

BSE SENSEX  
19,636S&P CNX  
5,940

CMP: INR504

TP: INR585

Buy



Bloomberg	KKC IN
Equity Shares (m)	277.2
M.Cap. (INR b)/(USD b)	139.7/2.6
52-Week Range (INR)	550/396
1,6,12 Rel. Perf. (%)	4/-3/0

### Financials & Valuation (INR b)

Y/E March	2013E	2014E	2015E
Net Sales	45.6	52.7	61.8
EBITDA	8.6	10.2	12.0
Adj PAT	7.0	8.0	9.1
EPS (INR)	25.3	28.9	33.0
EPS Gr. (%)	27.2	14.4	14.2
BV/Sh. (INR)	86.1	97.5	110.6
RoE (%)	31.7	31.5	31.7
RoCE (%)	31.8	31.6	31.9
Payout (%)	55.6	60.7	60.3

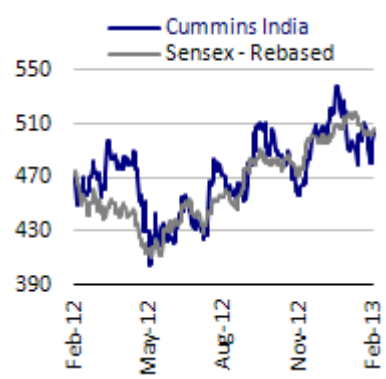
### Valuation

P/E (x)	20.0	17.4	15.3
P/BV (x)	5.9	5.2	4.6
EV/EBITDA (x)	15.3	12.8	10.8
Div Yield (%)	2.4	3.0	3.4

### Shareholding pattern %

As on	Dec-12	Sep-12	Dec-11
Promoter	51.0	51.0	51.0
Dom. Inst	21.7	21.9	21.5
Foreign	13.2	12.7	11.9
Others	14.2	14.4	15.6

### Stock performance (1 year)



## LHP products to be an important growth driver

### Cross service charges at INR100-200m/quarter

- The initial traction in LHP exports has been encouraging and the revised expectations are that revenues could potentially increase to INR20b pa in the next 4-5 years (v/s the earlier expectation of INR12b).
- The strategy for domestic power generation markets would be: 1) to defend market share in MHP/HHP segments and 2) launch new products in the LHP segment (and the attempt is to increase channel density, broaden retail network etc).
- Cross service charges will be recovered by the parent company from Jan 2013, and while the amount is still under discussion, the impact is likely at INR100-200m/quarter (4-8% of PBT by FY14).

We attended Cummins India's (KKC) analyst meet and also visited the HHP engine manufacturing plant at Kothrud, Pune. The key takeaways are:

- **LHP exports show increased traction:** The initial traction in LHP exports has been encouraging and the revised expectations are that revenues could potentially increase to INR20b pa in the next 4-5 years (v/s the earlier expectation of INR12b). The key markets are Middle East and South Africa, and India is being established as a global hub for such products. The powergen factory (for Urja Gensets) will be commissioned in April/May 2013. Exports in 3QFY13 were impacted given the ongoing inventory correction and the trend has now normalized.
- **Domestic power generation to be supported by price increases/LHP products:** The strategy for domestic power generation markets would be: 1) to defend market share in MHP/HHP segments and 2) launch new products in the LHP segment (and the attempt is to increase channel density, broaden retail network etc). LHP products could be important growth drivers, going forward.
- **Cross service charges at 4-8% of FY14 PBT:** Cross service charges will be recovered by the parent company from Jan 2013, and while the amount is still under discussion, the impact is likely at INR100-200m/quarter (4-8% of PBT by FY14). These charges pertain to support like product/marketing/HR related services etc and are separate from technical support, which is being recovered through royalty.
- **Margins supported by twin trends of currency movements and declining commodity prices:** Margin expansions witnessed in 3QFY13 to 19.1% are largely driven by value engineering, cost rationalization programs etc. However, given the volatility in commodity prices, unfavorable currency movement etc, management stated that EBITDA margin could possibly decline by 50bp, going forward.
- **Valuation and view:** We model revenue growth of 11%/16%/17% in FY13E/14E/15E and EBITDA margin of 18.8%/19.4%/19.5% (FY12 16.9%). On current estimates, KKC trades at 20x FY13E, 17.4x FY14E and 15.3x FY15E. Maintain **Buy** with a target price of INR585 based on 18x FY15E EPS.

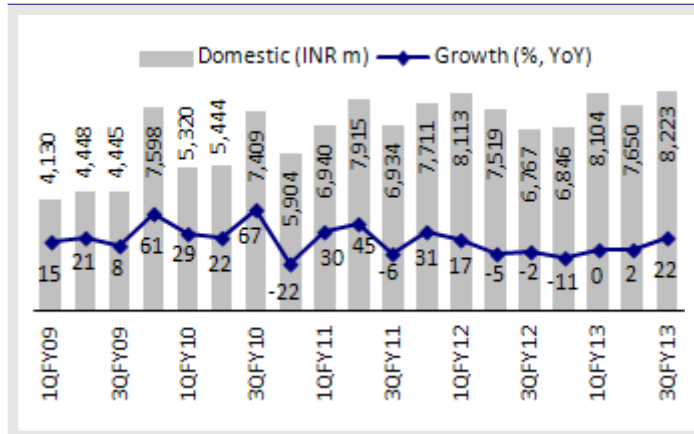
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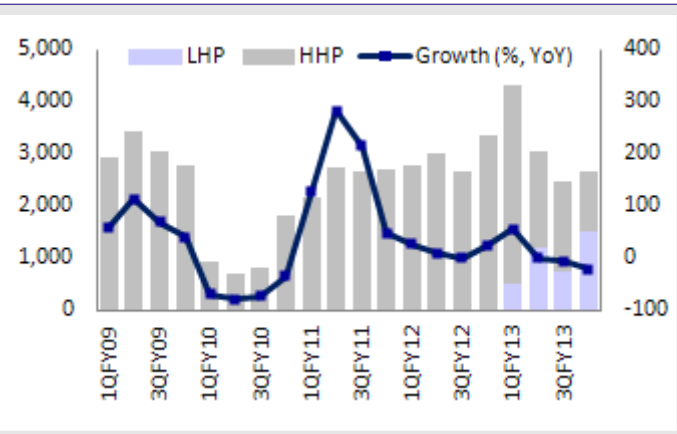
**LHP exports show increased traction; Domestic power gen to be supported by price increases/LHP products**

- LHP exports show increased traction:** The initial traction in LHP exports has been encouraging and the revised expectations are that revenues could potentially increase to INR20b pa in the next 4-5 years (v/s the earlier expectation of INR12b). During FY13, LHP exports should contribute ~INR4-4.5b in revenues, of which Urja Gensets will contribute ~INR2b. The key markets are Middle East and South Africa, and India is being established as a global hub for such products. The powergen factory (for Urja Gensets) will be commissioned in April/May 2013 with initial capacity of 15,000-20,000 units pa and will be ramped up to 50,000 units in next 2-3 years. Exports in 3QFY13 were impacted given the ongoing inventory correction and the trend has now normalized.
- Domestic power gen to be supported by price increases/LHP products:** The strategy for domestic power gen markets would be: 1) to defend market share in MHP/HHP segments and 2) launch new products in the LHP segment (and the attempt is to increase channel density, broaden retail network etc). LHP products could be important growth drivers going forward. Also, revenues in FY14/FY15 will be supported by the 15-20% price increase expected post implementation of CPCB norms (likely in 4QCY13). KKC reiterated its long term expectations that growth over 3 years would be in high teens in the domestic market.
- Emerging growth drivers:** In industrial business, the key drivers are mining, railways and construction. During 3QFY13, industrial/auto business witnessed cyclical uptick, with revenues rising +35%/+100% on QoQ basis respectively; also, on YoY basis, the revenue decline has moderated to ~5% YoY. Medium term growth drivers will be offshore oil and gas (QSK 60), railways (attempt to influence policy for replacing batteries), new OEM business (like SANY, Leigeng), mining etc.

**Domestic sales grew strongly supported by power shortages**

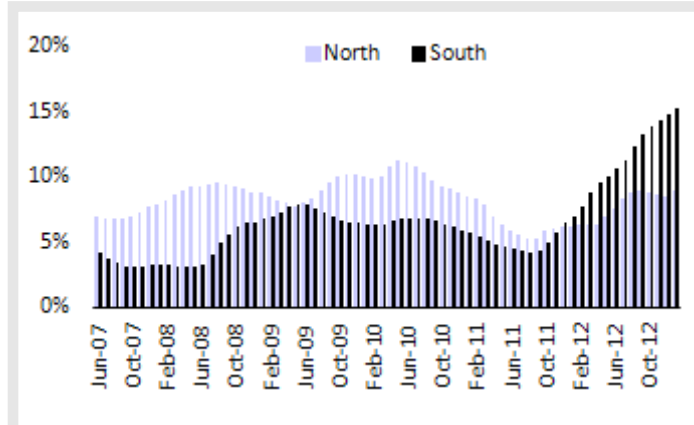


**Export sales impacted by lower HHP sales**

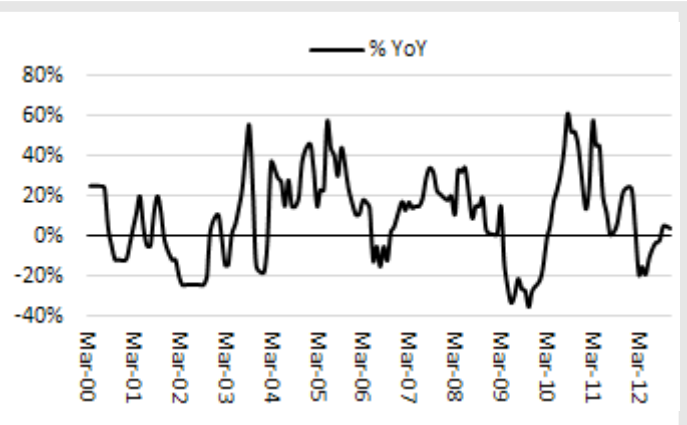


Source: Company, MOSL

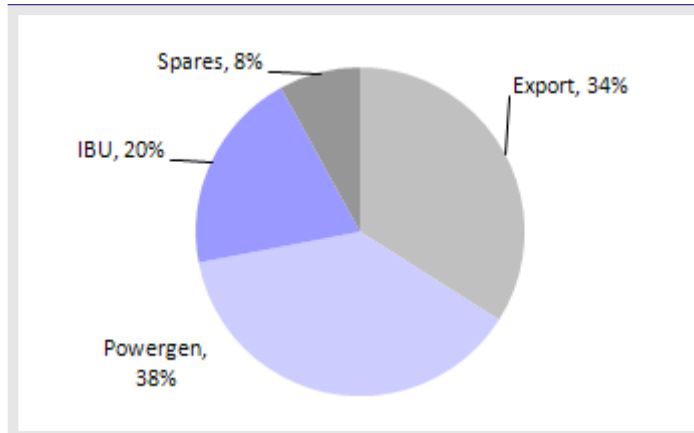
**Power shortages driving demand, largely in South India**



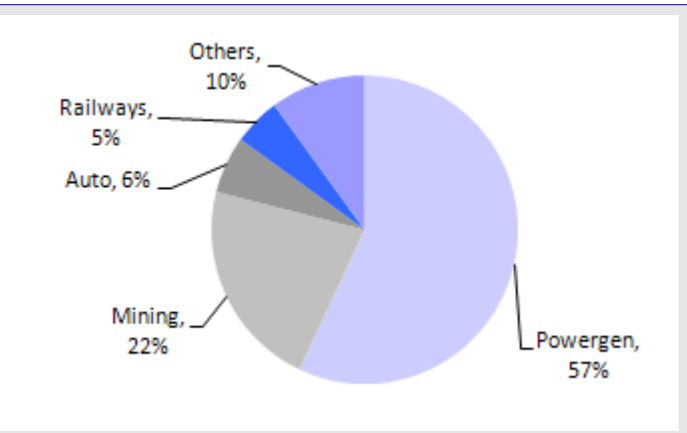
**Caterpillar dealer statistics show initial signs of improvement**



**Revenue composition (industrial business)**



**Revenue composition (distribution business)**



Source: Company, MOSL

**Cross service charges at 4-8% of FY14 PBT; Charges would be over and above royalty**

- Cross service charges will be recovered by the parent company from Jan 2013, and while the amount is still under discussion, the impact is likely at INR100-200m/quarter (4-8% of PBT by FY14).
- These charges pertain to support like product/marketing/HR related services etc and are separate from technical support which is being recovered through royalty. Management stated that there is intense scrutiny by US regulators regarding the corporate expenses being incurred by US companies, which leads to passing on the benefits to overseas subsidiaries. The attempt is to increasingly pass these costs to the benefiting entities.
- As per FY12 annual report, Cummins India paid INR1.5b to Cummins Inc group (3.7% of revenues), which includes royalty of INR649m and service charges of INR832m. Since FY10, these charges increased from 2.1% of revenues to 3.7% in FY12. We have not factored the increase in charges to the parent company in our estimates.
- Management stated that CPCB norms would not lead to any meaningful increase in royalty charges.

**KKC currently pays 3.7% of revenues to Cummins Inc (INR m)**

	FY10	FY11	FY12
<b>Services Received</b>			
Cummins Power Generation Ltd	0	130	155
Cummins Technologies Ltd	208	414	556
others	124	114	121
<b>Transfer of technology including royalty</b>			
Cummins Inc	274	612	649
Others	0	9	0
Payment by Cummins India	606	1,278	1,480
% of Revenues	2.1	3.2	3.7

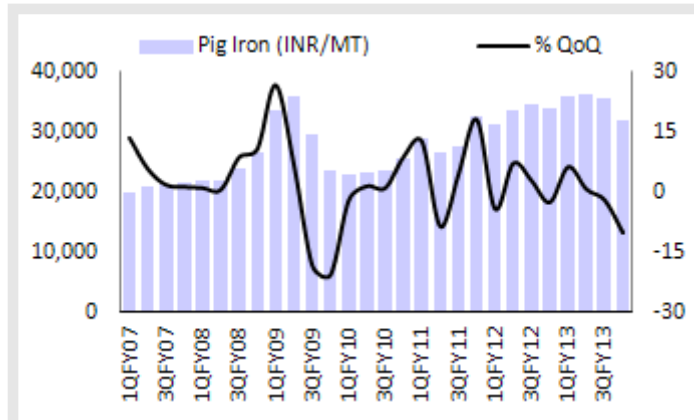
Source: Company, MOSL

**Margins supported by twin trends of currency movements and declining commodity prices**

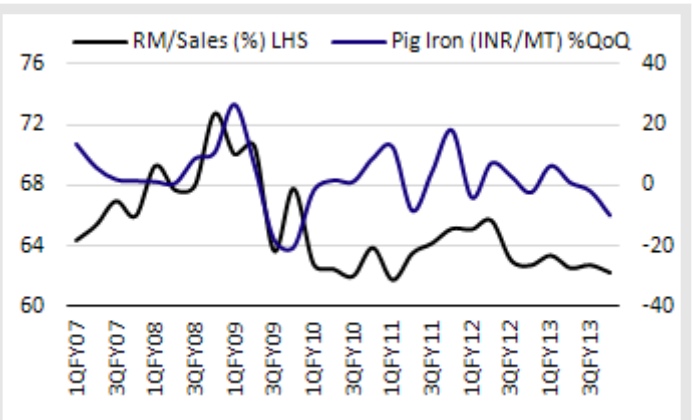
- Margin expansions witnessed in 3QFY13 to 19.1% are largely driven by value engineering, cost rationalization programs etc. However, given the volatility in commodity prices, unfavorable currency movement etc, management stated that EBITDA margin could possibly decline by 50bp, going forward. During 3QFY13, KKC's margins improved despite flat revenues, supported by (i) twin trends of currency depreciation and lower commodity prices and (ii) benefits accruing from

**EBITDA margin supported by twin trends of lower commodity prices and depreciating rupee**

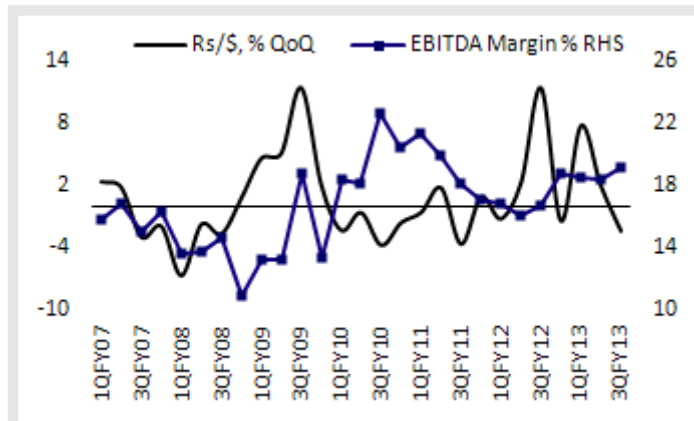
**Pig iron prices declined meaningfully in 4QFY13**



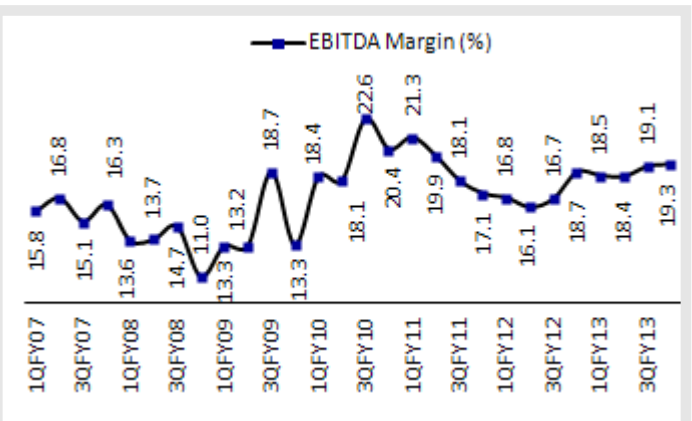
**KKC's RM cost has a very direct co-relation with pig iron prices**



**Depreciating rupee likely to have positive impact on margins**



**EBITDA margin supported by twin trends**



Source: Company, MOSL

2.5-3% price hike from June 2012. We believe that the 3% further price increase taken during Jan 2013 will again support margins and expect 4QFY13 EBITDA margin at 19.3%.

- KKC's raw material costs have historically demonstrated very direct correlation with pig iron prices. Stabilizing/declining trend in commodity prices should lead to savings in KKC's raw material costs, particularly due to its ongoing efficiency measures such as Six Sigma, ACE and TRIMs. Currency depreciation makes KKC more competitive in the global network of Cummins Inc, leading to possibilities for increased outsourcing. The currency movement also improved KKC's competitive positioning vis-à-vis competitors, particularly Perkins (Caterpillar), MTU, Volvo, MHI, Kohler, Navistar etc. Several of these global players rely on imports, thus severely impacting their pricing ability. In contrast, KKC has very low import content at ~20% of its total RM basket.

### Valuation and view

- We estimate revenue growth of 11%/16%/17% in FY13E/14E/15E and EBITDA margin of 18.8%/19.4%/19.5% (FY12 16.9%).
- Our EPS estimate stands at INR25.3 (up 27% YoY) for FY13E, INR28.9 (up 13% YoY) for FY14E and INR33 (up 14%) for FY15E.
- On current estimates, KKC trades at 20x FY13E, 17.4x FY14E and 15.3x FY15E.
- Maintain **Buy** with a target price of INR585 based on 18x FY15E EPS.

## Financials and Valuation

<b>Income Statement</b>		<b>(INR Million)</b>				
<b>Y/E March</b>	<b>2011</b>	<b>2012</b>	<b>2013E</b>	<b>2014E</b>	<b>2015E</b>	
<b>Total Revenues</b>	<b>40,425</b>	<b>41,172</b>	<b>45,588</b>	<b>52,706</b>	<b>61,823</b>	
Change (%)	39.5	1.8	10.7	15.6	17.3	
Raw Materials	25,803	26,454	28,584	32,783	38,485	
Staff Cost	2,546	3,039	3,343	3,744	4,306	
Other Expenses	4,441	4,706	5,083	5,956	6,986	
<b>EBITDA</b>	<b>7,635</b>	<b>6,973</b>	<b>8,578</b>	<b>10,223</b>	<b>12,047</b>	
% of Total Revenues	18.9	16.9	18.8	19.4	19.5	
Depreciation	366	420	470	575	650	
Other Income	804	1,233	1,661	1,536	1,549	
Interest	48	54	45	60	60	
<b>PBT</b>	<b>8,025</b>	<b>7,732</b>	<b>9,725</b>	<b>11,124</b>	<b>12,885</b>	
Tax	2,114	2,334	2,796	3,115	3,737	
Rate (%)	26.3	30.2	28.8	28.0	29.0	
<b>Adjusted PAT</b>	<b>5,911</b>	<b>5,502</b>	<b>7,000</b>	<b>8,009</b>	<b>9,148</b>	
Extra-ordinary Income (net)	0	514	475	0	0	
<b>Reported PAT</b>	<b>5,911</b>	<b>5,913</b>	<b>7,404</b>	<b>8,009</b>	<b>9,148</b>	
Change (%)	33.1	0.0	25.2	8.2	14.2	
<b>Adj. Consolidated PAT</b>	<b>5,911</b>	<b>5,502</b>	<b>7,000</b>	<b>8,009</b>	<b>9,148</b>	
Change (%)	33.1	-6.9	27.2	14.4	14.2	

<b>Balance Sheet</b>		<b>(INR Million)</b>				
<b>Y/E March</b>	<b>2011</b>	<b>2012</b>	<b>2013E</b>	<b>2014E</b>	<b>2015E</b>	
Share Capital	396	554	554	554	554	
Reserves	17,667	19,877	23,388	26,530	30,163	
<b>Net Worth</b>	<b>18,063</b>	<b>20,432</b>	<b>23,943</b>	<b>27,085</b>	<b>30,718</b>	
Loans	183	0	0	0	0	
Deferred Tax Liability	-187	-70	-70	-70	-70	
<b>Capital Employed</b>	<b>18,058</b>	<b>20,362</b>	<b>23,873</b>	<b>27,015</b>	<b>30,648</b>	
Gross Fixed Assets	9,144	9,703	11,203	14,203	16,703	
Less: Depreciation	4,734	5,054	5,524	6,099	6,749	
<b>Net Fixed Assets</b>	<b>4,411</b>	<b>4,649</b>	<b>5,679</b>	<b>8,104</b>	<b>9,954</b>	
Investments	7,255	5,976	5,976	5,976	5,976	
<b>Curr. Assets</b>	<b>16,804</b>	<b>19,826</b>	<b>22,681</b>	<b>24,829</b>	<b>28,528</b>	
Inventory	5,190	5,676	6,245	7,220	8,469	
Debtors	7,182	6,783	7,494	8,664	10,163	
Cash & Bank Balance	1,037	2,235	3,589	3,300	3,876	
Loans & Advances	3,297	5,082	5,303	5,595	5,970	
Other Assets	98	50	50	50	50	
<b>Current Liab. &amp; Prov.</b>	<b>10,325</b>	<b>10,509</b>	<b>11,263</b>	<b>12,778</b>	<b>14,674</b>	
Creditors	6,129	5,186	5,745	6,642	7,791	
Other Liabilities	894	1,587	1,598	1,849	2,171	
Provisions	3,302	3,736	3,919	4,287	4,711	
<b>Net Current Assets</b>	<b>5,356</b>	<b>7,006</b>	<b>7,729</b>	<b>8,636</b>	<b>9,842</b>	
<b>Application of Funds</b>	<b>18,058</b>	<b>20,362</b>	<b>23,873</b>	<b>27,015</b>	<b>30,648</b>	

E: MOSL Estimates

## Financials and Valuation

### Ratios

Y/E March	2011	2012	2013E	2014E	2015E
<b>Basic (INR)</b>					
<b>Adj EPS</b>	<b>21.3</b>	<b>19.8</b>	<b>25.3</b>	<b>28.9</b>	<b>33.0</b>
Cash EPS	22.6	21.4	26.9	31.0	35.3
Book Value	64.5	73.5	86.1	97.5	110.6
DPS	15.0	11.0	12.0	15.0	17.0
Payout (incl. Div. Tax.)	82.3	64.2	55.6	60.7	60.3
<b>Valuation (x)</b>					
P/E		22.1	20.0	17.4	15.3
Cash P/E		20.5	18.7	16.3	14.3
EV/EBITDA		16.3	15.3	12.8	10.8
EV/Sales		2.8	2.9	2.5	2.1
Price/Book Value		6.0	5.9	5.2	4.6
Dividend Yield (%)		2.5	2.4	3.0	3.4
<b>Profitability Ratios (%)</b>					
RoE	35.5	28.8	31.7	31.5	31.7
RoCE	35.4	28.8	31.8	31.6	31.9
<b>Turnover Ratios</b>					
Debtors (Days)	65	60	60	60	60
Inventory (Days)	47	50	50	50	50
Creditors. (Days)	55	46	46	46	46
Asset Turnover (x)	4.3	4.2	4.0	3.7	3.6
<b>Leverage Ratio</b>					
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0

### Cash Flow Statement

(INR Million)

Y/E March	2011	2012	2013E	2014E	2015E
PBT before EO Items	8,025	7,732	9,725	11,124	12,885
Add: Depreciation	366	420	470	575	650
Interest	48	54	45	60	60
Less: Direct Taxes Paid	2,114	2,334	2,796	3,115	3,737
(Inc)/Dec in WC	(1,253)	(1,072)	(723)	(974)	(1,407)
<b>CF from Operations</b>	<b>5,072</b>	<b>4,800</b>	<b>6,721</b>	<b>7,670</b>	<b>8,452</b>
EO Income	0	514	475	0	0
<b>CF from Oper. Incl. EO Items</b>	<b>5,072</b>	<b>5,315</b>	<b>7,196</b>	<b>7,670</b>	<b>8,452</b>
(Inc)/Dec in FA	(1,440)	(2,082)	(1,903)	(3,100)	(2,500)
Investment in subsidiaries	0	(148)	0	0	0
Investment in liquid assets	75	1,761	0	0	0
<b>CF from Investments</b>	<b>-1,366</b>	<b>-469</b>	<b>-1,903</b>	<b>-3,100</b>	<b>-2,500</b>
(Inc)/Dec in Networkth	1,389	(226)	(1)	(2)	(2)
(Inc)/Dec in Debt	96	-183	0	0	0
Less: Interest Paid	48	54	45	60	60
Dividend Paid	4,666	3,185	3,892	4,798	5,314
<b>CF from Fin. Activity</b>	<b>(3,228)</b>	<b>(3,648)</b>	<b>(3,938)</b>	<b>(4,860)</b>	<b>(5,376)</b>
<b>Inc/Dec of Cash</b>	<b>478</b>	<b>1,198</b>	<b>1,354</b>	<b>(289)</b>	<b>576</b>
Add: Beginning Balance	559	1,037	2,235	3,589	3,300
<b>Closing Balance</b>	<b>1,037</b>	<b>2,235</b>	<b>3,589</b>	<b>3,300</b>	<b>3,876</b>

E: MOSL Estimates

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