Indbank Merchant Banking Services Ltd (A Subsidiary of Indian Bank)

Cummins India Ltd.

EQUITY REPORT

November 29, 2013

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Cummins India Ltd (CIL), established in India in 1962, is a group of complementary business units that design, manufacture, distribute and service engines and related technologies, including fuel systems, air handling, filtration, emission solutions and electrical power generation systems. Part of the US$17 bn Cummins Inc., Cummins India is a Group of eight legal entities across 200 locations in the country with a combined turnover of ₹11,560 crores in 2012 and employing close to 9,000 individuals.

Investor's Rationale

- On account of economic uncertainties, the company posted a dismal performance in Q2FY'14, however the management seemed quite confident as the company continued to maintain margins, owing largely to its increased focus on cost efficiencies. During the September quarter, net sales declined 14% YoY to ₹9.1 bn, due to fall in domestic sales by 19% YoY during the period. However, the decline in company's net profit was limited to 10% YoY at ₹1.4 bn supported by higher other income and lower interest cost as well as taxation cost.

- Although the growth prospects of the company in the short-term might have been affected, but for long term, the company continues to be strongly positioned to resume growth upon revival of the markets. Further, the company is continuously investing in critical technologies geared towards serving its customers dependably. So, we believe that CIL could perform better in the coming quarters.

- The management expects the domestic revenues to remain weak, while it is more optimistic about exports in near to medium term. CIL is developing channel network in key markets for LHP engines in key end markets like Middle East, China, Australia, US and Africa. During Q2FY'14, the company had been able to achieve a 9% YoY rise in exports realisation (though they were flat as compared to the same quarter last year).

- CIL is exploring business opportunities with new Original Equipment Manufacturers' (OEM) that are planning to enter the Commercial Vehicle Market in India and is also considering leveraging relationships with its existing customers for new solutions. Further, in order to expand its geographical presence, CIL has supplied its first engines to Latin America which will help consolidate and diversify regional business risks to the company.

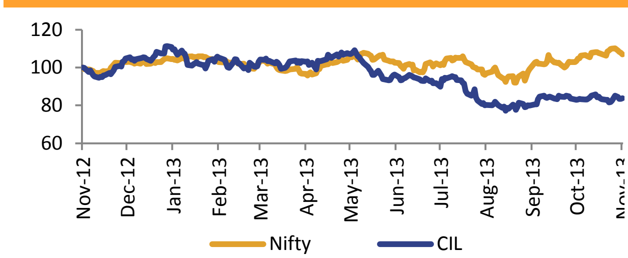
Market Data

Rating	**BUY**
CMP (₹)	431.8
Target (₹)	**490**
Potential Upside	~13.5%
Duration	Long Term
Face Value (₹)	2.0
52 week H/L (₹)	542.4/369.1
Adj. all time High (₹)	567.9
Decline from 52WH (%)	20.4
Rise from 52WL (%)	17.0
Beta	0.4
Mkt. Cap (₹bn)	119.7
Enterprise Value	116.1

Fiscal Year Ended

Y/E	FY12A	FY13A	FY14E	FY15E
Revenue (₹bn)	41.2	45.9	48.2	54.0
EBITDA (₹bn)	7.0	8.3	6.9	8.3
Net Profit (₹bn)	5.9	7.6	6.2	7.4
Adj EPS (₹)	21.3	27.6	22.5	26.8
P/E (x)	20.2	15.7	19.2	16.1
P/BV (x)	5.9	5.0	4.3	3.8
EV/EBITDA (x)	16.8	13.9	16.8	13.7
ROCE (%)	29.0	29.2	20.0	21.2
ROE (%)	28.9	32.0	22.3	23.5

One year Price Chart



Shareholding Pattern	Sep'13	Jul'13	Diff.
Promoters	51.0	51.0	-
FII	15.5	16.2	(0.7)
DII	19.8	19.5	0.3
Others	13.7	13.3	0.4

CIL, a US based Cummins Group company, is India's leading manufacturer of diesel and natural gas engines.

Established in 1962, the company comprises of four business units - Industrial Engine, Power Generation, Distribution, and Automotive.

CIL sells in approximately 190 countries and territories through a network of more than 600 company-owned and independent distributors and approximately 6,000 dealers.

India's leading manufacturer of diesel and natural gas engines for power generation, industrial and automotive markets

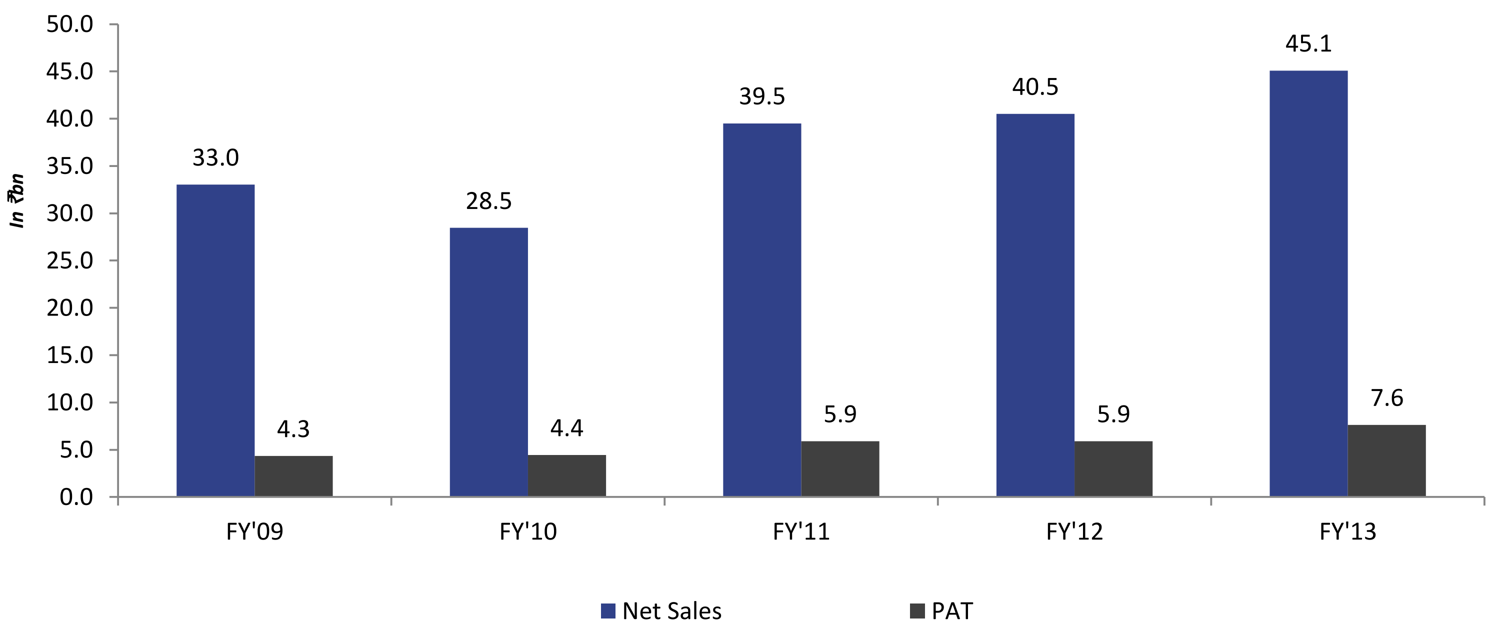
CIL is one of the eight legal entities of the Cummins Group in India. The company operates in two segments, namely, Engine Business Segment, which is engaged in manufacturing and sale of internal combustion engines, gensets and parts thereof, and Others. Established in 1962, the company comprises of four business units - Industrial Engine, Power Generation, Distribution, and Automotive. The Industrial Engine Business segment caters to the industrial sector with the company's engines ranging from 65 horse powers to 3,500 horse powers. The Power Generation Business Unit operates in diesel, natural gas, producer gas and biogas generator set segment. The company operates single window for power solutions, offering products and services. The Automotive Business caters to the commercial vehicle segment in India with its range of engine platforms and related technologies alongside parts and customer support. Lastly, the Distribution segment operates under the brand name Cummins Sales and Service India. CIL is also the largest entity of the Cummins Group in India.

CIL is a subsidiary of the US based firm, Cummins Inc., the world's largest manufacturer of diesel engines above 200 HP. CIL offers the complete range of Cummins Worldwide products. Where indigenous production is not available, Cummins imports products from Cummins Inc.

CIL is a group of eight legal entities across 200 locations in the country with a combined turnover of ₹115.6 bn in 2012 and employing approx. 9,000 individuals. Globally, CIL sells in approximately 190 countries and territories through a network of more than 600 company-owned and independent distributors and approximately 6,000 dealers.

During FY'13, the company registered a net sale of ₹45.1 bn, up by 11.3% YoY. Net profit before tax witnessed a surge by 28% YoY to ₹9.9 bn, reflecting the healthy performance. Further, the company generated significant amounts of cash, strengthened its balance sheet and financial position and most importantly continued to return value to its shareholders.

Sales and PAT trend



Despite economic uncertainties, CIL continued to maintain margins on increased focus on cost efficiencies

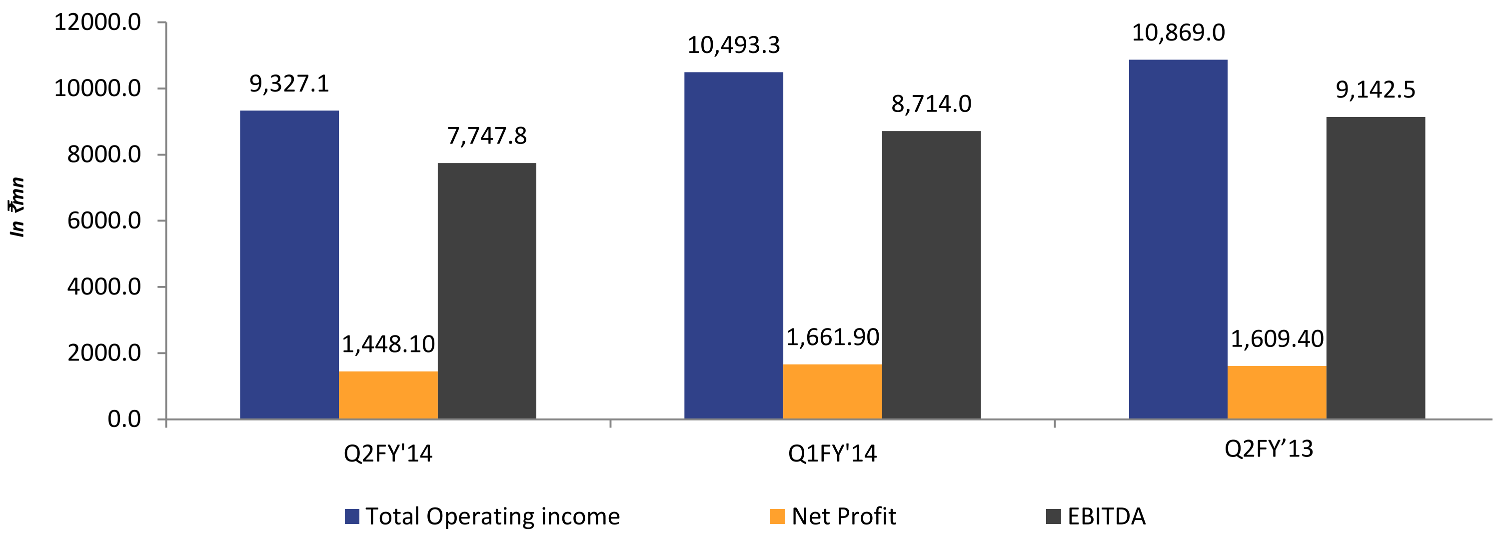
Despite of lower sales and profit for Q2FY'14, management seemed quite confident as the company has been able to maintain margins, owing largely to its increased focus on cost efficiencies.

Net sales tumbled 14% YoY to ₹9.1 bn, while net profit declined 10% YoY to ₹1.4 bn in Q2FY'14.

CIL's performance during the quarter ended September 2013, was significantly impacted by the economic uncertainties, however the management seemed quite confident as the company continued to maintain gross margins, owing largely to its increased focus on cost efficiencies.

During Q2FY'14, the company registered a fall in its net sales by 14% YoY to ₹9.1 bn, while a decline of 11% was observed sequentially. Net sales for the half year ended September 2013 declined 16% to ₹19.4 bn. Lower sales together with 200 bps contraction in operating profit margin translated into 24% YoY fall in operating profit. Domestic sales were down 19% YoY largely on the back of a slump in the power gen market. However, higher other income and lower interest cost as well as taxation cost has restricted the decline in net profit to 10% YoY at ₹1.4 bn. It was reported that other income rose 65% YoY to ₹0.6 bn, while financial cost for the company was down by 28% YoY to ₹0.01 bn, limiting further decline in profitability. Taxation in absolute terms was lower by 17% YoY to ₹0.5 bn and the effective tax rate was lower at 25.5% compared to 27.1% in the corresponding previous period. While, depreciation cost surged 12% YoY to ₹0.1 bn on the back of capacity augmentation programme.

Performance in Q2FY'14 impacted by unfavourable economic conditions



Higher staff and other costs led to a decline in EBITDA margin by 200 bps to 16.4% in Q2FY'14.

On operational front, EBITDA margin contracted by 200 bps to 16.4% largely on account of higher staff and other costs. The Staff cost and other expenses were higher by 200 bps and 270 bps to 9.5% and 14.3% respectively. Higher staff cost is largely on account of lower sales not supporting the higher fixed cost as new plants are still in ramp up stage. The material cost (including cost of traded goods) was lower by 261 bps to 59.7% benefiting out of softening commodity prices even though the rupee depreciation escalated the imported engines/components.

Resultantly lower sales together with contraction in OPM has led to 24% fall in operating profit to ₹1.5 bn.

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

Power shortage in South, north and east india has catapulated demand for DG sets, which is a positive news for the company.

Coal demand from the power sector continues to be robust due to huge investments in power capacity addition over the past few years. Coal India, the leading coal producer is finding it difficult to scale up production on account of delays in environmental clearances, land acquisition problems, etc. As a domino effect, India's power deficit is likely to remain high. The country is facing acute power shortage, primarily in South, and lately in North and East India, which has boosted the demand for diesel generator (DG) sets (20% growth in FY'13 YTD). This augurs well for the company, given its exposure to the power gen market segment (50% of the total Engine revenues).

Expected rise in prices, post CPCB implementation, may limit the expected decline in sales

The company's domestic growth is expected to be down by ~10-15% on account of a slow-down in the domestic economy.

CPCB norms II are expected to come into effect from H2FY'14 for engines up to 800 kW, with significant reductions targeted in emission level. This calls for investments in development of critical components and subsystems across the product line in alignment with this norm and validation by qualified authorities of product lines confirming to that. Responding positively to this, most of the major players have started investing in development of critical components and subsystems across the product line in alignment with this norm. During Q1FY'14, CIL expected the prices of its products to go up atleast by 20% with new CPCB norms coming into effect from July 2013. However, the notification has not been out yet.

The company in its Q2FY'14 conference call indicated that it expects the company's domestic growth to be down by ~10-15% on account of a slow-down in Indian economy. Further, without any pre-buy impact, the company expects the sales to be down in the same range. However, since post CPCB norms implementation, the pricing gap will widen meaningfully, CIL may be able to cope up with the expected deline in sales.

DG Sets Emission Regulations In India

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

**Source - CPCB*

CIL's management expects to maintain the margins as witnessed in Q2FY'14 led by sustained cost control initiatives and exports.

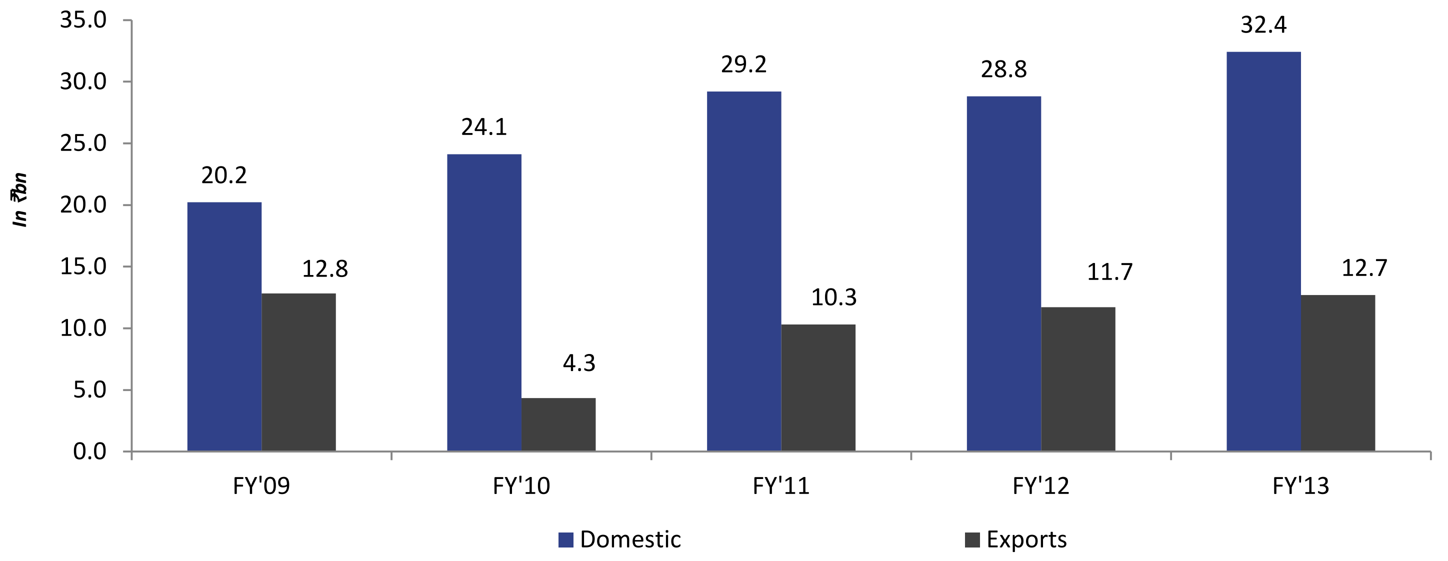
The management expects domestic revenues to remain weak, while it is more optimistic about exports in near to medium term.

Margins beat expectations in spite of lower sales

Cummins reported 240 bps gross margin expansion in Q2FY'14 mostly led by favorable currency and new product line, while margins declined 30 bps sequentially, mainly led by lower volumes. The management expects to maintain the margins as witnessed in Q2FY'14 led by sustained cost control initiatives like ACE, which is based upon significant amount of value engineering, localisation etc. Moreover, the exports portion has become more profitable due to a regular depreciation in Indian currency. During Q2FY'14, the company had been able to achieve a 9% YoY rise in exports realisation (though they were flat as compared to the same quarter last year). Taking altogether the US, Europe, Middle East, Africa, China, Asia, the company expects a growth of ~20%. However, overall, CIL's exports are likely to be down 10% fiscal year.

The management expects domestic revenues to remain weak, while it is more optimistic about exports in near to medium term as it has introduced a number of products for this market. CIL is developing channel network in key markets for LHP engines in key end markets like Middle East, China, Australia, US and Africa.

Sales : Domestic vs. Exports



The company has invested a total of ₹149 crore in the current fiscal as compared to ₹136 crore in FY'13.

Well focused on expanding facilities, to position itself for long term success

CIL is well positioned to expand its capabilities in terms of technology, product and capacity enhancements. The company has invested a total of around ₹1,490 mn in the current fiscal as compared to ₹1,360 mn in FY'13. Further, with its plans to expand the laboratories and engineering facilities at its Kothrud site into a global technical center, the company is positioning itself for the long term growth. Geared towards strengthening the company's capabilities to design technologies for the future, the technical center will house over 2,500 engineers and is expected to become fully operational over the next two years. Despite of tough market conditions, CIL has always tried to be ahead of its

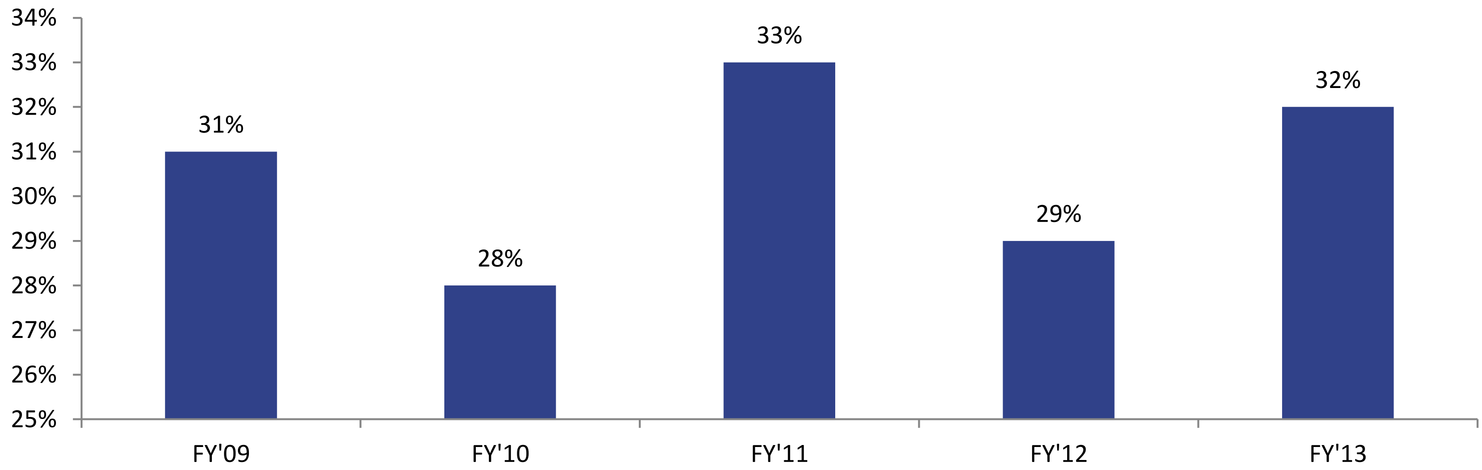
CIL plans to double the capital investments to ~₹450-500 crores for the next couple of years, against the capex of ₹220-230 crore spent in the last fiscal year.

peers, signifying the company's decisiveness. Subsequent to starting operations at three facilities in early 2011 at the Megasite, the India Parts Distribution Center (CIL's logistics hub) became fully operational in 2012 and has since been able to achieve and sustain record world-class levels of spare parts fill rates for customers. Further, following the opening of its fifth facility at the Megasite, Phaltan Midrange Upfit Center in 2012 for manufacturing generator sets and G-drives for exports in the low and medium horsepower range, CIL has built another facility, also the first one on the SEZ of the Megasite and is expected to commence operations in the second one by the end of CY'13.

Plans to double the capex

The company has cut back on some items which are demand driven due to the relatively ongoing slower demand. However, there are some strategic investments that are required to be made, such as in its technical center as well as an office campus and a couple of other investments that are more related to specific products. The company plans to double the capital investments to ~₹450-500 crores for the next couple of years, against the capex of ₹220-230 crore spent in the last fiscal year.

Strong ROE Performance over the last five years



Key Concerns

- ✓ Any major slowdown in the domestic market (70% of the total revenues) would pose a significant down side risk to the estimates.
- ✓ Low liquidity in the market is causing some delay in projects, thereby impacting the growth momentum.
- ✓ Leading international players are making their foray into India. Private players are also entering PSU dominated sectors like mining and exploration which is likely to raise competitive intensity.
- ✓ Slow global economic conditions have impacted the demand for engines across all engine families and while the company is trying to explore new sales avenues through new business initiatives, the uncertainty over the prolonged slowdown is expected to continue to impact export revenues.

Balance Sheet

Y/E (₹mn)	FY12A	FY13A	FY14E	FY15E
Share Capital	**554.4**	**554.4**	**554.4**	**554.4**
Reserves & Surplus	19,877.1	23,312.9	27,319.5	31,153.0
Net Worth	**20,431.5**	**23,867.3**	**27,873.9**	**31,707.4**
Provisions	3,755.7	4,781.7	3,347.2	4,278.3
Current Liabilities	6,682.7	7,569.0	8,174.5	9,155.5
Deferred Tax Liability	0.0	327.8	327.8	327.8
Long Term Liabilities	147.0	150.4	156.4	162.7
Capital Employed	**31,016.9**	**36,696.2**	**39,879.8**	**45,631.6**
Fixed assets	5,145.8	6,142.2	7,247.8	9,422.1
Deferred Tax Assets (net)	69.5	0.0	0.0	0.0
Investments	5,975.5	6,275.6	6,275.6	6,275.6
Loans and Advances	5,081.9	6,788.2	8,174.3	9,645.6
Current Assets	14,744.2	17,490.2	18,182.2	20,288.2
Capital Deployed	**31,016.9**	**36,696.2**	**39,879.8**	**45,631.6**

Profit & Loss Account

Y/E (₹mn)	FY12A	FY13A	FY14E	FY15E
Total Income	**41,172.2**	**45,893.8**	**48,188.5**	**53,971.1**
Expenses	34,199.7	37,545.0	41,299.5	45,635.9
EBITDA	**6,972.5**	**8,348.8**	**6,889.0**	**8,335.2**
EBITDA Margin (%)	*16.9*	*18.2*	*14.3*	*15.4*
Depreciation	419.8	472.5	536.3	611.4
Exceptional Items	514.4	615.9	-	-
EBIT	**7,067.1**	**8,492.2**	**6,352.7**	**7,723.8**
EBIT Margin %	*17.2*	*18.5*	*13.2*	*14.3*
Interest	54.1	46.1	41.5	37.3
Other Income	1,233.3	2,067.2	2,273.9	2,501.3
Profit before Tax	**8,246.3**	**10,513.3**	**8,585.1**	**10,187.8**
Tax	2,333.6	2,872.2	2,360.9	2,750.7
Profit after Tax	**5,912.7**	**7,641.1**	**6,224.2**	**7,437.1**

Key Ratios

Y/E	FY12A	FY13A	FY14E	FY15E
EBITDA Margin (%)	16.9	18.2	14.3	15.4
EBIT Margin (%)	17.2	18.5	13.2	14.3
NPM (%)	14.4	16.6	12.9	13.8
ROCE (%)	29.0	29.2	20.0	21.2
ROE (%)	28.9	32.0	22.3	23.5
Adj EPS (₹)	21.3	27.6	22.5	26.8
P/E (x)	20.2	15.7	19.2	16.1
BVPS (₹)	73.7	86.1	100.6	114.4
P/BVPS (x)	5.9	5.0	4.3	3.8
EV/Operating Income (x)	2.9	2.5	2.4	2.1
EV/EBITDA (x)	16.8	13.9	16.8	13.7
EV/EBIT (x)	16.6	13.7	18.2	14.8

Valuation and view

While economic uncertainties across the globe continue to pose growth challenges, CIL is focusing aggressively on implementing measures to counter the dampened demand. The growth prospects in the short-term have been affected, however, the company continues to be strongly positioned to resume growth upon revival of the markets. Further, CIL is well focused on increasing the export sales of its products and is taking substantial business development initiatives to diversify into new territories with new and existing products. Further, the company is continuing to invest in critical technologies geared towards serving our customers dependably.

At a current market price (CMP) of ₹431.8, the stock trades at 19.2x FY14E and of 16.1x FY15E, P/E. We recommend 'BUY' with a target price of ₹490, which implies potential upside of ~13.5% to the CMP from 1 year perceptive.

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