Cummins Inc (CMI)

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Disclaimers

- I am not a registered investment advisor and I do not offer any investment advise
- No parts of this talk are suggestions to invest, not invest, buy or sell any kind of securities or other financial instruments

Cummins Inc – business

- Engine 62%:
  - Diesel and natural gas engines – Cummins + customer brands
  - Trucks (PACCAR, Ford, MAN Latin America, Daimler Trucks North America;)
  - Bus, RV, light-duty automotive (Chrysler, RV manufacturers)
  - Agricultural, construction, mining, marine, oil and gas, rail, and governmental equipment (Komatsu, Hyundai, Case New Holland, Belaz, Liugong, Hitachi and Brunswick)
  - New parts, service, remanufactured parts and engines
- Components 22%:
  - Filtration products, turbochargers, aftertreatment systems, intake and exhaust systems, and fuel systems for commercial diesel applications
  - Filtration and exhaust systems for on-and off-highway heavy-duty and mid-range equipment, as well as supplies filtration products for industrial and passenger car applications.
  - After treatment and exhaust systems for meeting emissions standards
- Power Generation 20%:
  - Power generation systems, components, and services, including diesel, natural gas, gasoline, and alternative-fuel electrical generator sets for use in recreational vehicles, commercial vehicles, recreational marine applications, and home stand-by or residential applications
  - Components - engines, controls, alternators, transfer switches, and switchgears
- Distribution 17%:
  - Parts and services

Cummins Inc – business (cont'd)

- Main customers:
  - Volvo Trucks North America, PACCAR (exclusive engine supplier), Daimler Trucks North America (formerly Freightliner LLC), Ford, MAN (formerly Volkswagen), Chrysler (Dodge Ram engine), Komatsu Ltd. – 25% total sales
- Competition:
  - Captive engine manufacturers
  - International Truck and Engine Corporation (Engine Division), Detroit Diesel Corporation, Caterpillar Inc. (CAT) and Volvo Powertrain
  - International: Weichai Power Co. Ltd., MAN Nutzfahrzeuge AG (MAN), Fiat Power Systems, GE Jenbacher, Tognum AG, CAT, Volvo, Yanmar Co., Ltd., GuangxiYuchai Group and Deutz AG

Cummins Inc – Misc thoughts

- What can go wrong?
  - Move towards captive engines
  - Asian growth collapses or native manufacturers dissolve JVs
- Opportunities:
  - Continued Asian expansion through JVs
  - New diesel standards

Strategic considerations

- Moat (*switching costs, habit, low cost*):
  - What are the moats? High quality? Brand recognition?
  - What does it take to sustain the moats? Best solution, emission standards
  - Bargaining power of suppliers/customers? Possibly high for some customers
- Is it a low risk business? Somewhat.
- Is there high uncertainty? Medium
- How capital intensive is the business? Somewhat
- Future growth – saturation? Unknown
- Are the revenues and cash flows of the business sustainable or overstated / understated due to boom or bust conditions? Possibly high in cycle

Management

- I don’t usually do management analysis. Included for template completeness
- No dilution
- Can I trust management?
- Management shareholding (> 10%)
- Management incentives?
- Are the salaries too high?
- Is there heavy insider buying?
- Is there heavy insider selling?
- Do I like the management? (Operators, capital allocators, integrity)
- Profitable reinvestment
- What has management done with the cash?
- Where is Free Cash Flow invested? Share buybacks, dividends, reinvested, ROE & ROCE, incremental BV

Piotroski Score

Only applicable to Graham Cos – N/A to CMI

1. Net Income: Bottom line. Score 1 if last year net income is positive.
2. Operating Cash Flow: Better earnings gauge. Score 1 if last year cash flow is positive.
3. Return On Assets: Measures Profitability. Score 1 if last year ROA exceeds prior-year ROA.
4. Quality of Earnings: Warns of Accounting Tricks. Score 1 if last year operating cash flow exceeds net income.
5. Long-Term Debt vs. Assets: Is Debt decreasing? Score 1 if the ratio of long-term debt to assets is down from the year-ago value. (If LTD is zero but assets are increasing, score 1 anyway.)
6. Current Ratio: Measures increasing working capital. Score 1 if CR has increased from the prior year.
7. Shares Outstanding: A Measure of potential dilution. Score 1 if the number of shares outstanding is no greater than the year-ago figure.
8. Gross Margin: A measure of improving competitive position. Score 1 if full-year GM exceeds the prior-year GM.
9. Asset Turnover: Measures productivity. Score 1 if the percentage increase in sales exceeds the percentage increase in total assets.

- Total: / 9

Is it a good business?

- 9 year history of profits
- ROE:
  - 2009: 10.6 2010:20.8 2011:30.74
- Margins
  - 2009: 4 2010:8 2011: 10
- Growing earnings: 3 year sales growth 6%, earnings growth 31%
- No dilution
- Strong balance sheet
  - Debt < cash/short term investments
- ROIC = Earnings / (Equity + Debt – Cash) = Earnings / (Assets – non-debt liabilities - Cash)
  - ~ ROE

Is it a good business? Cash flow

- So-so operating cash flow and FCF:
  - 2011 h1 902M earnings, 744M operating cash flow, 530M FCF (FCF = OCF – capital expenditures)
  - Free Cash Flow/Share higher than dividends paid

Is business cheap? – Buffettology calculations

- ROE 15%
- Earnings in 10 years = ROE*Equity*$(1+ROE)^9$ = $2.9B
- Equity in 10 years = Equity*$(1+ROE)^9$ = $19.4B
- Market cap = 1.9B x P/E (15) = $43.7B
- Rate of return = 9% after tax (calculations omitted), 16% at 20% ROE

- 9 year earnings growth: 30%. Assuming 30% earnings growth: 29% share price growth. Not realistic though – we are probably on top of the cycle.

Is business cheap? DCF

- Discounted cash flow
  - Current earnings of 1.7B
  - 10% growth for 5 years, leveling after that
    - 15% discount -> $16.5B current valuation (if you buy company at <$16.5B, you will get 15% return or higher)
  - 5% growth for 10 years, leveling after that
    - 15% discount -> $15.2B current valuation
  - 10% growth for 10 years, leveling after that
    - 15% discount -> $20.69B current valuation
- Owner's yield = earnings / (market cap + debt - cash) = earnings/EV
  - 1.7B / (16.4B+.7B-1.5B) = 11%

- What makes up the margin of safety? Brand/quality
- Is there a sufficient margin of safety? No.

Is business cheap? – Graham investment considerations

- N/A for CMI – included for completeness
- 3 P/Book – not a net net
- Altman Z score (http://en.wikipedia.org/wiki/Altman_Z-score)