Cummins Inc. (CMI-NYSE)

**SUMMARY**

Cummins' earnings per share increased 32% to $2.56 in the fourth quarter of 2014, beating the Zacks Consensus Estimate of $2.50. Revenues rose 11% year over year to $5.1 billion, driven by better revenues from North America. Furthermore, revenues surpassed the Zacks Consensus Estimate of $5 billion. For 2015, Cummins expects revenues to increase by 2%-4% and EBIT at 13.5%-14%. Cummins will gain from higher use of its engines by a number of OEMs and benefits from acquisitions in North America. However, we are concerned about weak market conditions in Brazil along with intensifying competition. Therefore, we have maintained our Neutral recommendation.
CUMMINS INC.

OVERVIEW

Cummins Inc. is a leading worldwide designer, manufacturer and distributor of diesel and natural gas engines, electric power generation systems, and engine-related components, fuel systems, controls and air handling systems. Headquartered in Columbus, IN, the company serves more than 190 countries through its network of 600 company-owned as well as independent distributor facilities and more than 7,200 dealer locations.

Cummins sells its products to original equipment manufacturers (OEMs), distributors and other customers worldwide. The company's customer base comprises leading manufacturers, namely, Chrysler LLC, Daimler AG, Volvo AB, PACCAR Inc., Navistar International Corporation, CNH Global N.V., Komatsu, Scania AB, Ford Motor Company and Volkswagen.

Cummins has four operating segments: Engine, Power Generation, Components and Distribution.

- **The Engine segment:** The segment contributed to 57% of the net sales in 2014. Under this segment, the company produces engines and parts for sale to customers in on-highway and industrial markets. The engines are used in trucks of all sizes, buses and recreational vehicles, as well as various industrial applications including construction, mining, agriculture, marine, oil and gas, rail and military. The principal customers of the heavy and medium-duty truck engines include truck manufacturers such as PACCAR Inc. (PACCAR), Daimler Trucks North America, Navistar International Corporation (Navistar), Ford Motor Company, MAN Latin America and Volvo. Cummins also sells industrial engines to manufacturers of construction, agricultural and marine equipment, including Komatsu, Belaz, Hyundai, Hitachi and JLG. The principal customers of the light-duty on-highway engines are Chrysler and manufacturers of Recreational Vehicles or RVs (vehicles equipped with living space and amenities found in a home). The company's competitors for the segment in North America are Navistar, Daimler Trucks North America, Caterpillar Inc. (CAT), Volvo Powertrain, Ford Motor Company and Hino Power. Other engine manufacturers in international markets include Mercedes Benz, Volvo, Renault Vehicles Industrials, Scania, Weichai Power Company, Nissan Diesel Motor Company, Yanmar and Deutz.

- **The Power Generation segment:** This segment represented 15.1% of the net sales in 2014. The segment sells engines, generator sets and alternators, and rents power equipment for both standby and prime power uses. Cummins' power generation products are organized around the following businesses, Power products, Power systems, Alternators and Power Solutions. This segment explores emerging technologies and provides integrated power generation products. The company uses its research and development capabilities along with those of its business partners to develop cost-effective and environmentally sound power solutions. Cummins' customer base for power generation products is highly diversified, based on power needs. The geographic markets outside North America are India, China, the U.K, Western Europe, Latin America and the Middle East. This segment competes with a variety of engine manufacturers and generator set assemblers across the world. Caterpillar Incorporated, Tognum and Kohler/SDMO (Kohler Group) are the primary competitors, but the company also competes with GE Jenbacher, FG Wilson (CAT group), Generac, Mitsubishi (MHI) and numerous regional generator set assemblers.

- **The Components segment:** This segment generated 26.6% of the net sales in 2014. The segment has four businesses, namely, Cummins Filtration, Cummins Turbo Technologies, Cummins Fuel Systems and Cummins Emission Solutions. The company manufactures filtration and exhausts systems for on- and off-highway heavy-duty equipment, and supplies filtration products for industrial and passenger car applications. Under the filtration business, the company supplies filtration, exhaust, coolant and chemical products including air, coolant, fuel and hydraulic filters, antifreeze and coolant additives, catalysts, particulate filters and controllers. The company also makes products for the automotive specialty filtration market and the industrial filtration market through the Kuss
subsidiary. Turbo technologies design, manufacture and market turbochargers for commercial and light-duty diesel applications from manufacturing facilities in five continents, and for sales and distribution worldwide.

- **The Distribution segment**: The segment generated 26.9% of net sales in 2014. It includes wholly owned and partially owned distributorships engaged in wholesaling engines, generator sets and service parts, as well as servicing and repairing the company's products and maintaining relationships with various OEMs throughout the world. The segment consists of 34 company-owned and 8 joint venture distributors that distribute the entire range of Cummins' products and services to end users, at approximately 400 locations, in over 80 distribution territories. Cummins' company-owned distributors are located in key markets, including North America, Australia, Europe, the Middle East, India, China, Africa, Russia, Japan, Brazil, Singapore and Central America, while its joint venture distributors are located in key markets, including North America, South America, China, Thailand, Singapore and Vietnam. The company's distributors collectively serve a highly diverse customer base with 43% of revenues coming from the wholesaling of new power equipment (engines and power generation equipment) and the remaining portion consisting of parts and filtration and service repairs. In 2008, Cummins purchased the majority of the interest in three previously independent North American distributors and an equity interest in another North American distributor to increase the company's ownership interests in key distribution channels.

Cummins also has joint ventures and partnerships with large automakers in the emerging markets including Tata Motors in India, Dongfeng and Foton in China, and Kamaz in Russia.

**REASONS TO BUY**

- Cummins is poised to benefit from its innovative products. The transition to new emission standards in developing economies will boost the results of the company. In Jul 2014, Cummins announced the development of an ETHOS engine and powertrain that reduce carbon dioxide emissions by 80% as compared with a gasoline-powered medium-duty truck. Its innovative engine design and combustion approaches with low-carbon alternative fuels help in reducing greenhouse gas emission. Cummins has been focusing on producing industry-leading emissions-control technologies and products over the years. Further, the company will benefit from the actions taken by the government to enforce the new emission control regulations. The company also expects the transition to NS4 products in 2015 to benefit results. In Jan 2015, the company announced that it will expand the QSF engine line-up with new configurations, emphasizing simplified installation packages for rental equipment applications. This engine will range across 49–74 hp (37–55 kW) and meet EU and EPA low-emissions regulations. In the same month, Chongqing Cummins Engine Company, which is a joint venture between Cummins and Chongqing Machinery and Electric Co., Ltd., started the construction of a new plant in the Northern New District of Chongqing. This new facility will include a tech center for developing High Horsepower engines and a new engine manufacturing plant. Cummins expect that the new facility will further strengthen its position in China's High Horsepower power industry.

- Cummins expects to achieve revenues of $25–$31 billion by 2018. The company also projects earnings before interest and taxes (EBIT) in the range of 16–18% by 2018. For 2015, Cummins expects revenues to increase by 2%–4% based on improvement in North America, new products and distributor acquisitions, which will offset continued weakness in international markets and the negative impact of a stronger U.S. dollar. Cummins expects its 2015 EBIT margin in the 13.5%–14% range, higher than 13.2% recorded in 2014.

- Cummins is focused on enhancing shareholder value by pursuing aggressive share repurchases and increasing dividend payouts. In 2014, the company returned 50% of its full-year operating cash
flow to shareholders through dividends and share repurchases. During 2014, Cummins repurchased 4.8 million shares for $670 million. In Jul 2014, the company’s board authorized share repurchase of up to $1 billion after the completion of the previous $1 billion program. At the end of 2014, the company had $174 million available for purchase under the 2012 repurchase plan. In July 2014, the company also announced a 25% increase in its quarterly dividend to $0.78 per share from $0.625.

- Cummins’ Distribution segment is poised to gain from the acquisitions in North America. In 2014, the company completed seven acquisitions which generated earnings of $0.40 per share. The company expects to complete three additional acquisitions in 2015. These acquisitions are expected to generate incremental revenues of more than $1 billion in 2015. The company also anticipates earnings per share to increase by $0.50 in 2015 due to these acquisitions. Fortified by these acquisitions, Cummins is positioned to benefit from the strength in the North American market.

- Cummins has the potential to benefit from higher use of its engines by a number of OEMs, including Nissan and Navistar. Shipments to Chrysler increased 9% year over year in 2014 and the company expects shipments for 2015 to be consistent with the 2014 level.

**REASONS TO SELL**

- Weakness in the operating markets is considerably affecting the results of Cummins. The company is witnessing a challenging situation in Brazil, where truck production for 2015 is expected to decline 15% as the government has stopped the finance program. Moreover, the company will face challenges in global off-highway markets and emerging markets. Decline in infrastructure spending in China and Latin America and falling commodity prices pose challenges to off-highway market demand.

- Cummins operates in a highly competitive environment. Moreover, new technologies, including those developed for gasoline, will provide further competition for the company.

- Cummins sources a significant amount of parts from a single supplier. Any fluctuation in deliveries from the supplier will adversely affect Cummins’ operations at multiple manufacturing locations.

- Management expects that revenues from the Power Generation market will decrease 4% in 2015. Higher military revenue in the U.S will be offset by moderate growth in the company’s base business. In 2014, revenues from the segment declined 4% from 2013 levels and EBIT margins declined to 6.9% from 7.3% in 2013.

**RECENT NEWS**

**Cummins Tops Q4 Earnings on Solid Segment Results** - Feb 5, 2015

Cummins’ earnings per share increased 32% to $2.56 in the fourth quarter of 2014 from $1.94 in the year-ago quarter. Earnings also surpassed the Zacks Consensus Estimate of $2.50 per share. Net income improved 28.5% to $465 million, compared with $362 million in the fourth quarter of 2013.

Revenues in the reported quarter rose 11% year over year to $5.1 billion. The year-over-year improvement was driven by better revenues from North America, partially offset by lower demand in Brazil and Europe. Further, revenues surpassed the Zacks Consensus Estimate of $5 billion.
Operating income increased to $581 million from $553 million a year ago. Adjusted EBIT improved to $661 million (13% of sales) from $566 million (12.3% of sales) a year ago.

2014 Performance

Earnings for full-year 2014 increased 21.4% to $9.13 per share from $7.52 in 2013 and surpassed the Zacks Consensus Estimate of $9.08. The enhanced profitability was based on better performance in the Components and Distribution businesses, and higher earnings in the Engine business.

Revenues for 2014 increased 11% to $19.2 billion, marginally surpassing the Zacks Consensus Estimate of $19.1 billion. Revenues benefited from the acquisitions made by the company. Revenues from North America improved 20% year over year in 2014. Additionally, revenues from international markets rose 2% year over year on the back of strong demand in China, partially offset by weak performances in Brazil and India.

Segment Performance

Sales in the Engine segment rose 11% to $2.8 billion on increased demand in on-highway markets in North America, partially offset by weakness in the markets of Brazil, China and Europe. The segment’s EBIT increased to $315 million (11.1% of sales) from $235 million (9.2% of sales) a year ago.

Sales in the Components segment grew 16% to $1.3 billion on the back of strong on-highway demand in Europe, China and North America. This segment’s EBIT increased to $160 million (12.1% of sales) from $140 million (12.3% of sales) in the prior-year quarter.

Sales in the Power Generation segment were flat at $760 million due to improved sales in Latin America and Africa, offset by weaker demand in Eastern Europe and India. The segment’s EBIT dropped to $22 million (2.9% of sales) in fourth-quarter 2014 from $46 million (6.1% of sales) in fourth-quarter 2013.

Sales in the Distribution segment rose 58% to $1.7 billion on the back of benefits from acquisitions and higher demand for parts and service in North America. The segment’s EBIT improved to $158 million (9.3% of sales) from $107 million (10% of sales) a year ago.

Financial Position

Cummins’ cash and cash equivalents decreased to $2.3 billion as of Dec 31, 2014 from $2.7 billion at the end of 2013. Long-term debt decreased to $1.68 billion as of Dec 31, 2014 from $1.69 billion as of Dec 31, 2013. Consequently, the debt-to-capitalization ratio stood at 17.8% as of Dec 31, 2014, compared with 18.4% as of Dec 31, 2013.

In 2014, Cummins’ net operating cash flow increased to $2.3 billion from $2.1 billion in the same period a year ago. Capital expenditures went up to $743 million from $676 million in the prior-year period.

Capital Deployment

Cummins is focused on enhancing shareholder value by pursuing aggressive share repurchases and increasing dividend payouts. The company returned 50% of its 2014 operating cash flow to shareholders through dividends and share repurchases.

During 2014, Cummins repurchased 4.8 million shares. The company also announced a 25% increase in its quarterly dividend to $0.78 per share.
2015 Guidance

For 2015, Cummins expects revenues to increase by 2%–4%. EBIT is expected in the range of 13.5%–14%.

VALUATION

Shares of Cummins are currently trading at 13.8x our 2015 EPS estimate of $10.2. The company's trailing 12-month earnings multiple is 15.4x, compared with the 29.0x average for the peer group and 19.3x for the S&P 500. Over the last five years, shares have traded in a range of 9.9x to 24.2x trailing 12-month earnings. The stock is also trading at a discount to the peer group, based on forward earnings estimates. The current P/E is at a 10.4% discount to the peer group for 2015. Our long-term Neutral recommendation on the stock indicates that it should perform in line with the broader market. Our target price of $148.00 is 14.5x our 2015 EPS estimate.

Key Indicators

![Key Indicators Table]

TTM is trailing 12 months; F1 is 2015 and F2 is 2016, CF is operating cash flow
Earnings Surprise and Estimate Revision History
DISCLOSURES & DEFINITIONS

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Our recommendation for each stock is closely linked to the Zacks Rank, which results from a proprietary quantitative model using trends in earnings estimate revisions. This model is proven most effective for judging the timeliness of a stock over the next 1 to 3 months. The model assigns each stock a rank from 1 through 5. Zacks Rank 1 = Strong Buy, Zacks Rank 2 = Buy, Zacks Rank 3 = Hold, Zacks Rank 4 = Sell. Zacks Rank 5 = Strong Sell. We also provide a Zacks Industry Rank for each company which provides an idea of the near-term attractiveness of a company's industry group. We have 264 industry groups in total. Thus, the Zacks Industry Rank is a number between 1 and 264. In terms of investment attractiveness, the higher the rank the better. Historically, the top half of the industries has outperformed the general market. In determining Risk Level, we rely on a proprietary quantitative model that divides the entire universe of stocks into five groups, based on each stock's historical price volatility. The first group has stocks with the lowest values and are deemed Low Risk, while the 5th group has the highest values and are designated High Risk. Designations of Below-Average Risk, Average Risk, and Above-Average Risk correspond to the second, third, and fourth groups of stocks, respectively.