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Caterpillar, Inc. (CAT)

Q4 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to the Q4 2020 Caterpillar Earnings Conference Call. At this time, all participants are in a listen-only mode. 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 Kay Driscoll

Director of Investor Relations, Caterpillar, Inc.

Thank you, Jason. Good morning, everyone. Welcome to Caterpillar's fourth quarter 2020 earnings call. Joining me this morning are 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.

During our call, we'll be discussing the earnings news release that we issued earlier this morning. Our slides from today, the news release, and a video recap are all in the Investors section of caterpillar.com under Events and Presentations. 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'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 in aggregate 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.

Today, we're reporting profit per share of $1.42 for the quarter and $5.46 for the year. We're showing adjusted profit per share in addition to our US GAAP results. Our adjusted profit per share of $2.12 for the fourth quarter excluded remeasurement losses of $0.63 per share resulting from settlements of pension and other postretirement obligations, it also excluded restructuring expenses of $0.07 per share, which Andrew will discuss. For the full year, adjusted profit per share of $6.56 excluded $0.55 per share resulting from the settlements of pension and other postretirement benefit obligations and $0.55 per share in restructuring expenses. We provide a GAAP reconciliation in the appendix to this morning's news release. You can also find information on dealer inventory, backlog, services revenues, and full year 2020 numbers in our slides.

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

Donald James Umpleby

Chairman & Chief Executive Officer, Caterpillar, Inc.

Thank you, Jennifer, and thanks, everyone, for joining the call. I'd like to start by thanking our global team for their resilience and performance during 2020, a year of unprecedented challenges. The Caterpillar team continued to provide the essential products and services that enabled our customers to support society during the pandemic. In this difficult environment, we leveraged our strong safety culture and had the best year on record for employee safety. Our employees' generous contributions and volunteerism are also notable. We had a record level of support for worldwide relief efforts in 2020 through the Caterpillar Foundation.

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Before turning over the call to Andrew for a detailed review of our results, I plan to briefly cover the following topics this morning. I'll share my perspectives on Cat's fourth quarter results. I'll then provide comments on our performance for the full year, followed by some high-level thoughts about 2021. I'll close by highlighting several ways we're advancing our strategy.

Starting on slide 4, I'll recap fourth quarter results versus a year ago. Sales and revenues of $11.2 billion decreased 15%, about as we expected. Lower sales volume drove the decline, reflecting lower end user demand and reductions in dealer inventory. Dealers decreased their inventories by $1.1 billion in the fourth quarter of 2020 roughly $400 million more than we expected. For the full year, dealers reduced their inventories by $2.9 billion. This positions us well to produce closer to demand in 2021, which was our goal when we introduced our enhanced S&OP process.

Fourth quarter sales to users declined by 10% versus the previous year. Sales to users for both construction and mining equipment were better than we expected. While fourth quarter 2020 operating margins declined year-on-year, they improved by 230 basis points versus the third quarter. At 12.3%, they were better than we expected, reflecting better operational performance. Restructuring expense was lower than we expected as was the effective tax rate. Profit per share in the fourth quarter was $1.42. Adjusted profit per share was $2.12.

Regarding our full year results on slide 5, we said at the start of the pandemic it would be challenging to achieve the operating margin target we communicated during our 2019 Investor Day due to the impact of COVID-19 on our operations and supply chain as well as our intent to continue investing in new products and services to drive long-term profitable growth. So, we're pleased that our final operating margin for 2020 was within our targeted range. We finished 2020 with sales and revenues of $41.7 billion and an adjusted operating profit margin of 11.8%.

Our ME&T free cash flow for the full year was $3.1 billion. While we did not achieve our target for ME&T free cash flow of $4 billion to $8 billion, our free cash flow performance improved as the year progressed. Our decision to hold higher Caterpillar inventory to mitigate potential supply chain disruptions and to position ourselves for changes in market demand also impacted our free cash flow generation in 2020, as Andrew will discuss shortly. We remain focused on returning substantially all ME&T free cash to shareholders through the cycles, and we returned $3.4 billion or 110% of our free cash flow through dividends and share repurchases in 2020.

Turning to slide 6, I'll provide some comments on our end markets. Market conditions remained fluid due to the pandemic. However, I'll provide some thoughts based on what we see today. In Construction Industries, we see construction in North America benefiting from increased residential demand. We expect a strong selling season in China, including demand for our new GX excavator line. We expect continued recovery in the rest of Asia Pacific. The current shutdown in some regions of EAME may constrain construction activity in Europe in the short-term. However, we expect improved market conditions due to favorable expansionary policies as well as benefits from higher commodity prices in Africa, the Middle East, and Eurasia. In Latin America, we see Brazil's construction sector supportive of machine demand, while weakness outside Brazil is expected to continue at least in the short-term.

Turning to Resource Industries, the improvement in mining fundamentals is expected to continue. We anticipate most mine sites to continue operating with limited disruptions and high levels of truck activity. In addition, metal prices are supportive of reinvestment and quoting activity continues to be robust. The number of parked trucks continues to decline. We continue to see strong interest in autonomy. Heavy construction and quarry and aggregate markets remain uncertain. A US infrastructure bill would likely have a positive impact on these end markets.

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Moving to Energy & Transportation, we expect typical seasonality. Although we are encouraged by recent moves in oil prices, we expect oil & gas will continue to reflect conditions in that market. We expect some improvement in power generation supported by data center activity. We expect growth in industrial across all applications, and transportation should grow due to services and higher international rail activity later in the year. Overall, we expect our sales in 2021 to be stronger due to the lack of a dealer inventory reduction and improving market conditions, as I've described. We also expect services revenues to increase during the year.

Given the continuing uncertainty, we're not providing earnings guidance at this time. Andrew will provide several assumptions for the first quarter in a moment, but we expect the first quarter to benefit from stronger year-over-year sales to users and dealer restocking. We also expect modestly higher margins in the first quarter of 2021 compared to the fourth quarter of 2020. You may recall that during our third quarter earnings call, I said that I felt better today than I did a quarter ago, and the same is true today for the reasons I explained earlier concerning our markets. In addition, we're executing well against our strategy for long-term profitable growth. We expect to achieve our Investor Day operating margin targets in 2021 despite the impact of reinstating short-term incentive compensation.

We also expect to meet our Investor Day free cash flow targets this year. Given our intention to return substantially all of our ME&T free cash flow to shareholders as well as our desire to be in the market on a regular basis, we expect to revisit our current pause in share repurchases later this year. We have paid higher annual dividends to shareholders for 27 consecutive years, and we're proud of our status as a Dividend Aristocrat. As I mentioned on our last earnings call, all decisions concerning the dividend are made by our board of directors, but we anticipate recommending an increase in the current year. We signed an agreement last quarter to acquire Weir's Oil & Gas business. We see a strong fit between Weir and our current offerings. This strategic transaction enhances our ability to serve our existing customer base, while adding services revenue opportunities. We anticipate the acquisition will close very soon.

Turning to slide 7, we remain committed to our strategy, which we launched in 2017. We're focused on operational excellence and continue to invest in services and expanded offerings during the pandemic. An example of our continued investment in expanded offerings was our new GX line of excavators launched in November in China, which has received a positive response from our customers. The GX Series provides the durability, safety and services that customers expect plus 15% lower fuel consumption than the prior models. It also offers 25% lower maintenance cost.

Our technology, along with our engineering know-how and global dealer network, has always played a pivotal role in making our customers more successful with Caterpillar. For the first time, we displayed some of our technology at the Consumer Electronics Show earlier this month. We featured Cat MineStar, a suite of technology and solutions that powers our autonomous trucks. With Cat MineStar, customers say their employees are safer, machines are more efficient, and operations are more consistent and productive. Customers have realized productivity increases of up to 30% with zero reportable injuries. We believe our autonomous capabilities provide a competitive advantage in mining.

We were recently awarded research funding from the US Department of Energy for two development projects. The first project, which is expected to launch in the first quarter of this year, is a three-year program for a hydrogen fuel cell system for data center power. The second project is expected to launch in mid-2021 and is a three-year program related to a flexible natural gas and hydrogen-combined heat and power system. Caterpillar announced 2020 sustainability goals in 2006, and we're proud of our progress. By 2019, we reduced our greenhouse gas emissions by 54% from our 2006 baseline, exceeding our goal of 50%, and more than 35% of

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our electrical energy was obtained from renewables or alternative sources, exceeding our 2020 goal of 20%. We'll disclose our final 2020 goal attainment in May when we also plan to disclose our new sustainability goals for the next horizon.

I'll also comment on services, which is an important element of our strategy. As you know, we have a target of doubling our services revenue from 2012* to 2026. Our annual services revenue declined 13% to $16 billion in 2020 versus the prior year. As we expected, services were less cyclical than original equipment and rose as a percentage of sales, representing 41% of ME&T sales in 2020. Year-over-year services declines reflected the reduction in machine hours related to the pandemic and customer decisions to delay planned maintenance and rebuilds as they sought to conserve cash.

However, we did see an increase in Customer Value Agreements both in the number and the average length. With over 1 million connected assets, we feel we have critical mass from a connectivity perspective, which will leverage to increase services sales over time. In the coming year, we expect to return to growth in services. We did see positive momentum from the third to the fourth quarter of 2020. All three segments have detailed plans to increase services by making our customers more successful.

In summary, we continue executing our strategy, improving operational excellence, and investing in expanded offerings and services to help our customers succeed. We continue to maintain a strong balance sheet and intend to deliver higher margins and free cash flow through the cycles, as outlined during our 2019 Investor Day. We're grateful for our team's accomplishments in 2020, including their high level of engagement. We have a great team and will emerge from the pandemic as an even stronger company well-positioned for long-term profitable growth.

With that, I'll turn it over to Andrew.

Andrew Robert John Bonfield

Chief Financial Officer, Caterpillar, Inc.

Thank you, Jim, and good morning, everyone. I'll begin by walking you through the fourth quarter results including sales to users, changes in dealer inventory, and segment performance. Then I'll comment on the balance sheet before finishing with our key assumptions for the first quarter of 2021.

Starting with the fourth quarter on slide 8, versus last year, sales and revenues declined by 15% to $11.2 billion. Operating profit decreased by 25% to $1.4 billion. Good cost control in the quarter partly offset the impact of lower volume. Fourth quarter 2020 profit per share was $1.42. That includes pre-tax remeasurement losses of $438 million or $0.63 per share resulting from the settlements of pension and other postretirement obligations. Last year's profit per share for the fourth quarter was $1.97.

Fourth quarter 2020 adjusted profit per share was $2.12 compared to $2.71 last year. You will have seen from the release that the full year effective tax rate was approximately 28% excluding discrete items. This was lower than the 31% rate we'd anticipated and added $0.26 to profit per share. We also had a $0.05 benefit from discrete tax items in the quarter. Excluding restructuring expense, adds another $0.07 per share. The balance of the outperformance reflected better-than-expected operating results, which saw adjusted operating margins improve by 170 basis points versus the third quarter of 2020.

**Correct date range is 2016-2026; this was clarified later in the call (page 10).*

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Since 2019, we have only reported adjusted profit per share in the fourth quarter when we had mark-to-market impacts from our pension and other postretirement benefit plans. This change happened because restructuring expense had returned to base levels, which was between $100 million and $200 million per annum. This was not considered material and did not warrant adjusting profit per share. However, restructuring expense has risen to $350 million a share as we took additional actions to address certain challenged products.

We also expect restructuring expense in 2021 to be similar to or even greater than the 2020 total as we continue to take the necessary actions to improve our cost competitiveness. So, we're now reporting adjusted profits per share excluding restructuring charges and we'll report adjusted profit per share each quarter in the coming year to exclude restructuring. We've also adjusted the prior year numbers so they're on a comparable basis. Our restructuring efforts in 2020 made good progress and we expect $150 million benefit in 2021 from these actions.

As shown on slide 9, overall sales and revenues finished fairly close to what we anticipated in October as stronger end user demand was offset by further reductions in dealer inventory. The top-line declined by $1.9 billion to $11.2 billion primarily due to lower volume and a larger year-on-year reduction in dealer inventory. As Jim mentioned, sales to users decreased by 10% for the fourth quarter. Sales to users for Construction Industries declined by 1% versus the prior year. It was a mixed bag geographically as Asia Pacific rose by 16%, benefiting from stimulus spending in China. Latin America also improved, up 11%. North America was down 8%, a solid improvement from the third quarter trend.

Resource Industries, which tends to be lumpy, had a 3% decline for the quarter. Energy & Transportation sales to users decreased by 25%. The largest driver of that decline was attributed to lower levels of activity in oil & gas. Between earnings calls, we've been reporting rolling three months sales to users every month. Going forward, we will report the sales to users only once per quarter when we discuss earnings so we can put them in the proper context.

Machine orders improved in the fourth quarter as dealers began preparing for the spring selling season and the Chinese New Year. Machine orders accelerated by the double-digit percentage points from the third quarter to the fourth, in line with normal trends. Dealers decreased inventories by $1.1 billion during the fourth quarter. That compared to the decrease of $700 million in the fourth quarter of last year. Improving sales to users enabled dealers to reduce the inventory by about $400 million more than we had anticipated in October. Dealers reduced inventory over the course of 2020 by $2.9 billion. This change brought the inventory levels to the lower end of their normal range for months of sales.

As you know, dealers are independent businesses and make their own decisions on inventory. In the first quarter 2020, we finished the rollout of our new S&OP process, which we believe promoted better alignment between us and our dealers through a volatile year. This dealer inventory reduction positions us well for 2021. Reported sales decreased versus the prior year in all three primary segments. Energy & Transportation contributed the majority of the decrease in total sales, declining by 19%. This segment had weakness in all four applications, led by oil & gas and transportation. Sales in Construction Industries declined by 10% due to lower sales volume associated with the reduction in end-user demand and changes in dealer inventories. Sales in Resource Industries decreased by 9% due to lower end user demand for equipment and aftermarket parts.

I'll now move to slide 10. Operating profit for the fourth quarter fell by 25% to $1.4 billion mostly due to volume declines. Similar to the trend we've seen throughout the year, lower manufacturing costs and SG&A and R&D expense partially mitigated the decline in volume. We delivered an adjusted operating margin of 12.8%. Restructuring expense for the quarter was flat at $58 million compared with $54 million in the fourth quarter 2019.

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I'll discuss the individual segments results for the fourth quarter starting on slide 11 with Construction Industries. For Construction Industries, sales decreased by 10% to $4.5 billion. Volume declined as a result from changes in dealer inventories led by North America and lower end user demand. We also saw lower sales in China in part due to lower dealer inventory, which included the impact of the later Chinese New Year in 2021. However, sales to users were better than expected and we're seeing momentum in residential construction, although we're still seeing weakness in pipeline and road construction.

The segment's fourth quarter profit decreased by 4% to $630 million driven by lower volume and higher warranty expense. That was partially offset by favorable cost absorption and lower SG&A and R&D expenses, including the absence of short-term incentive compensation. Margins remained resilient, rising 90 basis points versus 2019 to 14.0%. Versus the third quarter, margins were down slightly. This was a smaller seasonal decline than we normally see, reflecting the improvements in the top-line quarter-over-quarter.

As shown on slide 12, Resource Industries sales decreased by 9% in the fourth quarter to $2.2 billion. We experienced lower end user demand for equipment and aftermarket parts, supporting heavy construction and quarry and aggregates, and to a lesser extent, in mining. As anticipated, sales for Resource Industries improved compared with the third quarter. Despite lower sales in the fourth quarter, profit increased to $273 million compared with $261 million in the fourth quarter of 2019. The segment's profit margin of 12.5% rose by 160 basis points compared to 2019 on strong cost controls. Variable labor and burden efficiencies as well as material costs were favorable, despite the lower sales volume. SG&A and R&D expenses benefited from lower short-term incentive compensation and other cost reduction actions, and benefits were realized from prior restructuring programs. Versus the third quarter, the operating improved by 330 basis points mainly reflecting the higher volume.

Turning to slide 13, fourth quarter sales of Energy & Transportation declined by 19% to $4.8 billion. The decline included a 29% sales decrease in oil & gas mainly due to lower demand in North America for reciprocating engines using gas compression and well servicing. Sales were also lower for turbines and turbine-related services. Power generation sales decreased by 9%. This decline was primarily due to lower sales volume in small reciprocating engines, turbines and turbine-related services, and engine aftermarket parts.

Transportation and industrial sales decreased by 28% and 19%, respectively. Transportation declines reflected lower locomotive deliveries and related service revenues primarily in North America as well as lower sales in marine. Profit for this segment decreased by 41% to $687 million due to lower sales volume. That was partially offset by lower SG&A, R&D, and period manufacturing costs. The segment's operating margin declined to 14.3%, a 530-basis-point decrease in comparison to a record quarter a year ago. Versus the third quarter, the operating margin improvement was 250 basis points, reflecting the higher volume and favorable mix partially offset by the timing of product development expenses, which we mentioned in the third quarter call.

Moving to slide 14, to wrap up the segment commentary, Financial Products revenue decreased by $103 million or 12% to $743 million. The decline was due to lower average financing rates across all regions and lower average earning assets in North America. The latter reflected lower purchase receivables which resulted from volume declines. Segment profit of $195 million declined by 7% year-over-year, mostly reflecting higher provision for credit losses and lower earning assets. While used prices were flat-to-up in construction equipment, we also had an unfavorable impact from returned or repossessed marine and mining products.

Our customers remain in good financial condition. Credit applications continued to rebound in the quarter, up 6% compared to the third quarter and up 15% compared to a year ago. Cat Financial supported customers during the year with a streamlined process for loan modifications, but modification activity declined significantly and requests

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for second modifications remain very limited. Past dues were 3.49%, up 35 basis points year-over-year, but an improvement of 32 basis points from the third quarter. As has been the case, Cat Financial will continue to work closely with customers as they manage the impacts of COVID-19 on their business and cash flow, but we are pleased to see that our customers remain in good financial health.

Now, on slide 15, free cash flow from Machinery, Energy, and Transportation was about $1.7 billion in the quarter, a decrease of about $200 million versus the fourth quarter of 2019. The decrease reflected changes in Caterpillar inventory as our inventories remained stable in the fourth quarter 2020 compared to a decrease in 2019. As we've mentioned previously, we continue to hold higher Caterpillar inventory primarily in components and other work-in-process to ensure that any potential disruptions to supply do not affect our customers and to make sure we're able to respond quickly to improve demand.

However, free cash flow from ME&T did increase by $800 million versus the third quarter of this year. The sequential improvement was largely due to the higher profit and favorable working capital. We generated $3.1 billion of ME&T free cash flow in 2020. Although this was below our Investor Day range of $4 billion to $8 billion, we expect to return to our Investor Day cash targets in 2021. We ended the fourth quarter with $9.4 billion in enterprise cash and maintained a strong liquidity position. You'll recall that we issued $2 billion in debt last year partly to increase liquidity and partly anticipation of $1.4 billion in scheduled maturities this year. Our credit ratings remain strong.

We recently declared our normal quarterly dividend of $1.03 per share, which translates to around $560 million. As Jim has indicated, we're proud of our status as a Dividend Aristocrat. All decisions concerning the dividend are made by our board of directors, but we anticipate recommending an increase in the current year. Last year, including the quarterly dividend as well as share repurchases made earlier in the year, we returned $3.4 billion to shareholders. Our intention at Investor Day was to return substantially all ME&T free cash flow to shareholders through the cycles, and in 2020, we returned 110% of our ME&T free cash flow to shareholders.

In fact, of the past three years, on average, we've returned 106% and we've reduced our quarterly average diluted shares outstanding by about 10% since the first quarter of 2018. While share repurchases were paused in April due to uncertainties associated with COVID-19, we aim to be in the market on a regular basis. Given what we're seeing in the business, we expect to revisit the decision to pause the share repurchase program later this year. We also continued to maintain a strong balance sheet, which we can use for compelling M&A opportunities such as our pending agreement to purchase the Weir Group's Oil & Gas business.

Whilst we're not providing annual guidance, we do have a few thoughts on the first quarter. A summary of our key assumptions is shown on slide 16. In the first quarter, we expect stronger year-over-year sales to users to mainly to grow within Construction Industries. We anticipate ongoing strength in China and benefits from the pickup in residential construction in North America, although non-residential remains subdued. We expect Resource Industries, a lumpy business, to begin the year a little lower with a similar year-over-year STU trend to what we saw in Q4. Energy & Transportation is also expected to have a negative start to the year, although the trends are expected to improve versus the sharp drops in sales to users reported in the third and fourth quarters of 2020.

As a reminder, our sales to users were only impacted marginally in the first quarter of 2020, so we expect stronger STU growth in the remainder of 2021. We expect a normal seasonal dealer inventory build in anticipation of the spring selling season. Note that the Chinese New Year is about three weeks later this year, so the inventory build for Asia Pacific has shifted more to the first quarter 2021 rather than occurring in the fourth quarter as happened between 2019 and 2020. Our aim this year is to produce closer to end user demand, and we anticipate

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our dealers will remain within their normal range for months of sales and inventories. Again, we will benefit in 2021 from not having the headwind of the dealer inventory reductions that took place in 2020.

With respect to operating margins, we expect a sequential improvement in the first quarter versus the fourth, even with the impact of about $225 million from restoring short-term incentive compensation. On a year-over-year basis, the benefit of higher volumes will almost entirely offset the impact of short-term incentive compensation, which means we expect operating margins to be about flat versus Q1 2020. As Jim mentioned in his comments, we do expect to deliver margins in the Investor Day range as the benefits of operating leverage and the restructuring cost actions, I mentioned earlier will offset the impact to short-term incentive compensation and higher expenses were deferred into 2021.

Looking at margins by segment, in Construction Industries, stronger sales and leverage on higher volumes are anticipated to drive the sequential margin expansion in the first quarter compared to the fourth quarter despite the impact of short-term incentive compensation. Resource Industries is also anticipated to have a higher margin sequentially on higher sales and leverage along with favorable mix. However, from a margin perspective, Energy & Transportation is likely to have a weaker start to the year, which is in line with typical seasonality. This excludes any impact from the Weir acquisition, which we anticipate will close very soon, although we don't expect it to be material to our full year results.

In addition, we assume a tax rate in the first quarter of about 26% to 28%, consistent with what we project for the full year based on the current US statutory tax rate. This is in line with the tax rate we have reported in 2020. We'd expect normal CapEx at a pace that would translate to about $1 billion to $1.2 billion for the year.

So, finally, let's turn to slide 17 and let me recap today's key points. We continue to execute our strategy for profitable growth. We're investing in services and expanded offerings while improving operational excellence. In the fourth quarter, trends in sales to users improved compared to the third quarter, dealer inventories declined, and we improved adjusted operating margins relative to Q3. We expect to see improved margins sequentially and stronger volumes in the first quarter. We're grateful to our employees for ensuring we provided the essential products and services that enable our customers to support a world in need, and most importantly, for doing so safely.

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

Jennifer Kay Driscoll
Director of Investor Relations, Caterpillar, Inc.

And as we do that, we'll just say to be clear, our goal for services is to double it from 2016 at $14 billion to 2026 to $28 billion. Thank you. Jason?

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QUESTION AND ANSWER SECTION

Operator: Excellent. And at this point, we will open the call for Q&A. [Operator Instructions] Your first question comes from the line of Rob Wertheimer from Melius Research. Your line is open.

Rob Wertheimer
Analyst, Melius Research LLC

Q

Hi. Good morning, and thanks for the overview of what you're seeing in the end markets. Given that the decision not to reinstate the outlook, and obviously there's a lot of uncertainty, can you talk about at least the key points of uncertainty to the upside and/or downside? And where are you seeing where there may still be downside revenues, if there is some, where are you seeing more upside risk versus 2020 levels? Just a little bit of characterization of why you made the decision and where the points of uncertainty are. Thank you.

Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.

A

You bet. Good morning, Rob. This is Jim. As we indicated in our prepared remarks, we do expect 2021 to be a better year than 2020 for us. We expect higher sales, but just given the uncertainty around the pandemic, the rollout of the vaccine, the resulting impact on the global economy, although we expect it to be a better year, it's difficult for us to quantify how much better it will be just based on the pandemic. And we mentioned several bright spots whether continued strength in China, continued strength in residential activity in the United States, which drives our smaller construction business. We generally continue to be bullish on mining, still some concerns around heavy construction and quarry and ag, which impact Resource Industries. But again, it isn't so much a concern about downside as it is uncertainty as to how much better things will get this year.

Operator: Your next question comes from the line of Jerry Revich from Goldman Sachs. Your line is open.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Good morning, everyone.

Jennifer Kay Driscoll
Director of Investor Relations, Caterpillar, Inc.

A

Good morning, Jerry.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

I'm wondering if you could talk about the first quarter margin outlook. It's nice to see the margin expansion plan sequentially despite the two-point headwind from incentive compensation, so that's a better cadence than normal seasonality. Can you just talk about how much of that is momentum in price-cost improvements versus other drivers? We were pleasantly surprised by that part of the outlook.

Andrew Robert John Bonfield
Chief Financial Officer, Caterpillar, Inc.

A

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Yeah, thanks, Jerry. It's Andrew, and good morning. Yeah, I mean, the big driver is really volume. As I said, the fact that we expect a more normal seasonable dealer buying pattern ahead of the spring selling season, and if you'll recall last year, we only had about $100 million of dealer inventory increase in Q1. That is a big factor, obviously from a volume perspective and given the operating leverage that we have in the business, that enables us to more than offset the STIP increase.

We continue to monitor and control costs. We're in an environment where everybody is obviously focused on making sure every dollar counts and that will continue as we go forward. That is something, which we'll obviously continue until we start seeing stronger recoveries. And obviously, continue to make sure that we're investing in the business, as Jim said. We continue to invest in services. We continue to invest in new products. That's really critical for our long-term growth.

Operator: Your next question comes from the line of Ann Duignan from JPMorgan. Your line is open.

Ann Duignan
Analyst, JPMorgan Securities

Q

Hi, yes, good morning. As we contemplate our 2021 models, could you provide us more color in terms of your outlook by subsegment in E&T? And then in particular, you talked about oil & gas, but turbines in particular, in turbine services and then the other sub-sectors. Thank you.

Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.

A

Well, good morning, Ann. We expect starting with your question about Solar, we expect Solar to have a relatively flat year to 2020. We do believe their services will be up a bit, and again, there's still uncertainty out there. But our current view is that Solar will be about flat year-to-year.

We expect power generation to have a stronger year, and a lot of that is driven by data center activity. We expect industrial engine activity to strengthen during the year. We do expect in rail to see continued low levels of sales of new locomotives in North America, but we do expect stronger activity internationally for sale of locomotives and also services as well.

Marine, I would expect to remain at a relatively low level in the first quarter compared with the fourth quarter of 2020.

Operator: Your next question comes from the line of David Raso from Evercore ISI. Your line is open.

David Raso
Analyst, Evercore Group LLC

Q

Hi. Good morning. A bigger picture question. I mean, many of the classic signs of CAT's prospects turning positive are there like the low inventory, the higher commodity prices, but when we think about the whole cycle, as you're well aware, right, some investors question CAT's longer-term growth prospects. And due to the part some people question sustainability of the reflation trade, but really even more so, they believe CAT's business portfolio is poorly positioned for a world evolving to clean energy and carbon-neutral goals.

So Jim, can you provide your thoughts on those two issues, particularly the second issue of the portfolio and how we should think of acquisitions, maybe help changing that investor view? Especially given your net debt to

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EBITDA and that's on a weak 2020 EBITDA is only 0.4. And if you can tie into that with the percentage of aftermarket revenues you gave this morning, it does suggest your aftermarket revenues have to grow at a 9.8% CAGR from 2020 to 2026 to meet your revenue goal of $28 billion in 2026 for aftermarket. So if you can talk to those issues it would be helpful as people think about the whole cycle.

Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.

A

Good morning, David. Always good to hear from you. Starting with your question about our portfolio and the way we're positioned. You know, I feel quite good about the way we're positioned. If you stop and think about the potential impact on our Resource Industries business over time particularly in mining as the energy transition occurs, thinking about the commodities that will be required both in terms of investments in infrastructure, electric vehicles, again, I believe we're very well-positioned in RI to take advantage of that.

We also, as when you asked the question last quarter, I talked about the fact that we do intend to continue to support our customers both during and after the transition, and so I believe we're well-positioned to do that. So again, we continue to work closely with our customers. We continue to invest in new products.

Again, last quarter when you asked the question, we talked about some of the things that we're doing in terms of investments with new products, and we have an all-electric switch locomotive. We've done things to help make our oil & gas customers more sustainable, whether it be an engine that allows them to substitute up to 85% natural gas, substituting natural gas for diesel fuel for well servicing. We're doing things in terms of allowing oil & gas customers to reduce flaring. So again, a whole variety of things that we're doing and we're investing in to support our customers both during and after the energy transition.

In terms of your question about services, certainly our goal is an ambitious goal, and we said that when we introduced that goal and we certainly recognize that it is ambitious. But we're very focused on this as a business. We've been making investments over the last few years in our digital capabilities, in many of our processes and our models, and we're going to work hard to leverage those connected assets and those investments that we've made to grow services going forward, and we think that represents just an excellent opportunity for future profitable growth over the next few years.

Jennifer Kay Driscoll
Director of Investor Relations, Caterpillar, Inc.

A

As a reminder, if we could have one question per analyst, that would be terrific.

Operator: Your next question comes from the line of Jamie Cook from Credit Suisse. Your line is open.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Good morning. Jim or Andrew, I guess the question for you is on the margin side. You look at Resource and Construction, your margin has improved year-on-year despite sales declines. You look at your margins for the total year, they were at about 11%, which is above the low-end of your targeted range, and taking into account you said you didn't think you'd be able to hit your targeted range when COVID first started. So clearly, it looks like the margin performance of the business is doing better than you originally anticipated.

So is there any way you can help us understand what's happening there? And I'm just trying to figure out if the margin targets that you laid out at the Analyst Day if there's some upside there, if there's a reason structurally why

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margins are performing better in particular given some of the headwinds that we faced this year with COVID, dealer inventory, et cetera. Thank you.

Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.
A

Well, Jamie, thanks for your question, and good morning. Certainly, we are very proud of our team and the fact that we were able to achieve our Investor Day target this year, despite the fact that we continued to invest in services and expanded offerings and new products and positioning ourselves for long-term profitable growth.

As we said at Investor Day, our measure of profitable growth is absolute OPACC dollars and we believe that by growing absolute OPACC dollars that will drive long-term TSR. So certainly, we're always looking across the business to find ways to improve our competitiveness, to improve our footprint, to improve cost of our back-office operations, so that's a never-ending journey that we're on. But we really are growing, attempting to grow long-term absolute OPACC dollars as opposed to just squeezing higher-margins out. Again, margins will fluctuate over time, but again, keep in mind, two things. One is we're very focused on meeting those Investor Day targets in terms of margins and free cash flow, and we're also very focused on growing absolute OPACC dollars to grow long-term TSR.

Operator: Your next question comes from the line of Ross Gilardi from Bank of America. Your line is open.

Ross Gilardi
Analyst, BofA Securities, Inc.
Q

Hey, thanks. Good morning guys.

Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.
A

Good morning.

Andrew Robert John Bonfield
Chief Financial Officer, Caterpillar, Inc.
A

Good morning, Ross.

Ross Gilardi
Analyst, BofA Securities, Inc.
Q

Jim, yeah, I was just wondering if you could just discuss the outlook for reinvestment in 2021 in the next several years. You've committed to the $4 billion to $8 billion in free cash through the cycle. It sounds like you plan to raise the dividend and resume the buyback, but CAT spent about 60% of depreciation on CapEx in 2020. You under spent depreciation by a pretty wide measure. I think every year going back to 2013, R&D spend is down about $500 million from where it was at the trough of the last cycle. Should we be expecting some catch-up the years on CapEx and R&D in the next several years? And if not, why not? And just with that, what are you baking in for R&D and CapEx in 2021?

Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.
A

Yeah, we're going to disclose the discrete number for R&D and CapEx in 2021. But just to make some general comments, we certainly are very committed to continue to invest in our products. One of the things that did impact

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R&D in 2020 was the lack of STF, so keep that in mind as well, that is part of the calculation. But we're very committed and we talked about the GFs product line, we talked about some of the other investments that we're making in new products, and that's something that we will continue to do.

We talked about the fact that we recognize there's an energy transition occurring and we are investing in and will continue to invest in new technologies that allow us to support our customers moving forward.

In terms of CapEx, one of the things we worked very hard on is lean operations to get more production out of the existing bricks-and-mortar. So rather than build – continue to build factories we may not need at certain points in the cycle, we're really focused on manufacturing flexibility, working across that value chain, reducing lead times, becoming more lean to try to meet those fluctuations in demand in a cost-effective manner.

Andrew Robert John Bonfield
Chief Financial Officer, Caterpillar, Inc.
A

And let's just add, I think we got it in my notes, between $1 billion and $1.2 billion for CapEx this year, which is 2021 – which is our more normal level. Obviously, 2020 was disrupted a little bit as well because obviously the impact of COVID, some of the same projects that would normally have happened have been deferred and delayed.

Operator: Your next question comes from the line of Tim Thein from Citigroup. Your line is open.

Tim W. Thein
Analyst, Citigroup Global Markets, Inc.
Q

Great. Thank you. Good morning. Maybe, Jim -

Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.
A

Hi, Tim.

Tim W. Thein
Analyst, Citigroup Global Markets, Inc.
Q

If we could go – good morning – just go back to mining, if we could, in terms of you alluded to the order activity and just the healthy level of discussions. Maybe just a little bit more in terms of what Denise and team are hearing as you look at mining markets around the globe in terms of how we're thinking about the – how the recovery and the interplay between whole goods versus parts, so maybe again just a little bit more color in terms of your expectations for the mining piece within RI. Thank you.

Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.
A

Certainly. As I mentioned, we continue to be optimistic about our mining business. The quotation activity is strong. Certainly base metal markets support additional activity. Number of parked mining trucks has declined.

Now keep in mind of course RI includes heavy construction and quarry and ag, so there's some uncertainty there and that business is relatively subdued, that could be helped by stimulus programs. But at this point, that is relatively depressed. But again, in mining, we're quite bullish.

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So again, as we look at our autonomous solution, we believe we have a competitive advantage there and we expect strong activity in new equipment. We expect strong activity in parts. Keep in mind, of course our business is quite lumpy both in RI and E&T, we'll see fluctuations quarter-to-quarter. But again, the medium and long-term trend we're quite bullish on.

And again, I mentioned the Energy transition. We're very well-positioned to take advantage of that in Resource Industries.

Operator: Your next question comes from the line of Nicole DeBlase from Deutsche Bank. Your line is open.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah, thanks. Good morning, guys.

Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.

A

Good morning, Nicole.

Andrew Robert John Bonfield
Chief Financial Officer, Caterpillar, Inc.

A

Good morning, Nicole.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

So I guess I wanted to ask about the safety stock that you've built within RI and maybe within Resource as well if there's any there. How do you feel about that compared to what's going on in the market with respect to raw materials, difficulty getting any supplies? Maybe characterize what you're seeing with respect to COVID and how much of a concern that is, as presumably demand really starts to ramp throughout 2021.

Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.

A

Well, thank you. So as I mentioned, we did make a conscious decision and we talked about this in previous earnings calls that we would hold some additional inventory to mitigate the potential disruptions on our supply chain of COVID just given the uncertainty of the trajectory of the pandemic. And our decision was not to hold finished goods inventory but to hold that inventory in a lean way in components and further up the value chain.

So at this point, we haven't seen major issues in terms of supply disruptions. So, so far so good on that count. So based on everything we see today, we're confident in our ability to meet demand going forward.

Operator: Your next question comes from the line of Mig Dobre from Baird. Your line is open.

Micrea Dobre
Analyst, Robert W. Baird & Co., Inc.

Q

Thank you. Good morning, everyone.

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Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.

A

Good morning, Mig.

Micrea Dobre
Analyst, Robert W. Baird & Co., Inc.

Q

I want to ask a question around restructuring in at 2021. You're excluding it now from earnings. It would imply to me that you're expecting restructuring activity to potentially pick up maybe quite a bit, and I guess I'm wondering, what's left to do here? What are some of the portions of the business that you believe need more tweaking? And I'm wondering if you've got portions where you're outright trying to either reduce capacity or take out footprint. Maybe that goes back to David's question on your – on some of your businesses that maybe have some more structural concerns long-term.

Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.

A

Yeah, so again, as I mentioned earlier, we are continually looking for ways to improve our competitiveness and reduce our cost structure. That means evaluating not just our capacity, but also our footprint and where we are. We previously publicly announced the decision to close the Dortmund, Lunen, Wuppertal operations to get to move closer to our customers and also to reduce costs.

So again, in my view, that needs to be something that we continually do and it isn't just our factories and brick-and-mortar. It's also looking at our back-office operations as well. And again, always finding ways to improve our cost structure and be more competitive.

So really, the restructuring that we put in, again, is more reflective of our continuous journey to improve our competitiveness.

Andrew Robert John Bonfield
Chief Financial Officer, Caterpillar, Inc.

A

And Mig, just from the accounting perspective to refer to the fact why are we excluding it from adjusted profit per share, as I said in my remarks, when we get to a base level which is between $100 million and $200 million, it is effectively at a level where it's not material and therefore, it doesn't warrant us adjusting profit per share for that.

Given the size of the spend, the magnitude of the spend, $354 million, and as we say, we expect a similar level maybe slightly higher in 2021, that does require us to be consistent with where we've been in historic periods and therefore, do exclude it.

I know it causes you guys some challenge because you have to go back and restate your models, but unfortunately, it is one of those things which from a disclosure perspective is good practice for us to do.

As regards what the spend is, obviously some of the spend will be ongoing programs as Jim mentioned, but some of those programs actually do have – our multiyear program, they're not just a single year, and so some of that spend does recur. So obviously we're not doing a big restructuring program, we're not announcing anything, which comes to your question about – on some of the back to the questions about are there more structural long-term concerns.

This is just really about tweaking, making sure we're doing the right thing to drive our cost base.

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Operator: Your next question comes from the line of Noah Kaye from Oppenheimer. Your line is open.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Thanks. Jim, back to mining, and this is really, I think following up on CES in your presentations there, as you see mining RFP activity coming back and customer engagement growing, can you talk about sort of growth trends and potential share gains for autonomous offerings?

And then clearly, with the Marble acquisition, you could leverage that to go from a very linear mining ecosystem to move to more dynamic and predictable markets like construction and quarry [indiscernible] (56:00). So can you talk a little bit about that dynamic as well, how you're seeing that playing out in the new quoting activity you're seeing, and to the extent to which that's a share gain opportunity for you.

Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.

A

Certainly. We do continue to see a strong pull for automation and autonomy by our mining customers. And again, we believe it delivers tremendous value. We've had customers say publicly that they are seeing productivity increases of 30% against their best-manned sites. Again, it's got a safety component for them as well. It helps improve the utilization of their equipment which is so important and we do feel strongly that we have a competitive advantage with our autonomous solution.

And generally, it requires a certain size in terms of a mine in terms of number of trucks for the capital investment to make sense, but we're continually working on that as well. So there's a lot of opportunity going forward in mining with autonomy.

And you make a very good point. Now we are starting to deploy some of those technologies. We have a lot of programs in-work to deploy a lot of that technology, whether it's autonomy, semi-autonomy, remote control, many of those same kinds of technologies into Construction Industries. And it isn't one-size-fits-all. It happens over time. But again, we do believe there's applicability of many of those technologies to our Construction business over time, and that's something that we're working very hard on, and again, it's part of our R&D plan.

Jennifer Kay Driscoll
Director of Investor Relations, Caterpillar, Inc.

A

And we have time for one more question, please.

Operator: Your final question comes from the line of Steve Volkmann from Jefferies. Your line is open.

Stephen Edward Volkmann
Analyst, Jefferies LLC

Q

Great. Thanks for fitting me in, guys. My question is really about how to think about sort of working capital for 2021, maybe it's an Andrew question. But in the spirit of the S&OP that I think has changed a little bit how you manage all this, I'm just curious if we could expect a normal working capital build with revenue increases, or if there's anything different to think about there. Thank you.

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Andrew Robert John Bonfield
Chief Financial Officer, Caterpillar, Inc.

A

Yeah, Steve, thank you, and one of the things obviously you would normally have expected in the year where there's a downturn to see a working capital inflow this year in 2020. Obviously, because of the decision we took around inventories to make sure we held a little bit of extra inventory to buffer against supply disruption and/or demand changes, we have – we will be in a situation in 2021 where we don't expect a big build of inventory, so that helps our free cash flow, which gives us confidence that we'll be able to deliver our free cash flow targets in 2021.

The other thing just to remember on the working capital and cash flow basis is obviously, last year, in 2020, we paid about $700 million of short-term incentive compensation. We will not have that in 2021, so that will be again a strong boost to our cash position as we go through the year.

But the one thing I would say that to me that has been really remarkable just to remind you again, in a year of significant turmoil, where we've held our sort of additional inventory, we have still been able to generate free cash flow of $3.1 billion. This is a hugely cash-generative company and one which I think sometimes investors do under-appreciate.

Jennifer Kay Driscoll
Director of Investor Relations, Caterpillar, Inc.

Okay. And we'll turn it back to Jim for closing remarks.

Donald James Umpleby
Chairman & Chief Executive Officer, Caterpillar, Inc.

Well, thanks, everyone, for joining this morning. We greatly appreciate your questions. Caterpillar faced many challenges in 2020, and we're very proud of how our team responded. We met the operating margin target that we communicated during our 2019 Investor Day while importantly continuing to invest in expanded offerings and services to secure our long-term future, and our team did this while having the best year on record for employee safety. And as I mentioned earlier, we fully intend to emerge from the pandemic as an even stronger company. Thank you, again.

Jennifer Kay Driscoll
Director of Investor Relations, Caterpillar, Inc.

Thanks, Jim. Thanks, everybody, who joined us today. We appreciate your time with us. 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. Fourth quarter results video with our CFO and SEC filing with our sales to users data and our quarterly highlights are already posted there.

Click on CAT – 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 at driscoll_jennifer@cat.com. The Investor Relations general phone number is 309-675-4549. We hope you enjoy the rest of your day and the weekend, and I'll turn it back to Jason to conclude our call.

Operator: That concludes today's conference call. Thank you, everyone, for joining. Have a wonderful day. You may now disconnect.

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