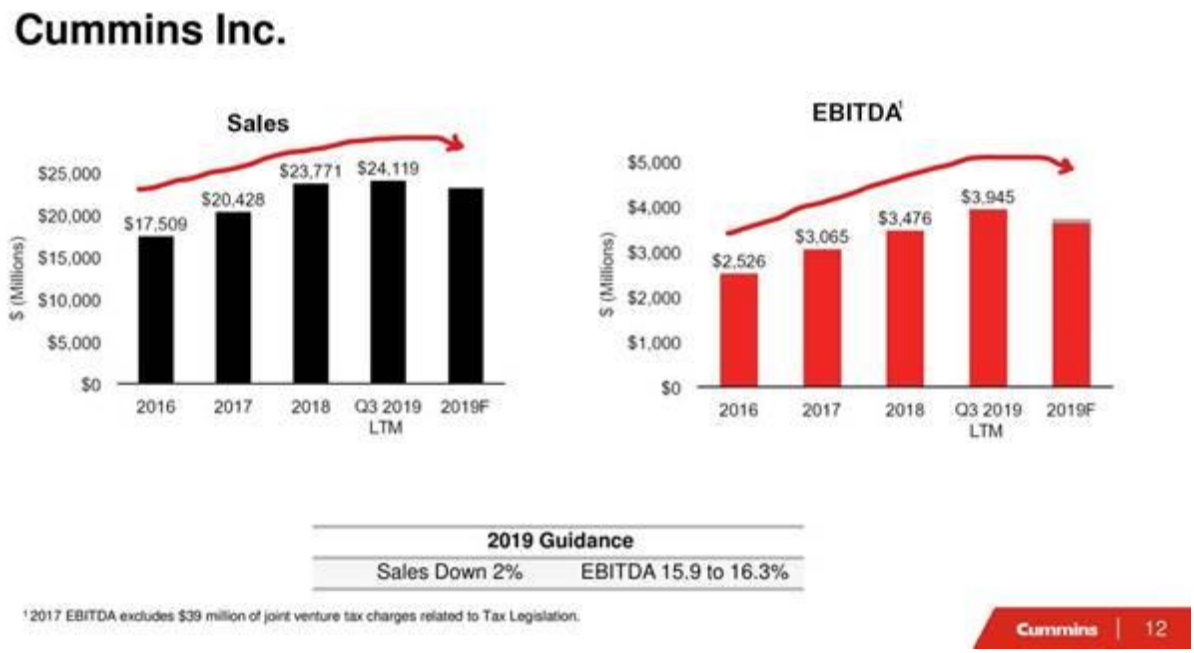
Inside Cummins: Last Quarter's Progress

Oct. 31, 2019

If an investor wandered in off the street, so to speak, to hear Cummins' 3rd-Quarter Earnings call; and if our investor didn't happen to have much prior knowledge about the "diesel engine king;" then she might well have staggered out of the call, an hour later, thinking the wheels were not only falling off the company but had already fallen off the worldwide truck and engine industries, not mention most of the global economy.

Cummins' CEO Tom Linebarger and his key managers used the words "downturn" and "down cycle" too many times to count, during the call. And just to make sure we didn't hang onto any false optimism, they attached adjectives like "broad-based," "unexpectedly sharp," and even "train wreck" to all those "downturns." Yes . . . if we didn't know much about this company, we might think Cummins is in the same fix as such bleeding celebrity companies as WeWork, Twitter, or even IBM, which after 2 or 3 whole years, still can't seem to apply a tourniquet to its loss of sales blood. So the best thing to do is look at the actual facts and bypass the colorful adjectives.



Like every "heavy industry" company, Cummins lives with the cycle which defines its diesel-engine and trucking industry. Those peaking, gently easing-off red lines above show about 4 years of "up cycle" for our company, then the very beginnings of a reversal into "down cycle." That peak and early-stage slide hit Cummins between the eyes this past quarter. Here are just a few of Mr. Linebarger's comments:

- "Total company revenues for the third quarter of 2019 were $5.8 billion, <u>a decrease of 3%</u> compared to the third quarter of 2018."

- "Third quarter revenues in China, including joint ventures were $1.2 billion, a decrease of 2% over the prior year. Lower demand in construction and light commercial vehicle markets was partially offset by increased demand in medium- and heavy-duty truck markets."

- "Broadly speaking, we've seen a number of our markets rising to cyclical peaks over the last couple of years, which has been terrific for the company. We've generated strong earnings and cash flows as a result, but now indeed some of those markets are beginning to turn down, and we've been seeing signs of that. Maybe what's surprising to me is it's broader than I thought. Like we are seeing challenges in India, challenges in China, challenges in – even in Europe is slowing. We saw North America coming, that was all part of what we expected, but some of the challenges in some of the other markets, how quickly we've seen the large-engine markets sort of peak out and begin to turn the other way, has been a little surprising."

- "But we've been ready for this all year. We are committed to pushing our costs down as demand drops. We're committed to managing the cycle. We've been tight on discretionary spending and hiring all year, and we actually really started to take costs out in the third quarter. We've been analyzing underperforming businesses and as Mark said, we decided to close one in the third quarter. We've launched a voluntary retirement program here in the U.S., and so these are all actions we're taking, the majority of which will bear fruit in 2020—but we are moving now to take out cost as demand drops."

We might wonder about that last remark, knowing how many excellent CEO's are straightforward about admitting they never see the cycle turns coming ahead of time. But Cummins' people are excellent indeed, and have many decades of experience with "the cycle." Here is evidence that they've been doing exactly what they're saying.

Cummins: Sales Down . . . but Profitability Mostly Up. (Quite a Trick.)

Guidance for 2019 Segment Results

ITEM	ENGINE	DISTRIBUTION	COMPONENTS	POWER SYSTEMS	ELECTRIFIED POWER
Consolidated Revenue Growth	Down 5% to 6%	Up 2% to 3%	Down 4% to 5%	Down 3% to 4%	$40M
2019 EBITDA Margins (% of Revenue)	14.3 to 14.8%	8.4 to 8.8%	15.6 to 16.1%	12.5 to 13.0%	($145M)
2018 EBITDA Margins (% of Revenue)	13.7%	7.2%	14.4%	13.3%	($90M)

Our guidance does not include expenses associated with executing future cost reduction initiatives.

As the chart says, it is quite a trick indeed for a company to increase profitability per sales dollar when sales dollars as a whole are declining. "We're committed to managing the cycle," said Mr. Linebarger. He is doing rather well, so far.

The last 2 questions during the Earnings Call were highly interesting. In the first, an analyst asked one of Mr. Linebarger's group chiefs to "take us around the world," commenting on just how deep the economic and engine-industry problems might be, in each area. He gave a long answer, naturally, which amounted to: "Perfectly normal cyclical downturns everywhere except Argentina (the "train wreck") and India, whose "banking sector" has slammed the brakes on lending this year. But India will fix it over the next few quarters, as it always does; and almost every other world market has already begun fixing the excess inventories which must be cleared away to allow the next upturn. It looks to us as if we should see those upturns within 2 to 4 quarters from now, everywhere except Argentina."

Even more interesting was the last question for Mr. Linebarger, which was roughly, "What are the world's giant truck-makers (Cummins' customers) thinking about, right now?"

"I talk to them all," said Cummins' CEO, in essence. "Every one of them is staring down the barrel of capital spending requirements which are 100% to 200% higher than normal, over the next several years. They face much-tougher emissions standards; electrification and fuel cell development; and the tremendous need to put digital technology into engines and vehicles. They all make most of their money selling diesel trucks, today . . . but they know the future is changing and it will cost them a lot to keep up. We are telling them to let Cummins handle the diesel-engine capital spending—and electrification too—then they'll have the money to spend on their other needs."

Here's what that means. The world's big truck-makers build their own engines for their own trucks, and they also buy Cummins' engines (which are superior, and cost more.) Mr. Linebarger is gently suggesting to those customers that they don't appear to have the money, anymore, to keep making their own engines . . . so they'd best give the whole business to Cummins, going forward. (A few years ago Navistar was forced to do exactly that, for a while, when it discovered catastrophic quality problems in its "in house" engines.)

The bigger picture for Cummins is all about the next cyclical upturn, no matter how many quarters it takes to arrive. Like every Outlook company, Cummins is outstanding at "managing its cycle." Costs are cut on the way down, and profits take off on the way back up, rising higher than ever. At Outlook we often make fun of the market's frequent inability to see the obvious, but when we gaze at the 10-year chart below, it kind of looks as if the market "gets it" about Cummins, doesn't it?

10 Years of Cummins Cycles: Higher Lows and Higher Highs

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