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EDITED TRANSCRIPT

CAT - Caterpillar Inc. Fourth Quarter 2012 Earnings Conference Call

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OVERVIEW:

CAT reported 2012 sales and revenues of $65.9b and profit per share of $8.48. 4Q12 sales and revenues was $16.1b and profit per share was $1.04. Expects 2013 sales and revenues to be $60-68b and profit per share to be $7.00-9.00.

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Caterpillar full-year and fourth-quarter 2012 earnings results. At this time, all lines have been placed on a listen-only mode and we will open the floor for your questions and comments following the presentation. It is now my pleasure to turn the floor over to your host, Mr. Mike DeWalt. Sir, the floor is yours.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Thank you very much and good morning and welcome, everyone, to our year-end earnings call. I am Mike DeWalt, Caterpillar's Corporate Controller and Director of Investor Relations. On the call today, I am pleased to have our Chairman and CEO, Doug Oberhelman and our Group President and CFO, Brad Halverson. This call is copyrighted by Caterpillar Inc. and any use, recording or transmission of any portion without the express written consent of Caterpillar is strictly prohibited.

If you would like a copy of today's call transcript, we will be posting it in the Investors section of our caterpillar.com website and it will be in the section labeled Results Webcast.

This morning we will be discussing forward-looking information that involves risks, 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 can be found in our cautionary statements under Item 1A, Risk Factors, of our Form 10-K filed with the SEC back on February 21 of 2012 and also in the forward-looking statements language contained in today's release.

In addition, a reconciliation of non-GAAP measures can be found in our financial release and that has been posted on our website at caterpillar.com.

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Okay, this morning, before we get into the Q&A, I am going to cover four topics. The first will be a short summary of the full-year 2012. Then I will take a few minutes to discuss how we ended the year compared with what we expected in our outlook for 2012 that we issued back in October. My third topic will be a comparison of the fourth quarter of 2012 with the fourth quarter of 2011 and then I will finish up with my final topic, which is a discussion about our 2013 outlook. Then I will turn the floor over to Doug Oberhelman and Doug will take a few minutes to talk about our Siwei acquisition.

All right, let's get started with 2012. And we were very pleased to report this morning that it was another record year for both sales and revenues and profit. Sales and revenues were $65.9 billion and that was an increase of 10% from 2011. Profit was $8.48 a share and that was up 15%. Now the $8.48 per share for the year did include the goodwill impairment charge of $580 million, or $0.87 a share and we announced that back on January 18.

At $65.9 billion, sales and revenues were lower than we expected when we were at this point about a year ago in January 2011 with our first outlook. After a great first half, economies around the world began to slow around midyear. As a result, dealer sales to end users began to flatten out, and we found ourselves with inventory that was too high and dealers also found themselves with too much inventory.

As a result, dealers slowed orders and in the third quarter, we began the process of scaling back production. Now while production declined somewhat in the third quarter, we took it down much more in the fourth quarter. And because of that, we were able to reduce inventory in the fourth quarter by $2 billion, far surpassing our goal of reducing inventory by about $1 billion.

Now, in addition to the $2 billion that we took out in the fourth quarter, dealers also reduced inventory by about $600 million in the quarter. So in combination with our inventory and dealer machine inventory, a total of $2.6 billion came out in the fourth quarter. That is a lot of inventory coming out in one quarter and it was certainly a negative for sales, efficiency and the impact on cost absorption.

Now turning back to the full year, from an operational standpoint, 2012 was a good year. We have been providing a table near the back of our financial release each quarter this year highlighting our incremental operating profit pull-through. Now when we show that, we try to make it apples-to-apples and to do that, we have been adjusting for the impact of acquisitions and divestitures. And on that basis, our full-year incremental operating income was 43% of incremental sales and revenues. Now that 43% was helped by currency impacts over the course of 2012 and excluding those items, it was 33%. Still much better than our goal of about 25%.

Now, in addition to operating income, we continue to improve quality, safety measures and our sales improved faster than the overall machine industry in general.

Finally, in response to the weaker economic climate we found during the second half of the year, we've slowed down capital spending. Our CapEx for 2012 was about $3.4 billion and that is over $0.5 billion under our original expectations for 2012.

Okay, that is a quick review of 2012. Let's move onto the second topic, and that is how we did versus the outlook we provided last October. Last October, we were expecting 2012 sales and revenues to come in at about $66 billion. And with actual sales and revenues of $65.9 billion, we were right about on what we thought.

Our outlook for profit at the time was a range of $9 to $9.25 with a midpoint of $9.13. We ended the year at [$8.48] (corrected by company after the call), so we missed the outlook. There were two large items that we didn't anticipate in the outlook, one negative and one positive. The negative item was the $580 million, or $0.87 a share goodwill impairment related to Siwei. The positive item was the settlement of US tax returns and that was a $300 million, or $0.45 per share, positive.

Excluding those two large items, again, neither of which was anticipated in our outlook, profit was $0.10 per share lower than the bottom of our range and about $0.23 per share below the middle of the range. About two-thirds of the difference from the $9.13 midpoint was the cost impact from the more substantial production and inventory cuts in the fourth quarter. Most of the remaining difference was from currency translation losses reported in the other income and expense line below operating profit and that was related to the euro primarily.

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While the scale of production and inventory reduction was certainly negative to efficiency and profit, we were pleased with what we achieved in terms of the inventory reduction. It has been a major focus throughout the Company over the last couple of quarters and it was an exceptional result.

Okay, let me move onto my third topic this morning and that is the fourth quarter versus the fourth quarter a year ago. Sales and revenues of $16.1 billion were about $1.2 billion or 7% lower than the fourth quarter of 2011. While there were certainly pluses and minuses, the most significant factor in the sales chain was dealer inventory. Dealers added about $800 million to inventories in the fourth quarter of '11, which was positive for sales back then and in the fourth quarter of '12, they reduced new machine inventories about $600 million and that was a negative. In total then, the impact on sales of dealer inventory changes was about $1.4 billion and that was more than the total change in our top line.

Profit per share in the quarter was $1.04. And that is lower than the $2.32 per share that we reported in the fourth quarter of 2011 by about $1.28. As with the full-year numbers, the Siwei goodwill impairment was negative $0.87 a share and the tax settlement was positive $0.45. Other unfavorable factors in order of importance were manufacturing costs and they were unfavorable $417 million and that was primarily a result of the significant impacts of the decline in production in the fourth quarter and the $2 billion inventory reduction.

Sales volume was negative $371 million, tax impacts, and this is excluding the $300 million positive item, were unfavorable $0.36 a share. We had a higher tax rate in absence of favorable items from a year ago. Other income and expense, again, which is below operating profit, was negative $136 million. And that is essentially the absence of currency gains a year ago versus losses in the fourth quarter of '12. Now one positive factor that partially offset those negative items was price realization and that was a positive for the quarter. Now, in our release today, on page 6, we have a waterfall chart that goes through the changes in operating income and that can provide a little more detail. All right, that is the fourth quarter.

My final topic this morning here is the outlook for 2013. We will start with economics. And from that standpoint, we do see conditions improving and expect world economic growth of at least 2.5% in 2013 and that would be a small improvement from our estimate of about 2.3% for 2012. I think the key phrase here when we talk about the world economy in 2013 is a bit better, but still weak.

In the United States, we are becoming increasingly optimistic. The Fed's interest rate policies and their plan to continue injecting liquidity are, in our view, positive for 2013 growth. We are expecting the US economy to grow at least 2.5% in 2013. Now that is not what any of us would consider a robust level of growth, but it is certainly better than what we saw in the second half of 2012. We expect the US housing industry to help the economy in 2013 and we have all seen the positive news items related to housing over the past few months.

In Europe, we are expecting another tough year for growth. The problems in Europe are well-known and much of the region is entrenched in fiscal austerity. As a result, we expect growth in the euro zone to struggle to match 2012. And we expect that construction activity there will decline. We are more positive about the prospects for the developing economies around the world. In many countries, they have been easing policy and lowering rates for more than a year and average rates today are close to levels that were last reached during the financial crisis. So we expect that to contribute to better growth in '13.

Specifically, in China, we are expecting improvement in 2013. In response to the 2012 slowdown, the Chinese government has accelerated credit growth and infrastructure spending and as a result, the economic data that we have seen in the fourth quarter has begun to improve. Our outlook assumes the Chinese government will maintain pro-growth policies throughout 2013 and we are expecting economic growth in China to be near 8.5%, a more favorable environment for construction and higher commodity demand. Okay, that is a quick look at our economic view. Let's turn to sales and revenues.

We are expecting sales and revenues to be in a range of $60 billion to $68 billion, reflecting both upside and downside potential from 2012. We are increasingly optimistic that there may be potential for better growth ahead, but we remain cautious about how quickly that improvement is going to translate into higher sales for Cat. At the $64 billion middle of that outlook range, we are expecting overall end-user demand to be relatively flat with 2012. We do expect pluses and minuses by segment and I'll cover that in a minute, but overall demand relatively flat.

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At the midpoint of the outlook though, we do have a $2 billion decline in sales and revenues from 2012 and that is primarily a result of dealer inventory changes. Over the course of 2012, dealers added about $1 billion to their inventories and in '13, our expectation is that dealers will reduce inventory by well over $1 billion. So the net of that is an unfavorable impact on sales of over $2 billion.

By segment, we expect sales in Resource Industries, which is mostly mining, to decline. As we said last October, mining customers have been lowering their CapEx expectations for 2013 and order levels have been very weak since the middle of 2012.

Another sales negative next year is going to be in our All Other segment. In terms of sales, it is very small and we usually don't have much to say about it. But over the first half of the year, we expect it to be about $400 million lower in sales and revenues than the first half of 2012 and that is due to the absence of sales from our third-party logistics business, which we sold in July of 2012.

We expect sales in our Power Systems segment to be relatively flat with 2012 and on the positive side, we expect that construction industry sales will be flat to up in 2013 with improving end-user demand.

In summary on sales, at the middle of our outlook range, dealer inventory changes are driving the most significant piece of the reduction in sales. For profit, we are expecting a range of $7 to $9 a share. Profit in 2012 was $8.48. So at the middle of the range, we had profit declining $0.48 a share. Negative items include absence of the tax settlement, that was $300 million in the fourth quarter, absence of about roughly $275 million gain from the third quarter related to the sale of our third-party logistics business, the $2 billion decline in sales, higher depreciation.

Now if you look at cost and price realization together, excluding depreciation, so price net of cost, we would expect that to be overall relatively neutral next year. We do have a big positive item and that is absence of the $0.87 per share impairment charge that we recorded in the fourth quarter.

Now my final point here on the outlook is really about the first quarter. And while we are not providing a specific sales and profit outlook for the quarter, we are expecting that sales and revenues are likely to be significantly lower than the first quarter of 2012. Now to put it in perspective, let's think about the full year.

At the middle of our outlook range, we expect sales and revenues to be down about $2 billion for the year and it looks like all or more of that $2 billion is likely to be in the first quarter. And that is a result of further reductions in production from the fourth quarter as we and our dealers continue to work down inventory. As a result, profit is also expected to be significantly lower in the first quarter of 2012. Again, a result of lower sales and some negative cost impact from continuing to reduce production and take out inventory.

Okay, that is my review. With that, I will turn the floor over to Doug.

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

All right, thank you, Mike and good morning, everyone. It is Doug Oberhelman. I would like to take a few minutes to talk about the $580 million impairment charge that we announced on January 18 related to our acquisition of Siwei. I will start by going over some background.

Siwei is a company located in China and they make hydraulic roof supports that are used in underground coal mining. China is the world's largest coal producer and the vast majority of it is mined underground. The acquisition of Siwei is a starting point for Caterpillar's entry into the Chinese underground coal business. We completed the acquisition in June 2012 and at about that time, as we do at Caterpillar, we moved experienced Cat people into our newly acquired company to start the process of bringing Siwei into the Caterpillar family.

In the fall, we started a physical inventory and reconciled or I should say attempted to reconcile the physical inventory with the books. Our newly appointed team at Siwei found a substantial discrepancy, which led to our investigation. What we discovered was deliberate multiyear coordinated accounting misconduct at Siwei. It was executed by several senior managers at Siwei for the purpose of inflating sales, understating costs and overreporting profit and it included fabricated documentation designed to cover their tracks.

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In light of this new information, we had to take a goodwill impairment charge, which was included in our fourth-quarter results that we reported this morning. The conduct we discovered does not represent in any way, shape or form the way Caterpillar does business or how we expect our employees to work. As a result, we moved quickly and decisively to hold responsible the leaders that were directly accountable for the wrongdoing and we have changed the leadership at Siwei.

Because this happened in an acquisition we made in China, it has raised questions in the media about our strategy in China and I would like to address that. China is the largest country in the world by population. It is developing rapidly and it is one of the fastest-growing large economies in the world. It is already the world's largest market for construction equipment and has a large mining industry. It is a very important market now and as we look to the future, we expect it to become even more significant.

While the industries we serve in China are significant, it doesn't mean there aren't challenges. The construction industry in China had a tough year in 2012. As in other countries, the construction and mining industries in China are subject to changes in the overall economy and over time move with the business cycle. We don't have to look any further than US housing to see that cyclicality happens in countries other than China.

Our strategy in China has centered around bringing our products, services, support capability, manufacturing scale, supplier development procurement, product development and distribution to China for the long term. That will continue. The impairment at Siwei doesn't change that. China is the world's leading coal producer and the products we make at Siwei are important for that industry. We will develop and improve those products for use in China and for export and we intend to add more products to better serve the Chinese coal mining industry.

When we looked at Siwei, we felt we could make improvements with Caterpillar's experience and people and given our strategic imperatives, this deal made sense. In fact, we have already made good progress on significantly lowering Siwei's most significant cost driver, steel. The ability to lower steel costs is just one example of leveraging Caterpillar's scale and global network to improve Siwei's operation.

Our announcement of the accounting misconduct and impairment is something that no CEO wants to make. It is disappointing, one we would rather not have had to deal with, but when faced with challenges like this, it is how we respond that defines us. We talk a lot about accountability at Caterpillar and I sure have preached that here in the last three years as CEO. I recognize the decision to acquire Siwei happened on my watch and the buck stops at my desk. I am accountable for that acquisition.

There has been a tremendous amount of time, energy and resources dedicated to this investigation up to this point and we are not done. We are putting in more effort to finish our investigation. As we do with processes and products at Caterpillar, we are constantly looking for improvement. We will apply what we learned from this as we go forward.

One final point, we were deliberately misled by the accounting misconduct at Siwei and we are considering all options to recover our losses and hold those responsible accountable for their wrongdoing. Related to that, we have a long-standing policy not to comment on pending or contemplated litigation and further comment is not appropriate at this time. That means we won't be going into more detail on this subject when we take your questions about 2012 results and the '13 outlook. With that, I will turn it back over to Mike.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Okay, thanks, Doug. With that, we are ready to go into Q&A please.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). David Raso. Please announce your affiliation, then pose your question.

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David Raso - *ISI Group - Analyst*

Hi, ISI. For 2013, the sales midpoint, if we strip out Cat Financial, we are speaking about $61 billion. So that said, a question on the Company inventory. Your Company inventory as a percent of trailing sales -- I am looking at the equipment company -- just came down from over 27% of trailing sales to now below 25%. So when we think about 2013, the target for Company inventory, are we comfortable with that 25% level? I am just trying to get a feel for how much more Company inventory you expect to take out in 2013.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Good question, David. And honestly, we don't track it as a percent of sales. What we are targeting is inventory turns, which is essentially related to cost of sales, not so much sales. Although, of course, they are tied together.

I think, to a large degree, where -- in terms of dollars where we end up on inventory at the end of 2013 will kind of depend, to some degree, on where we are at in terms of the outlook. If we are at the bottom of the outlook or the top of the outlook, I suspect that the inventory number will look different.

If you just start with where we are today in terms of inventory, there is more to come out in the first quarter. I certainly don't think it will be on the scale -- we are not predicting it will be on the scale of what came out in the fourth quarter, $2 billion, but certainly there is more coming out in the first quarter. So it has got to come down from here.

David Raso - *ISI Group - Analyst*

But at the midpoint, do we feel there is more inventory to come out?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Yes.

David Raso - *ISI Group - Analyst*

Okay. And then related to that, the guidance by segment, if I look at Construction Industries, you said flat to up slightly. You used 3%; Power, flat. I assume all other pullout Cat Logistics and -- it's a small number, call it flat after you pull that Cat Logistics out. It would seem to be implying Resource Industries down call it 10%, 11%, 12% on revenues for the year. Is that a fair characterization of how you are looking at Resource Industries and how do we square that revenue guidance up with the orders for the equipment have been down more than that the last two quarters?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Yes, a couple of things. One, we gave general direction on the segments and I think the way you have described it in terms of general direction is absolutely correct. It is Resource Industries that is going to have -- again, other than the absence of logistics -- really all the decline. How that squares up with orders -- we are starting the year with actually a reasonable backlog for the big product. But we do need to take on more orders over the course of the next maybe two quarters to make the forecast. So it is not a case where orders can stay at the level that they have been during the second half of '12. So it will need to go up.

But it looks to us like the bottom is actually the third and the fourth quarter of last year. We have already seen a pretty substantial pickup in construction orders in the fourth quarter. Most of the decline in orders that we saw I think in 2012 and the second half of the year on construction was related to dealers wanting to take out inventory. I hope that helps. David, we probably need to move on to the next person in line.

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David Raso - *ISI Group - Analyst*

All right. Thank you.

Operator

Jerry Revich.

Jerry Revich - *Goldman Sachs - Analyst*

Good morning, it's Goldman Sachs. My two questions are on the pricing outlook. Mike, first, how would you characterize the pricing environment on new Resource Industries' bookings today compared to what you were shipping out of backlog. Do you expect positive price realization out of that business? And second, does the pricing outlook include any benefit for your construction equipment business from the net export position out of Japan given the recent movement that you had? Thank you.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Okay, that is a real mouthful, Jerry. I think, in general, I would say we are cautious on pricing next year. Our outlook reflects something around 1%. We did better than that in 2012. I think we were actually a bit surprised as we went through the year at how well pricing held up. We don't have a big difference looking forward to next year between the segments. We have small improvements baked into each of them, but nothing big.

I think given another year of relative weakness in the global economy, I mean, my goodness, 2.5% is nothing to jump up and down about in the world economy; it is pretty weak. I think we are sounding a fairly cautious tone on pricing, but, by the same token, we are not trying to be alarmists here. It is not as though you have a big touch anywhere. It is just weak economic growth and caution on our part.

Jerry Revich - *Goldman Sachs - Analyst*

Thank you.

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

I would like to add to that, Mike, just a little bit on kind of our business model and strategy and we are really working on market share, field population around the world to make sure that that seeds our business model and that plays also into the kind of pricing philosophy we have because we are trying to juggle that much better as we go after an increasing field populations, which then drives our aftermarket, drives our dealers, as you all know. So that plays into that equation as well.

Jerry Revich - *Goldman Sachs - Analyst*

Thank you.

Operator

Jamie Cook.

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Jamie Cook - *Credit Suisse - Analyst*

Hi, good morning, Credit Suisse. Just wanted to dig a little deeper into how you guys are thinking about the backlog and in particular mining backlog or order trends. I guess, Mike, at what point do you expect to see a stabilization or improvement in orders within mining and which areas are you guys most optimistic or pessimistic on because I guess when I think about your stock, the overhang has been mining -- I'm sorry -- has been inventory, which you are working through -- mining is the next one -- because we are just trying to get a feel can Cat -- if you look at Cat 2013 as a transition year, can Cat grow their earnings in 2014 on just construction if mining continues to deteriorate? And I will get back in queue after that.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Okay. Well, in terms of 2014, of course, we'd like to get through 2013 first.

Jamie Cook - *Credit Suisse - Analyst*

I know. But you did lay out 2015 long-term targets, so --.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

On mining again, we had massive orders, very large orders in mining throughout much of '11 and really through almost the entire first half of '12. That is when sentiment changed I think in the world economy. It was evident that China was softer. You had an easing of commodity demand, although, overall, mining activity actually did go up in '12. So orders on hand were quite significant and over the past six months, customers have really eased off on ordering. It did start to pick up a little bit late in the fourth quarter, but it is certainly not what we would consider to be at a sustainable level. It needs to go up from here.

Right now, we have good availability, so when the order rates start to move back up a bit, we will certainly be in a position where we can take care of the customers. Again, for the large product, we don't have certainly 100% coverage for 2013, so we do need to take in orders both for kind of filling out the year in 2013 and for 2014. So I think we would want to see some continued improvement in order rates really between now and midyear to make that happen.

Jamie Cook - *Credit Suisse - Analyst*

And Mike, can you just say -- you said it picked up a little late in the fourth quarter. Can you just talk about which areas specifically within mining that you saw that? Geographically by commodity, however you wish to --.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

No, no, no and partly because it is relatively small. I mean I am not trying to make a big deal about it. We went from let's say very low to low. So still below where we needed to be.

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

I would just add, Mike, that we did add a slightly firmer price forecast for iron ore and copper; you saw that in our outlook statement. If that happens, of course, that will help the order rates as the miners respond to that. A lot of it is just dependent on world growth as it goes through the year as well and if that would be above our 2.5% rate on a global basis, we would probably expect that to go up. If it is lower, we would probably not see it come back as fast. So there is really a high correlation there. But we did put out a $135 order price. So we will see how that goes throughout the year.

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Jamie Cook - *Credit Suisse - Analyst*

Thanks.

Operator

Seth Weber.

Seth Weber - *RBC Capital Markets - Analyst*

Hey, good morning, it's RBC. A couple clarifications just to start. The fourth-quarter pickup in construction equipment orders that you cited, Mike, is that just typical seasonality or can you talk about how that is trending year-over-year?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Yes, no, I think, in some ways, I think, Seth, the year-over-year trends, at least if we are looking at order rates for construction, have more to do with dealer inventory than actual demand levels. I think it is a case where -- think about it. If you are a dealer and you want to lower inventories, the way you do that is you lower order rates below what you are selling and then we ship you less and then you lower your inventory. So that is what happened really beginning in the third quarter. Construction orders were very weak in the third quarter and that means our production levels in the fourth quarter went down and dealers cut out inventory.

So the order level is always, order of magnitude, three, four months ahead of where our production levels are. So what that means is I think the pickup that we saw in the fourth quarter probably has more to do with dealers seeing the light at the end of the tunnel on inventory reduction.

Seth Weber - *RBC Capital Markets - Analyst*

Okay, that's helpful. Thank you. And then on the inventory reduction that you saw this quarter, was the Siwei adjustment, did that contribute to the inventory reduction that you booked?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

No, no, virtually not at all. I mean not zero, but it is so small that it would be less than rounding.

Seth Weber - *RBC Capital Markets - Analyst*

Okay. And then if I could ask another question just on the mining space, the slowdown that you are seeing or the cancellations, is that related -- is that still related to primarily growth projects or are you starting to see the mining companies scale back on sort of more maintenance type stuff?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Yes, no, I think if you were to judge it by order levels, they have cut back on capital spending across the board.

Seth Weber - *RBC Capital Markets - Analyst*

So including maintenance type stuff?

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Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Yes, I mean order rates over the last six months in mining have been very low. I mean if you think about it, I mean at about midyear, we had a very large backlog as a result of the year and a half of very high orders. And really for the last half of 2012, they essentially took a break from ordering and it was pretty much across the board. I wouldn't pick necessarily on one commodity versus the next or one type of project versus the next.

Seth Weber - *RBC Capital Markets - Analyst*

Okay, thank you very much.

Operator

Theoni Pilarinos - *Raymond James - Analyst*

Theoni Pilarinos - *Raymond James - Analyst*

Good morning, Raymond James. I'm just reading through your outlook section and I see a lot of bullish points. You have higher housing starts, PMI, commodity prices going up, pro-growth policies. So I am just wondering why you have such a wide guidance range and what is really baked into that $7 number.

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

Yes, this is Brad Halverson. I think if you look at our range, we have been down this path before. We do see some positive news as we have mentioned in our release. North America is getting stronger. At Cat Financial, we finished the fourth quarter strong with retail financing up and frankly past dues at the lowest level they have been since 2007.

But if you look at the last two years, we have been in this path with good momentum in the first half of the year, fiscal cliff issues, debt ceiling issues, election issues, China slowing down. And so, in our industry, we are prepared for both sides and that is why we have a wide range and I think when we get through the first quarter, we are going to know a lot better. But internally, we are planned for both sides and we surely hope to see the high side of our outlook and another record year for sales and profit.

Theoni Pilarinos - *Raymond James - Analyst*

Okay, great. And a follow-up question. You talked about your construction orders picking up at the end of the fourth quarter. Where do we see that in your dealer stats (technical difficulty)?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Theoni, you are cutting out. Could you restate that?

Theoni Pilarinos - *Raymond James - Analyst*

Yes, sorry. You mentioned that there was a pickup in orders in the back half of the -- at the very end of the fourth quarter. And I am just wondering where do we see that in your dealer stats? From what I saw, they were declining.

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Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Dealer stats are what they are selling, not what they are ordering.

Theoni Pilarinos - *Raymond James - Analyst*

Sorry. You said there was a pickup in demand rather, and so the dealer stats indicate demand was declining in December. Am I correct there?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Well, if I said demand, what I meant to say was that, for construction in particular, orders later in the fourth quarter picked up. Again, that is what they are ordering; that is not what they are selling.

Theoni Pilarinos - *Raymond James - Analyst*

Okay, thank you.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Now, but I will make a comment on the retail dealer statistics that came out last Friday. And it was a little weaker than it had been. I mean we were in the range over the last few months of about 5% or 6% and in December, it was down 1%. And I think there are two reasons for that or two -- I am sure there are definitely many more, but the two that stand out are, in the fourth quarter last year, we had just a very, very large pickup between November and December in North America, up more than 50% in one month. And I think a lot of that or some of that anyway had to do with the bonus depreciation that was expiring at the end of last year. So I think that helped out dealer sales a bit in the fourth quarter of last year. So I think between that and coal mining sales being down a bit in December, that really amounts I think to most of the decline. Next question please.

Operator

Robert Wertheimer.

Robert Wertheimer - *Vertical Research Partners - Analyst*

It's Vertical Research Partners. Good morning. My first question is on mining. It seems as though you have a little bit of mining inventory at dealers, which I don't think is typical other than in-transit assembly and so are you able to quantify that or comment on it? And the related question to that is it seems as though, despite all the noise on mining CapEx and there is clearly cancellations and push-outs and a more cautious atmosphere, it seems as though the top 10 or 15 miners are only spending down 5% or 10% in '13 versus '12. Your orders sound a lot worse than that.

So I guess there is a question. Did the companies over order and there is a lot of inventory sloshing around either at mine sites or at dealers and that the normal level is actually, based on CapEx as it stands now, is higher than now or not? So how do you feel like orders are versus mining global CapEx?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Well, there is a lot wrapped up into that, Rob. But I think there are a couple of differences between order rates and mining CapEx. First off, I mean we come into the year still with growth for the large products in particular a reasonable order backlog. So that is reflective of that plus whatever

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new orders we take in what we are actually going to sell. What has happened, as dealers and customers have ordered mining orders over the last six months, a bit of that has come out of the backlog. So I think there is a little bit of a difference because of that.

Your point on dealer inventory is also actually a good one. We don't usually have dealer inventory in the normal way you would think about it where we ship a bunch of trucks to a dealer, they put them together and set them on the lot and wait for a customer to come by. It doesn't normally happen that way. But we do have substantial dealer inventory and that's essentially a pipeline.

Now with activity levels, with sales levels coming down that we would expect a part of the decline in dealer inventory, actually quite a bit of it, next year to be related to mining. So what that means is what the miners would have as CapEx is what they would be buying from dealers, not what we are selling to dealers. So I think their CapEx numbers probably are going to look a little bit better than our sales number because some of it will be out of dealer inventory if that makes any sense to you at all.

There are a couple of spots where we actually do have inventory that is a little bit beyond what you would think of as just a pipeline that's in process waiting to get put together, assembled and commissioned on site. But by and large, most of the mining inventory around the world is a pipeline that is kind of on its way to dealers.

Robert Wertheimer - *Vertical Research Partners - Analyst*

That is helpful. And if I can ask Mike a quick follow-up. On hours run on mining equipment, has it come off at all? And I know Central Appalachia is a little down, but if you looked at your global total number of trucks running and total number of hours, your aftermarket mining was down again this quarter. Are they running fewer hours or not?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

I don't know the answer to that. If I did, I would give you an indication, but I don't. I do know that parts volume around coal mining is down, but in terms of hours elsewhere, I'm sorry, I don't know the answer.

Robert Wertheimer - *Vertical Research Partners - Analyst*

Great. I'll stop there. Thanks.

Operator

Ann Duignan.

Ann Duignan - *JPMorgan Chase - Analyst*

Good morning, JPMorgan. And Doug, you and Jamie Dimon can commiserate I think together. My question is around China and the inventory overhang that we have been dealing with there on the construction equipment side. I would be remiss if I didn't ask how that is going and where are we in that process since, according to our contacts when we were over there in December, that we got about a year's worth of excess inventory still there. So maybe you could update us on that region.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

I am not quite sure what the contact is -- your contact is, Ann. In China, remember, they normally have a pretty good selling season in the spring. It's sort of disproportionate with the rest of the year in terms of seasonality. We have really not taken much inventory -- dealers have taken a bit of

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inventory out of China over the last quarter, but we have not taken much inventory out. If you look at our $2 billion decline in the fourth quarter, actually very little of that had anything to do with China.

Our view is that that will be a first and second-quarter phenomenon as we go through the selling season. We are keeping production levels in China pretty low so that we can use the selling season to kind of soak up the inventory that is there. But certainly there is not a year's worth of sales.

Ann Duignan - *JPMorgan Chase - Analyst*

Well, that was actually the President of LiuGong and also confirmed by comments on excavators in particular. And then can you talk about in general reducing your inventories? Are you having to use financial services as a way of incentivizing sales in anyway, both either you or the dealers? We look around the world and it doesn't seem like the greatest environment to be trying to liquidate inventories. Can you talk a little bit about what you're having to do to get those inventories down?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

I feel like an old TV commercial. We are doing it the old-fashioned way. If you think of inventory as a bucket with water flowing in and water flowing out, we are severely -- we have severely restricted the water flowing in. So we have really lowered production. That is the main driver of inventory down. There is no fire sale of finished inventory going on. It is a lowering of production.

Ann Duignan - *JPMorgan Chase - Analyst*

So no extended terms or changes in leasing arrangements or anything on the financial services side?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

I mean nothing of any materiality, no. And if you think about it in context, sales to users have been relatively flat. We have lowered -- dealers lowered order rates; we lowered production. Our inventory is going down. Dealers are receiving less material; their inventory has gone down. So it really has to do with what is going into the channel. What is leaving the channel I think has been fairly stable.

Ann Duignan - *JPMorgan Chase - Analyst*

Okay, I'll leave it there and get back in queue. Thanks.

Operator

Andrew Kaplowitz.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Good morning, guys. It's Barclays. Mike, can you talk about the Bucyrus business, in particular maybe talk about its execution? Sales were up in the quarter, but margins are still I think pretty low. Maybe how it is trending versus your expectations?

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Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Yes, I mean there is a lot of moving parts in Bucyrus. I will make a few generalizations overall to kind of maybe frame it for the future. There is a lot that we are working on there, a lot of benefits that we are working hard to deliver. One of the things that we have talked a lot about is putting Cat components in Bucyrus product. And we have done that for some of the trucks, we have done that for some of the hydraulic shovels, have availability to Cat engines. That engineering work goes on.

So on one hand, there is a lot of extra engineering spend going on right now at Bucyrus to get that done. That's a big positive for the long term that we don't have completed yet and aren't really seeing much of the benefits. So that is sort of one point.

We are in the middle of selling off to the dealers Bucyrus distribution. And again, that is a good positive for the long run for us. That puts one of the world's premier distribution and service organizations, the Cat dealer network, squarely in the middle of driving aftermarket sales for that product. But we are still in the middle of doing that.

In the short term, immediately after you do that, after you sell distribution to a dealer, they have essentially bought a profit stream and they have margin and our margin goes down. So while we are in this process of transferring the distribution to Cat dealers and they are ramping up and making improvements and we are putting inventory in place, there is going to be a bit of a lag between the time that we lose margin because they bought it and the time where the good things that they can bring to it generate higher sales.

So I think we will probably be in a period for a year or two where we would think of sort of normalized -- I always hate to use that word, but I suspect -- if you look at the rest of the mining business, you have much higher margins. Because of the extra engineering work, the process of selling distribution to the dealers, we are probably looking at more high single digits for a while until the benefits start kicking in as opposed to mid-teens prior to the acquisition.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Mike, that's helpful. If I could step back and ask you maybe a slightly more philosophical question, if I asked you about lane inventory strategy, like this is sort of the first, I don't know if you want to call it mini downturn or whatever it is, to test the strategy, how would you assess this strategy? How has it worked? And is there anything that you could do to improve it as you go forward?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Well, there is always things you can do to improve it. I think lane inventory right now -- despite everything that we took out in the fourth quarter, lane inventory did not -- it was a piece of the total, but it wasn't the major piece of the total. I think we still, and I talked about this a little bit ago, there is still too much inventory in China and again, the post Chinese New Year selling season we think will take care of much of that.

Outside of that, generally speaking, it is our view that the lane inventory is by and large thereabouts the right level based on what we think we are going to sell. We have got good performance in terms of shipping out of lane one and I think that is certainly going to be a contributor to dealers being able to take out some more inventory.

So it is like all things. There are things you can do better. While the overall inventory level, excluding the China piece, is probably close to what we would like it to be. There is some product that we wish we had less of and some product we wish we had a little bit more of. But I think, by and large, it is at about the right amount and it is doing what we want.

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

This is Brad Halverson. Maybe I'd make one quick comment here. As dealers started to reduce their inventory, it really kind of delayed the benefit of all the actions that we really started on midyear and we are really happy with the inventory reduction that came out in the fourth quarter.

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As we move forward, integrated supply chain from order to customer delivery is something we remain focused on and we would expect improvements throughout the year. We have operating targets at all of our units, as we call it inventory turns, to improve in 2013 and this will remain a focus for us. We see some opportunity in this space.

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

I would just add also I think you probably all read our announcement regarding Gerard Vittecoq, our Group President, who is retiring in May of 2013. We have asked him and a small team of very deep experts on everything from lean manufacturing to integrated supply chain to order-to-delivery to really study where we are right now and deliver by May timeframe a vision and strategy to really take us into world-class levels of integrated supply chain and ordering.

I expect great things from that study. Gerard is really wound up about it and off to a great start. We will probably talk more about that at the analyst meeting later this year, I suppose. But that will really chart us then for the finale I would say of our CPS efforts between now and '15. And I am really excited about it. I will be leading that, cheerleading that and driving that the next couple of years.

Andrew Kaplowitz - *Barclays Capital - Analyst*

I appreciate it.

Operator

Eli Lustgarten.

Eli Lustgarten - *Longbow Research - Analyst*

Longbow Securities. Good morning, everyone. Can I just get one clarification? The $85 million R&D tax credit, is that all going to be taken in the first quarter?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Yes.

Eli Lustgarten - *Longbow Research - Analyst*

Can we go back to resources? You basically said $2 billion, more than $2 billion down in the first quarter. I mean the implication, when you look at the year, is the second and third quarter will be relatively flat and you hope you get enough orders to match the fourth quarter, which was quite strong? Is that a fair profile of what we can expect?

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Well, I will respectfully decline to answer. I mean we tried to give a little guidance on the first quarter. We tend not to do quarterly. I think the way we have kind of set it up, and I wouldn't say specific to every quarter, but I think most of the, I don't know, call it pain inventory reduction, negative impact on sales and production is likely to be in the first quarter.

Again, from an overall demand standpoint, we are looking at, right now, at the midpoint anyway for 2013 to be relatively similar to 2012. Again, ups and downs by segment. As you mentioned Mining, weaker; construction, stronger; Power Systems, relatively flat. But I think what that leaves

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you -- if you think about most of the decline being in the first quarter, at the midpoint of our range, it would tell you that we wouldn't be expecting big changes for the rest of the year.

Eli Lustgarten - *Longbow Research - Analyst*

And a follow-up. We have final Tier 4 being effective January 2014. Can you give us some idea of how that is going to affect Cat as you go through it? Do you plan to roll out the product this year or the beginning of next year? That is another big deal that we have to deal with, not as big as interim, but still something to deal with.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

I think at the risk of patting ourselves on the back too much, Tier 4 for us, whether it was interim or the work that has gone on for final, has just gone exceptionally well. In our releases over the last couple of years and the outlook that we talked about today, you have not really heard us talk about one bad thing that was the result -- either on margins, pricing, cost. We haven't said one bad thing about Tier 4.

The changes that we made in our R&D process, what we learned from Tier 3, we have applied and it has gone very well. So I wouldn't expect that -- if rest of it goes anything like it has so far, I wouldn't expect anything negative.

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

Mike is right, Eli and I would just add here that we are about halfway to Tier 4 final. And certainly January of '13 brings another batch of new machines in throughout the year as does January '14 and then in 2015, of course, we have heavy horsepower locomotive and inland marine and oceangoing coming.

So, so far, our teams have just performed outstandingly with quality results on Tier 4 introductions and our customers are happy, our dealers are happy, but we are really just about halfway and the next 18 months are going to be heavy as you suggested.

Eli Lustgarten - *Longbow Research - Analyst*

All right. Thank you very much.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Okay, I think we have time for certainly one more.

Operator

Ted Grace.

Ted Grace - *Susquehanna Financial Group - Analyst*

Hi, thank you. It is Susquehanna. Hey, Mike, how are you doing? I don't know if this is for Mike or Doug or possibly if Steve is on the line, but we have talked about kind of the need for mining orders to inflect some point this year to potentially reach the goals. But could you at least characterize how sentiment feels on 2014? Some mining companies have already given a framework -- Vale, Freeport, Newmont to name a few -- but could you maybe just give us a sense for, base on what you're hearing, how you are thinking about 2014 on the Resource Industries side?

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Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Yes, this is Mike. I will start it off. I will let the other guys chime in as they would like to. But, again, what is going to happen with mining is a function of world growth, what happens to commodity demand. As Doug mentioned earlier, we are, I would say, cautiously optimistic on China, which is good for commodities, which stabilizes prices and ought to be good for mining.

So our long-term view of mining remains I think very good. The issue of declining ore grades and deeper mines is still there. So equipment sales over the long term in our view should outpace actually even mining production. So I think the fundamentals economically around it look pretty good for the long term on our part. I am not personally close to the miners. I don't talk to them, so I'm afraid I don't have any insight on that piece of it.

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

I don't have much to add. It's Doug here. But I fully, fully believe that our idea on long-term mining around the world and our strategy to get after it, whether it is surface or underground, is exactly the right one for this Company. I am not sure anybody saw -- could see the current cycle with what happened in China slow down, but having said that, we deal with cycles in this Company and we have for many, many years. You know 2009 dropped 39% in one year. We are used to this, unfortunately. But I have got to believe that a decade out, mining -- the moves we've made in mining and the strategy that comes from that if we execute well, will really pay off.

I also think that, at some point, we are going to see world GDP above 2.5%. And I don't know if it is '13, I hope it is, and I don't know if it is '14, I really hope it is, but we will see world growth move up to 3% to 4% at some point. I have got to believe that's in our near-term future. If that happens, it is going to be mineral-driven. It has to be around the world as we have seen every time.

Housing starts, we are calling for over a million. The drive for copper on that is huge. You all know that and lumber. So I am still as optimistic as I have ever been on mining long term. The cycle we have to deal with and we always have and we will get through it. But I really like the play. I think -- I come back to the number of people on the planet that want to move up their standard of living and will and over time that plays right to mining and arguably to some of our infrastructure construction as well. But medium and long term, I am still really bullish on what I see for mining.

Ted Grace - *Susquehanna Financial Group - Analyst*

And then as a follow-up, maybe a Brad or Mike question, if you look at the midpoint of earnings guidance and you think about pulling more inventory out and the guidance you have given on CapEx, it looks like it could be a really big free cash year. So I'm wondering if you could just maybe frameout your expectations on free cash and then just philosophically how you are thinking about use of cash, whether it is continuing to kind of fortify the balance sheet and build cash, any change in views towards a dividend increase or buybacks and things of that sort and that would be great.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

Well, that is a very long-winded question, Ted and I will get started on that. I think if you look at -- we report on operating cash flow, so let's use that for a proxy. I think our expectation is that, at the midpoint of our outlook range, we would see operating cash flow substantially better in '13 than '12. I mean substantially. And the factors are declining inventory rather than increasing inventory and I think there is a little bit of a timing impact there as well. We took $2 billion out of inventory in the fourth quarter and that was split between raw material, work in process and finished goods.

And so we had a quite sizable decline in payables related to that. And as that kind of stabilizes out, you won't have that year-over-year negative on that. So I think all in all, from a cash flow perspective, 2013 looks like a better year relative to '12 than if you just looked at the profit relative to

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'12. And I think beyond that -- in terms of our overall -- the structure of our balance sheet, nothing has really changed over the last 30 days or three months in terms of what we are thinking about the future and how we structure the balance sheet.

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

I would just say, Mike, our balance sheet is strong right now. Our debt-to-cap is 37%, under 30% on a net debt-to-cap basis. We have over $5 billion in cash and so we did manage our CapEx down this year below expectations as the volume moved. And so we think we are in a great position capacity wise, we are in a great position moving forward and clearly, our priorities for cash that we have talked about many times has not changed.

Ted Grace - *Susquehanna Financial Group - Analyst*

That's great, guys. Congratulations. Good luck this quarter.

Mike DeWalt - *Caterpillar Inc. - Corporate Controller & Director, IR*

We are a little past time. Thank you for joining us. We will sign off.

Operator

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

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