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EDITED TRANSCRIPT

CAT.N - Q2 2020 Caterpillar Inc Earnings Call

EVENT DATE/TIME: JULY 31, 2020 / 12:30PM GMT

OVERVIEW:

Co. reported 2Q20 sales and revenues of $10b, operating profit of $784m and profit per share of $0.84.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Q2 2020 Caterpillar Inc. Earnings Conference Call. (Operator Instructions) I would now like to hand the conference over to your speaker today. Jennifer, please go ahead.

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

Thank you. Good morning, everyone, and welcome to Caterpillar's second quarter earnings call. Joining our call today are Jim Umpleby, Chairman of the Board and CEO; Andrew Bonfield, Chief Financial Officer; Kyle Epley, Vice President of our Global Finance Services Division; and Rob Rengel, Senior IR Manager.

The call today builds on our earnings release, which we issued earlier this morning. You may find the slides that accompany today's presentation, along with the news release on our recently relaunched Investor Relations website in the Investors section of caterpillar.com. When you have some time, please take a moment to check out the new look and improved organization. We welcome your feedback on any ways that we can make it a better tool for you.

Moving on to Slide 2. The forward-looking statements we make today are subject to risks and uncertainties. We'll also make assumptions that could cause our actual results to be different than the information we discuss today. Please refer to our recent SEC filings and the forward-looking statements reminder in the news release for details on factors that, individually or in aggregate, could cause our actual results to vary materially from our forecast.

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This year's quarter included a $0.19 per share remeasurement loss resulting from the settlement of pension obligations. We provide a non-GAAP reconciliation in the appendix to this morning's news release.

Now let's flip to Slide 3 and turn the call over to our Chairman and CEO, Jim Umpleby. Jim?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Thank you, Jennifer, and good morning, everyone. The second quarter brought unprecedented challenges for our customers, dealers, employees and suppliers. We thank those in health care as well as the first responders helping fight to pandemic on the front line.

We also want to thank Caterpillar's global workforce for their commitment to support our customers while keeping each other safe. Working with our dealers, Caterpillar is delivering products and services that enable our customers to provide critical infrastructure that is essential to support society during the pandemic. During this time, Caterpillar is leveraging our strong safety culture and remains dedicated to the safety, health and well-being of our employees.

Our workforce is successfully navigating this uncertain environment by focusing on keeping period costs down, managing inefficiencies and continuing to meet customer needs. The execution of our strategy, including the disciplined management of structural costs during the last 3 years, is also helping us weather the storm created by COVID-19. We've reduced discretionary expenses, including consulting, travel and entertainment.

Effective July 1, to support our employees, we reinstated 2020 base salary increases, except for our most senior executives. Short-term incentive compensation plans for 2020 will remain suspended for most salaried management employees and all senior executives.

We've also reduced production to match customer demand. Our teams continued to focus on improving operational excellence, which includes making our cost structure more flexible and competitive.

We worked through a number of operational challenges relating to the pandemic. As of mid-July, substantially all our primary production facilities across our 3 main segments continue to operate, although many are operating at reduced capacity.

We've worked to mitigate disruption to our supply chain by using alternative sources, redirecting orders to other distribution centers and prioritizing the distribution of the most impactful parts. Our global supply chain is in relatively good shape, although the situation remains fluid. We'll continue to work through the challenges.

Our financial position is strong, and we're confident in our ability to continue serving our global customers.

On a consolidated basis, Caterpillar ended the second quarter with $8.8 billion of enterprise cash and $18.5 billion of available liquidity sources.

Now I'll provide a summary of the second quarter's results on Slide 4. Second quarter sales and revenues of $10 billion decreased by 31%. The decline was mainly due to lower sales volume, driven primarily by lower end-user demand and changes in dealer inventories. This morning, we reported sales to users decreased by 22% in the second quarter. That was less of a drop than we anticipated. Machine sales to users, including Construction Industries and Resource Industries, decreased by 23%, driven by a 40% decline in North America. Asia Pacific was a bright spot. The 7% increase in end-user demand for machines in Asia Pacific was led by improved demand from China.

Energy & Transportation sales to users decreased by 18% as transportation and industrial were soft, while reciprocating engines for oil and gas continued to decline as expected. Power generation remained steady with a year-ago quarter.

During the second quarter of 2020, dealers decreased their inventory by $1.4 billion. This compares with a $500 million increase in dealer inventory during the second quarter of 2019. The year-over-year change drove nearly half of our sales decline for the quarter. The decrease in dealer inventories in this past quarter was greater than we expected. We now anticipate our dealers will reduce their inventory by more than $2 billion by year-end. Andrew will share more details later in the call.

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Lower sales volume was the primary contributor to our 750 basis point margin decline in the quarter to 7.8%. In spite of the challenging operating environment, we continued to invest in our highest priority R&D programs including expanded offerings. We also continued to invest in services, such as enhancing our digital capabilities.

Profit per share for the second quarter was $0.84 compared with $2.83 in the prior year period. This year's quarter included a $0.19 per share pension remeasurement loss.

In the second quarter, we returned $600 million to shareholders largely through our quarterly dividend. Year-to-date, we have returned $2.3 billion to shareholders via dividends and share repurchases. As a reminder, Caterpillar has paid a quarterly dividend every year since 1933 through a variety of challenging business conditions. We continue to expect our strong financial position to support our dividend.

In April, we suspended our share repurchase program upon completion of the program we established in January. At this point, we don't expect to repurchase more shares for the balance of the year.

We anticipate returning substantially all of our ME&T free cash flow to shareholders through the cycles. We also retain balance sheet flexibility for compelling M&A opportunities.

Our focus on operational excellence, shorter lead times and flexibility in manufacturing operations will allow us to react quickly to future changes in market conditions, either positive or negative. Our financial results for the remainder of 2020 will depend on the duration of the pandemic and its impact on global economic conditions.

We withdrew our financial outlook for 2020 in March of this year, and we're not providing annual guidance today.

We believe it is more helpful at this time to compare the third quarter to second quarter of 2020.

Our views are based on current conditions, assuming there are no significant changes in the environment compared to where we are today.

Overall, for the third quarter, we expect a reduction in sales to users compared to the previous year's quarter of around 20%, which is consistent with the decline in the second quarter. We normally see modestly lower Caterpillar sales in the third quarter versus the second.

Turning to Slide 5. We expect overall demand in Construction Industries to follow normal seasonality. In North America, while nonresidential construction is hard to call, we expect residential construction to begin to improve, which would favor smaller equipment. We see Asia Pacific mixed due to the varying effects of the pandemic. In China, we expect a normal seasonal pattern. Typically, the third quarter is a bit weaker than the second. Likewise, we anticipate normal seasonality in EAME.

In Resource industries, overall demand in the quarter is expected to remain soft, largely due to weakness in nonresidential construction and quarry in aggregate, especially in North America. Commodity prices are mixed. Copper and iron ore improved during the second quarter and gold remained strong. Demand is likely to remain low for products sold into coal applications and in the oil sands. In addition, earlier this year, some mining customers shut down operations related to the COVID-19 pandemic. However, activity in May and June started to improve. Globally, the average age of large mining trucks -- of the large mining truck fleet is historically high. And in addition, customer interest in autonomy remains strong, which we believe represents a competitive advantage for Caterpillar. Conversations with our mining customers indicate that greenfield and brownfield projects are still moving forward. We remain optimistic about the medium and long-term outlook for mining.

Energy & Transportation sales typically do not decline in the second half of the year. We expect continued challenges in oil and gas to impact demand for reciprocating engines. Solar turbines continues to execute their long-term projects. We continue to anticipate that the demand for data centers and emergency power will be a relative bright spot within power generation. Industrial engines and transportation are expected to continue to reflect conditions in the markets they serve.

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Turning to Slide 6. During our last earnings call, we reviewed our strategy, which focuses on services, expanded offerings and operational excellence. We also discussed that the impact of COVID-19 in our business have been more severe and chaotic than any cyclical downturn we'd envisioned. Importantly, while we've taken actions to reduce costs, we've made a conscious decision to continue to invest in enablers of services growth, including enhancing our digital capabilities and expanded offerings, key elements of our strategy for long-term profitable growth.

While we expect our margins in 2020 to be better than our historical performance at a similar level of sales, we continue to believe it will be challenging for us to achieve the margin targets we communicated during our 2019 Investor Day.

Free cash flow for 2020 is less certain at this time as we are holding incremental inventory to mitigate against the risk of supplier disruption. It will become clearer as the year unfolds how much of the inventory needs to be retained.

To wrap up, the challenges we've successfully navigated have only strengthened our resolve that we're pursuing the right strategy. That's why even in this environment, we're investing in expanded offerings and services, all of which are key elements of our strategy. We have a strong balance sheet and ample liquidity. We're ready for changes in market conditions, either positive or negative. We fully intend to emerge from this crisis an even stronger company, better positioned for long-term profitable growth.

Now let me turn the call over to Andrew for a more detailed recap of our second quarter results, segment performance and our expectations for the third quarter.

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

Thank you, Jim, and good morning, everyone. I'll begin with a review of our second quarter results as well as our cash flow. Then I'll comment on the third quarter and our liquidity position before ending with a brief update on actions we're taking to improve our competitiveness and profitability.

As you can see on Slide 7, total sales and revenues for the second quarter decreased by 31% to $10 billion. Operating profit declined by 65% to $784 million. Profit per share for the quarter was down 70% to $0.84 per share including a pension remeasurement loss of $0.19 per share.

This quarter's top and bottom line results were largely driven by volume. Sales to users declined by 22%, which was less of a decline than we had anticipated. However, this had a minimal impact on reported sales and revenues because dealers used the opportunity to reduce their inventory levels by more than we had expected. Services revenues also declined, but as anticipated, they were down less than the original equipment sales.

As you see on Slide 8, second quarter sales declined by $4.4 billion, $3.9 billion of which was the volume decline. The volume decline reflected an approximately $2 billion reduction in end-user demand and a $1.9 billion movement in dealer inventory. As Jim mentioned, dealers decreased inventory by $1.4 billion this quarter compared with an increase of $500 million in the prior year's quarter. Volume declined in all segments but were most pronounced in Construction Industries and Resource Industries. While sales were low in all regions, the declines were led by North America, which fell by 42%.

Price realization lowered sales by $259 million. The negative price was a combination of changes in geographic mix and continued competitive pressures, primarily in Construction Industries.

The Brazilian real and the Australian dollar drove the adverse currency movement of $190 million.

Order backlog decreased by about $1.2 billion since the end of the first quarter following our normal seasonal pattern. It was driven by Construction Industries and Energy & Transportation. Compared with the year ago, the backlog declined by $2 billion with decreases in all 3 primary segments.

Moving to Slide 9. Operating profit for the second quarter fell by 65% to $784 million. The volume decline drove the $1.4 billion decrease in operating profit. Operating margins decreased by 750 basis points. Lower manufacturing costs more than offset the unfavorable price realization.

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We announced in March that we were suspending the year's short-term incentive payments. This action, along with other cost reductions, lowered our manufacturing costs, SG&A and R&D expenses again this quarter. For comparison, incentive compensation expense in the second quarter of 2019 was about $200 million.

With regards to SG&A and R&D, it is important to note that the incentive compensation was the major driver of the decline. A portion of the remaining decrease was due to reductions in discretionary spend such as travel due to the slowdown of activity in the quarter. While certain specific cost actions have been taken, we continue to prioritize our spending on those projects that have the greatest opportunity to drive long-term profitable growth.

Starting on Slide 10, I'll discuss the individual segment's results for the second quarter. Second quarter sales of Energy & Transportation declined by 24% to $4.1 billion with declines in all regions and applications. The sales decrease was relatively even across transportation, industrial and oil and gas, with power generation declining at a lesser rate.

Transportation sales declined by 24%, driven by reduced rail traffic and lower marine activity. Industrial sales declined by 29% with lower demand across all regions. Oil and gas sales decreased by 21% as demand for reciprocating engines in North America remained weak. However, this was partly offset by higher sales of solar turbines and turbine-related services. Power generation sales decreased by 12% with declines moderated by demand for emergency power and data centers.

The profit story for Energy & Transportation is similar to the company overall as lower volume drove a 30% decrease to $624 million. Partly offsetting the volume decline were lower manufacturing costs as well as lower SG&A and R&D expenses for the reasons I mentioned a moment ago. The segment operating margin declined by 120 basis points to 15%.

Turning to Slide 11. Construction Industries sales decreased by 37% in the second quarter to $4 billion. Lower end-user demand and the impact from changes in dealer inventories drove the volume decrease. We also saw unfavorable price realization as the pandemic influenced our geographic mix of sales. By region, this included a 54% decrease in North America driven by lower pipeline and road construction activities. The 10% sales decline in Asia Pacific was primarily due to a combination of price realization and currency impacts. China sales were about flat as higher end-user demand was largely offset by changes in dealer inventory and unfavorable price realization.

The segment's second quarter profit decreased by 58% to $518 million. We had lower volume and unfavorable price realization, including unfavorable impacts from the geographic mix of sales versus a record second quarter in the prior year. Lower manufacturing costs partially offset that as did SG&A and R&D savings. The segment's profit margin declined by 650 basis points to 12.8%.

As shown on Slide 12, Resource Industries sales decreased by 35% to $1.8 billion in the quarter against a strong comparative from the year ago quarter. Changes in dealer inventories and lower end-user demand drove the decline. Dealers decreased their inventories in the quarter compared with an increase last year. We saw lower machine sales into nonresidential and quarry in aggregate applications, while mining equipment declined to a lesser degree. Our mining customers dealt with disruptions in the quarter due to COVID-19 impacts and adjusted production to address weaknesses in some -- in demand for some commodities. The parked truck percentage, however, has stayed low and we remain positive on the replacement cycle and overall prospects for mining in the medium and long term.

Resource Industries profit decreased by 68% in the second quarter to $152 million. The decline reflected lower sales volume. Partially offsetting that were favorable manufacturing costs and lower short-term incentive expense. Profit margin declined by 880 basis points to 8.3%.

Moving to Slide 13. Financial Products revenues decreased by 13% in the quarter to $763 million. The decline was due to lower average financing rates and lower average earning assets, the latter reflecting lower purchase receivables from Cat Inc. as volumes declined.

Profitability decreased by 23% in the second quarter to $148 million, led by lower net yield and the lower asset base. We have also increased the provision for credit losses by $58 million compared with the first quarter of 2020 due to the expected impacts of COVID-19 on future credit losses.

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We continue to support our dealers and customers during these challenging times. As we mentioned on last quarter's earnings call, we launched customer care programs that allow customers around the world to apply for payment relief through a simplified and streamlined process. It is encouraging to see that new request for payment relief has slowed dramatically since April.

It's worth reviewing additional key indicators of customer health in the quarter. We've told you that most of our customers entered this downturn fairly healthy and current on their loans. This quarter, past dues were 3.74%, down from 4.13% in the first quarter. The second quarter benefited from the fact that loans with modifications are not considered past due so we'll be carefully monitoring these accounts as their normal payments resume.

New business volume declined by 18% compared to the second quarter of 2019, but outperformed compared to the first quarter of 2020 as we saw an uptick in June across all regions except Latin America. Our dedicated teams continue to provide financial solutions to qualified customers around the globe.

Turning to cash flow. Free cash flow from Machinery, Energy & Transportation for the quarter was about $500 million, down from $1.8 billion in 2019 on about $1.2 billion of lower profit. We began to reduce Caterpillar inventories this quarter, which provided a bit of an offset to the decline in profit. This was less of a benefit than we would normally see with such a substantial reduction in the top line as we are holding an amount of safety stores, including components and other work in process to mitigate the risk of supply disruption. The negative working capital component was driven by lower accounts payable as we reduced total purchases in the quarter due to spending declines.

Let's turn to Slide 14. The full year impact of the COVID-19 pandemic on our business cannot be reasonably estimated at this time. So while we continue to suspend annual guidance, I thought it would be helpful for modeling purposes to share a few of our key thoughts for the third quarter.

As Jim mentioned, we expect normal seasonality in the third quarter, which means that total sales to users are expected to be lower than in the second quarter. We expect a similar percentage decline in end-user demand in the third quarter as we saw in the second. Whilst we expect dealer inventory to decline in the third quarter, we expect that to be around the level we saw in the third quarter of last year, and I will talk a bit more about dealer inventory in a moment.

In terms of profitability, we're now starting to lap some of the benefits of the material cost reductions, which began in the second half of 2019. So this likely will have a negative impact on our gross margin. Whilst the benefit from incentive compensation will continue, the absolute dollar amount will be lower in the third quarter than it was in the second. So overall, we may not see an improvement in operating margins in the third quarter versus the second quarter.

Let me also give you an update on our full year expectations for dealer inventory reductions. In the first half of the year, dealers reduced their inventories by about $1.2 billion. As a reminder, dealers are independent businesses and manage their own inventories. Based on their latest read on end-user demand, we currently anticipate that dealers will further reduce their inventories by another $1 billion in the second half of the year. That is similar to the reduction they made in the second half of 2019. We anticipate that this reduction will enable us to produce in line with end-user demand in 2021. As we typically do, we expect to be able to update you in January on our 2021 outlook.

Turning to Slide 15 for our capital allocation and cash and liquidity position. We recently declared our quarterly dividend and remain proud of our status as a dividend aristocrat. In combination with our share repurchase program, we have returned about $2.3 billion to shareholders this year-to-date, including $600 million returned to shareholders in the second quarter.

At our Investor Day in May 2019, we shared our intention to return substantially all of our free cash flow to shareholders through the cycle via dividends and more consistent share repurchases. We suspended our share repurchase program in mid-April, and as Jim indicated, we don't expect to recommence share repurchases this year.

We ended the second quarter with $8.8 billion in enterprise cash. Given the environment, we've maintained an incremental $3.9 billion short-term credit facility as well as our existing $10.5 billion revolving credit facility. Both of these liquidity resources remain undrawn. As we mentioned last

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quarter, we've also registered for $4.1 billion in commercial paper support programs now available in the United States and Canada, and we issued $2 billion in corporate bonds. In July, Cat Financial issued $1.5 billion of medium-term notes to further supplement its liquidity position.

We currently have $11.1 billion in Machinery, Energy & Transportation long-term debt with no maturities due in 2020 and less than $1.4 billion due in 2021. We don't expect to make discretionary contributions to the U.S. pension plans for the foreseeable future given the current funding status.

We are comfortable that the strength of our balance sheet enables us to manage through the cycle and we believe we are well positioned to respond to changes in demand, either positive or negative as we move into 2021.

You will recall at the start of the year, we estimated that we would invest $300 million to $400 million in restructuring expense including a placeholder of $200 million to address certain challenged products, which weren't producing the expected level of OPACC. To improve our competitiveness and profitability, in the second quarter, we reached an agreement to close our Luenen and Wuppertal facilities in Germany. These facilities manufacture longwall products. Production will be transitioned to Asia and will be closer to end customers and improve its competitiveness.

We also reached an agreement to sell Caterpillar Propulsion AB which manufactures propulsion systems and marine controls for ships. Any lost sales from the actions we've taken thus far are not expected to be material this year or in 2021. We still expect about $300 million to $400 million in annual restructuring expense as we continue to drive the operating and execution model.

In the second quarter, our restructuring expense totaled approximately $147 million compared with $110 million in the prior year's quarter. We expect restructuring expense to be higher in the third quarter than it was last year, but it will be slightly lower than it was in the second quarter.

So finally, let's turn to Slide 16 and recap today's key points. We have a strong financial position and we're confident in our ability to continue to serve our global customers in the current environment.

We have returned $2.3 billion to shareholders via dividends and buybacks in the year-to-date.

We're working with our dealers to manage customer demand, and we expect dealers to reduce their inventories this year by over $2 billion. Our factories remain agile, leveraging lean principles, and we remain ready to respond to positive or negative changes in demand. In 2021, we expect to produce to demand.

Our strategy is working, and we remain focused on operational excellence, services and expanded offerings.

We thank all our employees for staying safe while enabling us to continue to serve our customers, supporting some of the critical infrastructure, enabling the transportation of essentials and satisfying global needs for energy.

With that, I'll hand it over to the operator to start the Q&A session.

QUESTIONS AND ANSWERS

Operator

Our first question comes from the line of Ross Gilardi from Bank of America.

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

Ross, are you muted?

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Operator

We'll move on to our next question from the line of Stephen Volkmann from Jefferies.

Stephen Edward Volkmann - *Jefferies LLC, Research Division - Equity Analyst*

I think I'm here. Can you hear me?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Yes, Steve.

Stephen Edward Volkmann - *Jefferies LLC, Research Division - Equity Analyst*

All right. Great. And thanks for all the detail here today. I guess, if it's possible, you may not want to go too far down this path, but I'm trying to think a little bit about 2021, not in terms of an outlook, but in terms of just sort of the comparative things. And so I'm guessing we're going to get some benefit from that underproducing the $2 billion, which is probably substantial $500 million or $600 million of tailwind, I guess, from that. But we'll have a headwind because I guess you'll be reinstating incentive compensation and various other sort of temporary things.

So I guess my question specifically is what costs were sort of temporary this year that may come back next year irrespective of whatever volume we may choose to forecast?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Well, thanks, Stephen. As you mentioned, certainly, we're not giving guidance for next year, obviously, because of the -- all the uncertainty that's there. So much depends upon the pandemic and the resulting impact on the economy. But you correctly stated that it would be reasonable to assume that short-term incentive would be a cost next year that we wouldn't have this year. We are certainly continuing to look for other ways to reduce costs. We've challenged all of our leaders to continue to find ways to be more efficient. We're working on what we do inside, what we do outside, things we do inside. If they continue to be done inside, can we do them in a more efficient, lower cost way through a location change or some other change. So again, we're continually working every cost angle we can think of. But probably the biggest one that comes to mind is that short-term incentive comp, as you mentioned.

Stephen Edward Volkmann - *Jefferies LLC, Research Division - Equity Analyst*

And Jim, are you willing to talk at all about the benefits of all the restructuring that Andrew laid out for us this year, what you might see for benefits in '21?

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

I mean, at this stage, Steve, we won't talk about it, but probably we'll give you a little bit more of an indication in January when we give the outlook because, obviously, there'll be lots of puts and takes, as you clearly point out.

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

And again, the biggest determining factor, I suspect, will be volume, right? So we'll have to see how the economy plays out.

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Operator

Our next question comes from the line of Ross Gilardi from Bank of America.

Ross Paul Gilardi - *BofA Merrill Lynch, Research Division - Director*

Sorry about that guys. Can you hear me now?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

We can.

Ross Paul Gilardi - *BofA Merrill Lynch, Research Division - Director*

I'm trying to piece together what's happening with pricing in Construction when you mentioned that it was influenced by geographic mix, and I'm wondering if the overall 4% decline is heavily biased towards China perhaps. Reason I'm asking is your Asia Pacific Construction is down 10% despite the strength that we're all aware of in the China excavator market. Yet, of course, as you show, your pricing is down 4% for the segment. So is the 10% -- down 10% in Asia Pacific because China excavator pricing is particularly challenged? Or is it because the rest of Asia Pacific was hit significantly harder than the China excavator market? Any color there will be really appreciated.

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Ross, one of the issues is we call geo mix. I mean the biggest pricing factor was the fact that North American sales were down so that has a big impact on pricing. So that was the #1 impact.

Certainly, yes, we -- there's competitive pressures in China. We're confident in our ability to compete in China long term, continue to expand our products and our dealers are well positioned. But to answer your question, the biggest single issue impacting pricing was the fact that North American sales were down so significantly.

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

Ross -- sorry, Ross, yes, just to give you a little bit more color as well. Don't forget, there's currency impacts in the reported China sales. And also, remember, we had built inventory ahead of the Chinese New Year. So some of that inventory got burned down in the CI in Q2.

Ross Paul Gilardi - *BofA Merrill Lynch, Research Division - Director*

Okay. Got it. And then just as a follow-up, I'm just curious about mining. And when do you think we'll see positive margin comps again in Resource Industries? I mean copper and iron ore prices are very strong. Cash flow with the big miners is very strong yet it's just a little bit puzzling, the revenue declines are -- seem to be intensifying and the segment and margins are going lower. Despite what you're doing on digital, I'd also think you'd be seeing a very favorable mix shift towards parts as miners refurbish existing fleet. So I understand that miners are being frugal in deferring CapEx. But just curious about that sort of persistent margin erosion aside from the COVID-19 impact. And are you getting paid for your new technology that's obviously generating enormous cost savings for your customers?

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D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

The biggest issue affecting margins, of course, is volume because of the leverage we have there. And you've seen that as volume came down, you saw an impact there. So again, what will have the biggest impact on operating margins and ROI is higher volume. As we mentioned, we are -- we continue to be positive on mining outlook, medium and the long term. It's not surprising that in the short term, given what's happening with COVID, customers are being a bit cautious. But as I mentioned in my remarks, we haven't seen any projects that were involved in being canceled. The greenfield and brownfield projects are moving forward. We've -- so we haven't seen any significant kind of cancellation. So again, we're bullish about that. So the biggest thing that will have an impact certainly is -- the biggest impact will come from volume due to operating leverage.

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

(Operator Instructions)

Operator

Our next question comes from the line of Jerry Revich from Goldman Sachs.

Jerry David Revich - *Goldman Sachs Group, Inc., Research Division - VP*

A question on digital. Can you talk about how much progress you've been able to make in this environment in rolling out the full suite of digital tools to your dealers in terms of the ability to assess market share by product and all the analytics that you folks are providing, where are we in that rollout? Were we slowed by the obvious challenge travel environment?

And by the same token, can you also comment on -- with all the telematics data that you're getting, have you seen any slowdown in utilization rates in July with the flare-up in COVID-ed parts of the U.S.?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

You bet. Well, we continue to invest in our digital capabilities from a whole variety of perspectives. I mean we've created and continue to create tools, which give us ability -- a better read internally on where some of the biggest opportunities are in the aftermarket. So that's a tool for both Caterpillar and our dealers to use.

In addition to that, we talked about the fact that we hit 1 million connected assets at the end of last year, and we're looking at ways of leveraging that data.

Clearly, in parts of the world where economic activity was shut down, as you can imagine, we saw an impact in utilization rates. But again, it's a very fluid dynamic situation. Some areas that went down have come back up. And so again, it's very fluid and dynamic as the pandemic impacts economies differently around the world.

But again, it's an area that we continue to invest in and I think we're making good progress. So we really haven't slowed down.

Jerry David Revich - *Goldman Sachs Group, Inc., Research Division - VP*

And sorry, just a clarification. When do you expect the full suite of market share tools by product to be available to your dealers globally? Can you just provide an update there?

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D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

It's a never-ending journey. So I don't think we'll ever get there. So what we're doing is looking at continually adding on new capabilities as we move forward. So we still have a ways to go, there's no question. And again, we'll continually add upon those capabilities. That's our intent.

Operator

Our next question comes from the line of Ann Duignan from JPMorgan.

Ann P. Duignan - *JPMorgan Chase & Co, Research Division - MD*

I just wanted to ask -- step back and ask a more long-term question. Back in the old days, when I visit Cat dealers, they would always say that their life begins and ends with residential construction because if you're building new houses, you're eventually putting in sewage systems and schools, et cetera, et cetera. So I'm just curious if there's any reason to believe that we're not kind of back at the beginning of a brand-new cycle where residential leads nonresidential in terms of at least infrastructure.

And then what is your thinking in terms of rental as opposed to purchase as we move forward given the uncertainties out there? And how would that impact your business long term?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Well, thanks for your question, Ann. And certainly, as you ask that question, I think it's important to think about our dealer network and our business from a global perspective so I suspect your question is more slanted towards North America. And clearly, residential construction is important, and as you say, if, in fact, there are builds out -- build-out of new homes that requires infrastructure to support all of that. So I certainly understand your question. But again, obviously, we have to keep in mind that we have a very strong mining business and oil and gas business and other kinds of businesses as well.

Rental, I think, will be important and will continue to be important. It's an area that we're focused on. I'm not ready to make a call as to whether or not the COVID will have a significant step change in purchase versus rental, but we view rental as an important business that -- and that market will continue to grow over time.

Operator

Our next question comes from the line of David Raso from Evercore ISI.

David Michael Raso - *Evercore ISI Institutional Equities, Research Division - Senior MD & Head of Industrial Research Team*

My question relates to incremental margins. Can you give us some sense as to how to think about a lot of puts and takes you threw out there for 3Q year-over-year? How to think about the decrementals in 3Q versus the 30% you just posted for 2Q?

And on the way back up, there were some questions alluding to this earlier. But Jim, you mentioned short-term incentives coming back, you would continue to look for other ways to cut cost to offset that. Would you be willing to give us some sense as to how you think of incremental margins on the way up in totality? I know there's a lot in there with mix and so forth. But I mean, historically, Cat, after a year of revenue decline, has put up pretty significant incrementals. I know the business has changed a bit, but just wanted to get some level set how you're thinking about it.

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

Yes, David. I think this comes down to the fact, and as Jim alluded to in the script, the fact that we haven't built in structural costs over the last 3 years does enable us to actually, when you think about absolute margins going forward, we are obviously most sensitive to volume variances, which is probably the biggest single factor driving margin performance. So obviously, in an environment where margin -- where volumes are improving, you'll see, obviously, a very significant improvement in overall margins. You'll notice I'm not using incrementals or decrementals again. But I do think that really is the -- obviously, the biggest single benefit to us.

As we look out in Q3, as we mentioned, obviously, normally, as you would always expect, there is some seasonality because of lower volume in Q3 versus Q2. That does have an impact on -- particularly on gross margin. You obviously also -- we are lapping those material cost changes. So that will have a slightly negative impact on gross margin, as I mentioned in my notes. We will see a lower absolute dollar number in step savings in Q3. It was a lower number in the quarter last year. So that will have some impact.

So overall, what we're saying is probably margins should -- we shouldn't expect a margin improvement as we move into Q3. What that does mean, though, obviously, is normally -- overall, I think margins last year in Q3 were slightly lower than they were in Q2 so actually that would be, what we would call, relatively good performance year-on-year within that regard because I think, overall, the margin in Q3 last year -- actually, sorry, was slightly higher, was 15.8% rather than 15.3%. So -- but that would sort of hold those sorts of levels.

David Michael Raso - *Evercore ISI Institutional Equities, Research Division - Senior MD & Head of Industrial Research Team*

So that last comment, just to be clear, it should be roughly around the 30% that we saw in 2Q, just ballpark?

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

It shouldn't be -- if you do the math and you assume margin -- there's no improvement in operating margins from the 7.8% we've just posted against the 15.8%, that will be slightly higher as a percentage.

Operator

Our next question comes from the line of Andy Casey from Wells Fargo Securities.

Andrew Millard Casey - *Wells Fargo Securities, LLC, Research Division - Senior Machinery Analyst*

Just wanted to ask a question. It's around the benefits, if you will, from the pandemic. Other companies have mentioned cost/benefit pull ahead from acceleration of initiatives due to the pandemic and things like technology. Could you help us understand whether you're seeing similar opportunities internally and then are they meaningful?

And then also kind of back to Jerry's question, have you seen any increased, I guess, indication of interest in your digitally enabled product as an outcome of the response to the pandemic?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Yes. Well, certainly, again, as I mentioned, we're continually looking for ways to reduce costs and to be more efficient. And certainly, a situation like this causes, I think, every company to step back and look at ways they can accelerate cost-reduction activities and think about their structural costs. And so again, we're no different than anyone else. We're thinking about those things as well.

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In terms of digital, obviously, if, in fact, things can be done remotely and not -- and an individual does not have to travel and be face-to-face, there's an advantage in that. So we're using digital capabilities where we can. But certainly, our dealers continue to support our customers and we have technicians that continue to work on equipment. So again, what this pandemic has really demonstrated is that, that digital strategy is correct.

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

And I think the other area where, obviously, is the autonomous solutions where people will be looking for those. And obviously, we are optimistic that this will actually encourage further uptake rather than make it -- expand it faster.

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Yes. That is a very good point because when you think about our mining operation, the number of autonomous mining trucks we have, if, in fact, you can do more using autonomous technologies, it reduces the need for think about camps and all the things that our mining customers have to do with people in close proximity. So that certainly could be an acceleration from a market perspective.

Andrew Millard Casey - *Wells Fargo Securities, LLC, Research Division - Senior Machinery Analyst*

Sure. I guess are you seeing any of that, the external response at this point? Or is it more optimism it's going to come?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

No. As I mentioned in my prepared remarks, we see very strong interest in our autonomous solution and we do believe quite strongly that we have the best solution there, and that gives us a competitive advantage. But yes, interest in autonomy in mining has been very strong. Lots of conversations with customers about that.

Operator

Our next question comes from the line of Jamie Cook from Crédit Suisse.

Jamie Lyn Cook - *Crédit Suisse AG, Research Division - MD, Sector Head of United States Capital Goods Research, and Analyst*

I guess, Jim, I think you mentioned in the prepared remarks while you don't expect your margin performance to be what you outlined at the Analyst Day, you do expect to have better margins relative to another downturn, I think, with -- on similar sales. Is there any way you could help us understand sort of which downturn you're talking about so we can understand the comp?

And then I guess just as a follow-up, relative to Ann's question or maybe even Ross', outside of the pandemic, there does seem to be some green shoots. Can you just speak to markets that you would be more positively inclined to sort of think would recover first or which markets structurally you're more concerned about?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Yes, Jamie. When we talk about margin comparisons to the historical past, we're looking at a year when we had a similar year of sales. So I believe, if memory serves, that would have been 2016. So again, I think we were about $39 billion. So again, if you think about margin -- we always think about it is we think about for a similar level of sales, we expect higher operating margins and we expect that to be the case this year as well.

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In terms of green shoots, I mean, China was an area that hit -- the pandemic hit China first and business has been quite strong in China, so that's quite positive. So again, it's very much a fluid dynamic situation. Obviously, the virus starts to go away in an area then it starts -- then it can come back. So again, it's very fluid. So it's difficult for me to really predict any year other than right now. Again, we see a lot of strength in China in CI.

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

And just to elaborate, that's 10% to 21% then range across the cycle.

Operator

And our next question comes from the line of Rob Wertheimer from Melius Research.

Robert Cameron Wertheimer - *Melius Research LLC - Founding Partner, Director of Research & Research Analyst*

So just a simple question. I think you talked a lot about sales to end users and the trend and the expectation of dealer destock. So that was all very helpful. How did the aftermarket trend in 2Q? I know you don't give a lot of disclosure. We've seen other companies down like 20%, is disruption caused less repair. I don't know if that's a relative tailwind into 3Q, if it dipped that much for you or less? And whether you expect it to come back?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Yes. So services in total were down, but they were down less significantly than new equipment sales were, which is what we'd expect, which is one of the reasons that it's an advantage to build out our services revenue. So there was a drop, but it wasn't as significant as new equipment.

Robert Cameron Wertheimer - *Melius Research LLC - Founding Partner, Director of Research & Research Analyst*

And then as the economies have finally restarted, is utilization, we've seen that from Komatsu and others, up and therefore an expectation that services kind of comes back? Or you're not seeing that trend yet come back?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

It's a mixed bag. It depends on geography and it depends upon the area that we're talking about. But again, in areas where economic activity has strengthened, certainly, we're seeing improvement there. So it tends to follow economic activity leads to more utilization, which leads to more services sales.

Operator

Our next question comes from the line of Nicole DeBlase from Deutsche Bank.

Nicole Sheree DeBlase - *Deutsche Bank AG, Research Division - Director & Lead Analyst*

I guess my question is around the outlook for retail sales to remain in the same range as they were in 2Q and 3Q on a year-on-year basis. I guess I'm a little surprised by that. 2Q, obviously, saw the worst impact of the pandemic in April and May with respect to end-user demand. And definitely, the comps get easier in the second half. So just curious if maybe there's some conservatism baked in there? And maybe if there's scope for some upside if trends continue to improve like into July and the rest of the fall?

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

Yes. So obviously, to reach a couple of things. One, which is obviously there is a seasonal pattern to some of our retail stats. So obviously, if people have missed the summer season, obviously, it's unlikely that they would revert back. So whether there's any pent-up demand is unlikely to come through.

Secondly, what we do believe is that if retail stats do improve and are slightly better, we've actually done most of our production scheduling for the quarter, we would probably see a further acceleration in the reduction in dealer inventory. So probably not much of a surprise to Cat Inc., but obviously, we would obviously improve pull-through the dealer inventory reductions a little bit quicker.

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

And maybe just to restate the obvious, we're in a very dynamic market, right? And what we've said is that we're ready for changes, positive or negative. So we're giving you a sense of what we see as to where we see things today. We're not -- what we're saying is we're not expecting a further decline in sales to users is what we're saying, basically, right? And so that's really the message. We don't expect things to get worse based on what we see today. And again, things could get better. Again, it's very difficult to judge just based on for obvious reasons.

Operator

The next question comes from the line of Mig Dobre from Baird.

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

And just to follow up on that previous question. If we're kind of thinking about the third and the fourth quarter here, you're essentially saying that, at retail level, things aren't really getting worse, maybe they're getting a little bit better. The $1 billion worth of dealer destock that you're expecting in the second half won't really create a headwind on a year-over-year basis. So I guess my question is this: as we're thinking about normal seasonality here, is it fair to expect that normal seasonal uptick in revenue in the fourth quarter? And if so, how do you think that's going to translate to margins based on all the moving pieces to the cost structure that you talked about previously?

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

Yes. So interesting, seasonality varies by business by business as you go through. As you know, Mig, the -- one of the things you'll see probably in the fourth quarter is particularly transportation and solar normally traditionally have a strong fourth quarter, which drives their uptick and particularly in Energy & Transportation. Nothing we see today, would expect that to be any different.

As regards Q3 and Q4, for both of those, CI does have -- obviously, it tends to be a little bit negative in Q3 and Q4. Obviously, the timing of Chinese New Year in Q4 last year, the inventory build won't probably rehappen this year. So again, that's another factor to build in as you think about the outlook on a higher level sort of look-through.

And then RI just remains lumpy. It is very much related to project by project, particularly on the mining side. So that's difficult to predict and doesn't really have a seasonality. It's really based around customer orders.

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

And maybe just one comment about dealer inventory, just to add on to that. One of the things we're doing is, again, positioning ourselves both within Caterpillar and around dealers to respond hopefully to positive or negative demand by -- our dealers are independent businesses, they

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make their own decisions about inventory. But by, in fact, having that dealer inventory go down, that allows us to produce to demand. So again, that will remove a potential headwind, obviously, for next year.

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

But just to clarify, if revenues are up sequentially in the fourth quarter, is it fair for us to expect lower decrementals than what you've just talked about for the third quarter?

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

At this stage, we are not -- but yes, normally, you would expect if there is a volume increase that obviously that, quarter-on-quarter, that does help reported margins. However, just to point out always, we do always see a fourth quarter decline in margins in CI in particular. That is one of the biggest factors. So again, it may not -- the decrementals may not change from quarter-to-quarter. We just need to see what we think the volume will be at that point in time.

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

And it depends on mix as well. I mean, so typically, as Andrew mentioned, we have a strong fourth quarter. Solar typically has a strong fourth quarter and we don't expect that to be any different this year, and that helps our mix perspective. So again, it's mix-dependent as well.

Operator

Our final question today will come from the line of Steven Fisher from UBS.

Steven Fisher - *UBS Investment Bank, Research Division - Executive Director and Senior Analyst*

So your Machinery, E&T cash and your enterprise cash were up by quite a bit. It sounds like you're still kind of reserving a little bit of caution on deployment there. Is there a certain level of cash that you'd like to have such that you'd be then comfortable returning more of it or deploying it? Or is it really just a matter of timing till you really feel comfortable that activity levels have bottomed and we have some visibility to things possibly turning a little bit better?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Yes. Really, it's just really a function of us looking at global economic conditions and the pandemic and just the uncertainty that's there. So it really is a function of the pandemic.

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

So now I'd like to turn it back to Jim for some closing remarks, and then I'll close it at the end.

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

All right. Well, again, thank you for your questions today. We greatly appreciate it. As we mentioned, we are very well positioned, we believe, to profitably grow our company. Although we've got challenges due to the pandemic, we're continuing to invest in our long-term future, in new products, in enabling our services capabilities. And again, we greatly appreciate your time this morning. Thank you.

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

Thank you, Jim. Thanks, everyone, who joined us today. A replay of our call will be available online later this morning. We'll also post a transcript on the relaunched Investor Relations website probably on Monday. Click on investors.caterpillar.com and then click on Financials.

If you have any questions, please reach out to Rob or me. You can reach Rob at rengel_rob@cat.com. And I'm at driscoll_jennifer@cat.com. The Investor Relations general phone number is (309) 675-4549.

I hope you have a nice weekend. And now let's turn it back to the operator to conclude our call.

Operator

Ladies and gentlemen, thank you for participating. This concludes today's conference call. You may now disconnect.

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