

Company Overview

Cummins Inc., a prominent name in the Class 8 truck production industry in North America, boasts a business portfolio that extends far beyond its well-known truck manufacturing operations. In this write-up, we delve into Cummins' diversified business interests, recent performance, and future prospects, shedding light on key factors that could shape its trajectory in the coming years.

While Cummins is commonly associated with Class 8 truck production, the company's business interests are notably diversified. Despite the inherent cyclicity of some of its operations, Cummins has established a robust presence in various sectors. The recent performance of Cummins' stock witnessed a dip following its Q2 earnings report, primarily due to weakness observed in its aftermarket business. Historically, such weakness has often foreshadowed downturns in engine production. However, recent statements from Cummins' management at investor conferences provide a more optimistic outlook. They anticipate a potential 10% reduction in Class 8 truck production next year. Still, they highlight the strength of the medium-duty and bus markets, which experienced undersupply during the COVID-19 era shortages. Furthermore, most other segments of Cummins' business remain robust, with a sense that the Chinese market may have reached its bottom, at least for the markets Cummins serves.

Data as of June 30, 2023

Business Segment	% of Sales	2023 Revenue Guidance	Description
Components	32%	Up 32% - 37%	Filtration, turbo technologies, emission solutions, electronic/fuel systems
Engines	28%	Up 2% to 7%	Designs/manufactures diesel & natural gas engines for on/off highway use
Distribution	25%	Up 10% to 15%	Global sales, service, support (world's largest number of certified service/support locations of any engine manufacturer)
Power Systems	14%	Up 8% to 13%	Power generation systems, components/services, and alternative-fuel electrical generators for residential & commercial
Accelera	1%	*Up 400%	Zero-emission power segment focusing on *electrolyzers & hydrogen production for truck, marine, mining and rail industries

**Electrolyzers are a system that uses electrolysis to break down water into hydrogen and oxygen creating hydrogen gas for power. Accelera is a new business line initiated in early 2023. The segment is currently not profitable. For the three months ending June 30, 2023, revenue was \$85 million and is not expected to generate profits over the next 12 months.*

Cummins recently increased their 2023 revenue guidance to be up 15% - 20% and EBITDA margins to 15% - 15.7%.

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Positives

2027 Emissions Tightening:

One potential catalyst for Cummins lies in the 2027 tightening of nitrous oxide emissions regulations. Historically, this has led to significant "pre-buys" of trucks and engines ahead of regulatory changes. Such pre-buys could serve as a hedge against soft economic demand, though this is contingent on financing conditions. Additionally, regulatory tightening typically leads to increased manufacturing costs, resulting in price hikes that boost revenue over time. The scale of Cummins positions them to potentially take additional market share as truck OEMs (original equipment manufacturer) to evaluate whether it is economically practical to produce their own engines and components versus partnering with a market leader like Cummins.

Investment in Non-Carbon Technologies:

Cummins is strategically investing in non-carbon technologies (demonstrated by their acquisition of Meritor), and their organic approach is commendable. They are developing engine platforms that can accommodate different fuels such as natural gas or hydrogen, with only the fuel systems above the head gasket requiring specific engineering. While electric vehicles are on the horizon they remain distant prospects for most heavy applications. Cummins' investment strategy allocates less than 10% of its operating earnings to develop new technologies, thereby mitigating potential earnings and cash flow dilution. This approach also shields Cummins from the multiple compression seen in sectors heavily reliant on traditional internal combustion engines.

Financial Strength and Innovation:

Cummins' ability to navigate the evolving technological landscape is further bolstered by its financial stability. The end of easily accessible capital for disruptive startups positions Cummins to acquire promising technologies at favorable terms. This self-financing capability allows Cummins to explore innovative opportunities efficiently.

Negatives & Risks

Despite an increase in guided 2023 expectations, Cummins' stock performance may remain subdued, awaiting a resolution of market concerns related to a potential recession. Historically, cyclical stocks tend to bottom out ahead of economic downturns, and this holds true for earnings as well.

Freight volume could weaken if the consumer reduces spending resulting in a slow industrial recovery, causing truck operators to hold off on new truck purchases.

The investment in alternative power solutions (Accelera) may not be developed quick enough to address increasing stringent emission standards which would devalue their brand with customers and potentially have a negative impact on aftermarket revenue.

Dividend Characteristics

The stock aligns well with our established criteria for yield, size, and financial stability. Notably, the dividend has not seen a reduction since the economic downturn of 1990-1991, demonstrating a consistent track record of dividend stability. Cumulative annual dividend payments have experienced steady growth over the past 18 years (2006-2023), including the recent announcement of a 7% increase in July. The current payout ratio, as projected based on the 2023 consensus estimate, stands at a prudent 33%. This compares favorably to an average payout ratio of 37% over the last 10, 5, and 3 years.

Cummins maintains a robust credit rating in the investment-grade category, with its leverage primarily impacted by the Meritor acquisition from the previous year. Notably, the company's current priorities are directed toward capital expenditure and debt reduction, with dividends taking precedence over share buybacks. Given this financial profile, it is reasonable to anticipate that dividend growth may slow during adverse economic conditions. However, the likelihood of an outright dividend reduction remains low.

Conclusion

Cummins Inc. stands as a resilient and diversified entity in the midst of market uncertainties. While challenges exist, the company's strategic outlook, anticipation of regulatory changes, and commitment to innovation place it in a favorable position to weather industry fluctuations and remain a prominent player in the evolving landscape of transportation technology.

Current & Historical Valuations

Valuation Metric	Current	5-Year High	5-Year Low	Average	Vs. Industry
Trailing PE	12.6	25.3	7.0	15.4	1.0
Forward PE	11.4	21.1	8.1	13.0	1.0
Price to Book Value	3.1	5.2	2.0	3.7	.8
Price to Cash Flow	14.8	19.6	4.8	12.4	1.1
Price to Sales	1.0	2.1	.7	1.3	.7
Enterprise Value to EBITDA	8.8	15.1	5.9	10.0	.9
Enterprise Value to Sales	1.1	1.9	.8	1.3	.6
Dividend Yield	3.0	4.9	1.9	2.6	1.9

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Morgan Dempsey Large Cap Value – Strategy Materials

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Definitions

PE (Price-to-Earnings Ratio): PE is a financial metric that measures the valuation of a company by comparing its stock price to its earnings per share. It indicates how much investors are willing to pay for each dollar of a company's earnings. Trailing refers to the past 12 months and forward is on expected next 12 months of earnings.

Book Value: Book value is the net asset value of a company, calculated by subtracting its total liabilities from its total assets. It represents the theoretical value of a company's equity if all its assets were sold, and its debts were paid off.

Cash Flow: Cash flow refers to the money that flows in and out of a business. It's the difference between the cash generated from operating activities and the cash used for investing and financing activities. Positive cash flow indicates a healthy financial position.

Enterprise Value to EBITDA (EV/EBITDA): EV/EBITDA is a financial ratio used to assess a company's overall value in relation to its earnings before interest, taxes, depreciation, and amortization (EBITDA). It provides a more comprehensive view of a company's value, accounting for its debt and other financial factors.