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Caterpillar, Inc.; Chairman and Chief Executive Officer

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PRESENTATION:

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Operator^ Ladies and gentlemen, welcome to the Fourth Quarter 2023 Caterpillar Earnings Conference Call. Please be advised that today's conference is 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 fourth 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 Director of IR.

During our call, we'll be discussing the fourth 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.

The content of this call is protected by U.S. and international copyright law. Any rebroadcast, retransmission, reproduction or distribution of all or part of this content without Caterpillar's prior written permission is prohibited. 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.

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 our earnings call slides. Now, let's turn to 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 2023, I'd like to start by recognizing our global team for delivering another strong quarter and the best year in our 98-year history. For the year, we delivered record sales and revenues, record adjusted operating profit, record adjusted profit per share and record ME&T free cash flow (company clarified after the call). Our results continue to reflect healthy demand across most of our end markets for our products and services. We remain focused on executing our

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strategy and continuing to invest for long-term profitable growth.

I'll begin with my perspectives about our performance in the quarter and for the full year. I'll then provide some insights about our end markets, followed by an update on our strategy and sustainability journey.

Moving to quarterly results, it was another strong quarter. While sales and revenues increased 3% in the fourth quarter versus a strong quarter last year, our adjusted operating profit increased by 15%. Adjusted operating profit margin improved to 18.9%, up 190 basis points versus last year. We also generated \$3.2 billion of ME&T free cash flow in the quarter.

Sales, adjusted operating profit margin, adjusted profit per share and ME&T free cash flow in the fourth quarter were all better than we expected. For the full year, we generated a 13% increase in total sales and revenues to \$67.1 billion. Services also increased by 5% to \$23 billion, a record.

We generated \$13.7 billion of adjusted operating profit in 2023, up 51% from 2022. Adjusted operating profit margin for the full year was 20.5%, a 510-basis-point increase over the prior year. This exceeded the top end of our target margin range, for this level of sales, by 80 basis points. Adjusted profit per share in 2023 was \$21.21, a 53% increase over 2022.

In addition, we also generated \$10 billion of ME&T free cash flow, exceeding the high end of our target range by over \$2 billion for the full year. This performance led to continued growth in absolute OPACC dollars, which is our internal measure of profitable growth. As a result of our strong execution and record financial performance, we are increasing our target range for adjusted operating profit margin and ME&T free cash flow. We are increasing the top end of our adjusted operating profit margin range by 100 basis points relative to the corresponding level of sales.

Moving to ME&T free cash flow. We've generated more than \$30 billion over the last five years, including a record \$10 billion in 2023. Based on our demonstrated ability to generate strong ME&T free cash flow, we are raising our ME&T free cash flow target range to \$5 billion to \$10 billion, up from \$4 billion to \$8 billion. Andrew will provide additional details around these updated targets.

Turning to Slide 4. In the fourth quarter of 2023, sales and revenues increased by 3% to \$17.1 billion, driven by favorable price realization and partially offset by lower volume. Both price and volume were slightly better than we expected. Compared to the fourth quarter of 2022, overall sales to users increased 8%, slightly better than our expectations.

Energy & Transportation sales to users increased 20%. For machines, which includes Construction Industries and Resource Industries, sales to users rose by 3%. Sales to users in

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Construction Industries were up 4%. North American sales to users increased as demand remained healthy for non-residential and residential construction. Non-residential continued to benefit from government-related infrastructure and construction projects.

Residential sales to users in North America also increased in the quarter. Sales to users in EAME and Latin America were down slightly relative to a strong comparative. In Asia Pacific, sales to users declined in the quarter.

In Resource Industries, sales to users increased 1%. In Mining, sales to users also increased. And in Heavy Construction and Quarry and Aggregates, sales to users declined against a strong comparative in 2022. In Energy & Transportation, sales to users increased by 20%. 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 gas compression and well-servicing Oil and Gas applications, including the Tier 4 dynamic gas blending engines used in well-servicing fleets. Power Generation sales to users continued to remain positive due to favorable market conditions, including strong data center growth.

Transportation sales to users also increased, while Industrial declined from historically strong levels in 2022. Dealer inventory decreased by \$900 million versus the third quarter. Machines declined by \$1.4 billion, slightly more than we expected. We saw the largest decline in Construction Industries, as dealer inventory decreased across all regions. The largest decline was in Excavators.

We remain comfortable with the total level of machine dealer inventory, which is within the typical range. Adjusted operating profit margin increased to 18.9% in the fourth quarter, a 190-basis-point increase over last year. Adjusted operating profit margin was slightly better than we had anticipated. Relative to our margin expectations, we saw higher price realization and higher sales volume, both marginally better than expected.

Turning to Slide 5. I'll now provide full year highlights. In 2023, we generated sales and revenues of \$67.1 billion, up 13% versus last year. This was due to favorable price and higher sales volume, driven primarily by higher sales of equipment to end users. As I mentioned, we generated \$23 billion of services revenue in 2023, a 5% increase over 2022.

We continue to see improvement of Customer Value Agreements with new equipment, which remains an important part of our services growth initiatives. We saw strong eCommerce sales growth as we continue to enhance our digital tools to make it easier for customers to identify and purchase the right parts. We added more than 100,000 new customers to our online channel. We also exceeded the eCommerce goal we shared at our May 2022 Investor Day.

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By combining the data from more than 1.5 million connected assets with our engineering expertise, advanced analytics and AI, we are helping customers avoid unplanned downtime through intelligent leads, which we call Prioritized Service Events, or PSEs. We continue to execute our various service initiatives as we strive to achieve our 2026 target of \$28 billion. Our full-year adjusted operating profit margin was 20.5%, a 510-basis-point increase over 2022.

Moving to Slide 6. We generated strong ME&T free cash flow of \$10 billion in 2023, a \$3.7 billion or 58% increase over our previous record. We returned a record \$7.5 billion to shareholders through repurchased stock and 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 7, I'll describe our expectations moving forward. Overall demand remains healthy across most of our end markets for our products and services. We ended 2023 with a backlog of \$27.5 billion, which remains elevated as a percentage of revenues compared to historical levels.

We currently anticipate 2024 sales and revenues to be broadly similar to the record 2023 level. We expect continued strength in end user demand, including services growth, and a slight benefit from carryover pricing, offset by a dealer inventory headwind, which was a \$2.1 billion benefit in 2023.

We currently do not anticipate a significant change in dealer inventory of machines in 2024 as compared to an increase in 2023.

Now I'll discuss our outlook for key end markets, starting with Construction Industries. In North America, after a very strong 2023, we expect the region to remain healthy in 2024. We expect non-residential construction to remain at similar demand levels due to government-related infrastructure investments. Residential construction is expected to remain healthy relative to historical levels.

In Asia Pacific, excluding China, we are seeing some softening in economic conditions. We anticipate China will remain at a relatively low level for the above 10-ton excavator industry. In EAME, we anticipate the region will be slightly down due to economic uncertainty in Europe, somewhat offset by continuing strong construction demand in the Middle East. Construction activity in Latin America is expected to increase due to easing financial conditions. In addition, we also anticipate the ongoing benefit of our services initiatives will positively impact Construction Industries in 2024.

Next, I'll discuss Resource Industries. After strong performance in 2023 in Mining, Heavy Construction and Quarry and Aggregates, we anticipate lower machine volume versus last year, primarily due to off-highway and articulated trucks. In addition, we anticipate a small decrease in dealer inventory during 2024 versus a slight increase in dealer inventory last year.

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While we continue to see a high level of quoting activity overall, we anticipate lower order rates as customers display capital discipline. We expect to see higher services revenues, including robust rebuild activity.

Customer product utilization remains high, the number of parked trucks remains low, the age of the fleet remains elevated and our autonomous solutions continue to see strong customer acceptance. 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.

Moving to Energy & Transportation. In Oil and Gas, we expect reciprocating engines and services to increase slightly after a strong 2023. As we said during the last two quarters, well servicing in North America is showing some short-term moderation. Gas compression order backlog remains healthy, and overall, we continue to remain optimistic about future demand.

CAT reciprocating engine demand for Power Generation is expected to remain strong due to continued data center growth. Solar turbines has a strong backlog and continues to experience robust quoting activity. As we said in the last quarter, Industrial demand is expected to soften in the near-term from a strong 2023. In Transportation, we anticipate high-speed marine to increase slightly as customers continue to upgrade aging fleets.

Moving to Slide 8. Now I'll provide an update on our strategy and sustainability journey. Over the past year, we have discussed constraints for our large engines, given the robust demand in Power Generation for data centers and in Oil and Gas. We believe that our total addressable market is expanding due to the secular growth trend for data centers relating to cloud computing and generative AI. We also expect the energy transition to create opportunities for distributed generation.

As more renewables are added to the grid, our reciprocating engine and gas turbine generator sets can help provide grid stability. We are making a large, multi-year capital investment in our large engine division, including increasing capacity for both new engines and aftermarket parts. This will help us satisfy growing customer demand and contribute to future absolute OPACC dollar growth, which we believe has the highest correlation to total shareholder return over time.

We continued to advance our sustainability journey in 2023. I'll highlight some recent announcements demonstrating our commitment to a reduced-carbon future. Caterpillar has a goal that 100% of new products will be more sustainable than the previous generation, including by lowering fuel consumption and thus, corresponding emissions.

One recent example is our 420 XE backhoe loader with the CAT C3.6 engine. Through internal testing in a typical mix of applications, it consumed up to 10% less fuel and produced up to 10%

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less tailpipe emissions than the previous model. Earlier this year, we announced the success of our collaboration with Microsoft and Ballard Power Systems to demonstrate the viability of using large-format hydrogen fuel cells to supply reliable and sustainable backup power for data centers.

The demonstration validated the hydrogen fuel cell power system's performance at more than 6,000 feet above sea level and in below-freezing conditions. Caterpillar led the project, providing the overall system integration, power electronics and microgrid controls that form the central structure of the hydrogen power solution. These examples reinforce our ongoing sustainability leadership. With that, I'll turn it over to Andrew.

Andrew Bonfield^ Thanks, Jim. And good morning, everyone. I'll begin with commentary on the fourth quarter results, including the performance of our segments. Then I'll discuss the balance sheet and cash flow, followed by an update to our target ranges for adjusted operating profit margins and ME&T free cash flow. I'll conclude with our high-level assumptions for 2024 and our expectations for the first quarter.

Beginning on Slide 9. Strong operating performance continued in the fourth quarter as sales and revenues, adjusted operating profit margin, adjusted profit per share and ME&T free cash flow were all better than we had expected. In summary, sales and revenues increased by 3% to \$17.1 billion. Adjusted operating profit increased by 15% to \$3.2 billion. The adjusted operating profit margin was 18.9%, an increase of 190 basis points versus the prior year.

Profit per share was \$5.28 in the fourth quarter compared to \$2.79 in the fourth quarter of last year. Profit per share in the quarter included favorable mark-to-market gains of \$0.14 for the remeasurement of pension and OPEB plans and certain favorable deferred tax valuation adjustments of \$0.04. It also included restructuring costs of \$92 million or \$0.13.

Adjusted profit per share increased by 35% to \$5.23 in the fourth quarter compared to \$3.86 last year. The provision for income taxes in the fourth quarter, excluding the amounts relating to mark-to-market and discrete items, reflected a global annual effective tax rate of 21.4%. This was lower than we had expected a quarter ago due to favorable changes in the geographic mix of profits. The lower rate benefited performance in the quarter by about \$0.24.

Moving on to Slide 10. I'll discuss top line results in the fourth quarter. The 3% sales increase versus the prior year was primarily driven by price realization, partially offset by lower volume as impacts from dealer inventory changes more than offset the 8% increase in sales to users. Both price and volume were slightly better than we had anticipated.

The dealer inventory change resulted in an unfavorable sales impact of \$1.6 billion versus the prior year. Dealer inventory decreased in the fourth quarter by \$900 million overall compared to an increase of approximately \$700 million during the fourth quarter of 2022. The dealer

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inventory decrease in the fourth quarter was led by Construction Industries, where the reduction was at the high end of our expectations.

The decrease in this segment was led by Excavators and the impact of the CAT engine changeover in Building Construction Products that we have mentioned in previous earnings calls. Dealers also reduced their inventories in Resource Industries. Overall, the decrease in dealer inventory of machines was \$1.4 billion in the quarter.

Conversely, dealer inventory in Energy & Transportation increased mostly due to extended commissioning timelines, resulting from strong shipments, which were supported by healthy demand.

As a reminder, dealer inventory in both Energy & Transportation and Resource Industries is mainly a function of the commissioning pipeline, and over 70% of dealer inventory in these segments is backed by firm customer orders.

Looking at sales by segment, sales in Construction Industries and Energy & Transportation were slightly higher than we had anticipated, while sales in Resource Industries were about in line with our expectations. Moving to operating profit on Slide 11. Adjusted operating profit increased by 15% to \$3.2 billion. Price realization and favorable manufacturing costs benefited the quarter, while higher SG&A and R&D expenses and lower sales volumes acted as a partial offset.

The increase in SG&A and R&D expenses was primarily driven by higher short-term incentive compensation expense and strategic investment spend. The adjusted operating profit margin of 18.9% improved by 190 basis points versus the prior year. Margins were slightly higher than we had anticipated on volumes and price being marginally better than we had expected.

Now on Slide 12. Construction Industries sales decreased by 5% in the fourth quarter to \$6.5 billion due to lower sales volume, partially offset by favorable price realization. Lower sales volume was primarily due to the changes in dealer inventories that I mentioned earlier and more than offset the favorable sales to users. The dealer inventory changes impacted all of the regions.

By region, sales in North America increased by 4%. In Latin America, sales decreased by 25%. Sales in EAME decreased by 18%. This region accounted for the largest dealer inventory decline in the quarter. In Asia Pacific, sales decreased by 4%.

Fourth quarter profit for Construction Industries was \$1.5 billion, an increase by 3% versus the prior year. The increase was primarily due to favorable price, partially offset by the profit impact from lower sales volume. The segment's operating margin of 23.5% was an increase of 180 basis points versus last year. This is broadly in line with our expectations.

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Turning to Slide 13. Resource Industries' sales decreased by 6% in the fourth quarter to \$3.2 billion. The decrease was primarily due to lower sales volume, partially offset by favorable price realization. Lower volume was impacted by changes in dealer inventories as dealers decreased inventories during the fourth quarter of 2023 compared to an increase in the prior year's quarter.

Volume was also impacted by slightly lower aftermarket parts sales volume, partly due to dealer buying patterns. Fourth quarter profit for Resource Industries decreased by 1% versus the prior year to \$600 million. The segment's operating margin of 18.5% was an increase of 90 basis points versus last year and was in line with our expectations.

Now on Slide 14. Energy & Transportation sales increased by 12% in the fourth quarter to \$7.7 billion. The increase was primarily due to higher sales volume and favorable price realization. Sales volume benefited from higher shipments of large engines and Solar turbines and turbine-related services in the quarter.

By application, Oil and Gas sales increased by 23%, Power Generation sales were higher by 29%, Industrial sales decreased by 5% and Transportation sales increased by 11%. While Industrial sales decreased, they remain at healthy levels.

Fourth quarter profit for Energy & Transportation increased by 21% versus the prior year to \$1.4 billion. The increase was primarily due to favorable price and higher sales volume, partially offset by higher SG&A and R&D expenses, currency impacts and unfavorable manufacturing costs. The increase in SG&A and R&D expenses reflected ramping investments related to strategic growth initiatives and higher short-term incentive compensation expense.

As a reminder, most of our strategic investments relating to electrification and alternative fuels are in Energy & Transportation, which therefore, impacts this segment's margin. The operating margin of 18.6% was an increase of 130 basis points versus the prior year. Margin exceeded our expectations on higher volume, including favorable mix, and price.

Moving to Slide 15. Financial Products revenues increased by 15% to \$981 million, primarily due to higher average financing rates across all regions and higher average earning assets in North America. Segment profit increased by 24% to \$234 million. The increase was mainly due to a lower provision for credit losses at Cat Financial, higher average earning assets and a higher net yield on average earning assets.

Our portfolio continues to perform well with past dues near historic levels of 1.79%. We saw a 10-basis-point improvement compared to the fourth quarter of 2022 and a 17-basis-point improvement compared to the third quarter. This is the lowest fourth quarter past dues percentage since 2006.

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The year-end allowance rate was our lowest fourth quarter rate on record at 1.18% and was the second lowest quarterly rate ever. In addition, provision expense in 2023 was at the lowest level we've seen in over 20 years. Business activity remains strong, as retail new business volume increased versus the prior year and the third quarter. The increase versus the prior year reflected higher end user sales and rental conversions in the U.S.

In addition, we continue to see strong demand for used equipment. Though used inventories have ticked up slightly, they remain close to historically low levels. Despite some moderation in used pricing on improved availability, it is still comfortably above historic norms.

Moving on to Slide 16. The record \$10 billion in ME&T free cash flow for the year included \$3.2 billion in the fourth quarter, an increase of \$200 million versus the prior year. On CapEx, we continue to make disciplined investments that are right for our business, governed by our focus on growing absolute OPACC dollars. We spent about \$1.7 billion in 2023.

Looking to 2024, we expect CapEx in the range of \$2 billion to \$2.5 billion. This is higher than our recent run rate and includes the investment in large engine capacity, which Jim referenced a moment ago. We also plan to invest more around AACE, which is autonomy, alternative fuels, connectivity & digital and electrification. In addition, we are investing to make our supply chain more resilient.

Moving to capital deployment. We returned \$3.4 billion to shareholders in the fourth quarter, including \$2.8 billion in share repurchases. Our net share count has decreased by approximately 14% since 2019, when we shared our intention to return substantially all ME&T free cash flow to shareholders over time and on a consistent basis.

Our dividend remains a priority as we increased our quarterly payout by 8% in 2023. You will recall from our Investor Day in 2022, we shared that we expected to increase our dividend by at least high single digits for the next three years. The increase in 2023 reflected the second of those three years. Our balance sheet remains strong. We have ample liquidity with an enterprise cash balance of \$7 billion, and we hold an additional \$3.8 billion in slightly longer-dated liquid marketable securities to improve yields on that cash.

Now on Slide 17, I'll discuss our revised adjusted operating profit margin targets. We exceeded our progressive target range in 2023, and we are confident that our strong execution and operating performance supports the potential for higher top end adjusted operating profit margins than were reflected in the prior range. Therefore, we have increased the top end of the range by 100 basis points relative to the corresponding level of sales.

Achieving the top end of the range will remain challenging, as we are committed to increase investments in our strategic initiatives supporting long-term profitable growth. The bottom end of the target range remains unchanged.

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To explain, while higher gross margins support increasing the top end of the range, they actually pressure our margins in periods of decreasing volume. For that reason, we believe that the bottom end of the range remains challenging, but achievable. We will now target adjusted operating profit margins of 10% to 14% at \$42 billion of sales and revenues, increasing to 18% to 22% at \$72 billion of sales and revenues.

Now on Slide 18. When I joined Caterpillar just over five years ago, I was impressed with the potential of our business to deliver higher, more consistent ME&T free cash flow as a result of the Operating & Execution model and our focus on generating absolute OPACC dollars. This is how we define winning at Caterpillar. We believe increasing absolute OPACC dollars will lead to higher shareholder returns over time.

Since the beginning of 2019, we have generated \$30 billion in ME&T free cash flow, including a record \$10 billion in 2023. We are confident in our ability to consistently generate positive ME&T free cash flow over time. Therefore, we are introducing an updated target range for ME&T free cash flow, which is between \$5 billion and \$10 billion. Our strong operating performance as well as confidence in our future execution supports the higher range.

The updated target range still maintains our flexibility to invest in our strategic initiatives, which is a priority. We also continue to expect to return substantially all of our ME&T free cash flow to shareholders over time through dividends and share repurchases.

Moving to Slide 19. I will share our high-level assumptions for the full year. As Jim mentioned, in 2024, we anticipate sales and revenues will be broadly similar to 2023. We expect slightly favorable price realization and continued healthy underlying demand across the business as a whole. We anticipate another year of services growth as we continue to target \$28 billion by 2026.

We do not expect a significant change in dealer inventory for machines by the end of this year. And for Energy & Transportation, it is difficult to predict with certainty what will happen to dealer inventory as we have discussed previously. In total, dealer inventory increased by \$2.1 billion in 2023.

By segment, in Construction Industries, sales of equipment to end users should remain roughly similar compared to the strong year we saw in 2023. However, we do not expect a dealer inventory build as we saw last year. We also anticipate our services initiatives will benefit the segment in 2024.

In Resource Industries, we anticipate lower sales versus 2023, impacted by lower machine volume primarily in off-highway and articulated trucks. We had strong sales of these products in 2023 as we converted our elevated backlog into sales, making for a challenging comparison.

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We also anticipate an unfavorable year-over-year change in dealer inventories. However, we expect services revenues will increase in this segment.

In Energy & Transportation, we expect slightly higher sales in 2024. Power Generation, Oil and Gas and Transportation sales should be positive, while Industrial sales are expected to be lower compared to our historically strong levels in 2023.

On full year adjusted operating profit margin, we currently expect to be in the top half of the updated margin target range at our expected sales levels. I'll discuss some of the puts and takes. In 2024, we expect a small pricing benefit weighted towards the first half of the year given carryover from increases taken in the second half of 2023. For the full year, we expect price to modestly exceed manufacturing costs. Versus last year, price in absolute dollar terms should moderate as we lap the more favorable pricing trends from 2023.

Short-term incentive compensation expense was about \$1.7 billion in 2023, while we anticipate \$1.2 billion in 2024. We expect the benefit of that lower expense will be offset by increases in SG&A and R&D expenses as we continue to invest in strategic initiatives aimed at future long-term profitable growth. Investments are focused in services, new product introductions and AACE.

We also anticipate there may be some negative margin impact due to mix this year. I'll explain. During 2023, when availability was somewhat challenged, we biased our production and shipments to products with the highest OPACC potential. Given that availability has improved, we anticipate a more normalized mix of products in 2024. We may also see an impact on margins from the mix of different segments as we anticipate sales in 2024 will be slightly more weighted towards Energy & Transportation than they were in 2023.

Moving on, we expect to be within the top half of our updated ME&T free cash flow target range of \$5 billion to \$10 billion. As you consider our cash position, keep in mind the \$1.7 billion cash outflow in the first quarter related to the payout of last year's incentive compensation expense. We also anticipate restructuring charges of \$300 million to \$450 million this year. Finally, we expect a global effective tax rate in the range of 22.5% to 23.5%, an increase versus the 21.4% in 2023.

Now on Slide 20. Our expectations for the first quarter, starting with the top line. We expect first quarter sales and revenues to be broadly similar to the prior year. We anticipate price to be favorable, although significantly less in absolute dollar terms than had occurred through 2023. We expect demand to remain healthy. However, we anticipate a slightly lower dealer inventory build for machines in the first quarter compared to a \$1.1 billion build in the first quarter of 2023. This will act as a headwind to sales.

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At the segment level, in Construction Industries, we anticipate flattish to slightly higher first quarter sales versus the prior year, primarily due to favorable price. We anticipate lower sales in Resource Industries compared to the prior year, driven by lower volume, partially offset by favorable price. In Energy & Transportation, we expect flattish to slightly higher sales versus the prior year, with favorable volume benefiting the upside scenario.

On margins, we expect the enterprise adjusted operating profit margin in the first quarter to be broadly similar to the prior year. Price should more than offset manufacturing costs as price actions from 2023 roll into 2024. We expect price will be lower in absolute dollar terms versus the prior year. We anticipate manufacturing costs to increase compared to last year, principally impacted by cost absorption as we do not expect an inventory build like we saw in the first quarter of 2023. We also anticipate an increase in SG&A and R&D expenses related to strategic investment spend.

By segment, in Construction Industries, we anticipate a similar margin as compared to the prior year. We expect price to offset strategic investment spend and slightly higher manufacturing costs, including cost absorption. In Resource Industries, we expect a lower margin compared to the prior year, impacted by lower volume, partially offset by favorable price. In Energy & Transportation, we anticipate a similar margin versus the prior year as slightly stronger price should be offset by higher manufacturing costs.

Turning to Slide 21. Let me summarize. Adjusted profit per share of \$21.21 exceeded our previous full year record by 53%. We exceeded the top ends of our targeted ranges for adjusted operating profit margin and ME&T free cash flow. We have increased the top end of our adjusted profit margin range, and we have raised our ME&T free cash flow target range.

We expect to be in the top half of our updated margin and ME&T free cash flow target ranges in 2024, and we anticipate another year of services growth as we continue to execute our strategy for long-term profitable growth. And with that, we'll take your questions.

Operator^ (Operator Instructions) And your first question comes from the line of Rob Wertheimer with Melius Research.

Robert Wertheimer^ My question is on inventory, kind of at all levels. You had a healthy destock in the quarter. I think your volumes were down around 4%, retail sales up 8%, and so that's nice. I wanted to see inventory versus what you expect out of the business at the dealer level, at your finished goods level, and also at your WIP/raws, where your own inventories have been elevated. So just, how do you feel the business is performing at those levels? And then what's the path from here, especially on your own inventory?

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Jim Umpleby^ Starting with our inventory, as we discussed in previous calls, just because of the supply chain constraints we've had, our internal manufacturing operations are not running as efficiently as I would like. We still have an opportunity to do a better job there.

Certainly, the supply chain constraints have started to ease, and that's made things a bit easier, but we still are dealing with some areas of constraint. So again, I think we have opportunities there, and we'll continue to work on that and try to get more lean.

In terms of dealer inventory, we talked about it in our prepared remarks. Of course, dealers are independent businesses, make their own decisions. And their decisions on inventory are a combination of what they see in future demand. But also, availability and our ability to reduce lead times allows them and our customers to place orders later. So again, we've talked about the fact that we don't expect a significant change in dealer inventories in 2024, but again, they're independent businesses and will make their own decisions.

Andrew Bonfield^ Yes. Just a couple of things to add. I mean if you look at our days inventory outstanding, Rob, it's running at about 15% to 20% higher than historic levels. So that gives us an opportunity over the next several years to work that down in a way that manages also from a supply base perspective, not to create undue problems for them in their outlook. So, we'll continue to look at that.

And then just to mention on dealer inventory, particularly within Construction Industries, dealer inventory is about the middle of the target range we talk about: three to four months [of sales] (company clarified after the call). So, it's pretty much bang on there. So, dealers are holding what probably we would continue to expect them to hold.

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

Michael Feniger^ You guys just reported a record sales and earnings. There's a view that many of your businesses are operating at peak levels. I'm curious when you look at your overall portfolio, especially maybe on a unit basis versus prior cycles, are there areas and regions where you feel like your business is still not operating at peak levels or record levels?

Do you feel if as we go in the back half of this year, if rates come down, financial conditions ease, is there a torque in areas of your business where you feel like the backlog could start to maybe bottom and pick up as those conditions start to get a little bit better through the year?

Jim Umpleby^ Thanks for your question. Maybe just to talk about some of the areas that we're most excited about as we move forward.

And without putting a time dimension on this, but one of the things that we've talked about is that we believe that the energy transition will increase demand for commodities over time,

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thereby expanding our total addressable market. So, as we look forward and you think about the increased adoption of things like EVs and the amount of minerals that will need to be produced by our mining customers to satisfy that demand, we believe that, creates an opportunity for us moving forward over the next few years.

And also, we're very excited about the opportunities around large engines. There's a secular growth trend going on in data centers related to cloud computing and generative AI. And so, we're very excited about that. We're making an investment to increase our large engine capacity.

So again, we believe that is an area of increase in our total addressable market as well. And just thinking about around the world, one of the things we talked about in previous calls is the fact that our market in China is relatively weak. Over time, that market has been 5% to 10% of enterprise sales, and we had strong years in China in 2020 and 2021. We saw a decline in 2022, a further decline in 2023, and we expect that market to still be relatively weak again this year.

We're not in a situation where we're hitting on all cylinders in all markets around the world, both from a product and geographic perspective. Europe, we do believe there's opportunities there over time depending on what happens in the economic cycle. So again, it's not a situation where if you look around the world, we're hitting at all the cylinders going as good as they can. We believe we have opportunities here.

Operator^ And your next question comes from Tami Zakaria, JPMorgan.

Tami Zakaria^ My question is more a medium to long term in nature. So, services growth was 5% in 2023. If you want to hit the \$28 billion target, it seems like growth would need to accelerate from that to, call it, a high single-digit percent number over the next three years annually.

So, can you help us understand what could drive this acceleration in growth? And do you need industry growth to remain positive during these next three years to support that aspiration? Or can services grow independent of the end market or industry growth?

Jim Umpleby^ Well, thank you for your question. We've been pleased by the progress we've made. You recall, we started with that 2016 baseline of \$14 billion, and we have increased it to \$23 billion. Our teams continue to strive to achieve that \$28 billion number.

And one of the things we said when we laid out the target is we didn't expect it to be in a straight line. We thought it would be relatively back-end loaded. But we continue to invest in our digital capabilities, eCommerce. I talked earlier about Customer Value Agreements and the other things that we're doing. We're working very closely with our dealers as well.

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So, we do believe that there's an opportunity, regardless of industry growth to increase services. And again, we continue to strive to achieve that number.

One of the things that we also would note is STUs were positive as well. And one of the things that impacts, our services sales is dealer buying patterns around parts, but we're encouraged by the fact that STUs were positive.

Operator^ And your next question comes from David Raso with Evercore ISI.

David Raso^ First, just a clarification in your answer, if you could. The operating margin guidance, I know you have the sales framework, but just if you can just help us, do you expect your operating margins to be flat, up or down for the year?

But my real question is the backlog. I'm just trying to understand the size of the backlog. The relationship it usually has with next year's sales would imply a lot stronger growth than you're forecasting? And I'm just trying to understand maybe the orders in the quarter were okay. The dealer inventory drag, right, the growth last year, but not growth this year, that's a drag year-over-year. That wouldn't really account for where the sales would normally be guided for next year with this level of backlog.

So, I'm just trying to put my head around, with that size of backlog, the flat sales, is that a concern that -- again, the orders were good for the quarter, that you're seeing slower orders coming? Just trying to correlate that backlog to only flat sales.

Andrew Bonfield^ Let me start on the backlog and then talk about margin guidance afterwards. On backlog, obviously, backlog conversion varies. The one thing you should always think about is backlog is not a single type of activity. It's not just related to, for example, machines. Some of it is related to large engines and some of it is related to Solar.

Not all of those elements of the backlog actually are in 2024. Some of those will convert in 2025 and beyond. And why you wouldn't actually necessarily convert that. But that's part of it.

Again, just when we talk about guidance and what we're guiding around flattish sales and also around top half of the margin ranges, we are talking about ranges of outcomes. Obviously, it's the beginning of the year. We've indicated where there will be some puts and takes. But obviously, performance this year has been exceptional.

Our aim is to continue to drive to that level of performance. That's what we're focused on. And I think that's what the organization is focused on as well.

Operator^ Your next question comes from Nicole DeBlase with Deutsche Bank.

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Nicole DeBlase^ Just a few on parts. So, if you could elaborate on the parts decline that you saw in Resource Industries. Any color on the magnitude of parts growth that you might expect for '24? And then how would you characterize parts inventory levels in the dealer network right now?

Andrew Bonfield^ So, as we talked about, I mentioned part of the decline in parts sales in Resource Industries was related to dealer buying patterns. We're talking about dealer inventory, that's machines and engines. It's not actually parts. And what we did see as availability improved as we went through 2023, we did see dealers reduce their inventory a little bit.

It's probably more at normalized levels now. Obviously, they'll continue to monitor it. They make their independent decisions. And as we always remind you, it's very complex, with over 150 dealers globally and a large number of parts that they order, but they obviously try and optimize their network.

[In 2024], we do expect a benefit from services revenues growth (company clarified after the call). Obviously, if we are to achieve our target, we would hope for a little bit of an acceleration versus what we saw in 2023. That does depend a little bit on what happens with the dealers and buying patterns.

And on Resource Industries, given the amount of truck utilization, we do expect services revenues to improve as we go through 2024 based on the need for rebuilds, particularly the large mining trucks. So that's where we are on services.

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

Mircea Dobre^ Yes. Going back to Construction Industries, I'm curious to get your thoughts in terms of how you think about margin here. And it sounds like you're guiding Q1 flat margin year-over-year, which would be tremendous given the comp there. Are margins sustainable at this level? Is there any insight you can give us as to how you see the year progressing beyond Q1?

Andrew Bonfield^ There's going to be a couple of things, Mig, which are going to happen as we go through 2024. The one that's a little bit hard to predict at the moment is any potential mix impact. As we said, when we were going through 2023, we biased our production towards machines with the highest levels of OPACC. That's what customers wanted as well. So met customer demand, particularly those products.

We expect a more normal mix product. That may have some impact on margins as we go through the year. Obviously, it's a little bit difficult to predict at this stage, given that we're at the beginning of the year, but that potentially is the one. We will continue to invest in the business. We are continuing to drive services and services growth.

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As you know, that's a possible upside potential, particularly in Construction Industries, where we have the largest opportunity. So those are the sort of big things or big buckets I would look at as we think through 2024. And both of those, one will be slightly negative and the other one possibly will be slightly more positive. So those are the sort of puts and takes at the moment.

Operator^ And your next question comes from Jerry Revich with Goldman Sachs.

Jerry Revich^ Jim, Andrew, I'm wondering if you could just say more about the increase to the free cash flow guidance, a bigger increase there than on the margin framework. And we're a couple of years away, where you folks in 2020 were below the \$5 billion number. So, can you just talk about what's playing out better than you folks expected to drive the much stronger outlook for free cash flow conversion? And obviously, we're seeing a little performance here as well, but I'm wondering if you could just expand on the comments on the confidence through the cycle?

Jim Umpleby^ Well, Jerry, you recall when we launched our strategy in 2017, we really focused very heavily on OPACC, operating profit after capital charge. And we're really challenging our teams to work to ensure that we get a return for every dollar of capital that we invest. And we've also worked hard to reduce our structural costs. And again, with OPACC as our measure, that obviously helps us produce more cash.

Again, we demonstrated the ability to produce higher ME&T free cash flows. If I remember the numbers correctly, between 2019 and 2022, we produced \$5 billion to \$6 billion of ME&T free cash flow. And then in 2020, we had a 22% decline in our top line. And even that year, even during the COVID year when our top line dropped more than 20%, we still produced \$3 billion of ME&T free cash flow. So again, we have the whole organization based on OPACC, and that's working all those levers every single day, and that helps us drive increased ME&T free cash flow.

Andrew Bonfield^ And that is part of the reason why we've upped the bottom end of the ME&T free cash flow range because we are now more confident that OPACC will flow through to the bottom line. Obviously, with margins, the issue you have there is in a period of time where revenues decline, margins become an impact of a function of what happens from a gross margin perspective.

Actually, on ME&T free cash flow, we can generate more ME&T free cash flow by actually using up some of our working capital and bringing that back through. And that's one of the things we expect as well and if that happens.

Jim Umpleby^ And really glad you asked the question, that's one thing that maybe is underappreciated about our performance, it's just our ability to produce cash and the way we

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really transformed the business over the last few years to produce higher ME&T free cash flows more consistently.

Operator^ And your next question comes from Angel Castillo with Morgan Stanley.

Angel Castillo^ Just wanted to maybe continue on that note. I wanted to understand a little bit maybe the reasoning or the thought process around not lowering the kind of low end of your operating profit margin range. You talked about the gross margin and you mentioned this in the prior response, but gross margin dynamic, maybe on volumes potentially also leading to a little bit more challenged, lower end of the range.

So maybe what gives you confidence in keeping that rather than lowering that as well? And how do you kind of think about a wider range overall through the cycle rather than kind of a step higher?

Andrew Bonfield^ , One of the things you will have seen over the last couple of years is the improvement in gross margins. Effectively with the progressive margin range, what happens is the leverage is what benefits us as we go through, which gives us more confidence now that there's more opportunity from a leverage perspective to drive the top end of the range. But that obviously means on a declining volume basis, there's more pressure.

So that really was the reason why we kept the bottom end of the range as it was. Interestingly, if you go back to the previous ranges, the top end of the range now is virtually within a very, very marginal difference to the old margin target ranges that we had before.

Operator^ And your next question comes from Chad Dillard with Bernstein.

Chad Dillard^ So on the price cost, so I think in your full year guide, you talked about price modestly exceeding manufacturing costs for the full year. But then also you talked about, I guess, carryover is going to stay in the first part. So just trying to understand the cadence on that. And just to confirm, do you expect price cost to be positive through each quarter through the balance of the year?

Andrew Bonfield^ I think what we guided to is that we expect price to exceed manufacturing costs for the full year. We expect price more positive in the first half of the year because of carryover pricing. Obviously, there will be some other factors that go through there.

Geographic mix, for example, was positive this year. That may not be as positive as we go through the second part of the year. So those are the sort of mix things that can happen. At this stage, we're not giving you a firm prediction. We know what we think overall for the full year, but most of that price benefit will come through in the first half.

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Operator^ Your next question comes from Steve Volkmann with Jefferies.

Stephen Volkmann^ Jim, I wanted to go back, if I could, to a response to one of the earlier questions, where you talked about supply chain has kind of improved a little bit, but it's still causing productivity issues. And I guess I'm trying to think that through as we go forward, if supply chain continues to normalize, is there any reason to think we wouldn't get that productivity back?

Jim Umpleby^ Well, certainly, that's what we're driving our teams to do. And one of the things we talked about, of course, is we have still constraints in large engines. And we're not running as lean as I would like in that area. And of course, when you have some issues in engines, that can also impact machines as well, just because of the dynamics of shipping engines to our machine lines.

So certainly, our goal is to become more lean and to get back into a better operating cadence. And it has improved and supply chain conditions has improved, but we still have a ways to go. But again, difficult to predict how long it will take that to happen. Our engine investment, as we mentioned earlier, is a multi-year investment to increase that capacity for both new engines and for parts. And then I think that will be an important element of us achieving better lean operations and getting some of that inventory out internally.

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

Kristen Owen^ Great. Just a longer-term question here related to the hydrogen fuel cell pilot program, just given that secular growth opportunity in data center, how quickly can you commercialize this? And should we expect the business model for CAT to be more systems integration and components? Or is there some additional vertical integration in like the balance of systems that is being supported by this capital campaign that you outlined?

Jim Umpleby^ Most of the capital, the investments that we're making around large engines around parts and new engines, that's really what the focus of it is.

Andrew Bonfield^ Overall, when we look out, one of the opportunities for us, particularly when Jim was talking about distributed generation, was the fact that grid stability is going to be an issue. And one of the things that's going to be needed is there are system whole system projects that will be part of that. So, I think there is definitely an opportunity for us there to think more broadly about services in those environments as well.

Ryan Fiedler^ We have time for one more question.

Operator^ And today's final question comes from Stanley Elliott with Stifel.

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Stanley Elliott^ Congratulations. And can you talk a little bit more about the free cash flow? I mean, you got \$1 billion to \$2 billion more additional that you're looking at and targeting. You've done a very nice job of increasing the dividend on a steady basis. Should we think of this as accelerated repurchase activity into '24? Is there something on the M&A front? Any color there would be greatly helpful.

Jim Umpleby^ Really, what we continue to talk about is the fact that we intend to return essentially all ME&T free cash flow to shareholders over time through a combination of dividends and share repurchases.

In terms of M&A, we're always open to opportunities. But frankly, we believe we have outstanding opportunities to grow our business organically. While we have made some relatively small acquisitions to do things like gain some technology, or we think about the Weir/SPM in Oil and Gas to expand our product line a bit, we're really focused on organically growing our business because we think we have great opportunities around services.

We talked about the secular growth trend around data centers. Conditional LNG exports, the fact that the energy transition will create opportunities for commodities increase over time. So again, our primary focus is on organically growing our business.

Okay. With that, I just would like to thank everyone for joining the call. I appreciate all your questions. I'd like to just close by thanking our global team for another great quarter and just an exceptional record year.

As we discussed, we're increasing the top end of our target range for adjusted operating profit margins, and we've raised our target range for ME&T free cash flow. And this reflects continuing healthy customer demand as well as our strong operating performance. And we remain focused on executing our strategy and continue to invest for long-term profitable growth. Again, I appreciate you joining us. Stay safe.

Ryan Fiedler^ Thanks, everybody. And thank you, Jim, Andrew and everyone who joined the call 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 a fourth 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. The Investor Relations general phone number is (309) 675-4549. Now let's turn the call back to Abby to conclude our call.

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Operator^ Thank you. Ladies and gentlemen, that concludes our call. We thank you for joining. You may now disconnect.