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Second Quarter 2023 Earnings

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PRESENTATION:

Operator^ Ladies and gentlemen, welcome to the Second Quarter 2023 Caterpillar Earnings Conference Call.

Please be advised that today's conference is being recorded.

I would now like to hand the conference over to your speaker today, Ryan Fiedler. Thank you.

Please go ahead, sir.

Ryan Fiedler^ Thanks, Abby. And good morning, everyone. And welcome to Caterpillar's second quarter of 2023 earnings call.

I'm Ryan Fiedler, Vice President of Investor Relations. Joining me today are Jim Umpleby, Chairman and CEO; Andrew Bonfield, Chief Financial Officer; Kyle Epley, Senior Vice President of the Global Finance Services Division; and Rob Rengel, Senior IR Manager.

During our call we'll be discussing the second-quarter earnings release we issued earlier today. You can find our slides, the news release and a webcast recap at investors.caterpillar.com under Events and Presentations.

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Moving to Slide 2.

During our call today we'll make forward-looking statements which are subject to risks and uncertainties.

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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.

A detailed discussion of the many factors that we believe may have a material effect on our business on an ongoing basis is contained in our SEC filings.

On today's call we'll also refer to non-GAAP numbers.

For a reconciliation of any non-GAAP numbers to the appropriate U.S. GAAP numbers please see the appendix of the earnings call slides.

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

Jim Umpleby^ Thanks, Ryan. Good morning, everyone. Thank you for joining us.

As we close out the first half of 2023, I want to recognize our global team for delivering a very strong second quarter. This included double-digit top-line growth, higher adjusted operating profit margin, record adjusted profit per share and robust ME&T free cash flow. Our results continue to reflect healthy demand across most end markets for our products and services. We remain focused on executing our strategy and continue to invest for long-term profitable growth.

In today's call, I'll begin with my perspectives on our performance in the quarter. I'll then provide some insights on our end markets. Lastly, I'll provide an update on our sustainability journey.

It was another strong quarter. Sales and revenues increased 22% in the second quarter versus last year. Adjusted operating profit margin improved to 21.3%, up sequentially and year-over-year. We also generated \$2.6 billion of ME&T free cash flow in the quarter.

Our second-quarter results were better than we expected for sales and revenues, adjusted operating profit margin and ME&T free cash flow. In addition, we ended the quarter with a healthy backlog of \$30.7 billion.

We continue to see improvement in the supply chain, which allowed us to increase production in the quarter. However, areas of challenge remain, particularly for large engines, which impacts Energy & Transportation and some of our larger machines. While

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we continue to closely monitor global macroeconomic conditions, we now expect our 2023 results to be better than we had previously anticipated.

Turning to Slide 4. In the second quarter of 2023, sales and revenues increased by 22% to \$17.3 billion. This was primarily due to higher sales volume and price realization. Sales volumes were higher than we expected, largely due to an increase in dealer inventory relating to Energy & Transportation, which is supported by customer orders. We saw double-digit increases in sales and revenues in each of our 3 primary segments.

Compared with the second quarter of 2022, overall sales to users increased 16%. For machines, which includes Construction Industries and Resource Industries, sales to users rose by 8%. Energy & Transportation was up 47%. Sales to users in Construction Industries were up 3%. North American sales to users increased and were better than expected as demand remained healthy for non-residential and residential construction. Non-residential continue to benefit from government-related infrastructure and construction projects.

Residential sales to users in North America also increased in the quarter. EAME saw lower sales to users due to weaker-than-expected market conditions in Europe. The Middle East continued to demonstrate strong construction activity. In Latin America and Asia/Pacific, sales to users declined in the quarter.

In Resource Industries, sales to users increased 26%. In Mining, sales to users increased, supported by commodities remaining above investment thresholds. Within Heavy Construction and Quarry and Aggregates, sales to users also increased, supported by growth for infrastructure-related projects.

In Energy & Transportation, sales to users increased by 47% in the second quarter. All applications saw higher sales to users in the quarter. Oil and Gas sales to users benefited from strong sales of turbines and turbine-related services. We also saw continued strength in sales of reciprocating engines into oil and gas applications, such as Tier 4 dynamic gas blending, gas compression and repowering active well servicing fleets.

Power Generation sales to users continued to remain positive due to favorable market conditions, including strong data center growth. Industrial and Transportation sales to users also increased.

Dealer inventories increased by \$600 million in the quarter, led by Energy & Transportation. We are very comfortable with the total level of dealer inventory, which remains in the typical range. Adjusted operating profit margin increased to 21.3% in the second quarter as we saw improvement, both on a sequential and year-over-year basis. Adjusted operating profit margin was better than we had anticipated, primarily due to better-than-expected volume growth and lower-than-expected manufacturing costs, including freight.

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Moving to Slide 5. We generated strong ME&T free cash flow of \$2.6 billion in the second quarter. We returned \$2 billion to shareholders, which included about \$1.4 billion in repurchased stock and \$600 million in dividends. In June, we announced an 8% dividend increase.

Since May of 2019, when we introduced our current capital allocation strategy, we have increased the quarterly dividend per share by 51%. We remain proud of our Dividend Aristocrat status and continue to expect to return substantially all ME&T free cash flow to shareholders over time through dividends and share repurchases.

Now, on Slide 6, I'll describe our expectations moving forward. While we continue to closely monitor global macroeconomic conditions, our second-quarter results lead us to expect that full year 2023 will now be even better than we described during our last earnings call. We now expect adjusted operating profit margin to be close to the top of the targeted range relative to the corresponding expected level of sales. This positive operating performance increases our expectations for ME&T free cash flow, which we now expect to be around the top of the \$4 billion to \$8 billion range for the full year. Our current expectations for adjusted operating profit margin and ME&T free cash flow reflect continuing healthy customer demand and our strong operating performance.

Now, I'll discuss our outlook for key end markets this year, starting with Construction Industries. In North America, overall, we continue to see positive momentum in 2023. We expect continued growth in non-residential construction in North America due to the positive impact of government-related infrastructure investments and a healthy pipeline of construction projects. Although residential construction growth has moderated, we expect the rest of 2023 to remain healthy.

In Asia/Pacific, excluding China, we expect growth in Construction Industries due to public infrastructure spending in support of commodity prices. We mentioned during our last earnings call that we expected sales in China to be below the typical 5% to 10% of our enterprise sales. We now expect further weakness as the 10-ton and above excavator industry has declined even more than we anticipated.

In EAME, we anticipate that it will be flat to slightly up overall, with the Middle East exhibiting strong construction demand, whereas Europe is expected to be down. Construction activity in Latin America is expected to be down in 2023 versus a strong 2022 performance.

In Resource Industries, we expect healthy mining demand to continue as commodity prices remain above investment thresholds. As I've mentioned previously, customers remain capital disciplined, which supports a gradual increase in mining over time. We anticipate production and utilization levels will remain elevated.

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We also expect the age of the fleet and the low level of parked trucks to support future demand for our equipment and services. We continue to believe the energy transition will support increased commodity demand, expanding our total addressable market and providing further opportunities for profitable growth.

In Heavy Construction and Quarry and Aggregates, we anticipate continued growth due to major infrastructure and non-residential construction projects.

Now, I'll discuss Energy & Transportation. For CAT reciprocating engines in Oil and Gas applications, although customers remain disciplined, we are encouraged by continuing strong demand for gas compression. CAT reciprocating engine demand for Power Generation is expected to remain healthy, including strong data center growth. New equipment orders and services for Solar turbines in both Oil and Gas and Power Generation remain robust. Industrial continues to be healthy. In Transportation, we anticipate strength in high-speed Marine as customers continued to upgrade aging fleets.

Moving to Slide 7. We continue to advance our sustainability journey. Since our last quarterly earnings call, we published our 2022 Sustainability Report, which disclosed our estimated Scope 3 greenhouse gas emissions for the first time. We also published our first-ever Task Force on Climate-related Financial Disclosures report. We're helping our customers achieve their climate-related goals by continuing to invest in new products, technologies and services that facilitate fuel flexibility, increased operational efficiency and reduced emissions.

For example, a customer in Chile is realizing fuel savings and lower emissions after purchasing our CAT D6 XE, the world's first high-drive diesel Electric Drive dozer. The customer reported a 30% reduction in fuel consumption versus the previous model working in the same operation. This example reinforces our ongoing sustainability leadership and how we help our customers build a better, more sustainable world.

With that, I'll turn the call over to Andrew.

Andrew Bonfield^ Thank you, Jim. And good morning, everyone. I'll begin with commentary on the second-quarter results, including the performance of our segments. Then, I'll discuss the balance sheet and free cash flow before concluding with our assumptions for the remainder of the year, including color on the third quarter.

Beginning on Slide 8, our team delivered a very strong second quarter as overall results exceeded our expectations on strong operating performance. We saw healthy top-line growth, improved operating margins and robust ME&T free cash flow. For the year, we now expect our adjusted operating profit margin to be close to the top of the targeted range at our anticipated sales level. We also expect ME&T free cash flow to be around the top of our \$4 billion to \$8 billion target range.

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To summarize the results, sales and revenues increased by 22% or \$3.1 billion to \$17.3 billion. The sales increase versus the prior year was due to higher sales volume and price realization. Operating profit increased by 88% or \$1.7 billion to \$3.7 billion. The adjusted operating profit margin was 21.3%, an increase of 750 basis points versus the prior year.

Adjusted profit per share increased by 75% to \$5.55 in the second quarter compared to \$3.18 last year. Profit per share was \$5.67 in the second quarter of this year. This included a discrete deferred tax benefit of \$0.17 per share, while restructuring costs were \$0.05 per share, flat compared to the prior year. We continue to expect restructuring expenses of about \$700 million for the full year.

Other income of \$127 million in the quarter was lower than the second quarter of 2022 by \$133 million. The year-over-year decline was primarily driven by an unfavorable currency impact related to ME&T balance sheet translation and a recurring increase in quarterly pension expense of approximately \$80 million, which we initially spoke to you about in January. Higher investment and interest income acted as a partial offset.

The provision for income taxes in the second quarter, excluding discrete items, reflected a global annual effective tax rate of approximately 23%, which remains our expectation for the full year.

Moving on to Slide 9. The 22% increase in the top line versus the prior year was due to higher sales volume and price. Volume improved as sales to users increased by 16% and from changes in dealer inventory. Sales for the quarter were higher than we had anticipated, mostly due to volume. The volume outperformance reflected a dealer inventory increase, which was primarily due to our stronger-than-expected shipments in Energy & Transportation, particularly in Power Generation, which is aligned with strong data center demand. Price realization was in line with our expectations for the quarter. As I mentioned, sales to users grew by 16% in the quarter. As Jim has discussed, demand remains healthy across most end markets for all our products and services and is supported by a healthy order backlog.

Moving to Slide 10. Second-quarter operating profit increased by 88%, while adjusted operating profit increased by 87% to \$3.7 billion. Year-over-year favorable price realization and higher sales volume were partially offset by higher manufacturing costs, which largely reflected higher material costs. An increase in SG&A and R&D expenses included higher strategic investment spend.

The adjusted operating profit margin of 21.3% was better than we had anticipated. Volume exceeded our expectations, which supported the margin outperformance. In addition, manufacturing costs increased less than we expected due to lower freight costs and a lower-than-anticipated impact from cost absorption. SG&A and R&D expenses were about in line.

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Moving to Slide 11. I'll review the segment performance. Construction Industries sales increased by 19% in the second quarter to \$7.2 billion due to price realization and higher sales volume. By region, sales in North America rose by 32% due to higher sales volume and price realization. Stronger demand and supply chain improvements enabled stronger-than-expected shipments in North America. This supported stronger sales of equipment to end users and some dealer restocking in what remains our most constrained region.

Sales in Latin America decreased by 11%, primarily due to lower sales volume, partially offset by price realization.

In EAME, sales increased by 20%, primarily the result of higher sales volume and price realization. Sales in Asia/Pacific were about flat.

Second-quarter profit for Construction Industries increased by 82% versus the prior year to \$1.8 billion. The increase was mainly due to price realization and higher sales volume. The segment's operating margin of 25.2% was an increase of 880 basis points versus last year. Margin exceeded our expectations, largely due to better-than-expected volume and freight costs, which were lower than we had anticipated.

Turning to Slide 12. Resource Industries sales grew by 20% in the second quarter to \$3.6 billion. The increase was primarily due to price realization and higher sales volume. Volume increased due to higher sales of equipment to end users. Although aftermarket sales volumes were lower, dealers' sales to customers for services remained positive.

Second-quarter profit for Resource Industries increased by 108% versus the prior year to \$740 million, mainly due to price realization and higher sales volume. This was partially offset by unfavorable manufacturing costs, largely material costs. The segment's operating margin of 20.8% was an increase of 880 basis points versus last year. The segment's margin was better than we expected, primarily due to favorable volume, timing of SG&A and R&D spend and lower-than-anticipated freight costs.

Now on Slide 13. Energy & Transportation sales increased by 27% in the second quarter to \$7.2 billion. Sales were up double digits across all applications. Oil and Gas sales increased by 43%, Power Generation sales increased by 39%, Industrial sales rose by 18% and Transportation sales increased by 12%. Second quarter profit for Energy & Transportation increased by 93% versus the prior year to \$1.3 billion. The increase was mainly due to higher sales volume and price realization, partially offset by unfavorable manufacturing costs and higher SG&A and R&D expenses. The segment's operating margin of 17.6% was an increase of 600 basis points versus last year. The margin was generally in line with our expectations.

Moving to Slide 14. Financial Products revenue increased by 16% to \$923 million, primarily due to higher average financing rates across all regions. Segment profit

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increased by 11% to \$240 million. The increase was mainly due to a lower provision for credit losses at Cat Financial, partially offset by an increase in SG&A expenses.

Business activity remains strong, and our portfolio continues to perform well. Past dues in the quarter were 2.15%, a 4 basis point improvement compared to the second quarter of 2022. This is the lowest second-quarter past dues percentage since 2007.

Retail new business volume performed well, increasing versus the prior year and the first quarter. In addition, we continue to see strong demand for used equipment.

Now on Slide 15. Our ME&T free cash flow generation was again robust as we generated \$2.6 billion in the quarter. This was an increase of \$1.5 billion compared to the prior year. With approximately \$4 billion generated in the first half, we now expect ME&T free cash flow to be around the top of our \$4 billion to \$8 billion target range for the full year.

CapEx in the second quarter was about \$300 million, and we still expect to spend around \$1.5 billion for the full year. As Jim mentioned, we returned about \$2 billion through share repurchases and dividends in the second quarter.

Our balance sheet remains strong. We have ample liquidity with an enterprise cash balance of \$7.4 billion, and we also hold an additional \$2 billion in slightly longer-dated liquid marketable securities to improve yields on that cash.

Now turning to Slide 16. I will share some high-level assumptions for the second half and the third quarter. In the second half of 2023, we expect higher total sales and revenues as compared to the second half of last year. We anticipate both sales to users and price realization will be positive in the second half. Keep in mind that on a comparative basis, we start to lap the stronger price we saw from the third quarter onwards last year.

Caterpillar sales will be impacted by changes in dealer inventories as dealers increased their inventories in the second half of last year, which is not typical, versus our expectation of a more typical reduction in the second half of 2023.

I want to spend just a few moments talking about dealer inventories. Dealers are independent businesses and they make their own decisions around the level of inventory they hold. We obviously work closely with them because this impacts our production levels. As Jim mentioned, we are very comfortable with the levels of inventory that dealers are holding.

We talk about dealer inventory in aggregate. This is difficult to predict with certainty as it arises from 3 different business segments, over 150 dealers and hundreds of different products. In Resource Industries and Energy & Transportation, dealer inventory is mainly

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a function of the commissioning pipeline. Keep in mind that over 70% of dealer inventory in these segments is backed by firm customer orders.

For Construction Industries, dealer inventory is principally a function of end-user demand and availability from the factory. In Construction Industries, dealers typically increase inventories during the first half of the year. Around 60% of the \$2 billion increase during the first half of this year was from products in this segment. The remaining 40% is in Resource Industries and Energy & Transportation. For Resource Industries and Energy Transportation, we currently anticipate a slight reduction in levels in the second half, but this is dependent on commissioning.

In Construction Industries, dealers are currently holding around the midpoint of the typical 3- to-4 month range. Some dealers would like to increase inventories of certain products, such as BCP and Earthmoving due to strong customer demand. Conversely, some dealers would like to reduce their levels of Excavator inventory because of high availability.

In addition, we are scheduled to replace third-party engines with CAT engines in certain products, which will impact production of these products during the second half. Our current planning assumption for Construction Industries is that dealers will reduce their overall levels of inventory in the second half of 2023, with a primary focus on excavators. Overall, at the enterprise level, we currently expect dealer inventory should be slightly higher at the end of 2023 versus last year.

Moving on. On this slide, we provide our adjusted operating profit margin target chart to assist you in your modeling process. Based on our current planning assumptions, we anticipate full year adjusted operating profit margin to be close to the top of our 300 basis points target range at our expected sales level. Your expectation for total enterprise sales this year will inform you where on the curve margin we should finish for the year.

Specific to the second half, we anticipate adjusted operating profit margin in the remaining quarters of the year will be above the year-ago levels, although they will be lower than the levels we saw in the first two quarters of this year. As compared to the first half, we anticipate a margin headwind from cost absorption in the second half. We do not expect to build our inventory as we did in the first half and anticipate that there will be some inventory reduction if we continue to see sustained supply chain improvement. In addition, spend related to the strategic growth initiatives should continue to ramp.

Price realization should remain positive, though the magnitude of the favorability versus the prior year is expected to be lower in the second half as we lap the more favorable pricing trends from last year. Therefore, the increases in margins that have occurred from price outpacing manufacturing cost inflation should moderate in the second half of this year.

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Now let's move on to our assumptions that are specific to the third quarter. We anticipate third quarter sales to be higher than the third quarter of 2022, but to exhibit the typical sequential decline when compared to the second quarter of 2023.

In Construction Industries, as is our normal seasonal trend, we expect lower sales compared to the second quarter. In Resource Industries, which can be lumpy, we anticipate slightly lower sales compared to the second quarter. We expect sales in Energy & Transportation will increase slightly compared to the second quarter.

Specific to third-quarter margins versus the prior year, adjusted operating profit margin at the enterprise level and segment margins should be stronger. However, we do expect lower enterprise adjusted operating profit margin in the third quarter compared to the second quarter of this year on lower volume and impacts from cost absorption. We also anticipate investment spend will ramp across our primary segments as we continue to accelerate our strategic investments in areas like autonomy, alternative fuels, connectivity and digital and electrification.

At the segment level, for Construction Industries, we expect a lower margin compared to the second quarter as is typical. This is largely due to lower quarter-on-quarter volume, increased investment in strategic initiatives and slightly higher manufacturing costs, including a headwind from cost absorption. Favorable price realization will act as a partial offset.

We also anticipate lower third quarter margin in Resource Industries compared to the second quarter, primarily due to lower volume quarter-on-quarter. Conversely, we expect third quarter margin in Energy & Transportation will be slightly higher compared to the second quarter on higher volume and stronger price realization, partially offset by higher manufacturing costs and spend related to strategic initiatives.

Now turning to Slide 17, let me summarize. We generated strong adjusted operating profit margin with a 750 basis point increase to 21.3%. We now expect to be close to the top of the targeted range for adjusted operating profit margin for the full year based on our expected sales levels.

ME&T free cash flow generation was robust at \$2.6 billion in the quarter. We returned \$2 billion to shareholders through share repurchases and dividends. We now expect ME&T free cash flow to be around the top of our \$4 billion to \$8 billion range for the full year. Lastly, we continue to execute our strategy for long-term profitable growth.

And with that, we'll now take your questions.

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QUESTION & ANSWER:

Operator^ (Operator Instructions) And your first question comes from the line of Jamie Cook with Credit Suisse.

Jamie Cook^ Congrats on a nice quarter.

Jim Umpleby^ Thanks, Jamie.

Andrew Bonfield^ Thanks, Jamie.

Jamie Cook^ Based on your performance in the first half of the year and what you're saying for sales and margins for 2023, it looks to me like you can achieve the high end of your margin targets around the 21% on lower sales versus the \$72 billion target. So do we need to sort of revisit our targets again and adjust the margins on lower sales? I'm just trying to understand what's going on structurally here? Or is this just all price? I think it's really important for your story.

And then just my second follow-up. On 2024, I know you don't want to guide, but you're sitting here with record backlog. I guess you're saying dealer inventories are going to be slightly higher. Supply chain is going to ease. What's the probability that you think you could potentially grow your EPS in 2024? Or is there anything out there that's giving you caution? And if so, are you pulling any levers.

Jim Umpleby^ Well, thanks, Jamie. And as we mentioned in our prepared remarks, we expect our adjusted operating profit margin to be close to the top of the targeted range for the year. We will look at our ranges at the end of the year and make an assessment as to what makes sense when moving forward from there. As we look forward to next year, and you mentioned some of the dynamics that are going on, we're closely monitoring economic conditions, but we do feel good about the business. But as I'm sure you know, we're not going to make a '24 prediction at this point.

Operator^ We will take our next question from the line of David Raso with Evercore ISI.

David Raso^ I'm just curious, the backlog was surprising to me, how strong it was. And I'm just curious, any thoughts around the backlog you can help us with in your framework in the guide for this year on how it moves from here sequentially? Anything unique in the backlog about what percent of it ships in the next 12 months versus normal? Just trying to get a handle on that. And if you could give any early color around pricing for '24 with the base order management program opening up this month. Just trying to get a sense of how you're thinking about pricing for '24.

Jim Umpleby^ Well, thank you, David. And certainly, our backlog does remain healthy. We didn't have a dramatic change quarter-to-quarter. It was up modestly. And of course,

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backlog includes, everything for Energy & Transportation, Resource Industries and also CI. For the Energy & Transportation and RI projects that are in that backlog, those are typically tied to firm customer orders. Solar has cancellation charge schedules. And so again, we feel good about the quality of the backlog.

In terms of price for next year, as is always the case, we'll assess market conditions. We look at our input costs, and we'll make a call on that later in the year, but it's a bit too early to really predict that.

Operator^ And your next question comes from the line of Michael Feniger with Bank of America.

Michael Feniger^ Just a broad question on inventories. When investors hear inventories are coming out, there's always concern on the impact to the margins. There were big destocking periods in the second half in years like 2019, 2015, 2012. What makes this second half of the year different from those other destocking periods? Is it less broad-based? Is it the fact that retail sales accelerated that gives you confidence we don't have that type of destocking effect that we've had in prior cycles?

Andrew Bonfield^ So, at that time, Michael, and thanks for the question, we were in a situation where actual demand was reducing when we did see those inventory reductions from dealers. And what that did mean, was the production levels were declining much more rapidly, which impacted overall, both leverage as well as absorption.

As we look it out over this period of time, we are still seeing healthy demand as we've indicated. We actually still expect positive sales to users in the second half of the year. What that does mean is when we are making modest inventory adjustments and dealers are making modest inventory adjustments, we are able to absorb that a little bit better than we have done historically.

The whole point about all of this is, just to remind everybody, we're around the midpoint of the [3 to 4 months] range [for Construction Industries] (company clarified after the call). We are actually being proactive with our dealers, particularly around things like excavators, where there's a little bit better availability to actually help them reduce inventory at a time when actually demand remains very strong out there in the market.

Michael Feniger^ And Andrew, just to put a fine point on it, obviously, dealer retail sales accelerated in the quarter. To inform your view that dealer inventories for the rest of the year, your comfortability around it, do you expect those retail sales to accelerate? Is that your base case? Is it to moderate slightly and remain positive? Just directionally to give us comfortability with the second half, how are your retail sales outlook in the second half informing your view on the inventory levels out there?

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Andrew Bonfield^ So, if you actually take the view that we expect retail sales to continue to grow in the second half, we're not giving a prediction as to whether they'll accelerate or decelerate. That's all we're going to be saying about that. But just a point is, with a dealer inventory reduction and with increased retail sales, the levels of inventory that dealers hold on a month basis actually would decline by the end of the year. That's how the math works.

Operator^ And your next question comes from the line of Rob Wertheimer with Melius Research.

Rob Wertheimer^ So, my question is actually on Cat's own inventories. And I know you've got rising sales to deal with, at least so far. But I'm curious, are you still holding safety stock on raw materials and components? Is any of the finished goods waiting on completion? Or is it all just rising sales flowing through? And then just maybe how much cash could come out of inventory if inventories normalize slightly?

Jim Umpleby^ Rob, thanks for your question. So certainly, we are still seeing supply chain challenges. As I mentioned earlier, there is an overall improvement but it only takes one part to prevent us from shipping a machine or engine. And so we're still dealing with supply chain constraints around large engines, which impact both E&T and machines. And we also have some issues with things like semiconductors for displays that are impacting other machines as well.

So to answer your question, our inventory, quite frankly, is a bit higher than I would like. And I do expect over time, as supply chain conditions improve, that we will be able to be more lean and improve our turns. So the good news is that even with our factory not running as lean as we would like and having a bit more inventory internally than we would like, we still, of course, produced very strong cash in the quarter. So I won't quantify how much cash could come out of inventory. But certainly, when we get back to pre-pandemic levels in the supply chain, we should be able to free up some additional cash.

Rob Wertheimer^ You look at your margins, it looks like you're crushing operations. And you look at inventory and it's like, well, okay, I understand you've got some pockets where delivery is holded up, any view on the totality of how Cat's managing production flow, factory flow, et cetera? You look at safety, you look at other indicators, you do. I mean what's your assessment? Is this the best you've done? Is there -- are there other problem spots? Just an overall look at how Cat is managing, et cetera? And I'll stop there.

Jim Umpleby^ Thanks, Rob. And certainly, I'm very proud of the team and the strong performance that we're producing. We put out a new strategy in 2017, and we asked people to have faith in our ability to produce higher operating profit margins and higher and more consistent ME&T free cash flow, and I'm really pleased that the team has been able to achieve that. We always have areas that we can do better. I mean, I talked about

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the fact that we're not as lean as I would like us to be in our manufacturing operations. We're doing a good job growing services, but I always want to grow it faster. So there's always things we can do a better job at. But again, just I'm very proud of the team and the fact that we have been able to meet the targets that we set out to our investors a few years ago.

Operator^ Your next question comes from the line of Tami Zakaria with JPMorgan.

Tami Zakaria^ So, going back to backlog, it went up by \$300 million sequentially. What exactly drove that? Was it purely driven by pricing? Or did you see a net increase in order volumes in the quarter as well?

Andrew Bonfield^ So, there are a couple of factors. Obviously, price does have some impact overall. And that was probably the major impact on the increase for the quarter. Obviously, volumes fluctuate quarter by quarter and depend on availability. But overall, we're pleased that the backlog is holding at healthy levels.

Jim Umpleby^ And maybe just one additional comment there. Honestly, some customers are waiting longer for products than I would like. And so backlog is a function, of course, of demand, but it's also a function of our ability to ship. So in fact, supply chain conditions ease and we're able to ship more quickly, customers shouldn't have to wait as long for certain products, which should bring our backlog down. So again, a declining backlog wouldn't be a bad thing if, in fact, it's the result of our ability to shorten lead times and improve availability.

Tami Zakaria^ Got it. If I can ask a quick follow-up, for the back half, is it fair to assume price realization goes down to, let's say, mid- to high single-digit growth, do you have any incremental pricing planned for later this year?

Andrew Bonfield^ We've seen very strong price as you've seen through the year. Obviously, we expect that to reduce as we go through the second half. If you take a function of lapping price increases, I think you'd get closer to a single-digit number. Obviously, we don't estimate that by quarter. But yes, the price range will come down as we move through the remainder of the year.

Operator^ And we will move to our next question from Nicole DeBlase with Deutsche Bank.

Nicole DeBlase^ Just on the retail sales trends this quarter, there was a deterioration across like both of the machines businesses in EAME. Can you just talk about what you're seeing from that region? I think there have been some indications of a little bit of slowing in Europe. So would love to hear what's capturing on the ground.

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Jim Umpleby^ Yes, we have seen a bit of slowing in Europe, as I mentioned, but Middle East is quite strong. So it's a mixed bag there. So, we're seeing a lot of strong construction activity in the Middle East, a lot of non-residential construction projects going on, but we are seeing a bit of weakness in Europe around construction.

Operator^ We will move to our next question from the line of Steve Volkmann with Jefferies.

Stephen Volkmann^ I wanted to just ask a little bit about productivity because I guess I'm hearing you say that supply chain is improving, but there's still issues. Are there still kind of productivity headwinds or penalties that you're paying in the factories because the supply chain is not yet as smooth as we'd like it to be? And obviously, I'm trying to think about whether there's some margin opportunity when supply chains -- when and if supply chains are sort of normal again.

Jim Umpleby^ As I mentioned, because we do have some supply chain constraints, overall, the situation has improved, there's no question. But it's like we've gone to 6 pages of shortages for certain machines. It's down to 1 page, that's an improvement, but you still have some shortages that you have to deal with and has not allowed us to operate our factories as lean as we have in the past and as lean as I would like them. So again, I do expect that as supply chain conditions ease in the future, we should be able to get back to running our factories with more just-in-time manufacturing, leaner, which should help increase inventory turns and reduce the amount of absolute inventory we hold based on a current level of sales. So, an opportunity to answer your question.

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

Timothy Thein^ Just a question on parts -- yes, just on parts. I guess we can broaden it to Cat across the board. But specifically, I was interested in the comment on RI for down volumes. Is that just maybe a function of kind of prioritizing whole goods just in light of the constrained availability? Or is that -- I would imagine there's notch by way of destocking going on with the dealer. So maybe just any more comments you have just on that comment on parts volumes in RI.

Jim Umpleby^ Maybe just to start with overall. So certainly, the services sales were up year-over-year, and we have seen fluctuations in dealer buying patterns, which impacts volumes. Services, dealer sales to customers were up in the quarter, and availability has improved. So our ability to ship parts to our dealers has improved, and that has had an impact on it as well. So again, not concerned about it, but it really is just a function of as our availability improves, dealers oftentimes conclude they're able to hold a bit less inventory, which will have an impact.

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

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Chad Dillard^ So, I wanted to focus mainly on Construction Industries. And I just wanted to get a better sense of -- for your orders that came in the quarter, can you just give us a rough breakdown between retail versus stock? And then, look, as you're thinking about like inventory shift, that really helpful stat about 70% is retail for E&T and Resource Industries. Could you do the same for Construction Industries?

Andrew Bonfield^ So, when we talk about it we don't break down what dealers take the orders for between retail and stock in CI. A significant proportion of the purchases they make are based on customer orders, particularly if there is a degree of customization that is needed. And there will be some where once the machine has actually been delivered to the dealer, they will have a number of things or attachments put on, which will impact the timing of commissioning. So, there's a little bit of commissioning within CI, but obviously, it's nowhere near around the 70% plus that we talked about for E&T and for Resource Industries.

What we are seeing, as I indicated, is there are patches, particularly in BCP and Earthmoving, where dealers are constrained and actually would like to have more inventory available to them, and that impacts their orders. So obviously, orders in those divisions are much stronger. Obviously, with excavators an impact of what's happening, particularly, say, for example, in China, where, obviously, demand is reduced, that means we have more availability. And dealers would like to decrease their inventory of excavators accordingly. So it's a bit of a mixed pattern. But as I say, [for Construction Industries,] dealers only have 3.5 months of inventory on hand, and that percentage will actually decrease around by the time we get to the year-end (company clarified after the call).

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

Steven Fisher^ Wonder if you could talk a little bit more about the drivers of the broad Oil and Gas segment. [Oil and Gas is part of our Energy & Transportation segment] (company added after the call). Where do you think we are in the kind of the rebuild cycle of equipment there? To what extent do you need rig counts to rebound to keep the current level of revenue sustained? Or are there really other drivers with this segment to be aware of? It was obviously a very strong acceleration of sales to users. So just kind of curious for color on the drivers and the longevity of the strong trend in the segment.

Jim Umpleby^ Well, Steven, we're certainly not dependent upon rig counts to drive Oil and Gas. It's just one element of the many applications that we sell into. So, as I mentioned earlier, we are encouraged by the strong demand that continues for gas compression for Cat-branded reciprocating engines. That's quite positive. We have seen a bit of slowing in well servicing, but that's expected to increase again based on most analyst views over the coming months.

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Solar continues to have quite robust sales into a number of oil and gas applications, including gas compression, but also offshore platforms and international business as well. So again, at this point, Oil and Gas certainly looks strong. And in some areas, we're quite bullish on what we see moving forward.

Operator^ Your next question comes from the line of Kristen Owen with Oppenheimer.

Kristen Owen^ I wanted to come back to a question on pricing. First, for the second quarter, if you can help us understand what's supporting the strength there. I think that was a little bit ahead of where we were expecting price to be. Is that a function of mix or just the better-than-expected end-user demand? And then as we think about that stepping down through the back half of the year, to get to that single-digit number that you outlined on a previous answer, just how we should think about the cadence of that stepping down throughout the remainder of the year?

Jim Umpleby^ So, price realization was about in line with our expectations. And certainly, as we look at price, the price we realize is a function of a whole variety of things. You mentioned mix, but a lot of it has to do with, of course, the competitive situation that we and our dealers are facing in a particular market.

So, we saw significant increases in price in the second half of last year, and that will lap in the second half of 2023, but we still expect to benefit from positive price in the second half, but it will moderate and certainly understandable based on that -- again, those strong price increases in the second half of last year. And as always, we'll continue to monitor the global price environment, and we'll determine if actions need to be taken.

Andrew Bonfield^ And just, Kristen, just to add on. Just if you recall last year, price continues to improve from the third to the fourth quarter. So you probably should see the reverse of that this year, which price will be slightly stronger in the third versus the fourth.

Operator^ And your next question comes from the line of Mig Dobre with Baird.

Mig Dobre^ Just a quick clarification based on the way you're kind of thinking about the dealer inventory destock in the back half. In order to make that happen, do you have to adjust production sequentially in any way? Maybe you can comment on that? And then related to this, your manufacturing cost, the \$283 million drag, should we think that this drag lessens in the back half? And could that actually be a positive benefit as we think about the fourth quarter on a year-over-year basis?

Andrew Bonfield^ So first of all, on this, obviously, production level, as we've indicated from beginning of the year, last year, we did see, if you remember, production was rising throughout the whole year as we went through the year as the supply chain started to improve. That, particularly in Construction, will be slightly different this year. And that

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obviously, we will see some headwind as we do see some dealer inventory reduction in the second half. We are already making production adjustments as we move on. That's part of the business. We do that day in, day out. And those will continue, and there will be some impact in the second half of the year. But overall, we still expect positive revenues through that period of time for Caterpillar as a whole.

Talking about manufacturing costs. Yes, manufacturing costs will decrease, but obviously price benefit will reduce as well. So the net of the two will mean we won't see quite that margin improvement that we did see as we went through the last 4 quarters. So yes, we still expect price to offset manufacturing costs in the second half of the year. Manufacturing costs will reduce and so will price as well, so no real, main benefit to margins as we think through the remainder of the year.

Jim Umpleby^ Just to expand upon the answer, we talked earlier about the fact that there is enough excavator dealer inventory out there. So, we certainly would expect to produce less excavators, as an example, in the next 6 months. And we also mentioned the fact that we're going to have some changeovers in some of our BCP products where we're switching to Cat engines, which is certainly the right thing to do for the long term and growing services. But that will have an impact on production as well during the last 6 months of the year. But keep in mind that we have said, we now expect to be close to the top of our targeted range for adjusted operating profit margin. So that all goes into the mix.

Operator^ Your next question comes from the line of Mike Shlisky with D.A. Davidson.

Michael Shlisky^ Historically, prior to the pandemic, your operating margins in the fourth quarter were usually a bit of a step downward compared to the third quarter. That's mainly Construction and Resource. I think it got a little off better than the last couple of years, obviously, for a few reasons. But I was wondering if you could tell us whether you will be back to that sort of more normal seasonality on margins here in the second half of this year or if operationally, these have kind of changed permanently here?

Andrew Bonfield^ I think that definitely, we would expect a step down in margins in the fourth quarter in both, particularly in Construction as is the normal seasonal trend. It does tend to be the lower production period. Also, just as Jim mentioned, we will have the impact of the BCP changeover, which will impact us slightly more stronger in the fourth quarter. So, there will be some impact as we move through the fourth quarter.

Operator^ And your next question comes from the line of Matt Elkott with TD Cowen.

Matt Elkott^ Kind of a higher-level question on non-residential construction. Good to see the tailwinds of the infrastructure packages continuing to materialize. But can you help us gauge what innings you think we're in with these tailwinds? Can we expect like an acceleration next year or just steady?

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Jim Umpleby^ Thanks for your question. I'm going to try to avoid a baseball analogy here. But as I mentioned earlier, we are starting to see some benefit of the numerous infrastructure bills that have passed. Some of that is coming from the states. But as you can imagine, permitting takes time for a number of projects. And it's, as you can imagine, very difficult to judge exactly how long that permitting process will take and how this will play out. But I do expect it to last for some time. Difficult for me to estimate, all right, what will the acceleration be in a 6-month or 1-year period. But again, it's a very positive thing for us, and it's a positive thing for our customers that we have these projects coming down the pipe.

Operator^ And your next question comes from the line of Stanley Elliott with Stifel.

Stanley Elliott^ A quick question on the cash flow. You guys have pretty been consistent about discussing returning all the free cash. You have basically, let's call it, another kind of \$4 billion, \$5 billion at run rate in the back half of the year. Should we think of all of that going back to share repurchases or using for other investments? Any thoughts there would be great.

Jim Umpleby^ As we said, our intent is to return substantially all of our ME&T free cash flow to shareholders through dividends and share repurchases over time. We do maintain a healthy balance sheet for a whole variety of reasons. When we went into COVID in 2020, I was very pleased that we had a strong balance sheet. We also have increased our dividend since we introduced our new capital allocation strategy. In May of 2019, we've increased the [quarterly] dividend per share by 51% since that period of time (company corrected after the call). So again, we're proud of our Aristocrat status. So certainly wouldn't be surprised. It's a Board decision, both if we continue to increase our dividend and continue to share repurchase as well.

Operator^ And today's final question comes from the line of Jerry Revich with Goldman Sachs.

Jerry Revich^ Jim, I'm wondering if you could just expand on your comments in mining. Your biggest competitor in trucks is posting 250% book-to-bill. I'm wondering if you're seeing that level of bookings activity? And are we finally at a point where we're hitting the sweet spot of that replacement cycle for what we delivered a decade ago? Or are there some idiosyncratic ebbs and flows in the data points?

Jim Umpleby^ Certainly, as we've talked about many times, mining is kind of a lumpy business quarter-to-quarter. And our mining customers are remaining capital disciplined. What we've talked about for some time is what we expect is a gradual increase over time in our mining business, and that's certainly the way it's played out. Certainly, at the moment, large truck sales, that activity is robust. That quotation activity is quite robust, and some other products, not quite as strong. But again, just based on what we see

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required in terms of commodity production increases to support the energy transition. We feel very good about that business.

We do believe quite strongly that we have the best autonomous mining solutions. We now have about 600 autonomous trucks in operation around the world. And one of the great things that's happened is that we've been able to reduce the cost such that now, a smaller mine can make a capital investment to put autonomy in. And so when we're talking to miners now, autonomy is almost always part of that discussion. We're down to about 12 to 14 trucks. We've actually seen mines adapt autonomy with that low number of trucks.

So we're quite bullish about what we see coming in again, and we're leveraging that autonomous solutions, whether it's in iron ore, copper, gold, oilsands, a whole variety of applications. But again, we're certainly long-term bullish about that business.

All right. Well -- so if I can, I'd like to thank you all for joining us, and we certainly appreciate your questions. Again, I want to thank our global team one more time for just an outstanding quarter. And to reiterate, based on our strong operating performance due to the strong results that we achieved in the second quarter, we now believe that 2023 will be even better than we had previously anticipated during our last earnings call. That includes higher full year expectations for adjusted operating profit margin, ME&T free cash flow, which, again, reflects that continuing healthy customer demand and our performance. Please stay safe. Thanks for your interest.

Ryan Fiedler^ Thanks, Jim, Andrew and everyone who joined us today.

A replay of our call will be available online later this morning. We'll also post a transcript on our Investor Relations website as soon as it's available. You'll also find the second quarter results video with our CFO and an SEC filing with our sales to users data. Click on investors.caterpillar.com and then click on financials to view those materials.

If you have any questions, please reach out to Rob or me. Investor Relations general phone number is (309) 675-4549.

Now let's turn it back over to Abby to conclude our call.

Operator^ Thank you. Ladies and gentlemen, that concludes our call today and thank you for joining.

You may all disconnect.