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EDITED TRANSCRIPT

CAT - Q2 2013 Caterpillar Inc. Earnings Conference Call

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OVERVIEW:

CAT reported 2Q13 sales and revenues of $14.6b and profit per share of $1.45. Expects 2013 sales and revenues to be $56-58b and profit per share (at middle of sales and revenues outlook range) to be about $6.50.

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PRESENTATION

Operator

Good morning ladies and gentlemen and welcome to the Caterpillar earnings call. (Operator Instructions) 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. - Corporate Controller*

Thanks, Kate. Good morning everyone and welcome to our second-quarter earnings call. I am Mike DeWalt, Caterpillar's Corporate Controller. On the call today I'm pleased to have with me our Chairman and CEO Doug Oberhelman, and Group President and CFO Brad Halverson.

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Now this morning, undoubtedly we'll be discussing forward-looking information that involves risks, uncertainties and assumptions that could cause our actual results to differ materially from the forward-looking information. A discussion of some of the factors that either individually or in the aggregate could make actual results differ materially from our projections that can be found in our cautionary statements under Item 1a, Risk Factors, of our Form 10-K filed with the SEC in February of this year and also in the forward-looking statements language in today's release.

Now in addition, a reconciliation of non-GAAP measures can be found in our financial release. And again, that has been posted on our website at Caterpillar.com.

Now before we start the Q&A today, I'm going to be covering three main topics. The first will be a summary of our second-quarter results and revised outlook. Then I'm going to take a few minutes and talk a little bit about our business segments, and then I'm going to finish up with cash flow and the stock repurchase that we talked about this morning.

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So let's start with second quarter, which I'm going to discuss in two ways. First, I'm going to cover at a high level our second-quarter results versus the second quarter of 2012. And then I'm going to discuss the specific headwinds we faced in the second quarter and how we're thinking about them going forward in our expectations for the second half of 2013.

First, compared to the second quarter of 2012, our results this morning were quite a bit lower. But to put the year-over-year comparison in context, the second quarter a year ago was certainly a tough comparison.

The headline from last year's second quarter started with Caterpillar reports best quarter in history. Sales this quarter -- sales and revenues were $14.6 billion and that's a 16% decline from the second quarter of 2012. And this morning we reported profit of $1.45 per share, and that was down $1.09 from the second quarter of last year.

Now, the sales and revenues decline versus last year in dollars was about $2.8 billion, and about half of that was the result of dealer inventory changes and the other half from lower end-user demand. Now in last year's second quarter dealers bought more machines from Caterpillar than they delivered to customers. And their machine inventories rose again last year about $300 million.

In the second quarter of this year 2013, it was the reverse. Dealers bought less from us than they sold to their customers, and their inventory of new machines as a result declined about $1 billion. So, in combination, the impacts and the changes of dealer machine inventories was negative by about $1.3 billion for the quarter over quarter.

The remaining sales decline was a result of lower end-user demand for machines and, to a lesser extent, power systems.

The decline in profit was largely a result of that drop in sales. And on page 6 of this morning's financial release, we have a waterfall chart that would step you through the quarter to quarter changes in operating profit. It shows a decline in total from last year to this year of about $1.059 billion, and lower volume, which includes product mix, more than accounted for the total decline in operating profit.

So, the overwhelming story on the quarter to quarter profit decline was volume. And I think the waterfall chart covers the other plusses and minuses reasonably well.

So I'm going to change gears a little here and talk about the headwinds in the second quarter and how we are thinking about them relative to the second half of the year. And we'll start off with dealer inventory.

As I mentioned before, dealers took out about $1 billion of inventories in the second quarter. And that was a sales headwind for us, as our sales were about $1 billion below end-user demand.

In terms of what that means for the second half of the year, well, we expect that to continue. We think dealers are going to take inventory down another $1.5 billion to $2 billion or so between now and year end.

The continued dealer inventory decline, in fact, is the main reason we lowered our sales and profit outlook for 2013 this morning. We're expecting sales and revenues in a range of $56 billion to $58 billion, and profit of about $6.50 a share at the middle of that sales and revenues range. That's a drop of about $2 billion on the topline and $0.50 a share at the bottom line.

So, dealer inventory reductions were a headwind in the quarter, and the main reason we lowered the outlook.

Now, our inventory was also a headwind in the quarter. In addition to what the dealers took out, we cut inventory by $1.2 billion in the quarter. That was negative to profit from a cost absorption standpoint. And just to help you get a handle on the profit impact, we use a rule of thumb of 13% to 15% of the inventory change.

The year-end expectation for our inventory is that it will end the year about where it ended the second quarter. That means we do not expect the profit headwind that we had in the second quarter from inventory absorption to continue in the second half of the year.

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In addition, we also had a substantial currency headwind in the second quarter. And in this context, I'm not really talking about year-over-year. I'm not talking -- I'm not comparing to the second quarter a year ago.

I'm talking about actual translation and hedging losses of about $134 million that happened in the quarter and were reported in the other income and expense line of our P&L, which is a couple of lines below operating profit on the P&L.

Now as we put our outlook together, we don't forecast future currency movements. We do our outlook based on exchange rates as they are. As a result, our outlook does not expect currency translation and hedging losses in the second half of the year like the $134 million in the second quarter.

Now the flip side of that is we did have a positive item in the quarter. We had $135 million gain on our settlement related to the Siwei acquisition, and that's also something that we don't expect to repeat.

So, as we are thinking about the second half of the year kind of relative to the second quarter, the average sales for each of the two quarters on a quarterly basis in the second half is about the same as the second quarter. But we don't think will have the negative cost absorption impacts like the second quarter had. We don't think we'll have the $134 million -- at least in our outlook -- of currency losses, and the current -- or the Siwei [$135] (corrected by Company after the call) million gain we don't expect to continue.

The other difference that we're -- that you need to take into consideration is that we're taking additional actions to reduce costs in the second half of the year. Now, we started taking action in the second quarter and began implementing cost reduction measures, and we're going to do more of that in the second half of the year.

Okay, that's enough for now on the quarter and the outlook. I'd like to change gears just a little bit and talk about segments.

Now, I'm going to start by saying that our largest segment this year by sales has been Power Systems. Our most profitable segment this year has been Power Systems. The highest margin rate of any segment this year has been Power Systems.

Now, I know that most of you on the phone here today already know that. But there are many casual observers of Caterpillar that if you asked them that question would have said mining, which is in our Resource Industries segment.

The point of this discussion is that we serve a number of different cyclical industries. But thankfully, they don't all follow the same path at the same time. The diversity within and in fact between our segments helps mitigate year-to-year swings in sales both down and up for the Company.

The Power Systems segment, again our largest and most profitable segment over the past five years, has also been relatively speaking the most stable of our three large equipment segments. And that's because it spans a number of different industries itself -- electric power, oil and gas, rail, marine, and industrial engines.

And actually, even within those industries there's diversity. In oil and gas for example, our sales of engines for drilling and fracking are weaker, but gas compression continues to do pretty well.

Moving on, our Constructions Industries segment sells an extensive range of construction equipment around the world. It supports infrastructure development, commercial and residential construction. The worldwide construction industry is showing signs of recent improvement but remains relatively depressed from a historical standpoint.

Construction in the United States, while starting to turn up, is still far below the 2006, 2007 peak. And the construction equipment industry in Europe is, as you'd expect, well below the prior peak. And construction equipment sales in China in 2013 we expect to be about half what they were in 2011.

The point is there's a lot of room to grow, just to get back to where we've been before. When economic and construction activities begin to improve in the world, you know, particularly in the US and hopefully eventually in Europe, it should be a positive for our business.

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Our Financial Products segment is also important to our business and it's doing very well. It provides financing to end-users that purchase our equipment and it also provides financing for some Caterpillar dealers. Financial Products revenues and profits have proven to be much more stable through the business cycle than our product related businesses, and they are currently performing well. Revenues this quarter were up 5% from the second quarter a year ago and profit was up.

Now the segment that's currently getting significant attention is Resource Industries, which is primarily mining. I'm going to give you a rundown of what's happening in mining. But before I do that, I'd like to point you to today's financial release. And on page 16 in particular, question number 5 in the Q&A in the back of the release, we've tried to provide a pretty comprehensive discussion of the mining industry and how it impacts our sales.

Now the high points of that discussion start with the production of mined commodities. And the underlying health of the mining industry relies on commodity demand and production. And based on the data that we've seen, it looks like mining production in 2013 is going to be a little higher than it was in 2012. And recently a couple of the big public mining companies have reported they are producing at record levels.

Now commodity production underpins the need for mining CapEx. And despite 2013 increases in commodity production, it is clear that mining companies are currently cutting their CapEx after significant increases in 2011 and 2012. While we don't specifically accumulate CapEx estimates ourselves for the industry, we do follow the market surveys.

Based on those surveys, it appears total mining CapEx in 2013 is likely to be down 5% to 10% from 2012. And some surveys are also indicating a further CapEx decline near 20% for 2014.

Now the mining industry CapEx includes spending on exploration and development, building and structures, things like processing plants and equipment. At Caterpillar, we are most impacted by spending on equipment.

While we don't have consistent CapEx deals at that level of detail for the industry worldwide, we have reviewed data at that level of detail from the Australian Bureau of Statistics. And it tells us that over the past few years the largest and fastest-growing category of CapEx in Australia was for buildings and structures. And while this is the largest category, the most significant declines in 2012 have been for exploration and development and equipment.

And based on our own experience with large capital projects that makes sense to us. It's difficult to stop construction on large-scale facilities once they get substantially started. That means in the short-term, we believe that more of the decline in mining CapEx is for equipment, things like Caterpillar machines.

And that leads us to end-user demand for our products. That is how much Cat dealers are actually delivering to end users, the mining companies. Year to date deliveries to end users and our expectations of what dealers will deliver for the full year are declines of about 20%.

While dealer inventories are down -- while dealer deliveries, I'm sorry, are down -- for the type of equipment that we make, we believe we're doing a little better than the equipment industry overall.

And that brings us to Resource Industries sales. So we started with CapEx, we have moved on to end-user demand from our dealers and now to our sales. And to relate the decline in mining and equipment demand placed on our dealers to our sales, you need to consider several other factors besides mining CapEx.

Our Resource Industries segment includes things that are not directly related to mining CapEx, like aftermarket parts sales as well as equipment sales to the forestry, paving and quarry and aggregate industries. Although Resource Industries sales of aftermarket parts are down a little inthe second quarter of 2013 compared with a year ago, the decline is much less than the decline for equipment, and in the context of the total decline in sales for Resource Industries, it's just not a significant factor.

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And the collective sales of equipment for forestry, paving and quarry and aggregates are also down. But again, the vast majority of the decline in Resource Industries sales for the quarter, the second quarter of 2013, is mining equipment.

Now in addition to those factors, to understand our sales, you also need to consider dealer inventory changes. Dealer inventory increased in the second quarter last year, and it declined substantially in the second quarter of 2013. That means that last year we were selling more products to dealers than they were delivering to the end-user mining companies. And in the second quarter of this year, we sold far less equipment than dealers were selling to mining customers.

In fact, our sales of traditional CAT mining equipment such as mining trucks, large track-type tractors, and wheel loaders, would have had to have been more than 50% higher in the second quarter to match what dealers were delivering to end-users.

In the second half of 2013, we expect that dealers will continue to substantially reduce their inventories. And that means we expect to continue to undersell mining demand for the remainder of 2013.

Given the substantial decline in sales in 2013, the uncertainty around when cyclical recovery will resume, we've taken substantial action to adjust our production levels and to reduce costs. We expect to take further action in the second half of the year.

Now our intention is to reduce cost and drive operational improvement, and do it in a way that doesn't significantly reduce our ability to ramp up when production improves.

I know many of you would like to get a better understanding of what we think will happen after 2013. Now we're going to discuss that here for a couple of minutes, but we want to start by saying we are not providing a sales outlook for 2014, either for Resource Industries or for Cat in total. It's certainly too early to do that.

And the activities over the past five years in the mining equipment industry certainly reinforce that. It's experienced significant demand shifts both up and down, and the mining industry overall has had difficulty in forecasting those shifts in advance. And frankly, that's impacted our forecasts.

We understand that. It's a part of being in this industry. And this year is a good example, as mining companies have been cautious and dealers have reduced their inventories.

What we will discuss here this morning is what the industry surveys, not our forecast, but what the industry surveys about next year suggest and what that could mean as the impact of dealer inventory reductions wind down.

Now earlier I mentioned that we've seen surveys that suggest another 20% decline in mining CapEx in 2014 from 2013. Again, that's not our estimate and we're not providing an outlook. But if you take that CapEx survey at face value it suggests another down year in 2014.

To put mining CapEx in the context of our sales, though, you have to consider the impact of dealer inventories. Even if dealer inventories -- or, I'm sorry, even if dealer deliveries of new mining equipment were to be down 20% next year from 2013, if we see an end to the dealer inventory reductions over the next few quarters, we believe our sales of new mining equipment to dealers would be positive.

In other words, we believe the significance of the end of dealer inventory reductions would have a more significant positive impact on year-over-year sales than a 20% decline in end-user demand.

Just to clarify this, we're not suggesting an increase in inventories next year, just the absence of the big declines in 2013 that pulled our sales well below what dealers are delivering to mining customers.

Now in addition to that, if the world economy continues to improve, we would expect commodity production to also increase, and that coupled with a relatively large number of new machines placed in service over the past several years, that should be a positive for mining aftermarket parts sales. Again, that's not -- this is not a forecast for 2014 at this time. It's too early to do that.

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The purpose of this discussion was just to illustrate for you the significance that dealer inventory changes are having on our mining business today, and what the implications are for when the decline comes to an end.

Now, looking further ahead, our long-term view of mining remains positive. Commodity demand is driven by economic growth, population increase and rising standards of living. And we believe they will all continue to improve over the long-term.

In addition, declining ore grades implied that in the future more material will need to be moved per ton of commodity output. And that's another positive, at least from our perspective, for long-term equipment needs.

Finally, much has been written and said about the impact of China on commodity demand in the mining industry. Our long-term view of China is also positive. We expect continued urbanization and improvement in the standard of living for the people of China. We believe that means more electricity production will be generated and increased production and consumption of goods in general.

Now, increasing electricity production in particular is a positive for coal. Coal makes up a large portion of the electricity generated in China and they continue to add coal-fired capacity.

Now that said, we do not expect the significant economic growth rates that China experienced over the past 10 years will continue indefinitely. But we do believe that China will continue to grow at a much faster pace than the rest of the world.

And it's also important to remember that over the past 10 years the size of the Chinese economy has more than doubled. And that means that economic growth rates of 7% to 7.5% have a greater impact today than a 10% growth rate would have had 10 years ago. It's a big economy that, relative to the world in total, is growing faster.

So, in summary on mining, we don't expect much change in the environment in the short-term and the remainder of 2013 will be tough for our mining business. As dealer inventory reductions come to an end, our mining equipment sales could rise from 2013 levels even if mining CapEx declines. And our long-term of mining remains positive.

The world needs mined commodities. As the world grows, we believe commodity demand will continue to increase.

One last quick topic and then we'll go on to the Q&A, and that topic is cash flow and cash deployment. While it was certainly a tough quarter for sales and profit, our Machinery and Power Systems operating cash flow was better than it's been in a long time.

We generated $3 billion worth of operating cash flow in the quarter, and that's a substantial increase from $1.3 billion in last year's second quarter. And we've put that to work for stockholders.

In the second quarter, we repurchased $1 billion of Cat stock and we announced a 15% increase in the quarterly dividend. And in this morning's financial release, we announced that with the strength of our cash flow, balance sheet and cash on hand, we expect to repurchase an additional $1 billion of Cat stock in the third quarter. Repurchasing stock in the downturn has been a key part of our cash deployment strategy and we're executing on it.

So, with that, we're ready to open up the floor for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Robert Wertheimer, please announce your affiliation, then pose your question.

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Rob Wertheimer - *Vertical Research Partners - Analyst*

It's Vertical Research Partners. Thank you. Good morning, everybody. Let's see, let me just start with Power Systems since you did highlight that division.

I mean, you had one of the strongest margins you've ever had, and wanted to just check in on whether you're seeing -- well, actually, just whether that was a mix-related -- you know, I know backup power gen has been off or whether it's structural improvement in the margin in that division, and then whether you are seeing any change in electric power at all.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Yes, you know if you look actually, Rob, at the dealer statistics we put out yesterday morning you can see that's a little bit better than it was a year ago. I think a lot of that has to do with it was kind of even turned down a year ago. So I think a little bit on electric power in particular, the comps will probably just continue to get a little bit easier.

I think for Power Systems overall they had a pretty darn good quarter. Sales volume was down a little bit but some of the pieces were up. I think more of their profit improvement had to do with they had a little price realization and they'd done a pretty good job on cutting costs.

And as opposed to power -- or as opposed to Construction and Resource Industries, they didn't have near the decline in inventory that those other two segments did. So the absorption impact was relative to the Company in total a lot smaller for them.

Rob Wertheimer - *Vertical Research Partners - Analyst*

Could I ask you a different question? I'm not sure if this is one you're willing to or able to answer, but is it possible to look through the turmoil that has gone on in Resources over the past six months and think about what your margin would be in a more stable environment at these volume levels?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Well, you're right; I'm not going to throw out a number. But I think -- in my opinion, we had one positive item, the Siwei settlement, that would be in their numbers that you would have to take out. That would actually make it a little bit lower.

But we are in the middle of pretty heavy inventory decreases, and that in total, the amount that they're really underselling real demand and absorption impact probably more than offset that.

And since we're moving from -- let's just say higher volumes over the last year to lower volumes this year, you know, cutting costs has been a process. And that's going to continue into the second quarter.

So if, for example, you know volume -- end-user demand kind of hung in at this level, our sales would probably go up a little bit because we stopped cutting inventory. We wouldn't have the Siwei adjustment in there. But costs would likely be lower as we've, as we are part-way through kind of the cost-cutting activities that we've been doing.

I guess my thought is that it would probably be a little higher than it is now. But I don't know that I would want to throw out a number.

Rob Wertheimer - *Vertical Research Partners - Analyst*

I guess that was my two, thank you Mike.

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Operator

Ann Duignan, please announce your affiliation then pose your question.

Ann Duignan - *JPMorgan - Analyst*

Hi, good morning, JPMorgan. I'll start out with the decremental margin question. Doug, you've been pretty vocal about driving for 25% pull-through. Can you talk about the decrementals this quarter, whether they were disappointing or not to you? And are we going to get back to 25% by year-end?

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

Hi Ann, this is Brad Halverson and it's a good question. If you look at the second quarter I think there's a couple of things if you look through the write up to consider in terms of results.

One is close to 70% of our drop in sales are mining, which is negative for mix. But even putting that to the side, if you just look to the period cost absorbed kind of impact, you will get to a decremental margin slightly under 30%. And we've talked about 25% to 30% kind of a decremental margin in terms of our target. So for the quarter you would get slightly under 30%.

If you look full year at our outlook, even with all the headwinds, you'll get to a decremental pull-through of 24%. And this is something that we spend a lot of time on internally. We have targets that we've committed to. And if you look across our segments, Resource, Construction, Power, Financial Products, each of them as we have talked about before have made a commitment as to what they'll make at certain volume levels, which ties to our external commitments. And they are executing on that. So when we get to the end of the year, we'll be at [6.50], right around 24% which is, with the mining headwind, I think a good number.

Ann Duignan - *JPMorgan - Analyst*

Fair point, thanks for the clarification. It's normally in the press release but it wasn't conspicuously there today.

My follow-up would be on pricing. You also mentioned in the press release some negative pricing. I think it was in Resources in Australia.

Can you talk about pricing overall and where you are seeing the most pressure obviously, probably in mining? But why would we be giving up pricing at this point in the cycle?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Yes, Ann, this is Mike. Just a couple of comments. You know, I think when we talk price realization here, it's versus the second quarter a year ago. And again I don't want to harp too much on this. But we had an absolutely fabulous quarter a year ago.

Price realization the second quarter last year you know kind of everything came up heads. And we had just about $500 million reported for last year, which was pretty close to a third of the whole year. So, I think to start the discussion off, it was in total, and in particular for price, a pretty tough comparison.

We did have a slightly negative price realization, well less than 1% for Resource Industries and for Construction Industries. For Construction Industries, it was mostly in Latin America and we have a few big deals going on down there that had a little tighter pricing.

And I think for mining in general, it's a tough market out there right now. I mean volume is down quite a bit. And I think by and large we're pretty close to holding our own, again with a slight reduction in the quarter compared with really big quarter a year ago.

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I don't think there's any big fundamental shifts. You didn't ask this question but I'm going to answer it anyway. As a part of this updated outlook, before we were kind of talking about 1% up this year. We're not far off that.

You know I think we're looking at just a little under 1% for the full year for the total Company this year. So it was a little tighter, I think, in the second quarter? But pricing didn't overall go down; it was helped a little bit by better numbers out of Power Systems.

Ann Duignan - *JPMorgan - Analyst*

Okay, wonderful. That's my two up, so I'll turn it over. Thanks guys.

Operator

Ross Gilardi, please announce your affiliation then pose your question.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Hi, Bank of America. Thank you. Mike, in talking about mining, there's an awful lot of focus on dealer destocking and the business is a big source of pain. But this is a made-to-order business. So I mean, isn't the real fundamental issue that miners are just canceling orders and as long as that remains the case, you're not going to see much of a pickup in production and margins unless -- until you see a pickup in orders?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Yes, Ross, that's actually a great point. And one of the things I think that's been impacting orders, remember we don't take orders directly from the mining companies. We take orders from the dealers. The dealers take orders from mining companies.

So if you look at the destock in inventory, I think that's certainly having some impact on the dealer order rates to us. So we definitely would like to see order rates pick up.

But, you know, I think certainly until we get through the inventory reduction, that will probably be a drag at least on orders placed on us. But to your point, I'll just kind of go back to it.

I talked about the surveys that suggest mining CapEx down another 20%. For that to be the case, I mean, orders have to pick up. I mean if dealers don't order anything -- or I'm sorry, if customers don't order from dealers and dealers from us don't order anything, or don't order more, then 20% is just not -- I don't think it's in the cards. That would look like an optimistic number.

So, I think that for mining CapEx next year to be down 20%, they have to order more. Dealers would have to order more from us than they are today.

I'm not trying to make that overly complex. But to say that even a 20% decline in mining CapEx, considering that dealers ought to be out of inventory here pretty soon, would have to mean more orders placed on us. Maybe that's a better way to say it.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Okay, thanks Mike. And then you mentioned in the discussion of Resources in the press release that acquisitions and divestitures negatively impacted operating profit by $33 million in Resources. And I believe that's with $135 million gain from Siwei in there.

So is that $33 million a year-on-year swing in earnings? Or should we assume that Bucyrus is loss-making at this point?

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Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

No, no, no, no, no. I think what you need to do is go back in our second-quarter release from a year ago. One of our Q&A's in the back of that release had quite a bit of detail on Bucyrus. And included in there we had pretax gains on the sale of Bucyrus distribution. We had some big ones.

So, basically, the gains from last year on the sale of Bucyrus distribution to some of the big dealers more than offset the $135 million this year.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

I got you. Just related to that, though, have you had an impairment test for Bucyrus yet? And if not, is there a next test coming up? Do you do that annually?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Yes, we do that annually. You know I -- I want to be careful how I answer this. You know if you do an impairment test, it looks forward to what you think you're going to generate in that business over a longer period of time. And we certainly wouldn't be using a cyclical low straight-line going forward.

You know our mining business, I think there's reasonable headroom. I certainly don't want to predict what a test would be. But I think the chances of an impairment there are probably not -- certainly not likely.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Okay, thanks very much.

Operator

Ashish Gupta, Please announce your affiliation and then pose your question.

Ashish Gupta - *CLSA - Analyst*

Hi, good morning, it's CLSA. I believe in the past Doug mentioned that China is not over-excavated and I'm wondering kind of what the pickup in sales we have seen recently, I'm wondering how to think about the machine population over time. Now that we're moving to more to maintenance from infrastructure, I'm just wondering how you guys view the long-term machine population in China relative to some of the more developed economies.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Yes, I mean, this is a case where there's a short-term story, there is a long-term story. I think clearly if you looked at long-term, I mean, I know the market doesn't like to look out this far. But if you look out at a point where China is developed, say, for the level of Japan or South Korea or Europe maybe, the excavator population, the construction equipment population in terms of equipment relative to the economy, currently is a lot lower than those developed countries.

So, you know as the standard of living rises there, as the level of development builds out over time, the population of equipment in China will certainly need to grow. I guess the big question you have is will that take three years, five years, 10 years, 20 years, 50 years? And I think that depends a lot on the scale of China's growth.

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From our perspective, I think it's going to grow. Our view is it's probably I guess the second biggest economy in the world today, and it's growing at a faster pace than the rest of the world. And its importance is going to grow and its level of development is going to grow.

And I think as a result of that the construction equipment industry there is going to need to grow. But it is true, and we see that in our parts sales in China.

As the population has increased and the equipment gets used, it has driven part sales up in China over the past few years. And as that population continues to develop, that's a trend that will probably continue.

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

Yes, Doug Oberhelman here. I'll just comment a bit on China as we see it and particularly as I see it. I am not one in the camp of a China implosion, that China will implode and drag the world down into a massive black hole.

I think what we will see in China is very healthy with a much slower rate of growth, and I would call it 5% to 8%. They say 7% to 7.5%. So be it.

But that means a maturing of that market for construction equipment and all kinds of things. And as that economy has doubled in the last decade, we have seen our field population of machines grow and grow and grow, allow parts and service opportunities for our dealers, and our business model plays well with that. And that's exactly what we're trying to do.

We've also been working hard on market share in China. And that is up, and we're quite happy with that. And in fact year-over-year sales are up, that is for all of our business in China, fairly substantially.

So we're going to see China go in fits and starts. I've said this before to many that I hope we don't see another double-digit boom . The after effects of that and the residue is painful for everyone.

A 5% to 7% to 8% growth rate is just fine. We have sized our business for that. We'll do very well with that, particularly trying to get to a leadership position in market share. And that's really the way we see China overall.

Mining certainly is an opportunity there and we're working on that. Much of that is underground, as you know. We now have an underground offering to work with.

So long-term, China and mining are appealing to us. Short-term we go through cycles. And we are certainly in that downturn at the moment.

Ashish Gupta - *CLSA - Analyst*

Thanks for that, Doug. Just one quick follow-up. When you guys look at your global fleet of machines with GPS data, can you help provide us with some sort of indication of what you're seeing globally by region?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

You know, Ashish, I'd like to give you the answer to that. But of all of the myriad of data that I made sure I was up to speed on before I came in here today, I didn't look at that. So I don't know the answer.

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

We can't do it regionally anyway. But overall machine operation -- service meter units on the field population that we have monitored today are relatively steady and have been. And I think -- as we look back a few months. So overall that's a worldwide number including the US, China and everywhere else in the world. So it's hard to say that regionally.

Ashish Gupta - *CLSA - Analyst*

Great, thanks very much.

Operator

Andrew Kaplowitz, please announce your affiliation then pose your question.

Andrew Kaplowitz - *Barclays Capital - Analyst*

It's Barclays, good morning guys. So, if you look at your press release, one of the things that you said is you believe it's unlikely that dealers will continue to reduce machinery -- machine inventory in 2014. So maybe, Mike, if you can talk about your conviction level in that statement. This is the first down cycle that you had with your PDCs, with your product distribution centers.

So, I guess what I'm wondering is there any way to look at the overall inventory in the channel between the PDCs and the dealers to get a read on whether you think inventory is low enough that you can sort of make that statement? Because it's hard for us because the PDCs are a relatively new development.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Yes, that's actually a very good question, Andy. If you just look at dealer inventories, they are really, today, really on the lower side of the historic range. Actually, you know, really on the lower side. If you include PDC inventories, right now the sum of the two is probably right kind of -- maybe more in the middle of a reasonable range.

We're looking for continued dealer inventory reduction through the rest of this year. We're looking at somewhere between $1.5 billion and $2 billion coming out in the second half, so further from here. Mining inventory probably be at about half the level that it started the year and construction down some.

Now your question about conviction level, as in all things, it depends upon what the economy does, what our sales forecast for next year ends up being and we don't have that. But if you look at just where months of supply are, the severity of what's happening, kind of particularly in construction the trajectory of the way the sales chart looks, I think there is a pretty reasonable conviction that dealer inventory is certainly not going to have the kind of declines it had this year.

And probably, I guess at this point I think it would be -- we would have a pretty reasonable conviction that it's not going to go down, certainly at least much, next year. But again, I'm going to qualify that, because it depends a lot upon what happens to sales and to some degree when it happens next year.

Now just a couple other comments, dealers are using PDC quite a bit more this year. The usage rate, the percent of dealer machine sales that are coming out of PDC is actually quite a bit higher in the second quarter than it was last year. So, it looks like dealers are using PDC inventory and that's a good thing.

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Our delivery times for product to dealers, you know, compared with a year ago are much less and I don't think that's probably a surprise. So, that's happened.

So I think that's there's a pretty reasonable conviction on dealer inventory that it's going to slow or stop.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Mike, it's fair to say then that at the end of this year, when the dealer inventory comes out as you expect, that the addition of PDC plus the dealer inventories would then be at the low-end of your historical range versus dealer inventories in the past?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Well, that will depend upon what our forecast of the first-quarter sales is, because when we look at it in months of supply, it's kind of related to the forward-looking sales estimate for the quarter. So, since we don't have that out there right now, it's a little bit tough for me to just say that. But I think our expectation is it would certainly be in the range, yes.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Okay, and then if I could ask a follow-up on Resource Industries margins. I know people are already hitting you on that. I guess the issue that we have is the decremental margin and that particular business looks exceedingly low, and you've talked about really accelerating cost take-out in 2Q.

Is it possible to quantify how much cost take-out you really started in 2Q in terms of expense, so maybe we can sort of parse through why the decrementals were so low? I know you're going to tell me that mix is negative also.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Well, while mix is certainly negative for the total Company because more of the decline was mining. But you know we have -- we introduced this concept of profit curves inside the Company to manage the business and each of our three segments have a profit curve.

In other words, if sales go up, there is an expectation of a certain amount of profit. When sales go down there's an expectation that only that much will come out. It's basically think of it as an incremental and decremental margin rate for each segment.

And the take-out rate for mining is a little higher than the 25% that we look at for the total Company, and that's probably not a surprise. So we're trying to take actions on costs that will allow us to get as close as possible to that sort of curved decremental margin rate.

So they've been -- I'm not going to quantify it for you, but they have been doing rolling layoffs, rolling temporary layoffs for salaried management employees. We've taken R&D down a little bit.

And the things that we're going to do in the second half of the year we certainly haven't announced to our own employees yet. So the specifics on that are probably going to start coming out I would guess over the course of the next month or so. So it would probably be better to talk about specific items after that. But definitely we're planning to take some more action here in the second half of the year.

Now one thing that -- and this is through the first half of the year and this will ease in the second half of the year. It's particularly hurting decrementals. And that is this period cost absorption.

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We added a lot of inventory in the first half of last year and the second half. I'm not talking dealer inventory. I am talking our inventory. And in this year's first half we've taken inventory out. We took about $0.5 billion out in the first quarter, we took [$1.2 billion] (corrected by Company after the call) out this quarter.

And that has primarily impacted Construction and Resource Industries. And the more vertically integrated you are, the larger the impact is on your business. And that's been a particular negative for Resource Industries in terms of incrementals. It was a positive last year, a negative this year.

It's not really an operational item. You know, when you think about it, it's not operating efficiency. So, as the inventory declines start to slow down, that should be a little better in the second half.

Andrew Kaplowitz - *Barclays Capital - Analyst*

And for that segment the decrementals to inventory reduction would actually be higher than 13% to 15% as you said, for the whole Company?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Yes, we don't -- we've not given out a number overall. But if you think about it, the absorption thing is basically down to fixed costs that essentially get absorbed in and released from inventory, you know, when you build and sell inventory.

If your entire business was just buying and selling material, you wouldn't have a lot of value-added to absorb. And then the businesses where you're a lot more vertically integrated you would have more and I think Resource Industries is probably a little more vertically integrated than Construction, for example.

Operator

Jamie Cook, please announce your affiliation and then pose your question.

Jamie Cook - *Credit Suisse - Analyst*

Hi, good morning, Credit Suisse. I guess just two quick follow-up questions. Under your new forecast, I think your old forecast implied that mining OE would be taken down about $7 billion. What are your assumptions under your new forecasts?

Because I'm just trying to back into what mining OE will be in as a percentage of total sales as we exit 2013, because I actually think that would be most helpful as we can all -- we all have different macro assumptions or assumptions on mining. But if we could get a sense of what mining OE would be, I think that would be much easier for us. And as I calculate, it could be as low as 10% or as high as 15% and I'm just wondering how off I am.

And I guess my second question, Mike, last quarter I think you said your core mining business would be down 50%, (Bucyrus) 15%, and then aftermarket flat. Can you talk to what your new assumptions are? Thanks.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Yes, again, if you look at the last outlook and this outlook, the main driver of the decline is dealer inventory. So that I mean that's the biggest driver and that is machines, so it's a combination of Resource Industries and Construction.

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What we're looking at in the back half of the year is probably more slanted to Resource Industries. So I think proportionately, of the decline in the outlook, more of it would've been Resource Industries, certainly, than Construction. And actually, Power Systems is sort of flat to slightly up in the outlook.

Jamie Cook - *Credit Suisse - Analyst*

Okay. But you didn't answer the question on --

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

We don't disclose new equipment separately from aftermarket in our results, so I can't really give you a mining equipment number separate in resource industries. We just don't disclose it that way; I'm not trying to be cagey.

What I am trying to tell you is that whatever your current estimate is, probably the majority of the decline in the outlook -- when I say majority, I mean more than half in this context -- would be Resource Industries for equipment they have, they have more of the decline in dealer inventory in the second half.

Jamie Cook - *Credit Suisse - Analyst*

And then any change in your assumption, so Bucyrusis trending what you thought aftermarket. Can you just talk to those relative to your last forecasts?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Yes, I think directionally both of those numbers are kind of the same. But remember when we were talking about the 50%, that's not end-user demand,that's what we're selling to dealers. And that has been impacted of course by the dealer inventory. So, you know that means that our sales of the traditional product is down.

The Bucyrus product is down a little bit, but I think that sort of proportion that you used with Bucyrus sales holding up much better than the traditional Cat product is absolutely true. And a lot of that is because the dealer inventory impact is much more pronounced for trucks and dozers and wheel loaders than it certainly is for Bucyrus product.

Jamie Cook - *Credit Suisse - Analyst*

And then the mining aftermarket? I mean --

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

It's holding up, it's holding up pretty steady. We had a really strong first half last year. You know coal mining was still doing okay. And then it's kind of -- it started to tail off a bit in the second half of last year. But you know, our expectations for aftermarket this year haven't really changed.

Jamie Cook - *Credit Suisse - Analyst*

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

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Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

To any degree that you would be concerned about.

Operator

David Raso, please announce your affiliation and then pose your question.

David Raso - *ISI Group - Analyst*

ISI. I'm just trying to gain some comfort with the second half implied margins. If you pull out the settlement gain in 2Q, the margins for the year so far are about 8% and 9%. The second half of the year is implying more like 11.5% to 12% operating margins.

So when I think about how to bridge that gap, basically find about 300 bps of margins improvement, you're looking for sales growth of about 7% sequentially first half to second half. And I can get a decent amount of that margin improvement with a pretty healthy incremental margin on that sequential build increase.

But can you help us a bit with the mix to better understand the incremental margins, the overhead absorption benefit? Where do you see the 7% sequential increase, which businesses, maybe geographies? Just help us a bit with trying to get a feel for how much could the incremental margins be, the overhead absorption benefit, what could it be on that sequential improvement?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Yes, I think if you're just -- when you say incremental margins, you're talking about kind of from the first half to the (multiple speakers) second half?

David Raso - *ISI Group - Analyst*

Yes, I'm talking sequentially.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Yes, yes, yes. I think there are three big things that are driving that. One is just the absence of negative inventory absorption.

And if you start with the premise that the second half of our year, if you look at the implied guidance at the midpoint of sales and revenues, it has sales in the second half of the year averaging about what they did in the second quarter, but up a bit from the first half average. So volume will be some help and we would certainly expect reasonable incremental margins on the volume. I mean, I'm not talking massive, but our kind of target range is around 25%.

And so incremental margin on volume second half versus first half a little better.

I think the second thing is absorption. That was a pretty big deal the first half, and in particular in the second quarter we had $1.2 billion inventory decline, so that had a pretty sizable effect.

And I think the third thing is if -- to get to a point where inventory is not going to go down further, our production needs to go up. And that's certainly the case particularly for Construction. So that ought to be positive for just efficiency in general.

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And then we have cost reduction activity. We've said were going to do it. We haven't really, particularly because we haven't announced it internally, any specifics. But we're going to take additional actions in the second half of the year to lower costs.

So, volume, some efficiency as production goes up, absence of the large negative cost absorption impacts and some additional cost reduction.

David Raso - *ISI Group - Analyst*

But where is it coming? You mentioned Construction. But if you had to handicap the 7% increase in revenue sequentially first half/second half, is the increase mostly in Construction? Is it Power or even suggesting Resource Industries sequentially better? I'm just trying to get a feel to better gauge the incremental profitability.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

Yes, I think you would -- normally if you think about fourth quarter, our Power Systems business usually has a stronger second half than they do first half. So I don't know anything this year that would cause that to be different. And where we are ramping up production is mostly in Construction.

David Raso - *ISI Group - Analyst*

Okay. Lastly, not to even suggest you going to tell me 2014 sales guidance, but just going from what you've articulated in this press release and this discussion, you feel inventory won't be lowered further next year as a base case, right? So that's $3.5 billion of Cat sales growth next year if retail is flat. I mean that's a caveat there.

But when I think about your commentary and your thoughts around Construction and Power, can we walk away from this call saying base case Cat is thinking revenue growth at a bare minimum is up next year?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

You know, I would love to answer that question directly. But -- and I said it about five times in my script -- we're not doing an outlook.

I think the message that were trying to get people to think about is just the scale of the impact that dealer inventory reduction has had in this year, and the likelihood that there's a lot of water to go under the bridge, and so I'm hesitating a little bit on making too much in the way of predictions about next year. I think given the scale of what's happened this year it's certainly not likely that that's going to happen again in terms of dealer inventory reduction.

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

David, Doug here. I've kind of been waiting to make this point. And this inventory swing up and down has been painful on us and our dealers.

That is the fundamental reason we established our enterprise system structure, organization and emphasis a few months ago, working on lead times, lean manufacturing and really getting after a condensed supply chain. And that's my number one initiative between now and the end of 2015. And I think I said in the last call we expect to see some of that in 2015.

There's lots of fruit to be picked on this one. And if there's ever a reason or a good way to get after it, it's this inventory swing that we've seen up-and-down. I just want to make sure you all understand how important that is that we get that organized.

We've come a long way, but we still have a ways to go with that. And we'll start to see that manifest itself late next year and certainly into 2015 a little bit.

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David Raso - *ISI Group - Analyst*

Okay, thank you very much.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller*

All right, with that I'm afraid we're at the end of our hour here today. Thank you very much for joining in, and we'll talk to you again this time again next quarter.

Operator

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

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