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Jefferies 2020 Virtual Industrials Conference

Caterpillar Inc. (CAT) Fireside Chat

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<<Steve Volkmann, Analyst, Jefferies LLC>>

Great. Hello, everybody. Welcome back to the next section of the Jefferies Industrials Conference. I'm Steve Volkmann. I cover machinery and diversified industrials here at Jefferies, and very pleased to welcome Caterpillar for this session. And we're joined by several CAT folks, but Andrew Bonfield will – the CFO, will be doing a bit of a presentation and then some fireside chat with me. [Operator Instructions]

Jen Driscoll, I think, will kick things off for us with some opening remarks. We do have a slide presentation. It's about eight slides. It's available on your MeetMax schedule as a link. Hopefully, you're also seeing it on your screen right now, and I'll do my best to kind of keep up and work those slides through as Andrew does his opening comments. So with that, CAT folks, welcome. Thanks so much for coming.

<<Jennifer K. Driscoll, Director of Investor Relations>>

Thanks, Steve. We're delighted to be here with you today. And I just wanted to remind you briefly that we may make forward-looking statements today. They are subject to risks and uncertainties. For a list of the factors that could cause our actual results to differ materially from what we might say, please refer to our latest 10-Q. It came out Wednesday, or in the slide deck, there's a forward-looking statements reminder as well.

So with that, let me turn it over to our CFO of two years now, Andrew Bonfield.

<<Andrew Bonfield, Chief Financial Officer>>

Thanks, Jennifer. And good morning, everybody. If we move to Slide 2, obviously, we are in unprecedented times with the COVID-19 pandemic impacting across the world. Obviously, Caterpillar is an essential business, and we – and our customers have continued to work through the crisis. And we've been working with our organization, with our dealers and our employees and suppliers through the crisis to make sure we are able to get people to continue to do the essential business that they are responsible for, at the same time, obviously, making sure we are working hard to keep our teams safe.

And, obviously, in an environment where infection rates, and we just thank our employees for their hard work and efforts in putting themselves at risk by coming to work every day at a time where, obviously, there's a lot of challenge. The good news is we believe that our focus on having a flexible and competitive cost structure has enabled us to manage our cost base at the same time. And actually, even with results in the second quarter, which reflect the challenges from a top line perspective, able to deliver margins, which were a good result in the context of what we're doing.

And obviously, we continue to focus on our strong balance sheet, with $8.8 billion of cash on hand and $18.5 billion of liquidity sources available to us. It means that we are in a strong financial position and able to weather whatever comes at us from any perspective.

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If we turn to Slide 3, we continue to focus on executing our strategy. The operating and execution model is at the heart of everything we do. Remind you that, that is focused on delivering long-term profitable growth, comes through three parts. We've continued to invest in enablers of services growth. Even though we're going through this downturn, we're continuing to focus on digital and the other work areas we're focusing on to drive towards our target to deliver $28 billion of services revenues by 2026.

We continue to focus – invest in our expanded offerings. New products introductions continue to be made, and we're continuing to focus on delivering machines to our customers with the productivity and quality that they expect, and all at the same time wrapped around a focus on operational excellence. This is about being – having that flexible and competitive cost structure. It's around things like quality, lean and safety.

And it's really good to know that actually in our – in the second quarter, we actually had our best safety record within the plants on record since we took records at Caterpillar. So that's – even with this crisis, that focus has not gone away. And at the same time, we are maintaining that flexibility to be able to respond to changes in demand, whether they be positive or negative as we go forward and come out through what has been this challenging period of time.

If we move to Slide 4, you – those of you who may have listened in to the call, sales and revenues were down 31% from $14.4 billion to $10 billion. I'll talk a bit more about that in a moment. Operating profit margin, 7.8%, down 7.5%, reflecting the volume – loss of volume. And profit per share down 70% to $0.84 per share, including a $0.19 loss on pension remeasurement for some of our pension plans.

If we move to Slide 5, the movement in revenue, you can see was all due to sales volume. Price and currency did have some impact, but the $3.9 billion of revenue decline, $1.9 billion of that was due to the movements in dealer inventory. In 2019, we had a $500 million increase in dealer inventory; in 2020, a $1.4 billion decrease. And $2 billion of volume, that includes reflecting our sales to users, both the machines and engines. E&T were down around about 22% in the quarter.

So underlying demand was slightly stronger than reported sales, and that reflects our desire with our dealers to manage and reduce their levels of inventory, which they hold. Mind you, all these dealers are independent businesses and make their own decisions about inventory.

If we move to the next slide, as you can see, that loss of volume was the big driver on profitability. Price realization was negative but offset by positive manufacturing costs. Most part of that price realization was due to geographic mix, lower sales in North America and higher sales around the rest of the world that impacts price realization. Also, some impacts in China of the competitive nature of that market.

SG&A and R&D were favorable, a significant proportion of that related to the decision not to pay short-term incentive compensation in 2020. Currency was a small negative. Financial products, although down year-on-year in the quarter and included a larger write-offs for future credit losses, did have a continued strong performance. And other includes -- restructuring expense, which is

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slightly higher in the quarter than it was a year ago. But operating profit of $784 million for the quarter.

So with that, I'll hand over to Steve. And Steve, you can fire away with the Q&A.

<<Steve Volkmann, Analyst, Jefferies LLC>>

Great. Thanks so much, Andrew, for that. And I think Jen did this sort of in your intro, but if I'm not mistaken, I think we are 26 days away from your two-year anniversary here at Cat. And so, this was – you've had a lot of experience, but I think this was kind of your first industrial assignment. So, I guess my opening question is, what has surprised you in terms of your experience here? Maybe if you can give us one thing that surprised you positively, and one thing that maybe needs some extra work from the eyes of an outsider? And I'll open with that.

<<Andrew Bonfield, Chief Financial Officer>>

Yes. Thanks, Steve. So, a couple of – so on the surprise, I think the resilience of the business model and the cash flow we generate. I mean, I think the ability to generate cash in all circumstances even in the downturn has been underappreciated. Obviously, this year we're slightly behind what we would see as a normal level of cash flow. Part of that is our profitability. Normally, we would see a reduction of Cat inventories. Given some of the supply chain challenges, we haven't reduced inventory as strongly as we would normally do. But that's an area of opportunity. But that resilience of the cash flow through the cycle is something which I think is underappreciated.

And part of our capital allocation strategy last year was designed to give investors a feel for how much cash we can generate on a consistent basis. What surprised me on the – or where do we have areas of improvement? I think we – Cat tends to be a very internally-focused company in many regards because, obviously, we work through the dealer network. What that does mean is some of the things you would expect as best practices haven't necessarily flowed through. So, for example, we have an opportunity in our finance function to deliver services that are significantly lower cost, and that's been an area which hasn't necessarily been an area of focus in the past. And I think things like that, so we are doing some back-office restructuring, those are things where I think Caterpillar can move and join what a lot of other companies have done in that regard. So that's where we do have opportunities for cost improvement and also efficiency improvement as a result of that. So those are probably the two areas.

<<Steve Volkmann, Analyst, Jefferies LLC>>

Great. Okay. I appreciate your candor. Not everybody answers the second question when I ask those types of things. So, thanks. So, you talked about the second quarter being sort of stronger, I think, than most of us expected. But the outlook seems sort of flattish going forward. And in a lot of my follow-up conversations, I think people are a little bit surprised by that. So maybe just talk about why you think that's the right trajectory for the next few whatever months.

<<Andrew Bonfield, Chief Financial Officer>>

Okay. So, a couple of things which influenced that. So, if you actually look at the detail of the STUs on a month-on-month basis, I know they're on a rolling three-month basis. But if you look at North America, for example, they have continued to go down month-on-month through the quarter, second quarter. So not necessarily have we seen the bottom in STUs yet, although obviously the rate of decline has slowed down as we got into June.

So that is one area why we said we think the STU – the actual decrease in STUs will be a similar percentage decrease quarter on quarter as we did see in Q2. Remember obviously with capital goods, some of our particularly larger equipment, obviously it's a significant capital outlay. While there is uncertainty out there as to what the future part of construction expenditure is going to be, that is obviously enabling people to defer making decisions for a period of time. So that is a challenge from a top line perspective.

Also, on top of that, we just try to remind the market that we do have a normal seasonable pattern and that Q3 tends to be, particularly in CI, lower than it is in Q2 as the summer season comes off. That will also, obviously, have an impact on our sales and revenue. On the other side, obviously we expect lower dealer inventory reductions quarter-on-quarter and that will be a positive. So that was how we sort of implied the – sort of framed the top line perspective.

When you look in margin structure, obviously throughout the year, so far this year, we've been able to offset particularly the negative price realization by favorability in manufacturing costs. Within the manufacturing costs, obviously there are puts and takes. One, obviously, has been variable labor and burdens. It does have an impact on us in a quarterly basis. Obviously, that had some impact in Q2 where probably – actually we did better than we originally expected in managing the plants. The plants did really, really well in avoiding significant bottlenecks.

So that headwind is not as big as probably the people expect. We don't disclose it, but it's not a huge number. And then offsetting against that is the fact that we start to lap some of the material cost positivity that we started seeing in the second half of 2019. So that means, although we still expect a positive benefit from material costs being lower year-on-year, that won't be as great as it was in Q2. So that will have some impact on margins. Again, remember, volume also has a significant impact on the gross margins we report. Then the other thing we've just pointed out was that STIP loss in the second quarter was about a $200 million benefit year-on-year. We actually reduced our STIP accrual in the third quarter of last year. And that is a smaller number in absolute dollar terms, so it will have some impact. So, we expect margins to be around about the same level as we saw in Q2 – in Q3.

<<Steve Volkmann, Analyst, Jefferies LLC>>

Okay. Great. That's good color. I think on the conference call, you sort of sounded like you were saying that a lot of – maybe even most of your third quarter production has already sort of been allocated and scheduled. And that even if things were a little better, that probably wouldn't reflect too much in what you report. Is that the right way to read this?

<<Andrew Bonfield, Chief Financial Officer>>

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Yes. I think, Steve, what we're trying – we're trying to manage the company the best we can. I mean let's talk about what we're trying to do on how we manage dealer inventory or with our dealers. As again, just to remind you, dealers are independent businesses, so we can't force them to hold a certain level of inventory. They make the determination of what they want. But we can work with them to make sure that we use the right analytical tools and processes to actually say to them, why are you holding so much inventory? And what is the right level of inventory for you to hold to meet demand?

One of the historic impacts on Caterpillar has been dealer order behavior hasn't necessarily always followed underlying demand. And what that tends to mean is availability goes down in an upturn because people are over-ordering. That puts strain on availability. And then when availability starts to improve, the factories start working properly, dealers tend to reduce their rate of order because availability has improved. And therefore, then that gives us a problem and actually that we – if there is starting to be a downturn, we exacerbate that bullwhip impact.

So we're working very closely with the dealers around making sure with their new sales and operations process, to make sure that we use artificial intelligence, for example, working with dealers to try and estimate what their future demand would be and what we believe the right level of OE equipment they have on their lots. And that process is starting to work better. It's starting to help us and dealers and as people get trust in that and trust in our ability to continue to manufacture, it does mean that dealers can look at their inventory levels on a more holistic basis.

So, as we look in the third quarter, we know that we expect about – we said we would expect a similar level of decrease in dealer inventories as we saw in the second half of last year, which is around about $1 billion. That means between second and third quarters, if third quarter STUs are a little bit stronger, we will work with the dealers to see whether they will take down more inventory in the third quarter than otherwise and not actually boost production then have to pull it back down again.

So, it's all about trying to manage that whipsaw effect and then sort through its impact on production as best as we can, which is what we're trying to do. We won't get it perfectly. We won't get it correlated, but obviously producing to demand is one of the key things we're trying to do better, and that's part of this process. And obviously our aim is by 2021 to be able to produce to demand.

<<Steve Volkmann, Analyst, Jefferies LLC>>

Right. Okay. Good. So, I want to get to 2021 in a minute. But can you just outline a little bit – you sort of stepped up the restructuring a little bit in the quarter. Can you just sort of describe what's happening? And then also, is there more in the wings, if necessary, if things remain sort of depressed for longer than we all hope they will?

<<Andrew Bonfield, Chief Financial Officer>>

Yes. So obviously what we said at the beginning of the year was we would expect to spend between $100 million to $200 million on normal restructuring in what will come as normal, which is

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ongoing things. And then probably about – we put a placeholder of $200 million, what we call our challenged products. Those are products which don't achieve the level of OPACC we are targeting for all our products and applications. That, we – in the second quarter, we completed the contemplation period for the Luenen and Wuppertal facilities, which produce longwall products for mining. Those will be moving to Asia, closer to where the customer base is. And we believe that's a good opportunity. And we also announced the sale of the marine propulsion business. So those are actions which we're taking.

With regards to back office, as I said, we – at the beginning of the year, we already had a number of opportunities which we were looking at. We're doing the first wave of outsourcing in finance. There may be other areas which follow suit later on. That's an opportunity for us. We're looking about obviously how we can be more efficient with our investment dollars in every regard. And so those are things which are what I would call business-as-usual-type restructuring. With regards to the crisis itself, I mean the challenge is actually getting visibility as to what future demand is. And obviously if we are in a situation where demand looks like it's going to be lower for longer, we would obviously have to come back and look at things like the manufacturing network to see whether that could be optimized further. And obviously things like that in order to manage our cost structure as best as we can.

<<Steve Volkmann, Analyst, Jefferies LLC>>

Okay. Great. [Operator Instructions] So on the spirit of this, you mentioned that you have sort of found some businesses that didn't quite meet their OPACC targets. I guess the question is, are there more of those? And should we expect kind of more of these types of actions as you go through the review?

<<Andrew Bonfield, Chief Financial Officer>>

Yes. So, I mean we have a number of businesses we're working on today, and we still have some further opportunities with that regard. Obviously, we – this is an ongoing process. This is part of what we call working in the O&E model is all about, making sure we allocate our resources to the areas that produce the greatest opportunities for long-term profitable growth. So again, we are focused on those, making sure we do what we can to actually go for those and challenge those businesses, which aren't delivering sufficient OPACC. So yes, it's an ongoing process. There are some other businesses we're looking at, at the moment, but it just will be – that again is almost business as usual. And obviously we will let people know where we are taking charges relating to those businesses and what we're going to be doing with those. But there obviously, are other businesses which sometimes go through periods of challenge. The whole point about this is to make sure we have the right long-term plans in place to deliver that long-term profitable growth.

<<Steve Volkmann, Analyst, Jefferies LLC>>

Okay, great. Understood, thank you. I have about seven minutes left. I have two other topics I was hoping to get to. So, the first one, we touched on ever so briefly. But in 2021, it strikes me – none of us probably has a great idea what volume is going to look like, and that's probably the key driver anyway. But absent that, you're going to have a few moving pieces I think we can quantify.

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And presumably, you will probably have some incentive comp that's somewhere back to normal. You'll have some benefits from some of this restructuring. You will have some benefits from not under-absorbing on the big dealer inventory reduction. But you'll also have some temporary costs that return. So, a few moving pieces there, and I'm hoping you can just maybe comment about those irrespective of volume, just the stuff we can put bookends around.

<<Andrew R. J. Bonfield, Chief Financial Officer>>

Yes. So obviously, yes, normally STIP would sort of be a – revert back to one next year, assuming a normal environment, and that will, obviously, be a significant headwind in 2021. As we say, it's about $200 million in Q2, will be a slightly lower number in Q3. So that is a headwind as we move into the year next year, because obviously, we'll assume that we reset that back to one rather than zero.

Obviously, yes if we assume flat volume, you would see – expect that if we produce to demand, demand is greater than actual underlying production this year or our shipment out of our factories. So that should help us as well moving into 2021. Then obviously, there are some expenses which have not been spent. I mean the reality is obviously travel has been impacted. Things like new projects, consulting spend has been slightly behind. And obviously, during those periods of time when the COVID was at its hardest, obviously much more got deferred at that stage.

We will need to evaluate that and compare that to the benefits from the restructuring we're doing. And obviously, that will also come in then to factor what we think about as there are other restructuring activities we should be doing in 2021, which would have a payback to mitigate that. So that will be the bit which we'll have to work through. We haven't started our 2021 planning yet. It's early. And obviously given currently the lack of visibility that all of us have as to what the shape of the recovery is going to be, particularly in our space, it's one of those things where we'll have to work over the next several months and obviously update market in January when we give guidance, hopefully for 2021.

<<Steve Volkmann, Analyst, Jefferies LLC>>

Yes. Fair enough, fair enough. Are there – is there anything else that I didn't mention? I don't know, I'm thinking maybe pension with a lower discount rate. Does that have a likely headwind? Or anything else that I didn't mention on my list.

<<Andrew R. J. Bonfield, Chief Financial Officer>>

Yes. Pension may be, but I think we did see some of the benefit of that already in 2020. So – and that's below the line outside operating margins, but that may be one area where – but I think we did see quite a significant benefit in 2020, as we moved into 2020 on lower pension expense. Also because of the amount contributions we made to the U.S. pension plan as well. So those are a factor – we've probably already got the benefit of that mostly this year.

<<Steve Volkmann, Analyst, Jefferies LLC>>

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Okay, all right. So, three minutes left. I wanted to touch on capital allocation. And you guys have sort of pledged to return, I think what you call substantially all of ME&T free cash flow to shareholders. But obviously you've suspended repurchases this year. So, I guess the first question is, you've had a target to increase dividend sort of faster than normal for a period of time. Is that still intact?

<<Andrew R. J. Bonfield, Chief Financial Officer>>

Yes. I mean as you know, our intent as we told at Investor Day, was to – we increased the dividend by 20% last year. And our stated intent was to increase the dividend by high single digits thereafter. Obviously, this year given the uncertainty that's out there, we decided that it was a moment not to pause that. Given the unprecedented nature of what's happened, we believe the right thing to do is to make sure we have visibility on liquidity before making a decision to pay – to increase the dividend, which we normally have done in June.

So that has been put on pause. We'll wait and see what happens as things unfold. And obviously, that is still our intent, even with that intent in a normal trough year, we would estimate that the dividend payout ratio were going to be somewhere in the 55% to 65% range. So that does cover that. Obviously, also not paying – not buying back stock also means that the total cost of dividend, while that's on pause, also increases, because you're not buying back shares at the same time, which reduces your share count.

<<Steve Volkmann, Analyst, Jefferies LLC>>

And in the 30 seconds we have left, do we get more dividend and repo next year to make up the difference? Or does this sort of push everything out a year?

<<Andrew R. J. Bonfield, Chief Financial Officer>>

It depends where we are in this year versus our free cash flow targets. If you think this year, we may – with the dividend of approximately $600 million – just under $600 million in a quarter, plus the $1.2 billion we already bought back, we're close to $3.5 billion this year potentially already committed, and wanting to see where our free cash flow comes out for the year. We may actually spend slightly more than free cash this year. We have the capacity to do that with the balance sheet. And that's why, as we say, it's substantially all over time.

<<Steve Volkmann, Analyst, Jefferies LLC>>

Great. Okay, good. And that is perfect. We are exactly on time. Very much appreciate your comments here and wish you a wonderful rest of the day. Thank you, guys, and that does it for this session.

<<Jennifer K. Driscoll, Director-Investor Relations>>

Thanks for hosting us.

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<<Andrew R. J. Bonfield, Chief Financial Officer>>
Thank you.