October 29, 2019

Cummins Inc. 3rd Quarter Earnings Call

Tom Linebarger – Chairman and CEO

Thank you, James. Good morning.

I'll start with a summary of our third quarter results and finish with a discussion of our outlook for 2019. Mark will then take you through more details of both our third quarter financial performance and our forecast for the full year.

Revenues for the third quarter of 2019 were $5.8 billion, a decrease of 3% compared to the third quarter of 2018. EBITDA was $958 million, or 16.6%, compared to $983 million, or 16.5%, a year ago. Positive pricing, lower variable compensation, material cost reduction activities, and lower warranty expense partially offset the impact of lower volumes and increased investments in research and engineering.

Engine Business revenues declined 11% in the third quarter compared to a year ago. Revenues in North America decreased by 6% as we began to the see the impact of OEMs preparing for lower production of heavy-duty trucks in North America, as well as declines in shipments to construction markets. International revenues declined by 25%, primarily as a result of lower demand in Chinese light-duty truck and construction markets. EBITDA margin for the quarter was 14.1% compared to 14.9% for the same period in 2018 and included a $33 million charge related to ending production of our 5-liter ISV engine for the US pickup market. Improved pricing and lower material costs partially offset the impact of lower volumes, reduced joint venture income, and the $33 million charge.

Sales for our Distribution segment grew by 4% year-over-year, driven by higher demand for power generation equipment in North America. Third quarter EBITDA was a record $186 million, or 9.3% of sales compared to

8.0% in the third quarter of 2018. EBITDA margins benefitted from higher volumes, positive pricing, and lower variable compensation costs.

Third quarter revenues for the Components segment declined by 6%. Sales in North America increased 2%, driven by higher demand in the US pickup market, while revenues in international markets declined by 18% as a result of lower truck demand in Europe, India, and China. EBITDA for the third quarter was $286 million or 17.3% compared to 16.4% in the same quarter a year ago. The increase in EBITDA percent was primarily due to lower warranty costs and the benefit of material cost reduction programs, which offset increased investment in the development of new products to meet advancing emissions standards in China and India as well as the impact of lower volumes.

Power Systems sales in the third quarter increased by 2%. Demand in industrial markets increased 3%, with lower sales to oil and gas markets offset by increased sales to marine, rail, and mining customers. Power generation sales increased 8% in North America driven by continued strength in data center markets offset by a 4% decline in international markets, mainly in Europe and the Middle East. While sales increased compared to a weak third quarter last year, sales declined 6% sequentially, with lower demand in power generation, oil and gas, and mining markets.

EBITDA in the third quarter was 14.0% compared to 14.7% a year ago. The decrease in EBITDA percent was largely due to the impact of higher material costs, including tariffs, and lower sales of industrial engines.

In the Electrified Power Business, EBITDA was a loss of $36 million in the third quarter and in line with our expectations. We completed the acquisition of Hydrogenics, a leading producer of fuel cells and electrolyzers for the production of hydrogen, on September 9th. Our third quarter results included a $2 million EBITDA loss related to Hydrogenics.

Now, I will comment on the performance in some of our key markets for the third quarter of 2019, starting with North America, and then I will cover some of our largest international markets.

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Our third quarter revenues in North America were flat at $3.6 billion. Increased sales of power generation equipment, especially to data center customers, were offset by lower shipments of heavy-duty truck and construction engines.

Industry production of heavy-duty trucks increased 3% in the third quarter of 2019 compared to a year ago and decreased 4% compared to the second quarter of this year, with low truck orders, a declining industry backlog, and historically high levels of new truck inventory driving lower industry production. While industry truck production increased compared to last year, our shipments declined as OEMs prepare to ramp down production in Q4. Our market share through September was 32%.

Production of medium-duty trucks increased 4% in the third quarter. A growing US economy, coupled with high levels of consumer spending, low unemployment, and low interest rates, continues to drive demand for medium-duty trucks. Our market share in the medium-duty truck market was 78% through September, compared to 81% a year ago.

Total shipments to our North American pickup truck customers increased for the third consecutive quarter to over 41,000 units, supported by strong demand for RAM 2500 and 3500 pickup trucks.

Engine demand for construction equipment in North America decreased 30% in the third quarter. While non-residential construction spending remains high, we are seeing industry participants take steps to reduce their equipment inventory, which currently stands at historically high levels.

Revenues for power generation grew by 8% due to higher demand in data center markets, partially offset by lower sales to recreational vehicle OEMs. Demand for engines in oil and gas markets declined by 86% due to continued low purchases of new fracking equipment.

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Our international revenues decreased by 8% in the third quarter of 2019 compared to a year ago.

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.

Industry demand for medium- and heavy-duty trucks in China increased by 1% compared to a year ago and was positively impacted by a pre-buy of natural gas engines ahead of the move to NSVI standards. We estimate the impact of this pre-buy to be approximately 27,000 units this quarter, increasing market size by 10%. This increase is in addition to the 20,000-unit Pre-buy that occurred in the second quarter. Our market share improved to 16.1% this quarter from 15.6% a year ago as we increased our share at Foton and saw a shift towards over-the-road trucks versus construction-related dump trucks.

Industry sales of light-duty trucks declined by 3% in the third quarter and 15% sequentially. Our engine market share was 7.4%, 0.2 percentage points higher than a year ago. We continue to be impacted by increased enforcement of loading regulations, where truck models that had historically been registered as light-duty trucks are now to be classified as medium-duty trucks, which limits access to urban areas and requires additional licensing for drivers. OEMs did begin to launch new light duty vehicles in the third quarter, resulting in higher industry production than we had originally forecasted.

Third quarter demand for excavators in China increased 16% from a year ago. Our market share also increased, from 15.0% to 15.4%, driven by the strong performance of our local partners. While industry sales and our market share increased compared to a year ago, our sales for the quarter, including joint ventures, declined 29%, due to OEMs and dealers reducing inventory built primarily in the second half of last year.

Demand for power generation equipment was flat in the third quarter, with lower demand for standby power partially offset by growth in data center markets.

Third quarter revenues in India, including joint ventures, were $344 million, a reduction of 29% from the third quarter a year ago with lower demand in all of our major end markets. Industry truck sales decreased 52% year-over-year, an even larger decline than we had expected, driven by continued lack of credit availability. Credit availability also started to impact other markets during the third quarter, with construction revenues down 75% as companies struggle to finance construction projects placing pressure on equipment purchases.

Now, let me provide our overall outlook for 2019 and then comment on individual regions and end markets.

We now expect company revenues to be down 2% for the year, compared with our prior guidance of flat.

We are lowering our forecast for industry production of heavy-duty trucks in North America slightly to 299,000 units or up 5% compared to 2018, down from our prior guidance of 300,000 units. More concerning, the industry backlog declined 31%, or 61,000 units, this quarter to 133,000 units from its peak of over 300,000 units a year ago. Inventory remains elevated at 81,000 units and third quarter orders of 34,000 units were the lowest since 2009. Industry production decreased monthly as we moved through the third quarter, and we expect these monthly declines to continue through the end of the year.

We expect our market share for the year to be at the low end of our forecast range of 32% to 34%. Market share is being negatively impacted by lower shipments to OEMs ahead of truck production cuts.

Demand in our parts and remanufacturing business remained stable in the third quarter as we continued to see the impact of increased capacity of

fleets and lower freight demand, resulting in lower utilization of available equipment in the industry.

We continue to expect parts demand to be relatively weak through the end of the year as dealers reduce parts inventory in anticipation of lower market activity.

In the medium-duty truck market we are lowering our forecast for industry production to 138,000 units or up 5%, compared to our prior guidance of 140,000 units, or up 6% year-over-year. While retail sales of medium duty trucks remain strong, up 13% year-to-date, industry truck production has now been above order intake for 7 months, lowering the industry backlog to levels that will result in lower build rates. We continue to expect our market share to be in the range of 74% to 76%, unchanged from our prior guidance.

We expect our engine shipments for pickup trucks in North America to be flat for 2019, compared to a very strong 2018, and unchanged from our expectations three months ago.

Shipments of construction engines are now expected to decline by 5% compared to our prior expectations of 10% growth, as OEMs and dealers reduce inventories from historically high levels.

In China, we now expect domestic revenues, including joint ventures, to be down 1% in 2019, an improvement compared to our prior guidance of down 2%. We are increasing our outlook for medium and heavy-duty truck market demand to 1.23 million units, or down 7% compared to our prior guidance of down 10%, due to the additional pre-buy of natural gas trucks that occurred in the third quarter. In the light-duty truck market we now expect a 7% reduction in demand compared to our prior guidance of down 12%. This improvement is driven by OEMs launching new truck models in light of the more stringent enforcement of overloading regulations that began in the second quarter. We expect our market share in the medium- and heavy-duty market to be in the range of 13 to 14%, and in light duty we expect our share to be 8 to 9%, both in line with our prior guidance.

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We now expect industry sales of excavators to increase 8% from the record levels achieved in 2018, compared to our prior guidance of flat. While industry sales are expected to increase this year, we are expecting lower levels of industry production in second half of 2019 compared to 2018, as the industry prepares for lower demand in the Spring 2020 selling season.

In India, we now project total revenue, including joint ventures, to be down 20% in 2019 compared to our prior guidance of down 5%. We anticipate industry demand for trucks to be 30% lower than the record levels experienced in 2018, compared to our prior guidance of down 17%. We now expect construction demand to decline 40% compared to our prior outlook of 5 to 10% growth, with a lack of financing for construction projects lowering demand for new equipment. Demand for power generation equipment is now expected to be flat compared to 5 to 10% growth.

In Brazil, we are now projecting truck production to be flat in 2019, down from our forecast of 2% growth three months ago. While domestic demand in Brazil continues to increase from levels experienced in 2018, truck production in Brazil for export markets is expected to decline 50% compared to 2018, primarily due to weak demand for trucks in Argentina. We continue to project total revenues in Brazil to be down 10% this year.

We now expect our global high horsepower engine shipments to be down 10% this year, compared with our prior guidance of down 5%. Demand for new oil and gas engines is now expected to decline 50% compared with our prior guidance of down 40%. We now anticipate sales in North America will decline by 85% compared to our 75% expectation three months ago, with lower demand for new equipment in the Permian basin as well as reduced demand for engine rebuilds.

The deterioration in our outlook for North America is partially offset by growing sales in China, which have represented 61% of our oil and gas engines sales year-to-date. Demand for mining engines has moderated over the last three months as commodity prices have fallen and capital

budgets have been cut. We now expect mining engine sales to be down 7%, lower than our prior guidance of down 5%.

Demand for power generation equipment increased 2% compared to the low levels experienced in the third quarter last year and declined 3% sequentially, below our expectations primarily due to lower demand in India. We now expect full year revenues to be down 2% compared to our prior guidance of flat primarily due to lower demand in India. For the full year growth in data center markets and increased military revenue is being offset by lower sales of generator sets to the RV market, lower demand in backup power applications in China and India, and a drop in large prime power applications in Europe.

In summary, we are now expecting revenues to be down 2% for the year, lower than our prior guidance of flat. This revenue decline is driven by lower demand in domestic and international truck markets, weakness in Indian end markets, and lower demand in several off-highway markets. Lower sales, reduced joint venture income in India, and the acquisition of Hydrogenics, will impact our EBITDA for the year, which we now project at 15.9 to 16.3% of sales, down from our prior guidance of 16.25 to 16.75% of sales.

Strong execution across all of our business resulted in record revenues being translated into record EBITDA and operating cash flow in the first 9 months of the year. Our strong and consistent cash flow generation continues to support our plans to return cash to shareholders, and we returned $910 million of cash in the third quarter, buying back 2.9% of outstanding shares.

While we were pleased with our operating performance in the third quarter we have been working to prepare the company for what lies ahead in the fourth quarter and in 2020. As we have discussed before, several of our end markets have been above replacement level for some time and are now expecting cyclically reduced demand.

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Our third quarter revenues declined 7% sequentially and our guidance projects that they will decline another 8% in the 4th quarter. This steep level of decline has resulted in a number of actions to align costs with production levels, including a recently announced voluntary retirement package in the United States which we anticipate will lower headcount by 400 to 450 people. We are in the process of making additional structural changes in several areas of the business and will continue to drive actions to improve costs. As always, we will capitalize on the downturn period to improve our company and emerge as a stronger, more profitable Cummins. We will also maintain our investments in the key technologies and product development programs that will ensure leadership and sustainable growth in the future.

During the third quarter we announced new investments in alternative powertrains and the launch of an updated ISX15 engine for the North America heavy-duty truck market. These actions demonstrate our commitment to lead in alternative powertrain technologies while continuing to lead in traditional powertrains.

We closed on our acquisition of Hydrogenics, one of the world's premier fuel cell and hydrogen production technologies providers in September. Their expertise and innovative approach will strengthen Cummins' fuel cell capabilities. This is another step forward as we continue to invest in a broad range of clean, fuel-efficient and high-performing products and technologies that deliver value to our customers. During the quarter we also made an investment in Loop Energy, who design and manufacture fuel cell range extenders, and announced a partnership with Hyundai to jointly evaluate opportunities to develop and commercialize electric and fuel cell powertrains.

While we increase investment in alternative powertrains, we continue to enhance our diesel and natural gas products, delivering more fuel efficiency, power, and lower emissions. At the North America Commercial Vehicle show in Atlanta, we are currently showing our new 15-liter ISX efficiency series. The 2020 efficiency series with an Endurant transmission will provide up to a 5% improvement in fuel efficiency for end users, fully meeting 2021 greenhouse gas standards one year early.

Now let me turn it over to Mark.

Mark Smith – Chief Financial Officer

Thank you, Tom, and good morning everyone.

I will start with a quick summary of our financial performance in the third quarter and then comment on our revised outlook for the full year.

Third quarter revenues were $5.8 billion dollars, a decrease of 3% percent from a year ago. Sales in North America were flat and international revenues decreased 8%. Currency movements negatively impacted revenues by 1%.

Earnings before interest and tax, depreciation and amortization (EBITDA) were $958 million dollars or 16.6 percent of sales for the quarter, compared to $983 million dollars or 16.5 percent of sales a year ago. EBITDA decreased by $25 million over the third quarter last year driven by the negative impact of lower sales, reduced joint venture income and higher tariffs, partially offset by material cost reduction activities, lower warranty and decreased variable compensation expenses.

Gross margin of $1.5 billion or 25.9% decreased by $57 million or 20 basis points. Benefits from favorable pricing actions, material cost reductions and lower warranty and variable compensation expenses mitigated the negative impact of lower volumes, charges incurred to cease production of certain unprofitable product lines and higher tariffs.

Our Selling, Administrative and Research costs of $842 million increased by $9 million year over year, driven primarily by new product development in the Engine, Components and Electrified Power Segments, partially offset by lower variable compensation expense.

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Joint venture income declined by $22 million dollars, due to weaker demand for light duty trucks in China and lower truck production in India.

Other Income of $61 million, increased by $34 million, driven primarily by $35 million of gains related to closing out certain derivative contracts associated with the company's foreign exchange hedging program.

Net earnings for the quarter were $622 million dollars or $3.97 per diluted share compared to $692 million dollars or $4.28 from a year ago. Third quarter results were positively impacted by $23 million or $0.14 per diluted share in discrete tax items and the after-tax gains of $28 million or $0.18 from closing out the foreign exchange hedging contracts I just referred to. During the quarter we incurred after-tax expenses of $35 million dollars or $0.23 related to actions taken to cease development and production of certain products, which will benefit future financial performance.

The effective tax rate in the quarter was 18.4%. Excluding discrete tax items, the tax rate was 21.5% in the third quarter and in line with our full year forecast of 21.5%.

Operating Cash Flow in the quarter was a record inflow of $1.1 billion, $208 million higher than last year. Year to date, cash generated from operating activities totals a record $2.3 billion, up $955 million from the same period last year, driven by higher earnings and a much slower pace of working capital expansion.

I will now comment on our revised guidance for 2019.

For the Engine Segment, we expect full year revenues to be down 5 to 6 percent, compared to our previous guidance of flat at the midpoint. The reduction in sales is driven by lower shipments of heavy-duty truck engines in North America, weaker demand for construction equipment in North America and India, as well as medium duty truck engines in North America, Europe and Brazil.

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We revised our forecast for EBITDA margins to be in the range of 14.3 to 14.8 percent down from our prior guidance of 15.0 to 15.5 percent, driven primarily by the impact of lower volumes, weaker joint venture income and the costs associated with ending production of one engine platform.

For the Distribution segment, we now expect revenues to be up 2 to 3 percent compared to our previous guidance of up 1 to 5 percent, due to lower sales of construction engines in North America and lower engine rebuild volumes by oil & gas and mining customers. We are raising our outlook for EBITDA margins by 35 basis points to be in the range of 8.4 to 8.8 percent, as continued solid operational performance and lower variable compensation expense more than offset the impact of lower sales.

For 2019, we now expect Components revenue to be down 4 to 5 percent compared to our prior projection of flat at the midpoint, driven by reduced truck demand in North America, India, Europe and Brazil. As a result of the lower sales outlook, we have revised our forecast for EBITDA margins to be in the range of 15.6 to 16.1 percent, down from our prior guidance of 15.75 to 16.25 percent.

Power Systems revenues are forecasted to be down 3 to 4 percent, lower than our previous guidance of flat at the midpoint, due to lower international demand for power generation equipment and weaker demand for new equipment and rebuilds in mining and oil & gas markets. We are also revising our forecast for EBITDA margins to be in the range of 12.5 to 13.0 percent of sales, down from our prior forecast of 13.25 to 14.0 percent.

In the Electrified Power segment, we now expect a net expense of $145 million dollars, at the high end of our previous guidance range due to the completion of our acquisition of Hydrogenics.

The net impact of the changes to individual segment projections is that we now forecast total Company revenues to be down 2 percent and Company EBITDA margins to be between 15.9 and 16.3 percent. This compares to our prior guidance of flat sales and EBITDA margins in the range of 16.25 to 16.75 percent.

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Full year Operating Cash Flow is projected be a record $3 billion due to strong earnings and lower working capital.

Capital expenditures for the third quarter were $153 million dollars, bringing our year to date total investment to $395 million dollars. We expect our full year capital investments will be in the range of $650 to $700 million dollars, unchanged from prior guidance.

In the third quarter, we returned a record $910 million dollars to shareholders. We repurchased 4.6 million shares for a total of $706 million dollars. For the first nine months, we returned $1.4 billion dollars through dividends and share repurchase activity. We still plan to return 75 percent of operating cash flow to shareholders this year, while maintaining a strong balance sheet.

To summarize, we delivered a solid set of results in the third quarter, including record quarterly operating cash flow. In response to a slowing global economy driving weaker demand in a number of our end markets, we have taken a number of actions to reduce cost and address some under-performing parts of our business. Consistent with prior downturns, we will continue to identify additional opportunities to drive efficiency and cost reduction while maintaining investment in the products and services that will deliver a stronger future.

Finally, I wanted to remind everyone of our upcoming Analyst Day on November 21st at the New York Stock Exchange. A webcast of our presentation will be available in the Investor Relations section of our website.

Thank you for your interest and patience today.

Now let me turn it back over to Tom before we move to Q and A.

Tom Linebarger – Chairman and CEO

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As you will remember, we announced on April 29, and then discussed in our first and second quarter earnings calls, that we had initiated an internal review of our emission certification and compliance processes for our pick-up truck applications as a result of conversations with the EPA and California Air Resources Board. Our review continues, and we are proactively working with the EPA and CARB, as well as with the Department of Justice and SEC, to address their questions and information requests.

During conversations with regulators, they raised concerns that certain aspects of our emissions systems on the model year 2019 RAM engine may reduce the effectiveness of our emissions control systems and thereby act as defeat devices. Based on these discussions, we have developed a new calibration for the engines in model year 2019 RAM 2500 and 3500 trucks that has been included on all engines shipped since September.

During our discussions, the agencies have asked us to look at other model years and other engines, though the primary focus of our review has been the model year 2019 RAM.

Consistent with the values and the history of our Company, which include a strong commitment to compliance, we will work with regulators and other agencies to address the issues identified in our internal review and develop future technologies that will advance our industry.

We are already making changes to our processes and organization structure as a result of our review. However, it is too soon to know what the response of our regulators or agencies will be to our review or determine any potential financial consequences.