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Caterpillar Inc.

Third Quarter 2023 Earnings

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3Q 2023 Earnings

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PRESENTATION:

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Operator^ Ladies and gentlemen, welcome to the Third 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.

And please go ahead.

Ryan Fiedler^ Thanks, Abby. Good morning, everyone. And welcome to Caterpillar's third 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 third 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 & 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.

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.

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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 our 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.

Before discussing our results, I'd like to take a moment to acknowledge the tragic events in the Middle East. We are deeply saddened by the loss of life and are hopeful for a quick and peaceful resolution.

The Caterpillar Foundation is donating $1 million to the American Red Cross and its network of Red Crescent Societies in the region to support the humanitarian needs of those impacted.

As we close out the third quarter, I want to thank our global team for delivering another strong quarter. This included double-digit top-line growth, strong adjusted operating profit margin and robust ME&T free cash flow.

Our results continued to reflect healthy demand across most of our end markets for our products and services. We remain focused on executing our strategy and continue to invest for long-term profitable growth.

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

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Moving to quarterly results, it was another strong quarter. Sales and revenues increased 12% in the third quarter versus last year. Adjusted operating profit margin improved to 20.8%, up significantly year-over-year. We also generated $2.9 billion of ME&T free cash flow in the quarter.

Sales were generally in line with our expectations, while both adjusted operating profit margin and ME&T free cash flow in the third quarter were better than we expected. In addition, we ended the quarter with a healthy backlog of $28.1 billion. Backlog is a function of demand and lead times. As I've mentioned, demand remains healthy in most of our end markets. Due to improving supply chain conditions, product availability and lead times have improved for many products.

Dealers and customers can wait longer to place orders, which has led to a moderation in order rates as expected. In addition, we have seen a reduction in dealer orders for Building Construction Products, which we anticipated due to the changeover to CAT engines that we previously discussed, and for Excavation, in anticipation of dealers reducing their inventories in the fourth quarter. Although our backlog decline is expected, it still remains elevated as a percentage of revenues compared to historic levels. While we continue to closely monitor global macroeconomic conditions, we now expect our full year 2023 results to be better than we anticipated during our last earnings call.

Turning to Slide 4. In the third quarter of 2023, sales and revenues increased by 12% to $16.8 billion driven primarily by favorable price realization as well as volume growth. Sales increased in each of our 3 primary segments. Compared with the third quarter of 2022, overall sales to users increased 13%, which was below our expectations.

Energy & Transportation sales to users increased 34%, but was lower than expected due to some supply chain challenges for large engines and the timing of gas turbine and international locomotive deliveries. For machines, which includes Construction Industries and Resource Industries, sales to users rose by 7%, in line with expectations.

Sales to users in Construction Industries were up 6%. North American sales to users increased as demand remained healthy for non-residential and residential construction.

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Non-residential continued to benefit from government-related infrastructure and construction projects.

Residential sales to users in North America also increased in the quarter. EAME sales to users were up slightly, primarily due to continuing strength in Middle East construction activity. In Latin America and Asia Pacific, sales to users declined in the quarter.

In Resource Industries, sales to users increased 10%. In Mining, sales to users increased, with 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 34%. 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, repowering well servicing fleets and gas compression.

Power Generation sales to users continue 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 Construction Industries and followed by Energy & Transportation.

In Construction Industries, the increase was in North America in some of our most constrained product lines, including BCPand Earthmoving. We remain very comfortable with the total level of dealer inventory, which is within the typical range. Andrew will provide more color later in the call.

Adjusted operating profit margin increased to 20.8% in the third quarter, a 430 basis point increase over last year. Adjusted operating profit margin was better than we had anticipated. Relative to our expectations, we saw lower-than-expected manufacturing costs, including freight, as well as slightly favorable price realization, which included a positive impact from geographic mix.

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Moving to Slide 5. We generated strong ME&T free cash flow of $2.9 billion in the third quarter and $6.8 billion in the first 3 quarters of 2023.

Year-to-date, we returned $4.1 billion to shareholders, which included about $2.2 billion in repurchased stock and $1.9 billion in dividends. 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. As I mentioned earlier, we now anticipate the full year to be better than we previously expected. We expect our adjusted operating profit margin to be slightly above the targeted range relative to the corresponding level of sales. This positive operating performance increases our expectation for ME&T free cash flow, which we now expect will exceed the $4 billion to $8 billion target range for the full year. This outlook for the adjusted operating profit margin and ME&T free cash flow reflects healthy customer demand and our strong operating performance.

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

In Asia Pacific, excluding China, we expect growth in Construction Industries due to public infrastructure spending in support of commodity prices. As we have mentioned during previous earnings calls, we anticipate continued weakness in China and expect it to remain well below our typical range of 5% to 10% of enterprise sales.

In EAME, we anticipate the region will be slightly down as weakness continues in Europe, partially offset by continuing strong construction demand in the Middle East. Construction activity in Latin America is expected to be about flat versus strong 2022 performance.

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In Resource Industries, we continue to see a high level of quoting activity. In Mining, customer product utilization remains high, the number of parked trucks remains low and the age of the fleet remains elevated.

Order rates are slightly lower than we expected at this time, reflecting continued capital discipline by our customers. We continue to believe the energy transition will support increased commodity demand over time, expanding our total addressable market and providing further opportunities for long-term profitable growth.

In addition, customer acceptance of our autonomous solutions continues to grow. This is evidenced by the announcement this morning with Freeport-McMoRan who will convert their fleet of CAT 793 large mining trucks at an Arizona copper mine to autonomous haulage using CAT MineStar Command. We also expect Heavy Construction and Quarry and Aggregates to remain at healthy levels due to major infrastructure and non-residential construction projects.

Moving to Energy & Transportation. In Oil and Gas, we remain encouraged by continuing strong demand for CAT reciprocating engines and gas compression. As we said last quarter, well servicing in North America is showing some short-term moderation, but we remain optimistic about future demand.

CAT reciprocating engine demand for Power Generation is expected to remain strong, primarily driven by data center growth. New equipment and services for Solar turbines in both Oil and Gas and Power Generation remain robust. Industrial demand is expected to soften slightly from recent high levels but remains well above our historical averages. In Transportation, we anticipate strength in high-speed marine as customers continue to upgrade aging fleets.

As we've described, we continue to see strength in most of our end markets. Based on our backlog, dealer inventory and current market conditions, we expect to have another good year in 2024. We will provide additional information during our fourth quarter call.

Moving to slide 7. We continue to advance our sustainability journey. We're helping our customers achieve their climate-related objectives by continuing to invest in new

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products, technologies and services that facilitate fuel flexibility, increased operational efficiency and reduced emissions.

For example, Caterpillar provides a number of low-carbon intensity solutions to customers. In Construction Industries, the CAT 980 XE wheel loader, which features a CAT-designed and manufactured continuous variable transmission, improves fuel efficiency by as much as 35% and reduces CO2 emissions by as much as 17% compared to the previous model.

We also introduced the new CAT G3600 Gen 2 engine, the latest evolution of the powerful G3600 series offering lower emissions. With more than 8,500 CAT G3600 units in the field, the Gen 2 engine is designed to build upon the platform's robust performance to provide a 10% increase in power and lower emissions compared to the previous model.

We've also made several joint announcements with customers that demonstrate our commitment to supporting their climate-related objectives. I'll highlight one here.

In September, Caterpillar and Albemarle introduced a unique collaboration aimed to support their efforts to establish Kings Mountain, North Carolina as the first-ever zero-emissions lithium mine in North America, while also making lithium available for use in Caterpillar battery production. These examples reinforce our ongoing sustainability leadership and how we're helping our customers build a better, more sustainable world.

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

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

Beginning on Slide 8, our overall operating performance was strong. Adjusted operating profit margin, adjusted profit per share and ME&T free cash flow all were better than we expected, while sales grew in line with our expectations.

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Based on the strong third quarter and year-to-date operating performance, we now expect that the adjusted operating profit margin for the year will be slightly above the top end of our target range at the corresponding level of sales. We also anticipate that ME&T free cash flow will exceed the target range of $4 billion to $8 billion.

In summary, sales and revenues increased by 12% or $1.8 billion to $16.8 billion. The sales increase versus the prior year was driven primarily by price realization as well as higher sales volume.

Operating profit increased by 42% or $1 billion to $3.4 billion. The adjusted operating profit margin was 20.8%, an increase of 430 basis points versus the prior year.

Profit per share was $5.45 in the third quarter of this year. This included restructuring costs of $0.07 per share as compared to $0.08 in the prior year. We continue to expect restructuring expenses of about $700 million for the full year.

Adjusted profit per share increased by 40% to $5.52 in the third quarter compared to $3.95 last year. Other income of $195 million was lower than the third quarter of 2022 by $47 million. The decline was driven by less favorable currency impact in the quarter related to ME&T balance sheet translation as compared to the prior year, along with the recurring increase in the pension expense of approximately $80 million per quarter. Higher investment and interest income acted as a partial offset.

The provision for income taxes in the third quarter, excluding discrete items, reflected a global annual effective tax rate of 22.5%, which is the rate we now expect for the full year. The slightly lower-than-expected tax rate along with discrete items added about $0.14 to profit per share in the quarter.

Moving on to Slide 9. As I mentioned, the 12% increase in the top line versus the prior year was primarily due to price realization, as well as higher sales volume. Volume improved as sales to users increased by 13%, while year-over-year changes in dealer inventory acted as a slight offset.

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Overall, the magnitude of the sales increase was in line with our expectations. However, by segment, Construction Industries sales were higher, Resource Industries were in line and Energy & Transportation sales were lower than we had anticipated.

Services revenues increased in the third quarter. We will update you with our progress towards our services growth target when we report our fourth quarter results and as is our normal practice.

Price realization was slightly better than we had expected for the quarter. However, as we anticipated, we did see the magnitude of the year-over-year price effect moderate compared to the second quarter as we lapped prior year price increases.

Volume was slightly below our expectations. As Jim mentioned, sales to users were lower than we had anticipated, principally in Energy & Transportation. However, this was nearly offset by the increase in dealer inventory versus our expectations of being about flat for the quarter.

The increase in dealer inventory was driven primarily by Construction Industries. There, we had stronger-than-expected shipments in North America, particularly in Building Construction Products and Earthmoving.

Within North America, these products remain constrained and are near the bottom end of the typical dealer inventory range of 3 to 4 months of sales. We also saw some dealer inventory increase in Energy & Transportation within the quarter.

I'll remind you that dealer inventory in Energy & Transportation and Resource Industries is mainly a function of the commissioning pipeline, with over 70% of dealer inventory in these segments backed by firm customer orders. Because dealer inventory is more a function of commissioning in Resource Industries and Energy & Transportation, it is difficult for us to predict in these two segments. I will discuss further our full year expectations for dealer inventories a little bit later.

Moving to Slide 10. Third quarter operating profit increased by 42% to $3.4 billion, while adjusted operating profit increased by 41% to $3.5 billion. Price realization, which

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included a slight benefit from a shift in the geographic mix of sales, and sales volume were favorable in the quarter.

Our largest headwinds to operating profit were higher SG&A and R&D expenses and higher manufacturing costs. SG&A and R&D expenses included higher strategic investment spend. Manufacturing cost increases included higher material costs and unfavorable cost absorption as we reduced our inventories compared to a corresponding increase in the third quarter of 2022. Lower freight costs acted as a partial offset within manufacturing costs.

The adjusted operating profit margin of 20.8% improved by 430 basis points. This was better than we had anticipated primarily due to favorable manufacturing costs, of which freight was the largest contributor. Also, the slightly better-than-expected price helped margins.

Now I'll discuss the performance of the segments. On Slide 11, Construction Industries sales increased by 12% in the third quarter to $7 billion, primarily due to favorable price realization.

By region, sales in North America rose by 31% due to higher sales volume and favorable price. As I mentioned, supply chain improvements enabled stronger-than-expected shipments in North America, which supported some dealer restocking. Sales of equipment to end users were in line with our expectations for the region.

Sales in Latin America decreased by 31%, primarily due to lower sales volume, partially offset by favorable price. In EAME, sales increased by 8% mainly due to favorable price and currency impacts. Sales in Asia Pacific decreased by 8%, primarily due to lower sales volume driven by lower sales of equipment to end users.

Third quarter profit for Construction Industries increased by 53% versus the prior year to $1.8 billion. The increase was mainly due to favorable price realization. The segment's operating margin of 26.4% was an increase of 710 basis points versus last year. Margin exceeded our expectations on better volume, price and lower-than-anticipated manufacturing costs, primarily freight.

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Turning to Slide 12. Resource Industries sales grew by 9% in the third quarter to $3.4 billion. The increase was primarily due to favorable price realization, partially offset by lower sales volume. Volume decreased as higher sales of equipment to end users were more than offset by lower aftermarket parts volume, which reflected changes in dealer buying patterns.

Third quarter profit for Resource Industries increased by 44% versus the prior year to $730 million mainly due to favorable price realization. Profit was partially offset by the impact of lower sales volume, which included unfavorable product mix.

The segment's operating margin of 21.8% was an increase of 540 basis points versus last year. Margin was better than we had expected primarily due to lower-than-anticipated manufacturing costs driven by freight and price.

Now on Slide 13. Energy & Transportation sales increased by 11% in the third quarter to $6.9 billion. Sales were up across all applications. Oil and Gas sales increased by 26%. Power Generation sales were higher by 21%. Industrial sales rose by 5%, and Transportation sales increased by 6%.
Third quarter profit for Energy & Transportation increased by 26% versus the prior year to $1.2 billion. The increase was mainly due to favorable price realization and higher sales volume, partially offset by higher SG&A and R&D expenses, unfavorable manufacturing costs and currency impacts.

SG&A and R&D expenses reflected ramping investments related to strategic growth initiatives. A reminder that most of our strategic investments relating to electrification and alternative fuels occur in this segment, which impacts reported margins.

The segment's operating margin of 17.2% was an increase of 210 basis points versus the prior year. Margin was lower than we had anticipated primarily due to lower-than-expected sales volume impacted by supply chain challenges for large engines and delivery delays for Solar turbines.

Moving to Slide 14. Financial Products revenue increased by 20% to $979 million primarily due to higher average financing rates across all regions. Segment profit decreased by 8% to $203 million. The decrease was mainly due to a higher provision for

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credit losses at Cat Financial. The unfavorable impact reflects a challenging comparison as we had reserve releases in the prior year as compared to a more typical provision expense in the third quarter of 2023.

Of note though, through the third quarter of this year, provision expense for a comparable nine-month period is at the lowest level in over 20 years. Business activity remains strong and our portfolio continues to perform well with past dues and write-offs at historic low levels. Past dues in the quarter were 1.96%, a 4-basis point improvement compared to the third quarter of 2022 and a decrease of 19 basis points compared to the second quarter.

Retail new business volume increased versus the prior year, and though it declined compared to the second quarter, this follows the typical seasonal pattern. In addition, we continue to see strong demand for used equipment, and used inventory remains at low levels.

Now on Slide 15. Our ME&T free cash flow has been robust this year with another $2.9 billion generated during the third quarter. With $6.8 billion generated through the first 3 quarters of this year, we expect to exceed our target of $4 billion to $8 billion this year.

From a working capital perspective, we had a small inventory decrease of around $200 million in the quarter.

Looking ahead, we expect our inventory levels will continue to decrease as we see sustained supply chain improvement.

CapEx in the third quarter was around $400 million. With about $1.1 billion in CapEx through the first 3 quarters, we continue to expect around $1.5 billion for the full year.

Our balance sheet remains strong. We have ample liquidity with an enterprise cash balance of $6.5 billion, and we hold an additional $4.3 billion in slightly longer-dated liquid marketable securities to improve yields on that cash.

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Now on Slide 16, I will share some high-level assumptions for the fourth quarter and the full year. During the fourth quarter, we anticipate slightly higher sales as compared to the prior year. Price should remain favorable. We expect sales to users to continue to support good underlying growth, though changes in dealer inventories should act as an offset.

As a reminder, we saw dealers increase inventories by $700 million in the fourth quarter of 2022 whilst we expect a decrease in the fourth quarter of this year. Specifically in Construction Industries, we do not expect the seasonal sales increase typically seen from the third to the fourth quarter. Those sales to users are expected to increase on both a sequential and year-over-year basis.

Instead, we anticipate lower shipment volumes as we complete the CAT engine changeover in Building Construction Products, and dealers reduce their inventories, principally of excavators. This compares to a dealer inventory increase in the fourth quarter of 2022.

Though we now expect that dealer inventory in Construction Industries will be higher at the end of 2023 than it was at the year-end 2022, we still expect it to be within the typical 3 to 4 months of sales range. A reminder, this is an average across all dealers and all products in Construction Industries and is difficult to predict with precision, given over 150 independent dealers and hundreds of different products.

Similar to last quarter, there are still areas and/or products where dealers would like to have more inventory. As Jim has mentioned, we are very comfortable with the level of inventory held by dealers overall.

In Resource Industries, we anticipate slightly lower sales as compared to the third quarter as a result of improvements in availability. We also expect lower sales versus the prior year driven by changes in dealer inventory. In the fourth quarter of 2022, there was an increase in dealer inventories for Resource Industries, while we expect to decrease in the fourth quarter of this year.

We expect sales in Energy & Transportation to increase in the fourth quarter as compared to the third quarter with higher Solar turbines and Rail deliveries. However,

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keep in mind that we continue to work through supply chain challenges primarily impacting large engines. We also anticipate some moderation in Industrial sales during the fourth quarter, compared to recent high levels.

Now I'll comment on our expectations for margins. We provided our adjusted operating profit margin target chart to assist you in your modeling process. Based on our current planning assumptions, we anticipate the adjusted operating profit margin to be slightly above the target range for the full year 2023. This is based on the corresponding estimated level of sales. Your expectation of total enterprise sales this year will inform where margins could finish for the year.

Specific to the fourth quarter, we anticipate the adjusted operating profit margin to be lower than the third quarter. We anticipate lower-than-normal volume leverage, particularly impacting Construction Industries for the reasons I mentioned previously.

We also anticipate a negative segment mix impact to operating margins, as Construction Industries sales will be a lower proportion of total sales as compared to the third quarter. Price realization should remain positive, though we expect the magnitude of the favorability versus the prior year to moderate as we continue to lap 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 fourth quarter.

In addition, as you look down the income statement for the prior year, there are a couple of points to note. First, short-term incentive expense in the fourth quarter of 2022 was lower than normal due to the true-up for the final outcomes for the financial year. This will be a headwind for year-over-year operating margins. However, this will be partially offset by favorability in other operating income and expense as we do not expect the significant currency translation losses that we saw in the fourth quarter of last year to recur.

By segment in Construction Industries, we expect slightly lower margin compared to the third quarter assuming lower volume. We also anticipate lower sequential margins in Resource Industries as is typical, impacted by cost absorption along with higher spend related to strategic investments.

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In Energy & Transportation, we expect margins will be similar to the third quarter with stronger volume offset by manufacturing costs and an unfavorable mix of products, which includes international locomotive deliveries in Rail.

Now turning to Slide 17. Let me summarize. Adjusted profit per share is $15.98 through the first 3 quarters of the year, which already exceeds our previous full year record by 15%. We generated strong adjusted operating profit margin with a 430-basis point increase to 20.8%. We now expect to be slightly above the targeted range for adjusted operating profit margin for the full year based on our expected sales levels.

ME&T free cash flow remained robust, with $6.8 billion year-to-date. We now expect ME&T free cash flow to exceed our $4 billion to $8 billion target range for the full year. We continue to execute our strategy for long-term profitable growth.

And with that, we'll take your questions.

Operator^ (Operator Instructions) Your first question comes from Michael Feniger with Bank of America.

Michael Feniger^ Just based on where the backlog sits today, you discussed the easing supply conditions impacting lead times and orders. As that normalizes, do you expect the backlog to consolidate at these levels and then move higher? You mentioned some capital discipline with customers. Just curious, Jim, with where commodity prices are for oil, iron ore, copper, is that enough to support growth in 2024?

Jim Umpleby^ As I mentioned, we do expect another good year in 2024, and we'll provide more detail in January. We talked about this a bit in our last quarterly call. Our backlog is higher than it normally would be because our lead times are higher than I'd like them to be, frankly.

And what we've talked about is as supply conditions continue to improve, we expect lead times to come down, which should have a corresponding impact on our backlog. Our backlog should come down. So that's a positive thing.

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If you look at our backlog over a number of years, it's still elevated compared to where it normally would be based on revenue. So again, we do feel good about market conditions. And we expect that as we improve lead times, that backlog as a percentage of revenue would come down to more normal levels.

Andrew Bonfield^ . Let me just give you some numbers to add to that.If you look at the backlog as a percentage of trailing 12-month sales in the period of 2017, it was 37%. In 2018, it was 32%, currently today is around 44%. So, backlog still is elevated based on historic trends, and I'd like to remind you also that services revenues now are a higher amount of our total sales base as well.

Operator^ And we will take our next question from Tami Zakaria with JPMorgan.

Tami Zakaria^ Staying on backlog, I think orders were down in the third quarter. Have you seen any improCvement in order trends quarter-to-date or if orders continue to be down? What would support a good year in 2024, like you mentioned in your call?

Jim Umpleby^ . Again, we expected some moderation in order rates based onimproving availability. So, that wasn't a surprise to us. Again, what would give us another good year in 2024 is market conditions.

If we look at where we are in most of the markets we serve, we feel quite good. Starting with just Construction Industries in North America, the infrastructure investments that are being made by the government although we are starting to see some benefit of that, we expect more benefit in 2024.

Residential, although the growth rate has continued to moderate in North America, it is still growing. Oil and Gas still remains quite healthy for Solar turbines. Gas compression in Oil and Gas is strong as well.

So again, there's a lot of positive things in - Power Generation. Data center growth continues to provide a tailwind as well. The market conditions would lead us to believe that we'll have another good year next year.

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Andrew Bonfield^ And Tami, just to add again a little bit more, just to remind you that specifically in the third quarter, there were two factors which did impact order rates. One, which is, as we talked about, the CAT engine changeover for a number of quarters. That is beginning in the fourth quarter. If you think about when dealers will place orders for Building Construction Products machines, they would tend to impact us in the third quarter, which is why we saw those order rates decline.

Similarly, we also saw some excavator orders decline in anticipation of dealers reducing their inventory levels as well. So overall, those are specific factors in the third quarter themselves, which actually moderated the overall order rates as well.

Jim Umpleby^ Just another comment about the Building Construction Products changeover. We deliberately limit the number of orders because we have a fixed amount of machines being built prior to that changeover to the new model. And then we closed the order board at some point when we run out of allocation spots, and we haven't yet opened the order board for the new model. So again, that helps explain the reduction in order rates for Building Construction Products around that engine changeover.

And again, as expected, we also have talked about the fact that we expect dealers to bring down excavator inventory. And again, that would result in a lower order rate as well for Construction Industries for excavators. So again, none of this is surprising.

Operator^ And we'll take our next question from Rob Wertheimer with Melius Research.

Robert Wertheimer^ My question is on Resource Industries, and it's going to be basically on business model, revenue model and margin. And so you announced the deal with Freeport today on retrofit of autonomous mining trucks. And I know you've had retrofit for a while. I don't recall an announcement quite this big, although maybe I've missed 1 or 2.

But the question is really as you see deals like that, you deliver value to customers through autonomous operations, saving direct and indirect costs, how do you think about margin support for you guys? And then how do you think about market share

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going forward? I think a year ago, you'd sort of won a large majority of autonomous mining contracts or tenders out there. And I'm wondering if you can give us an update on that. So, kind of market share, margin and business development.

Jim Umpleby^ You bet. And Rob, we have talked in the past about the fact that we are very bullish about our autonomous solution. We do believe we have the best solution in the industry because our trucks move faster, and we're able to allow our customers to produce more commodity in a 24-hour period.

We continue to invest in our autonomous capabilities and continue to add more value. And that's really resulting in us receiving the orders like the one that was announced this morning.

Certainly, we're always striving to add more value. That helps again. It's not just about cost competition, it's providing more value to customers to make them more successful.

We have talked about the fact that our customers in Mining are displaying capital discipline. That's not surprising. Quotation activity is quite high, and the number of parked trucks is low. So again, if one thinks about the energy transition, combining that with our autonomous solution, we do feel good about Resource Industries, particularly in Mining moving forward.

Operator^ And we'll take our next question from David Raso with Evercore.

David Raso^ The question is on the fourth-quarter margins. I know the framework you historically worked within for providing margin guidance, but I must say the fourth quarter, I mean, it's implying a range of EPS that you can drive a truck through.

So, I'm just trying to get a little better sense of -- I think I heard you say the margins in Construction Industries and Resource Industries slightly below the third quarter and Energy & Transportation similar. But then when you gave that – yes, that range of whatever you think your sales are, I mean, we have a rough idea of what you’re thinking for sales given the fourth-quarter guide.

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I'm just trying to get a sense of margins year-over-year, at least appear that they'll be up. Is that a fair statement? But the slight on Resource Industries and Construction Industries almost make it seem like it's down only 100 bps or 150 bps sequentially. So, I apologize for the granularity, but it's just a wide range. I just want to make sure we understand.

Andrew Bonfield^ So obviously, was slightly different so if you got to think about it from a sequential basis and also year-over-year. So, we try to give a little bit of color on both.

On a sequential basis, we do expect both Construction Industries' and Resource Industries' margins to decline. If you think normally, there's a seasonality for both of those. What exacerbates that probably above the normal level of seasonality, particularly in Construction Industries, is the expectation for volume to be impacted by dealer inventory. So that will have a slightly bigger impact than normal on Construction Industries.

On Energy & Transportation, as I said, we expect them to be broadly flat compared to the third quarter. Some of that is due to product mix and timing of international rail deliveries, which are low-margin business. So that's sequential, quarter-over-quarter driving that.

And then if you look year-over-year, obviously, yes, we do expect both Construction Industries and Resource Industries [company removed reference to Energy & Transportation segment] to show margin improvement year-over-year What will slightly offset that will be some increase in corporate items as a result of the true-up of incentive comp that I talked about a moment ago.

On a PPS basis, offsetting that will be some favorability in other income and expense because last year, if you remember, we did have a significant, unfavorable impact from foreign [company removed "big one time charge for"] currency translation losses, which impacted the fourth quarter. So hopefully, that gives you a little bit more color overall, but that's sort of trying to get the way we can guide you from a margin perspective. Hopefully, that's helpful.

Operator^ We will take our next question from Steven Fisher with UBS.

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Steven Fisher^ So, clearly, terrific margins this year. Pricing is such a strong driver at the moment but year-over-year, as you said, is moderating a bit. I'm just curious about your strategy on how to manage in a lower pricing growth environment going forward. I mean, to what extent do you think you can ramp up the cost focus there? And if that's a key part of the plan, kind of what are the biggest opportunities for cost savings next year?

Or do you think sort of a narrower price versus cost is really just the base case from here?

Jim Umpleby^ Well, thank you, Steven. And as we mentioned, we do expect pricing to moderate just based on lapping the price increases that we had last year. We're continually focused on having a lower cost structure. We're looking for ways to reduce structural cost.

A lot of things that are back office now being performed in lower-cost countries, more engineering done in lower-cost countries, looking at ways to become more efficient. I also mentioned the fact that supply chain has improved, but we still have some challenges and some surprises there that create some incremental cost due to inefficiencies based on having shortages.

So, I do believe there's still an opportunity for us moving forward to operate more efficiently in our manufacturing operations and also to find ways to reduce structural costs. We really try to make that a way of life going forward - is always finding ways to reduce structural costs.

Operator^ And we will take our next question from Tim Thein with Citigroup.

Timothy Thein^ Maybe just continuing on that thread there in terms of pricing and just thinking about kind of the outlook into '24. I'm interested from a competitive dynamic, if you look historically, especially focused in Construction Industries in a market with a lot of global competitors and just looking at the Dollar-Yen relationship where it is at near decade-high levels, just maybe talk about what you're seeing, what your dealers

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are seeing from a competitive dynamics and your thoughts into '24 in terms -- and how that interplays with pricing?

Jim Umpleby^ A lot of dynamics there. One, of course, is the strength of the market. So, if you think about the strength of the market in North America for the reasons we described - infrastructure spending and continued growth in residential. And certainly, we feel good about market conditions.

Competition, we've always had competition. We always will. We make pricing decisions based on a whole variety of factors. Certainly, we look at input cost. We look at our competitors.

We look at other factors in the market, and we make decisions. There's no one big decision. We make a whole variety of decisions based on what we're seeing in the market at any one time.

We're always focused on remaining competitive, pricing for value. No one likes to raise prices. But of course, in the last couple of years, we've been in an inflationary cost environment, but we're always looking to add more value to our customers, adding technology, things that make our customers more efficient. And you stop and think about the labor shortage that we have now.

Some of the technology that we're putting into our Construction Industries products allows less experienced operators to be more effective more quickly. And so, all those kinds of things help add value to our customers.

And of course, we’re investing in our digital capabilities and our services capabilities as well to help reduce downtime, unplanned downtime, increase productivity. So that all goes into it. But certainly, we recognize it’s a competitive world out there, always has been and always will be. But we feel confident about our ability to continue to compete effectively.

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

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Nicole DeBlase^ Just on the parts demand, noticed that you guys called out a decline in aftermarket parts in Resource Industries as a driver of volume decline there. If you could talk a little bit about that? And then any color on parts demand in Construction Industries or Energy & Transportation?

Andrew Bonfield^ Within Resource Industries, the volume did decline. It doesn't necessarily mean the absolute dollar value declined, but the volume decline was partly due to dealer buying patterns. And so that was a factor within Resource Industries.

Overall, we're still very comfortable with the growth rate of aftermarket parts volumes. And we'll give you the update as per normal, as I said in my remarks in January. But overall, services revenues still continue to grow and are a very good factor for us, as you know, given our drive to double services revenues to $28 billion by 2026.

Jim Umpleby^ And dealer sales to customers were up in the quarter.

Andrew Bonfield^ Yes.

Operator^ And we will take our next question from Chad Dillard with Bernstein.

Charles Dillard^ More of a bigger picture question. So, I was hoping you could give us an update on your approach to Rental. So, to what extent are you looking to expand your footprint through dealers in this channel? And if you can share how much of the sales today come through this channel today? And then if we do see any near-term air pocket, do you think any expansion could provide an offset?

Jim Umpleby^ We do see Rental as a growth opportunity, and we're working with our dealers to improve our rental business. We set up a new division within the last year or so with an –experienced Senior Vice President leading that division to help increase rental.

The rental industry is, in fact, growing. So, we've been refreshing our rental growth strategy and working with our dealers to allow them to more sustainably grow revenue in Rental. So again, '–we do think it's an opportunity. It's a good one for us to be focused on.

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Operator^ And we will take our next question from Kristen Owen with Oppenheimer.

Kristen Owen^ I was wondering if you could provide a little bit more commentary on the manufacturing cost increase in the quarter, just how to think about that going forward. I mean, this was – this is the easiest comparison of the year and in a more favorable cost environment. So just trying to think about how much of the manufacturing cost increase was maybe related to timing of orders versus we're still seeing some inflation in the supply chain.

Andrew Bonfield^ –It's a bit mixed across the businesses. Material costs are still growing in some areas and other areas growing less rapidly. So that's sort of the bigger part of that from an overall manufacturing cost perspective.

Other factors include things like, particularly for us this quarter, things like absorption impacted us, where we built inventory last year and had inventory reductions this year. But overall, we are seeing lower levels of manufacturing cost inflation that we have done historically and partly offset by some benefits in freight, which are helping us.

Really does depend segment by segment. So, one of the things just to remind everybody, we are not a uniform business as far as we only serve one market. We serve a variety of different markets. Markets are in different parts of the growth phase as a result of post -COVID impact. That means thatsome of those cost increases are coming through in a different way from business-to-business as well as then our ability to price to offset some of that as well.

Operator^ And we will take our next question from Mig Dobre with Baird.

Mircea Dobre^ I wanted to ask a question surrounding dealer inventories. They built 2.6 billion year-to-date, which seems to be a little bit different than the way you were framing expectations.

So, I guess I'm curious, first, how do you expect dealer inventory still exiting 2023? Why is there a bit of a variance relative to your initial expectations? And lastly, if we are indeed going into a bit of a dealer destock mode, does it stand to infer that your

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incoming orders are going to continue to be soft and obviously, backlog continues to erode?

Andrew Bonfield^ So Mig, a couple of comments. One, which we tried to explain in the last quarter. Dealer inventory, we give you one number for 150 independent dealers with a very large number of products underneath that and underpinning it. So, it is very complex.

Secondly, Construction Industries is a slightly different model from Resource Industries and Energy & Transportation. Energy & Transportation and Resource Industries represent about 40% of the increase in dealer inventory. That's really a function of commissioning. Over 70% of those orders are for firm customer orders. They're not sitting on a lot, waiting for somebody to come in and buy them.

Effectively, it's more difficult to predict because it depends on the commissioning time. It's also more difficult to predict because of the nature of the business and how they are moved through. For example, a large mining truck, which is disassembled and then reassembled on site and the revenue recognition coming from the dealer as part of that.

So, it's a very different part of the business. That's why effectively, we almost can't predict that with much certainty. It is much more difficult to predict.

With regard to Construction Industries, we've always had probably normal ranges between 3 and 4 months of inventory. At the moment, we're within that range. Dealers will have within excavator inventory, they're slightly at the top end of that range. They want to bring them down.

We agree with that. We think that's a good thing. That will reduceinventories as we move in. As we've said with Building Construction Products and also with Earthmoving, particularly in North America, which are the largest markets for those products, we are at the low end of the range, and dealers could actually want to hold a little bit more.

So overall, net-net, we do expect a decline in the fourth quarter. It's going to have an impact, possibly. Will there be some impact in the first quarter next year? Probably not.

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Just remind you, we normally see a dealer inventory build in the first quarter of the year getting ahead of ready for summer selling season.

So, it may not be quite as big as normal. But overall, there are some seasonality parts of our business.

With regard to the backlog, backlog is completely different. Remember, for Construction Industries, backlog is a function of dealer orders. For Energy & Transportation and Resource Industries, it's much more of a function of firm customer orders underpinning those.

So as we think about dealers, how much inventory they're holding, as they are able to get better availabilityfor machines, they don't need to order as much in advance. So, one of the things we've done, as you know, through our S&OP process is trying to moderate overorders. And we think we're doing a better job of trying to avoid some of the swings which caused production swings as a result of dealer inventory buying patterns.

Overall, just to remind you, finally, we still expect sales to users to grow in the fourth quarter of this year. We're still expecting end demand to remain strong, and that sets us up into 2024 as we move forward.

Operator^ And we will take our next question from Mike Shlisky with D. A. Davidson.

Michael Shlisky^ I wanted to ask about interest rates real quick. On interest rates, you kind of touched on it, but maybe a little more color. How have high interest rates or higher interest rates affected the dealership inventory desire and their ability to actually pull and carry inventory? And secondly, maybe how is interest rates -- have they affected any end user appetite to buy any equipment?

Andrew Bonfield^ So first of all, let me say on higher interest rates, probably today, just remind you that even though there are many of us who remember 5% has been the norm of interest rates. I know we've lived through lower for the last decade.

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Overall, though, it's really a function of dealers hold inventory based on what their expectations of future demand are. -- They are comfortable holding current levels of inventory. And as I said, we'd like to hold more for particularly Building Construction Products and Earthmoving products and hold a little bit less of excavators. But that's a reflection of their expectations of sales to users rather than actually of interest rates.

I think they're a little bit less sensitive to that assuming that they can actually sell the equipment on. As far as actually our customers are concerned, where it does impact us within Caterpillar is in Cat Financial. We have seen a slight reduction in the share of new machines we are financing within Cat Financial because we fund in the wholesale market. So, we're slightly less competitive against banks.

They have to work. So, they haven't been sensitive to interest rates as far as buying machines is concerned.

And overall, if you look, and it's one thing we keep a very close focus on, write-offs, past dues and the like and provision levels, our customers are in very robust shape and do not appear to be be impacted by the higher interest rates yet. So, nothing we've seen yet tend to indicate that there's any impact of that today on that business.

Operator^ We will take our next question from Jerry Revich with Goldman Sachs.

Jerry Revich^ Jim, I'm wondering if you could just talk about where lead times stand in mining equipment. I know it's a broad range of products, but can you get us a sense for how far visibility you have?

And if you're willing to quantify the comments you made earlier about really good pipeline just within the context of relative to the really strong bookings rate we've had year-to-date, any way to quantify the pipeline versus the bookings run rate we've been at?

Jim Umpleby^ So, we have been working hard to bring lead times down, as I mentioned. We do feel good about where we are in that process. We had over the last couple of years, some real challenges around availability, but it has gotten better in

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most areas. Probably the area that's still a challenge is large engines but you know in mining, we do feel good about the progress we've made around lead times.

Andrew Bonfield^ As far as the quoting activity, there is a lot of activity, Jerry, going on. As we've said, we would have anticipated more of that coming into order rates. There seem to be some slight delay in actually pushing the button on committing to firm orders as we have seen.

Operator^ Today's final question will come from the line of Steve Volkmann with Jefferies.

Stephen Volkmann^ I just wanted to go back to Rental, if I could. And I'm curious, Jim, would you characterize the CAT dealer rental fleets in terms of size? Do they want more equipment? And can you also just comment on what you think the age would be in that CAT rental fleet?

Jim Umpleby^ One of the things that's been happening over the last year or so is that there has been some upgrading of that fleet because it had gotten quite old because of some of the supply challenges we've had. I'm reluctant to characterize the size of that in total.

But again, we are working with our dealers to help them grow rental. We want them to have a successful, profitable rental business. And that means having the right size of rental inventory for the amount of business that they execute.

So again, it has been a bit aged. It's improved a bit, but there's still some room there to have newer machines going into the fleet because it had, again, it gotten quite aged.

And again, our expectation here is as we grow Rental that the fleet should grow. But again, the goal is not to have a bigger sized rental fleets. The goal is to have profitable, growing rental businesses by our dealers, which they want to be as efficient as they can with turns. But over time, that should result in larger rental fleets.

All right. Well, thank you. That was our last question. Thanks all for joining us, and we always appreciate your questions.

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I'd like to just close by thanking our team for another great quarter. As I mentioned earlier, due to our strong results in the third quarter, we now do believe that 2023 will be even better than we had previously anticipated during our last call, and that includes higher full year expectations for adjusted operating profit margin and ME&T free cash flow. And that reflects continuing healthy customer demand and our strong operating performance.

And we're continuing to execute our strategy and invest for long-term profitable growth. And we'll look forward to updating you again in February.

Ryan Fiedler^ Great. 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 third quarter results video with our CFO and an SEC filing with our sales to users data.

Click on investors.caterpillar.com then click on financials to view those materials.

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

Now we'll turn it over to Abby to conclude the call.

Operator^ Thank you. Ladies and gentlemen, this concludes today's call. We thank you for your participation. You may all disconnect.

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