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CAT - Q1 2016 Caterpillar Inc Earnings Call

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OVERVIEW:

Co. reported 1Q16 results. Expects 2016 sales and revenue to be \$40-42b and profit per share to be \$3. Expects 2Q16 sales to be about \$10b and profit per share to be just a shade less than \$1.



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CORPORATE PARTICIPANTS

Mike DeWalt *Caterpillar Inc. - VP of Finance Services*

Doug Oberhelman *Caterpillar Inc. - Chairman and CEO*

Brad Halverson *Caterpillar Inc. - Group President and CFO*

CONFERENCE CALL PARTICIPANTS

Stephen Volkmann *Jefferies LLC - Analyst*

Andrew Casey *Wells Fargo Securities - Analyst*

Joe O'Dea *Verticle Research Partners - Analyst*

David Raso *Evercore ISI - Analyst*

Ann Duignan *JPMorgan - Analyst*

Robert Wertheimer *Barclays Capital - Analyst*

Ross Gilardi *BofA Merrill Lynch - Analyst*

Jerry Revich *Goldman Sachs - Analyst*

Jamie Cook *Credit Suisse - Analyst*

Eli Lustgarten *Longbow Research - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Caterpillar first-quarter 2016 results conference call. At this time all participants have been placed on a listen-only mode and we will open the floor for your questions and comments after the presentation.

It is now my pleasure to turn the floor over to your host, Mike DeWalt. Sir, the floor is yours.

Mike DeWalt - Caterpillar Inc. - VP of Finance Services

Thank you and thank you very much for everyone on the line and welcome to our first-quarter earnings call. I am Mike DeWalt, Caterpillar's Vice President of Finance Services. And on the call with me this morning, we have Doug Oberhelman, our Chairman and CEO, and Brad Halverson, our Group President and CFO.

We are going to do today's call similar to what we have done the past couple of quarters. We will be going through a short slide deck before we get to the Q&A. If you don't have that slide deck in front of you, it is available on our Caterpillar.com website with the conference call webcast link.

Remember this call is copyrighted by Caterpillar Inc. Any use, recording or transmission of any portion of the call without the express written consent of Caterpillar is strictly prohibited. If you would like a copy of today's call transcript, we will be posting it in the investor section of our Caterpillar.com website and that will be in the section labeled results webcast.

So if you go to page two of this morning's slide deck, you will see our forward-looking statements and certainly this morning we will be discussing forward-looking information and that involves risks, uncertainties and assumptions that could cause our actual results to differ materially from the forward-looking information.



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In addition to page two of the slide deck, a discussion of some of the factors that individually or in the aggregate could make actual results differ materially from our projections can be found under Item 1A, Risk Factors, in our Form 10-K filed with the SEC, and in the forward-looking statements in today's financial release.

In addition, a reconciliation of non-GAAP measures used in both the financial release and this presentation can be found in our financial release and again that has been posted on the Caterpillar.com website.

Okay, with that, let's flip to page 3 of the presentation, which is the agenda. I'm going to walk through the first quarter and the 2016 outlook and Doug will go over a page of key points and then Brad and Doug and I will move to Q&A and answer your questions.

So with that, let's move to page 4 and this is a pretty high-level summary of sales and profit for the quarter. In the little box at the top right-hand corner of the page, I think is an important point. First-quarter is quite a bit lower than the first quarter a year ago and I will cover that here in a second. But it was essentially right in line with what we were expecting for the first quarter in terms of sales and profit and profit excluding restructuring costs.

So this page then primarily covers this year versus first quarter of last year and sales were down \$3.2 billion; \$1.6 billion of that was Energy & Transportation, \$1 billion Construction, \$0.5 billion Resource Industries, and I will cover those in a little more detail on the next page. Sales volume was the primary driver of the \$1.57 decline in profit per share or decline of \$1.40 excluding restructuring costs.

Price realization contributed another \$234 million and I will cover price realization a little bit more in the context of the outlook.

Other income and expense was unfavorable, that is below operating profit, \$194 million. Two things really in there. In the first quarter of last year, we had \$120 million gain and that was from the sale of our, the last part of our interest in our third-party logistics business and then the difference between currency, translation and hedging was negative, the primary reason for the rest of the \$64 million.

Restructuring costs were unfavorable \$126 million in the month. That comes after our announcement last September where we accelerated actions and then in addition to that in the first quarter, we recorded a large chunk of restructuring costs for our ending production of our vocational on-highway truck and that was not considered in the outlook before.

Then on the bright side today, we have \$474 million, almost \$500 million of lower costs in the quarter. That is period costs and variable costs and certainly for the period cost piece, a decent chunk of that was from the restructuring actions that we have been implementing over the last few years.

So let's move on to page 5. This is a little more explanation on sales change. It was a pretty good magnitude; \$3.2 billion so we thought it would be a good idea to kind of go through the elements.

Energy & Transportation had the most significant decline and that was \$1.6 billion. Now Oil & Gas and Transportation made up over 80% of that. With Oil & Gas, and we have been saying this for the past year, we had a sizable backlog for reciprocating engines for drilling and well servicing as we ended 2014 and started into 2015. And those turned into sales for us despite lower oil prices during the first half of 2015. We always knew the comparables between first and first and second to second were going to be tough. That was a big piece of it.

We also had a high level of locomotive sales in the first quarter of last year and that was certainly not the case in the first quarter of this year. So those two things were the bulk of the decline in Energy & Transportation.

If we move onto Construction, the single biggest reason for the decline in sales is not demand, it is change in dealer inventory. So last year we had a much more sizable increase in dealer inventory in the first quarter and it is not uncommon to have an increase in the first quarter as dealers choose to stock up a bit for the second quarter selling season, the spring and summer and that is more activity. But the increase this year was smaller than the increase last year and that was about half of that decline.



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About one-third of Construction Industries decline was in user demand, mostly North America and Latin America. The North American piece, we are actually seeing in terms of general construction and infrastructure decent business in North America. Much of the decline in demand in North America is in the oil patch so the first quarter of last year, that was still going fairly strong and we think that is a decent piece of the reason Construction is lower. And as we go through the year we ought to be lapping that because it declined as we went through last year.

Latin America is down, Brazil for example and Mexico are quite a bit lower. Asia on the other hand, demand was actually up in the quarter and that is a good thing. I'm sure Doug will talk about it in a little bit but China was better for us. And then EAME, principally in the Africa, Middle East part of it down slightly.

Price realization was negative \$172 million so of the \$234 million for the Company, \$172 million of it was in Construction and again when we get to the outlook, I will talk a little more about that.

In Resource Industries, we were down \$0.5 billion. Most all of that was volume, essentially no dealer inventory impact there and price realization was relatively benign in terms of dollars, a negative \$38 million. So most of the Resource Industries is lower end user demand.

So that is a recap of the sales change. Let's move forward and talk about the outlook.

We did trim the range for sales and revenues. We moved it from a range of \$40 billion to \$44 billion to a range of \$40 billion to \$42 billion. So the midpoint is down about \$1 billion and that represents about 2%. Profit per share moved from \$3.50 to \$3.00. Restructuring costs actually are up a bit from \$400 million to about \$550 million and the vocational on-highway truck, our ceasing of production there is most of that difference. And excluding the increase in restructuring costs, we are moving from \$4.00 to \$3.70 a share.

There are puts and takes on cost but the primary reason for the decline in the \$4.00 to \$3.70 is the \$1 billion decline in sales at the midpoint.

So that is the outlook for sales and profit. I thought I would take a minute and talk about the elements of the sales change. So first, with Construction really no change in our volume. I mean there are some again puts and takes here. China again is a bit better. We took the forecast up a little for that. Latin America a little weaker than expected.

Sentiment around Construction and I think Doug will talk about this in a few minutes is a bit better. That is good, we like that but it is a bit too soon I think to start playing that into the outlook.

So fundamentally the outlook for volume in Construction Industries is pretty neutral.

Resource Industries, demand looks like it is going to be down again, weaker than we had expected when we started the year even though it is already pretty low. The recent improvement in commodity prices is a good thing. We are happy that that is positive for our customers but it is certainly not enough and it hasn't been around long enough to drive a sustained increase in demand for our product.

Now that decline in Resource Industries is about one-quarter of our decline in the outlook.

So Energy & Transportation, this is where the outlook for the year came down the most and essentially it is for the most part transportation related. The biggest piece of that is rail, looks like it is going to be a tougher year for our customers in rail. They have a lot of locomotives idled and we think some of the orders on hand are going to get moved out to later than this year.

Marine is also weaker. A competitor of ours announced results yesterday and they talked about this same thing particularly around work boats that service offshore oil. We are also down a bit in transportation because of the stopping of the on-highway vocational trucks. There were sales in the forecast for that when we started the year and that is going to ramp down fairly quickly.

The last item that affects sales and it affects profit and that is price realization. When we started the year, we were thinking negative price of maybe about 0.5% and that is what was in our outlook. We have raised that to about 1% and from a year-over-year standpoint we think that that will be



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mostly in the first half of the year. We saw prices trending down in the second half of last year so the comps are particularly more difficult in the first half than they will be in the second half and most of that decline is going to be in Resource Industries and Construction Industries.

In terms of the timing of the outlook as you know, there is always some seasonality in our business and if you look at Caterpillar over the last 20 years, about 49% of our sales usually end up in the first half of the year and about 51% end up in the second half of the year. This year that is going to be a little bit more skewed to the second half. We are thinking maybe 47.5% or so in the first half, 52% in the second half and that represents about \$600 million more in the second half of the year than kind of our historical average would lead you to expect. I just wanted to put that in for context so you didn't think that there was some big hockey stick at the end of the year. There is not. A bigger second half is normal.

Much of the reason for a little bit more skewing in the second half is rail and we have talked about this for the last couple of years, we will be introducing the Tier 4 locomotive in North America in the second half. And then in addition to that, our turbine business is a little bit more skewed to the second half.

We've got a good backlog there. In fact, the backlog from first quarter to second quarter is about the same -- or I'm sorry -- from the end of the year to the end of the first quarter is about the same.

So now what that all means for the second quarter is that sales will be up about \$0.5 billion or so from the first quarter to the second quarter. That is about \$10 billion and on that we think profit will be just a shade less than \$1.00 a share.

So with that, I would like to turn the floor over to our Chairman, Doug Oberhelman.

Doug Oberhelman - *Caterpillar Inc. - Chairman and CEO*

Thank you, Mike and hello, everyone. I will just walk down through this slide I hope you have in front of you on these seven points I would like make with you and shed a little color and then we will go to Q&A as well.

First of all around China, I was over there about three weeks ago as I usually do in March to attend a state sponsored forum of CEOs from Europe and the United States and there is a lot of sharing about government policy, where they are going with a five-year plan, where they are going with a 10-year plan for that matter as well and a lot of discussion around the transition from an investment economy to a consumer economy and I think that is part we are all feeling.

They also announced about the same time or a little bit before that actually a little bit of a stimulus which was minor but frankly we are feeling that. This is the first post Chinese New Year in probably three that we have seen a continued industry uplift for the industries that we serve around construction. It is not a hockey stick, it is not a boom, it is not a 2010 but it is the first time we have seen that happen and we have lifted our schedules as a result of that this year. We talked about that in the release.

We will see how long that goes. This was around infrastructure primarily high-speed rail and a lot of it is development in the West where it is really needed, where there is lot of very backwards places. So they recognize that and they are working on that trying to balance I think the infrastructure needs with what I described plus continued investment in airports and so on with the consumerism they're trying to drive and that is balance I think they are trying to pull off. We will see how it goes. So far, so good.

In the US, just about any market that is away from oil is doing pretty good. Southeastern US, Southwest US, we are feeling the benefit now more of housing. In fact, Construction and Paving segments were up about 7% and that is positive. When you get around the oil pads, there is an oversupply of everything and that is kind of shadowing the numbers. I think once that balances out we will be able to show a fairly anemic but stable growth and we are looking -- I just heard about the South Carolina construction plan the other day. That is a \$4 billion program they are trying to pass. There's a lot of states lining up to get those kind of things done and then of course, the Fast Act comes in on top of that right now. And as I have said before I think the last call, we are looking at more in 2017 but certainly that is giving states confidence and we are seeing more and more of that around the country.



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So that is building. Again, I am not here to project a hockey stick by any means but it appears to be sustainable and good news for us.

Energy is as Mike said and everybody knows, is really flat. We haven't seen any kind of an uptick in our numbers with oil at \$43 or whatever it is that these rates -- that's probably going to have to go awhile before we do see that so we are getting through that.

Going on to the second point, operational performance continues to be very satisfying here. I know some of these metrics aren't ones you all watch every day but I do. Certainly safety have improved again in terms of reportable injury frequency rate and I use that to judge how management teams are operating in our factories in their offices and wherever they are running as well as employee engagement involvement. Those numbers continue to drop. They have dropped 90% plus in the last 15 years and they are down significantly again already in the first three months of 2016.

Our quality metrics continue to be good and we just had some reaffirmation of that in Germany at our big Bauma show there in talking with customers and our big dealer Zeppelin. So I'm happy with that. Variable margin continues pretty well even with the absence of our big obviously mining and oil business that are high-margin contributors in the past.

So all in all operationally, our lean efforts, our value chain is working, our material cost reductions for our purchasing group is working very well and continues on the path that we have been.

A little bit more on restructuring. We actually bumped that up a bit in the first quarter as Mike described for the truck. Our global workforce is down about 8600 people. We have announced a closure, a consolidation of about 15 facilities. We are on plan, about \$0.5 billion in cost out as Mike mentioned, about 375 of that or so is period cost which as you would expect to see and we will make our goals I am very confident this year in what we projected.

It has been a tough road needless to say when we take those kinds of deep actions and we've got several more coming for the rest of the year on plan that would be included in what we announced in September but it is working.

A strong balance sheet is another important area for us and we have been very focused on that for a long time. You will recall we entered 2009 with a highly leveraged balance sheet. We did buy back some shares, we reduced our debt to cap ratio. Today we are sitting on about \$6 billion in cash and in fact, debt to capital improved again by almost a couple of points in the first quarter.

So our balance sheet is strong, our priorities, the dividend, as I have said before and will continue to say, and that balance sheet strength is one of the reasons we are able to do that and get through this turbulent period.

Just a quick comment on Cat Financial. Nothing really obvious to report there. Continue to be very tightly controlled and managed. 80% of our customer base has a balance, less than \$100,000 so it is a very diverse portfolio. Our past dues bumped up a bit in the first quarter to be expected in the first quarter kind of a seasonal thing but less than last year. So I think all the external and internal metrics we look at point to that business continuing on the path it has been which is a real strength for us.

Finally, a couple of things on the future. We have maintained R&D and that is one that has been paying off well for us. We did not cut R&D to the bone as we might have in earlier cycles in 2009 and that is paying off for us now in terms of the product that is out there. We invested about \$2 billion the last three years. Those products will come to market in the next two to five years and I can tell you what I have seen, there will be outstanding additions to our fleet and really be nice payoff. So to the extent we can, we are going to hold R&D and cut everywhere else.

Our Lean efforts are working, three years over \$1 billion of cost reduction through our variable costs and how we are going about that. Inventory improvement is down about \$6 billion since 2012 as well. We have seen a big culture change across our factories and some of that is demonstrated by safety of course.

Then lastly I would focus on digital and I know some of you were at Bauma in Germany and we showed -- we just started to scratch the surface of that by introducing the age of smart iron. We intend to be the leader here in terms of asset management, product health, productivity, safety, sustainability and predictive analytics which is coming, will be a cornerstone of our CONEXPO display next March in Las Vegas. Today we've got



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400,000 connected assets and growing. By this summer every one of our machines will come off the line being able to be connected and provide some kind of feedback and operational productivity to the owner, to the dealer and to us for improvements down the road. The idea being to get to a point where we can show the customer on his iPhone everything going on with his machine, his fleet, its health, its run rate, its productivity and so on and we will be very close to that.

We've got over 100 customers on an experimental basis with that right now, several dealers participating and a lot of pull from the marketplace for this which is quite exciting.

I think, Mike, I will stop there and we can move into Q&A and we can embellish on any of that as we need to as we go forward. Thank you.

Mike DeWalt - *Caterpillar Inc. - VP of Finance Services*

Okay, we are ready for Q&A.

Operator

Thank you, ladies and gentlemen, the floor is now open for questions. (Operator Instructions). Stephen Volkmann.

Stephen Volkmann - *Jefferies LLC - Analyst*

Great. Good morning, guys. It is Jefferies and thanks for taking the question. Maybe, Mike, I might take you back to your comments on pricing if you would. It does seem like things have deteriorated kind of sequentially over the last three quarters and I guess I'm just trying to figure out it feels like some of this at least probably isn't in your control and yet it feels like you have fairly good confidence that things get better in the second half. And I am just curious if there is any more color you can give us, maybe it is product related, maybe it is geography or how to think about that?

Mike DeWalt - *Caterpillar Inc. - VP of Finance Services*

It is a little of both actually. I think one of the big issues going on right now is that we have a stronger dollar. Now there is much of the world, Europe for example, Japan, where we sell in local currency so not as big an issue, we adjust for that. But in places like the US and much of the Africa Middle East where transaction prices are essentially in dollars, competitors of ours that are coming from a manufacturing base outside the US are being more aggressive on pricing and so that is putting pressure on us. So that is quite a bit. And then of course in mining, it is a deal by deal battle and that business certainly hasn't seen any signs of improvement yet. So dollar is quite a bit of it I think.

Doug Oberhelman - *Caterpillar Inc. - Chairman and CEO*

Mike, let me just add there on this point. We have for several years really focused on market share. That drives this business, it drives this business model, it drives our dealers and we have been very fortunate up until now and I agree with Mike completely that the dollar is a big piece of that and building market share every year for the last five years and in fact we have built market share again so far this year over last year. And that comes with a little bit of sacrifice on price and that is the balance we are going to continue to drive. And I just maybe leave it at that but it is a balance and it is kind of a market share game for us because that drives this Company long-term.

Stephen Volkmann - *Jefferies LLC - Analyst*

Great. I appreciate it. Mike, the tax rate going forward, any change?



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Mike DeWalt - Caterpillar Inc. - VP of Finance Services

We did 25% in the first quarter and that is essentially what our expectation is for the year.

Stephen Volkmann - Jefferies LLC - Analyst

Thank you.

Operator

Andrew Casey.

Andrew Casey - Wells Fargo Securities - Analyst

Wells Fargo Securities. Good morning. On the guidance, the change in the pricing expectation seems to account for kind of most if not all of the guidance reduction. Did you change any of your assumptions related to the variable or period costs that you provided last quarter to offset the rest of the revenue decline?

Mike DeWalt - Caterpillar Inc. - VP of Finance Services

Yes, Andy, so price realization is a couple hundred million of the \$1 billion and certainly that goes right to the bottom line. There is additional cost reduction and a lot of that would come from incentive comp. I mean that is lower because the outlook is lower. There is a relationship between those. So those are a couple of offsets from the profit side and then the rest of it is essentially lower sales volume and what the variable margin is on that.

Andrew Casey - Wells Fargo Securities - Analyst

Okay. Thanks, Mike. And then just want to ask a second question on the accounting principle change. The benefit that you got this year and then the recast for last year, should we view that as a foundation for future years or can that kind of go the other way?

Mike DeWalt - Caterpillar Inc. - VP of Finance Services

The reason the two years were different is because the amortization of prior-year losses for the most part were different. And that is out of the equation now so I think the ongoing normal cost will be less influenced by that so it will be I think relatively speaking more stable except for we are doing this mark to market now. So at year-end, there will likely be -- who knows right now whether or not it will be a big positive or a negative, we don't know and it is not included in the outlook. There could be a mark to market change at the end of the year if interest rates go up or down or there is a material change in returns on the funded asset portfolio. You could get quite a bit of variability at year-end on that mark to market adjustment. Outside of that, I think it is probably a good base to come from.

Andrew Casey - Wells Fargo Securities - Analyst

Okay, thank you very much.

Operator

Joe O'Dea.



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Joe O'Dea - Verticle Research Partners - Analyst

Good morning. It is Vertical Research. First question on the E&T margin in the quarter and then relative to the full-year outlook, it seems like that embeds some improvement in E&T where you had found stability in the midteens level the previous couple of quarters. So could you just talk about expectations there, visibility and timing and seeing that step up or anything that was a bit of an overhang in the quarter?

Mike DeWalt - Caterpillar Inc. - VP of Finance Services

I think the actual operating margins for E&T were down in the first quarter and that is because of relative to the rest of the year, relative to last year, a low sales quarter in the first quarter. So if you think about it, much of the increase in the quarterly sales between the first and the rest of the year is going to be E&T, Energy & Transportation, and that will get added at certainly a higher than operating margin rate. So it is a bit of operating leverage on the sale. We've had a pretty low sales quarter so I think that will come back up as we go through the year.

Joe O'Dea - Verticle Research Partners - Analyst

Okay. And then on Construction, looking at your revenue trends relative to what we get out of the retail sales statistics, it looks like some pretty significant destock over the past couple of quarters or at least a low rebuild in 1Q relative to normal. In general, how do you characterize inventory levels at your dealers and I guess particularly in North America if those have reached pretty thin levels relative to history?

Mike DeWalt - Caterpillar Inc. - VP of Finance Services

So you are right, there is if you look at the retail sales for Construction Industries and what we actually reported as sales, there is a disconnect. I don't have the number right in front of me but I think our sales were down 18%, 19% and the retail sales were down less than 10%.

The difference is not so much a destocking in the channel. We normally build inventory in the first quarter. We did that in both quarters but they built a lot more inventory, our dealers I am sorry, built more inventory a year ago. So that is negative for our sales and that is what has taken that retail sales level and bumped it up a little bit for us in the first quarter.

I would say there is always some seasonality in dealer inventory. It goes up during this part of the year and then everything else being equal with relatively level demand or expected seasonal demand, it will come down between here and the rest of the year and that is exactly what we think will happen.

Brad Halverson - Caterpillar Inc. - Group President and CFO

This is Brad. It is hard to look at all of the factors but I will tell you one factor that is influencing this we believe is the benefit of Lean. Hitting our promise states to our dealers in terms of the products has improved over the last few years. I think there is a higher level of confidence that we will deliver the product when they need it and I think because of the benefits of Lean, we are seeing a little bit lower inventory at the dealers.

Joe O'Dea - Verticle Research Partners - Analyst

Got it. That is really helpful. Thank you.

Operator

David Raso.

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David Raso - *Evercore ISI - Analyst*

Evercore ISI. Just trying to think through the inventory changes at the dealer level. Have you changed at all your view of the dealer inventory target for the year and if you can refresh us on what that is?

Mike DeWalt - *Caterpillar Inc. - VP of Finance Services*

We have not made any changes. I don't recall talking about a target. I think last year dealer inventory declined I think around \$1 billion if memory serves me and I would expect it probably to be somewhere close to that this year as well.

David Raso - *Evercore ISI - Analyst*

And regarding the backlog, how much of the backlog doesn't ship this year? I'm just trying to get a feel for where the backlog is relative to hitting the guide and just trying to understand maybe where -- we obviously have our own thoughts about orders the rest of the year but where would it leave the backlog toward the end of the year?

Mike DeWalt - *Caterpillar Inc. - VP of Finance Services*

Honestly I don't have -- I mean I have the backlog numbers in total which were flat from the end of the year to where we are now. But I don't have a breakdown of what ships later in the year. I think we normally put that in the Q but I don't have it in front of me, David.

David Raso - *Evercore ISI - Analyst*

Then I guess maybe the same kind of question, on the backlog change, I think you had mentioned the backlog similar at Solar sequentially. Is that correct?

Mike DeWalt - *Caterpillar Inc. - VP of Finance Services*

We didn't say Solar in particular but we said each of the segments but you could throw Solar in there as well. It was similar to -- relatively unchanged from year end to the end of the first quarter, actually up just a touch but not much.

David Raso - *Evercore ISI - Analyst*

All right, that is helpful. I appreciate it. Thank you.

Operator

Ann Duignan.

Ann Duignan - *JPMorgan - Analyst*

It is Ann Duignan, JPMorgan. Can I ask a question on working capital and the balance sheet and cash flows? If I look at days on hand and days sales outstanding, both were up year-over-year and quarter over quarter. Quarter over quarter may be seasonal but should we be concerned at all that inventories are not being cut quickly enough, Doug? And what is the outlook for free cash flow for the full-year? You used cash this quarter versus normally in this type of an environment we might have expected some inventory release and working capital to be a positive.



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Mike DeWalt - *Caterpillar Inc. - VP of Finance Services*

Ann, this is Mike. I'll take that. We don't really make a forecast for cash flow. That has never really been a part of our outlook. But if you look at the operating cash flow for this quarter, it was a couple hundred million positive and that is despite two big negatives in the first quarter.

As a part of our restructuring cost last year, we had a fair bit of employee-related costs and that was for the most part paid in January so there was I think about \$400 million of extra negative cash flow in the first quarter that was related to the restructuring actions from last year. So that was a bit of a drag.

And then of course in the first quarter, we always pay, we accrue incentive compensation throughout the year but it gets paid in the first quarter and that was I think \$600 million. So between the two we had close to \$1 billion drag on operating cash flow in the quarter. So I think you will see that improve -- operating cash flow ought to improve quite a bit from first-quarter levels as we go through the rest of the year.

I think on inventory, we have been pretty public by saying that the one operational thing that we have not been as happy with is inventory turns. There's all kinds of reasons why quarter to quarter to quarter things can change but on balance, our forecast has an improvement in turns built into this year and we have everybody in the Company working to make that happen.

Ann Duignan - *JPMorgan - Analyst*

Okay, thank you. Just as a quick follow-up, I noticed that the Financial Services took a \$1 billion loan from the Parent or from Machinery. Can you talk about what is happening there and why that was necessary? Is that unusual? It didn't show up a year ago I'm just curious what is going on?

Mike DeWalt - *Caterpillar Inc. - VP of Finance Services*

No, that is not unusual, that is a -- I don't know if I would call it routine but it is not all that unusual. Intercompany loans between the Parent and all of our subsidiaries to kind of help better manage cash happens all the time.

Ann Duignan - *JPMorgan - Analyst*

Okay, thank you. I will get back in line.

Operator

Robert Wertheimer.

Robert Wertheimer - *Barclays Capital - Analyst*

It is Barclays and good morning, everybody. The question is on the oil patch, oil service companies are obviously feeling a lot of price pressure whether it is pressure pumping or offshore rigs and some of that price pressure is because the fleet in the field is idle and so maybe it is easier to discount. So I have a specific question.

Are you seeing pricing on aftermarket, are you feeling increasing pressure from people like that? And a general question, it sure feels like a lot of people are trying to target bringing the whole cost curve down to 60. I wonder if you feel like you are already there on costs? You never raised pricing as everyone else did or whether you really have a lot of work to do to get structural cost down to where everybody is trying to target it in the future?



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Mike DeWalt - Caterpillar Inc. - VP of Finance Services

That is a lot, Rob. First on parts pricing, if you look at our year-over-year price realization and the issues that we have, for the most part that is new machines, that is not aftermarket. I'm not saying it is zero but in terms of materiality, it is not that big of a deal. So that is the pricing point.

In terms of the cost curve, a lot of the product that we have particularly on the reciprocating engine side is similar -- take a 3500 Series engine, it goes into machines, electric power, it goes into marine, it goes into providing power for a drill rig or a frack pump. So it is actually spread across a number of industries. I mean we worked on the cost structure and I think actually not just for oil and gas but across most of our products, I think it is a sales level that we are at right now based on the material cost reductions. We have got the Lean related efficiency improvements, the period cost reductions, the restructuring. I think we've actually done a pretty darn good job on trying to get the cost structure in line for the most part with where reasonable demand would be.

Robert Wertheimer - Barclays Capital - Analyst

That is perfect. Mike if I can ask just a very quick procedural one. You don't usually guide the quarter, you did and I'm sorry if we cost you a trip to London. And then you kind of obviously -- the dealer sales pointed to a slight reduction in the outlook so that was no surprise but procedurally did you just not do it until all of the quarterly numbers came in or was there something that sharply accelerated down in the last few weeks?

Mike DeWalt - Caterpillar Inc. - VP of Finance Services

No. We don't normally provide actual guidance. We kind of nudge I guess, we provide some color around what we think. And I think we probably didn't do that explicitly enough when we did our year-end release and the analyst guidance for the quarter ended up looking more like the pattern for last year rather than the pattern for this year from a quarterly cadence. And we were coming down from Oil & Gas last year. So I don't think that was well played into the guidance.

No, what we did at Barclays was just trying to get expectations set there, thereabouts where we had thought all quarter. There was not a big step down or run down and we ended up actually being pretty close to what we thought.

Now you know, we've got many businesses, not just three segments. Within each one of those like E&T, we have marine, we have recip oil & gas, we've got turbines, we've got electric power. We've got rail, we've got rail services and each one is difficult enough to forecast but there is just a lot of moving parts. I know from the outside looking in, it might seem like our business ought to be easy to forecast but it is actually pretty tough. But we have come reasonably close and certainly we were in the first quarter.

Robert Wertheimer - Barclays Capital - Analyst

Perfect, thanks.

Operator

Ross Gilardi.

Ross Gilardi - BofA Merrill Lynch - Analyst

Ross Gilardi, Bank of America Merrill Lynch. Good morning everybody. Mike, I was wondering if you could just help us bridge Q1 to sort of the implied step up in Q2 more from an earnings perspective so you are doing mid to high 60s in Q1. And based on your commentary for the revenue breakdown, I mean I assume you are somewhere in a \$1 per share neighborhood or something to do the full-year. And can you just help us break



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that down into a few buckets? Are there any things weird things going on with other income or anything like that that could make us more comfortable in that step up that you would seem to need at the very least in Q2 to do the full year?

Mike DeWalt - *Caterpillar Inc. - VP of Finance Services*

It is actually not that tough, Ross. So in the first quarter, I will tell you one thing that I would say we don't forecast but I guess by definition we tend to forecast at zero, is the impact, the short-term impacts of currency as a result of our balance sheet position. And that is below operating profit and that other income line. We tend not to forecast it.

Our whole business is hard enough to forecast. Trying to forecast exchange rates over the next three months, we just don't do. So we would be expecting currency exchange in that other income and expense line to essentially be zero.

In the first quarter if memory serves me, we had about \$0.05 a share I think negative. So that would be coming out. So that would be a little bit of a boost in the second quarter. Then we have higher sales in the 500 to 600 range and you probably want to use something closer to our variable margin rate. I mean period costs over time like year-over-year, we can fluctuate them up or down. But in the short term rather than kind of an incremental margin kind of look, variable margin is probably a little bit better indicator. For us, that is right around 40%.

So I think a little less drag from currency translation and higher sales and maybe a little bit more continued cost reduction but mostly it is sales and absence of exchange loss and a little bit of product mix too.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Got it. Thanks very much. That is helpful. And then can you just talk a little bit more about Solar, the backlog, any comments you can make on the turbine side and just your overall exposure to midstream CapEx? We have seen some pipeline cancellation announcements compared to the upstream side I mean the midstream CapEx is in the relatively earlier stages of -- seems to be getting cut. So what do you see in there and given the long lead times, does this pose risk to the 2017 outlook?

Mike DeWalt - *Caterpillar Inc. - VP of Finance Services*

We will kind of address those one at a time. I won't mention names but a company in the last few days announced a pipeline cut and that doesn't involve us, we are not part of that. In particular, that one isn't affecting us. The backlog for Solar has remained pretty stable. I mean it is only a couple hundred million below where it was a year ago at this time. It actually rose a tiny bit from year-end. Most of the decline in the business has been oil related, not gas related. I think we feel pretty comfortable with the backlog that we have in.

Given the lead times of the projects, our stuff would go in maybe more near the end of a big project. If you're going to put turbines on a platform, you've got to have the platform up before you put the turbines in.

So I think we feel pretty comfortable about this year and I know you asked about 2017. I am going to politely defer that not because I'm trying to be cagey but because it is way too soon to start talking about 2017. There is a whole range of things that could be positive or negative. I think we are probably a couple of quarters away from getting a good view of that.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Thanks, Mike.



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Operator

Jerry Revich.

Jerry Revich - *Goldman Sachs - Analyst*

Good morning, it is Goldman Sachs. Mike, can you talk about the manufacturing facility restructuring program? In the press release you spoke about 15 facilities have been consolidated. In what inning of that process are we? How many more are we thinking about in front of us on a relative basis to what has been done? And in the past you have spoken about low 20s incremental margin targets in a recovery. I am wondering if the thought process has changed at all based on the change in the footprint?

Mike DeWalt - *Caterpillar Inc. - VP of Finance Services*

A couple of things on that. When we made the announcement last year in September about these restructuring actions, we were thinking maybe 20 facilities would be impacted. We have announced about 15 plus now this on-highway vocational truck. So at least in terms of numbers of facilities, I think we are pretty far down that path. There is still more to go and certainly it will take even for the ones that we have announced these phase in, it takes a while to shut down and change and shed the cost. So we still, from a savings standpoint, we still have quite a bit to go so that is a positive.

On the incrementals, I think low 20s is too small a number. Normally we think of incrementals as around 25. I think based on all the actions that we have done when recovery starts, Doug has been probably the most vocal in saying this and I believe it too, we should probably do a bit better than that when things turn around because we certainly have plenty of capacity right now for most of our products and a period fixed cost structure that could handle a bit more.

Jerry Revich - *Goldman Sachs - Analyst*

And on mining obviously the commodity price recovery is fairly fresh. But I'm wondering if you can comment on what you are seeing at the dealer level for parts demand, any sort of pickup recently? There have been a couple of higher cost producers that have come back online. I'm wondering if your dealers are reporting pickup in inquiries or broader demand levels for the parts business?

Mike DeWalt - *Caterpillar Inc. - VP of Finance Services*

So for mining in particular, it was not a very good first quarter for aftermarket. We said that in the release so -- or for Resource Industries. Looking backwards over the last quarter, no, no signs of turnaround at all there. More broadly on aftermarket for the Company, I think we feel pretty confident in the outlook for parts and I think it is a little bit like construction sentiment seems to be a little bit more positive but probably a little too soon to declare victory.

Jerry Revich - *Goldman Sachs - Analyst*

Thank you.

Operator

Jamie Cook.



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Jamie Cook - *Credit Suisse - Analyst*

Good morning, Credit Suisse. I guess two questions. One, Doug, if you could just provide -- in your prepared remarks, you gave some color on China but I think investors are really trying to struggle with how real is the stimulus, how long this will last? Some of your peers have come out and said the stronger equipment sales in the first part of the year had been more emissions driven and to expect -- you know what I mean -- so the buy I guess wasn't real. So I'm just trying to gauge your confidence level or are you trying to call China as a bottom and do you expect things to continue to be strong after the quote unquote pre-buy?

And then I guess my second question which I don't if you will answer but I will try, you cut numbers today which I think the street wanted. At the same time, your commentary whether it was China or the US seems a little bit more constructive relative to last quarter. So are you feeling better about the economy? And if there is as downside risk to your earnings going forward, where are you most concerned? Thank you.

Doug Oberhelman - *Caterpillar Inc. - Chairman and CEO*

I would share the caution in China. I am pretty sure that it is more than just the tier change, the Tier 3 institution implementation on April 1. Our folks over there were pretty emphatic that that is going to hold and that this is beyond pre-buy. But I am very cautious about how far that goes and I would share that as well.

We are going to have to watch this month by month and see where it goes. There is no question though that the government is concerned about growth and too slow of a growth and a change and growth will be much more negative than some stimulus now and I think that is what they are trying to balance.

So I'm not going to declare a bottom in China, I don't know. But certainly as I said earlier, the first post Chinese New Year where we have had sustained shipments now 60, going on 90 days past the New Year in several years. So we are watching that and I am cautious but that is a better statistic than we have had.

Jamie Cook - *Credit Suisse - Analyst*

Do you know if the trends continued into April what we know so far?

Doug Oberhelman - *Caterpillar Inc. - Chairman and CEO*

I do not know that. If I did, I probably wouldn't tell you.

Jamie Cook - *Credit Suisse - Analyst*

I have to try. Sorry, and then just broader on the macro, are you more positive today, where do you see the biggest risk to downside earnings because we are all trying to gauge is this the last cut?

Doug Oberhelman - *Caterpillar Inc. - Chairman and CEO*

Yes, again going over to Europe, we met with hundreds of customers and all of our major dealers over there and it was hard to find any more pessimism than has been there for several years. They all recognize it has been a seven-year slog, they all recognize there is not a boom coming. But at the same time, the stories were much more positive and even in France, in an election year there is simulating a bit into infrastructure and some of those big projects were feeding and thus our big dealer there was feeling better.



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So I would say that a very small bit of optimism is in order in Europe but I have been there now the last two years. I said about a year ago that Europe was two years behind the United States and I still believe that. So it is a very, very slow crawl out. I don't see much negativism there right now.

I would say the downside has continued. The continued disappointment around oil and energy I think that could go a while. I do think that our numbers are to the point where it is hard to go from -- from 2 to 1 is 100% drop but it is not a material amount of impact on us. But we saw some of that in the first quarter in Resource.

So we are getting near the bottom in all of that just because we are at the bottom. But the downside would be any big downside is going to be something we all don't see coming and frankly I have talked about that before too. All in all I would say slightly more feeling better about things but very, very cautious.

Jamie Cook - *Credit Suisse - Analyst*

Okay, thank you. I appreciate it. I will get back in queue.

Mike DeWalt - *Caterpillar Inc. - VP of Finance Services*

I think we have time for one more question.

Operator

Eli Lustgarten.

Eli Lustgarten - *Longbow Research - Analyst*

Longbow Securities. Good morning, everyone. Can we talk a little bit -- during the commentary, Mike, you sort of gave us some outlook for the relative sectors. Now we have a restatement of all the numbers but the implication is that the 5% to 10% decline in Construction is about the same. But on your numbers it says there is a 15% decline in E&T that was sort of talked about, looks like it would be closer to 20% and the 20% decline in Resources looks like it would be closer to 25% based on the \$1 billion change. Is that still a fair statement?

And more importantly, we are losing money more modestly in Resources with the bankruptcy in (inaudible) and US coal production right now down 32% year to date, are the losses going to get worse for a while before they get better or can you give us some quantification of what is going on in that sector?

Mike DeWalt - *Caterpillar Inc. - VP of Finance Services*

You've got a couple of questions wrapped up there and I think I can deal with both of them. The first one on kind of what we said last time, we said CI down 5% to 10%. That I think is still pretty good. We said RI would be down 15% to 20% and that is probably still in the range but it has maybe moved up a little. On E&T, we said 10% to 15%. I think it is fair to say that range still holds true but they are right at the top of it. I think for E&T about 15% is probably better than the 10% to 15%.

On the US coal, that business is so low right now we are not selling much into that industry. So I think all the negative around -- or I don't want to say all -- I think fundamentally the negatives of the market are already in our sales.



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Eli Lustgarten - Longbow Research - Analyst

I guess I'm asking about the profitability of the Resource business and sales. I mean will the losses get worse for awhile as we go through the rest of this year or are we able to keep the current loss rate or some idea but of what is going to happen in that sector?

Mike DeWalt - Caterpillar Inc. - VP of Finance Services

I don't see anything that would make it worse. I think this is probably the backlog for that business has stayed pretty flat. Kind of what is coming in and what is going out are in a reasonable balance. So I don't see anything out there that would cause it right now anyway at least over the next couple of quarters to shift down.

Doug Oberhelman - Caterpillar Inc. - Chairman and CEO

Let me just add to that, Eli, Doug here. There are two things that are going to happen in mining and Resource Industries is specifically mining for us. Number one, we've got a lot of restructuring underway right now and that will help us down the road.

Number two, ore is being mined, coal is being mined, trucks are still running, tractors are still dozing, loaders are still loading around the world. The replacement cycle has been stretched out a long way which is the first time that has happened to us including parts. And at some point, that replacement cycle will come to us parts first, then rebuilds and then new truck orders. Those are the things we are waiting for. We are closer to it than ever I think just because of the longevity of the replacement cycle here and we should start to see that I would say at any time.

Maybe we are seeing some signs of it in a few areas that someone mentioned on the call a minute ago but it will come to us.

Eli Lustgarten - Longbow Research - Analyst

Thank you very much.

Mike DeWalt - Caterpillar Inc. - VP of Finance Services

With that, thank you again for joining us. This concludes our call and we will talk to you next quarter.

Operator

Thank you, ladies and gentlemen. This does conclude today's conference call. You may disconnect your phone lines at this time and have a wonderful day. Thank you for your participation.

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