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EDITED TRANSCRIPT

CAT - Q2 2015 Caterpillar Inc Earnings Call

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OVERVIEW:

Co. reported 2Q15 sales and revenues of $12.3b and profit per share of $1.16. Expects 2015 sales and revenues to be $49b and profit per share to be $4.70.

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PRESENTATION

Operator

Good morning ladies and gentlemen and welcome to the Caterpillar second-quarter 2015 results conference call.

(Operator Instructions)

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

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Thank you, Anthony, and good morning everyone and welcome to our second-quarter earnings call. I'm Mike DeWalt, Caterpillar's Vice President of Financial Services.

On the call today I'm pleased to have our Chairman and CEO Doug Oberhelman and Group President and CFO Brad Halverson.

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If you'd like a copy of today's call transcript we'll be posting it in the investor section of our Caterpillar.com website. And it will be in the section labeled results webcast.

This morning we'll be discussing forward-looking information and 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, that's risk factors of our Form 10-K filed with the SEC in February of this year and also in the forward-looking statements language in today's release.

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In addition there's a reconciliation of non-GAAP measures that can be found in our financial release today. And that's also been posted at our Caterpillar.com website.

Okay, let's get started. This morning we'll be reviewing our results for the second quarter and our outlook for 2015. For the quarter, sales and revenues were $12.3 billion and profit per share was $1.16 and that was $1.27 excluding restructuring costs. Both of those numbers were about as what we expected, no big surprises.

In fact from a macro standpoint much of what we were expecting when 2015 started seems to be playing out. We expected that mining would continue to be very weak and it certainly has. We were concerned about weakening sales of construction equipment in China and Brazil and both are down substantially from last year.

With the sharp drop in oil prices from last fall we expected we'd have sales headwinds in our Energy & Transportation segment and in Construction Equipment sales in the parts of the world where oil production was important and that's happening.

Now on the plus side we also expected that our people would continue to execute on the things that we can control. And we've done that with decremental margins better than our target.

Machinery, Energy & Transportation operating cash flow of $1.6 billion in the second quarter and a balance sheet that remains healthy with a debt-to-cap ratio near 35%.

With that introduction behind us let's get into a little more detail on the quarter. Again sales and revenues were 13% lower than last year. The decline was widespread with lower sales in every geographic region of the world and down versus last year in each of our business segments.

We'll start with Construction Industries which was down 18% and down in all regions. Latin America was the most significant decline, down 47% and that was mostly a result of weak demand in general and in particular Brazil, and also absence of a large order that we had from the Brazilian government from last year.

Asia-Pacific region was down 30% with much of that decline in China and Japan. In China the construction industry continued to weaken and in Japan the main issue was currency exchange as the yen weakened versus the dollar and our sales that are denominated in yen there are translating into fewer dollars.

In the Europe, Africa, Middle East region Construction Industries sales were down 18% and much of that was from currency translation as local currencies, particularly the euro, were weaker than the dollar compared with the second quarter of last year. In addition there was some unfavorable dealer inventory change in the Europe, Africa, Middle East region.

Now North America was off 3% and we have seen some strength in residential and non-residential construction but that's been offset or slightly more than offset by a drop in sales to customers serving oil and gas. In Resource Industries, which is mostly mining, sales were down 11% versus the second quarter of 2014 and mining sales continue to weaken for both new equipment and to a lesser degree for aftermarket parts.

Sales related to quarry and aggregates did improve but it wasn't enough to offset the decline in mining. In Resource Industries sales were down in all regions; suffice to say that mining remains weak around the world, and we haven't yet see signs of a recovery. If you'd like a little more regional flavor there is more in the Resource Industries section in this morning passed financial release.

For Energy & Transportation sales were down 12% and while down in all regions, I think probably the most useful way to cover Energy & Transportation is by major industry and that's oil and gas, transportation, PowerGen and industrial sales. In short, sales in each of these industries was down and in order of magnitude the most significant decline was for transportation and that was mostly lower locomotive sales in North America.

Locomotive sales last year in 2014 were pretty good. In 2015 regulations for emissions changed in the United States and Tier 4 started. And our tier locomotive isn't expected to be available until later in 2016 so sales this year are down.

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Now oil and gas related sales were also lower and that's probably not surprising to you given the decline in oil prices over the past year and softening investment by oil producers. Sales of industrial engines also declined and just for your reference we sell these industrial engines to ag customers, electric power packagers, construction and material handling customers and for a wide variety of other application.

And in general demand was down a bit and currency also had an unfavorable impact particularly in Europe. Power generation sales were also down and most of that was currency translation related again in Europe in particular where our euro-based sales translated into fewer dollars.

Okay, that's a summary of sales and revenues. Again all in all about as we expected for the quarter and down about 13% from last year.

Profit in the quarter was $1.16. We did have $0.11 a share or $89 million of restructuring cost and without restructuring profit was $1.27.

Profit is down from a year ago. We were $1.57 all-in and $1.69 last year in the second quarter excluding restructuring.

Operating profit declined from $1.475 billion in the second quarter last year to $1.130 billion this year. That's a drop of $345 million. More than all that decline, $483 million in total, was a result of lower sales volume.

In addition Financial Products was down $49 million, R&D costs were a little bit higher than the second quarter of last year as well.

Now on the favorable side for operating profit price realization was a positive, it was $84 million, certainly in the right direction but less than 1% of sales. Manufacturing costs were slightly favorable and would have been more so if not for a headwind from inventory absorption. And that was a result of an increase in our inventory over the course of the second quarter of 2014 and a decline in inventory in the second quarter of 2015.

Now let's talk about currency for a moment. While the impact on sales was negative over $400 million, it was actually positive to operating profit about $80 million. And that's because we have a significant cost base outside the US and a stronger US dollar causes those costs to translate into fewer dollars and that more than offset the negative impact on sales.

Now there are other currency impacts in our P&L as well below operating profit. Other income and expense, again below operating profit, quarter over quarter was unfavorable $78 million and most of that was related to currency translation on our balance sheet position and hedging.

So in summary on balance, relative to profit, currency didn't have much of an impact second quarter to second quarter. Okay, that's profit versus last year. The major story is sales volume.

So let's turn to the Outlook. And that will be actually pretty easy to cover because little has actually changed. Back in January with our original outlook we expected sales and revenues of about $50 billion and at the end of the first quarter we held that.

This morning we lowered about $1 billion to $49 billion. The most important point in that is for the most part the change is currency related. The dollar strengthened some in the first quarter and strengthened a bit more in the second quarter, particularly against the yen, and it's moved enough versus our original outlook that we needed to reflect it in today's updated outlook for the year.

Now sitting here about halfway through the year, except for currency impacts the overall sales and revenues outlook is still pretty close to what we expected when we started the year. While we would have liked to have been surprised to the upside our sales outlook of six months ago has proven to be pretty accurate so far. Particularly given the degree of uncertainty in the world and the things that we expected would happen in 2015, including world economic growth, it wasn't much different than 2014: the impact of lower oil prices on Energy & Transportation and Construction Equipment sales, lower mining sales, headwinds in China and Brazil and the decline in locomotive sales.

Now profit in the outlook is being held flat with what we expected at the end of the first quarter and that's $4.70 a share, or $5 a share excluding restructuring. While that's unchanged from last quarter it is up from our original outlook from January which was $4.60 a share cup of or $4.75 without restructuring.

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I mentioned it a few minutes ago and I think it's probably worth repeating while we're talking about the outlook, what happened in the second quarter for sales and profit is about what we were expecting when we were on this call three months ago.

Now if you consider that our full-year outlook and actual results for the first half, it's evident that we're expecting lower sales and profit in the second half of the year. Excluding restructuring cost our outlook would reflect about $1.24 decline in profit per share first half to second half. And that's a result of lower sales in the second half, about $1 billion.

Seasonal cost patterns, the first quarter is usually a pretty light quarter for cost and the fourth quarter is seasonally higher. And that includes R&D costs.

We have the absence of the gain in the first quarter on the sale of our remaining interest in the third-party logistics business. We do expect some negative sales mix in the second half, particularly related to oil and gas. That will likely decline more in the second half than it has in the first half and we're expecting more negative inventory absorption.

We're forecasting a decent sized inventory decline, that's Caterpillar inventory, in the second half of the year, more than the first half of the year.

Now, in terms of how the next two quarters are going to play out we think that sales will be less in the third quarter than the fourth quarter, about $750 million lower. And that's not unusual; just a for example, in 2014 last year sales in the third quarter were about $700 million below the fourth quarter.

Now as a result of lower sales in the third quarter, third quarter is likely to be our lowest profit quarter for the year. As expected, again, 2015 is turning out to be another challenging year. We're serving several industries that at the moment are weak: mining, oil and gas and in many parts of the world construction, again particularly China and Brazil.

We are, however, executing on the things that are more in our control. We've taken substantial restructuring actions and more are likely. We're improving quality, safety and our market position for many of our products.

We make also generating cash. Our Machinery, Energy & Transportation operating cash flow again was $1.6 billion in the quarter.

And given the weakness in many of our businesses right now we don't need cash to deploy for capacity and our balance sheet is strong. Our ME&T debt-to-cap ratio is near 35%, well within our target range, and we had $7.8 billion of cash on the balance sheet at the end of the second quarter.

And that brings me to the other announcement we made this morning. That's our intention to repurchase another $1.5 billion of stock in the first order.

Now that plus what we've repurchased in the first half should take us to around $2 billion by the time we get to the end of the third quarter. And as a reminder, we did increase the quarterly dividend in the second quarter and that was back in June. We took it up $0.10 from $0.70 a quarter to $0.77 and if you annualize that it's a rate of about $3.08 a share.

So in summary sales and profit in the second quarter about as we expected, no change in the profit outlook for the year, $1.6 billion of ME&T operating cash flow in the quarter, $1.5 billion share repurchase, 10% increase in the dividend. We think we've done pretty well with the economic and industry climate we have to work with.

We've improved our market position and our operations. Now all that said we'd certainly be happy to see a better global economy.

So with that we are ready to take your questions.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jamie Cook. Please announce your affiliation then pose your question.

Jamie Cook - *Credit Suisse - Analyst*

Hi, good morning. So I guess thanks for the time on the question. I guess a couple of questions.

Just more broadly can you guys talk about I guess Mike when you're thinking about the second half of the year or can you talk about oil and gas, the declines that we saw in the second quarter relative to what you expect in the second half?

And then what is implied in your profitability in the second half of the year with regards to oil and gas? I feel like before you said it would be more on the reciprocating engine side and you still expected solar in the marine business to be up. Has that mix changed at all?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, I would say in general what we said before about the recip business for drilling and well servicing, that's where the brunt of the decline is going to be felt. And we had a pretty sizable backlog of that coming into the year. That's actually helped sales in the first half.

So we're going to see more of the decline in that recip business in the second half. And that goes back to my comment on sales mix in the second half. So that will likely be a bit more negative.

Jamie Cook - *Credit Suisse - Analyst*

And then I'm sorry, your visibility specifically on solar right now and I'm assuming solar is still good relative to b-

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Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, I'd say everything that we've said about solar this year and holding up in the backlog is still the case. I'm going to try not to get too far ahead of ourselves into a discussion about 2016. We don't have an outlook in front of us for 2016 and that's not trying to avoid that question, it's just we commonly do that with our October third-quarter release, give a preview of what we think for the next year.

That said, if you do look at backlogs and what's happened you don't see solar falling apart. It's marching along reasonably well so far this year. I wouldn't say there's anything that I've seen that I would consider to be alarming, if that helps.

Jamie Cook - *Credit Suisse - Analyst*

Okay. And then I guess just can I ask a second question?

Just broadly, Doug, on mining we've seen a lot of the mining data points continue to deteriorate what you're hearing from your customers as well as your competition. I guess, Doug, what would you need to see to change your longer-term view on mining and to take sort of a more aggressive restructuring within Caterpillar? And as we think, I know you're spending this year for the long term do you feel like the brunt of the spend in mining in terms of new products and R&D does that go away in 2015 so 2016 that's less of a headwind? Thanks and I'll get back in queue.

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

Around mining most of the restructuring we've taken to date has been aimed at mining. A number of facilities have been downsized, closed and have been announced to do so in this year and next year. We'll continually view that, what we're hearing from customers of course and seeing from customers is an ongoing, fairly high production rate.

Now I don't know how long that will hold up but so far we haven't seen a big drop in production. We've certainly seen no expansion and won't for the foreseeable future.

But we have not seen any, or I guess we have seen our trucks and ancillary equipment especially being used longer and longer and longer. Service intervals being extended, as long as we see that we know there's a replacement cycle coming at some point. It's just extended.

In terms of where do we see this long term, I think a lot of that's going to depend on what we see for long-term growth rate and is the world going to grow at 2% for the next 10 years or is it going to grow at 3% or something else? And I think we'll continue to monitor that.

We're doing that right now and particularly as we go into 2016 we'll take a look at that towards the end of the year. But that would be the driver of how fast, how much mining is going to require over the next decade or so and then thus the supply of equipment to them.

Operator

Joel Tiss.

Joel Tiss - *BMO Capital Markets - Analyst*

Sorry, I was on mute. Bank of Montreal.

I was just in Asia and there's this whole I guess it's a little old but I'm old too, but I'm a little behind the curve probably, but they're talking about expanding like giving countries money to help expand their infrastructure and dragging a lot of the Chinese overcapacity in the Chinese suppliers with them. And so not stopping at the Chinese border, going all the way Africa, Eastern Europe, former Soviet republics.

So as long as Doug is here I just wondered if you could talk a little bit about does China bring you guys along with them because you are a local Chinese supplier as they go to these different regions or are you already there and can effectively compete with them? How does this play out over the next decade?

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

I think you're referring primarily to the Asian infrastructure bank, AAIB, which was announced a year or so ago, has been funded now and run by the Chinese. It's a somewhat similar bank to the several regional banks that are around whether it's Latin America or Asia, to some degree World Bank.

They are focusing certainly around Asian infrastructure. We are there. Our business model works very well.

I think a significant piece of this is aimed at the Silk Road, the new Silk One Belt One Road project, it's probably a 50-year project going forward. My expectation would be that we're a local Chinese company. Our dealers service products throughout that region and when it comes down to it and they build infrastructure, complete those kind of things funded by that AAIB that the best supplier is going to win on construction equipment just like anything else.

Now will there be bias in another direction? Probably as we see today, but we do pretty well in China.

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So my expectation is that that's China trying to take its investments even more broadly than they had been doing. We've done pretty well with that around the world so far. And that would be my expectation going forward.

Having said that a bit political it would be nice to see the United States involved with that. We've not been a lot of the European countries have joined in and most Asians have joined in to aim at areas that need a lot of development of that I hope is in our future. But again a little bit off the subject but is I think pertinent to the answer.

Joel Tiss - *BMO Capital Markets - Analyst*

I can't do a quick follow-up? Okay fine.

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

Yes, go ahead.

Joel Tiss - *BMO Capital Markets - Analyst*

I just wondered if Mike, this isn't giving away 2016 guidance but can you share with us what the energy book to bill has been in those two different -- in the recip engines and in solar?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Well, definitely for recip engines the backlog has been going down. That's probably no surprise.

We haven't got a lot of new orders for oil and gas over the last six months as the oil price has declined and investment is beginning to dry up. So our backlog has definitely come down for the recip side. Not so much for solar.

Joel Tiss - *BMO Capital Markets - Analyst*

Okay, thank you.

Operator

Joe O'Dea.

Joe O'Dea - *Vertical Research - Analyst*

Good morning. It's Vertical Research.

First question just on mining and in the press release talking about both equipment and aftermarket being down, I think for a little while now aftermarket has been trending more flat. And so just looking for any context around those aftermarket trends in the quarter whether this is the beginning of another chapter of declines given commodity movement over the last six months or if those decline rates were actually pretty small?

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Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, good question, Joe. I wish honestly we had a crystal ball where I could give you very crisp answer for that. I think I'll refer back to Doug's comment a bit ago around customers delaying maintenance intervals and repair intervals and that's going to in our view that's going to catch up.

I know that a little bit of a broken record and we've been saying that but fundamentally the more they run this equipment and the longer those repair and maintenance intervals go the more pressure there's going to be. I don't think anything fundamentally has changed.

They still need to repair and maintain vehicles. I think they're pushing it a little harder right now.

Joe O'Dea - *Vertical Research - Analyst*

Perfect, thank you. And then maybe just as a follow-up on the PowerGen side, North America and Asia-Pac both flat in the quarter. I think this is on the heels of actually several years of seeing weakness in PowerGen, so really just asking your confidence in finding any sort of bottom and any visibility you have into improving demand in PowerGen.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

You know I think for PowerGen and I'll just make my comment an around-the-world comment here, it's very dependent or reasonably tied to global GDP. We've not seen much improvement generally.

We've got a pretty flattish world economy. If you think about electric power and a lot of it is backup power, when you build a new school, when you build a new shopping mall, you build a new factory you need backup power. And until you have maybe an improvement in construction around the world you're probably not going to see much of a big improvement in electric power.

Now that said it was the least unfavorable in the quarter of the sectors under Energy & Transportation and a lot of the decline was actually currency in Europe. So it's been from a demand standpoint I think more flattish than some of the others.

Joe O'Dea - *Vertical Research - Analyst*

Great, thanks very much.

Operator

Jerry Revich.

Jerry Revich - *Goldman Sachs & Co. - Analyst*

Good morning, it's Goldman Sachs. You folks have spend a lot of time on supplier development.

Can you just give us an update on how much more room you have to reduce material costs beyond raw material deflation? So obviously steel costs coming down will help you folks in the back half of the year, maybe you could also touch on what kind of steel price you're assuming in the guidance over the balance of the year. Thanks.

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Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, Jerry, good question. If you look at our results over the past actually about three years we've gotten pretty decent what we call material cost reduction. That's really been a combination of a couple of things.

We have had commodity declines over the last few years. But we've actually as a Company, kind of throughout the Company, done a pretty good job on not just commodity-related price reductions but actually cost reducing components in our products. We've got pretty good cost reduction doing that.

So that's a lot of work between suppliers, purchasing, our engineering group to take cost beyond insulation and commodities out of the product. That continues this year. I think our expectation is there's still quite a bit of room to go there.

That's always an ongoing effort. Above and beyond that it does rely a little bit on what's going on with commodities. But I think there's still a lot of room to run there.

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

I would just add here a little bit. We reorganized our procurement, our logistics and our lean manufacturing group a while back. And we are releasing the benefits of that.

As Mike said, we've seen lower cost, material cost for several years but at rates that have been unheard of around here prior to that. The operating margins, the pull-through numbers we've seen, even in this down period of sales we've never experienced before in the past either.

And I would give this group and the fact that our operating units are embracing that all of the credit because we're seeing our built-in quality numbers and our quality metrics measured by defects per unit also drop through the floor. So all of this is really helping us at a time when we need that kind of efficiency and it's working well.

I think the best is yet to come when sales do pick up and we can put to work in a growing environment. But certainly now it's helped us on our decrement pull-through and quite happy about that.

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

Doug, maybe I'd just make one comment. This is Brad.

Frank Crespo leads that area and I go on visits with Frank. You would probably maybe not be surprised but the tenor of these discussions when we go in with our suppliers is all about how we can collaborate, how we can develop a better product solution, more value to the customers and how can we take cost out of the process. And so when we go in I would say to our suppliers in today's environment maybe compared to seven, eight, nine years ago the discussions are incredibly different.

They are not about what kind of a price decrease can you give me and a discussion and negotiation around that. The discussions are all around collaboration.

I would say that that group has done a great job in the last four, five years with improving the collaboration. There's a lot of talented suppliers and they are a huge asset to us.

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Jerry Revich - *Goldman Sachs & Co. - Analyst*

Just on the pricing side you folks got better pricing in Resource this quarter and Doug over the course of your leadership you've delivered pretty well on the pen side. I'm wondering how much room do you have to deliver modest price increases even as material costs are flat to down? Do you think you have room there over the next couple of years because of how much the premium has come in versus the competitor set?

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

I really don't see much change coming in the next couple of years there unless we would see some inflationary pressure. The entire industry has more than enough capacity. We've got a strong dollar to contend with many of our big key competitors.

I'm quite happy with the fact that we've been able them more or less to beat or meet anyway retail CPI around the world in price realization the last few years. The cost reduction at this point, at one point we talked about cost reduction efficiency putting into market share which we have been doing. I'd like to think we could continue that.

Our market share, our market position over the last few years has trended up nicely and is even the last year up a bit in a very tough environment. I'd like to see that continue. So I don't know, I think we continue to see more of the same where we've been in terms of price realization.

Jerry Revich - *Goldman Sachs & Co. - Analyst*

Thank you.

Operator

David Raso.

David Raso - *Evercore ISI - Analyst*

Good morning. The conversation on the stock is going to increasingly shift toward the set up into 2016 so I know you're not giving 2016 guidance but can you help us a bit with where you see margins exiting 2015?

In particular E&T, I mean the margins have been stellar there, basically 18% haven't really taken much of a hit. So I'm just curious how do you see those margins as well as CI exiting 2014, I'm sorry 2015?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

David, this is Mike. Let me start with that. There are some headwinds in the second half of this year and again I'm not going to get into next year but I'll just talk about a couple.

One is inventory absorption impacts negative. This year we are going to end up with a pretty healthy by the time we get to the end of the year we think a reasonably healthy inventory reduction for Cat inventory.

And if you think about it our sales this year versus last year are down from about 55 and our outlook down to about 49. So there is inventory coming out.

Now without getting too far ahead and talking about next year, I'll just say if I look at what the analyst consensus is right now for next year, not our forecast but collectively you guys have our sales about roughly flat with that next year. And if that were the case the degree of inventory coming

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out, which is going to be pretty heavily weighted to the second half of this year, that would be less of a drag. So I think the second half of this year is going to have some negatives in it related to that.

Also there's a lot of first-half, second-half differences, some that are seasonal. Just for example, we tend to build dealer inventory in the first half of the year of as we're preparing for the summer selling season, particularly for construction. And then we tend to use -- dealers tend to use inventory in the second half of the year and we tend to undersell demand.

That will be the case we think again this year. We expect dealer inventories to come down.

So there are some kind of built-in headwinds in the second half of the year. So I'm not going to get into a guidance game too much. But I don't think it's appropriate to probably take a second half of this year and multiply by two I think because of headwinds like that.

Now all that said, next year will definitely be set up as a bit of a mix problem for us. We have if you think about this year particularly in the recip piece of oil and gas, we came into the year with a pretty decent backlog, so much of the sales decline that we are going to have for the year in oil and gas is going to be in the second half of the year.

So one way to think of it is good first half or reasonable first half for recip oil and gas, lower second half. Unless something changes in the marketplace I think the likelihood is that you would have a couple of weak halves next year. The backlog now we're kind of through.

So I think without and I don't think that's likely a big secret year over year, full year over year you'll be looking at probably some margin weakness because of that. I think in terms of E&T margins overall they've done a great job, I mean just if you look at the work that they've done over the past three, four years it's just been phenomenal. And we focus a lot and we talk a lot when we have you on the phone about oil and gas but they've taken up margins in almost every part of the business.

Industrial for example, they've done a fabulous job on controlling cost and getting margins up there. So I think it's no doubt with recip oil and gas coming down there will be some pressure on E&T margins in the second half of the year.

And unless the situation with oil and gas changes, I'm sure those pressures will continue. I know you would have probably liked a little more of a numerical discussion around 2016 but we'll have that maybe in October.

David Raso - *Evercore ISI - Analyst*

Well I guess not even 2016 but Mike I was asking directly if you could at least quantify a little bit the margins exiting the year in E&T and CI. Are you willing to at least say you expect double-digit margins in both CI and E&T both 3Q and 4Q? We're just trying to get a feel for the run rate, the set up into 2016.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Well I mean certainly based on where E&T is right now there's no doubt in my mind they'll be certainly double digits over the course of the second half. And I believe that, too, for construction.

David Raso - *Evercore ISI - Analyst*

Okay. And then lastly on the backlog, obviously it's down 23% year over year. It's down 15% since the start of the year.

How should we think of the backlog expectations the rest of the year given they at least historically show some relationship to how you guide sales? Are we expecting the backlog to improve the rest of the year or still a drawdown?

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Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

I think it probably depends upon the business that we're in because they all have some seasonality to them. For example, in construction we tend to get a lot of orders late in the year and very early in the year we developed a bigger backlog. Again it's a little bit like dealer inventory, dealers are preparing for getting equipment lined up for the selling season.

So that will likely happen I would think again. So without again getting too specific I would suspect if the seasonal patterns hold that on the second half we'd probably build a little bit of backlog in construction.

In mining the whole book to bill has been slightly negative. It's getting to a point where there's not a lot of drawdown coming and I think we should probably be coming to the point where that's not very significant one way or the other. Until we get a recovery that would be great.

And then in E&T you know you talked about the backlog coming down this year. That goes back to the point that I made a little bit ago.

We started the year with a pretty healthy backlog of recip engines for oil and gas and that's worked down throughout the year. There might be a little bit more of that can come out but I can tell you order rates for the first half of the year have been extremely lean. So I hope that --

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David Raso - *Evercore ISI - Analyst*

I guess in aggregate then is the CI uptick seasonally expected to be large enough to offset the E&T drawdown I guess is the answer to that question.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, honestly I don't know what the backlog forecast is. That isn't something we cover and if I did I probably wouldn't, I mean we've never disclosed a forecast for that and I probably wouldn't start. But to be honest with you I don't know.

I would be surprised if -- I would personally be surprised given everything I know if the change was very much one way or the other over the course of the second half.

David Raso - *Evercore ISI - Analyst*

All right. I appreciate it. Thank you very much.

Operator

Ted Grace.

Ted Grace - *Susquehanna Financial Group - Analyst*

-- said that the total revenue guidance is down $1 billion to $49 billion and it's mostly FX. Is there any mix shift we should just be cognizant of between Construction Resources and E&T and the expectations for the year?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, I think what I would tell you is that probably a disproportionate share of the currency impact is construction. Mining tends to be in a lot of the world a pretty dollar-denominated business. Oil and gas tends to be as well, not entirely.

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So it's not 100% is construction but it's probably disproportionately construction. So earlier in the year we had thought construction would be down 5 to 10. It will probably be closer to the top end of that.

But outside of that I think no big shifts in what we thought was going to happen. I said this kind of in my opening comments. We've actually been pretty good at predicting what's going to happen this year I think, certainly on the top line and by and large on the bottom line as well.

Ted Grace - *Susquehanna Financial Group - Analyst*

Agreed. So I mean I think everyone's cognizant of how tough the macro is. One of the key tenets of Cat's business model is marketshare.

I was wondering if you could just talk about in the context of challenging markets how you feel Cat's executing against the competitors? And specifically maybe in North America construction if you're comfortable talking about that, EMEA construction and then whatever you might feel comfortable talking about within engines?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, I think generally I would say we've done pretty good on share. It's been a fairly consistent march up year after year for about I think the last four years. It's not always every product, every quarter but it's a good generic comment to make.

We've done well over that time period in North America. We've got a couple of things I would say are really helping us with share. We have excellent Tier 4 products.

We are the fuel economy leader at Tier 4. We're promoting the heck out of that. Quality of the Tier 4 products has been very good.

Customers like them. So that's helped us a lot and Tier 4 and the European equivalent is essentially in those developed markets and that's a very much a comment around North America.

We've done a pretty decent job. We've also as Doug mentioned earlier kept price increases pretty modest and that's helped. And we've been able to do that because we've taken a lot of cost out and we've essentially reinvested that in market share and have done I think a pretty decent job.

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

I just would like to add here on our Tier 4 final product, this is another big year for that, we're over halfway through final here and in Europe, and in all of our models we've seen an increase in fuel economy. We've seen a drop in defects per unit and those two things going into the marketplace have really helped us offset aggressive competitors both because of the dollar and because of capacity.

I really am happy with where our product stands today, particularly given our past history in some of these things we're going to introduce a lot of new product at once, but we're in really good shape with this going forward. And I think the built-in quality, the lean metrics around what we measure now and the way in which we manage our factories and design are coming through nicely. We see that and that's been a big help to us in a tough cycle here.

Ted Grace - *Susquehanna Financial Group - Analyst*

And the last thing I'll ask and I'll get back in queue, in terms of what you're seeing on the pricing front from a competitive dynamic, particularly in North America is it staying rational, are you seeing any kind of shifts in that regard? And that will be the last thing I ask.

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Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

I don't have anything in particular that's dramatically different, no.

Ted Grace - *Susquehanna Financial Group - Analyst*

Okay, thanks. Best of luck this quarter, guys.

Operator

Henry Kirn.

Henry Kirn - *Societe Generale - Analyst*

Hi, good morning. It's SocGen. You mentioned in the press release accelerated focus on emerging technologies.

Could you talk a little about the expectations for the level of investment required? And maybe at a high level the required returns profile in the bigger picture goals there?

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

What we're really referring to is the ongoing number of investments around connected machines to our factories, to our engineers, to our suppliers, to their owners and to their dealers. We've had a number of announcements around that.

I expect to have a number, more of those, the evolution is happening around big data and data analytics and we're right in the middle of it with the idea being to connect every single one of our machines and hopefully those that aren't our machines and our customers with us in a very efficient way to raise their productivity. And I think you'll see continued emphasis on that.

I would expect the returns actually on those to be very attractive as we go. It's a process because we're starting from, not starting from scratch because we had a lot of that internally but developing that externally we're taking advantage of a lot of that investment that's occurred outside of our industry and is known there.

So really optimistic about it early days. And I think we'll really change our customers' and our dealers' world over the next decade. So this is really the basis, the beginning of that basis.

Henry Kirn - *Societe Generale - Analyst*

Thank you. At now that the Greek situation is at least temporarily resolved, can you talk about what your folks on the ground there are seeing and if there were green shoots would you expect that to begin to show up in the order book?

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

I would say in Greece we have such a small position there, it's such a small market, even in the good days it wouldn't ring any bells around here. I think the bigger issue with Greece is the amount of uncertainty it drives in the EMEA and beyond and that is specifically in South Europe. Having that toned down and calmed down out of the headlines every single day may help.

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I think it depends on what the European Central Bank does and the individual governments going forward to have some kind of recovery in their economies. I would point out our retail numbers yesterday while down in EMEA were after the United States were the best. It's still a down market but we're not seeing total catastrophe there like we saw two, three, four years ago.

I would say stability is probably in the not-too-distant future and I don't know quite when growth will return but it will. So I think the Greece thing is one of those that it needs to get behind us all in order to reestablish some kind of stability in the political environment over there which will lead then to some kind of economic stability and hopefully growth in the not-too-distant future.

Henry Kirn - *Societe Generale - Analyst*

Thank you very much.

Operator

Ann Duignan.

Ann Duignan - *JPMorgan - Analyst*

Yes, hi, JPMorgan. My first question is just around the backlog being down 23% at this point. Mike, how feasible is it in any way, shape or form that revenues could be up next year?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

It all depends on what happens in the economy. We're not, in many of our businesses we don't commonly have much of a backlog. The entire aftermarket business, construction is a pretty shortly time business.

So I think whether sales are up or not next year isn't necessarily driven by what's in the backlog today. It will be more a case of where are commodity prices as we start to exit the year and that will be based on where is the global economy going. So I don't think right now I would draw a direct link between the backlog and the sales forecast.

A lot could change in the next six months. Good or bad. I'm not trying to sugarcoat it.

I'm just saying that sales next year are going to be dependent a lot on what happens in the global economy. We're on the edge right now of what's needed for growth. We have a pretty decent correlation, particularly in the US when GDP is above 2.5% we tend to grow.

When it's about 2.5% or below it varies by degree we don't. So I think a decent recovery in the economy would help a lot. I know that's a simplistic answer but it's the truth.

Ann Duignan - *JPMorgan - Analyst*

No, I mean I think that's fair. And then my follow-up question would be of Doug, again with backlogs being down 23% I was a little surprised, Doug, that R&D was flat year over year and SG&A only down 3%.

What would it take for you to have to seriously look at those two line items and say, you know what, we're going to have to cut some of these projects that we're working on or some deeper cuts than just shutting manufacturing plants?

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

We started the year around December, January hoping to actually increase our R&D 2015 over 2014. We have not done that, in fact we took that back to flat as you alluded to as well as CapEx. We are constantly monitoring the market long term.

You've heard me say many times we in the past we have not had the availability when markets turn up and we lose market share, we're paranoid about market share around here. It what's drives us and drives our dealers.

I would say to see a major reduction and I'm not going define that, we'd have to see some kind of a cataclysm downwards in our top line. And we see that we'll react as we have in the past and show we can do that.

So that would be the catalyst. If we see something really nasty coming or happening we'd probably go right, not probably, we will go right after it.

Ann Duignan - *JPMorgan - Analyst*

Okay. And would you consider not repurchasing shares in the same environment or is the share repurchase a done deal?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Well, the share repurchase that we talked about this morning is what we expect to do for the third quarter. We've not really talked or placed any kind of forecast or estimates or anything in the market around what we would do after that. I certainly wouldn't describe the third quarter as a done deal per se but it's absolutely what we intend to do.

What drives the buyback, it drives our capital allocation and everything else is really a strong balance sheet. And with the balance sheet today at 33%, 34% debt-to-cap with $8 billion, almost $8 billion in cash taking $1.5 billion off in the third quarter still leaves us in a great position going forward if we saw a cataclysm or if we don't.

And that's really how we look at it because we absolutely have to have that strong balance sheet to get us through growth times and times we're not growing like we have. We've never been positioned at a time like this with that strong of a balance sheet which allows us to return some of that to shareholders.

Now we go down in the top line further we'll have to assess where we are with our capital structure and everything else and everything else and all that would play into it. We'd probably revise it to some degree. We've got plenty of room and plenty of years in our $10 billion authorization with 4 to go to get that done or not and we assess that every -- all the time.

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

But Ann, this is Brad, I'll just make a comment. We're trying to act very consistent within our business model. We've talked about going back to 2012, when our sales were down $16 billion, $17 billion.

What we wanted to do over this time frame is to grow our market share, to improve our quality. We've had very little price action relative to that. So the quality of our earnings is to deliver 25% decremental to 30% decremental numbers, balancing all these things in terms of what we can do.

With the work we've been able to do in our variable margin we're going to be right around 25% for that period. We're well below 25% to 30% decremental in the first half of the year.

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And so because of that we're very happy to be able to fund our R&D programs and to be in a position of strength to have those when the market does turn around. As Doug mentioned we've got close to $8 billion of cash. Our debt-to-cap is low.

We don't have huge CapEx needs at this point in time and we're going to fund R&D at close to the levels of 2012 which was a record year. And we'll do all of that and still have a very strong balance sheet heading into next year.

Ann Duignan - *JPMorgan - Analyst*

And I appreciate that. All in the backdrop of a global macro environment that's very hard to call right now.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, absolutely.

Ann Duignan - *JPMorgan - Analyst*

Okay, I'll get back in line. Thank you. I appreciate the time.

Operator

Vishal Shah.

Vishal Shah - *Deutsche Bank - Analyst*

Thanks, Deutsche Bank. Can you talk about your inventory levels, what do you think the right sized inventory levels would be and how does the reduction impact by different segments?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Now are you talking about our inventory or dealer inventory?

Vishal Shah - *Deutsche Bank - Analyst*

I would say your inventory levels. I think you said that you're going to reduce your inventory levels in the back half of the year. What is the run rate you expect at the end of the year and where does the reduction come from?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, so I think if you look at our business a bit like dealers sometimes tend to build some inventory at the beginning of the year as we're ramping up production for the selling season. Then when we get particularly in the fourth quarter we have a tendency to sell more than we produce inventory comes down. So I think a part of what you're going to see in the fourth quarter is just a little bit of the seasonal pattern for us.

That happened last year as well. We had a pretty sizable inventory reduction in the second half. I think if you just look at our inventory levels broadly, Cat inventory, you know we're working on lean.

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We'd like kind of year in and year out to take them down for efficiency. It would be nice if we had enough increase in volume that it caused inventory to go up from a volume standpoint. But all else being equal, we're working hard to improve inventory turns and be more efficient.

So I guess all else being equal we would like to see it continue to come down a little bit as we improve processes. But and I'd like to comment on dealer inventory, too, it wasn't asked directly but I think most of what we're seeing over the course of this year, first half, second half, it was it would be more reduction in the second half but again I think there's some seasonality in dealer inventory that way. It will likely start to build again in the first quarter for the selling season and I don't think dealer inventories overall are out of line or problematic or anything of the case like that.

So I think reasonably speaking most of the dealer inventory reduction that was because there was too much per se happened in 2013 and 2014.

With that, we are at the top of the hour. And I just want to thank everybody for joining us today. We'll sign off and talk to you again next quarter.

Operator

Thank you. Ladies and gentlemen, this does concludes today's teleconference.

You may disconnect your phone lines at this time and have a wonderful day. Thank you for your participation.

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