BUY

TP: Rs 2,000 | ⮝ 21%

CUMMINS INDIA | Capital Goods | 25 May 2023

From strength to strength; upgrade to BUY

- **Operationally strong Q4 despite supply chain constraints, with EBITDA and PAT each up ~60% YoY; exports resilient**
- **Strong pre-buying seen till June; demand guided to normalise in Q3 post absorption of CPCB4-related price hikes**
- **We raise FY24/FY25 EPS by 18% each as export and CPCB concerns abate; upgrade to BUY with a new TP of Rs 2,000 (vs. Rs 1,600)**

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Operationally strong Q4: Despite supply chain constraints, KKC achieved revenue growth of 29% YoY in Q4FY23 to Rs 19.3bn, thanks to robust demand in the power generator, distribution and industrial businesses which grew 43%, 31% and 14% YoY respectively. Exports continued to hold up, accounting for 27% of sales. The company's EBITDA margin remained robust at 17%, up 320bps YoY, due to healthy pricing power. This translated into higher net profits of Rs 3.5bn, up 61% YoY.

Exports resilient: Despite past management commentary on potential headwinds, exports have held up well, rising 16% YoY to Rs 4.9bn in Q4 (-9% QoQ as Q3 is a seasonally strong quarter for exports).

Positive long-term outlook: KKC expects the implementation of CPCB4 norms in Jul'23 to drive price hikes of 20-50% for its power generation equipment. While these steep hikes could cause a temporary demand blip for one or two quarters, the company expects to return to a sustainable growth trajectory (at twice the pace of GDP) for the medium term with demand from data centres, infrastructure, real estate and hospitality. KKC has recently launched fuel-agnostic engines, which addresses a key concern for the power-gen business.

TP raised to Rs 2,000: Given visibility of sustained long-term growth in the domestic market, strong exports, and likely demand normalisation in Q3 post absorption of CPCB4-related price hikes, we raise FY24/FY25 EPS estimates by 18% each. On rollover to Mar'25E, our TP rises to Rs 2,000 (vs. Rs 1,600), set at an unchanged P/E multiple of 35x, a 30% premium to the 5Y average.

Upgrade to BUY: Our earlier HOLD rating was premised on slowing exports in H2FY23 and delayed demand recovery following CPCB norm change. However, exports have remained resilient in H2 and the outlook for FY24 is also promising. On the CPCB front, despite strong pre-buying, the company expects demand to normalise much before the Dec'23 deadline for old engine sales. Since our premise for a HOLD rating no longer stands, we upgrade the stock to BUY.

Key changes

Target	Rating
▲	▲

Ticker/Price	KKC IN/Rs 1,650
Market cap	US$ 5.6bn
Free float	49%
3M ADV	US$ 13.4mn
52wk high/low	Rs 1,715/Rs 951
Promoter/FPI/DII	51%/10%/25%

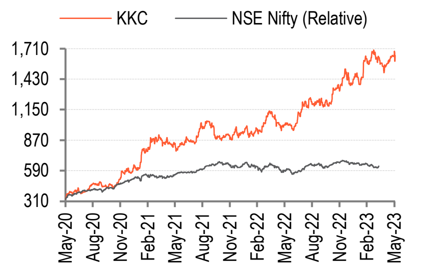
Source: NSE | Price as of 25 May 2023

Key financials

Y/E 31 Mar	FY23P	FY24E	FY25E
Total revenue (Rs mn)	77,721	86,816	96,924
EBITDA (Rs mn)	12,477	12,786	14,584
Adj. net profit (Rs mn)	12,425	13,431	15,507
Adj. EPS (Rs)	44.8	48.5	55.9
Consensus EPS (Rs)	44.8	48.2	55.1
Adj. ROAE (%)	22.8	22.2	23.1
Adj. P/E (x)	36.8	34.1	29.5
EV/EBITDA (x)	38.3	37.7	33.3
Adj. EPS growth (%)	59.0	8.1	15.5

Source: Company, Bloomberg, BOBCAPS Research | P – Provisional

Stock performance



Source: NSE

Fig 1 – Quarterly performance

Consolidated (Rs mn)	Q4FY23	Q4FY22	YoY (%)	Q3FY23	QoQ (%)	FY23	FY22	YoY (%)
Revenue	19,339	15,021	28.7	21,850	(11.5)	77,721	61,709	25.9
EBITDA	3,301	2,082	58.6	4,131	(20.1)	12,477	8,681	43.7
EBITDA Margin (%)	17.1	13.9	320bps	18.9	(180bps)	16.1	14.1	200bps
Depreciation	376	351	-	347	-	1,420	1,356	-
Interest	67	50	-	28	-	162	122	-
Other Income	875	672	-	849	-	3,082	2,432	-
PBT	3,733	2,354	58.6	4,604	-	13,976	9,635	45.1
Tax	955	552	-	1,189	-	3,631	2,732	-
Adjusted PAT	3,489	2,163	61.3	4,138	(15.7)	10,345	6,902	49.9
Exceptional item	0	0	-	0	-	143	(1,324)	-
Reported PAT	3,489	2,163	61.3	4,138	(15.7)	12,282	9,137	34.4
Adj. PAT Margin (%)	18.0	14.4	360bps	18.9	(90bps)	13.3	11.2	210bps
EPS (Rs)	12.6	7.8	-	14.9	(15.7)	44.8	28.2	-

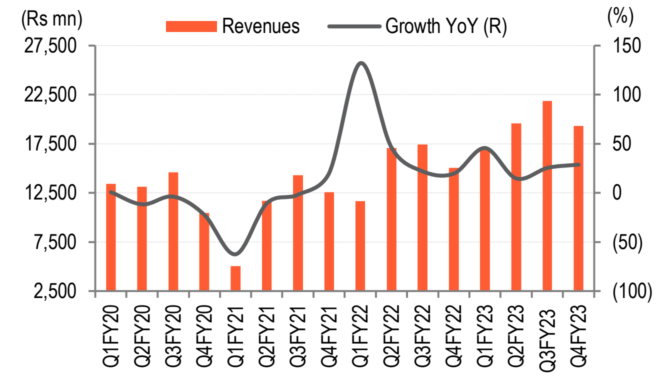
Source: Company, BOBCAPS Research

Fig 2 – Actuals vs. Estimates

Particulars	Actuals	Estimates	Variance (%)
Revenue	19,339	18,777	3.0
EBITDA	3,301	3,061	7.8
EBITDA Margin (%)	17.1	16.3	0.8
Adj. PAT	3,489	2,994	16.5

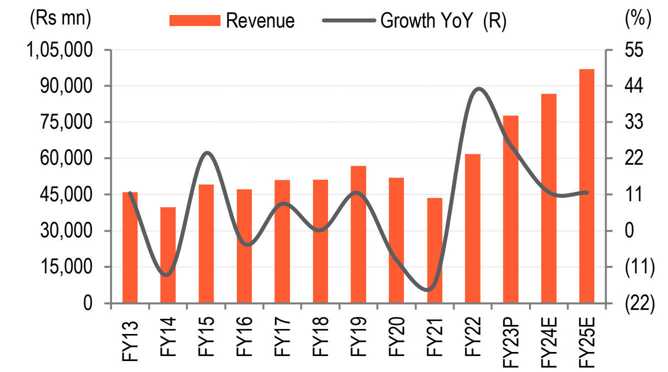
Source: Company, BOBCAPS Research

Fig 3 – Quarterly revenue trend



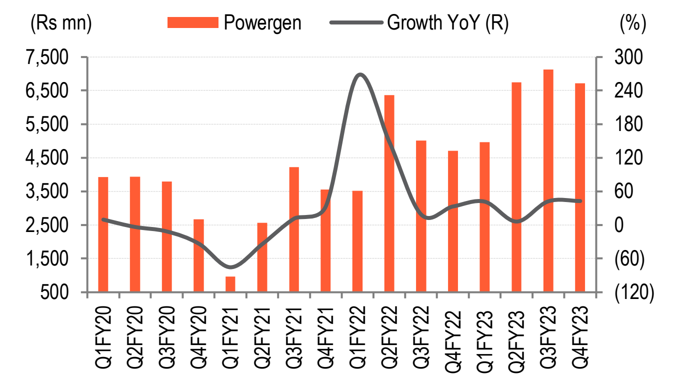
Source: Company, BOBCAPS Research

Fig 4 – Annual revenue trend



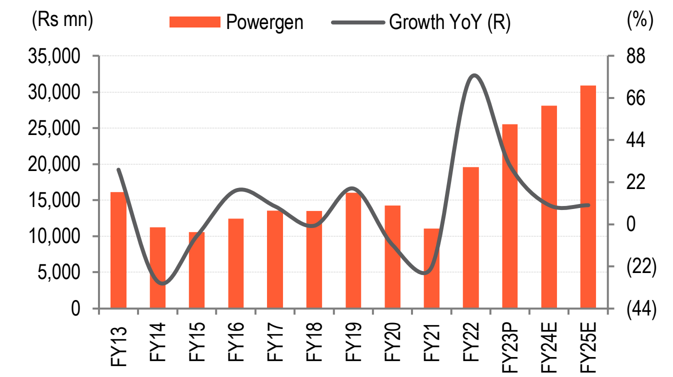
Source: Company, BOBCAPS Research

Fig 5 – Quarterly power segment revenue



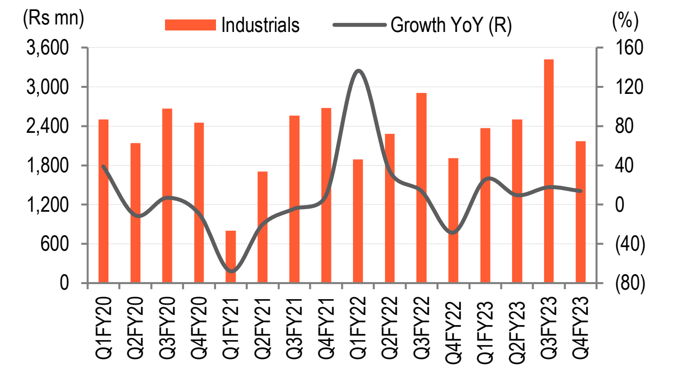
Source: Company, BOBCAPS Research

Fig 6 – Annual power segment revenue



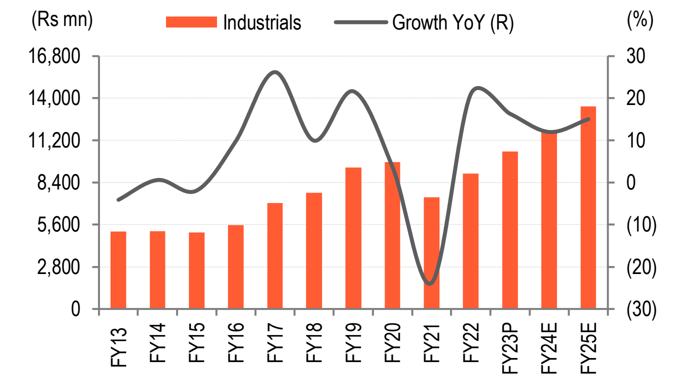
Source: Company, BOBCAPS Research

Fig 7 – Quarterly industrial segment revenue



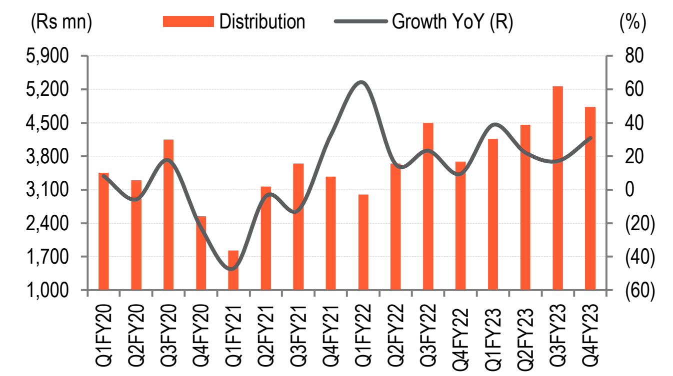
Source: Company, BOBCAPS Research

Fig 8 – Annual industrial segment revenue



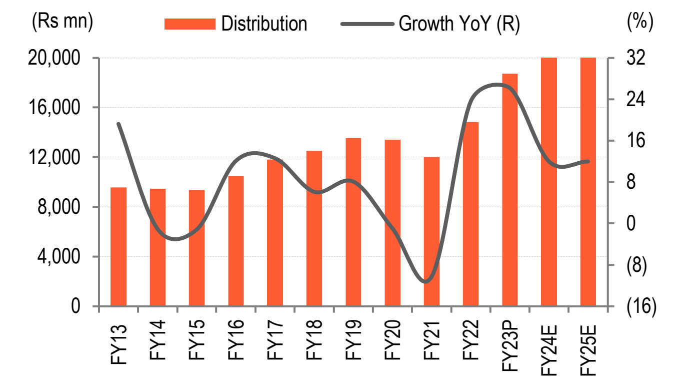
Source: Company, BOBCAPS Research

Fig 9 – Quarterly distribution segment revenue



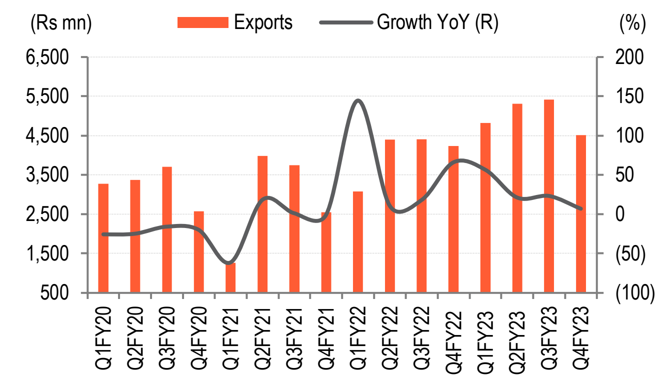
Source: Company, BOBCAPS Research

Fig 10 – Annual distribution segment revenue



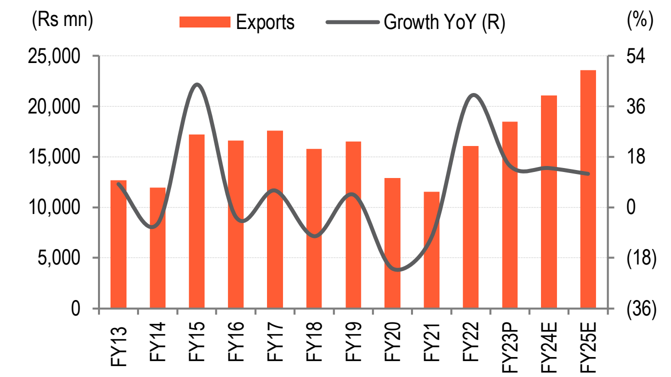
Source: Company, BOBCAPS Research

Fig 11 – Quarterly export trend



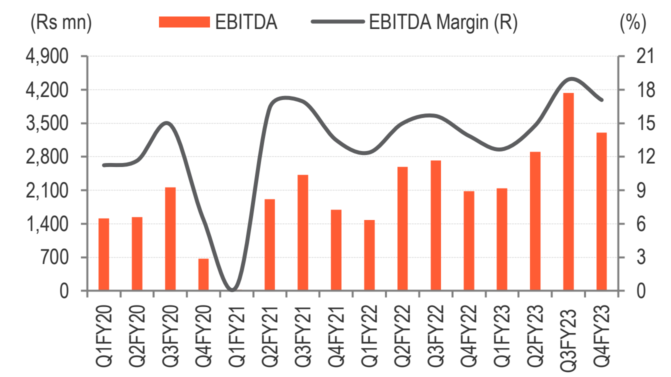
Source: Company, BOBCAPS Research

Fig 12 – Annual export trend



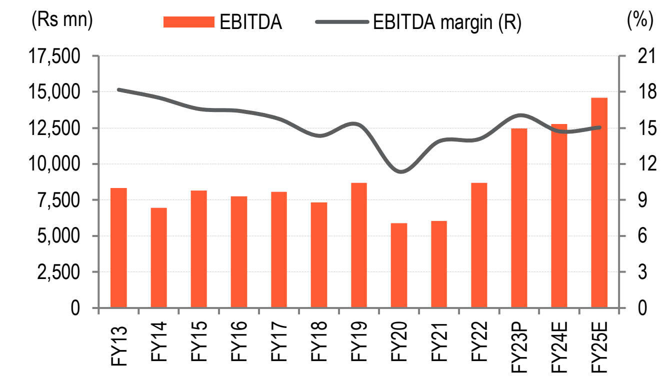
Source: Company, BOBCAPS Research

Fig 13 – Quarterly EBITDA trend



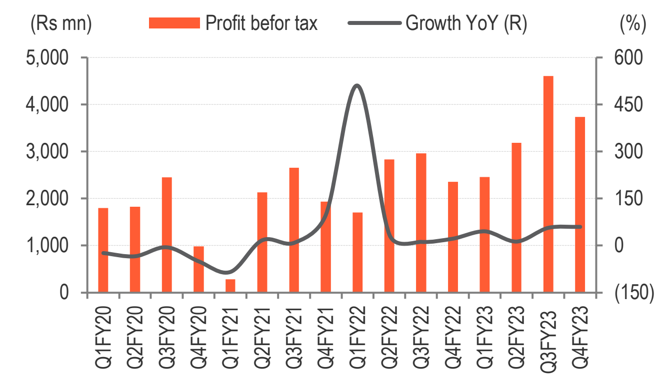
Source: Company, BOBCAPS Research

Fig 14 – Annual EBITDA trend



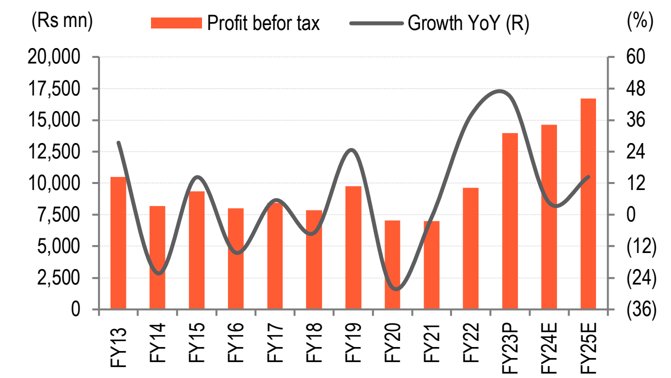
Source: Company, BOBCAPS Research

Fig 15 – Quarterly PBT trend



Source: Company, BOBCAPS Research

Fig 16 – Annual PBT trend



Source: Company, BOBCAPS Research

Earnings call highlights

- **Demand outlook:** Management expects a strong Q1FY24 given pre-buying trends ahead of the new CPCB4 emission norms for generator sets, and is cautiously optimistic on medium-term demand.

  Sector-wise, the company indicated that data centres, hospitality, hotels, and manufacturing are performing well. Realty has started improving and construction has bounced back strongly during the year. Mining and defense demand was strong in the previous couple of quarters but has been flat recently, although KKC pointed to early signs of an uptick due to rising demand for coal and steel. Rail business is yet to pick up the pace for KKC as it is still in the qualifying stage for products.

  Geography-wise, the company witnessed the largest revenue decline in Latin America, followed by the Asia Pacific in FY23. For Q1FY24 thus far, management indicated that Europe and Latin America are holding steady, demand in Africa has picked up while Asia is a mixed bag.

- **Segmental growth:** The industrial segment has been slower than the company's power generation segment due to lower construction activity in the last year. Some recovery was visible in the second half of FY23, but railways business remains slow due to high levels of electrification.

- **Exports:** Exports grew 27% in FY23 and management anticipates further growth ahead, albeit not at the same pace. Low horsepower (LHP) products are expected to continue to outpace high HP products in export markets.

- **Chip shortage:** The company expects the shortage of components to continue into the first half of CY24 before easing, as significant capacities for components are due to be added in January of next year.

- **Gross margin:** KKC's gross margin fell from 33.4% in FY22 to 32.8% in FY23 mainly due to a change in mix. Lower sales of industrial products in the areas of defense, marine and rail (high-margin products) and higher sales of construction-related products led to this margin reduction.

- **EBITDA margin:** The company aims to grow revenue at 2x GDP and leverage higher volumes to increase EBITDA margin in line with its longstanding goal of 100bps margin expansion per year.

- **CPCB4 norms:** KKC estimates that the CPCB4 emission norms effective Jul'23 will cause a 50-100% increase in powertrain costs and translate to a 20-50% price hike for the end-consumer. Management expects this to impact the sub-800kW engines that form ~80% of its domestic power generator business.

  Overall, based on past trends, KKC anticipates a ~30% drop in demand during the quarter immediately after the rating change with a return to normal in the subsequent quarter. Further, India's CPCB4 norms for gensets are among the tightest in the world which means KKC will be in a better position to service customers globally.

- **CPCB2 products:** According to the CPCB4 norms, the company cannot produce its CPCB2 products after 1 July and can only sell them till December of this year. This is motivating strong pre-buying in such products, and KKC indicated that it runs the risk of supply shortage by December. Hence, the company is stocking up on CPCB2 inventory to avoid revenue loss on account of sold-out capacity.

- **Diesel engines:** KKC expects sub-25kW engines to lose market to batteries but believes the market for >25kW to 500kW engines will continue at least till 2050 while that for >500kW engines will last even longer.
- **Capacity utilisation:** The company achieved 60-65% utilisation of installed capacity for FY23 and indicated that it has enough room to grow at minimal capex.
- **Hydrogen:** KKC sees a large demand opportunity in green hydrogen over the longer term. As an alternative to hydrogen fuel cells which are 5x more expensive than batteries, the company has a hydrogen combustion engine that reduces the cost of hydrogen storage, and expects this business to scale up as the country shifts to hydrogen storage.

Valuation methodology

Given visibility of sustained long-term growth in the domestic market, strong exports, and likely demand normalisation in Q3FY24 post absorption of CPCB4-related price hikes, we raise FY24/FY25 EPS estimates by 18% each. On rollover to Mar'25E, our TP rises to Rs 2,000 (vs. Rs 1,600), set at an unchanged P/E multiple of 35x, a 30% premium to the five-year average.

Our earlier HOLD rating was premised on slowing exports in H2FY23 and delayed demand recovery following CPCB norm change. However, exports have remained resilient in H2 and the outlook for FY24 is also promising. On the CPCB front, despite strong pre-buying, the company expects demand to normalise much before the Dec'23 deadline for old engine sales. Since our premise for a HOLD rating no longer stands, we upgrade the stock to BUY.

Fig 17 – Revised estimates

Particulars (Rs mn)	New		Old		Change (%)	
	FY24E	FY25E	FY24E	FY25E	FY24E	FY25E
Sales	86,816	96,924	81,549	91,080	6.5	6.4
EBITDA	12,786	14,584	11,611	13,268	10.1	9.9
PAT	13,431	15,507	11,347	13,065	18.4	18.7
EPS	48.5	55.9	40.9	47.1	18.4	18.7
EBITDA Margin (%)	14.7	15.0	14.2	14.6	50bps	50bps

Source: Company, BOBCAPS Research

Key risks

Key downside risks to our estimates are:

- prolonged supply chain constraints,
- delay in demand recovery post CPCB4 norms kicking in, and
- slowdown in exports.

Sector recommendation snapshot

Company	Ticker	Market Cap (US$ bn)	Price (Rs)	Target (Rs)	Rating
ABB India	ABB IN	10.2	3,942	3,700	HOLD
AIA Engineering	AIAE IN	3.3	2,910	3,300	BUY
Cummins India	KKC IN	5.6	1,650	2,000	BUY
Hitachi Energy	POWERIND IN	2.0	3,796	4,400	BUY
KEC International	KECI IN	1.6	523	500	HOLD
Larsen & Toubro	LT IN	37.7	2,205	2,630	BUY
Siemens India	SIEM IN	15.1	3,487	3,700	HOLD
Thermax	TMX IN	3.3	2,269	2,400	HOLD

Source: BOBCAPS Research, NSE | Price as of 25 May 2023

Financials

Income Statement

Y/E 31 Mar (Rs mn)	FY21A	FY22A	FY23P	FY24E	FY25E
Total revenue	**43,601**	**61,709**	**77,721**	**86,816**	**96,924**
EBITDA	6,051	8,681	12,477	12,786	14,584
Depreciation	1,272	1,356	1,420	1,444	1,480
EBIT	4,779	7,324	11,057	11,342	13,104
Net interest inc./(exp.)	168	122	162	112	105
Other inc./(exp.)	2,382	2,432	3,082	3,390	3,729
Exceptional items	0	0	0	0	0
EBT	6,993	9,635	13,976	14,620	16,727
Income taxes	1,900	2,732	3,631	3,684	4,215
Extraordinary items	(126)	(1,324)	143	0	0
Min. int./Inc. from assoc.	1,131	912	2,080	2,496	2,995
Reported net profit	**6,350**	**9,137**	**12,282**	**13,431**	**15,507**
Adjustments	(126)	(1,324)	143	0	0
Adjusted net profit	**6,224**	**7,814**	**12,425**	**13,431**	**15,507**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY21A	FY22A	FY23P	FY24E	FY25E
Accounts payables	7,310	9,997	11,539	14,747	17,261
Other current liabilities	3,574	3,502	3,864	8,325	9,294
Provisions	0	0	0	0	0
Debt funds	202	3,947	3,500	3,200	3,000
Other liabilities	1,962	2,224	2,701	3,017	3,368
Equity capital	554	554	554	554	554
Reserves & surplus	45,959	50,895	57,028	63,072	70,050
Shareholders' fund	46,514	51,450	57,582	63,626	70,605
Total liab. and equities	**59,562**	**71,120**	**79,186**	**92,915**	**1,03,527**
Cash and cash eq.	12,920	20,043	24,342	28,497	35,339
Accounts receivables	10,881	12,581	15,971	19,504	21,244
Inventories	5,642	7,375	9,037	9,990	10,622
Other current assets	3,113	4,135	1,635	5,471	5,576
Investments	2,724	3,255	4,218	4,711	5,260
Net fixed assets	22,367	21,891	22,258	22,814	23,334
CWIP	794	804	413	461	515
Intangible assets	0	0	0	0	0
Deferred tax assets, net	0	0	0	0	0
Other assets	1,121	1,037	1,313	1,467	1,638
Total assets	**59,562**	**71,120**	**79,186**	**92,915**	**1,03,527**

Cash Flows

Y/E 31 Mar (Rs mn)	FY21A	FY22A	FY23P	FY24E	FY25E
Cash flow from operations	**7,887**	**7,119**	**8,197**	**14,223**	**17,992**
Capital expenditures	(758)	706	(1,543)	(2,000)	(2,000)
Change in investments	(75)	(7,597)	1,858	(542)	(602)
Other investing cash flows	988	1,029	376	162	180
Cash flow from investing	**155**	**(5,863)**	**691**	**(2,380)**	**(2,422)**
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	(4,691)	3,745	(446)	(300)	(200)
Interest expenses	0	0	0	0	0
Dividends paid	0	0	0	0	0
Other financing cash flows	(4,041)	(4,567)	(6,427)	(7,387)	(8,529)
Cash flow from financing	**(8,732)**	**(823)**	**(6,873)**	**(7,688)**	**(8,729)**
Chg in cash & cash eq.	**(690)**	**434**	**2,015**	**4,156**	**6,842**
Closing cash & cash eq.	**12,920**	**20,043**	**24,342**	**28,497**	**35,339**

Per Share

Y/E 31 Mar (Rs)	FY21A	FY22A	FY23P	FY24E	FY25E
Reported EPS	22.9	33.0	44.3	48.5	55.9
Adjusted EPS	22.5	28.2	44.8	48.5	55.9
Dividend per share	15.0	18.5	25.0	26.6	30.8
Book value per share	167.8	185.6	207.7	229.5	254.7

Valuations Ratios

Y/E 31 Mar (x)	FY21A	FY22A	FY23P	FY24E	FY25E
EV/Sales	10.8	7.6	6.1	5.5	5.0
EV/EBITDA	77.6	54.2	38.3	37.7	33.3
Adjusted P/E	73.5	58.5	36.8	34.1	29.5
P/BV	9.8	8.9	7.9	7.2	6.5

DuPont Analysis

Y/E 31 Mar (%)	FY21A	FY22A	FY23P	FY24E	FY25E
Tax burden (Net profit/PBT)	89.0	81.1	88.9	91.9	92.7
Interest burden (PBT/EBIT)	146.3	131.5	126.4	128.9	127.7
EBIT margin (EBIT/Revenue)	11.0	11.9	14.2	13.1	13.5
Asset turnover (Rev./Avg TA)	71.8	94.4	103.4	100.9	98.7
Leverage (Avg TA/Avg Equity)	1.3	1.3	1.4	1.4	1.5
Adjusted ROAE	13.8	16.0	22.8	22.2	23.1

Ratio Analysis

Y/E 31 Mar	FY21A	FY22A	FY23P	FY24E	FY25E
YoY growth (%)					
Revenue	(16.0)	41.5	25.9	11.7	11.6
EBITDA	2.7	43.5	43.7	2.5	14.1
Adjusted EPS	(14.2)	25.5	59.0	8.1	15.5
Profitability & Return ratios (%)					
EBITDA margin	13.9	14.1	16.1	14.7	15.0
EBIT margin	11.0	11.9	14.2	13.1	13.5
Adjusted profit margin	14.3	12.7	16.0	15.5	16.0
Adjusted ROAE	13.8	16.0	22.8	22.2	23.1
ROCE	9.9	13.6	18.3	17.0	17.7
Working capital days (days)					
Receivables	91	74	75	82	80
Inventory	47	44	42	42	40
Payables	61	59	54	62	65
Ratios (x)					
Gross asset turnover	1.3	1.8	2.1	2.2	2.4
Current ratio	2.9	2.5	2.7	2.4	2.5
Net interest coverage ratio	28.5	60.2	68.1	101.3	124.8
Adjusted debt/equity	(0.3)	(0.3)	(0.4)	(0.4)	(0.5)

Source: Company, BOBCAPS Research | Note: TA = Total Assets

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Recommendation scale: Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

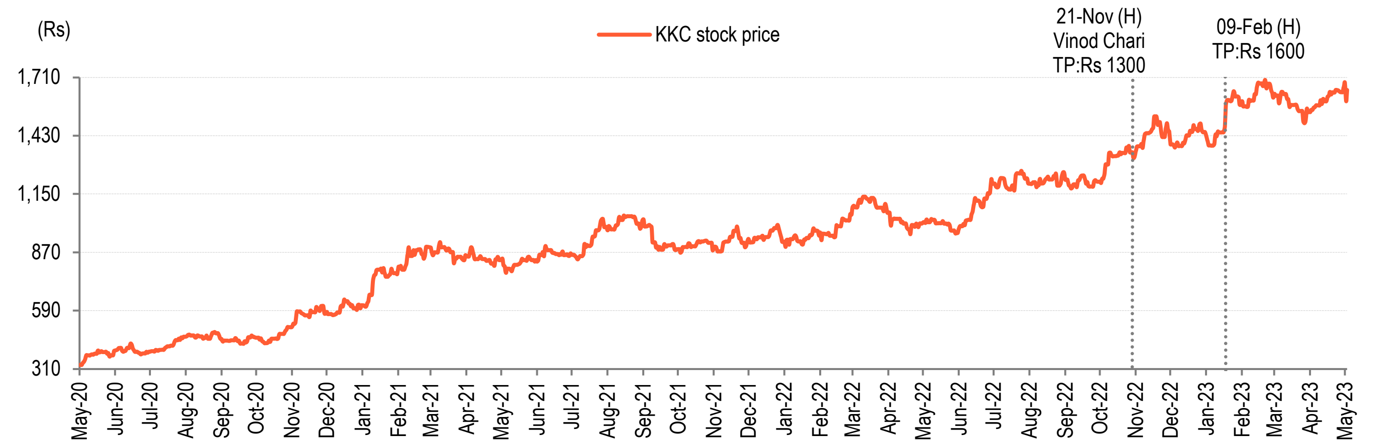
HOLD – Expected return from -6% to +15%

SELL – Expected return <-6%

Note: Recommendation structure changed with effect from 21 June 2021

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

Ratings and Target Price (3-year history): CUMMINS INDIA (KKC IN)



B – Buy, H – Hold, S – Sell, A – Add, R – Reduce

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