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EDITED TRANSCRIPT

CAT - Caterpillar Inc at Robert W Baird Global Industrial Conference

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PRESENTATION

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research and Senior Research Analyst*

Okay. Good morning, everyone. Thank you for joining us. My name is Mig Dobre. I'm the Baird analyst covering machinery and diversified industrials. And it is my pleasure to introduce to you today, Caterpillar. Now we're happy to have Andrew Bonfield, CFO, who's going to join us for a discussion. But before we do that, I'm going to turn mic over to Jennifer Driscoll to give us a little rundown on all the safe harbor statements.

Jennifer K. Driscoll - *Caterpillar Inc. - Director of IR*

Thank you, Mig, I guess. I'm Jennifer Driscoll, for those who haven't met me. It's a pleasure to see you all today. I just want to remind you that we may make forward-looking statements this morning, which are subject to risks and uncertainties. For a list of those factors that could cause our results to differ materially from any statements, look at our 8-K filings and 10-Qs and 10-Ks.

And with that, let me turn it over to Andrew Bonfield. He is the CFO of Caterpillar. He joined us a little over 1 year ago, yet he's been a CFO for 20-odd years. It was -- prior stints at Bristol-Myers Squibb and National Grid.

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Thanks, Jennifer. Good morning, everybody. It's always a pleasure to represent Caterpillar. Such an iconic brand, but one which actually obviously is known throughout the world in the 193 countries in which we operate. There are 4 million products around the world, Cat products in use, making sure our customers are making the difference to the jobs that they're doing around world, whether it be in Construction, Energy & Transportation or in Resource Industries, our 3 major business segments. Global workforce of over 100,000 employees around the world. But at the heart of everything we do is what we call our Operating & Executing model. That is the core of our strategy. The core of that is profitable growth. I have been CFO of 6 public companies. One of the hardest things a company has always find to do is the concept of profitable growth, which is growing and being profitable at the same time. And the way we do that is using Operating & Executing model, which actually relies on facts and data as a way to actually helping to make decisions. The core of that is a measure we use called OPACC, which is our form of economic value added, which is operating profit after capital charge, and that is at the core of how we make decisions. So basically, reminding people that assets have a cost to them, and return on invested capital is key to how we make decisions in operating the company and moving it forward.

There are 3 key levers that we look at as part of our strategy. Operational excellence is really around making sure we have the right cost footprint, flexible and competitive cost structure. Lean manufacturing is obviously a key part of that. We have reduced our factory footprint by some 25 million square feet. And one of the things I think that's been underappreciated about Caterpillar, and hopefully, our new capital allocation strategy has actually helped investors realize that, is around actually how much cash we will generate through the cycle and as a result of some of the changes we've made around our operational footprint. Also, the other thing that historically Caterpillar has done is chase the cycle upwards and built a lot more capacity as they move through the cycle. We've maintained that capital discipline. What that means is we are throwing off a lot more cash, and that enables us to not only increase the dividend, which I'll talk about in a moment, but also buy back stock at a greater degree than we have done historically. Expanded offerings all around, making sure that we have the right product offerings for customers. For example, our GC models in Construction Industries are around making sure that those customers who don't need a top-quality, fully functioning machine,

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which may be having a value proposition, which is slightly different, which is a slightly despeced model with the similar margin structure that enables us rather than discounting our higher-end models, actually enables us to provide and meet the functionality of what that customer requires.

Also things like Dynamic Gas Blend engine, which is a new engine in oil and gas applications, which reduces diesel usage by 85%. And if you think about gas gathering of the wellhead from fracking perspective, one of the challenges in that business today is the amount of gas at the wellhead, which they then have to pay somebody to transport away, actually using the fuel as both ways -- actually is a powering mechanism to enable them to carry on with the fracking side, actually is a huge opportunity for them to drive cost savings as well.

Our big driver is around services. Our target is to double our services growth between 2016 and 2026 from $14 billion to $28 billion. We're currently running last year at around $18 billion. Key part of that is around digital, which is connectivity and also then making sure that we actually drive the opportunities. Things like customer value agreements are part of that strategy to drive the services revenues as we move forward. That's a key part of that strategy. We believe that is a way to enhance profitable growth. And given that this is one where it is within our control, it is one of the biggest organic growth opportunities we have as we move forward.

You may have noticed a couple of weeks ago, we did report results. Our revenues in the third quarter were down 6% to $12.8 billion from $13.5 billion last year. Most of that reduction related to volume, most of that volume related to inventory movements within the wholesaler channel. Last year, as we were ramping up production and struggling to meet demand, end user demand, we did see dealers, who are independent businesses and control their own inventories -- increase their inventories by about $800 million in the third quarter last year. This year, they reduced inventories by about $400 million. Actually, our underlying retail stats, which are our sales machines, were actually up 6% in the quarter. That is positive and a higher rate of growth than we've seen since the beginning of the year, but we actually did expect it to be slightly higher than that. So as a result of that and our expectations of further dealer inventory reductions, we took down our guidance for the year to $10.90 to $11.40 per share rather than the $12.06 and to $13.06 at the low end of that range that we had previously. We are -- have maintained margins, 15.8% for the quarter despite, obviously, lower production levels, which normally operates on your leverage and impacts, and that is due to a number of things like lower short-term compensation expense.

As we look out over the next several months, we are expecting fourth quarter to be flattish from a retail sales perspective. Our expectations are based on people making -- pausing to make decisions about buying machines as they look out into the global economic uncertainty. I think that is a factor. But if we look at some of our leading indicators, particularly within Cat Financial, things like past due rates and also quoting activity, those remain very positive. In fact, actually past dues were low -- were better than they were in Q2 and better than they were a year ago, which is a sign of no financial stress in the system, it's more around people's expectations of where future economic growth is going to be.

So with that, why don't I hand back to Mig, and we can...

QUESTIONS AND ANSWERS

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research and Senior Research Analyst*

All right. That's great. And just as a reminder to everyone in the room, if you'd like to participate in the conversation, please e-mail questions to session1@rwbaird.com. Andrew, first and foremost, welcome to the Baird Conference. This is your first time attending, so we're happy to have you here. And it's an interesting time because the tectonic plates, if you would, seems to be shifting out there in terms of not just macro, but demand for your various businesses. And maybe we can pick up where you kind of left off here. As you're thinking about flat retail demand in the fourth quarter, right? I mean, if there's one thing in machinery, we know that nothing is ever really flat. You're either up or you're down. In many cases, you're up a lot or you're down a lot. How do you sort of think about what's really happening currently. Is this a pause? Is this the beginning of something more meaningful? And I do understand that, to some degree, there's a crystal ball element that's applied here, but I think it has implications for how you're going to be managing your business as you look into 2020.

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Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes. So I think one of the things as we look out -- I mean, obviously, as I say, global economic uncertainty is a major factor on our business. If you look at most of our commodities for Resource Industries, most of those commodity prices remain at investable levels, for example. But obviously, miners are maintaining capital discipline. If you look at the oil and gas business, which is a big driver of E&T, if you look onshore oil and gas, particularly here in the U.S., although the Permian takeaway issues have been partly resolved, we are seeing, obviously, a certain amount of pressure being placed by investors and also by bondholders on some of the small independent firms, fracking firms. So that is drawing them to be cautious about their decision-making as they look out.

I think if you're thinking about from a CI perspective, Construction Industries perspective as well, if you are looking out, there is uncertainty in the outlook for many people. So if you are in a situation where you're not sure where the economy is going to go, rather than spend a significant amount of dollars on a machine where you could rent for a period of time or look at other purchase options, you may do that, and we are seeing a little bit of that going on. So if you look across our segments, what we always remind people is we're only 3 years into a recovery phase. Normal recovery time is normally 7 years of an upcycle, we're only 3 years into that. We are disconnected slightly from the global economic 9-year growth that's been out there since the financial crisis partly because of that -- the machinery recession that happened in 2014 to 2016. But that does mean that we do have -- some of our businesses are -- still have significant potential upside. A lot of that will depend on what happens with oil and gas prices, what happens with Resource Industries, how people maintain their discipline. But things like electric power, for example, is still at very early stage of recovery. Rail is still very early stage of recovery. So we have quite a significant number of our businesses, still in the early stages of economic recovery. And the thing about our portfolio is it does have -- you do have businesses in different stages as you look through. So that does enable us to look -- the challenge for us is looking at all those pieces and then how would -- do we put the jigsaw puzzle together as we look out beyond 2020 and meet our customer needs. The thing what we said is, which is really important for everybody, is we do have this bit flexibility to move either way, and that is really key. So if we do see expansion, we're ready to respond to that. Our factories are in a lot better position than we were 2 years ago at the start of the ramp-up, where there was a lot of bottlenecks as a result of supply disruptions. We are in a position to respond positively or negatively to market conditions.

As we said in the Q3 results, we have cut back production levels in Q3 and Q4, as we have seen that slowdown in dealer orders diminish. Obviously, we'll look and see what happens in Q4 and then sort of set out our guidance for 2020. In January, we'll give you a bit more of a feel for how we see things and the outlook.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research and Senior Research Analyst*

Not to try to pin you down here, but I think a lot of your industrial peers are acknowledging the fact that 2020, at the very least, starts slow. Maybe things get better in the back half of the year, but it starts slow. Is it fair to say that at least at this point, you are drafting your not just production plans, but really, your cost structure to get it properly aligned with a weaker demand environment. I mean are we to hear, for instance, of potentially additional restructuring or something of that matter to shore up decremental margins into 2020?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

So obviously, as we said, we are ready to respond either way. That's the most important thing. I mean if you look what happens normally in the upcycle is obviously, availability is diminished, and that is a big driver of some of the inventory build that dealers have made over the last few years, partly because they have seen sales -- lost revenues as a result of an inability to deliver equipment in time to a customer. So again, it's important that we maintain that flexibility. So obviously, at this stage, we are not making major restructuring plans for our plant network because we need to see what happens as we look through next year. What we are saying is, though, there are opportunities for us to look at cost. Those opportunities are things like, for example, in our procurement area. Obviously, as we've moved through the last couple of years, we paid a lot for premium freight in order to meet demand. That sort of cost will not be there as we move forward. There is an opportunity to go back through some of the supply base on cost increases we've seen over the last couple of years and actually challenge some of those cost increases to look at that. And there are opportunities in things like variable labor and burdens, where we've had some bottlenecks in the plants, which we wouldn't expect to go forward.

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So that helps us. Then also in sort of G&A-type expense, there are some things we can do, particularly around the back office, indirect procurement and so forth, which obviously will help us in the situation where we need that financial flexibility. So we are ready to act. We are doing already some production cutbacks that you may -- some of you may have seen some of the contract labor force has been laid off in response to that news report. So it is part of what we're trying to do to make sure we do maintain that competitive and flexible cost structure.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research and Senior Research Analyst*

That's great. I want to change gears a little bit and talk about dealer inventories. As I recall, I mean, out of Q3, you still do expect to -- the dealers to finish the year with roughly $500 million of additional inventory versus Europe. So I guess my question is, in an environment in which we're looking at flat retail sales in the fourth quarter, inventories are up $500 million. What does that imply for how you're thinking about dealer inventories, how they're thinking about the levels of stocking into 2020?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes. So as we always say, dealers are independent businesses, want to make their own decisions about inventory, and it will depend from dealer to dealer what they decide to do. Then the most important thing for a dealer is to look at availability. And as we talked about in Q2, we did see, for example, in Resource Industries, a significant reduction in the time taken to deliver products, on average, from 26 weeks down to 12 weeks. That improved availability does help dealers make decisions about the level of inventory they will hold. Obviously, that will depend on what their expectations are for 2020 sales, and obviously, they will look at that and make those decisions as they walk through. So at this stage, it's too early to tell. Once we get into January, we'll give a guide on what we expect -- our expectations what dealers will do. But obviously, we are seeing a significant reduction in this quarter. But if retail sales stay flattish, we are in the range, we normally talk about a 3- to 4-month range of inventories, but that obviously, then depends what dealers are looking at going forward as to where they will look at their inventories at that point in time. We'll have much more of a feel for that in January, which is when we'll update the market again for 2020.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research and Senior Research Analyst*

Fair enough. Last question on dealer inventories is really around your resources segment. Thinking about the third quarter in particular, but this is a trend that we really kind of started seeing earlier in the year, a bit of a disconnect between your revenues, and there are still very strong reported dealer sales in resources, right? Now that gap was pretty glaring in the third quarter. My question is basically is this, what's going on?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes. Yes. So remember, that a lot of the -- so in mining, a lot of the RI machines are delivered by us to the dealer, so that goes into our revenue at that point in time. Obviously, then dealers actually then have to rebuild the product. So if you're talking about large mining truck is shipped in component form and then rebuilt on site, that rebuild process takes a while, so there's a lag between when something goes out of our revenues and then goes into the retail stats, so a little bit of what you're seeing. And 2/3 of RI inventory is actually designated to a customer sale already in the dealer channel. So that is a different model than you would see in CI, for example, where there's much more of a steady flow-through of dealer inventory from us, revenue recognition and then into -- from -- out from the dealer on the other side.

So it is a slightly different model, and that also then is obviously impacted by the lumpiness of orders as well and the time when actually miners want to draw down, particularly in Resource Industries, their product and put it into production. So it's dependent on a number of different factors. Obviously, the other part of that is 30% of RI also relates to heavy construction, and we are seeing the same destocking trend in heavy construction as you are seeing within CI itself.

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Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research and Senior Research Analyst*

But -- and I don't know, perhaps, I'm not getting this. But if you're sort of looking at the gap, the variance in the third quarter that you've experienced, how much of that would you say is related to the folks in mining that are experiencing those dynamics you just described versus what's going on in -- on the construction side of the business?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Well, as you say, it's about 2/3 of it is mining -- of our RI business is around mining and about 1/3 is heavy construction. So it's a little bit of a mixed bag between the 2. Our expectations of inventory reductions are greater in heavy construction just based on product availability and what's actually out in the market rather than in mining, because as I said, within mining itself, a lot of that product, as it goes to the dealer channel, is designated for an order, customer -- from customer order and basically, it's just actually the rebuild process that takes it through and the period of time it goes through.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research and Senior Research Analyst*

Fair enough. We have a question from the audience here. This relates to your service business. And the question is basically this, as you're putting forth your service business goals, what does that mean for services as a percentage of revenue? Does that mean that Caterpillar is looking to actually increase the overall contribution from this business? Or is this just a factor of normal cyclicality, right, and just regular way of capturing your aftermarket? And then related to this, how do customer value agreements work?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes. So the thing about the target is, obviously, at the moment, last year, we had $55 billion -- $54.7 billion of revenues, $18 billion of that came from services. So it represents about 30% of the total revenue base. Obviously, that fluctuates based on what OE sales are in any particular year. But obviously, the advantage of service revenues are that they are less cyclical than machine sales. And it's also important, though, from a customer perspective, in order to provide them the service they need to have their machines working as best as possible. Those services are a key part of that. Obviously, the most -- the way we want to grow that, we want to grow that because we believe that is organic. There's a significant chunk of that which will be incremental add to Caterpillar. It is not an element of seasonality. We've never been at $28 billion before of service revenues. So this will be a -- this is a challenging growth target that we've set ourselves. The way we're going to grow that mostly is around -- actually, connectivity is a really key part of that as we talk about it. Connecting assets is important because then you know the hours of work, utilization rates, and you can then actually start to get towards what everybody would like to get to predictive maintenance as part of their process. Now we are a long way from achieving that today. But obviously, that is where people would like us in order to be able to reduce the total cost of ownership of their machine or optimize that total cost of ownership, reduce downtime, maintain service intervals and so forth.

The concept of the customer value agreement ties in very closely to that connectivity. So basically, one of -- if you think about it as an owner of a machine, one of your challenges is, obviously, making sure your machine is productive, it's working, it's operating effectively. You have right parts at the right time, right availability and that you're not in a situation where your machine is down for a significant proportion of time. That is -- the CVA concept is around making sure you have priority on parts, you will have priority on service with the dealer. And actually, basically, you'll be paying for this all upfront, so you will have a known cost, so you'll be able to spread that through your -- over the total life of the machine. So it gives you certainty in that. We have mixed bag around the organization. We have some dealers who are able to sell 90% of machines with CVAs. For example, Zeppelin in Germany has a very good track record on that, and others less so. But if you think about it, the concept is very simple. We all do it, when we go and buy an automobile, there are things like maintenance agreements. You buy your insurance for your car tires. All of these products are similar things to the concept of the CVA. And it's just about how do we operate that through the dealer channel. And then what services you're offering? Is it parts-only, parts and service, parts, service warranty? And all those things are -- tiered approach you can have.

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Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research and Senior Research Analyst*

As far as you're concerned, now, your returns overall, these agreements are enhancing the returns and margins?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Well, the point about it is, it's value for the customers. You've got to be value -- you've got to have a value proposition. So it's going to be something the customer sees value and so that's going to be a key part of it. But also for us, what it does, is it enables us to sell more services. So basically, just the same as your car dealer locks you into a service contract, you will go back to him, basically, it's the same thing. You will then service your machine through Caterpillar and the dealer network. And it's about trying to make sure that people understand the total cost of ownership. If you speak to customers, that's their biggest driver of decisions about how they operate their machines.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research and Senior Research Analyst*

And then I think we have time for one last question and it has to be on trade, right? Now that we're about 18 months into this trade comps like war, whatever you want to call it. I'm sort of wondering how the company and the management team is thinking strategically about Caterpillar's positioning. Are you doing anything different as a result of this change either in terms of investment, footprint, CapEx? I'd love to hear your thoughts on that.

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes. So obviously, for us, actually, the tariff despite what people thoughts are, tariffs were actually relatively small cost to Caterpillar. It was between $250 million and $350 million was our guidance. We now expect to be below the bottom end of that range. Actually, if you consider we have $55 billion of revenue, it's a very small impact on our total margin. So obviously, from a cost perspective, that is part of it. Also from a footprint perspective, obviously, we have over 20 factories operating in China. In China, we actually sometimes have a higher local content in China than the local competitors. So we have a footprint that is very designated to China. So therefore -- and also, we don't export a lot of machines out of China into the U.S. So from our perspective, there isn't a huge manufacturing footprint change. Caterpillar obviously operates in 125 facilities around the world, so we have a pretty global footprint. Obviously, we are a free trade advocate. We obviously believe in free trade. That's important for us as a company. We believe it's good for our customers. And obviously, any trade barriers are raised, we would like to see lowered, but obviously, it does -- it hasn't impacted our current decision-making. And obviously, we'll need to see what the future brings. But at this point in time, we're very comfortable where we are.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research and Senior Research Analyst*

That's wonderful. Thank you. Thank you for your comments. Please join me in thanking the management team for the presentation.

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