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EDITED TRANSCRIPT

CAT - Q2 2012 Caterpillar Inc. Earnings Conference Call

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OVERVIEW:

CAT reported 2Q12 profit of $2.54 per share. Expects full-year 2012 sales and revenues to be $68-70b and profit per share to be about $9.60 at middle of sales and revenues range.

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PRESENTATION

Operator

Good morning ladies and gentlemen, and welcome to the Caterpillar second-quarter 2012 earnings results conference call.

At this time, all lines have been placed on a listen-only mode and we will open the floor for your questions and comments following the presentation.

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

Mike DeWalt - *Caterpillar Inc. - IR Director*

Thank you very much. Good morning, everyone, and welcome to our second-quarter earnings call. I am Mike DeWalt, the Director of Investor Relations. I am pleased to have our Chairman and CEO Doug Oberhelman, and Group President and CFO, Ed Rapp, with me on the call today.

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If you would 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 the section labeled Results Webcast.

This morning, we will be discussing forward-looking information that 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 individually or in the aggregate could make actual results differ materially from our projections, that can be found in our cautionary statements under Item 1-A, Risk Factors, of our Form 10-k filed with the SEC back on February 21 of this year, and also in the forward-looking statements language in today's release.

In addition, a reconciliation of non-GAAP measures can also be found in this morning's financial release and that will, again, be posted on our website at Caterpillar.com.

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Okay. To start off this morning, I'll do a few bullet points that summarize this morning's release. It was an all-time record sales quarter, in fact the best in the 87-year history of Caterpillar, and up 22% from the second quarter last year. A little over 12% of that was organic growth and a little underpin from our acquisitions.

Sales and revenues rose about 9% sequentially from the first to the second quarters. It was a great quarter for profit and also an all-time record at $2.54 a share, and operating profit was 15%, over 15%, of sales and revenues. We had very good incremental operating profit pull-through at 44%, excluding the impact of our acquisitions.

We did, however, make a downward revision of $2 billion to the top end of our sales and revenues outlook range. About $1 billion was a result of negative currency translation and about $1 billion because of weaker world economic growth than we'd previously expected.

We did not change the bottom end of the range, so that means the sales and revenues at the midpoint are down about $1 billion. And we increased our full-year 2012 profit outlook from $9.50 to $9.60 at the middle of the sales and revenues range. Those were the high-level points.

I'll add a little more color, then Doug and Ed and I will take your questions. I'll start with sales.

Again, sales and revenues up 22%, excluding the Bucyrus and MWM acquisitions, which we didn't own last year. Organic growth, again, a little more than 12%. The largest increase was in our Resource Industries segment, which is primarily mining.

Sales were up 68% from a year ago, about 37% from the acquisition of Bucyrus and about 31% organic growth. Sales were up in all geographic regions, both with and without Bucyrus.

Our Power Systems segment was up 12%. And that was 8% organic growth and about 4% from our acquisition of MWM. The strongest growth was in North America and the strongest industries were petroleum and rail.

Our Construction Industries segment was up 8%, and that increase was essentially all volume with negative currency impacts about offsetting positive price realization. Construction sales were up in North America, about flat in Europe, Africa, Middle East, and that's where most of the negative currency impacts were. Latin America was down 3% and Asia-Pacific was off 11%. And of that 11% decline in Asia-Pacific, more than all of that was China.

Speaking of China, over the past quarter, it's been very topical. What's happening there, what are we doing about it, and when do we think it will get better? And with most of the sales in China related to construction, this is a good place to address it.

So, in terms of what's happening there, the construction equipment industry remains very weak and it really hasn't shown much in the way of signs of improvement yet. In addition to the weak demand, there's still quite a bit of inventory available on the ground in China.

Now, while the industry is still pretty weak, it did turn down at about this time last year, so we're at about the point where the comparables are starting to get easier. So on a year-over-year basis, the numbers will likely start looking better than the first half of 2012, even though the industry isn't seeing much improvement yet.

So the question is what are we doing about it? And the answer is we are actually doing quite a bit. First, we are working with dealers to actually sell more product. Over the past couple of months, we put new programs in place to get that done. And we expect to start seeing results of those programs in the third quarter and expect to get more of the available market.

Second, we and our dealers are actively addressing inventory. During the second quarter, CAT dealers in China reduced machine inventories, and that's a good thing. However, with weak end-user demand and dealers cutting inventory, it's resulted in a very low level of shipments from us to dealers, and that makes it tougher to reduce inventory. We've already lowered production in China and expect to reduce it even more in the third quarter. That, along with a higher level of exports from China to other parts of the world, should help lower inventory there. However, because

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sales volume levels in China haven't begun to improve much, we expect it will take a couple of more quarters to get inventory levels in China where we would like them to be.

While we are actively working to get inventory down in China, we are trying to keep a balanced view. One of the few certainties in this business is that markets go down, and then markets go back up. In China, we are encouraged by the recent actions the government has taken to improve economic growth. They've cut interest rates, they've lowered bank reserve requirements, and we expect they'll increase infrastructure spending later this year.

So we do need to be a little bit careful. The construction industry in China has a history of turning quickly. And when it does, we do need to be prepared. We are actively working the plan to lower inventory there, but we don't want to go to the other extreme and take it down to a point below where we would have difficulty reacting when the improvement does inevitably come.

So, bottom line, we think there is a good chance that signs of better economic growth in China will start later in 2012. And while that's our view, our 2012 sales and revenues outlook does not rely on any material improvement in China sales this year. Okay, that's enough on China, construction and sales.

Let's shift to profit. And it's a great story to talk about. It was a great quarter, and in fact, again, at $2.54 a share, our best quarter ever. With operating margin just over 15% of sales and revenues, that was also one of our best performances ever.

Cost control was very good. Material costs were about flat. Freight costs were not an issue, variable labor productivity more than offset labor cost inflation, and period cost control was very good, with period costs increasing at well less than half the rate of the sales increase. All in all, a very well executed quarter.

However, on the negative side, there was a tax rate. We increased our estimated annual tax rate from 30% for the full year to 30.5%, mostly related to the geographic mix of where profits are earned from a tax perspective. That means that after-tax profit in the second quarter was about $24 million lower than it would have been had we not made a change to the estimated tax rate.

Okay, that's a quick review of the second-quarter results. Let's move on for a moment to the outlook.

Now, as a starting point, remember our previous outlook was a sales and revenues range of $68 billion to $72 billion and profit of about $9.50, at the midpoint of that range. This morning, we did tighten up the sales and revenues range by lowering the top end from $72 billion to $70 billion.

Now, we first introduced that $68 billion to $72 billion range at the end of January with our year-end 2011 financial release, and we held it steady last quarter in April when we released our first quarter. This morning's $2 billion decline at the top end of the range was a result of two things -- negative currency translation and weaker global economic expectations than we had previously thought.

The currency impact is a result of the stronger US dollar, its translation. Our sales that are denominated in non-US currencies are translating into fewer US dollars. And certainly the most significant negative impact is in the euro.

Now, we did not change the bottom end of the range, and as a result the midpoint is down $1 billion. And at the midpoint of that new range, that $68 billion to $70 billion sales and revenues range, we expect profit to be about $9.60 per share. That's up $0.10 from $9.50 a share at the midpoint of the $68 billion to $72 billion sales range that we previously had.

A few points about the outlook. Profit is higher despite the increase in the estimated annual tax rate. Operational execution has been very strong, and we expect that that will result in better profit despite the tax increase.

Currency, while impacting sales, has had little impact on the profit movement from $9.50 to $9.60. Our global manufacturing footprint and broad cost base provides an offset to the impacts from sales.

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You know, and on that point, I frequently read media commentary about Caterpillar when exchange rates moved. And it's frequently off base. And because of that, I think it's worth making this point one more time. We worked hard over the past 30 years to get a better balance on currency exposure, and because of that, we are in a much better currency position than we were historically. Rates can move and do move sales, but when they do, the cost impact is usually in the opposite direction and mitigates the overall profit impact.

So in summary, we had a great second quarter. We are a little more cautious at the top end of our sales and revenues outlook, and we raised the profit guidance to about $9.60, at the middle of the sales and revenues range.

Another point before we move on to the Q&A, and that's the level of uncertainty in the world economy. You know, it's hard to pick up a newspaper today and not read about troubles in Europe with Greece, Spain and Italy. There's angst with growth rates and GDP in China. There is concern about political polarization in the US, and what will happen at the end of the year with the fiscal and tax cliff. But those are the facts of life that we are all dealing with today, and there is no doubt that they have been a negative for business and consumer confidence. We see it, and we understand that some of these issues, like Europe's debt problems, could take a while to fix.

That said, we expect that, over the next couple of quarters, that some of those clouds will clear a bit and we can start forming a little bit better picture of 2013. And while none of us know at this point what those outcomes will be, we do know that US elections will be over in the fall, and we think chances are good there will be a resolution to the fiscal cliff.

The leadership change in China will also happen later this year, and after another quarter or two, we will get a better sense of the effectiveness of the easing measures the Chinese have already taken and any additional measures they may take to improve growth.

We know that, in Brazil, they started easing late in 2011, and we are seeing some improvement in our business there today, and we expect that improvement to continue to unfold as we go through the rest of this year. We also think that Brazil's preparations for the World Cup and the next Olympics will be positive for them moving forward.

Bottom line, we believe that some of the uncertainty that's facing the world economy today will at least be a little less cloudy by the time we get to the end of 2012. And as a result of numerous monetary easing actions that have been taken around the world, we're cautiously optimistic that the world economy in 2013 will be better than in 2012.

One last comment and then we will start the Q&A. And that's a seasonality reminder. We have numerous vacation shutdowns around the world built into our third quarter. That's normal; that happens every year. And as a result, the third quarter is usually a weaker seasonally sales quarter. The fourth quarter is usually a seasonally high quarter for sales, so for those of you that are trying to model our quarterly results, please take that into consideration. The third quarter is usually the weaker quarter of the second half.

So that's a review of our results, and with that, we are ready to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Jerry Revich.

Jerry Revich - *Goldman Sachs - Analyst*

Good morning. It's Goldman Sachs. Can you touch on how you're thinking about pricing heading into the back half of the year compared to the price realization we saw this quarter, and also comment on where you expect to see Company and dealer inventories at year-end?

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Mike DeWalt - *Caterpillar Inc. - IR Director*

Yes. I'll start with pricing. We've actually done better on pricing through the first half of the year than we expected. It's really held up pretty well. You know, earlier in the year, we had expected that we would get maybe 1% to 1.5% price for the full year. We are at probably between 2.5% and 3% right now through the first half. We think it will probably go down a little bit in the second half; that's what's baked into our guidance. We'll probably end up the year somewhere around 2%.

You remember one of the points I mentioned was we are working with dealers, for example, to sell more product in China, so there will be certain merchandising programs, for example, related to that. So I think a lot better year than we thought it was going to be, even including the economic impacts that you see today, but probably a little less in the second half than the first half.

In terms of dealer inventory, you know we did have a little bit of an increase in the second quarter. More than all of that was mining.

Now, when you look at dealer inventory for mining, you have to be a little careful. It's not a case where dealers are loading up 400-ton trucks on their lot and hoping for a customer. It's a case where we pass title to them, and then they have to get it, the product, to their customer, they have to get it assembled and commissioned, so usually when our shipments go up like they did in the second quarter versus the first, the pipeline for mining inventory increases a bit. And that's just a function of us shipping more through dealers to customers.

In terms of our inventory, we did have a bit of an increase, about $800 million, in the second quarter. And there were four reasons for that.

One, and I'll start from the smallest of the largest, in-transit inventory. That's basically where we sold a product -- I shouldn't say sold, we have a product that's been shipped, but it's an export. It's on the high seas essentially, and it's destined for a customer but we haven't passed title yet. When our shipments and exports go up, in-transit inventory usually goes up. We had a 9% increase in sales between the first and second quarters and then transit went up a bit. That's to be expected based on the sales increase.

About 20% of the increase in the second quarter was components, work in process, aftermarket parts, and that's very related to sales. And again, we had a 9% increase in sales from first to second quarter.

20% of the inventory increase was from the acquisition of Siwei, and Bucyrus. Siwei is an acquisition and Bucyrus inventory went up in the quarter, and again, that's not very surprising. We have businesses like Solar, like Bucyrus, where they have seasonally big fourth quarters. They build a bit of inventory all year long, have a big fourth quarter that usually goes down. And again, Siwei contributed about $100 million of the increase, not just an acquisition.

About half of the increase was finished goods, and more than half of that was in our Excavator division in China. And I tried to cover this a little bit in the release this morning. It's a case where we are cutting production there. There are more declines that are going to come in the third quarter. But dealers are cutting inventory there as well, and if you start with a slow market and dealers reducing inventory, there are not a lot of shipments going on from our factories to dealers then, so it's pretty hard to take inventory down. So even with the reduction in production that we had in the third quarter, it wasn't quite enough yet to offset -- offset the impacts of a really slow market. So, we are going to take it down a little bit more in the third quarter. We are exporting a higher percentage of the business in China outside of China, so that should help there.

Ed Rapp - *Caterpillar Inc. - Group President, CFO*

This is Ed. The thing I would add on CAT inventory, looking for the balance of the year, between now and year-end, I would be disappointed if we didn't take at least $1 billion out of inventory. But we are also trying to be very thoughtful in terms of how we manage the full supply chain.

If you think about what the supply chain has done, and $32 billion in '09, midpoint of the outlook $69 billion, and if you look at the basic outlook that says there are some drivers out there that says 2013 could be a positive versus 2012, we want to be very thoughtful about how we take that inventory down. But between now and the end of the year, getting $1 billion out is something we ought to be able to do.

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Jerry Revich - *Goldman Sachs - Analyst*

Appreciate the color. I'm wondering if you could talk about how much visibility you have in your gas compression business and whether that business can continue to outpace the slowdown we are seeing in US pressure pumping. And in electric power can you just touch on which regions are driving the weakness that we saw year-to-date, and what you expect heading into the back half? Thanks.

Mike DeWalt - *Caterpillar Inc. - IR Director*

Yes. We don't break our petroleum business out in quite that much detail, but what I would tell you is the largest -- the largest sort of application segment for oil and gas business is gas compression. So contrary to popular belief, it's not drilling and fracking. It's gas compression. So, the more gas you have, the more wells you've drilled, the higher consumption of gas goes, the more need you have for gas compression. So that business is actually doing quite well and looking up. We do a lot of gas compression with Solar and with Solar we have very good long-term visibility. So I would say oil and gas -- your point about fracking is right. Fracking is slowing down, but gas compression is doing very well. So our general view of the oil and gas industry is actually pretty good right now.

Jerry, we're going to have to move on to the next person in line. Thanks.

Operator

David Raso.

David Raso - *ISI Group - Analyst*

ISI. I'm just trying to look at the inventory guidance. Ed, you just mentioned $1 billion coming out ideally by the end of the year. That would still imply the next couple quarters that inventory will be growing faster than sales year-over-year. So just coming off the last five quarters of inventory still growing faster than sales, I'm just trying to, A, just understand why we continue to grow inventory faster than sales, or B, is the answer and everybody can have their own macro view, are you just that confident 2013 is an up year to continue to grow inventory at this rate?

Ed Rapp - *Caterpillar Inc. - Group President, CFO*

Two things. First of all, on inventory growing faster, if you really look at our guidance in terms of the midpoint of the outlook, we have sales in second half actually slightly up versus first half. And so you've got a slight increase in sales and a lower inventory level. So, you don't have inventory growing at a faster pace than sales.

And your second point is part of it as well. If you just -- Mike kind of walked around the world and you look at what 2013 could look like versus 2012, I can't imagine with the degree of uncertainty we have in the US today we don't have greater clarity in '13. I can't imagine with the steps that China is taking in terms of monetary policy, rate cuts, reserve requirement cuts you don't see a better 2013 than '12.

I can't imagine with all the moves that Brazil has taken as well as the coming of the World Cup, the Olympics that you don't see a '13 better than '12. So part of our thinking is making sure we are very thoughtful across the supply chain.

The other one to keep in mind and I think second quarter really demonstrated it, there are also some benefits to the inventory position we have, our point of use availability, our quality, our delivery performance, our pull through, were all very, very strong. And so I do think there's been some benefits as to how we worked with our supply base to ramp up and I think you're seeing it in some of those operating metrics.

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David Raso - *ISI Group - Analyst*

And I appreciate that math sequentially, but I was speaking about year-over-year. And the math is you're still planning on inventory growing faster than sales year-over-year, and obviously it sets up a little more risk on how much retail you need in '13 to continue to grow your production. So I guess, end of the day, I mean obviously you will give '13 topline guidance. I assume, Mike, you guys will give it in October. But the way you're handling the CapEx for the rest of the year, essentially no cut, the way you're guiding the inventory, I guess base case we have to be thinking -- you're thinking '13 is an up year, otherwise you'll be taking a bigger cut to your inventory and even maybe the CapEx.

Ed Rapp - *Caterpillar Inc. - Group President, CFO*

And David, that's why we tried to give you some color as to why we saw '13 being better. The other thing to keep in mind on the CapEx is that, in spite of the numbers that we reported today, which are an all-time record on both sales and profit, keep in mind that our traditionally strong markets, US, Europe and if you go back in history even Japan, are in the neighborhood of 40% off prior peaks. And at some point in time, those markets are going to turn. And when they turn, we want to be ready. There's places where we are taking and slowing down some of that CapEx, China being one example, but we are going through it business by business, industry by industry, really looking at what the long-term prospects are going to be.

Mike DeWalt - *Caterpillar Inc. - IR Director*

I'm just going to add one more comment on their on the year-over-year. And that is you almost have to look at it by the type of inventory that we are talking about. We've increased parts inventory, for example, faster than sales. Part of the reason for that is we are putting additional Bucyrus inventory into the system. We are doing that to increase delivery performance there. That is a key part of driving higher parts sales and profits out of Bucyrus.

Now, if you look at our actual production inventory, it's performed a lot closer to sales. If you look at PDC, that's where we are holding finished inventory on purpose; we call it Lane One inventory. That's up $1 billion or actually a little bit more than $1 billion year-over-year. That's very purposeful. The problem was, a year ago, we didn't have enough capacity in place to get it where we need it. So we've added more than $1 billion to PDC inventory on purpose; that was all part of the plan. And we have been able to do that really over the last six to nine months as production has come on-stream. So, it's not just a simple how much did sales go up, how much is inventory going up?

Then we also had acquisitions. Roughly half of the FIFO inventory increase is Bucyrus, MWM and Siwei, just acquisitions.

David Raso - *ISI Group - Analyst*

Okay, thank you very much. I appreciate the color Mike.

Operator

Andrew Kaplowitz.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Barclays. Good morning guys. Nice quarter. If I could ask you about backlog. Mike, I know you've talked about it in the past, you kind of rue the day when it would go down. I think we all expected it to go down sequentially here. But how do you look at the backlog decline in terms of mining and with your comments in the release about mining customers extending investment over the next few years, how is it affecting your business now? And if mining CapEx is down significantly, can you grow your business?

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Mike DeWalt - *Caterpillar Inc. - IR Director*

A couple of things. One, how is it affecting our business now? Well, organic sales were up 31% in mining in the quarter. If you look at our year-over-year backlog, how are we doing on backlog versus a year ago? It's up 11%, not down.

If you look at the change from the end of the first quarter, there are a couple of things that are definitely going on there. One, and this particularly affects construction, we took quite a few products off managed distribution. We've been in a situation for the last couple of years where we just couldn't supply enough, and we had dealers on managed distribution for quite a few products. We have been adding production capability over the last couple of years, that situation delivery times have improved a lot. And when that happens, it's almost like clockwork. Dealers take -- they don't have to be quite so cautious and -- because we can deliver quicker. So that was definitely a factor for construction.

On mining, customers did -- we shipped more than we took in new orders, and the backlog did go down. But you almost have to look at it in perspective. We were getting very large orders really over the past couple of years and we are increasing every quarter. And it's a function of we have been putting in more capacity to deal with that. We wanted for a long time to get the order book for mining to a more reasonable level, delivery times for customers to a better level. And that's why we've been putting capacity in place to do that.

That said, there's a lot of uncertainty in the marketplace today. Customers are -- just like my comments in the opening, we are all trying to get a better picture in terms of what's going on economically. Central bankers have done quite a bit, but that takes a while to actually materialize in the economy. I think people are taking a little bit of a wait-and-see to see how 2013 is going to shape up. And I think orders reflect that. That said, mining order book is quite long. We have very good visibility into 2013. For a lot of the big trucks, we are still taking orders into '14. So it's not as though all of a sudden the backlog has dried up and we don't have any visibility.

Andrew Kaplowitz - *Barclays Capital - Analyst*

That's helpful, Mike. If I could shift gears for a second, the first half of the year, you've done almost 15% margins. In the second half of the year, if you look at the implied guidance, you would do much lower margins. You talked about lower production in China, incentive comp is going up. We see all the things that are in the release but the question I have is this some conservatism in the guidance?

Mike DeWalt - *Caterpillar Inc. - IR Director*

Well, what I would tell you is this. Many of the comments that we've actually made here today were in the release. Price realization is probably not going to be quite as strong in the back half of the year. Seasonally, the fourth quarter is usually a higher cost quarter, so those things will certainly impact the second half of the year. But you're right, first-half execution has been very good. So I think our outlook is -- we raised the outlook today from $9.50 to $9.60 on a midpoint of the sales range that went down $1 billion. And we are looking at a higher tax rate. So, I think actually the profit story for the rest of the year is pretty positive.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Thanks, appreciate it guys.

Operator

Henry Kirn.

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Henry Kirn - *UBS - Analyst*

UBS. In the release, you called out the dealer rental inventories as old. How much opportunity is there to refresh the fleets? And if we went through a pause, do you think the dealers would take the opportunity to start to refresh?

Ed Rapp - *Caterpillar Inc. - Group President, CFO*

This is Ed. Yes, I think we are already seeing some of that in terms of dealers refreshing those rental fleets. But if you look at it in terms of the total fleet size, it's still below kind of historic levels, historical peaks. And on average the age is older. And I think it's not only a view of the rental fleet, but I think it's a pretty good proxy for where customer fleets are, especially in the developed parts of the world.

In a period of uncertainty, they just delay the decision to make an upgrade to the fleet than new purchase. And like I said, as we talk about moving forward, I think at the point in time they get greater clarity, one of them that helps is the fact we did finally get a passage of a highway bill. We are starting to see some -- the bottoming out and improvement in housing, I think as those issues get a bit clearer the opportunities for not only rental fleet replenishment but also the upgrade of customer fleets is one of the opportunities that lies ahead.

Henry Kirn - *UBS - Analyst*

That's helpful. Could you share your latest thoughts on Cat Financial and your appetite to take risk there, gain share or use as a competitive weapon?

Ed Rapp - *Caterpillar Inc. - Group President, CFO*

Henry, Cat Finance has been a competitive weapon since we launched it back in the 1980s. And the thing that we do with Cat Financial is we stay very close to home. So it's there to support and pursue the growth of the Caterpillar business.

And if you think about the '08/'09 financial crisis and how well it performed, I think it shows the benefits of staying very close to home in terms of the way you manage your captive finance company. I think with the uncertainty that you have today in the financial markets, having a captive finance company has become I think even a bigger strategic advantage.

I think the other place where we are going to see it play out as a strategic advantage, drive the full integration of Bucyrus is we will really be the only full line provider in that mining industry, and plus with a captive finance company, I think there's a real strategic advantage there. But we are not going to significantly alter our risk appetite. We think we manage that part of the Company well. I think you'll see us consistently manage it moving forward. But as you saw with the results, they had a good quarter. They are a great part of the Company.

Henry Kirn - *UBS - Analyst*

Thank you.

Operator

Robert Wertheimer.

Robert Wertheimer - *Vertical Research Partners - Analyst*

It's Vertical Research Partners. I wondered. You mentioned rail was strong in the press release and I wondered if you could break that down into a pre-buy maybe in North America versus I know rail has been booming in mining globally. Is that a business that's gotten up into a solid double-digit profit margin, or is it still lagging?

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Mike DeWalt - *Caterpillar Inc. - IR Director*

Yes, a lot of the rail increase we've seen so far this year has actually been in North America. To your point, a few years from now, there will be -- there will be a move to new emission standards in rail. And I think there is certainly some buying that's going on ahead of that.

We are actually doing a bit better than the industry. When we acquired EMD, it had lost a lot of its business over the years to GE. And thankfully, we're taking some of that back now. So actually we are doing pretty well.

In terms of profitability, in general, that business is actually doing quite a bit better than when we bought it. We've got the new factory going in Indiana right now in Muncie. They have come up on production remarkably well. We had a good quarter, despite the fact that we essentially shifted assembly in the first to the second quarter from Ontario to Indiana. So, they have done a great job.

Robert Wertheimer - *Vertical Research Partners - Analyst*

Great. Then if I could ask another Power Systems follow-up, just on electric, one of your competitors had cited some weakness. I know, you have some tough comp issues that maybe are fading. Is it possible for electric power gen to be up for you guys this year? Do you have an order book that would support that or is it looking a little softer?

Mike DeWalt - *Caterpillar Inc. - IR Director*

A couple of things. One, if you look at our overall Power Systems business versus that competitor that we are talking about, thank goodness for rail and thank goodness for oil and gas. Those are -- it's good to have a quite varied business. We have some end markets that are weaker, we have some that are stronger. We happen to have a very good balance.

So in total, you saw our sales to end-users accelerate the three-month moving average from overall plus 2 to a plus 7 in June. And that was a good thing. But I do -- there are comments about Power Systems in general, particularly the smaller diesel end of it. We are definitely seeing that in the marketplace. And so certainly at the smaller end of electric power, it will likely be a negative year. At the big end, at the turbine end, we had some really tough comparables in the first quarter that were with us throughout March. And so year-over-year, that part of the business has been a little -- comparably a little pressed because we had such big turbine sales in the first quarter a year ago. But on balance, I would say the bigger stuff is a little better than the small stuff. And the competitor that you referred to is probably, relatively speaking, stronger in the small stuff.

Robert Wertheimer - *Vertical Research Partners - Analyst*

Yes. True. Thanks Mike.

Operator

Seth Weber.

Seth Weber - *RBC Capital Markets - Analyst*

Good morning. It's RBC. Back to the mining business, you gave some good color on the truck -- trends in the truck side. Can you give us -- can you comment on what you're seeing more on the underground side?

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Mike DeWalt - *Caterpillar Inc. - IR Director*

Underground hard rock or underground coal? Underground hard rock has amongst the longest backlog of all of our products. You mean underground coal, Bucyrus underground coal?

Seth Weber - *RBC Capital Markets - Analyst*

Yes, the old DBT business.

Mike DeWalt - *Caterpillar Inc. - IR Director*

Yes, yes. Yes, that's probably weaker than the rest. We talked a lot about that I think in the first quarter where we were seeing some decline there. We don't -- we haven't broken out Bucyrus in a lot of detail separately in the outlook, but I think the overall sales for Bucyrus this year are going to be lower than we had originally thought, and really for two reasons. One is underground coal is a bit weaker. Thankfully, we don't have as much of our business tied up in US underground coal as maybe our largest competitor does, but it's still going to be a bit of a negative. And the flipside of that will be we have now sold four of the distribution businesses to Cat dealers. Those are in our numbers now and in our outlook. So, that will probably take a little bit off the topline for Bucyrus as well, and that's baked into our outlook as well.

Seth Weber - *RBC Capital Markets - Analyst*

Okay. Thanks. If I could follow up on Europe on the construction equipment business, can you just comment? Did it accelerate to the downside through the quarter? Are you seeing trends get weaker there during the quarter?

Mike DeWalt - *Caterpillar Inc. - IR Director*

Yes, I think it's probably fair to say if you just look at Europe, Africa, Middle East rolling numbers, you've seen that monthly get weaker. And I think that's definitely -- certainly been the case in Europe. Europe has moved from -- Europe, Africa, Middle East has moved from up to being about flat. And it's move that way throughout the quarter.

Seth Weber - *RBC Capital Markets - Analyst*

Do think that continues to deteriorate through the year, or is that kind of stabilized at a low level here?

Mike DeWalt - *Caterpillar Inc. - IR Director*

It's -- again we don't provide our outlook in quite that level of detail, but to Ed's point earlier, we have a decent sales outlook for the back half of the year. We are not looking for a big deterioration. That said, there are pluses and minuses. We are seeing, for example, better business in Brazil; that's turning up a bit. And you also would've seen that in the Latin America numbers. It moved from I think down 6% to down 3%. So you're seeing that move a little better. It was actually positive later in the quarter. And in fact our machine retail sales, I'll say this. In June, we reported the three-month moving average, but from a monthly perspective, June was the best month we've had since January in terms of month-over-month increase. It was one of the best months on a volume basis we've ever had.

Seth Weber - *RBC Capital Markets - Analyst*

Okay, thanks very much guys.

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Operator

Ann Duignan.

Ann Duignan - *JPMorgan Chase & Co. - Analyst*

JPMorgan. Can we take a step back again and look at US construction? Doug, you noted on CNBC this morning that you are seeing more broad-based recovery in housing starts across the country. There's a thesis out there that the rental channel is secularly going to grow versus kind of contractor ownership.

What are you guys seeing out there right now? And Doug, when would you anticipate that your contract customers would start to purchase equipment again rather than rent, which they usually do at the beginning of a cycle but as we get into the cycle, they usually prefer to own their own equipment? What are you guys seeing out there and what do you think happens over the course of the next year or two?

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

My comments earlier on broad-based housing recovery is relative. I mentioned that I was on the West Coast, in California specifically, and I met with several contractors and all of them had for the first time in five years a subdivision underway. And none of them were massive projects like we saw in the 2000s, but it was fairly widespread in a subdivision here, a subdivision there in different areas of California. I was impressed with that, but from a very, very small, small base.

I've heard that elsewhere around the country as well. I think that housing statistics support that as we look at that. There's no question the rental market, the multi-family, is booming, I guess in some parts, and we take advantage of that.

I don't really see our contractor base significantly picking up more based on housing probably until at least next year. If anything happens, it will be transportation spending and some degree of clarity on that through the highway bill we just saw, I suppose, for the next 2.5 years, I would say if we see it, when we see it, it will really be spring but it's too late in the construction season to get much underway. We'll see it first in the rental market for sure, and depending on the prospects of the debt cliff and everything else in this country and how that settles out this winter, that will impact the spring greatly. So, I see a couple of those things coming together that could be positive, and if the country blows itself up as some of the politicians are threatening, I guess it would be negative.

Ann Duignan - *JPMorgan Chase & Co. - Analyst*

Fair enough. And then on the operating side, you noted that material costs were flat in the quarter. Should we anticipate or why wouldn't we anticipate that material costs, shouldn't they be a tailwind going forward from here, particularly even if pricing weakens from here but it's still a positive, shouldn't that be a positive for Caterpillar going forward?

Mike DeWalt - *Caterpillar Inc. - IR Director*

Yes, this is Mike. Even when commodity prices were moving up, the impact on our actual material costs was quite muted. If you go back to the first quarter, we were up about 1%. Last year, we weren't up much more than 1%. So it was -- the impacts on us are quite muted, and part of that is because we -- for a lot of our purchase volume, we agree to prices is annually. We are not -- the majority of our material purchases are not actually commodities. So, I think, broadly speaking, your sentiment is correct. Obviously, the portion of our business that is commodity related, the pricing is a little bit easier. But I wouldn't get carried away in terms of order of magnitude there.

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Ann Duignan - *JPMorgan Chase & Co. - Analyst*

And just a real quick follow-up on that one then, looking at taking $1 billion out of inventory by year-end, what would the target be for days on hand or inventory turns once we get through all of the sales of the Bucyrus distribution businesses, etc., etc.? What should we be looking at a year from now in terms of the right kind of inventory levels for Caterpillar?

Ed Rapp - *Caterpillar Inc. - Group President, CFO*

If I were going to look out the net out all the acquisitions and all that and look out into a 2013 type time frame, something around three turns would be a place I would call.

Ann Duignan - *JPMorgan Chase & Co. - Analyst*

Okay.

Mike DeWalt - *Caterpillar Inc. - IR Director*

That would be sort of -- think of it as FIFO, not LIFO.

Ann Duignan - *JPMorgan Chase & Co. - Analyst*

Okay, thank you. I appreciate that.

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

I just want to come in here a little bit on our inventory outlook, run rate, etc., going forward. And I will tell you that we are playing the game here on a world that grows maybe anemically, but grows between now and call it the next 12 to 24 months. We are not playing for an implosion. We are not playing for a drop like we saw in '08. The tea leaves that we see, based on the monetary conditions that exist right now and the easy money flows, should loosen up the economies a year from now.

What we are seeing today is -- are the effects and impact of pretty tight monetary policies a year ago. These things take time to wind through. We have only in our dreams arrived at an availability position that we have today where we can concentrate on market share and pricing, which we are doing.

I am very reluctant to take too bold of a move on inventory in China because we have seen this China show before many times in the last 25 years. We've seen it in terms of an absolute stop in demand for excavators and wheel loaders probably three times since I've been watching China in my career, maybe four. And within a year, we've seen a recovery, sometimes booming recovery and some just a nice recovery.

We are in a position today where, if we miss that and have insufficient inventory with the amount of competition we have there, we will be out of that game, meaning it will be hard to get into a leadership position that we want. So we are watching China very carefully. There's no question we have too much inventory for today's run rate of sales, but, again, I am not at all convinced that, a year from now or less or a little more, we will see China back on its feet as we have seen so many times in the past. And everybody can argue this is different and China has changed and maybe it has, but I suspect there will be some amount of recovery. We will be in a position where we have a availability and we can build PINS in our distribution model that will work for us long-term. That's not a dissimilar place where we are with PDCs. We arguably are a bit heavy everywhere today at the run rates, but we are in a position where we finally have availability that we have built capacity around that we didn't have in the last two recoveries around here. And certainly that's been part of our strategy to take market share with availability.

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Our quality levels are as good as we have ever seen them. Our efficiency levels are as good as we have ever seen them, and we now have availability in the marketplace. We are not playing for an implosion. We are playing for arguable growth, maybe anemic, but as I sit here today and we look at '13, as Ed said, it's almost got to be better on an economic basis, GDP growth in the world. And that's what we're playing for.

So while yes we are watching inventory, yes I am very worried about inventory turnover, we're doing all we can with our supply chain, and it is improving, we don't want to call this the wrong way with too little inventory, and I would say get stuck with too much. So, it's all hands on all levers every day with inventory and run rate. We've got schedules in the third quarter that are very much reduced with maintenance shutdowns, with vacation shutdowns around the world, and we'll manage production to sales that way as well. But inventory levels are important if we believe the world is going to grow, which we do, maybe anemically. I guess that would be my statement around all of that, which is a little lengthy, and I apologize for that. But it is something we are managing, we are being very cautious and guarded with, both on the upside and the downside when it comes to working capital, specifically inventory.

Ann Duignan - *JPMorgan Chase & Co. - Analyst*

Good point, Doug, thanks for the color.

Operator

Jamie Cook.

Jamie Cook - *Credit Suisse - Analyst*

Credit Suisse. Nice quarter. Two questions. One, Doug, with regards to the economic outlook you just sort of laid out and obviously you guys are a little more constructive on 2013 relative to what the market -- relative to what your stock is saying, I guess just beyond 2012, and given the environment you just laid out, how do you think about CapEx? Do we need to state this $4 billion number to meet your targets in an okay macro but slightly weaker than what you were calling for? And then I guess how do you think about share repo in that context, given where your stock is -- given where your stock is?

And I guess my second question is can you just talk about your comfort level with dealer inventory levels outside of China? And I guess my thought or concern would be as I talk to dealers and just given the weaker macro, and just given your ability to deliver and given the fact that your leadtimes have come in, do you think the dealers can sit there with less inventory than they have been historically, one, because they're concerned the macro is weaker, and two, they are not as worried as they were historically that Cat can't deliver? They have actual confidence that Cat will deliver the equipment, so they don't need to sit with as much inventory as they've have historically.

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

You've got a lot there, Jamie. Let me take the CapEx one right off the bat. We are on track to get close to $4 billion. But I will tell you also that each of our groups, whether it's Construction or Resource for our aftermarket business, are looking at that very carefully. We significantly I would say delayed some of our plans and most of our plans in China for the time being as a result of that market to see how that sorts out. We have an aftermarket distribution business that is very antiquated, that needs upgrading. And most of the CapEx you could argue is capacity related, but I would also equally argue that it's cost reduction related, a la the Victoria, Texas excavator plant, the small dozer plant in Georgia that we are expanding, bringing production back in. Those are cost reduction activities as well.

Again, we are playing for growth, albeit slight growth, and significant cutbacks in CapEx will only hinder us in '14 and '15. We may have to do it, as sure as I'm sitting here today, if something happens on a macro scale between now and year-end, and we have to take actions, we will. We've proven we'll do it. But right now, we are playing for some kind of growth in the next 12 months to 24 months. That's kind of around the CapEx; that's kind of around inventory question.

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I think there's no question that dealers are gaining confidence in our ability to supply equipment, and our PDCs are at optimum levels. Hopefully, that model will work; they will carry less; we'll carry more and the chain takes cost out. That's what we are seeing, but again depending on if we see growth or not, we'll have to adjust that model.

I forgot what you had in the middle there. Oh, share repurchase.

Jamie Cook - *Credit Suisse - Analyst*

Yes, share repurchase.

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

How can I forget that one?

Jamie Cook - *Credit Suisse - Analyst*

Especially at $82.

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

Well, it's dirt cheap at $82. But having said that, we have a balance sheet today with debt to debt and cap at 40%, and net debt position when we consider our cash and securities, it's somewhere around 34%, 35%. And I want to be sure that as we go forward in this very uncertain world, although I have painted it somewhat rosy with anemic growth, that we have a bulletproof rock-solid balance sheet that we never have to worry about our credit rating or dividend, which I don't think we do. Share repurchase is not on our radar screen today; it's the last of our priorities. I have said before and I think I've said to all of you that I hope, in my career, which has a few years to go, I can buy one share back. But right now, we've got other priorities and I think we are investing them wisely.

Jamie Cook - *Credit Suisse - Analyst*

Great, thanks. I'll get back in queue.

Operator

Robert McCarthy.

Robert McCarthy - *Robert W. Baird & Co. Inc. - Analyst*

It's Robert W. Baird. Jamie basically asked my question. But the other side of the -- the other side of that coin is with valuations depressed, and recognizing that uncertainty has a lot to do with that, how tempted are you try to take advantage of that, and continue what so far has looked like a pretty successful external investment program? I'm talking about acquisitions.

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Ed Rapp - *Caterpillar Inc. - Group President, CFO*

This is Ed. We've laid out our cash deployment strategy and I think you're going to see us consistently stay focused on it. We think the number one is the opportunity for growth. We've moved aggressively in terms of the acquisition space. We try to do it early in the cycle because it's easier to integrate as you work through the cycle.

I think, on the acquisition front today, our primary focus is what I would describe as slow down, chew and digest. We feel good about where we are at with the integration of Bucyrus, but it's a lot of work. We feel good about where we are at in terms of EMD, and Mike talked about the operating performance there, but there's still more work to do as well with MWM and Siwei. So I think you're going to see us stay clearly focused on integrating what we have in the acquisition space.

Robert McCarthy - *Robert W. Baird & Co. Inc. - Analyst*

If that's the case, you're not showing any appetite really to try to reduce the absolute level of debt on the balance sheet. So should we then expect to see cash continue -- you're generating significant free cash flow. Are you just going to watch that accumulate on the balance sheet over the next two to four quarters?

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

Maybe. We'd like to get that debt-to-cap gross number, not the net number, down into the low 30s. And I think that that sets us up to have any flexibility we want in a downturn, for acquisition or any growth opportunity that comes along. So I would say that the concentration of the balance sheet, while generating cash and making sure our pull-through numbers are at that 25% level is exactly where we would be in the next two years, particularly the level of uncertainty out there.

Robert McCarthy - *Robert W. Baird & Co. Inc. - Analyst*

My follow-up has to do with I guess disclosure, if it's the right way to characterize it. But we've now anniversaried the Bucyrus acquisition. So two sub-questions. One, does that mean, next quarter, you're going to stop providing visibility into its performance as differentiated from the rest of Resources? And second, Doug, do you have some plans to maybe quantify the Company's progress towards its existing synergy targets when we see you at Mine Expo?

Mike DeWalt - *Caterpillar Inc. - IR Director*

I'll handle the first part, how's that? And probably I'll handle the second part too.

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

Yeah.

Mike DeWalt - *Caterpillar Inc. - IR Director*

The first part is yes, we'll probably continue to report Bucyrus just as we are throughout the rest of this year. They are, for example, not in our monthly dealer statistics, from a disclosure standpoint. And we would plan on doing that, for example, at the beginning of 2013, where you have good comparables. So, we'll continue to break it out certainly for the rest of this year.

And in terms of Mine Expo, we have an outline at this point of what we are thinking about in terms of material to share at Mine Expo. And since it is Mine Expo, there will probably be a little extra emphasis on mining and Bucyrus as a piece of that. We'll talk about that.

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

Yes. We'll put some definite definition around that, some definition around that, and just tell you that our synergy plan in the business case is ahead of schedule as of today, and we'll talk -- we'll get into some detail on that in September for sure.

Robert McCarthy - *Robert W. Baird & Co. Inc. - Analyst*

We'll look forward to that. Thanks Doug.

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

You bet.

Mike DeWalt - *Caterpillar Inc. - IR Director*

We have time for one more question.

Operator

We have no further questions in the queue at this time.

Mike DeWalt - *Caterpillar Inc. - IR Director*

Thank you very much everyone. We are happy to report a great quarter and an increase in the outlook. With that, we'll sign off.

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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