger

Hi, Joe.

Joseph O'Dea

Tom, I'm just curious about kind of what your assessment is of what's currently underway in terms of what we're seeing on slowing demand. I think there are pockets of these end markets that you've been talking about things slowing for at least a couple of quarters now, but whether or not you're seeing this more as we're coming off of a level of very strong demand or whether there's something else at play in terms of kind of how you're thinking about things slowing down here?

Thomas Linebarger

Yes. I want Tony to talk more specifically about what happening in the truck market. It'd be a good chance for him to – he's been very close to it and a good chance for him to talk about that. I would just say that broadly speaking, we've seen a number of our markets been at cyclical peaks over the last couple of years, which has been terrific for the company. We've generated strong earnings and cash flows as a result, but indeed some of those markets are beginning to turn down and we've been seeing signs of that. Typical signs that we're used to reading things like slowing orders, inventory build, et cetera.

And now what we're seeing is those things starting to come to fruition. Maybe what's surprising to me is it's broader than I thought. Like we are seeing challenges in India, challenges in China, challenges in – even in Europe is slowing. We saw North America coming, that was all part of what we expected, but some of the challenges in some of the other markets, how quickly we've seen in the large engine markets sort of peak out and begin to turn the other way has been a little surprising.

So maybe that's what's new, not the – not necessarily that things would turn down, but just how broadly and how quickly they have. And Tony, why don't you just talk about what you're seeing in North America?

Tony Satterthwaite

Yes. I would just add – thanks, Tom. Joe, I would just add, we are definitely seeing – freight growth has slowed. We are seeing orders slow and production has got to come down to meet – to match the backlog and meet those orders. And so we are seeing things slow. I agree with Tom. The surprise has been how quickly things have gone bad internationally and that was probably not expected at the beginning of the year.

I do believe in North America it is a cyclical downturn. I don't quite know what you mean by anything else other than that, but that's basically what we're seeing. Construction has also slowed down in the U.S., as Tom mentioned in his remarks, which I think is another sign that perhaps it is a broader slowdown than just freight and truck markets. But we've been seeing this coming all year and it’s here.

Mark Smith

I guess the other thing I'd add to that, Joe, really, in North America, the pickup truck market is the only one that's been holding out steady and strong through the year.

Joseph O'Dea

That's helpful. And then just a cost related question, maybe in the context of what's implied on 4Q EBITDA margins. Can you give any sense of what the impact would be from related cost actions that you're taking right now? So what kind of margin lift you would anticipate if you got the full benefit in the quarter with some of the cost actions underway?

Mark Smith

I think you should think about the actions that we're taking is really setting up 2020. The biggest impact will be 2020, by the time we fully executed those actions. And again, we'll give a framework for 2020 at our Analyst Day. We're not going to give specific guidance today, Joe, but our guidance is the results without the cost of those actions. We will call out the customer benefits at the appropriate point in time.

What's really driving our margins from the third quarter to the fourth quarter, which I think is underlying your question. Number one, it's the significant decline in revenues. That's by far the biggest single impact. Number two, whilst we haven't changed our full-year outlook for warranty or product coverage as a percent of sales is a little bit lower than trend rate in Q3, they're a little bit higher than the Q3 run rate and Q4 are unchanged for the year.

And then the third factor is really that our variable compensation plan is working as designed. So our outlook is lower than our projected payouts, short-term compensation is going down through the third quarter and will move back to more of a normal run rate in the fourth quarter. And really those are the three main factors. So the key now is really talking about the cost reduction initiatives going forward. And again, we'll provide a framework.

Tony will add some comments right now.

Tony Satterthwaite

Yes. I would just add. We've been ready for this all year. We are committed to flexing our costs down with demand. We're committed to managing the cycle. We've been tight on discretionary spending and hiring all year and we actually really started to take things out in the third quarter. We've been analyzing underperforming businesses and as Mark said, we decided to close one in the third quarter, we've launched a voluntary retirement program here in the U.S., and so these are all actions we're taking, the majority of which will bear fruit in 2020, but we are moving now to take out cost as demand drops.

Joseph O'Dea

I appreciate it. Thank you.

Operator

Thank you. Our next question comes from Jerry Revich with Goldman Sachs.

Jerry Revich

Yes. Hi. Good morning, everyone.

Thomas Linebarger

Hi, Jerry.

Mark Smith

Hi, Jerry.

Jerry Revich

I'm wondering if you can talk about what level of restructuring is embedded in guidance, Mark, just to follow-up on the last question. So in the past, you folks have been able to put up 20% decrementals as you've got production now embedded in guidance, looks like you have restructuring. It sounds like price cost is positive, so can you just help us disaggregate it a bit more? And I appreciate there's a wide range of restructuring actions that can be taken, but what level of core decremental margins are you folks expecting?

Mark Smith

Well, we're going to give that core margin kind of framework Jerry in a couple of weeks when we're reviewing with all your peers in New York, so I'll defer that piece. But other than to say that the guidance really does not anticipate. There will be some cost in the fourth quarter associated with further cost reduction activities that Tony has talked about, but most of those benefits and even the benefits of exiting production and some of the products we've exited here, they're going to flow into next year.

So we're incurring cost now, but actually even if we ignore the costs we're going to have a year-over-year improvement for those. But again, we'll come back and kind of bundle the overall picture together for you going forward. But as Tony said, we're committed to managing costs, managing well through the down cycle.

Thomas Linebarger

And I guess, Jerry, just to talk about decremental margins because we will get into the framework. But as you expect, the decremental margins in the fourth quarter are not where we want them to be. And that's just reflects the typical situation when the market starts falling quickly and we're still spending money on future investments. It doesn't work out in quarter one.

And so that's one of the reasons Tony is really focused – he and his staff on how to take actions right away, so that we're – as we go into 2020, we bring those decrementals around to what our goals are and you know those as well. So we will be – as Mark said, we will be showing you the targets we have for the core business, why we're confident that we can hit them and then what are some of the other things in and around that, what are some of our new investments, et cetera, that we’re having to stretch to meet, how that all going to fit together.

But needless to say, Q4 is not representing what our goal for our decremental margins is going to be. And that's just because the market is falling fast now and we're still doing the actions that were taken. So it's sort of hard to read core decremental margins from the quarter where all the revenues fall off.

Jerry Revich

Sure. I appreciate that. In terms of the light-duty diesel platform for you folks with exiting the 5-liter production here in the U.S., can you give us an update there, you folks finding that there are opportunities to source similar products from elsewhere, maybe the Isuzu joint venture or otherwise because you folks had been looking for light-duty diesel to be potential option value for you folks over the next couple of years. So can you just update us on the decision tree to discontinue production here in the U.S.?

Thomas Linebarger

Yes. I think it's – from a strategic point of view, we still think the light-duty diesel business is a good business for Cummins. And as you said, we are talking to Isuzu about how to cooperate fully across that market. It's a market that requires relatively high volume and scale to be successful. And so that's one of the reasons that we think the opportunities between Cummins and Isuzu are significant.

I think one of the things that we recognized with the Nissan-related business, the ISV, is we just didn't reach the scale we needed to reach. And that was a function of the customers and the segments that we're after. The scale wasn't there. But the scale across the light-duty segment for Cummins is significant. As you know, we have very large scale across our 3.8, 2.8, 4.5 and 6, 6.7-liter engines.

We have a global scale, which is unmatched in the industry and that's of course helping us get good profits, good returns off that engine. And we do expect by the way, electrification in the lower power segments to go faster and that in the higher power segments.

Having said that, we think the transition is going to be relatively slow and we think the opportunity to consolidate and earn returns over many, many years to come is there for Cummins and ideally there for the Cummins, Isuzu partnership. So we are investing there and trying to see what we can do to consolidate in the industry in the light-duty segment. It's just that, with the one – the ISV, we're after a certain segment in the U.S., it just didn't appear to offer scale for the engine.

Jerry Revich

Okay. Thank you.

Thomas Linebarger

You bet, Jerry.

Operator

Thank you. Our next question comes from Andy Casey with Wells Fargo Securities.

Andrew Casey

Good morning and congratulations.

Thomas Linebarger

Good morning, Andrew.

Andrew Casey

Just a couple of clarifications and then a question on China. In the quarter, you'd talked about $35 million charges for the cessation of development and product exit, $33 million of that showed up in engines. Was the remaining two also in engines? Or was that somewhere else?

Mark Smith

Components.

Andrew Casey

Okay. Thank you, Mark. And then on China – I'll come back offline for the other one. On China, you talked about the lack of credit availability, do you see that changing in the near future or in 2020?

Mark Smith

The credit availability issue is really in India. And just to kind of maybe provide a little more background, the credit market is supplied by non-bank credit institutions. Sometimes – in the country, they call it the shadow banking system, but it's these private credit institutions. And they had a couple of bankruptcies in there, in that segment and the market is largely closed, and to the extent it's opened up, prices are very high. So that's what's going up on India.

So we do expect it to find its way through as things do in India. We do expect that to mitigate. We just don't think it's mitigating really fast. It's going to take some time because the financial problem, financial crisis not an economic one. So it is a significant issue in the country and there are other economic challenges in India.

So we do expect that things are definitely worse than we expected at this time. And we expect some of those things to linger. The opportunity for us remember though, is BS VI is coming. So – and we are fully prepared for BS VI. Our technology, we believe is leading in the market.

We think we have not only a technology, but we also have a cost and scale leadership as well as a service network, which we think is better than competitors. So we do hope to see that this BS VI gives us an opportunity to increase share and increase profitability in India. We just think next couple quarters are going to be rough. That's just the way I'd summarize it.

Andrew Casey

Okay. I'll leave it there, and thanks for the correction.

Mark Smith

You bet.

Operator

Thank you. Our next question comes from Jamie Cook with Credit Suisse.

Jamie Cook

Hi, good morning and congratulation, Rich. I hope you have a fantastic retirement and thanks for all your help throughout the years. I guess sort of first question, I appreciate the color you guys gave on sort of what impacts the margins going from the third quarter to the fourth quarter.

But I think everyone was also trying to get their arms around just the magnitude of the revenue step-down in the fourth quarter. So I know you talked the markets globally being weaker, but how much of that is just demand versus you guys also making adjustments relative to what your customers are doing sort of on the production cuts size to rightsize inventory?

And then I guess my second question, Tom, as you look to 2020, can you sort of talk about cost conversations you're having with customers? Are they sort of reevaluating where their investments are going and how that could potentially be an opportunity for Cummins? And if so, should we think about that is a 2020 opportunity? Thank you.

Thomas Linebarger

Great, Jamie. So let me let Tony to talk a little bit about what's happening in North America. And I think it's applicable in some other markets, too, about inventory and inventory corrections.

Tony Satterthwaite

Hi, Jamie. This is Tony. We have OEM supply chain where we don't hold a lot of inventory for our OEM customers. We pretty much deliver to their schedule. As they adjust their schedules, they move their inventory around a bit or just their production flow.

And we think that's part of the challenge we're seeing in the market today. Those adjustments are making it difficult to kind of pin down exactly what our numbers are going to be versus the market. But we are seeing a little bit of that. I would say none of our OEM customers have significant engine inventory, but there is inventory of trucks in the fields that we see peaked here at the end of September. And so that's just another signal I think that we're going to see demand coming down.

The vast majority of the revenue drop into the fourth quarter is from the North American truck side though rather than all the other markets. They are down bit, but it's really North America that's down the most.

Thomas Linebarger

And we do expect market share – our market share to be impacted Jamie to some degree in the fourth quarter as well. I mean it happens every downturn. What happens is that the OEMs basically keep building to fill orders and they slowdown shipments of our engines and they use up their engines more than our engines.

We see it, that market share move just as we see it move our way when things start to get busy or in fall. These quarter-to-quarter variations smooth out pretty quickly and we still expect to be in our normal range 32% to 34% or there thereabouts. But in the short-term, we expect we'll see some short-term market share numbers, which are lower just because – this is just what happens every time. So we expect it at this time too.

I think with regard to your question about conversations with OEMs. There is no question that every OEM I talked to is wondering where they want to put their investments. Their decisions are still in front of them for many of them, but they are wondering because they're looking at autonomous vehicle investments.

They're looking at, of course, a whole new set of truck ranges, very competitive markets. They're looking at where they want to go internationally and what that takes and what joint ventures and partnerships and they want to do. They're thinking about telematics and other information technology investments. They're thinking about electrification, fuel cells, other CO2 related investments, especially for the European truck makers of CO2 regs are really, really tough.

So they just look staring down the barrel of a set of investments that look 2x or 3x their average R&D spend and asking themselves what they want to do. They're mostly making money selling diesel engines today. So the difficulty is, do I keep selling and investing the things that I'm making money today or do I prepare myself for the future where money is going to be made tomorrow?

Those are hard set of discussions and we are in discussions with them all the time trying to demonstrate to them that we can help partner with them, take some of those diesel investments off the table. We also of course have electrified powertrains and now fuel cell powertrains to offer them to.

But all of this is to say we can take some of those investments and still partner with you, so you can do the rest and succeed in competition. And those conversations are hot and happening all the time. Where they'll come out? We'll see. But there's no question, you can hear in my voice that I think it's an opportunity for us to expand our relationships with OEMs and increase our opportunities to sell more of both traditional powertrains and alternative powertrains.

Jamie Cook

Okay. Thank you. I appreciate the color.

Operator

Thank you. Our next question will come from Ross Gilardi with Bank of America.

Ross Gilardi

Hey. Good morning, guys.

Thomas Linebarger

Good morning, Ross.

Ross Gilardi

Tom, I'm just wondering what your thoughts are on how some of your more stable businesses like after market components, distribution and power gen would perform in a downturn. I mean do you think they move sideways or do they actually go down on the aftermarket side or are you seeing much deferred maintenance at this point that's impacting that business?

Tony Satterthwaite

Yes. Ross, this is Tony. We expect distribution and our aftermarket business to mostly move sideways in a downturn. It's not perfect, but it does not go through the same cyclical ups and downs as our first-fit business. And we've been growing the aftermarket significantly over the last couple of years.

We're seeing a little – as Tom and Mark said, a little slowdown this year, a little moderation of the growth, but we have strong confidence in the aftermarket, both distribution and the parts businesses are going to look really – perform really well on the downturn.

Thomas Linebarger

And part of that Tony is due to the growing population of Cummins engine out in the field and in a number of end markets, that means we've got to build in pipeline of aftermarket opportunity over time.

Mark Smith

Yes. So I think you have that right. We've got some – we think are going to remain relatively sideways while the others go down. The other thing going on, which you probably saw in the numbers is in the distribution business, especially in North America, there's been still quite a bit of improvement driven from our initial acquisition of all of our North American distributors.

We spent the first four years making sure we consolidated, got the right managers in the right place, made sure we held on to customers and let them know that we're a good distribution business and care for customers.

And now what we're beginning to do is figure out how to operate those businesses more or like a North American distribution business rather than a bunch of different branches. And so we're beginning to see some improvement in profitability. We'll see where that goes from here, but there's a lot of good plans in that distribution business.

So my own view is I'd like to see it do better than sideways because I think there are opportunities for it to do better than sideways during the downturn. But I think Tony has called the aftermarket point just right. We always see a little bit of noise where utilization goes down here or there. We don't go down a little bit, but we're talking about 5% drops as opposed to 30% or 40% drops.

Ross Gilardi

Got it. Thank you. And then just a related follow-up. I mean your biggest customers still seeing in mid single-digit growth for Parts and your Components business is down 6%. I know they're not apples-to-apples and it sounds like most of the weaknesses is international as opposed to North America. But are you losing share in any of your key markets for components and is the model changing at all, particularly with respect to that customer? They're focusing very, very heavily on their distribution business and seem to be stocking more parts from others as well, so just thoughts there?

Mark Smith

The best proxy for our overall Parts business is really the Distribution business. The Components business is probably 70% for us fit, Ross. So turbochargers what was going on the new equipment, obviously that's down quite heavily in some of the markets right now. Our underlying Parts business, we're confident in that. That's not the real issue here.

Thomas Linebarger

Yes. And by the way, we believe that with OEMs like our customers, them doing well in parts is not a detriment to comments because remember there's a whole group of parts players, secondhand parts players and rebuild parts builders and even people that are bringing in different makes of parts.

And so what we are wanting to do is make sure our end customers get real quality parts and they get a good service experience. And if they do that Cummins and our customers grow their market share and we earn good parts revenue. So we earn good parts of margin selling through our OEM channels just as we do sell in through our own channel.

So from our point of view, just gaining share in the market through our customers and through us all looks like a win to us in terms of both revenue growth and profit growth. So for us, them – our customers gaining share is not a bad thing, but a good thing.

Ross Gilardi

Thank you.

Operator

Thank you. Our next question will come from Joel Tiss with BMO.

Joel Tiss

Hey, guys. How is it going?

Thomas Linebarger

Hi, Joel.

Joel Tiss

I just wondered if you can talk a little bit about power gen. The revenues were up a little bit. You guys have been working on that business for four years or five years to lower the cost. And just any color on why the margins are under pressure there?

Thomas Linebarger

Joel, I'd love to throw that one to Tony, but probably isn't very yet. I'll give them a quarter or two. But no, you hit it on the head. I mean we're not where we want to be on the power gen business. The good news, of course, overwhelmingly been data centers. The data center business has continued to grow. We keep expecting it maybe to be built out, but it just turns out not to be. We're continuing to see more data center business. And of course, we've now got the Asian section of data center business also growing, which is, which gives kind of a second kick to the data center business.

The basic standby business has not been good for some time. It's not that there isn't any, there is. It's a big business and it doesn't – it's a lot of business for our distribution system, but it hasn't been growing. It hasn't really recovered in any significant way. And we saw a little bit of recovery earlier this year and thought, well finally, and then it kind of tailed off. And then of course we had – we've had a couple of really bad areas like the Middle East has been really bad for a while, but I've just kind of pulled the life out of whatever growth we did see.

So we're not exactly sure what that means about the market. We have a lot of market data about it and trying to understand what the future trend is. I mean, we understand what the past is really well, what the future trend looks like. It's hard to see, but it looks like, broadly speaking that energy demand while still increasing is increasing at a rate that's slower than energy capacity build. And that's mostly because while there's been growth since the downturn in 2008 and 2009, its growth has been relatively modest and infrastructure has kept up as compared to the high growth we saw especially in developing countries in the decade before.

That said, we got a lot more work to do. It's still a profitable business for us and good returns, especially when you consider the fact we've got a distribution part to it, plus we've got all the industrial business engines that come from it, but we want it to be more profitable and we're disappointed with where we are. There's just nothing else to say about that.

Joel Tiss

Okay. And then so Tony doesn't feel left out. Can you give us your kind of best shot at, if you think the underlying demand for transportation is enough to absorb all the excess capacity that's in the channel now, by the time we exit 2021?

Tony Satterthwaite

That's a tough question. I probably was better prepared to answer the power gen, and this was given I ran that business quite a few years. That's a great question. And I don't think I have a good answer to be honest. I don't really have a strong view of that yet. So maybe in a very unfair thing, I'll see if Rich wants to have a shot.

Joel Tiss

Yes, that’s one of his babies.

Thomas Linebarger

He's going to bring out the pictures of his grandkids first, but then he'll answer the…

Richard Freeland

Just play back one more time, Joel.

Joel Tiss

The growth in transportation demand, the way you guys see it is enough that by the end of 2021, it can absorb all the excess capacity that we're seeing in the channel right now.

Richard Freeland

Okay. Yes, I mean I think so and what you have Joel, you know, when lead times get long, the order boards actually get over inflated because people are wanting to get, build slots and all that. And right now I think actually it's underrepresented what the demand is because I think – I mean what the future demand is. So like I talked to fleets, they're not putting orders in right now because they're saying lead time is low, I can put it in later, I can delay that. But eventually the trucks run and they need to be replaced. And so I just think we're going to have our normal shake out over a few quarters and then kind of get the backlog cleared out and the orders will begin to come back in.

Thomas Linebarger

And maybe just a little historical protective, Joel because it's always hard when you're here at the floor to figure out when does it all get right. But historically, you'd say what – I mean, you'd say in four quarters the market will be back. Again, there maybe something unique about this, but it isn't obvious that there is something unique.

So we'd expect by the end of the year that we would indeed have absorbed whatever there is. There's one other trend underlying. You've probably seen this, but people like the new engines and trucks, they're seeing much better performance reliability out of new engines and trucks.

So I think anything that's older than 2017 you're going to see no matter how, whatever we are in the cycle, people are going to want to switch out those trucks and engines just because they're getting such lower operating costs out of the newer engines and trucks. That'll be a little bit of a boost, I think as we start to get out to the back half of the year.

James Hopkins

Okay. I think we've got time for one more last question.

Operator

Okay. Our next question will come from David Raso with Evercore ISI.

David Raso

All right. Thank you.

Thomas Linebarger

You slipped in David. Way to go.

David Raso

I have a question about the JV income, really a clarification, but then I want to talk to the markets real quickly. I apologize with the phone cutting out, maybe I missed it. The JV incomes implied bouncing back in the fourth quarter versus the third quarter. Is that related to some of the emerging markets and how you're handling the upcoming emission standards? I'm just curious why it bounces back from $68 million to implied $79 million in the fourth quarter?

James Hopkins

Yes. Hey, Ross, this is James. So there's a couple of little things go on from the third to the fourth quarter, so most of the markets are relatively stable as we go from Q3 to Q4. China gets a little bit better than some of the on highway markets, like commercial vehicles starts popping up just a little bit as well. And so you've got a couple of positive things going in the right direction there. But it's a relatively modest on both from Q3 to Q4 in the grand scheme of things.

David Raso

But I was trying to think about is what you're implying about 2020 to have that bounce back because in the quarter the royalty and interest income really dropped down as just wasn't sure what was going on there. So we'll talk offline.

What I wanted to ask about particular though, outside of North America truck and obviously Tom, you have great insight from your customers and markets, what they're telling you, different players do different things and getting ahead of the curve behind the curve outside of North America truck.

Can you just take me around the horn quickly on which markets do you think what you're hearing from your customers? They're actually getting ahead of the curve on taking production down to almost leading things out by the end of the year, which ones are so clearly behind the curve and which ones look about just right. Just we'll get some level set on various geographies and end markets going into…?

James Hopkins

Yes. Let's start with China. So clearly in China, the construction guys overbuilt, in the second half of 2018 thinking they're going to have a great 2019. They overbuilt and they're clearly behind the curve, right. You saw that – you heard the numbers, like the markets up and we're down a pile and that's just because they're just selling dealer inventory and their own manufactured inventory, so that that's for sure.

It won't take very many quarters before they're caught up, but they're in not at that stronger market, so it's stronger than we thought it would be today, but it's not so strong. So we're hopeful they'll catch up in a few quarters. But again, it just really depends on end markets.

I think truck markets a little bit better than we thought. I think people are pretty much caught up. Nobody's really far ahead. The only thing as you heard was there some prebuy done, which means they'll have some inventory, but it's mostly in gas. It's pretty small markets I'd say.

China, we got the construction markets to catch up and they're behind and the truck market's kind of on. In India, it's just – we just got the rug pulled out. The whole finance thing means it's all underwrite. There's nobody carrying a bunch of inventory or anything. There are some, but that's not the big problem. The big problem is the demands all completely flatness back. So there's really, I mean who's behind the head is kind of the side story.

In Europe by the way is straight on. So Europe has got no big challenges in inventory a little bit here and there, but generally speaking, Europe has kind of moved from pretty good, okay, they're not – it's not a disaster. It's just, okay. And I see pretty quickly everybody's adjusting hourly rates in Europe. I was just talking to a bunch of the OEMs they're all adjusting down. Everybody's making the adjustments. There'll be down to the right numbers in a quarter or two. So I'd say that's right.

On the mining side, they adjusted super quickly. I mean, in my opinion too quickly maybe, but mining is not a disaster or anything. It just rose up and it kind of leveled out pretty quickly and they're not overbuying and for obvious reasons they already did and it's bad. So mining is one where I don't think we have a lot of – they're on plan. In fact, maybe keeping costs lower than they would have in the past segments.

And then Latin America, I guess broadly speaking, things aren't very strong. We thought Brazil would be better than it is. And the big issue has been export markets. The domestic demand is about where we thought, it's up a few percent in GDP. I mean, and then underlying demands up. But the export market, because Argentina is a big wreck.

And frankly all around, Latin America what you're having is used to be Brazil was the problem. Now you got every other economy is a problem. And so there is a little inventory there, but the numbers have been so low that it's nothing to worry about. So I guess the only place I'm really worried about is China construction with regard to inventory and we're already reporting those numbers thereof.

And in North America, Tony talked about this, but there'll be a couple of quarters where our market share will fall while they use their own engines and get all those, get their truck production down and get everything leveled out. But then it will be right back to normal.

Mark Smith

And then just a smaller market, but marine feels like it's on a bit of an opportunity…

David Raso

Is there a pick up in marine or is it production just getting back in line with a flat business?

Mark Smith

Yes. I think demand is picking up.

Thomas Linebarger

Demand is picking up a little. Again, it's in a weak set of markets. It's just that it started, came off the bottom basically.

David Raso

Okay. Thank you very much. I appreciate it.

Thomas Linebarger

Thank you, David.

Mark Smith

Thank you, David.

Thomas Linebarger

Thank you. Bye-bye.

Tony Satterthwaite

So thank you, everybody.

Mark Smith

Yes. Thanks everyone.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.