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EDITED TRANSCRIPT

CAT - Q1 2014 Caterpillar Inc. Earnings Conference Call

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OVERVIEW:

CAT reported 1Q14 sales and revenues of $13.2b, profit per share, excluding restructuring costs, of $1.61 and profit per share, including restructuring costs, of $1.44. Expects 2014 sales and revenues to be about $56b in a range of plus or minus 5%, profit per share, excluding restructuring costs to be $6.10 and profit per share, including restructuring costs, to be $5.55.

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Caterpillar first-quarter 2014 results conference call. (Operator Instructions)

It is now my pleasure to turn the floor over to your host, Mr. Mike DeWalt. Sir, the floor is yours.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Thanks, Kate. Good morning, everyone, and welcome to our first-quarter earnings call. I am Mike DeWalt, Caterpillar's Vice President of Strategic Services, and on the call today I'm pleased to have our Chairman and CEO, Doug Oberhelman, and our Group President and CFO, Brad Halverson.

This call is copyrighted by Caterpillar Inc. Any use, recording, or transmission of any portion of the call without our expressed written consent is strictly prohibited. If you would like a copy of today's call transcript, we will be posting in 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 those factors that either individually or in the aggregate could make actual results differ materially from our projections, that can be found in our cautionary statements under Item 1A, which is Risk Factors, of our Form 10-K that we filed with the SEC in February of 2014. It is also in the forward-looking statements language in today's release.

In addition, a reconciliation of non-GAAP measures can also be found in today's release, which has also been posted on our website at Caterpillar.com.

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Now before I get into the details I should also mention that we made organizational changes that went into effect at the start of 2014. Responsibility for paving, forestry, industrial and waste, and tunnel boring products moved from Resource Industries and you will find it in the financial release today in All Other operating segments line. In addition, responsibility for some work tools was moved from Resource Industries to the Construction Industries, and the responsibility for administration of three wholly-owned dealers in Japan move from Construction Industries and it's also in the All Other operating segment in today's release.

We also reclassified restructuring costs for 2013. We moved it from segment profit to corporate items and we did that to be consistent with how we are presenting 2014.

The most significant impact of these changes on our reportable segments was for Resource Industries. And to put that in context, for the full year of 2013 that reorganization moved about $1.5 billion of sales from Resource Industries, but it had very little impact on profit for Resource Industries. In fact, only about $10 million for the full year.

Now after these changes, the vast majority of Resource Industries' sales are related to mining and quarry and aggregates. We put a Q&A on this morning's release on the reorg. It's Q&A number 7 on page 17 and it includes a quarterly breakdown of the impact for Resource Industries.

We also changed the name of our Power Systems segment to Energy & Transportation. We did that to better reflect what the segment actually does and we made the changes before our analyst meeting at CONEXPO last March, but if you missed it, Power Systems is now Energy & Transportation.

Okay, let's get into first-quarter results. At $13.2 billion, sales and revenues were flat with the first quarter of 2013 and were pretty close to what we expected. Profit was $1.61 a share excluding restructuring costs and $1.44 including restructuring costs.

The restructuring costs were $149 million or about $0.17 a share. Most of the $149 million was related to the previously announced restructuring of our Gosselies, Belgium, manufacturing facility.

Now to better compare results for the first quarter of 2013, the remainder of my discussion on the quarter will be excluding restructuring charges.

The profit of $1.61 excluding restructuring was $0.29 a share higher than the first quarter of 2013. While in the aggregate sales were unchanged from last year, if you look at our three large segments, there were very different stories and I will cover each one.

The most positive was Construction Industries. It was up 20% from the first quarter of last year and in fact this quarter it was our largest segment by sales, which were over $5 billion and up more than $800 million from the first quarter last year. They were up about 36% in North America, 20% in Europe, Africa, Middle East, up about 10% in Asia/Pacific, and were almost flat in Latin America.

Now to understand what happened in Construction Industries' sales you do need to consider dealer inventory. It was a big part of why sales were relatively weak last year. Normally, during the first quarter of each year dealers buy more from us than they deliver to customers and they build inventory for the second quarter. We call it the selling season. And that means that for dealer deliveries to end-users the second quarter is usually the highest quarter of the year.

Now that inventory build didn't happen for construction last year. That is because dealers ended 2012 with sufficient inventory of construction equipment and their inventories during the first quarter remained pretty flat a year ago. This year that wasn't the case and dealers reverted to the more usual seasonal pattern and built inventory in the first quarter for sale in the second-quarter selling season.

Now, in addition to the dealer inventory impact, end-user demand also increased versus the first quarter of last year, and you may have seen that in our release of dealer statistics yesterday where dealer deliveries for the first three months of 2014 were up 9% for Construction Industries. Bottom line, for Construction Industries demand is better for construction and we believe dealer inventories are in pretty good shape relative to seasonal needs.

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Okay, that's Construction. For Energy & Transportation, sales were up about 8% in the quarter. Remember, Energy & Transportation is made up of several sales -- it serves several industries: oil and gas, power generation, transportation and industrial. And oil and gas, power gen, and industrial were all up a bit more than the 8% average that Energy & Transportation was up as a whole.

Transportation-related sales were about flat versus the first quarter last year. Energy & Transportation has been a stable performer over the past year and that certainly continued in the first quarter.

Move on to Resource Industries, which again is principally mining, that is a different story. Sales were down 37% from the first quarter of 2013 and most of the decline was end-user demand, which again you can see in the retail statistics that we released yesterday where deliveries of new equipment were down 46% in the first quarter versus the same period a year ago.

The decline we are seeing in the mining industry began in mid-2012 and it has continued. The business declined throughout last year, and because of that, the first quarter of 2013 was last year's highest sales for Resource Industries and it came down from there. So that's making it a particularly tough sales comparison for us Q1 to Q1.

For Resource Industries, order rates for new equipment have remained weak in the first quarter and substantially below the peaks of 2012. That's the bad news. The good news is that we were close to an equilibrium of order rates in sales in the first quarter, and as a result, the order backlog for Resource Industries was fairly close to being flat with year-end 2013.

So in summary on sales, Construction Industries up, Energy & Transportation up, and Resource Industries down quite a bit. Sales overall as a result, flat. But, while sales were flat, profit was up.

In general, it was a pretty good story across each of our three large segments and I think because of that it makes sense to talk about profit this quarter by segment. And I will start with Construction Industries, which had a great quarter with operating profit up $460 million on a sales increase of $845 million.

I think there are three things to cover with Construction Industries. One, you have to go back to last year, think about the first quarter of last year. Our sales and production were relatively low and partly that's because we and our dealers started 2013 with probably too much inventory.

In the first quarter of last year, most of the factories that we have that made construction equipment were at least partially idled. This year we were producing more and with our factories producing more we were doing it more efficiently. Related to that, inventory reductions from last year resulted in negative inventory absorption impacts on profit and this year that was much, much less.

Second thing about resource -- I'm sorry, Construction Industries profit, we have continued to focus on managing costs and we were able to hold our period costs. Those are costs that are relatively fixed. We have held them flat with last year despite a pretty significant increase in production volume.

The third thing about Construction profit was currency and currency impacts versus the year ago were positive for us and mostly related to the yen. But remember, we are a net yen exporter. We are a Japanese manufacturer. So all-in-all, profit for Construction Industries in the first quarter was the best since the second quarter of 2012.

Let's move on to Energy & Transportation, which had another good quarter with operating profit rising $236 million on a sales increase of $371 million. That resulted in operating profit as a percent of sales being up from the first quarter of last year.

Now the increase in our profit dollars was primarily due to higher sales volume, lower manufacturing costs, and price realization for Energy & Transportation was slightly favorable. Now when you think about Energy & Transportation and profit over the course of 2013, it's probably worth noting that the first quarter last year was the weakest profit quarter of 2013 and Energy & Transportation margins improved over the last three quarters of the year.

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The operating margin rate in first quarter of 2014, this quarter, was reasonably in line with the last three quarters of 2013. Thankfully it's a diverse business. It has been a consistent performer over the past year and that includes this quarter.

Let's turn to our Resource Industries. Operating profit for Resource Industries, again that's predominantly mining, was down substantially versus the first quarter. Operating profit declined $310 million on a sales decline of $1.2 billion. That's the bad news.

The good news is the decremental margin rate, that's the change in margin divided by the change in sales, was a mere 25%. And that's a demonstration, in our view, of good cost management in a business with variable margin rates that are much higher than 25%. Resource Industries has made substantial progress on reducing costs as demand has declined.

Operating margin as a percent of sales is now mid-single digits, but for a capital intensive business where demand has been hit this hard we think that is pretty good performance. It is a business where sales of its most significant product, mining trucks, are expected to be down this year about 80% from the peak year of 2012. To be even profitable in an environment like this demonstrates the success they have had in managing costs.

Okay, that's operating profit. Let's turn to the outlook for 2014. Now in our year-end financial release from January, we provided an outlook for 2014 sales and profit. We said we expected sales and revenues to be similar to 2013 at about $56 billion and we put that in the range of plus or minus 5%.

We said then that there were encouraging signs in the world economy and that we were expecting sales improvements in Construction Industries and Energy & Transportation. And that is still the case. Our outlook in January expected Construction and Energy & Transportation to be up about 5%, and that's still the case for Energy & Transportation. However, we increased our view of Construction from up 5% to up 10%.

However, in our original outlook we expected sales to be down in our Resource Industries segment by about 10%. In this outlook we have reduced that forecast and now expect it to be down about 20% from 2013.

Despite the prospects for a better year in the world economy and continued strong production at mines, mining orders for new equipment haven't really improved and remain at pretty low levels. Order rates are a fraction of where they were in 2011 and during the first half of 2012 and are substantially below where we believe the long-term sustainable level is.

Our outlook from January expected mining orders for 2014 to remain low, but be modestly better than the second half of 2013. So far this year that hasn't happened, and based on where we are today, even if we started to see some improvement in orders, it likely wouldn't be soon enough to have much impact on 2014. And that is why we lowered the Resource Industries' outlook today. That's the bad news.

The good news is new mining equipment sales in our outlook are low enough that we believe the downside risk for 2014 in our outlook related to Resource Industries is reasonably limited. That doesn't mean that it couldn't go down further. It just means that the sales of new equipment for mining are so low in the outlook that, even if there's no improvement in order rates at all, the downside in the scheme of things is limited.

So overall our outlook for sales and revenues remains $56 billion in a range of plus or minus 5%. There is certainly potentially it could be higher than $56 billion if the economic activity around the world accelerates or if mining orders increase meaningfully in the short term.

But there's also plenty of downside risk that could cause it to be below $56 billion. A couple examples include geopolitical. While we are hopeful that the situation in Russia and the Ukraine will be resolved, if it does get worse and has an impact on business confidence, world trade, and world growth it could certainly be a negative for us.

We are closely watching growth rates in China. We had a good first quarter in China. In fact, company sales were up 30%. But we are concerned that if economic growth in China slows enough, it could have an impact on our business. Those are two good reasons why we have a 5% plus/minus range around our $56 billion sales outlook.

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Now in terms of the profit outlook, on the strength of our great first-quarter results we raised our full-year operating profit by $0.25 a share. Excluding restructuring costs, our profit outlook moved from $5.85 to $6.10 and with restructuring charges or costs it moved from $5.30 to $5.55 this year. Now our overall expectations for restructuring costs in 2014 remains at about $400 million to $500 million with the midpoint impact on profit per share of about [$0.55] (corrected by company after the call).

Okay, to help you think about the rest of the year, there's one more thing I would like to cover in the outlook and that's how we think the rest of the year could shake out by quarter. Of the three remaining quarters of 2014, of course that is Q2, Q3, Q4, we would expect of those three the fourth quarter will be the highest for sales and profit. We think the third quarter will likely be the weakest and that the second quarter will be slightly below the average of Q2, 3, and 4 in terms of sales and profit. I hope that helps you calibrate your expectations for 2014.

One last point before we move to the Q&A. We had a good quarter for operating cash flow. We were up from $1.1 billion in the first quarter of last year to $1.9 billion in the first quarter this year. Our balance sheet remains strong with the debt-to-capital ratio for Machinery and Energy & Transportation of near 30%.

During the first quarter, we repurchased approximately $1.7 billion of stock and over the last four quarters we have repurchased about $3.7 billion. In January the Board authorized a new five-year program to repurchase an additional $10 billion in stock. And while we have not announced additional repurchase for this year, as we move through 2014 we will certainly continue to review our options for cash deployment.

So that's a rundown of the quarter and the outlook. With that we are ready to move on to Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Ted Grace.

Ted Grace - *Susquehanna Financial Group - Analyst*

Susquehanna. Congratulations on the quarter. I was hoping, Mike, maybe you could walk through, specific to Construction Industries, how production kind of progressed through 1Q and how you would encourage us to think about production in Construction Industries in the second quarter. I realize you gave that quarterly guidance and that in itself is helpful on a consolidated basis, but could you maybe just help us understand how production and cost absorption work through 1Q and how you would encourage us to think about 2Q?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Yes, I will -- we actually stretched it a little far, farther than we normally do on guidance for the rest of the year, so I'm going to be a little hesitant on breaking it out even further. But what I can tell you is this. If you just think about how it has changed over the course of the past year, as we came into 2013 a year ago we were cutting our inventory, our PDC finished inventory, and dealers would normally add inventory in the first quarter and they didn't do that. So our production a year ago was pretty low for Construction.

And if you look at the first quarter of this year, dealers built inventory as is kind of the normal pattern and as a result of that and us not making as substantial reductions to PDC inventory, our production went up a lot. Our production was up more in the first quarter than sales. I think if you look forward for the rest of the year, you can kind do the math on this a little bit based on us saying sales up 10% for Construction over the course of the year.

The rest of the year for Construction Industries sales will be probably not massively different than the first quarter. So probably not wide variations in production because the sales numbers -- the first quarter was not far off being a fourth of the year.

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Ted Grace - *Susquehanna Financial Group - Analyst*

Okay, that's helpful. The second thing I was hoping to ask is on the restructuring side just an update on where things stand in Europe specific to Belgium. And then in the press release it seemed like that you may have cited more potential restructuring benefits in the year. I was wondering if you could just elaborate on that.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

We certainly weren't trying to signal more restructuring benefits for the year. I think Gosselies restructuring is coming along about as we expected. We got approval in the first quarter from the local officials.

I was expecting maybe a question on why the entire $300 million that we were expecting for the year wasn't in the first quarter, and that's because we will be recognizing the expense related to that as we get specifics on the individuals that have accepted the offer. So that will probably come in through the course of the year.

I would say, if you look at all the restructuring activity that we have done over the course of the past year, one of the places you can see it is actually in employment. If you think about this, our sales in the first quarter of this year were about the same as the first quarter of last year. And if you look at the employment schedule in our quarterly release today on flat sales our employment levels are down I think 8,000 to 9,000 people. I think that's where you can see the impact of not just lower volume, but also some of the restructuring activities we have taken.

Ted Grace - *Susquehanna Financial Group - Analyst*

Okay, that's really helpful. Best of luck this quarter, guys.

Operator

Stephen Volkmann.

Stephen Volkmann - *Jefferies & Company - Analyst*

Good morning, it's Jefferies. I had a question about the revision in your outlook and I guess I'm wondering -- maybe two parts.

On the Construction business, what and where are you seeing the improvement that gives you the visibility on the 5% improvement on the top line that you talked about, Mike? Then on the Resource side, I'm curious; you talked about the OE being pretty limited at this point. But can you just discuss a little bit about what you are seeing on the aftermarket side and whether that's still declining? It sounds like it is, but what is the outlook there?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

A couple of things. One, with Construction, I think the one area, geographic area that I would say has had the most upside for us is actually North America and you can kind of see that I think in the retail statistics that we have provided. It's doing pretty good, so I'd say North America is the reason for the upside.

On Resource Industries, on your comments, specifically aftermarket, and in our release today we did say that versus the first quarter of last year within aftermarket or within Resource Industries parts sales were lower than a year ago and that's true. But they came down over the course of last

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year. If you look at parts sales within aftermarket -- within Resource Industries, over the last few quarters it has been stable. It's not down like it was from Q1.

So it fell during last year. It has held pretty stable over the last couple of quarters and we are hopeful at some point in time here it will start to tick up. It seems like it should.

Stephen Volkmann - *Jefferies & Company - Analyst*

Okay, and then just a quick follow-up. I guess pricing in both of those segments was a little bit weak, a little bit negative. Should we worry about that? What is the outlook there?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

We are not really expecting much price at all this year. We came into the year we said I think less than 0.5%, if memory serves me, which is, in the scheme of things for us, pretty small.

I think that if you look at the four quarters of last year actually pricing levels were probably in those businesses a little better in the first quarter than they were for the rest of the year, so it was a little bit of a tougher comp for us. There's certainly pricing pressure out in the marketplace and that's why we are not expecting much for the year, but overall our view on pricing by and large hasn't changed much from when we came into the year.

Stephen Volkmann - *Jefferies & Company - Analyst*

Thank you very much.

Operator

Eli Lustgarten.

Eli Lustgarten - *Longbow Research - Analyst*

Longbow Securities. Congratulations, guys. Can we talk a little bit -- you talked about Construction Industries. You sort of, in your commentary of the year, basically said that the rest of the year volume levels went up -- radically altered from the first quarter. Can you talk about the profitability of this sector for the rest of the year?

You had a very impressive first quarter for lots of reasons. I assume you are expecting double-digit operating margins in the sector, but not quite up to the first-quarter level. Is that a fair representation of what to expect the rest of the year?

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

Eli, this is Brad Halverson. It's a good question. One, I would say that we are extremely happy with the profitability of the Construction Industries. We had an operating margin of around 5% kind of in our core product line. If you look back a year, we finished the fourth quarter at 9.9%.

We like this business to be double digits. We did have good mix. Some positive things happened in the first quarter that gave us a record return for the Construction business at 13.6%. I would say an expectation for the rest of the year, slightly above a double-digit number would be a good estimate. We think that's good profitability for where this business is at right now.

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

Eli, it's Doug Oberhelman here. I would just add a comment on the pull-through objectives we've had going back a number of years of 25% on the additional dollar of revenue. And while we did much better than that in Construction and Energy & Transport this quarter, I would expect that over time 25% is our objective.

So we will have some quarters that are juicy like this one and maybe some that aren't so juicy I guess, but overall we are after that. And as Mike said in his comments, even our Resource business on the way down held with 25%, so I'm pretty happy with that.

But I would steer it that way as an answer to your question. If it comes up better than that, great, but there will be quarters where we will be talking about the other side of that.

Eli Lustgarten - *Longbow Research - Analyst*

Along the same line, when you look at Energy & Transportation, with the first-quarter volume up 8% and the year up 5%, we're talking maybe slower top-line growth. But I assume that we are expecting better product mix for the rest of the year that will enhance the profitability to match last year's numbers. Is that sort of the expectation that we should look at in that sector?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Eli, there are -- that segment has -- serves a bunch of different industries that have, let's say, sort of different profitability characteristics. So in any quarter that you get into you are subject to a little up and down on margin, based on whether the increase is oil and gas or industrial engines. They have a different margin profile.

If you look at what Energy & Transportation has done over the last four quarters, the margin rate has been within a relatively tight band and I don't think our view for the rest of the year would have it being dramatically at one side or the other of that. So it has been a consistent performer and I think our view of the rest of the year is that it will continue to be a consistent performer.

Eli Lustgarten - *Longbow Research - Analyst*

One final question. Will you talk a bit of what we should expect out of the finance company this year given the changes in the first quarter, the weakness in the first quarter?

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

Eli, this is Brad Halverson. The Financial Products division, I think, has continued to perform very well. Their profit was down compared to the first quarter of last year, but in the first quarter of 2013 we had a positive adjustment due to improved warranty, improved quality, and we have a Cat Insurance business in Cat Financial. So we had I think it was roughly $40 million positive adjustment in first quarter.

So their results quarter over quarter are slightly up. Their portfolio is growing slightly. Their past dues at the end of the first quarter were I think a record in the last 10 years or so, and so their portfolio is performing well. I think you can expect, similar to Energy & Transportation, pretty good, stable performance out of them the rest of the year.

Eli Lustgarten - *Longbow Research - Analyst*

Okay, thank you very much.

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Operator

Seth Weber.

Seth Weber - *RBC Capital Markets - Analyst*

Good morning, it's RBC. I'm just trying to reconcile the comment about Construction on the aftermarket sales being flattish in the quarter. If demand is really improving, wouldn't you expect to see an increase in aftermarket sales for the Construction business?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

I think aftermarket for the Construction business, for any business is usually related to activity. It was pretty flat for the first quarter versus a year ago.

It's not as -- aftermarket is not quite as, I don't know, maybe relative to the total maybe as significant as it might be in industries like mining. As activity goes up, as construction spending goes up, as housing starts go up, you would think that would as well.

Might have something to do a little bit, Seth, with a particularly bad winter. That might have put a little damper on actually work being done. Other than that I don't know of any big reasons why it should be off that pattern.

Seth Weber - *RBC Capital Markets - Analyst*

Okay, thanks. Then I guess a similar question on the Resource business. Are you seeing -- are customers still idling the equipment or bleeding off of parts inventory?

We are starting to get the sense that some commodity production volumes are going -- are rising like US coal. So can you give us a sense for where you think your customers stand on their parts inventory levels and how their -- how soon you think we could see a pickup in that business?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

I don't know about the inventory levels, but again, if you kind of look sequentially at what's going on over the last three months, it has not continued to go down. It has remained pretty stable over the last three quarters actually.

I think as activity goes up we would fully expect parts sales to go up. There's a pretty strong relationship. You could -- customers can only put off maintenance or cannibalize idle equipment or idle the oldest equipment for so long before that begins to catch up with you and the dynamics of a business that is pretty tough on equipment starts to come through. So I think at some point here we would think that it would pick up.

Seth Weber - *RBC Capital Markets - Analyst*

Okay. But do you get the sense that the idling is still occurring then?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Yes, I think there's definitely still some parked fleets. It's not the same everywhere in the world but, yes, I think -- I won't quote a number but, yes, there's definitely still parked fleets.

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Seth Weber - *RBC Capital Markets - Analyst*

Okay, thank you very much.

Operator

Jerry Revich.

Jerry Revich - *Goldman Sachs - Analyst*

Good morning, it's Goldman Sachs. Mike, you had nearly a 10% SG&A and R&D reduction on flat sales this quarter. Can you talk about is there something in the comparable period or is that consistent with your expectations for the year?

And then the restructuring actions and resources on the manufacturing side came over the course of last year. I'm just wondering how far along in harvesting those savings are we at the first quarter compared to the ultimate run rate.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Jerry, this is Mike. I will start this. We had a very good first quarter. Costs were lower than a year ago, but I think we also were very cautious coming into the year. We purposefully tried to slow down -- even what we have in the hopper for program spending over the course of the year, we tried as much as we could to be very cautious on spending, even what we planned to do for the first quarter, and so I think that has helped.

As some of those programs that we want to do because they are the right thing for the long-term, but we have been cautious on in the first quarter, I think there will be some increase in spending over the remainder of the year for programs like that. That's why -- if you look at the profitability of our outlook for the next three quarters, that's one of the reasons why it's down a little bit relative to Q1.

But, again, I will go back to a comment that I made earlier -- this is actually a total company question. We have taken a lot of costs out since the first quarter of last year. I think if you look at the employment numbers that kind of -- and particularly because this quarter was a quarter that had almost dead flat sales, it really brings home the magnitude of the actions that we have taken to adjust the cost base to the current volume situation.

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

And I might add -- this is Brad Halverson -- we are really happy with the quality of our earnings. We are focused on business model. We are growing share, a little price, and we are really focused on lean deployments across the enterprise, both at our factories and in the office.

And so we had increased short-term incentive pay expense in the first quarter, which we are happy about, going to our employees based on our performance of roughly $140 million. So we had roughly $500 million of cost reductions for us. And so with a mining business that is contributing just a little over $100 million that used to contribute $1 billion that will come back and where our cost structure is, we are going to continue to focus on this but we are happy with where we are at.

Jerry Revich - *Goldman Sachs - Analyst*

Thank you. Then can you talk about what you are seeing in Western Europe for Construction and Energy & Transportation? I know you are concerned about Eastern Europe, but it sounds like cement volumes are finally starting to pickup and maybe operating hours are starting to improve. I'm wondering if you could just touch on if you seeing a pickup in demand off of low levels in Western Europe across your businesses.

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Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Well, I was just looking at the Construction numbers this morning. If you look at our first quarter, actually Construction in Europe was positive, it wasn't negative. So I think it's not as robust as what we are seeing in North America, but I think it's probably a little bit of a case where the economic situation there doesn't seem quite so dire and I think the environment for customers to do some machine replacements is probably a little bit better. And we are seeing that, some positive in our Construction numbers in Europe in general.

Jerry Revich - *Goldman Sachs - Analyst*

Thank you.

Operator

Steven Fisher.

Steven Fisher - *UBS - Analyst*

Thanks. Good morning, it's UBS. Just trying to get a sense of the growth rate of the segments that you moved to the All Other category as it compares to the core mining business.

If you didn't to the re-class, would mining still have been down 20% or for the year would it have been more or less than that? Because I guess if the stuff you moved into All Other is not quite as bad, then the reduction in guidance might not be as severe.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

What we moved last year, for the full year anyway, was $1.5 billion. It's the kind of product that would more closely -- in most cases, more closely follow Construction. Paving for example. Forestry has a relationship, say, with housing construction.

So it would have been a year over year, at least year over year, first quarter to first quarter it would've been a little bit positive. It was -- it's a different profile than mining. Honestly, I haven't looked at that level of detail in the outlook but it wouldn't surprise me if what you say is to some small degree true.

The difference, though, is that it's a smaller portion. It was a relatively small portion of Resource Industries so I don't think the impact would have been that. On the percent change, the 10% to 20%, I don't think it would have been massively significant to that. But it certainly would not have been down 20%. It would have been likely up.

Steven Fisher - *UBS - Analyst*

And then to get to that minus 20% from minus 37% in Q1 in Resources, are you assuming any year-over-year growth at all or just kind of significant moderations in the decline?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

When you say year-over-year growth, explain it a little bit more, Steve.

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Steven Fisher - *UBS - Analyst*

Just because you have to do better than the minus 37% and the balance (multiple speakers). Is that just a rate that's well below the 20% or could you actually see something that's up year over year?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Yes, I think as we go through the year you'll see that gap narrow. I probably wouldn't want to be so specific as to say at fourth quarter it's up or down, but if you think about the trajectory of last year, it started out stronger. There were orders that were being produced and shipped and sales were higher, and it declined as you went through the year.

I think the fourth quarter, if memory serves me right for Resource Industries, was about 20% below the first quarter. So I think if we get any kind of a modest improvement going through this year it will narrow that gap. So I would think that year-over-year gap would come down probably in every quarter.

Steven Fisher - *UBS - Analyst*

Okay, great. Thank you.

Operator

Andrew Casey.

Andrew Casey - *Wells Fargo Securities - Analyst*

Good morning, Wells Fargo. I just wanted to go back to the profitability for the rest of 2014 and make sure I understand the puts and takes. Should I think about the slower margin improvement relative to what you posted in Q1 as driven really by three things: more difficult Energy & Transport comps, fairly good-sized headwind from higher incentive comp, and then fading headcount benefit? Are those the three main things?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

No, I wouldn't say -- no, I don't think so. I don't think Energy & Transportation is going to be materially different probably than the first quarter. So what we are thinking about here, Andy, is the second or the last nine months of the year versus the first quarter.

I think the way to think about it is we usually have seasonally low costs in the first quarter. We would approve programs that our units can spend money on during the year, but it usually takes a little time for that to ramp up. So first quarter is usually light on costs, fourth quarter is usually a little heavy so we would see program-related costs going up.

Incentive comp that you mentioned is up year over year, but we have that in the first quarter, too. So I don't think -- there is not a material -- there is no difference really between the first quarter and the rest of the year for that.

Depreciation usually kind of ramps up as we go through the year. As we put capital in place it goes up. We have things like our annual merit plan is effective April 1, so we get a bit of a bump up in labor costs usually from Q2 on.

I think another point, and Brad mentioned this earlier, and that is margins in Construction Industries. I think relative to the first quarter Construction Industry mix is going to probably get a little bit worse. More of the rest of the year we would have smaller product.

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We expect some rental reload to occur over the course of the year, more than we had in the first quarter. First quarter was a little more excavation-focused, particularly in China, so probably a little bit of a declining mix in Construction as we go through the year.

Then for Resource Industries there are programs that we cut last year, things that we really want to do for the long term. Engineering around getting our components and what was Bucyrus product, getting all the hundreds of thousands of part numbers into our system for aftermarket. That all requires some spending.

We delayed it last year and as we go through the course of this year, those are programs that we want to spend money on. They're the right thing to do for the long term. The rest of our business is pretty stable and we kind of need to get to it. So I think those are the kinds of things that caused profit over the course of the last three months of the year to be maybe a bit below the first quarter.

Andrew Casey - *Wells Fargo Securities - Analyst*

Okay. Thanks for that, Mike. Then if we go back -- thanks for the clarity, but it makes me a little more cloudy in my thinking about how to get to the Q4 being the highest of the last three quarters. Is there anything unusual that you are building into that quarterly comment? I'm wondering if there's any --?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

No, no. The fourth quarter for us usually is a big sales quarter. It's usually right up there with -- sometimes the second quarter can be higher than it, but in general the fourth quarter is usually seasonally a pretty high quarter. The third quarter and the first quarter are usually the weakest, so of the last three, the third quarter would be the weakest.

We think the second quarter is probably close to but a little bit below the average of the three. We don't really have anything unique, any big, strange expenses. When I talk about these numbers, by the way, I'm excluding restructuring costs because the timing of that could have a different effect. And of course, that's why we pulled it out.

But no, we don't have anything off the top of my head that I can think of that's going to be odd about any quarter. It might turn out to be that way, but certainly we are not planning it that way.

Andrew Casey - *Wells Fargo Securities - Analyst*

Okay, thanks. I will follow up offline.

Operator

Ann Duignan.

Ann Duignan - *JPMorgan - Analyst*

Hi, JPMorgan. Actually, my first question is for Doug, if you are still in the room. Doug, it was interesting to me that you mentioned Ukraine, Russia, and also China as potentially headwinds, but you didn't mention Latin America and in particular Brazil. Are you not concerned about the macro environment in Brazil, or is that something you've been planning for all year and so incrementally it's not getting any worse than you might have anticipated?

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

I would put Brazil macroeconomic as one -- or macro situation as one of those we would be watching. I would not put it in the same category as the others that I talked about -- China, Ukraine, and maybe a couple of others in the Middle East -- at all.

We have got a pretty stable business across Latin America. Brazil has got some projects that are coming in that would be doing some things around infrastructure this year, next year, and the year after that ought to help that. But the overall macro situation there is one to watch, frankly.

Ann Duignan - *JPMorgan - Analyst*

Okay, that's helpful, the color. Can one of you talk about where does Tier 4 pricing show up in your numbers? Is that in the pricing bucket or is that not included because it's separate pricing? Just trying to get a sense of net pricing; are you giving away the Tier 4 costs and is that impacting margins? Or are Tier 4 prices being passed through but not incorporated into pricing?

If you could just give us some color on what's going on with Tier 4 pricing and whether you are actually getting pricing.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

So it's not included in our price realization bucket in our kind of waterfall chart in the release and that is because the content is different. If you are going to add, for example, say after treatment and you are going to raise the price for that, there are kind of two ways that you could deal with that. You could say, hey, I have a price increase and I have a cost increase.

We think that kind of distorts what's going on. The content of the machine is changing, it's a different machine. So the way we deal with it is we net the content cost changes with specific, in this case Tier 4-related, price changes and we would just show the net of the two in the [volume] (corrected by company after the call) number.

I think as a generic comment I would say we are not giving away Tier 4. I think it has been a pretty successful introduction. The price increases that have gone in for Tier 4 generically were meant to cover the additional cost and a reasonable margin, and I think by and large that has happened.

Ann Duignan - *JPMorgan - Analyst*

Okay. In interest of time, I will get back in queue for my other questions. Thanks.

Operator

Ross Gilardi.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Good morning, thank you. Bank of America. I just had a couple questions.

From your backlog commentary, it sounds like Power Systems backlog is up fairly sharply due to locomotives. In the rest of your other parts of your press release, you mentioned that well service activity is picking up. You don't sound worried about oil and gas CapEx; natural gas prices have rebounded. Why aren't you raising your Power Systems outlook today?

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Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

A lot of those things we had in our original outlook. I think we were probably -- maybe in January what we were seeing in terms of quoting activity, deals in place with customers, our expectations haven't really changed all that much as a result of this. So I think we were reasonably positive on that sector all along.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Got you, Mike. Then could you comment a little bit more about recent order activity in oil and gas and maybe give some color on what your exposure is to sub-sea drilling, which seems to be sort of the weaker spot for a lot of your peers?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

I guess I would -- I will be careful how I say this. For our oil and gas business, particularly for recips, order activity has been pretty strong. It looks like the well servicing is starting to pick back up a little bit and that's a good thing.

In terms of deep-sea drilling, I would say in the scheme of our overall oil and gas business that is pretty minor.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Okay, thanks very much.

Operator

Mig Dobre.

Mig Dobre - *Robert W. Baird - Analyst*

Good morning, Robert W. Baird & Company. If we can, guys, going back to Brazil in Construction, Latin American revenue was slightly down this quarter. Can you maybe talk a little bit about dealer inventory levels in Latin America, maybe also your view on fundamental demand through the year excluding this large government order that you got from Brazil?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Yes, dealer inventory -- I think most places in the world, with a few minor product exceptions, is in pretty good shape. Dealers worked on adjusting dealer inventory to current demands really over the past year and a half and I don't -- I can't see any reason it looks out of line. Now you might be able to get to a country or a dealer and maybe draw a different conclusion, but I think overall and by region it's not sort of out of whack with selling these.

Your comment on demand in Brazil, it's a little bit hard to answer because last year related to these large orders that we had that Doug mentioned a minute ago because we had them last year. This year the amount related that we are going to sell related to those big orders I think is going to be a bit less than last year.

So far this year Brazil has actually been reasonably good for us. Most of the other countries in Latin America have been down a little, but Brazil has kind of held up for us. I think this big order, these large orders that we are getting from the government certainly helped that. But we have had them in both years, last year and this year.

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Mig Dobre - *Robert W. Baird - Analyst*

Okay, thanks for the color there. Then maybe a quick modeling question on the corporate expense line. There's a lot of moving pieces there with incentive comp, LIFO, legal settlements last year. Can you give us some maybe color or guidance as to how you expect this line item to move through the year?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

That's a tough one because I think the big variable for that will be the timing of the restructuring costs. That's probably the biggest variable. Then as you go forward if there happens to be changes, if the outlook from here goes up or goes down, that can have an impact on the corporate -- some of the corporate incentive comp. Based on the outlook where it's at now, we would think that could be pretty stable so probably the biggest variation going forward there is likely to be restructuring costs.

Mig Dobre - *Robert W. Baird - Analyst*

Okay, thank you.

Operator

Andrew Kaplowitz.

Andrew Kaplowitz - *Barclays Capital - Analyst*

It's Barclays. Nice quarter, guys. So, Mike, your cash flow generation in the quarter was strong, as you said. Some of it was obviously net income growth, but can you talk about the increased focus it seems that you have on keeping working capital down or any other changes you've made to generate more cash? Is this level of cash sustainable, this pace sustainable going forward?

And then how should we think about buybacks in subsequent quarters? I know you will tell you will be opportunistic, but it seems like you've shifted your focus that way at least a little bit.

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

Andy, this is Brad Halverson; I can start. And so I think on the cash flow side it's another positive story for us that we are extremely happy with.

We finished the end of 2013 I think with a debt-to-cap at 29.7%. We did complete the buybacks of the $1.7 billion and we had some incentive pay expense. Even with all that we're going to finish debt-to-cap at 30.2% at the end of the first quarter with $5 billion in cash.

We have been steadily working on our working capital management. We've made great progress, I think, in all areas. The one that I think remains the biggest opportunity for us would remain in the inventory turn area where we talked about a little bit at CONEXPO. If you look at a few years, we see still continued improvement there.

And so our cash flow situation is very good. Our priorities remain the same and the credit rating today is in good shape with our position of continuing to fund growth and push for organic growth. We don't see anything big.

Pension plan well funded. We only have $200 million of required contributions for the rest of the year. We will make our normal dividend decision in June to the board and announce that at that time, but our history of dividends will remain kind of consistent with our approach there.

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And you're right; stock repurchase will be opportunistic. But I can tell you what we will do is when we get to that decision time, we look out a couple of years and will model a couple of years of troughs and look st what our balance sheet strength would be. But at this point in time, Andy, yes, I would say we continue to be positive about our ability to generate cash out in the rest of the year and in the next three to four years, and we are in great shape.

Andrew Kaplowitz - *Barclays Capital - Analyst*

That's helpful, Brad. Then if I could ask you guys to step back and maybe talk about US and European non-residential construction. We've heard a lot of mixed feedback this quarter. I think a lot of people were positive at CONEXPO. Your results look good, but maybe just commentary on how you see that market unfolding here this year and beyond.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Sorry, I was -- I missed that question, Andy. I was saying something to Doug here.

Andrew Kaplowitz - *Barclays Capital - Analyst*

No worries. Just on US and European non-res or commercial construction, a lot of mixed feedback we get on that topic. People were pretty positive on it at CONEXPO. Your numbers look good, but maybe just commentary on the overall market.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

It seems like you get mixed messages almost every day on housing. One day it's -- prices are up and it's a hot market. Then the day after that you get sales of existing homes down. But if you look at the fine print of that, it's because -- one of the comments is there's not enough supply.

I think our view of housing is that it will continue, particularly for starts, continue to get better. We think this year is going to be over 1 million. So I think we are pretty constructive on, at least for the US, housing.

But, again, you've got to put that in perspective. It's still way below where it was six years ago, seven years ago. So getting better, but not great.

Europe has been -- I don't think I can give you a separate comment on res versus non-res there, but it has been a steady positive for us over the course of the quarter. Whether that will keep up I think depends a lot on kind of confidence there and is this economic growth starting to get little bit better? Does it continue?

There is one thing you've got to remember about our business and that is most of what we sell at any given quarter is to replace something that's worn out. What customers are -- it's not -- certainly at this point in those markets, it's not about increasing the capacity of the installed base. It's about replacing things that need to be replaced.

What you need is business confidence, reasonable results for construction activity, interest rates that are supportive, and we kind of have those things so I'd say we remain reasonably constructive on construction for the developed world. And you're right; the number for the first quarter kind of panned that out.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Thanks, Mike.

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Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

I think we have time. We are a little over, but we will take one more question and then we will wrap up.

Operator

David Raso.

David Raso - *ISI Group - Analyst*

ISI, thanks for getting me in. Just trying to figure out the EPS progression the rest of the year. It seems like you're implying second-quarter EPS is below 1Q and really it has only happened once in the last 20 years and that is the quarter when you were trying to absorb Bucyrus initially.

So I'm just trying to figure out, are you being conservative or maybe I need to figure out more about the sales mix help in the first quarter for Construction so I can more understand why the margins need to come down in Construction? And/or do you feel the Resource Industries margins have bottomed yet? I'm just not understanding why we are down sequentially in 2Q.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

I think couple of things. One, even in Resource Industries it's our intention to increase spending on programs that we really need to do for the long term. And I kind of talked about those a little bit.

So I think if you look at our level of spending on programs in the first quarter it was -- it's usually seasonally light and it was probably even more so in the first quarter this year. Now we had a rough year last year and I'll tell you we came into the year with the management team with a lot of caution. We were purposefully trying to push as much of the program spending out that we had allowed in the plan and was in our outlook beyond the first quarter. We wanted to get part of the year under our belts and see how it was actually going to turn out before we started up some of the programs.

So we have been cautious with the management team early on the timing of expense for this year, so I think we benefited by that in the first quarter and will see some cost increase, for things again that we need to do, that will come later in the year.

For Construction I think there will be some margin decline. The first quarter was heavier on excavation and earthmoving. The rest of the year proportionately will be a bit more of the smaller BCP product. I think we expect some more rental loading as we go through the year and that will be a little bit negative to mix, so we think that will be the case as well.

It would be great if it was better than that. We would certainly like that, but I think our outlook for the year is kind of our reasonable and prudent view today of how it looks.

David Raso - *ISI Group - Analyst*

All right, in the interest of time. I appreciate that. That's it for me.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services*

Thanks, David. Okay, thank you, everyone. With that, we are a couple minutes over. Thanks for sticking with us. We will sign off.

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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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