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CAT - Q2 2014 Caterpillar Inc Earnings Call

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OVERVIEW:

Co. reported 2Q14 sales and revenues of \$14.2b, profit per share excluding restructuring costs of \$1.69, and profit per share including restructuring costs of \$1.57. Expects 2014 sales and revenues to be \$54-56b, profit per share excluding restructuring costs to be \$6.20, and profit per share including restructuring costs to be \$5.75.



CORPORATE PARTICIPANTS

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

Mike DeWalt *Caterpillar Inc. - VP, Strategic Services*

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PRESENTATION

Operator

Good morning, ladies and gentlemen and welcome to the Caterpillar second-quarter 2014 earnings results conference call. (Operator Instructions). Now I'd like to turn the floor over to your host, Mike DeWalt. Sir, the floor is yours.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Thank you very much and good morning, everyone and welcome to our second-quarter earnings call. I am Mike DeWalt, Caterpillar's Vice President of Strategic Services and on the call today, I am pleased to have our Chairman and CEO, Doug Oberhelman and Group President and CFO, Brad Halverson.

Now this call is copyrighted by Caterpillar Inc. and any use, recording or transmission of any portion of the call without the expressed written consent of Caterpillar is strictly prohibited. And if you'd like a copy of today's call transcript, we will be posting it in the Investors section of our Caterpillar.com website and it will be in a section labeled Results Webcast.

So this morning, we will be discussing forward-looking information and it certainly involves risks and uncertainties and assumptions that could cause our actual results to differ materially from the forward-looking information. A discussion of some of those factors that either individually or in the aggregate could make actual results differ materially from our projections can be found in our cautionary statements under Item 1A, which is risk factors out of our Form 10-K filed with the SEC in February of 2014 and also in the forward-looking statements language in today's release.

Now in addition to that, a reconciliation of non-GAAP measures can also be found in our release today and again, it is posted on cat.com in the Investors -- or Caterpillar.com in the Investors section.



Okay, let's get started this morning and I will be covering three things before we get into the Q&A -- second-quarter sales and profit, the outlook for 2014 and our announcement this morning of additional share repurchase expected in the third quarter.

Now before we really get into the quarterly numbers, I thought it might be helpful to summarize the major themes from this morning's release. In other words, what were the key points we are trying to get across. The first point is around stability and consistency. Back in October of 2013, we provided a preliminary outlook for 2014 sales and revenues and back then, we said it looked to us like 2014 would be a relatively flat year with 2013. That was the case then and that is the case today. The midpoint of our outlook today is within about 1% of 2013 sales and revenues.

The second main theme this morning is around execution, which has been good. Manufacturing, SG&A and R&D costs are close to \$500 million favorable in the first half versus the first half of 2013. Cash flow has continued to be strong. We have improved inventory turns, PINS continued to improve and we have raised our profit outlook again this morning.

Now the third major theme this morning is cash deployment and the actions we have taken to help drive shareholder return. With the stock buyback we announced this morning, we expect that, from the start of 2013 last year to the end of the third quarter of this year, that we will have repurchased \$6.2 billion worth of Cat stock and made two substantial increases in the quarterly dividend. So that is three themes -- consistency, execution and shareholder-friendly cash deployment.

Okay, now let's get into the second-quarter results. Sales and revenues were \$14.2 billion and that was about 3% below the second quarter last year. Construction Industries was up 11%, Resource Industries down 29% and the rest, Energy & Transportation, Financial Products and our All Others segment, combined to be roughly flat with the second quarter of last year.

Now for Construction, North America has been an area of strength and you might be surprised to hear so is our EAME region, particularly Europe, in the second quarter. It has been better as well. Now Construction sales in Latin America were about flat with the second quarter last year, but as we get into the third quarter, Latin America will likely turn a bit negative versus last year. And that is not driven by big economics; it is primarily related to large sales of backhoe loaders and motor graders that we have had to the Brazilian government. It was positive for sales last year and through to the first half of this year, but those orders are complete. So you should expect to see in the retail statistics that we release each month some decline there. So don't be surprised if you see that. We expect that; it is included in our outlook.

Now Construction sales in Asia-Pacific were down slightly and that includes weaker sales in China. Now in China, we started the year 2014 with an improving Construction equipment demand, but, over the second quarter, it weakened a bit.

Our Resource Industries segment, which again is mostly mining, was down 29%. It was down 35% to 40% in every region of the world except North America. North America was much less negative than the other regions partly because the steep sales decline in North America started earlier. In other words, it was probably closer to the bottom a year ago. In addition, better sales to quarry and aggregate customers was also a factor. That part of Resource Industries tends to be a little more closely aligned with Construction and particularly in North America that has been performing better. So again, overall mining sales weak.

However, this was the first quarter since 2012 that Resource Industries sales were higher than the previous quarter. So that means second quarter of 2014 sales were about 6% higher than the first quarter. Sales improved from first to second for both new equipment and for parts. In fact, for parts, it is the second consecutive quarterly improvement. Q1 of 2014 was up slightly from Q4 of 2013 and Q2 this year was a little better than Q1. Now it is too soon to suggest that the mining business is turning around, but it is good to see a sequential improvement.

Moving on to Energy & Transportation. It has been an incredibly stable, high-performing business over the past few years and this quarter was no exception. Overall, sales for Energy & Transportation were stable with the second quarter of last year. And even if you take it down to the next level and you look at sales in the major industries served by Energy & Transportation, that is oil and gas, PowerGen, transportation and industrial, the sales were individually pretty flat with the exception of PowerGen. And that was down sort of high single digits, but even there we see that being an issue around the timing of some large projects. So in summary, on second-quarter sales, and as you probably expected going into the quarter, Construction sales were up nicely, mining sales were lower, everything else was pretty much flat.



Okay, I'll shift from sales to profit in the second quarter. Headline numbers. Profit per share of \$1.69 excluding restructuring and \$1.57 including restructuring costs. In comparison, profit was \$1.45 in the second quarter of 2013. Now by segment, Resource Industries was the only segment that we had that declined versus the second quarter last year. The rest were up. And a couple of big bright spots were a profit increase of more than 80% for Construction Industries and an all-time record profit for Energy & Transportation and in fact, their first quarterly profit over \$1 billion.

From a consolidated perspective, we provide an operating profit comparison by reason in our release and today, that is the graphic on page 6 of our financial release. Because the individual buckets in that waterfall graph are relatively small, I am not going to go into each one of them in any detail, but I would summarize by saying that manufacturing costs and price realization were modestly positive and the negatives were a bit lower sales volume, the restructuring costs in the quarter and absence of a sizable \$135 million gain that we had in the second quarter last year related to a settlement with the previous owners of our Siwei acquisition. So that is the quarter.

Let's turn to the outlook for 2014 where we have made a modest change to sales and revenues and increased our outlook for profit. For sales, half of the year is behind us and we have tightened up the range and lowered the midpoint slightly. Now, as I mentioned at the outset of the call this morning, our view of 2014 sales and revenues has remained reasonably constant. In other words, a flattish year versus 2013. We thought that was the case last year. We think that is still the case today.

That said, with half of the year over, we have tightened the range and the updated range is a forecast of \$54 billion to \$56 billion in sales and revenues and for reference, the previous range was \$56 billion plus or minus 5%. That meant a range of just over \$53 billion to just under \$59 billion. The middle of the new range is \$55 billion and that is slightly lower than the previous midpoint of \$56 billion and most of that change is in Construction Industries and reflects the weaker sales expectations in China. Based on the reporting out of China, that probably shouldn't be much of a surprise. And a decline in expectations in the CIS and in the Africa/Middle East region and given the political turmoil in those parts of the world, that is probably not a big surprise.

In terms of profit, for a better understanding of results, we are providing the outlook again both with and without restructuring costs. Today, we have increased the outlook for both and now excluding restructuring costs, we have increased it to \$6.20 a share. That is a \$0.10 increase from the prior forecast. Now our expectations for restructuring costs is near the bottom end of our \$400 million to \$500 million range and with restructuring costs all in, our updated outlook is profit per share of \$5.75, which is \$0.20 per share better than the previous outlook.

Now to help you think about the rest of the year, the third and the fourth quarter, there is one more thing I'd like to cover and that is how we are thinking about the last two quarters. There is typically seasonality in our sales and we think that is going to be the case this year as well. So we've got half of the year behind us and you know the midpoint of our outlook. We basically have the second half of the year not a lot different than the first half. Now we expect sales and revenues in the third quarter to be similar to the first quarter of 2014 and fourth-quarter sales to be more in line with the second quarter of 2014.

In terms of profit per share with lower sales in the third quarter, it will likely be the weakest profit quarter of the year and with higher sales in the fourth quarter, profit per share should be similar to the average of the first and second quarters of 2014. I hope that helps you think about our expectations and how the third and fourth quarter could play out and if you missed writing that down, again, we will be reposting the transcript of this call on our caterpillar.com website.

Now in addition to our financial results, this morning, we announced that we expect to repurchase another \$2.5 billion of Caterpillar stock in the third quarter. This repurchase is a part of the \$10 billion that the Board authorized earlier this year. Now the context behind our repurchases really over the past two years is consistent with our cash deployment priorities. Coming out of the 2008 and 2009 great recession, we had work to do to improve the strength of the balance sheet. We needed to invest for growth and with very low interest rates, our employee benefit plans needed additional funding.

Over the past few years, we've made significant progress. Our Machinery Energy and Transportation debt to capital ratio is at the low end of our target range. Benefit plan funding is in good shape and we generally have the production capacity in place that we think we will need for the next few years. And although we will continue to be opportunistic, we aren't expecting any large acquisitions.



So with nearly \$9 billion of Machinery Energy and Transportation operating cash flow last year in 2013 and nearly \$4 billion in the first half of this year and with significant cash on hand, we've had the opportunity to take substantial actions to improve shareholder return. In 2013, we repurchased \$2 billion worth of stock and raised the dividend by 15%. In June of 2014, we increased the dividend again an additional 17% and by the end of the third quarter of this year, we expect to have repurchased about \$4.2 billion of stock in 2014. That is the \$1.7 billion in the first quarter and the \$2.5 billion in the third quarter. Rewarding stockholders is an important goal and our actions demonstrate our commitment.

So in summary, we had a pretty good second quarter. We raised the profit outlook for 2014 and we announced another \$2.5 billion of stock repurchase. So with that, we are ready to shift over to the Q&A portion of the call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Andrew Kaplowitz. Please announce your affiliation.

Andrew Kaplowitz - *Barclays Capital - Analyst*

I'm from Barclays. Good morning, guys. Nice quarter.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Hey, Andy, good morning.

Andrew Kaplowitz - *Barclays Capital - Analyst*

So Mike, you said in the release that dealer inventories declined about \$500 million in the quarter and you also talked in the release about the decline in inventories this year now being more than you previously expected mostly driven by Resource Industries. How much did this contribute to the reduction of your sales forecast and what kind of visibility do you have to a bottoming and destocking really across the Company, but particularly in Resource Industries?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Yes, good question, Andy. And dealer inventory has certainly been a factor. Versus our original outlook when we started the year, it kind of looks now like dealer inventory is going to be down maybe \$1 billion or so more than we thought. In fact, the first quarter and the second quarter combined were still up slightly for the year. We had a \$700 million increase in the first quarter, a \$500 million decrease in the second quarter and a lot of that is seasonality.

But in the second half, we are looking for about \$800 million of decline per quarter, so about \$1.6 billion coming out in the second half. So that is having an impact on second quarter or, I'm sorry, second-half results. And it's a couple of things. One, we have not really had a turnaround in mining yet and so dealers are continuing to satisfy some demands out of inventory. We thought it was going to be a lot less coming into the year and things might start picking up. We really haven't seen that yet. So that is one factor.

And then I think on Construction, dealer inventory, we are going to end the year probably a little bit lower than we thought and that is actually despite a pretty darn good year so far for Construction. I think it is a case where we talk a lot about execution. We have actually been able to take down our lane one channel inventory that we have and dealers have been able to take their inventory down as well. I think when you think about what is an adequate supply, kind of going back to your question, it is within a range and I think particularly for construction, it is getting down to

a pretty good level. So if demand doesn't decline, then you would have to think going forward that dealer inventory is going to be in even better shape at the end of this year than it was last year.

So in summary to your question, I know that was kind long-winded, dealer inventory is having a bit more of an impact this year and it's a principal reason why the second-half sales aren't going to be better than what is in our forecast.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Okay, Mike, that's helpful. And then maybe just shifting gears, you talked about the timing of large projects negatively impacting your E&T retail sales, but really your outlook for E&T really hasn't changed. Can you talk about your visibility in this segment? Do you still feel good about it because backlog is up and maybe specifically about power generation, what you see there?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Yes, I'd say E&T overall I'd say we feel very good. Second half looks like it is going to be pretty strong. We've had, I would say, very good order rates over the last quarter, particularly for oil and gas. For large engine products in general, but oil and gas has been particularly good. So that has contributed to the increase in the backlog there.

With electric power, we kind of have a couple of different businesses. We break it down between the investor business, which is essentially large-scale installations and then small, we call it retail gen sets. The big gen set business, the big end has been pretty good and that is the piece of it that can tend to be lumpy around big projects. We had some last year; we will have some this year. The timing affects how that plays out certainly by month and by quarter. And you see that in the retail statistics. It will move around quite a bit. But I'd tell you we feel pretty good about Energy & Transportation overall. Really most of the sectors within there and particularly oil and gas.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Thank you, Mike.

Operator

Robert Wertheimer.

Robert Wertheimer - *Vertical Research Partners - Analyst*

Hi, it's Vertical Research Partners and good morning, everybody. Mike, you mentioned the oil and gas strengthened. I know fracking has been ticking up and some of your channel partners have been bullish on that and the pipeline and a bunch of other stuff. If I am not mistaken, you have a Tier 4 changeover in some of the oil and gas engines for next year. Could you talk generally about the higher horsepower Tier 4, how many engines you have running, how confident you feel whether there is any kind of pre-buy going on there?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

I am going to have to defer that question, Rob. I am not an expert on that. I don't know the number.



Robert Wertheimer - Vertical Research Partners - Analyst

Okay. No, that's fine, that's fine. I will follow up after. I should have sent it before. And then I guess the second question, you just kind of addressed at length, so I apologize for going back to it, but the dealer inventory, which you gave good disclosure on, but are you comfortable that the Construction, which has been very strong and you are gaining share in an upmarket, so it is really hard to sort out, but are you comfortable that Construction inventory hasn't restocked a little bit too much? Can you tell that -- especially in LatAm where some of the markets look really soft, you mentioned the big government project. So I'm just curious if you think the Construction inventory overinflated at all in the first half. Your margins were quite good in the first half and you are signaling down. So that is my second question.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Yes, no, I think the first and second quarters played out pretty close to what we thought. If you think about it, the first quarter for sales to end users is always one of the lowest quarters of the year. Dealers commonly stock up and then sell it down in the second quarter, which they did this year. It came down. And then the third quarter is usually pretty weak as well. A lot of Europe is on vacation, a lot of other parts of the world take vacation time and we feel that in our business. So certainly a bit more of that will come out in the third quarter and then again more probably in the fourth quarter. It is always tough to forecast this with massive accuracy. We look at what a reasonable month of sales are, but that varies by region and it is a reasonable range. And I think Construction, based on where we are in terms of the timing of the year, what their expectations are for year-end is definitely within that reasonable range.

Robert Wertheimer - Vertical Research Partners - Analyst

Thank you. And then are you able to say what the total mining dealer destock is this year? You have kind of said it, but I just want to make sure I back into it right.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Yes, I think it is going to end up being about \$1 billion if memory serves me. I am not 100% sure on that, but I think that's order of magnitude, which is more than we thought coming into the year.

Robert Wertheimer - Vertical Research Partners - Analyst

Thank you.

Operator

Jamie Cook.

Jamie Cook - Credit Suisse - Analyst

Hi, good morning, Credit Suisse. I guess a couple questions around the mining or the Resource business. The sales were up sequentially, which was nice. The margins were down sequentially. I get the year-over-year issues, but I guess the margins in Resource disappointed a little relative to my expectations. In particular, when you said aftermarket was up again. So can you just talk about that? Is that just investment that you incurred this year that you held off on last year? And then I think last quarter you said in terms of Resource margins you expected them to be about flat with the first quarter. Is that still the way to think about it?



And then my second question, again, sorry, a follow-up on just the Resource business. You said I think OE and aftermarket was up. Can you give a little color around what markets, both on OE and aftermarket, just a little more color on that commentary you mentioned in the prepared remarks? Thanks.

Brad Halverson - Caterpillar Inc. - Group President & CFO

Yes, this is Brad Halverson. Just one comment on our Resource Industries segment in terms of its margin. This segment is critically important to us and we've made a conscious effort to continue to invest in the technology and autonomous mining and those types of things, as well as our initiatives around Bucyrus. And so I would say that we have made a conscious decision relative to maybe our normal expectations on pullthrough to continue to invest in this segment even where their sales are at.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

And Jamie, their incrementals I think too were really operationally better than the numbers look like just right off the face of the statement. Last year, they had a \$135 million gain from the Siwei settlement. So if you take that -- if you adjust for that operationally, they were pretty good.

Jamie Cook - Credit Suisse - Analyst

No, I get that. But is there any way you can tell us like what the investment number this year relative to sort of what you are thinking about last year and then again how to think about margins for the full year?

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Yes, we are at a point now where margins are low enough and sales are low enough the percentages -- I think the dollars are probably in some ways a little more important and an easier way to think about it. We were \$140 million something in the first quarter, \$130 million something in the second quarter and I don't think you are going to see material changes from that probably for the rest of the year.

Jamie Cook - Credit Suisse - Analyst

Okay, sorry, and then just any additional color on the commentary with the aftermarket being up again in the second quarter? Was that a sequential uptick from Q1 and then just color on where you are seeing it and on the OE side as well?

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Yes, actually, from first to second -- in fact, what I looked at last night was sort of less about regions and more about products and that was actually -- I mean small numbers. I am going to start with that. Small numbers, but fairly widespread on the OE and the parts sales -- we have strength in parts sales on things like underground coal trucks, traditional Cat product were actually a little better than most. Where we are seeing downside on the aftermarket now are on things like deferred maintenance on big shovels and draglines and the like. But I say that and the numbers aren't huge. Even the increase quarter over quarter was actually relatively small, but thankfully turned in the right direction.

Jamie Cook - Credit Suisse - Analyst

Okay, great. Thanks. I'll get back in queue.



Operator

Nicole DeBlase.

Nicole DeBlase - *Morgan Stanley - Analyst*

Yes, it's Morgan Stanley. Good morning, guys. So I just wanted to address the locomotive business a little bit. Your biggest competitor there saw pretty strong equipment order growth this quarter, I think like 40%. So I am just curious how locomotive orders are trending for Cat? Are you guys seeing the positive impact associated with the Tier 4 pre-buy at all yet?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Yes, yes. So this is a big year for locomotive sales, probably the biggest since we've owned EMD. There have been a lot of misconceptions about this and this is a good opportunity I think to clear some of those up. EMD has been a great acquisition on our part. Their marketshare has gone up in North American locomotives quite a bit since we bought them. Their sales have gone up quite a bit. And I wouldn't use the words pre-buy, but certainly [customers] (corrected by company after the call) have ordered a lot of locomotives from us, as well as our competitors for delivery this year. (multiple speakers) big year for us.

Nicole DeBlase - *Morgan Stanley - Analyst*

Okay. Do you think we'll start seeing the sales pick up in like 3Q or is it mostly a 4Q event?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Well, again, when things get -- production has been going pretty solid all year long. Effectively, we are booked solid. We could have -- we could have probably -- if we could have built more, we probably could've sold a little bit more this year, but we are booked solid on locomotives. The timing of the sales is around when we deliver them and we will probably have a better both third quarter and fourth quarter.

Now on the whole Tier 4 question, we are close to our customers. There are not that many in North America. They are largely the big Class I railroads. We have very close relationships with essentially all of them. We have been talking to them about Tier 4 expectations for a long time. They have been telling us they don't expect to order much for the next couple of years. We have talked to them about our Tier 4 plans. It's no surprise to them. Our view is that the marketplace expectations over the next -- that the industry in North America over the next couple of years is going to be down a lot from where we are right now. And the impact of the timing of our Tier 4 product is not going to have a very material impact on our sales at all.

Nicole DeBlase - *Morgan Stanley - Analyst*

Okay, Mike, that is really helpful.

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

I would just add -- it's Doug Oberhelman here -- on the EMD acquisition in general. As Mike said, we are really happy with that business. Since we have owned it, sales have more than doubled. This is a big year, a big pre-buy year for sure. We would expect and have, in talking to our customers, a post-buy anemia in 2015 and 2016. Based on that, we modified the Tier 4 development program that was in place when we acquired EMD because we didn't really like what we saw in terms of the end product with that engine.

In doing that, we contemplated that there would be virtually no or little demand in 2015 and 2016 in North America. That is why we ramped up this year, that is why we delayed our Tier 4 program and we will have a really good offering late 2015 and 2016 in Tier 4. Not to mention our natural gas program for locomotives that's already in place and some of those will be available in fact aren't running today. So we think we have really got a good program going. Our marketshare has gone up significantly, as Mike said, in North America and outside North America, sales have been fairly active as well. So we are really pleased with EMD, the EMD acquisition, one of our better ones.

Nicole DeBlase - *Morgan Stanley - Analyst*

Okay, thanks. And then my second question is on E&T margin. So the segment margins there were really good, reaching a new high this quarter. Was there anything special to call out that drove the 19.5% or do you think that that level of strength could continue into the second half?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

I won't make any comments on their margin in the second half because we don't really do guidance by segment, but they have been doing just a fabulous job of executing on sales that were actually down a couple percentage points. They managed cost down and improved their margins and they have been very stable. Whether or not it is going to be exactly the same as this quarter, that depends a lot on production, mix of products, regions they are sold. So you can always expect some bit of up and down in the margin rate. But I think overall they have just done a great job, not just this year, but really over the past three years. Sales have been stable and profits have been going up.

Nicole DeBlase - *Morgan Stanley - Analyst*

Okay, thanks. I will pass it on.

Operator

Timothy Thein.

Timothy Thein - *Citigroup - Analyst*

Great, Citigroup. Thanks, good morning. Yes, Mike, just coming back to the comments on oil and gas and specifically within well servicing in North America, I'm curious as the capacity is starting to come back, how do you feel about your relative position in that market in terms of now having the full offering in terms of pumps, transmissions and engines? And kind of related to that, are you seeing any -- just given how quickly demand has come back after being dead for 18 months or so -- are you seeing or experiencing any particular kind of product delays or extended backlogs for your products?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Well, it's not a business so much, Tim, that orders today and expects it tomorrow. So we are increasing production of large engines. We are taking up the build rates in Lafayette because of the increasing demand. And back to your original point, we have been a leader in this kind of business for a long time and I think the addition of transmissions and now the pressure pumps with our JV strengthen that. I think it's a great business. It lines up well with kind of the strengths of Caterpillar -- durability, reliability, service, dealer network, parts supply. It's a great thing.

And you are right, if you go back a couple years ago, let's just say there was plenty of equipment in the market and it slowed down pretty dramatically from there. Last year was quite a down year for well servicing, but I think they've gone through maybe the excess inventory they've had. That plus a little bit lower supplies of -- softer supplies of gas, supportive prices. It looks like it -- it looks -- and good orders from our standpoint. It looks like it is going to be a pretty good business.



Timothy Thein - Citigroup - Analyst

Okay, thanks. And then just switching back over to -- you touched earlier on the parts sales and mining. And I saw one of the majors the other day, actually the largest miner, who they are guiding to production growth across some of their key industrial commodities of 4% to 10% in their fiscal FY '15. And I recognize the industry is doing a lot more now to kind of sweat their assets, but just going back to what is embedded in your guidance, obviously, you've taken the forecast down a bit on mining. But how long I guess do you expect before we start to see more of a recoupling between your parts sales versus underlying production?

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Tim, that is the \$64,000 question. It's been -- baffling is probably the wrong word, but generally mine production has been pretty good, but equipment sales have been very poor. They've probably had a little more equipment that they needed -- it's a little bit almost like the fracking situation. So it will come back; there is no doubt about it. They are buying right now at levels that are far below, far below what a normal sustainable replacement level would be. But, again, the question is on a little bit like fracking and well servicing. When will it turnaround?

It is hopeful to think that with parts sales starting to edge up a bit and the equipment sales not going down anymore that we are at an inflection point, but both mining customers and ourselves have proven that it is an industry that is extremely tough to forecast. So the honest answer is it needs to go up, it will go up. It is just the timing of when that is going to happen that we don't know.

Doug Oberhelman - Caterpillar Inc. - Chairman & CEO

Just a little more color on that Michael and Tim. There is no question that there was an artificial boom up until 2011, 2012 in the world. A bust since then is equally, I would say, of the same magnitude, if not worse. We are seeing our customers delay maintenance, defer maintenance, do things that they have not done in the past. So at some point, and as Mike says we don't know when, this will come back to us even if it is replacement parts cycle, which we haven't seen yet.

Now I fully believe, and as do our customers, that the bottom is just behind us and our numbers are just almost miniscule in terms of ticking up, but they are ticking up and I think anecdotally with our customers, they see that too. When they start to get back into a normal parts replacement cycle and even a normal OE replacement cycle is unknown, but a lot of that will depend on how they are mining. And I saw that announcement as well with a big one or two, I met with a lot of them the last couple of months and none of them are talking about taking production down, but most of them are just talking about continuing more of the same. So bottom line is we don't know when it is going to come back, but it will come back and I suspect we will see replacement parts cycle first of some magnitude.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Thanks, Tim.

Operator

Larry De Maria.

Larry De Maria - William Blair - Analyst

Thanks, Larry De Maria, William Blair. Just stick with EMD for one minute. I think you mentioned that you have an offering late 2015 or 2016 for Tier 4. Is that ahead of schedule for the 2017 launch and how successful are we now in building an international book to offset the declines you mentioned domestically?



Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Yes, a couple of things. Our view is that we should have a Tier 4 diesel offering for 2017. Now we have actually a big aftermarket rail business, a big service rail business and we sell locomotives and components internationally and we are increasing our passenger rail business as well. So there is a lot of aspects to this. And I think with the big push in North America that we've had this year, with the big demand from customers, one of the things that we've done our best to do is to defer as much of the non-North American demand as we can into next year. So we've done that. I am not going to maybe give a forecast for next year at this point; it's a little early for that. We will talk about 2015 maybe a little bit more next time we get together for one of these calls in October, but we have actively tried to focus as much as we possibly could more in North America this year because of the big demand.

Larry De Maria - *William Blair - Analyst*

Okay, thanks. And then moving over a little bit, I know the business plan obviously calls to increase field population and you got some pricing in Construction, but in strong markets like North America, are we any closer to pushing through bigger price increases or are we still concerned with decreasing PINS at this point? I know it is having some obviously reverberations in the industry, and maybe you are under earning a little bit compared to potential, but you are improving your market position. So just curious if we are any closer to getting more outsized price gains.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

I think our strategy over the last few years, and we have been just pounding through this quarter after quarter, is to have very modest pricing, get cost reduction, improve quality, improve delivery performance and get marketshare. And that is what we have been doing. Through that period, you've had a very stable pricing environment, not much up, not much down and I don't see that changing in the near future.

Operator

Theoni Pilarinos.

Theoni Pilarinos - *Raymond James - Analyst*

Hi, Raymond James. You made it clear at your Investor Day that it was a priority for you to take some of the cyclicity out of your business and make your cost structure more flexible. Just looking at the mining segment and talking about when it returns -- eventually it will return and when it does how do we balance the uptick in demand that we've see in previous cycles and the backlog that we get to with some of the restructuring and layoff costs that you are taking now? Do you think that you are going to be caught as you have in the past with not enough capacity to meet demand?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Well, we put in capacity, physical capacity in the last cycle and I think we have adequate capacity in mining, even for a sizable upturn when it comes. What we've tried to do with our cost structure, as you say, is make it more flexible and that means being able to take out costs when volume goes down and add costs when volume comes back. In other words, try to make more of the cost structure as variable as we can and we have done that. Over the past two years in mining, we've taken a lot of cost out. We've taken fixed cost out or we call it period cost out in our major manufacturing facilities. But we've done that without materially impacting capacity.

So when things turn up, there is no doubt we will need to hire more people to get the work done. But I will just give you an example of the kinds of things that we have done to make that happen. We increased capacity quite a bit for large trucks over the course of 2010, 2011 and 2012. But we essentially did that in our Decatur facility. We didn't add any square footage to do that. It was all about how we laid out the factory, the equipment,



the processes to get more production out of that facility. So other than depreciation, we didn't add a lot of fixed costs to get extra capacity. So that is just an example of the kinds of things that we have done. I hope we do get a big turnaround that causes us to need more people. That would be good for us, that would be good for the industry, that would be good for the country.

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

Let me just add a little bit more to that. Looking back at 2012, we did \$65 billion in volume at that time. This will apply to both Construction, Mining, as well as E&T, Energy & Transportation for that matter. We have been working hard, as you know, on lean manufacturing, which is adding capacity every day in a very lean way. As we go forward that will come home to help us as well.

So you've seen our CapEx numbers come down the last two or three years. We invested early during this cycle to take advantage of that, which we did. We built marketshare, so our CapEx needs are pretty well met, we think organically the next few years, at least early through the next upturn. So we are in pretty good shape with all of that. I don't expect to miss a sale to tell you the truth on the way up when the business returns in mining and I would go so far as to say I expect the same thing in Construction because of the lean activities we are doing there that help us with lead times, shortened lead times and better availability.

Theoni Pilarinos - *Raymond James - Analyst*

Okay, great. Thank you. And my second question has to do with your recovery. You have kind of described as slow and steady so far this year in the US. We've seen a couple of months now of nonres pickup and this has typically been the key turning point for you in addition to the highway bill. How do things sit now that we have had a month or two of nonres pickup, how does that change anything from the slow and steady recovery we've seen, if at all?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Well, it's been slow and steady overall. Actually North American construction has been pretty good this year. I would describe North America as a little better than slow and steady. And although we didn't change it a lot as a part of the updated outlook, the principal change was down for Construction, as I said before, a little China and then the turmoil in the Middle East and the CIS causing caution. But in the midst of all that, we actually edged US Construction up a little bit and I think the signs there are encouraging. And to put it in some context though, Theoni, we've had a few years of improvement in North American Construction. This has been actually a pretty decent year, but even through all of that, we are still thinking this year, on a unit basis, we are still thinking this year is going to be sort of 15%, 20% below the 2006 peak. So there is still a lot of room I think to run in Construction in North America. We just need some sustained decent economic growth in North America. We need the highway bill to get sorted out. We need economic activity -- housing is below -- housing starts are well below what the long term needs to be to support population growth and at some point, it is a little bit like mining. That stuff is going to come back and when it does, it will be positive and it is starting to now.

Theoni Pilarinos - *Raymond James - Analyst*

Okay, great. Thanks a lot, Mike.

Operator

Ross Gilardi.



Ross Gilardi - Bank of America Merrill Lynch - Analyst

Bank of America. Thank you. Mike, with respect to E&T and margins, shouldn't mix work strongly in your favor in the second half versus the first half given the pickup in oil and gas orders that you mentioned, which at least the turbine business I think is your highest margin business. You've got the sharp pickup in locomotive orders as well, which is still in front of you for the rest of the year or at least the locomotive deliveries, excuse me, coupled with a weaker PowerGen market. So I would think margins would be -- the mix would definitely be a benefit in the second half of the year.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

The stuff that you said was true or much of it was, but it doesn't necessarily all come to the conclusion that you've drawn. So oil and gas is going to -- should be, we think, good in the second half. But I think most of the areas of the Energy & Transportation business we think are going to improve in the second half. So it is not all going to be concentrated in oil and gas. So I don't see a big impact on mix in the second half. We do have a couple of big orders going out or one big sale that we are expecting that will probably be a little below the average. That will temper or will be certainly less than the average margin rate. That will temper E&T expectations I think a bit later in the year and E&T is in some ways similar to a lot of the rest of the business. We have higher discretionary costs in the second half of the year than we do in the first half of the year. Some engineering programs are likely going to ramp up there a little bit too. So I wouldn't get carried away on -- I mean margins this quarter were quite good. I wouldn't get carried away at all thinking they are going to get a lot better in the second half in E&T. We had a great second quarter there.

Ross Gilardi - Bank of America Merrill Lynch - Analyst

Okay, great. And then you talked about pricing as the principal driver of the margin expansion year on year in E&T. Can you flesh out a little bit more what is happening there and is it sustainable?

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Say that again?

Ross Gilardi - Bank of America Merrill Lynch - Analyst

Yes, in your press release, you attributed the year-on-year operating profit improvement for E&T to pricing and I was wondering what's happening there, any particular businesses where you are seeing more pricing power and is it sustainable?

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

So here is the thing. When the numbers are relatively small in terms of change -- operating profit, if memory serves me, was up a little over \$50 million; it wasn't a lot. When you have small changes in operating profit like that and we are describing the reasons, sometimes it makes it seem as though it's maybe more important than it was. The changes that we had in pricing for Energy & Transportation certainly weren't outsized. Again, it is like -- for the total Company, if you look at the waterfall chart, all the buckets are relatively small. So describing anything that is inside them can make them seem a little more important than they are. So no, there is not a big price increase going on there. I don't see any big change in pricing activity going forward.

Ross Gilardi - Bank of America Merrill Lynch - Analyst

Okay, thanks. And just a last one real quick, Russia and CIS, I mean how big is it and what are you seeing with the sanctions?

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Yes, I mean it's not a huge -- the CIS is not huge for us. We don't do sales by country. It is, as you would expect, a lot less than someplace like China. The industry there is just not as big. But it has come off -- even though it is not big, it has come off a lot and that is what makes it worth mentioning.

Ross Gilardi - Bank of America Merrill Lynch - Analyst

Okay. All right, thanks very much.

Operator

Jerry Revich.

Jerry Revich - Goldman Sachs - Analyst

Hi, good morning. It's Goldman Sachs. Mike, at the Analyst Day, we spent some time talking about the focus on supplier development and just improving the connectivity. I'm wondering if you could just give us an update on how those efforts are tracking, if you can share supplier on-time deliveries or other metrics that are willing to talk about just to give us a sense for progress?

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Jerry, that's a great question, but of all the things I tried to prepare for for this call that wasn't one of them. I'd be happy to ask the purchasing guys or our procurement group that question, but I'm afraid I don't have a good answer for you. How about a second question?

Brad Halverson - Caterpillar Inc. - Group President & CFO

But, Jerry, maybe I will just comment quickly in general terms and Mike can get the numbers back in terms of percent, but I would say that our global purchasing group under the lead of Dave Bozeman, combining that with our lean initiative, focused on built-in quality, right part, right time and then more importantly perhaps the customer lead times, the collaboration with our suppliers is outstanding right now and we are seeing good progress connected to our lean initiative across the board. So I would say relative to our engagement with suppliers in collaboration and you are kind of seeing that I think in our material cost results over the last year and a half, it has all been very positive.

Jerry Revich - Goldman Sachs - Analyst

Okay. And my second question, just on the restructuring costs, it sounds like the timing is moving around a bit. Can you just give us a sense for what kind of cost savings you will be delivering by the fourth quarter on a run rate basis and what kind of tailwind we should look for next year? And then separately, Mike, I guess in the past when sales have stabilized at low levels in places like Resources, you have been able to deliver improved profitability and margins even at flat sales once you stopped cutting production and I am wondering if that is a possibility as we think about 2015 if you are willing to address that.

Brad Halverson - Caterpillar Inc. - Group President & CFO

Yes, I will let Mike handle -- this is Brad again -- handle 2015 and the back half, but I would say the restructuring has just moved a little bit. We will have some of that cost move into 2015, I would say. Probably roughly around the midpoint of \$450 million is still a good number in total, but some of that will spillover to 2015 and I would say the benefits are by and large consistent with what we've talked about before.

But it is not the only thing we are doing around cost restructuring or cost management, I would say. We talked a little bit about what we said in terms of the last conference. We are embracing the fact that we do have some cyclical, but I think the thing to remember is the fact that we have a lot of diversity. We really have one segment right now that is not performing and it is in the bottom of their cycle, but we have a strong Energy & Transportation business and a Construction business, strong in North America, a little concerned in the developing world, but the margins have improved significantly.

So I would say from an execution standpoint how we are managing these businesses and where we are spending our money, we had a good cost reduction last year. We had \$500 million roughly in the first half of this year and it is kind of part of how we are operating now. So I feel pretty good about the fact that we have good consistent execution.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

You didn't ask this, but I am going to -- I just wanted to chime in one more thing that I thought might come up, but hasn't and that is, if you look at the second half of the year and the first half of the year, we got a headwind in the second half of the year that was a small headwind, it was a small tailwind in the first half. For the year, it is going to be pretty neutral and that is inventory absorption. We've had a -- not dealer inventory, but Cat inventory. We had a small increase in the first half and we expect that to come down in the second half and finish the year a little bit -- basically fairly neutral. But what that has meant is that has been a little positive in the first half of the year and it will be a little negative in the second half of the year. And that is also one of the reasons why you are seeing a little difference in first-half and second-half profit.

Jerry Revich - Goldman Sachs - Analyst

Thank you.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

I think we have time for one more.

Operator

David Raso.

David Raso - ISI Group - Analyst

ISI. Can I clarify the dealer inventory comments? Sequentially, did you say down \$800 million each of the next two quarters?

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Yes, sir, we did.

David Raso - ISI Group - Analyst

And that includes engines and machines or just machines?



Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Yes, that's machines. I don't think engines is forecast to change much. Dealer inventory in engines is smaller and has been much more stable. What I was talking about was machines.

David Raso - ISI Group - Analyst

So just to be clear then, the second half of the year, on a year-over-year basis, production then is going to be largely in line with retail?

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Say that again, David?

David Raso - ISI Group - Analyst

The year-over-year -- the first half of the year, you have had some nice help from the dealer swings in inventory.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Well, it wasn't -- I mean overall it wasn't much. We went up \$700 million first quarter, down \$500 million second quarter. So first half was a couple hundred million.

David Raso - ISI Group - Analyst

Well, I'm thinking year over year, Mike. The first half of the year, you had about \$1.8 billion. It was about \$1.8 billion help, right, just the year-over-year changes. The second half of the year, just so I am clear, it looks like the year-over-year change will be pretty much neutral because last year third quarter, inventory went down \$800 million. Last year fourth quarter, inventory went down \$700 million sequentially, right, so the year over year is a bit of a push.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Yes.

David Raso - ISI Group - Analyst

So that said, if production is going to be basically in line with retail year over year, it implies the dealer stats, the retail stats. You must be looking at something from the dealers that are telling you that the retail data is going to get also pretty close to flat year over year because that is how you are forecasting your own sales for the second half. I know the dealer stats don't include pricing, don't include parts, but I just want to make sure I am reading that right as I see the dealer stats come out. There must be some implication here that the dealer stats do get close to flat over the course of the second half of the year. Is that fair?

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Yes, I think we would see it trending more towards that as the year goes on. I think that is a very reasonable assumption.



David Raso - ISI Group - Analyst

Okay. And then last one, the sequential from mining revenue?

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

David, I will just go on from that.

David Raso - ISI Group - Analyst

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Throughout much of last year, the mining numbers were continuing to go down and so what a lot of that will be is we will be lapping what was actually quite low Resource Industries. That is probably where you will see a lot of the improvement. You have already started to see that. This last month on Resource Industries, it was less negative than the prior month by a reasonable margin.

David Raso - ISI Group - Analyst

Well, to that point, obviously, people watch the monthly retails and the fact is, if you look at the last three months for machines, it was still down 10, engines was also down 10. The way the guide plays out, obviously you must be looking at something from the dealers that tell you we are going to get pretty close to flat year over year in the second half. And I don't mean just one month, I mean basically for the first half and the second half, right? That is how you get to your own sales. So that moment retail turns positive, I mean obviously the stock is going to respond to that. So I am just trying to figure out am I reading that properly, that there is something you are seeing from your dealers that is telling you you are going to have a machine number, I don't care if it is Resource, Construction, but combined those numbers are going close to flat soon as well as an engines or you couldn't have a flat Cat sales in the second half because there is no longer that big production retail gap.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Yes, I think I will go -- I am not going to give you an exact kind of number because, as you started out, parts and service matters, pricing matters, currency impacts matter a bit, but I think your underlying premise that the retail stats should, relative to a year ago, start looking better is absolutely true.

David Raso - ISI Group - Analyst

All right. Now that we are past 12 Eastern, I will cut it off. I'll ask you my second question off-line. But thank you very much. I appreciate it.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services

Okay, with that, we are a couple minutes over; we will wrap it up. Thank you very much, everyone and we will see you again in October.

Operator

Thank you very much, ladies and gentlemen. This concludes today's presentation. You may disconnect your lines and have a wonderful day. Thank you for your participation.



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