Caterpillar Inc.

Fireside Chat at ConExpo

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Caterpillar: Confidential Green

CORPORATE PARTICIPANTS

Jerry Revich, *Goldman Sachs*

Andrew Bonfield, *Chief Financial Officer*

Jennifer Driscoll, *Director, Investor Relations*

CONFERENCE CALL PARTICIPANTS

David Raso

PRESENTATION

Jerry Revich

Okay. Good afternoon once again, everyone, I'm Jerry Revich from Goldman Sachs. I'm very pleased to have with me Andrew Bonfield, Chief Financial Officer, and Jennifer Driscoll, Investor Relations Director. Thank you so much for joining us.

Andrew Bonfield

Thank you, Jerry.

Jerry Revich

Andrew and Jennifer will step us through a few minutes of prepared remarks, and then we'll go on to the Q&A. Andrew, Jennifer, the floor is yours.

Jennifer Driscoll

I'd just like to mention, we may make forward-looking statements this afternoon. They are subject to risks and uncertainties. For a complete list of those risks and uncertainties, please refer to our 10-Q and 10-K available on our website. Thank you.

Andrew Bonfield

Thank you, Jennifer.

I'll just give you a little bit of background about Caterpillar, for those who are joining us. Obviously, when you come to something like ConExpo, you really do see how our iconic the brand is at Caterpillar. We obviously now are in a situation where we have about one million connected assets globally and technology is a big part of what we've been talking to customers about at the show this year.

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Overall, our strategy is determined by the operating execution model that has three key flanks to it to drive profitable growth; profitable growth is to increase OPACC dollars over time, absolute OPACC dollars over time. Those three elements are operation excellence. That really has been a focus of actually making sure we improve operating margins by about 3% and 6% points through the cycle, versus where they were in the 2010 to 2016 timeframe. Taken out about 25 million square foot of factory capacity; reduce structural costs by about $1.8 billion, which is a key part of what we've done to improve the overall structure of the business.

At the same time, we continue to work on expanded offerings. We've launched 13 GC models now; we have another about 15 or so in NPI, a new product development, which is about trying to make sure we give customers the options of having a slightly less configured machine to actually meet some more of the utility needs that they may have in their workspaces. Those GC machines, there are some, again, on show here, in ConExpo.

At the same time, we're focused on services and driving services revenue. As we disclosed at the year-end, we generated, through services revenues in 2019, grew by just over 2% to just over $18 billion. Our aim is to target still to drive, to double services revenue, to $28 billion by 2026. We believe this is the single biggest organic growth opportunity that we have, and is one where we're all really focused on making sure we can deliver those targets and connectivity, as we talked about a moment ago, is a key part of that strategy. Actually, it's to make sure that we connect the machines, connect to the customer, to help drive those service opportunities.

As you know, last year, we generated sales from revenue of just under $54 billion. We expect—when we gave guidance in January, we talked about the fact that we expect our end user sales to users to be down between 4% and 9% in 2020, and at the same time, we expect revenues to decline as a result of de-stocking by dealers between $1 billion and $1.5 billion as we go through 2020.

Overall though, cash flow still remains strong. We talk about cash flow as being between $4 billion and $8 billion through the cycle. That cash flow generation is strong, even in down years, where we do expect to actually have working capital inflows which will help mitigate the lower operating profit as we move into 2020.

What's here at the show? There's a lot of things. Actually, the highlight of the show was the global operator challenge. This was where we had 10,000 operators around the world competing in a challenge, a series of challenges, as they operate machines, be it an excavator, the Mini Ex was part of that as well. But (inaudible) doing certain activities. That is out on the fairgrounds; it's webcast for those of you who'd like to see it, including things like taking a golf club out of a golf bag and actually going through an obstacle course, and then putting the golf club back into the golf bag. That is what these guys are able to do.

We have about 60,000 square feet of booth out there, it's really worth going to see, and obviously a lot of that is online as well, for those of you who weren't able to make the trip.

We actually had the winner, I interviewed him this morning, of—we do an employee segment each quarter, and he came from Canada, Jaus Neigum, actually who's really, really interesting. He's the first ever winner of the Cat Global Operator Challenge.

Also out there, we're having a lot of demonstrations. I'm actually—just before I came over, I was over doing a technology demonstration, and it was packed out (phon). It is one of the good features for us, has been the success of that outdoor arena and outdoor facility where they're actually doing product demonstrations. Things like the next-generation excavators, which we're showing five here at the show: the 313 GC model, which is, again, part of that GC line; the 315; the M318; the 325; and the largest of all, the new 395, which is a very strongly reinforced breed (phon) which, again, is out there on the grounds to be seen. Again, much more productive machines again, and continuing that next-generation launch of excavators as we move out.

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As we looked into last year, obviously talked about sales and revenues; operating margin last year was up 20 basis points to 15.4%. I mentioned the services revenue. The three segments, obviously, the construction industries last year had a record year in terms of revenues, $22.6 billion, 17.4% (inaudible) margin. The resource industries had sales of $10.3 billion, still significantly below its last peak, at a 15.9% margin. Energy and transportation had sales of $22.1 billion with a 17.7% margin.

With that, why don't I just move into the Q&A, and Jerry, back over to you.

Jerry Revich

Oh, thanks, Andrew. Yes, I'm told that you folks at Cat have taken the Operator Challenge where you had a pretty strong showing, must be some (inaudible) features there.

Andrew Bonfield

Yes, I was very pleased to say that I won the bucket challenge and I had the largest load in the bucket on a medium with a load-up. They actually allowed me to get loose on the machine, which—and I managed not to do too much damage, so that was the most important thing.

Jerry Revich

(Inaudible) what really jumped out is the Customer Value Agreement push. Can you talk about, over what time do you think you could scale that; how meaningful could it be? Talk about the financial products tie-in?

Andrew Bonfield

Yes, so the CVA product we're talking about, mostly, actually relates—if you think about BCP machines, that is the highest volume machine generally sold to a person who has up to a maximum of probably three machines in their portfolio, in their fleet. The challenge often with those customers is the fact that we lose contact with them, so the connectivity, which is obviously a key part of the digital strategy, is a key part of that.

Then also, offering them a CVA as part of that, to actually maintain that customer touch point, is really important. We've been going through some pilots this year with a number of dealers, and we're starting to see, actually, increased penetration with CVAs versus the old product we used to have before. That penetration has almost doubled in those areas, so you can—we're starting to see some success. A long way to go to declare victory, but we do think it's a great opportunity for us to continue that customer connection.

The interesting thing, in a lot of our small machines, is they do change hands a number of times during their working life. These are machines that probably have low volume hours on them, and therefore may actually be in operation for a number of years, and actually through a number of different operators over that time period. Again, the CVA push is part of making sure we can hit those deeper customer connections.

Financial products, obviously, is a key part of that, because you'll do that in conjunction with an extended warranty. We've been doing those through Cat Financial for a number of years. Cat Financial can help make that—effectively, by doing the CVA contract with Cat Financial, it becomes portable and transferable. It's portable from one dealer network to another, and it's also transferable from one customer to another. But again, that's all part of this push to ensure that we actually do keep those deep customer connections over the years.

Jerry Revich

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In terms of the doubling in the pick rates, are we talking from 20% to 40%, or can you…?

Andrew Bonfield

No, lower than that. It's a lower percentage rate than that. But I think what it is, is about starting that process and getting bigger—obviously, one thing about CVAs, not one size fits all. Remember, for a large mining customer which has very high utilization, effectively their CVA, you'll have a very strong association contract where we've put some of our large mining customers, and that will vary down. As we say, this is principally aimed at the small equipment where we actually have had very weak penetration over the years.

Jerry Revich

In terms of your business structure today compared to the last two periods of meaningful slowdown in your end demand, can you talk about the most meaningful differences and your expectations for your performance in the cycle? We'll try to have that conversation without talking about margins.

Andrew Bonfield

Yes.

Jerry Revich

I said try.

Andrew Bonfield

Obviously, yes. I mean, one of the things, having taken out a significant amount of fixed cost through the last down cycle, what that does, I mean, obviously, is leverage, where it's much stronger on the way up, and obviously, more low—more negatively on the way down.

What we are focused on is the absolute level of margin. That's why we talk about the 3% to 6% points improvement in the margins versus the 2010 to 2016 timeframe. Obviously, if you think in that range of 3% to 6%, and probably you will be more towards the top end of the range when sales are increasing, because you're getting the benefit of volume leverage. Obviously if you're on the downstream, you are going to be at the bottom end of that range as you think about the margins target, because obviously you don't have as much structural cost to take out, and also you don't necessarily want to rip the heart out of the business.

One of the things we're trying to do better at Cat is about resource allocation and making sure—historically, what would have happened is if you went into a down cycle, cuts would have been across the board. We are still wanting to invest in services and services growth. We're still wanting to invest in new product development. All of those are... Obviously, it will have some impact in a downturn, but we'll try and mitigate that impact if possible, because if you think about the L&E (phon) model and that whole concept of growing OPACC dollars, you want to be in a position where you can take advantage of the next cycle.

Again, it's that balancing act, but it's absolutely… The other thing, which again, we just keep reinforcing is around the cash flow and the fact that we are able now to expect to generate $4 billion to $8 billion of free cash flow through the cycle. That enables us to grow the dividend. As you know, last year we grew the dividend by 20%, the quarterly dividend. This year, we expect to grow, and for the next four years, we expect to grow the dividend by the high single-digits percentage, even though we are in a slightly negative return.

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Even that, by the time we finish, we think the dividend will represent between 50% and 60% of free cash flow in a trough scenario. Again, that shows how—that strength then enables us to be in the market on a more consistent basis, for share buybacks.

Jerry Revich

On that note, it's tougher to pull the trigger on corporates, generally, on the buyback program when you're in an environment like this where visibility is low. It's a lot easier to pull the trigger when you're generating record free cash flow on the upside. Can you talk about your willingness to have a consistent buyback program without getting caught in that track of buying back the stock at its highs and not buying back on its lows?

Andrew Bonfield

Yes. I mean, one of things, we do expect to have much more consistent cash flow. What we've said is we will return, substantially, all the free cash flow to shareholders. That means—and we do have a very strong balance sheet. As you know, we had about $8 billion of cash at the end of last year and virtually no net debt in the ME&T business, so very low net debt. That gives us a very strong position to operate in, even if we do move into a downturn scenario.

That does give us that flexibility, but it does mean we will be in much more consistent (inaudible) about being that consistent—I think it's more important, Jerry, and that's what the policy is designed to do, which is to just be in the market and not try to second guess. We do a mixture of what we call (inaudible) program, etc., the share repurchase, plus then we have the grid scheme which does enable us then to buyback at different stock price levels, based on market conditions. We look at that and base that around things like intrinsic value. But that does not necessarily—it means that we will be in the market on a more consistent basis. That consistency is really the key for us.

Jerry Revich

Yes.

David Raso

Hi, David Raso; a kind of open-ended question, just with the recent situation with oil prices and obviously the virus. Inventory reduction this year has been a key focus and a target. How have the recent developments impacted how you're approaching hitting those inventory targets?

Andrew Bonfield

Yes. I mean, David, I would say we obviously continue to make sure we're flexing production to meet end user demand. We will have the new set of retail sets out tomorrow, which will give you an idea of where demand is; end user demand is a key factor for us.

As we've said, we expect—we would like dealers to be in a situation by the end of the year, although dealers are independent, but (inaudible) they make their own inventory decisions where they do not need to see further de-stocking as we go into 2021. We want to be in that position.

Obviously what we'll need to do is we'll need to continue to monitor the situation as we go through the year, continue to flex our production, either positively, slightly optimistically, or negatively depending on market conditions, both with an aim, ultimately, of actually starting 2021 in a really good place from an inventory perspective. Obviously that depends on what the outlook is for 2021. By the time we get there, we'll have a better position on that, so that will also finalize the final view as to what inventory is.

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But let me just be very clear: it is still our intent, this year, to take down the inventory levels to a more lower level of that. We do have a range; we expect it to be within—to a lower level in that range as we move into 2021 so that we're not in that situation as we move forward.

David Raso

Is it fair to say that's the main priority, as much as retail flexes up or down, your ability to get that inventory out is sort of priority one to set up 2021?

Andrew Bonfield

Yes, and obviously, what you also have to weigh up as you think through that, is the cost of changing production schedules. We just have to balance that slightly up, but we expect to be there or thereabouts as we go through the year. We would not expect that to be materially different from the number, just because they're changing external circumstances.

David Raso

Thank you.

Male Speaker

Thanks. Could you talk a little bit about OPACC PV and how the organization is using OPACC PV and incorporating that with the OPACC mindset that the business has used previously?

Andrew Bonfield

Yes, so let me try and explain. Obviously, OPACC, which is operating profit after capital charge—we also measure something called OPACC PV. OPACC PV takes into account the present value of future part sales and services revenues relating to that equipment.

Why that is important is because what you are trying to measure is the aftermarket impact as we go forward. One of the challenges on a pure OPACC basis is often, if somebody comes to you and says, a third-party supplier says, "We have a great opportunity to reduce your cost of a…" We take a hose—"By 35%", and that's a cost saving for the product manager. He could look at that on an OPACC lens and say, "That's a good thing to do."

However, when you look at the potential aftermarket impact, because if that hose manufacturer is in competition to sell hoses in the aftermarket, what will then end up happening is they will make up their price for their first fit, and then actually take away the aftermarket away from you, you lost the aftermarket opportunity. That's why we measure PV as well, so that when we're making those decisions, we are looking at the right decision versus just not necessarily that outsource at all cost decisions.

That is why we do the two measures, and it's to help try and make sure, when somebody's thinking about something, there is—the impact of future services revenue is taken into account on that decision making process. That is something that we look at when we're doing NPI, new product introductions, or when we're doing what we call our dream books, which are our investment proposals. All of that is built into that so that we can actually look at that and make sure we're making the right trade-offs. Because ultimately, at the end of the day, there may be times when you're looking at a part, for a component, for a product, where you would say, actually, it makes sense to outsource because it's not necessarily—say, for example, cabs (phon). Where it is not necessarily a huge aftermarket for cabs; that would be something you would sort of say, well, that—you would want the lowest manufacturing cost for that.

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Something where you think there's an aftermarket for, you may not be—you may either want some form of IP, some form of aftermarket protection as part of that before you would necessarily accept the first-fit cost.

Male Speaker

Great. Just one follow-up; so you've spoken a lot about technology, certainly at the booth you're highlighting that. There was an announcement at the show about yourselves and your joint venture with Trimble. I'm just curious, from an organizational perspective, how you guys think about investing heavily internally and doing things on your own as opposed to partnering with other folks.

Andrew Bonfield

Yes. I don't think as much of that is around. We're building some very strong digital capabilities, and we believe that there's some competitive advantages for us owning VisionLink ourselves and having that control over it and the future direction of it. That was part of the rationale. Obviously, during early stage development, occasionally we have gone out—previously, we've had alliances in that regard. We just felt this was the right time to bring it in-house, given that we have the scale and we believe, now, the digital capability under (inaudible) to actually do that driving Cat digital, to drive that faster, in a direction which actually focuses very much on the Cat end of things as well, and integrate that better into the whole digital process.

As we've spoken to investors, the digital platform is the key for us now, on building these new applications and helping customers. I don't know if you have been out to the booth, there's some software (inaudible) highlighting (inaudible) CATproductivity.com, which again, just starts giving customers more of that data and more of the access to that data, and helping them to see some of the productivity of the machines that they're operating and how that works. Again, so all of that is part of where we think our customers want to go. That's really important for us to do that. We do believe we have enough capability now in-house and we don't need to effectively (inaudible) for that.

Jerry Revich

Andrew, we've just got an email question here. In terms of the consolidation that you folks have taken, the question is, so now you have a network of higher scale manufacturing. In a downturn, presumably that means less under-absorption at smaller facilities. The questioner is asking, why doesn't that mean less operating leverage to the downside, because you're not under-absorbed in your (inaudible) facilities?

Andrew Bonfield

Yes. Yes, that does help. It helps mitigate some of that, obviously the absorption issues. However, we still have a very large network, and there is a lot of fixed cost associated with that network and just is impossible to mitigate the full impact.

Our absorption rates are pretty high still, so if you look at the absorption costs as a percentage of a machine cost, it's a significant number in that. That, again, is just part of the challenge of—which we will have in the downturn.

Again, just to remind people, I mean, one of the things we haven't done through this up cycle is build a lot of new capacity. Again, that helps us; yes, it means we don't have that capacity loss in the down cycle, but we also don't have the restructuring associated with that, which we would normally have. We have, as you know, talked about our challenged products, we talked about those in January. Those are products where we are not achieving our OPACC goals. You will have seen—you may have seen that we have actually started, for example, in Germany, a contemplation period with the workforce around some of the facilities there. Again, that is looking at—again, we are continuing to look at this all the time, but you

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shouldn't expect to see a very large scale restructuring program in the event of a downturn like we did in the last one.

Jerry Revich

Yes.

Male Speaker

Hi. Just given the nature of the Company is so global, you can sort of swing a little bit between vendors or sister facilities that make similar products. You're obviously a big customer for most all of your suppliers, so they're going to try to treat you well. But, can you give us some sense of ranking of where you feel your supply chain risk, given the recent macro developments, rests, just some sense…

Andrew Bonfield

Yes, I mean, (cross-talking).

Male Speaker

Geographic, business segments, however you want to do it.

Andrew Bonfield

Let me chime in. Obviously during the last up cycle, us, like many of our competitors, were chasing supply, and supply constraints were a real factor for us. We're in a good situation now where that obviously has mitigated quite significantly. That is clear.

We've talked about, if you look around the supply chain—I mean, the issue for us around the supply chain—potentially is a risk in the current environment. It probably is not necessarily our tier one suppliers. It would tend to be your tier two, tier three, because these are smaller enterprises—are feeding into the larger manufacturing element, with manufacturers. In our top 25 suppliers, for example, at the moment, only three of those are Chinese vendors. That is a signal that—obviously, but obviously we don't know whether other 22, where the supply chains go.

Obviously, if you're thinking about a coronavirus type impact, particularly on the supply chain, at this stage we haven't really seen anything. But obviously we are planning on the assumption, at some stage. Some of those smaller Chinese manufacturers will have some impact somewhere along the line, and building our contingency plans ready. I mean, obviously, where we are (inaudible) is the greatest area of risk and that's obviously going to get the greatest degree of attention in the short-term.

Those (inaudible) places where we have alternative supply choices, we will continue to monitor those as well, and obviously flex those through over the next few months. But obviously what we don't want to do is end up in a situation where we either can't produce, or we are constraining ourselves on production. We have lived with that a little bit over the last couple of years; that has been a big challenge for us, so that's a really big opportunity for us to unleash the supply chain a little bit better than we have done recently.

Male Speaker

Thank you. As we think about your oil and gas exposure, the solar business has not been cyclical over the past decade. Can you just talk about what's enabled that business to be a steady performer even as we've seen swings in pipeline, cap ex, and just expand on that, please?

Andrew Bonfield

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Yes, so let me talk about oil and gas generally, and then talk about the solar in particular. Obviously, the significant reduction in oil price in the last week, couple of days, obviously will have some impact on our business. Now, this year, as we moved into 2020 on the reciprocating engine side, we did assume about a 20% reduction in cap ex in the Permian Basin. That was based on external information from what we were picking up. Obviously, in the current environment, that probably will be cut back further, so we will see some further impact.

However, offsetting that is, obviously, we do also do a lot of parts and servicing into that business as well, which does help mitigate some of that OE-type risk. But that obviously will have some impact as we go through this year. As yet, it's too early to quantify. Hopefully by the time we get to first quarter results, we'll be able to give you a bit more of the flavor. Although, by that time, who knows what will have happened in the world and what will have changed. Russia and the Saudis could actually end up talking to each other; we could end up having oil prices stabilize. We'll see. We're not banking on anything. We always have to—you have to plan for the uncertainty.

As regards solar, and the reason why solar obviously is not as impacted—I mean, we've seen the bifurcation of the gas versus oil market, as you know, over the last several years—and solar obviously plays much more into the gas market. That hasn't seen the same swings you've seen in pricing as you will have seen within the oil markets; one reason.

Secondly, solar is much more a strong—is much stronger as a business around its services. Services are really, really critical for solar, and those are going to continue. People will still want to operate. I wouldn't expect gas volumes, natural gas volumes to vary that much. That obviously will mean that solar compressors are still working, the turbines are still working; those aren't going to be used as much as they would be otherwise.

But again, that generates that service revenue, a key part of it. Obviously, we'll need to see if there's any OE impact. Again, it's way too early to see that yet.

Male Speaker

On the OEM impact, (inaudible) swings in the pipeline, cap ex, because that's been much more volatile than your OEM sales.

Andrew Bonfield

Yes, it's—I mean, to be honest, I'm probably not the best person to answer that question. But just generally, I think generally, just having that strong customer relationship has been solar's really key competitive advantage. Actually being within the Company—effectively, we have fuel service personnel that's within most of our customers' facilities, actually helping them operate and run their equipment as efficiently as they can.

I think that's been the biggest driver of that change and obviously helping that helps drive service revenue, and helping them optimize their equipment and the maintenance of that equipment in the right way—and obviously since the technology—digital has been a key factor in that, as we've moved through the years.

Jerry Revich

Okay. Andrew, Jennifer, thank you very much for joining us. Please join me in thinking the Caterpillar team.

Andrew Bonfield

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(Inaudible).

Jennifer Driscoll

Thank you (inaudible).

Andrew Bonfield

Thank you.

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