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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Q3 2020 Caterpillar Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Jennifer Driscoll. Thank you. Please go ahead.

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

Thanks, Jason. Good morning, everyone, and welcome to Caterpillar's Third Quarter 2020 Earnings Call. Today, I'm joined by Jim Umpleby, Chairman of the Board and CEO; Andrew Bonfield, Chief Financial Officer; Kyle Epley, Vice President of the Global Finance Services Division; and Rob Rengel, Senior IR Manager.

On our call, we're expanding on our earnings news release and sales to users, which we issued earlier this morning. Our slides from today and the news release are all in the Investors section of caterpillar.com under Events & Presentations.

The forward-looking statements we make today are subject to risks and uncertainties as you (inaudible) to. We'll also make assumptions that could cause our actual results to be different than the information we're sharing with you on this call.

Please refer to our recent SEC filings and the forward-looking statements reminder in the news release for details on factors that, individually or combined, could cause our actual results to vary materially from our forecast.

Caterpillar has copyrighted this call, and we prohibit use of any portion of it without our prior written approval.

This quarter included a $0.12 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. There's also a backlog information and a couple of other things.

So in a moment, Andrew will update you on our third quarter results and our financial position. But first, please turn to Slide 3 as I hand you over to our Chairman and CEO, Jim Umpleby. Jim?

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

Thank you, Jennifer. Thanks, everyone, for joining the call. I'm proud of how our global team has performed in a challenging environment, providing the essential products and services that enable our customers to support a world in need. We continue to leverage our strong safety culture, remaining both safe and productive in this pandemic-altered work environment.

We remain committed to our strategy launched in 2017, which is based on operational excellence, expanded offerings and services. The operational excellence element of our strategy has served us well, resulting in disciplined management of structural costs. As a result, we went into the pandemic with a strong balance sheet and have continued to invest in expanded offerings and services to make our customers more successful. We're introducing several new products and are enhancing our digital capabilities.

Now I'll briefly cover our third quarter results, starting with Slide 4. While earnings -- while sales, earnings and profit per share declined versus the prior year's quarter, our performance in the quarter was better than we expected. Third quarter sales and revenues of $9.9 billion decreased by 23%. Lower sales volume drove the decline, primarily due to lower end-user demand.

In addition, dealers decreased inventory by $600 million this quarter versus a decrease of $400 million in the third quarter of 2019. That was more of a decrease than we anticipated. With dealers having reduced their inventories by $1.8 billion year-to-date, we now estimate they will reduce their inventories by about $2.5 billion by year-end.

This morning, we also reported 3-month sales to users which decreased by 22% versus the previous year. This was similar to the second quarter's trend and about in line with our assumptions. Machine sales to users decreased by 20% driven by a 31% decline in North America.

Asia/Pacific overall was flat, reflecting higher demand from China offset by declines in other countries in the region.

Energy & Transportation sales to users decreased by 27%, with declines primarily driven by oil and gas and industrial applications.

Profit per share in the third quarter of 2020 was $1.22 versus $2.66 in the third quarter of 2019.

Turning to Slide 5. We believe it's helpful to also compare the third quarter against the second as both periods were impacted by COVID-19. The second -- the third and second quarters of this year were roughly similar. Sales were only slightly lower in the third quarter compared to the second, down about $100 million or 1%. Sales are typically lower seasonally in the third quarter versus the second. Sales were essentially flat across 3 main segments.

While sales came in largely in line with our expectations, our operating margin performance was better than we anticipated. Third quarter margins were 10%, a 220 basis point improvement from the 7.8% we reported in the second quarter. The margin improvement came from a combination of cost control, favorable geographic mix and better factory efficiencies than we anticipated.

Looking at sequential margins for the segments, Construction Industries margins led the way with favorable price due to less of an impact from geographic mix and operating efficiencies.

The higher margins in Resource Industries reflected favorable manufacturing costs that more than offset unfavorable price.

Energy & Transportation margins declined relative to the second quarter. E&T had an unfavorable mix, including reduced sales from oil and gas, mainly in solar turbines. As you know, solar's business tends to be lumpy. In addition, margins in E&T were impacted by some nonrecurring items.

Next, I'll comment on the third quarter 2020 sales to users data released today versus the data from the second quarter of this year. The 20% decline in the third quarter of 2020 machine sales was a 3 percentage point improvement over the decline in the second quarter of 2020. That was about what we expected.

For Construction Industries, most regions reported less of a decline in year-over-year sales to users in the third quarter when compared to the second quarter year-over-year sale -- year-over-year performance. Stronger residential construction benefited our Construction Industries segment. Asia/Pacific remained positive, driven by continued strong demand in China.

Sales to users in Resource Industries declined sequentially as North America remained low, particularly in heavy construction, quarry and aggregates, while other regions continued to see lumpiness across the segment.

Energy & Transportation sales to users declined by 27% during the third quarter of 2020 compared with an 18% decrease reported in this year's second quarter. As expected, reduced demand in oil and gas contributed to the decline. Power generation continued to fluctuate, while industrial remained weak. Transportation improved as reported declines moderated in the third quarter versus the second quarter of 2020.

Turning to Slide 6. As we look ahead for the end markets we serve at Caterpillar, much still depends on the pandemic and its impact on the global economy. While the situation remains fluid, overall, we are cautiously optimistic. We continue to work closely with our suppliers to be well positioned to meet changes in market demand. We're maintaining good product availability levels for the vast majority of our products. Availability of our aftermarket parts is solid as well.

I'll share some thoughts on demand trends for the fourth quarter in each of our end markets based on what we see today. Overall, we expect sales and end-user demand to improve in the fourth quarter compared to the third. This follows our typical seasonal trends. End-user demand should improve going into next year as well.

For Construction Industries, we expect stronger sales and end-user demand in the fourth quarter compared to the third quarter. The percentage reduction in year-over-year sales to users should also improve in the fourth quarter compared to what we saw in the third.

Recovery in North America provides a boost as low interest rates, homebuilder confidence and growth in housing starts support demand for our smaller machines, which are built by our building construction products division.

In China, we expect our Construction business to continue to be strong due to government spending on infrastructure and building activity. Based on what we see today, the strength in China should continue going into next year.

We anticipate nonresidential construction will remain subdued in North America in the fourth quarter as will machine sales for oil and gas-related activity.

Overall, based on what we see today, we expect end markets for Construction Industries to continue to improve. As I mentioned earlier, the situation remains fluid.

Turning to Resource Industries. We expect higher sales in the fourth quarter compared to the third with sales to users improving versus the third quarter as well, although down slightly year-over-year in a business that tends to be lumpy. We're encouraged by continued solid quoting activity in mining, and orders picked up in the third quarter compared to the second. We have some large tenders pending for deliveries that will be spread over the next few years. The tender activity is particularly strong in large mining trucks and large tractors.

Demand for base metal commodities is expected to remain strong. Aftermarket part sales are expected to improve as machine utilization overall is high. Many miners have deferred rebuilds and some maintenance into next year. Mining CapEx is expected to increase over the next 12 months.

Based on everything we're seeing, we remain optimistic about improving conditions in mining. We expect heavy construction and quarry and aggregates in Resource Industries to remain weak in the near term, particularly in North America.

In addition, our autonomous mining trucks continue to gain traction with customers continuing to report improvements in efficiencies and safety on autonomous mining sites. We have over 340 autonomous trucks running now and expect to approach 400 by year-end.

Sales in Energy & Transportation are typically higher in the fourth quarter, including stronger sales to users compared to the third quarter. We expect that trend to continue this year.

We see continued challenges for reciprocating engines in North American oil and gas during the fourth quarter. However, we are encouraged by recent comments made by industry participants in well servicing. For power generation, we expect to increase data center activity to create higher demand in reciprocating engines.

As is typical, solar should have its best sales quarter of the year in the fourth quarter. However, solar sales will likely be lower than in previous years as we are seeing some customers delay maintenance into next year, which will also impact E&T's mix in the fourth quarter. In addition, in the fourth quarter, we expect the timing of product development investments to have a negative margin impact on E&T.

Meanwhile, demand for industrial engines and transportation is expected to show some improvement but continue to reflect the dynamics in the markets they serve.

Before moving off Energy & Transportation, let me comment on the agreement we signed earlier this month to acquire Weir's Oil & Gas business. We see a strong strategic fit between the Weir Oil & Gas and our current offerings in oil and gas. It comes with a strong services business and would expand our product portfolio, one of the broadest in the well service industry. Our goal is to make our customers more successful with us than with competitors. And upon closing, this acquisition would give us a more complete solution in this space.

We view this as an opportunistic time to strengthen our lineup of oil and gas products and services, and importantly, we believe the transaction economics will prove attractive even if oil prices remain low.

Andrew will share the details on the fourth quarter assumptions in a few moments.

Overall, versus the third quarter, we're looking for stronger volume performance, improved operating margins and additional dealer inventory reductions. We expect to be well positioned as we move into 2021.

Turning to Slide 7. We said at our 2019 Investor Day that we intend to return substantially all of our ME&T free cash flow to shareholders through the cycles. Year-to-date, we've returned $2.8 billion to shareholders via dividends and share repurchases.

As we said last quarter, our share repurchase plan will remain suspended through calendar year-end.

In the third quarter, we returned about $560 million to shareholders through our quarterly dividend.

We are proud of our Aristocrats status where, for 27 consecutive years, including 2020, we've paid higher annual dividends to shareholders. The dividend remains a high priority through all economic cycles. All decisions concerning the dividend are made by our Board of Directors, but we anticipate increasing our dividend again next year.

Before closing, let me mention 2 other important things: the retirements at year-end of Billy Ainsworth, Group President of Energy and Transportation; and Ramin Younessi, Group President of Construction Industries. We thank Billy and Ramin for their significant contributions to Caterpillar, and wish them all the best in retirement.

We also welcome Tony Fassino and Joe Creed to the executive office.

I'd also like to mention that the Caterpillar team is proud to have been recently recognized by The Wall Street Journal as #19 on its list of the most sustainably managed companies in the world. The new ranking assessed more than 5,500 publicly traded companies around the world.

In summary, as we continue to execute our strategy for profitable growth, we're investing in services and expanded offerings to better serve our customers, for improving operational excellence, which includes working more safely than ever and making our cost structure more flexible and competitive. We'll be able to react quickly and are well positioned for changes in market demand. We'll emerge from the pandemic as an even stronger company.

Now let me turn it over to Andrew.

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

Thank you, Jim, and good morning, everyone. I'll start on Slide 8 with a recap of our third quarter results. Then I will walk you through the segment results and free cash flow, touch on the fourth quarter outlook and finish with our cash and liquidity position.

To summarize, sales and revenues declined by 23% to $9.9 billion. Operating profit decreased by 51% to $985 million. Third quarter 2020 profit per share was $1.22. This included pretax remeasurement losses of $77 million or $0.12 per share, resulting from the settlements of pension obligations. Adjusted profit per share was $1.34. And $93 million or $0.17 per share discrete tax benefit is included in both our profit per share and adjusted profit per share figures. Last year's profit per share for the third quarter was $2.66.

Overall, sales and revenues finished fairly close to what we thought in July with the operating margin being better than we anticipated, although this was partially offset by negative foreign exchange impacts and lower investment income.

As shown on Slide 9, the top line declined by $2.9 billion, of which $2.6 billion were due to lower volume. A $200 million year-on-year movement in dealer inventory also contributed to the decrease. As Jim mentioned, sales to users overall decreased by 22% for the quarter.

Sales to users for Construction Industries declined by 15%. Within that number, Asia Pacific was a bright spot. It rose 4%, benefiting from stimulus spending in China where the industry is actually up year-to-date. North America, while down 27%, improved from the second quarter trend.

Resource Industries, which does tend to be lumpy, had some unfavorable timing and a 31% year-over-year decline mainly due to weakness in North America and Latin America.

Energy & Transportation sales to users decreased by 27%. This reflected lower levels of activity for reciprocating oil and gas engines, particularly in North America. We also had unfavorable timing in our solar turbines business and lower sales to users in industrial applications.

As you would expect, both Resource Industries and Energy & Transportation sales to users have been impacted more significantly this quarter as these products tend to have a longer lead time between when the order is received and when delivery of the final product is made to the customer by the dealer.

Dealers decreased inventory by $600 million this quarter. That compares with a decrease of $400 million in the third quarter of last year. The slight improvement in machine sales to users quarter-over-quarter enabled dealers to reduce inventory more than we anticipated. Dealers have reduced inventory by $1.8 billion year-to-date. I'll comment on our expectations for fourth quarter movements in the dealer inventory in a few moments.

Sales decreases versus the prior year were fairly consistent among the 3 primary segments. Sales declined in Construction Industries by 23% while sales in Resource Industries and Energy & Transportation declined by 21% and 24%, respectively.

Looking at the geographic region. Sales were most resilient in Asia Pacific, driven by healthy demand in China. While sales in North America and Latin America were fairly challenged, the percentage of decline was less pronounced than we saw in the second quarter of 2020. This was driven by better relative performance in Construction Industries.

Unfavorable price realization of $121 million was less of an issue than last quarter and reflected mainly changes in geographic mix within Construction Industries and Resource Industries.

Machine orders increased by double digits percent comparing the third quarter versus the second quarter. This is one reason we believe that despite their destocking, dealers are seemingly more confident about the future.

We saw dealers become more positive about demand in Construction Industries. We also saw our solar turbines backlog increase slightly compared to the second quarter of 2020.

Now on Slide 10. Operating profit for the third quarter fell by 51% to $985 million. Volume declines were the primary driver of the decrease. Favorable short-term incentive compensation helped partially offset that. Lower manufacturing costs also helped mitigate the effects of lower volume.

We delivered an operating margin of 10.0%, a 220 basis point improvement compared with a 7.8% operating margin in the second quarter of 2020. As I mentioned, this was better than we expected and primarily reflected good cost control, slightly more favorable geographic mix and better factory efficiency.

Restructuring expense for the quarter was $112 million compared with $24 million in the third quarter of 2019.

We continued to make progress addressing certain challenged products as we committed to doing so at the beginning of the year. This quarter, we completed the contemplation process related to closing the Dortmund facility in Germany. This facility manufactures the productivity class of hydraulic mining shovels. We are considering locations closer to our end customer and supply base. This will help us to improve our competitiveness in this market segment.

Pretax profit was impacted by foreign exchange losses and lower investment income due to lower interest rates.

And as I mentioned earlier, profit per share was $1.22 and adjusted profit per share was $1.34.

Now I'll discuss the individual segment's results for the third quarter, beginning on Slide 11. For Construction Industries, sales decreased by 23% to $4.1 billion. Volume declined due to lower end-user demand and changes in dealer inventories.

End-user demand decreased in North America, fueled by declines in pipeline and road construction-related sales. Dealers also reduced their inventories, principally in North America with a more significant decrease during the third quarter 2020 compared to the prior year's third quarter.

The segment's third quarter operating profit decreased by 38% to $585 million, reflecting the volume decrease and unfavorable price realization impacted by a geographic mix of sales. Lower manufacturing costs and favorable short-term incentive compensation expense provided an offset.

The margin declined by 340 basis points to 14.4%.

As shown on Slide 12, Resource Industries sales decreased by 21% in the third quarter to $1.8 billion. We saw lower end-user demand for equipment supporting heavy construction, quarry and aggregates and mining. We also saw lower aftermarket part sales in part due to customers deferring maintenance and rebuilds. In addition, unfavorable price realization contributed to the reduction in revenue.

Specific to mining, the timing of deliveries in this lumpy business impacted sales. But as Jim mentioned, we expect fourth quarter sales for mining applications to improve versus the third quarter. The parked truck percentage has stayed low as activity and production continues to improve. We saw lower machine sales across all markets, but it was primarily in North America and Latin America.

Third quarter profit decreased to $167 million.

The segment's operating margin declined by 430 basis points to 9.2% due to the volume decrease and unfavorable price, partially offset by favorable manufacturing costs as well as short-term incentive compensation expense.

Turning to Slide 13. Third quarter sales of Energy & Transportation declined by 24% to $4.2 billion. That included a 41% sales decline in oil and gas. Demand slowed in North America for reciprocating engines used in gas compression. Power generation sales decreased as well, down 8%. This was primarily due to lower sales volumes in engine aftermarket parts and small reciprocating engines as well as turbines and turbine-related services. An increase in large reciprocating engines partially -- helped partially offset those declines. Industrial and transportation sales decreased by 26% and 19%, respectively. Rail sales declined on lower locomotive deliveries and related services revenues, primarily in North America.

Profit for this segment decreased by 52% to $492 million, driven by lower volume.

The segment's operating margin declined by 690 basis points to 11.8%. As well as the negative volume impact, margins were also affected by positive onetime items in 2019 and negative onetime items in 2020.

Moving to Slide 14 to wrap up our segment commentary. Financial Products revenue decreased by 16% to $724 million. This is due to lower average financing rates across all regions and lower average earning assets. The latter reflected lower purchase receivables from Caterpillar Inc. associated with the volume declines.

Profitability decreased by 35% in the third quarter to $142 million led by a higher provision for credit losses, a lower net yield and a lower asset base. The increase in provision expense was primarily due to lower valuations on collateral that is held to support marine vessel financing -- finance receivables and certain oil and gas assets. Cat Financial continues to support our dealers and customers during this challenging time.

Overall, our customers are in good shape. Credit applications are at healthy levels, about flat with last quarter and up 15% year-over-year. Past dues were at 3.81% in the third quarter, up 7 basis points from the second quarter.

Our customer care programs were successful as requests for second modifications have been very limited. In the United States, second requests only represent about 1% of our customer retail portfolio while the global percentage remains in the low single digits percent range. Over 90% of customers whose loans were modified have now exited their first modification period, and the vast majority have resumed timely payments.

As is always the case, Cat Financial will continue to work closely with their customers as they manage the COVID-19 impacts on their businesses and cash flow.

Now on Slide 15. Free cash flow from Machinery, Energy & Transportation was about $900 million in the quarter, a decrease of about $200 million versus the third quarter of 2019, but up about $400 million versus the second quarter of this year.

Lower profit was partially offset by favorable cash impacts from working capital as accounts payable improved.

We continue to hold a higher level of inventory, including components and other work in process, to ensure that customers will not be impacted by potential supply disruptions and to make sure we are able to respond quickly to improve demand.

Whilst we are not providing annual guidance, we do have a few thoughts from the fourth quarter that may be helpful for your modeling purposes, as shown on Slide 16. Overall, we expect to see less of a decline in end-user demand in the fourth quarter compared with the third based on what we hear from dealers and see in orders.

Seasonally, the fourth quarter is also typically larger than the third.

Sales from services are expected to continue to outperform original equipment for both the fourth quarter and the full year.

We now expect our dealers will reduce their inventories by about $2.5 billion by year-end versus our prior assumption of more than $2 billion. For the fourth quarter, that would translate to a reduction of around $700 million, which is similar to the reduction we saw in the fourth quarter 2019.

The important point is we expect this reduction will enable us to begin 2021 with positive momentum as we'd expect to be producing much closer to demand. I'll remind you though that dealers are independent businesses and they manage their own inventories.

Overall, we expect an improvement in operating margins versus the third quarter. Keep in mind, we continue to lap some of the benefits of material cost reductions, which began in the second half of 2019, and we also do normally see a seasonal reduction in gross margins in the fourth quarter.

The fourth quarter will benefit from savings on incentive compensation. Overall, we do, therefore, expect an improvement in operating margins quarter-on-quarter.

We currently expect about $400 million in total restructuring expenses for the year. This implies a restructuring expense of around $100 million in the fourth quarter of 2020 compared with only about $50 million in the fourth quarter of 2019.

More importantly, we continue to make progress addressing challenged products, including the Dortmund facility action I mentioned earlier. These efforts will continue to increase our efficiency and competitiveness as we move forward. In total, we expect about $300 million of the $400 million spend to relate to these challenged products.

We also expect the tax charge to increase in the fourth quarter as we do not expect any discrete tax items at this time.

Now turning to Slide 17 and our financial position. Earlier this month, we declared our normal quarterly dividend of $1.03 per share, which translates to around $560 million per quarter. Including share repurchases made early this year, we've returned $2.8 billion to shareholders year-to-date.

In April, we suspended our share repurchase program due to uncertainties associated with COVID-19 and then extended that through to the end of the calendar year.

Our commitment for our Investor Day in May 2019 is unchanged, and we intend to return substantially all our ME&T free cash flow to shareholders through the cycles.

We continue to maintain a strong balance sheet, which we can use for compelling M&A opportunities. As Jim mentioned, earlier this month, we announced an agreement to purchase the Weir Group's Oil & Gas business for $405 million in cash. It's a financially attractive transaction even without a recovery in oil prices. Combining Weir's established pressure pumping and pressure control portfolio with our own engines and transmissions enables us to create additional value for customers. The proposed deal also enhances our ability to provide services to oil and gas customers. Its results will be included within our Energy & Transportation segment upon closing. This acquisition comes at a time when some valuations are compelling. It's consistent with our strategy of investing for long-term profitable growth.

We ended the third quarter with a strong financial profile, including $9.3 billion in enterprise cash and over $14 billion in enterprise liquidity. Our credit ratings remained strong. We've shown our resilience in the current environment, and we will emerge an even stronger company.

So finally, let's turn to Slide 18, and let me recap today's key points. We continue to execute our strategy for profitable growth. We're investing in services and expanding offerings while improving operational excellence. In the third quarter, we improved operating

margins versus the second quarter. We see improved margins and stronger volumes in the fourth quarter. With dealer inventory coming down by $2.5 billion, we'll start 2021 well positioned for changes in market demand. And we'll emerge from the pandemic as an even stronger company.

With that, I'll hand it back to Jason to prepare for the Q&A session.

QUESTIONS AND ANSWERS

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

Operator, we're ready for our first question. (Operator Instructions)

Operator

Certainly, your first 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, just trying to read between the lines here, just your comments on dealer inventory. It sounds like you think we've seen the bottom of declines in end-user sales. Your commentary just on orders or backlog. I mean do you have a more positive view of 2021 in terms of the possibility of end-user demand growth? And if so, can you sort of comment on which areas you're more constructive on versus less with understanding you're not going to want to quantify a revenue growth opportunity for next year?

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

Yes, you're correct. I'm not going to give 2021 guidance, but I will try to make some comments just to provide some color. So certainly as we sit here today, I feel better today than I did a quarter ago.

We've talked about the fact that we are quite constructive on what we see in mining. So mining quoting activity is quite high. I mentioned in my earlier remarks, we're tendering for some large projects that we feel good about that would involve multiyear deliveries of large tractors and large mining trucks. Again, mining really is -- continues to improve.

We've talked about the housing starts in the U.S. driving activity on the smaller end of our Construction Industries business as well and we believe that strength will continue going into next year as well.

So again, we're not going to give a guidance here for 2021, [but I feel] better today than we did a quarter ago.

Operator

Your next question comes from the lot of David Raso from Evercore ISI.

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

Sort of in the same spirit, I'm just trying to get a sense of you speak now a lot to revenues in sort of sequential historical terms. And now that we have a bit of a baseline for how you're thinking about fourth quarter, to extrapolate that into early '21, I'm just trying to appreciate the commentary about the improvement you're seeing on underproduction in CI to back in line with retail.

The way the year is going to start in '21, just for some perspective, should we still just think of it as normal sequential starting the year? Or it's what you're seeing on the order book, you mentioned maybe some timing issues with solar and mining. Just to give us a little baseline, I think Andrew said positive momentum into '21. I think we're just all trying to sanity check, when can the company return to positive revenue growth? I mean, 2Q isn't a relatively easy comp. I think people were just trying to figure out how much momentum to start '21. Just some perspective, I'd appreciate it.

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

Yes, David, it's Andrew. Obviously, if you remember, in the first quarter, we did see some inventory build, although lower than normal by dealers as a result of getting ready for the buying season and obviously, as we hit that, the pandemic hit as well.

I think a couple of thoughts on Q1. So that will be an impact. So obviously, year-on-year comp, as you say, is a little bit more challenging. We did see the big dealer inventory reduction occur in Q2.

We would expect also there's -- for example, in China, China has a later Chinese New Year this year. So that means there may be some inventory build in Q1. Chinese New Year is sort of middle of February this year. So that may impact Q1 comp. And I think generally, as we say, we think that the underlying momentum in end-user sales will start to have an impact more positively. But obviously, the first quarter had less of an impact.

So it's going to be a little bit challenging as we go through the year. I think as we get to January, we'll be able to give you a little bit more feel for exactly how that pans out for the year.

Operator

Your next question comes from the line of Chad Dillard from Bernstein.

Charles Albert Edward Dillard ***Sanford C. Bernstein & Co., LLC., Research Division - Research Analyst***

I hope you guys could comment on Cat's own inventory. It looks like it's running about 34% of sales on a trailing 12-month basis. How should we think about the pace and magnitude of destocking there? And what do you expect to be at the end of the year? And what would you consider to be healthy levels there?

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

Yes, Chad, it's Andrew. As we said, we are holding more inventory than we would normally hold at the Cat end for a couple of reasons for that. One, which is obviously we had a little bit of extra safety inventory as we've gone in through the year, partly because, obviously, we have been concerned about supply disruption. So our safety inventory levels are a little bit higher.

Second thing is, actually, this is one of those odd years where actually we have a downturn and potentially getting ready for an upturn in demand in the same time. Historically, you would always have seen in a down cycle obviously a reduction in Caterpillar-owned inventory. Given that dealers are reducing their inventory levels, given that we are expecting underlying demand to tick back up as we move into the next financial year, we believe it's right for us to hold a little bit more inventory than we would normally have held, getting ready for that so that we aren't in a position where the bullwhip effect catches us out as we move into 2021.

I mean, obviously, normally, if we were in a situation where we didn't see that, we obviously would be continuing to reduce inventory levels. Obviously, again, we are -- we have plenty of cash on hand. We are in a low interest rate environment. So financially, it is not a big drag on us to hold a little bit more inventory than we would normally do.

Operator

Your next question comes from the line of Joe O'Dea from Vertical Research.

Joseph John O'Dea ***Vertical Research Partners, LLC - Partner***

Question is related to services. And we saw end-user demand trends, the decline rate is pretty similar between 2Q and 3Q. It looks like the decline rates on the services side of the business might have accelerated from 2Q to 3Q. I think you've talked about some deferrals. But if you could just comment on what you saw a little bit on the year-over-year trends if, in fact, it was getting a little bit tougher sequentially.

And then in the recent announcements around the leadership changes, a clear focus on services there. What you see in terms of opportunities in the near term to control what you can control and drive those revenues higher.

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

Yes, certainly. Thanks for your question. And certainly, we are -- continue to be very focused on services as an important element of our strategy. And as you would expect, services did decline by a lesser extent than OE in this declining market. Having said that, again, we

are -- we're continuing to invest to increase services.

And I did make some comments, I believe, about what we expect in mining in terms of just given that utilization is high. We expect moving into next year to see higher aftermarket sales, but again continued to invest in that part of the business, and it's something that we're very excited about the opportunity.

Operator

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

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

If we could just focus on the comments you made on quarry and aggregates being weaker and then road construction also, I think, you noted in construction equipment being weaker. Can you talk a little bit about the importance of a new fast stack or new highway bill versus anything we get some ginormous infrastructure bill. How important is it to get a new 4-year highway bill going into 2021, particularly for your customers who may not be able to invest without a long-term contract?

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

Yes. The recent 1-year extension of the surface highway bill does provide some certainty for state and local governments, so they can plan for projects. As we think about -- and of course, we've continued to advocate for a long-term reauthorization of the federal highway bill. We think it would be very appropriate in terms of economic stimulus. And of course, the overall infrastructure bill that seems to have very broad bipartisan support certainly would be a positive for our customers and for us.

Timing of all that impact, of course, is uncertain. It all depends on politics and when it gets passed. But again, based on everything we see, that's the one thing that the 2 sides tend to agree on at this point.

Operator

Your next question comes from the line of Tim Thein from Citigroup.

Timothy W. Thein ***Citigroup Inc., Research Division - Director & U.S. Machinery Analyst***

So the question relates to the interplay of price and material costs. As we look into '21, just given the recent moves we've seen in most grades of steel and what looks to be a bit more of an inflationary environment, which, of course, will be coming down the pike for Cat, how should we think about the opportunity for pricing actions into '21 just given the state of markets globally and then Cat's ability to stay on the plus side of price versus material cost in '21?

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

Yes. Thanks, Tim. It's Andrew. Yes, just -- I mean, from that perspective, I mean, obviously, we do buy forward a little bit of our steel. So we are still seeing the benefits of price reductions at this stage.

As we're thinking about price actions in 2021, yes, you are completely correct. We are taking into account the demand side of the equation. Obviously, if demand is -- in a softer demand environment, you obviously do not want to push price too hard. And we are reflecting the fact that, obviously, at the moment, we are still seeing favorable material costs.

In the event, obviously, that, that does change as we go through the year, we always have the option of thinking about that later. But at the moment, we're in a reasonably good position as we move into 2021.

Operator

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

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

Rob, are you there? Are you on mute, Rob?

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

I am so sorry. I'm so sorry. You saw a transition to group presidents this quarter, which is a little bit unusual. And I wonder if you could talk about that for a second, perhaps what was accomplished and if there's a different focus on the future for Joe and Tony or whatever direction you want to take it?

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

You bet. Well, certainly, as I mentioned, we thank Billy and Ramin for their many contributions during their careers and wish them well in retirement. And we're very excited also about having Joe and Tony join the executive office. It doesn't signal any kind of change in strategy. We're going to continue to execute the strategy that we introduced in 2017, expanded offerings and services and operational excellence. So we have a very strong bench, and our Board has spent a considerable amount of time on succession planning. So again, that's -- again, we wish Billy and Ramin all the best.

Operator

Your next question comes from the line of Courtney Yakavonis from Morgan Stanley.

Courtney Yakavonis ***Morgan Stanley, Research Division - Research Associate***

If you can just comment -- you commented before that housing and resi was one of the parts of the business that seems to be driving activity on the small end of the business, but it sounded like you're expecting more muted nonresidential activity in the fourth quarter.

If you can just comment maybe on those relative sizes of your business and the margin profile between the two? And acknowledging that you've kind of talked about resi heading into next year, if there's any comments that you would make on nonresi?

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

Yes. Thanks, Courtney, it's Andrew. Obviously, with a broad portfolio like Caterpillar, you have different margin structures within different parts of the business and that varies across the portfolio.

Obviously, as we have been clear, obviously, the smaller machines tend to have a slightly lower margin than the larger machines. But overall, we think that the portfolio mix, as you've seen, even this year, is relatively small and manageable within the context of the broader Caterpillar. So I think overall, we are not too worried about that having a drag impact on gross margins.

Also, the other thing to remember is, obviously, if you get very favorable leverage from some of these products, it does help actually improve your margin structure.

So that has been the way it's been managed, which is why it's been very manageable and we expect it to be manageable going forward.

Operator

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

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

I had a question for Jim. Jim, the industrial economy seems to be getting better. I mean, thus far, you're not really seeing it in your retail sales growth in both mining and E&T. I mean maybe some of that, as you guys discussed, is lumpiness and delivery timing. But a lot of that, it's got to be due to a pretty anemic capital spending outlook in the energy sector and pressures in markets like coal. And it seemed to be flagging ongoing at least near-term headwinds for solar, which has been very resilient the last few cycles.

I know you're buying the Weir assets, but is the company giving any thoughts to using its $9 billion cash flow to diversify away from the fossil fuel industry, given the structural headwinds in the energy markets in markets like coal? And if not, why not?

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

Well, Ross, certainly appreciate your question. I don't believe we signaled any headwinds for solar. But probably the best way to start is -- it's quite an expansive question you've asked, so I'll give you a bit of an expansive answer.

But we'll start by reminding you, we're a large diversified business, both in terms of end markets and geography. As I mentioned earlier, we're proud to have been named 19 out of 5,500 companies around the world to Wall Street Journal's top sustainably managed companies. And we build the world's infrastructure and that would include investments in future energy infrastructure around the world, and I'm confident our products will play a part in that.

I believe that we are well positioned to benefit from both a period of transition and after the transition has occurred. And we'll continue to support our customers during the period of transition, no matter how long that is. But we're also very well positioned to succeed in the future.

In terms of how we're supporting our customers today, we have world-class products and services to support our oil and gas customers. But we're helping them with their ESG goals as well, helping them to reduce their carbon footprint, whether it's methane abatement by reducing flaring. We're providing battery storage solutions and efficiency improvement. And we've introduced a dynamic gas blending engine that allows our oil and gas customers to substitute up to 85% of diesel fuel with natural gas. And we continue to support all of our mining customers as well.

And by the way, our exposure -- you mentioned coal, our exposure to coal is low. It's generally between 3% and 5% of company revenues, including both machines and parts.

Now in our mining business looking to the future, we see future opportunities due to the growing electric vehicle market that's expected to increase demand for essential metals. In particular, copper and nickel are expected to see sustained growth.

And we're very excited about some of the opportunities in Energy & Transportation. I mean we have significant experience burning a wide variety of fuels in our -- both our recip engines and our turbines, including natural gas, coal (inaudible) gas, landfill gas and other biogases. We are well positioned to run our equipment on a variety of blended fuels, including hydrogen. Our solars gas turbine generator sets can burn 100% hydrogen to produce electricity. And our turbines and recip engines can be paired with advanced technologies, whether it's electric drive batteries, hybrid configurations to reduce overall fuel consumption and carbon emissions. And we have battery electric-powered and electric drive machines that enable customers to take advantage of available electricity as a renewable alternative to traditional fuels.

We've done things like we have an all-switch battery locomotive. We developed that in conjunction with Vale, one of our rail customers.

So when you think about distributed generation, which many believe will be a large part of the future, we're already selling reciprocating engines and gas turbines to back up wind farms and solar as well. You know our engines provide a variety of distributed generation solutions as hydrogen blends and are added to gas networks. And so again, we think we're very well positioned for the future as the transition occurs. But we are going to continue to support the customers that we have.

Operator

Your next question comes from the line of Larry De Maria from William Blair.

Lawrence Tighe De Maria ***William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure***

Obviously, you discussed your better environment and your optimism in 4Q and early next year. But can you talk maybe more on the profit side, just assuming, let's say, apples-to-apples, flat sales next year, what are some of the puts and takes in profit? For example, what's the incentive comp headwind? What are the benefits on run rate restructuring and other items on an apples-to-apples basis on profit from this year to next year without assuming any, let's say, incremental or decremental margin impact?

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

Larry, it's Andrew. Yes, obviously, the -- from a top line perspective, if we produce closer to demand, obviously, that means we won't have the negative impact of dealer inventory reductions. So that will be a positive flowing through to profit, assuming no other obviously changes from an operating leverage perspective.

On the sort of cost side, we did see, obviously, step -- normal step runs at about $800 million per year on the basis of a standard payout. We will have that as a headwind as we move into 2021.

We did see some delays in discretionary spending. Some of that may not come back. Some of that may come back, but it's relatively very minor overall. For example, things I travel has been less. Obviously, there have been other projects which haven't really got started as such because they've been delayed while people aren't in the office together.

So we'll see how that pans out as we get in, and obviously, we'll be able to give you a better guide to that as we get into January when we talk about 2021.

Lawrence Tighe De Maria ***William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure***

Was there a restructuring -- run rate restructuring number to think about?

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

At this stage, we are still putting our plans together for 2021. Obviously, we assume normally, on average, about $200 million of base restructuring. And then, obviously, we've seen some incremental relating to these challenged products. Some of the challenged products restructurings will recur in 2021. But we're spending about $400 million this year, probably wouldn't be that much significant at this stage, different next year. Well, maybe even slightly less, we'll need to see as we finish our planning process.

Operator

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

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

Just wanted to spend a little bit more time on E&T. I was a bit surprised by the retail sales deterioration there that you guys reported for the 3 months ending September. If you could just elaborate a little bit on that?

And then also with respect to that segment, decremental margins were a bit higher this quarter. Anything special going on there? And how to think about that into 4Q?

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

So I'll start with the, Nicole, with the margins piece. As I said in my comments, we did have a small onetime credit last year income in E&T. This year, we had a number of negative onetimers equated to about $70 million that related to some asset write-downs and also some inventory impairments. So that was actually the big driver of the margin change quarter-on-quarter.

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

And in terms of sales, both in E&T and in Resource Industries, but particularly E&T, it's really a lumpy business so you can see deviations quarter-to-quarter in terms of retail sales. So that drives a lot of it.

Operator

Your next question comes from the line of Stephen Volkmann from Jefferies.

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

It's on the return of cash to shareholders and understandable to sort of pause repo this year. I'm just curious how you think about next year, assuming it restarts at some point. Do you over return cash to sort of make up the difference and get to where you want to be? Or do you restart at kind of the operating cash flow level and proceed that way?

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

Obviously -- Steve, it's Andrew. Obviously, any decision around that will be a Board decision, which will take an update as we move into 2021.

Remind you that our actual policy is to return substantially all of ME&T free cash flow. This year, we will already have over returned based on our free cash flow year-to-date. And the amount of buyback we've done probably will be over. So probably we'll just rebase back to what the number is.

But again, we'll have a conversation and a discussion around that probably back -- in January time for ME&T.

Operator

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

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

We've seen across-the-board strong digital engagement in this environment for a lot of folks. And I'm wondering if you could just quantify, for your business out of your connected machines, what proportion of your customers use digital ordering over connected to dealers via that channel? I know you put in a lot of work there. I'm wondering if you could just quantify for us how much traction you're building in that way or any other way you're comfortable talking about it?

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

You bet, Jerry. We certainly aren't going to quantify a number, but that's something that we're very focused on and we're seeing improvement over time. So as we continue to invest in and our dealers investing as well in their capabilities, we're seeing improvements and we expect that to continue. But I really can't quantify it for you this morning.

Operator

Your next question comes from the line of Steven Fisher from UBS.

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

Wondering how much visibility you guys have on China construction. I mean it looks like the retail sales activity is maybe moderating, but Jim, you noted you expect continued strength into next year. So can you just talk a little bit about the visibility there and maybe the drivers in terms of some of the policy shifts versus market share and any other key factors?

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

As I mentioned earlier, we -- Steve, we do see continued strength in China. It's been quite strong. And we do expect that strength to continue into next year based on what -- obviously, we don't have a crystal ball, but based on everything we see today, we expect that business to continue to be strong. Again, hard to elaborate much more than that, frankly.

Operator

Your next question comes from the line of Seth Weber from RBC Capital Markets.

Seth Robert Weber ***RBC Capital Markets, Research Division - Equity Analyst***

Just kind of along the lines of a prior question. Your R&D spend has been down here for a couple of years. I mean in a scenario where revenue starts to come back up, would you expect a material pickup in R&D spend next year?

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

Yes. So I mean, I think one of the things that's obviously -- one of the bigger factors this year on R&D spend actually has been short-term incentive compensation reductions. That has, year-on-year, one of the most significant impacts.

Yes, there have been some project delays. Obviously, as we've gone through the year, just inevitably, not having all the engineers in the room together does mean that some of the R&D projects are going slightly slower. As a percentage of sales, actually, R&D is actually up year-over-year because, obviously, spend has held up slightly better than the rate of decline in revenues.

So obviously, we will see an absolute dollar increase but obviously, maybe not quite as a big -- maybe slightly lower percentage as a percentage of revenues.

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

But again, we are confident that we are investing in the most important R&D projects and continue to build with that and those expanded products, continue to invest in digital. So again, we're very committed to continue developing new products and investing in the most important R&D programs.

Operator

Your final 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***

Want to go back to mining, if we could. And maybe, Jim, a question for you here. If we're kind of looking at the current environment, you sound constructive on mining. It sounds like there are some things in the pipeline, and the customers are starting to move on deploying a little bit of capital. How would you compare the discussions in the pipeline that you have now versus where you were in, say, 2016 going into 2017? And I asked because the fleet, we all know it's older, so I'm presuming that the decision-making for your customers is a little bit different today than it was, say, in 2016.

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

Yes. I'd say that the conversations are very different, indeed. I mean, by the end of 2016, frankly, our customers were shell shocked just given what they had gone through between 2012 and 2016, a very, very tough time for them. And all the discussions were about continued cost reduction, about finding ways they could squeeze more cost out of everything they're doing.

The conversations are quite different today, conversations around autonomy, how we can help our customers be more successful. They're talking about greenfield projects, expanding brownfield projects, retrofits of autonomy on existing fleets. The conversations are very, very different. And I'd say the mood couldn't be more different.

I'm not expecting a wild spike up. As I've said previously, I think the best thing for both the industry and for us is more of a moderated increase over time. But the mood is very, very different than it was in '16.

Operator

That concludes Q&A. I now turn back to the presenters for closing remarks.

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

Well, thank you, Jason. Thank you, everyone, for your time this morning. Just to kind of summarize here, we're pleased with our performance in the quarter. The company is performing well. We believe we're very well positioned for next year and the longer-term future as well. And we look forward to discussing our fourth quarter results with you in January. Thank you.

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

Thanks, Jim. Thanks, Andrew, and everybody who joined us today. Before we close, let me point out Slide 20 where we're providing our preliminary dates for quarterly earnings in 2021: January 29, April 29, July 30 and October 28, 2021.

A replay of our call will be available online later this morning. We'll also post a transcript on our Investor Relations website later today. Click on investors.caterpillar.com and then click on Financials to find those materials. If you have any questions, please reach out to Rob or me. You can reach Rob at rengel_rob@cat.com, and I'm driscoll_jennifer@cat.com. The Investor Relations general phone number is (309) 675-4549.

I hope you enjoy the rest of your day, and now let's turn it back to Jason to conclude our call.

Operator

That concludes today's conference call. Thank you, everyone, for joining. You may now disconnect.