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EDITED TRANSCRIPT

CAT - Q3 2015 Caterpillar Inc Earnings Call

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OVERVIEW:

CAT reported 3Q15 sales and revenues of $11b and profit per share of $0.62. Expects 2015 sales and revenues to be about $48b and profit per share, excluding restructuring, to be $4.60.

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the third-quarter 2015 results conference call. (Operator Instructions). It is now my pleasure to turn the floor over to your host, Mike DeWalt. Sir, the floor is yours.

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

Thank you very much and good morning and welcome, everyone, to our third-quarter conference call. I am Mike DeWalt, Caterpillar's Vice President of Finance Services. And we have quite a few people with us today on the call: Doug Oberhelman, our Chairman and CEO; Brad Halverson, our Group President and CFO; Jim Umpleby, our Group President responsible for Energy and Transportation; Rob Charter, our Group President responsible for Dealer Support; and somebody you will probably be getting to know a lot better, Amy Campbell, she effective November 1 becomes our Director of Investor Relations.

So we are going to do today's conference call a little bit differently than we have in the past. We are going to be going through a slide deck. And if you don't have that in front of you right now, it's available on our website, Caterpillar.com, and it is where the conference call link is for the webcast. And it is under Events & Presentations and it is also in the quarterly results section. So I will go through the forward-looking statements and if you need to get that please do.

So this call is copyrighted by Caterpillar Inc. and any use, recording or transmission to any portion of the call without the express written consent of Caterpillar is strictly prohibited. If you would like a copy of today's call transcript, we will be posting it in the Investors section of our Caterpillar.com website and that will be in the section labeled Results Webcasts.

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, it can be found in our cautionary statements under Item 1A Risk Factors of our Form 10-K filed with the SEC in February of this year; also in the forward-looking statements language in today's release; it is also on page 2 of this morning's slide deck.

In addition, a reconciliation of non-GAAP measures can be found in our financial release as well and at the end of our presentation material. And again, all that has been posted at the Caterpillar.com website.

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Okay, with that let's get started with the slide deck. And if I could ask you to flip to page 3, the page numbers are at the bottom of each page. So, the first page is the agenda to the discussion. I will be going over third-quarter results, the 2015 outlook and the preliminary view of 2016. That will go fairly quickly.

Then I will turn it over to Doug Oberhelman and he will walk through kind of business conditions in our segments and key industries, actions we have taken, progress we've made and the things we are doing to protect the future of the Company.

So with that let's turn to page 4, and I'm going to start off with something again a little different. If you look to the bottom right-hand corner of the slide -- well, first at the top of the slide we have sales and revenues, profit per share, profit per share without restructuring costs.

So $13.5 billion in the third quarter a year ago, $11 billion in sales and revenues this third quarter, that is a decline of about 19% or $2.5 billion. About 14% of that is volume, about 3.5% of that was currency. Profit per share all in dropped $1.01 from $1.63 to $0.62 and, excluding restructuring costs, a similar amount down $0.97 from $1.72 to $0.75.

Now down in the bottom right-hand corner I have a comment and it is not year over year. The comment is kind of relative to probably be expectations that we had going into the quarter and probably the expectations that you had going into the quarter. We had two items that we didn't really expect that are of some significance here. One is lower incentive compensation and that is because we lowered the outlook.

Our previous outlook excluding restructuring costs was $5, the current forecast excluding restructuring is $4.60, and that means that incentive comp is going to be lower and we made a year-to-date adjustment to that expense in the third quarter. That was actually favorable for profit about $0.09 a share.

The flipside of that is we had currency translation hedging losses on our non-US assets and liabilities and that was about $135 million negative in the quarter. Now this is not what runs through our operating profit, it is not the translation impact on sales and cost. This is sort of your net monetary position; you have an asset or liability position in foreign currencies -- our operations outside the US.

We had losses in this quarter of about $135 million and a lot of that was from Brazil and China where currencies weakened during the quarter. We don't forecast that; we tend not to forecast short-term currency movements. And so, versus where we were it at the end of July when we talked about our full-year forecast, that was new news.

So now let's step back a little bit and talk about the change quarter over quarter. Again sales down 19%, that was mostly lower volume. The negative currency about 3.5%. And we also had a small change in price realization, negative about 0.5%. And it's certainly a tough environment for pricing out there. With volume down it's very competitive and the strong dollar is not helping that situation.

Now third-quarter of last year sales were still pretty strong in our businesses that support oil customers. And it was also a good quarter a year ago for locomotive sales in our energy and transportation segment. Both of those businesses are down this year. Energy and transportation was the biggest contributor to that $2.5 billion decline in sales; they accounted for about $1.4 billion of it.

Construction was also down and that was really led by Latin America and Asia. And Latin America, Brazil generally in recession, difficult economic environment there and sales for us certainly reflect that difficulty. And in Asia the same can be said for China -- slowing growth, a quite depressed construction equipment market in China.

Resource Industries, which is again principally mining, also down a bit. But as the numbers there decline percentage changes have less and less impact on the dollars. So that is a quick review of sales. Again profit in the quarter excluding restructuring was $0.97 and with it was down $1.01. And essentially the profit decline was a result of the lower sales volume.

Currency again was a little negative overall. I talked about the impact below operating profit, the negative $0.17 in this quarter. It was actually a positive [last] year (company corrected after the call), so the year-over-year impact of that below operating profit currency was even more. That

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was offset a little bit by currency benefits up in operating profit. Sales translated lower but it was pretty positive for costs. Manufacturing costs and SG&A were both lower and that was a partial offset to the lower volume.

So again, that is a quick run through of the third quarter. If I could get you to move on to the next slide, slide 5; at the top it is titled 2015 Outlook. So let's orient the slide.

On the right-hand side of the slide we have the outlook that we had in July with our second-quarter financial release. And at that point in time we were thinking this year was going to be about $49 billion in sales and revenues, profit of about $4.70 a share or $5 without the restructuring costs.

Now you can see in the box below that a month ago we did update that sales outlook to about $48 billion. We have kept that today, sales and revenues at the top end are about $48 billion. Now it says on the slide here top end of about $48 billion.

So the situation is we have a tendency to round our full-year sales forecast to the nearest billion. And most of the time that is okay when you have quite a bit of runway for the rest of the year. At this point in the year we only have one quarter to go, so I think it was good to remind everyone that we do tend to round it to the nearest billion. And in this particular case we rounded up to $48 billion from our internal forecast, and that is by and large about the same as it was when we updated the outlook a month ago.

So if we look at the profit outlook, today it is $4.60 excluding restructuring and [$3.70] including some fairly substantial restructuring (company corrected after the call). The restructuring costs for the year are about -- expected to be about $800 million now. In July with our profit outlook with the second-quarter release we were thinking about $250 million. That big increase is a result of all the actions that we announced on September 24 and I think Doug will talk a little bit more about that in a few minutes.

So if you look at the change from -- excluding restructuring from $5 down to $4.60, really more than all of that was due to -- or about all of that was due to the decline in the sales and revenues forecast. We also have the $0.17 negative that was in the quarter for currency translations. But partly offsetting that we have lower costs for the rest of the year. Some because we are I think doing a pretty good job of managing cost out and some of it because incentive compensation for the year is going to be a bit lower.

So that is a quick recap of the 2015 outlook. If I could get you to go to page 6 and that is the outlook -- preliminary outlook for sales and revenues for next year. And this is essentially unchanged from what we said a month ago in our restructuring announcement. We think 2016 is going to be about 5% below 2015. Now this would be our fourth consecutive down year. That's never happened to Caterpillar in the history of the Company.

Resource Industries, again which is primarily mining, we're expecting to be down around 10%, but again from a very low base. I can tell you 10% means a lot less today than 10% meant in 2012. Construction Industries down -- flat to down 5% from 2015; Energy & Transportation down 5% to 10% and that is mostly -- not entirely but mostly oil and gas.

I think it is worth mentioning around oil and gas the biggest impact that we have seen has been for reciprocating engines and related to drilling and well servicing. We had a pretty good healthy large backlog of those kind of products when we came into 2015. The result of that is our sales in the first half of the year, and we've talked about this before, were higher than what order rates were at the time because we were working off that backlog.

That is largely behind us now. We are going to have a very challenged second half of 2015. So in 2015 we had a good first half for that kind of product, a much weaker second half. Essentially what we have for that kind of product in 2016 is two weak halves, first half and second half. And that is quite a bit of the change year over year in Energy & Transportation.

Okay if I could get you to move on then to page 7. This is a little bit of a set up; after this slide I'm going to turn it over to Doug. And it is just a depiction of what has happened to our sales since the peak which was in 2012. It has been a pretty difficult three years; we think next year will kind of continue that.

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Overall we were about $66 billion in sales and revenues in 2012. Next year we are going to be down probably a little more than $20 billion from that level. And that ends up being over 30%.

Now what makes that declined tough and I think our performance more significant is that most of that decline, nearly two-thirds of it, has been in Resource Industries which is primarily mining and back in 2012 was without question our most profitable segment. Another 10% of that $20 billion or so decline is a result of currency impacts.

Now I should also -- it is not noted on the chart, but in construction we are also down and fundamentally one of the things that has changed is emerging -- or not emerging -- developing countries' construction; Asia, Latin America has also declined over that period. So that is a recap. And with that I would like to turn the floor over to Doug Oberhelman.

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

Okay, thank you, Mike. And good morning, everyone, and thank you for joining us this morning. We are taking a little different approach this quarter with the way in which we go through our business.

Mike summarized the quarter well I think and it is operationally reasonably solid, particularly when you factor back in that translation loss primarily in Brazil. There's not too many months you have a 22% devaluation in a currency anywhere in the world and that is certainly what happened in Brazil in the third quarter.

What I would like to do is run down our key industries and kind of talk about where we see them today. And then a little bit of a reminder of, while cyclical, why we like them so much over time. And we will just go through that. So I am going to start on page 8 and talk about mining a little bit.

There is no question that the China driven commodity super cycle drove a lot of things up in the world the last decade or so and now we are living off the backlash of that. It is kind of amazing to me that even with that, the amount of mining activity going on that is ore and overburden being moved with the exception of coal is still running at a pretty high level around the world. And that is one of the things that has kind of baffled us in terms of the replacement cycle.

As our trucks and fleet have continued to operate without replacement and frankly with very extended aftermarket and product support levels as miners are doing what they need to do to reserve cash, lower expenses, we haven't seen that dramatic of an extension in the lifecycles ever.

There is also a big push for productivity which we like an awful lot because it plays to our business model. And as a result of that of course all of that is piled onto the peak of 2012 and we are now at levels that go way back.

The other interesting thing in terms of mining trucks, at the peak in 2011 and 2012 we were producing 1,500 plus trucks a year on a run rate. Certainly in 2015 we will be probably 90 -- 10% of that 90 -- 70 -- or 80% to 90% below that. And with no replacement -- with the replacement cycle being extended, the parts demand being deferred a bit, we are seeing that really come through in 2015.

I guess if there is a silver lining in the cloud, as long as ore and overburden is removed, the trucks are running, the fleets moving, capacity -- the excess capacity of mining is being used up at some point, that replacement cycle will come back to us. We won't need a boom, and I don't expect a boom like we saw in the 2000s. But a replacement cycle would feel pretty good and we will be ready for that when it happens.

Long-term I think all of you are aware the population growth in the planet, the demand for electricity, the demand for a lot of things including coal and in fact even the US Government Commerce & Energy Department's forecast, fairly healthy energy growth over the next 20 years, 30 years including all aspects of energy supply -- coal, nuclear not so much but certainly gas will be a big player in that as well.

So we expect over time this industry to come back and of course for surface mines we provide -- can provide up to 70% of the rolling stock that goes into a surface mine and we have worked a lot on our underground mining that we didn't have prior to a few years ago.

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So we are very bullish about this over the long-term. And particularly as our business model matures here I think we will be set up. The problem of course is this big whiplash we have seen from the bust of the super cycle.

Moving on into oil and gas, and I would draw a distinction here as we have been doing lately between oil and gas. Oil certainly has taken the brunt of the downturn. You know the oil price, everybody does, we have seen CapEx dry up in that market. Our customers are adjusting. And we see idle rigs all over the place, therein lies the turnaround at some point when supply drops and demand continues to grow.

But in the case of oil that is where we see it. Of course we have a lived off a big backlog both in -- primarily in recip a year ago. We worked through that and as we go into 2016, that is what Mike talked about, feeling a full-year impact of the oil drop and to some degree gas.

Gas has held up a little bit better, gas pipelines have been good. The expansion of compression has been good. And of course the conversion of a lot of coal plants to natural gas has helped that demand. And while gas prices have come down quite a bit, they haven't tanked as we have seen with coal or oil for that matter.

So this is another really super business for us long-term with our Solar Turbine business which is a key player and provider in compression and elsewhere, our recip business. And over time as the world sorts out supply and demand we will enjoy that business again; it is a great aftermarket business as well, aftermarket opportunity.

Moving into Construction, we have got this kind of by region here, as we go through. North America is okay -- I am on page 11. I am sorry I am on page 10, I beg your pardon. I missed Energy & Transportation, I will go back there. Thank you, Mike.

Page 10 and specifically talking about rail here, I just went through oil and gas. Rail has -- rail primarily through Progress Rail, our acquisition there in the late 2000s and the acquisition of EMD have really put us on the map internationally in the rail business and it is a business we like an awful lot. It has a lot of characteristics in our larger horsepower, bigger iron products that we are used to dealing with. And it has turned out to be a -- one with a lot of growth and opportunity as well.

We have done an awful lot of restructuring primarily in EMD the last few years and are now quite competitive with the others in that business particularly internationally. Our 2015 locomotive sales are down. There is no question that we did not have a Tier IV-ready locomotive at the beginning of 2015. I would tell you that we planned it that way based on some early discussions with our customers in the rail business.

A year ago it looked like demand was taking off. Our Tier IV locomotive will be ready the middle of next year or so, we have orders today. The preliminary results are very positive. And in fact as we have seen the rail business soften here lately I'm kind of feeling better about our transition to Tier IV and where we will end up. So quite happy with that long-term.

It plays to all of our strengths here at Caterpillar with an awful lot of aftermarket opportunity that frankly the EMD predecessors really let atrophy. So we are spending a lot of time on that and our Progress Rail and EMD people are getting after it. Lots of opportunity internationally and certainly with a very high quality Tier IV locomotive that shares a lot of the DNA from our recip business, our normal Cat brand business, we will have a very competitive product there moving on into 2016.

Now I will go to page 11 and talk a little bit about Construction regionally. North America, as we said, for next year flat to down a little bit. This year we have kind of seen it slow down a bit as the year wears on. Certainly residential is improving, their statistics and news the last few days have been even better and non-res is building.

What we need frankly is some heavy civil and highway. I am optimistic that we will get some kind of a highway bill here between now and the end of the year. I am optimistic that it will be a multi-year and we will jumpstart this a little bit. Certainly from a low base anything will feel good.

We have seen a number of states around the country enact initiatives, whether it is bonds or tax increases, to pay for infrastructure. That will get going this winter and I would think by spring we can see a little uptick in that piece of it. But again we are calling kind of flat to down a little in our Construction business for 2016.

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Latin America led by Brazil is weak. I was just in Brazil two weeks ago, it is a profound slowdown there. I wouldn't expect to see much of an upturn until [after] 2016 (company corrected after the call). But what the Brazilians are talking about, what they typically have done in the past to stimulate their economy has been around infrastructure. So if they get that together we could see that coming out sometime in the next year as well.

Europe, Africa, Middle East really a split set of stories. Europe is actually kind of stable and positive and you have seen that in some of our retail numbers. We just had a big -- we had several of our officers in Europe with a big distributor meeting and the news is no longer totally gloom and doom but there are some stories.

Our numbers don't reflect all of that yet. But I would say -- and some of you have heard me say this -- I think that Western Europe anyway, including Scandinavia and Southern Europe is probably where the United States was two to three years ago, particularly with the QE now I think finally starting to kick in there. Middle East is all about the oil price and political unrest and we have seen that.

Asia-Pacific is backed up for China. And China has really -- is working to transform their economy. Long-term it is going to be great. It will be the largest construction equipment market in the world. I like our market position there, I like our business model there. It is coming our way but they are finding out the impact of cycles and as we see that as well.

So, long-term -- again population growth, lots of infrastructure needs hindered to some degree by a lot of debt load. But over time that infrastructure will be demanded and needed and we will be right in the middle of that as it goes.

Moving to number 12, page 12, I would like to talk now a little bit about operational progress. Even in this tough business climate I am very happy to report to you -- and this is not news for most of you -- but we have had a market position increase every year since 2010 and our market position is up significantly around the world in that period of time.

It is due to several things I think. One, the quality of our product has never been better by our metrics around defects per unit. Our dealers are performing well. We lost only one dealer in the Great Recession and they are very strong today, as strong as they have ever been. And the quality of our -- or the design of our product and the Tier IV offerings we are putting out there are strong.

So even with overcapacity in the industry and even with a very weak set of currencies for many of our competitors, even in the last year our market share is up slightly around the world. And I think that says a lot about what we can do -- should be doing in a downturn as we are in and then what we can do when things recover.

We are managing costs I think pretty well. We have talked to you all for years about increment and decrement profit margins. When we grew from $32 billion in 2009 to $66 billion in 2012, we were right in there with our incremental margins of 25% plus. As we have seen the top line come down from $66 billion to $48 billion now this year we have been in that decremental margin area of 25% to 30%.

We announced a major restructuring obviously a month ago as we anticipated 2016 to get out in front of that. And I would say going into 2016 we feel good about continuing on our decremental margin program if sales are down, which they appear to be and will be in 2016.

I talked about product quality, our balance sheet I can't say enough about. We entered the recession -- or rather we entered 2009 with a debt to cap ratio of almost 60% and kind of normal operating cash on the balance sheet.

Today even after a fairly significant stock buyback the last couple of years, a dividend increase of 83% during this period of time our balance sheet is strong at [37.4%] debt to cap with about double the amount of cash on our balance sheet of $6 billion which sets us up for I think just about anything that comes at us cycle wise or opportunity wise in the future (company corrected after the call).

Three of our four best years in history have been the last few years in cash flow. I mentioned the dividend, the stock buyback. I want to emphasize that the dividend is a priority use of cash, it is -- particularly the maintenance thereof. We did not reduce the dividend in the 2008/2009 financial crisis; we've paid a dividend every year for over 20 years. And maintaining that is a key use of our cash and a priority for our Company.

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Just a comment on Cat Financial and our captive finance business. It is a great business model, it has been proven through several ups and downs. Key metrics are in line with long-term averages, despite weakness in a few very critical markets and it is healthy, well-managed and risk is very much under control.

Moving to page 14. We will continue on this path of action items given the industry weakness. We in fact have more capacity than we need today. But that said the CapEx we have invested the last few years means our plants are modern, our machines and tooling are up-to-date. Our lean manufacturing is progressing very well inside our plants and we are positioned to handle a lot more volume when recovery comes.

CapEx this year and next year will be less than half of what it was in 2012, we are kind of in a maintenance capital mode and I would expect that to continue for a while even when volumes pick up.

We have implemented and announced substantial restructuring up until now and I think we reported the last few quarters that we have reduced about 10% of our production square footage already through consolidations and closings. And as painful as it is, our workforce has declined more than 35,000 in the last three years. These have generated substantial cost reductions for us.

Moving on to page 15. We talked -- I just mentioned the September 24 announcement, very painful to our people across the world, but necessary. We anticipate between now and 2018 about $1.5 billion of annual cost reduction. We will commit to you and I commit to you today, as we did on September 24, that in 2016 we will see $750 million of cost reduction and we will report on that specifically every quarter against that goal.

We plan on reducing about 4,000 to 5,000 of our nonproduction workforce before the end of 2016, a piece of that this year. Our team moved quickly once we decided to -- we decided that 2015 was not shaping up for recovery and 2016 would be down. We have never done it this way before.

Our idea was to come out with a voluntary early retirement program which was very successful. Follow it with a reduction in workforce and everybody ready to go with full year cost reductions January 1, 2016 and we are right on plan to make that happen.

All in all we should be about another 10,000 reduction by the end of 2018 with about another 20 facilities identified and we have already announced a few of those. We will have likely a few more by the end of the year. And as soon as we have a final determination on those we will be announcing them and you can expect to see them as we get to them.

Now page 16 is an important one, and this is really a summary of our Lean manufacturing and what I am calling leaning of everything journey. And I would like to start in the lower right-hand corner with Built in Quality, Defects per Machine. And this goes back to 2010.

We have introduced during this period, particularly in 2013 and 2014 and now 2015, we will have introduced 300 new models with Tier IV interim and Tier IV final product improvements. And you will notice that our quality in terms of defects per machine has improved significantly.

Now you can also see on there that it has kind of plateaued the last year. Well that is a plateau that far exceeds the targets we put in place back in 2010 and I would submit these are some of the best in industry quality numbers we have seen. This is evidence, in my opinion and all of us, around the benefits of implementing Lean manufacturing in our plants, this is one of them. And quality is right up at the front. And you can see we have had good luck with that.

I would like to move up to Cost. And in terms of gross margin as a percent of sales and these are right off the P&L, you will see it. And while you might think that a six-tenths [or 0.6] improvement in gross margin isn't all that great, I would like to point out a couple things.

This is a period of time when the mix has shifted significantly away from mining to smaller products. It is also a period where we had quite a bit of higher depreciation expense built in. So I am quite happy that we are seeing the cost of goods sold as a result of Lean make its way through here in terms of progress. And we see our mix return to some mining equipment later on, we have some very good opportunities for continued improvement.

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I would like to move over to safety, lower left. And this is one that for lots of reasons we are very happy with. But it is indicative again of the Lean manufacturing process and including people on the floor that do the work in the process of continuous improvement. We started this way back -- way back in the early 2000s. We were one of the industrial companies with highest recordable injury frequency; we are now at this level we think one of the best.

Why is this important? And you may not as an investor appreciate this in terms of dollars and cents. But a safe, efficient, high quality factory means a profitable place and we see that in the cost reduction and then of course our incremental and decremental pull-throughs.

Lastly, one area that is continuing to frustrate me and frustrate us greatly is inventory. And I will be just a bit defensive here but not too much. We have seen our top line decrease since 2012 by $20 billion, as Mike mentioned. Our inventory is also down about $4.5 billion, but our turns are flat. It is very difficult to improve efficiencies in plants when so many plants run on interim schedules. But we have managed to maintain our inventory turnover in that period of time.

I have high expectations that we will move from what today is about a 2.5 inventory turnover rate up smartly and our goal is 3.5 by 2018. And I think we've talked to most of you in the past about that, when we can get some consistent schedules.

And again, I don't want to sound overly defensive on that because I think we have done pretty well kind of catching the knife on the way down to reduce our inventory by $4.5 billion, but we have got a lot of opportunity still to come here that is upside in terms of inventory conversion and cash and efficiency of asset turnover.

So this to me is a pretty good status of our Lean journey. We will continue to talk to you about this in more detail as we go forward.

Finally page 17 and then I will get to Q&A. But two big initiatives we are working on besides Lean. Our dealer initiative that we call Across the Table to drive better market performance across our businesses where we distribute product through dealers. I can tell you we have about 11 or 12 different initiatives, everything from e-business to parts warehouse efficiencies to all kinds of things.

And we are very much on plan. 2016 will be our third year -- really our third year of implementation. And we sure like what we see. The dealers are pretty enthusiastic about it as well. And I think to end on this on the most exciting piece is really around technology and data analytics.

The Caterpillar of the next few years will be quite different than the Caterpillar of the last few years. We have a vision here that everyone of our 3 million machines and engines and many of our competitive machines and engines owned by our customers are connected, have sensors feeding to us, their owners, our dealer all kinds of data that then we can predict failures, we can predict hours of use, we can predict maintenance levels, all kinds of things that will really improve our aftermarket and our customer satisfaction.

We have invested in a joint venture called Uptake with a partner that we really like. That business started around our locomotive business, that is being taken to market -- beginning to be taken to market right now. I would expect to see the same around our construction equipment in the next year or two.

We also have a very important supplier with Trimble who supplies the hardware on our machines that connects us to them. So this is a very exciting area, I won't dwell on it too much although I could. It is one of the most exciting things I have seen in many years around here to change our world going forward and really use technology of the 21st Century for our customers for them to make more money and obviously us as well. So with that I'm going to conclude, Michael, and you can conduct Q&A.

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

Okay, so with that we are ready for Q&A.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Andrew Casey, please announce your affiliation, then pose your question.

Andrew Casey - *Wells Fargo Securities - Analyst*

Wells Fargo Securities. Good morning and thanks for the new presentation format. First, I know you're forecasting mining to be down again in 2016, but I am going to take the bait on the comment at the bottom of slide 8 that was related to improved resource machine utilization in the last three months.

And I know -- I think you have an internal database, but it may not stretch back decades. I am wondering do you have a sense of the typical lag between what you are seeing in the utilization rate and when parts may start to show up.

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

Good question, Andy. And honestly I don't know the answer to that. To your point, we haven't been gathering that kind of data that long over cycles before. And this has been -- mining has really been a tough industry -- well, since mid-2012 actually when all the order levels started to decline.

And there has not been much in the way of good news. I mean we are tracking truck utilization and we are tracking parked fleet. We really haven't seen much change in parked fleet, it is leveled out, not really got better or worse. And we started seeing this trend a couple of months ago and we have kind of watched it each month directionally.

And it seems like there is -- this is hours -- or this is hours in a day worked by a machine. And it has gone up each month for the last three months. Hopefully that is the beginning of a trend, but to your earlier point, we don't have a long history of tracking this. So I would encourage you not to read too much into that.

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

Yes, I just want to add here that I am -- we are watching everything, all this data very closely. I am not reading much into that. The first signal I think we will see and feel is when we see high hour trucks from our mining customers come in for rebuild at our dealers. We have not seen that yet.

And that will be the first signal that when that happens that the replacement cycle, although that won't be new trucks, but the replacement cycle for parts and aftermarket and then the rebuild of those trucks begins. And that is really I think the most concrete signal we would see that we would be past the bottom and right now we haven't seen that. But believe me, we are watching all of these and are in very close contact with our mining dealers that interface with our mining customers.

Andrew Casey - *Wells Fargo Securities - Analyst*

Okay, thanks.

Operator

Ted Grace.

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Ted Grace - *Susquehanna Financial Group - Analyst*

Susquehanna. Thank you, good morning, guys. Mike, I was hoping to maybe take a step back from Andy's question and talk about kind of the 2016 revenue expectations more broadly. I am wondering if you could maybe book end the 5% guidance, what would be kind of the optimistic scenario. What would be the more cautious scenario? And then I was just wondering if we could step through maybe some of the segments and understand within Construction what you expect in the developed markets versus developing.

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

Yes, I will do as much of that as I can. First off I would say when we say about 5%, I mean that is kind of our base case. It presumes a very modest improvement in kind of global growth, nothing that would be significant enough to really drive an upturn. So I would say our view is that is pretty balanced.

I think if we got some recovery in China or better US growth or maybe more energy demand that could be -- those could be positives. Some kind of a recession or a mistake by the Fed or the ECB that kind of drove down the economy I guess could be on the downside.

We are also not expecting much in the way of commodity prices, kind of by and large -- I am not saying exactly where we are today, but by and large around the levels that we are at today on commodities is pretty much what we are thinking around next year. And that is the same for currencies. I mean we are not expecting the dollar to get materially stronger or weaker.

So I think our view right now is it is pretty balanced. I think in Construction we have it, let's just say probably reasonably flat to slightly down in most places in the world. I mean Brazil is very weak, China is very weak, but they were in 2015 as well. In fact, the business is down so far in those two countries in particular that just the size and scope for it to have much significance in terms of a dollar decline next year is a bit diminished. And I think -- so I think Construction, not a lot of change from kind of where we've been this year.

I think in terms of mining it is just a really tough environment out there. And I think our forecast is reflective of what mining companies are saying about cutting CapEx a bit further. That said, the new equipment sales are so low right now, if it declined another -- if new equipment sales declined another 5% or 10% the dollar amount of that is -- I probably wouldn't use the word de minimis but it is not very much because it is down so far.

And I think that is an industry that -- it doesn't tend to move in small increments. So, the upside to that is if it turned around and we started to see some of the things that Doug talked about, maybe more rebuilds or some uplift in commodity prices that could be a help. But for now we are certainly not forecasting any of that.

For Energy & Transportation, really the big down next year is in a lot of ways absence of a good first half of 2015 in really the recip side of oil and gas or well servicing and drilling. We have a pretty low year this year already for rail after the 2014 peak and the -- not having a Tier IV locomotive for this year; we will have one next year. So I wouldn't see massive deterioration in other areas outside of that.

Ted Grace - *Susquehanna Financial Group - Analyst*

As it relates to the Middle East with lower oil prices, some other machinery companies have talked about challenges there. Should we expect that? Do you think that is a risk to that part of the world? And I will jump back in queue after that.

Jim Umpleby - *Caterpillar Inc. - Group President, Energy & Transportation Group*

Yes, this is Jim Umpleby. We really don't see that as a major risk. As Mike mentioned earlier, the major declines we have seen have been in well servicing and drilling, that is primarily a North American story. So I don't see a major risk there.

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Ted Grace - *Susquehanna Financial Group - Analyst*

And in Construction?

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

I think kind of the same thing, probably some downside risk, particularly in places like Saudi Arabia where construction -- they tend to have invested and it has held up. I am going to sort of pre-ask or answer another question or ask Jim to answer it.

I know via email we have gotten several questions on Solar. I think there is a general concern that investors have about our turbine business. It is an excellent business, it has done very well. And this morning we talked about it being down next year as a part of energy and transportation but less than 10%. So I think I will pitch that back to Jim to maybe add a little more color on.

Jim Umpleby - *Caterpillar Inc. - Group President, Energy & Transportation Group*

Sure, Mike. As we said, Energy & Transportation is expected to be down between 5% and 10% in 2016 and we have said that the primary driver of that decline is oil and gas. Again as we have said, the primary driver there is reduced sales into drilling and well servicing.

Our Solar business is made up of three major categories: oil and gas, power generation and customer services. And that oil and gas business can really be separated between oil production, which is primarily generator sets that we sell offshore and that business is certainly down, projects have been delayed and we have seen that translate into lower sales.

On the other hand, our gas compression business at Solar is doing quite well. A lot of that is driven by the robust activity in large interstate pipelines being built primarily in North America. And that is really being fed by a combination of fuel switching to natural gas and also the fact that the new LNG export facilities have to be fed. So again, that business is quite strong.

The customer services part of the business, as you all know, I think an important part of Solar's business. While oil companies are starting to squeeze their maintenance budgets, turbines are not being taken out of operation, they are still operating, that still requires parts and overhaul and field service. So that the business is expected to hold up fairly well as is our power generation business.

Ted Grace - *Susquehanna Financial Group - Analyst*

Super helpful, guys. Good luck this quarter.

Operator

Jamie Cook.

Jamie Cook - *Credit Suisse - Analyst*

I guest just, sorry, back on E&T. You talked about your sales decline. I guess when I looked at the profitability of the quarter within E&T, I was surprised your margins held up as well because I think there is a broader concern that that business is over earning with where oil and gas was.

So, I guess can you, Jim, help us think about how we think about the profitability in 2016 Because I think there is a broader concern other that what we saw in resource margins and where it is today that that same thing could happen in E&T? Thanks.

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

Yes, I am going to start out with that, Jamie. First off, kind of in the quarter the big negative for E&T was definitely volume and mix -- or volume on sales. But we also had a fair amount of cost reduction particularly in period costs. I think if we look at next year in terms of at least operating margin rates, and I think this will go kind of to the heart of one of the points that Doug made earlier and that is the restructuring that we are doing.

I mean we are looking at another $750 million of cost reduction next year and that will be spread across all of our segments and I think should be certainly a help for margins that is reasonably significant. I think Energy & Transportation is a pretty profitable business in most all of the underlying sectors, not just oil and gas. Oil and gas is definitely a good business.

And you will see -- in our third quarter of this year's results you are already seeing the major drop now in the third quarter from the recip, well servicing and drilling reductions, those are in the third-quarter numbers already. There is nothing really weird or unusual that is kind of propping up the third quarter that I know of.

Jamie Cook - *Credit Suisse - Analyst*

So is it -- I mean margins in the low-double-digit range next year? Is that unreasonable given what you said?

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

We will talk more about profit I think maybe when we get to the end of the year. We still have a little bit of work to do on our profit planning by segment and playing through all of these restructuring actions by segment. So, I will defer that question may be until January when we are ready to talk a little more about profit next year.

Jamie Cook - *Credit Suisse - Analyst*

All right, thank you, I will get back in queue.

Operator

Jerry Revich.

Jerry Revich - *Goldman Sachs - Analyst*

Goldman Sachs. Mike, Jim, just to dig in on the Solar discussion, you have done really well in North America on the pipeline side. Can you just talk about, based on the inquiries that you have, how the regional mix of the business could evolve over the next couple of years? So we have been through a pretty good build out in the US and I know you have some visibility on larger projects in other regions that maybe you could step us through.

Jim Umpleby - *Caterpillar Inc. - Group President, Energy & Transportation Group*

Yes, this is Jim again. Certainly Solar's business is quite diverse geographically, we are active in all parts of the world. If you look at the specific elements of their business, oil production is an area which has been very dispersed for Solar. Most of that business is outside the US.

On the gas compression side again right now most of that activity is in North America--Canada, US and Mexico. There is some gas compression activity in other parts of the world. But the big meaningful projects are in fact in North America. As we look at our backlog and quotation activity it does support our outlook for 2016. So again, that takes into account what is happening geographically in all different parts of the world.

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Jerry Revich - *Goldman Sachs - Analyst*

Thank you. And then separate question just on the restructuring program, I am wondering if you can talk about how the manufacturing footprint by region will look once you are through it in whatever broad strokes you are comfortable addressing that? And, Doug, you mentioned a focus on improving inventory turns. Can you just talk about whether the restructuring actions and consolidating facilities helps you move in that direction and if you can lay out any targets for us? Thank you.

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

Yes, I don't want to comment about locations and specifics yet. As I said in my review, it is a sensitive issue obviously internally with our people and we really want to think through those. I would think that materially the footprint geographically would not change.

There may be a little shuffling in terms of what we make versus what we outsource. But you have got to remember that most all of our construction equipment business is -- the higher volume machines are made in region. So we try to run the currency zones of yen, currency zone of the dollar, and the currency zone of the euro. And we had that philosophy for quite some time so we offset cost with sales.

To the extent that that will aid inventory turnover, maybe a bit. But the target that I will put out there and we have had is that 3.5 inventory turnover there in 2017 or 2018. And we if anything want to expedite that moving forward and I have teams in place to move that on. But it is difficult when we have plants that are closed weeks at a time because of lack of demand.

Jerry Revich - *Goldman Sachs - Analyst*

Thank you.

Operator

Ann Duignan.

Ann Duignan - *JPMorgan - Analyst*

JPMorgan. My question is more around clarification. You highlight the fact that you can achieve $750 in cost reductions going into 2016. And then you talk a little bit about mix being a negative of $500 million going into next year. Just conceptually you are not suggesting that the restructuring savings can more than offset the decline in revenue and the decremental profits are you?

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

Well, what we are suggesting is not the impact of volume, I mean $2.5 billion will have a variable margin decline or 5% will have a decline in margin as a result of volume. What we are saying is what is coming out is going to be a little richer margin mix than kind of normal and that is that $250 million headwind. That is kind of the difference between average margin of what is coming out and what we think is going to come out.

We will have a cost reduction next year just from the -- the restructuring is not the only thing we are working on, but we do expect substantial, as Doug said, $750 million of reduction just from this restructuring action. But volume will definitely be a negative.

Ann Duignan - *JPMorgan - Analyst*

So net-net that is down in profitability?

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

Yes. I don't think -- again, we are not really talking profit on this call, but I think it would be a pretty safe bet on a 5% decline in sales with negative mix that that puts a lot of downward pressure on profit, our $750 million of cost reduction and the other cost actions that we are working on that I would call kind of more normal, they push it in the other direction. But I think net-net it will still be down.

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

And I would still aim you, Ann, at the increment/decrement goals that we have. So if we have a step down in sales obviously our normal decrement down would apply and that is our goal for 2016. And then we have mix and cost reduction the rest of it, as Mike has talked about. But I don't want to lose sight of that because that is our internal planning as well.

Ann Duignan - *JPMorgan - Analyst*

Okay. And then just on those lines, what are you baking in for pricing for next year?

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

Again, Ann, I will make a comment without being too specific. Again, we are not done with the financial plan completely yet. But I think given what has happened with the strength of the dollar, you saw in this quarter we had a little bit of negative price, about 0.5% for the Company. And that has gotten a little worse as the year has gone on.

And I think partly what we are seeing is some of the impact of a stronger dollar in the places where it is a little harder to measure but it provides competitive pressure. I don't see that easing. So I would not be overly optimistic about price realization next year.

I also want to clarify something I said a minute ago that was wrong. You said $500 million on mix impact, that is right. I said $250 million back and I was just thinking the difference between $750 million of restructuring and the $500 million of mix is -- that piece of it is still in that net positive. Sorry, just wanted to clarify. I agree with your comment. We do think mix is going to be negative around $500 million.

Ann Duignan - *JPMorgan - Analyst*

Great, thanks for the clarification, I kind of figured that, but --. Thank you.

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

All right, we are slightly over on time. Our presentation ran a little longer than our historical preamble has been. But I think it was good to clarify things. So with that we will wrap up. Thank you very much.

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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