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CAT - Q4 2013 Caterpillar Inc. Earnings Conference Call

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OVERVIEW:

Caterpillar Inc. announced 2013 sales and revenues of about \$56b on 4Q13 sales and revenues of \$14.4b. 2013 profit per share came in at \$5.75 on 4Q13 profit per share of \$1.54, ahead of outlook. Management announced 2014 profit per share guidance of \$5.30 all in, on sales and revenues flat with 2013 at about \$56b.



CORPORATE PARTICIPANTS

Doug Oberhelman *Caterpillar Inc. - Chairman & CEO*

Brad Halverson *Caterpillar Inc. - Group President & CFO*

Mike DeWalt *Caterpillar Inc. - VP, Strategic Services Division*

CONFERENCE CALL PARTICIPANTS

Andrew Kaplowitz *Barclays Capital - Analyst*

Ross Gilardi *BofA Merrill Lynch - Analyst*

Jamie Cook *Credit Suisse - Analyst*

David Raso *ISI Group - Analyst*

Nicole DeBlase *Morgan Stanley - Analyst*

Alex Potter *Piper Jaffray - Analyst*

Robert Wertheimer *Vertical Research Partners - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Caterpillar full-year and Q4 2013 results conference call. (Operator Instructions)

It is now my pleasure to turn the floor over to your host, Mr. Mike DeWalt. Sir, the floor is yours.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services Division*

Thank you very much. Good morning, everyone, and welcome to our year-end earnings call. This is Mike DeWalt, Caterpillar's Vice President of Strategic Services.

On the call today I am pleased to have our Chairman and CEO, Doug Oberhelman, and our Group President and CFO, Brad Halverson.

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This morning we will be discussing forward-looking information that involves risks, uncertainties, and assumptions that could cause our actual results to differ materially from the forward-looking information. And a discussion of some of those factors that individually or in the aggregate could make actual results to differ materially from our projections can be found in our cautionary statements under Item 1A, Risk Factors, of our Form 10-K filed with the SEC in February of 2013 and also in the forward-looking statements language contained in today's release.

Now in addition to that there is a reconciliation of non-GAAP measures and that can be found in today's financial release, which has also been posted on our website at Caterpillar.com.

Okay, let's get started. This morning I'll be covering four main topics before we get to the Q&A and they are fourth-quarter financial results, a recap of 2013, the 2014 sales and profit outlook. And I will start this morning with the fourth topic, and that's the \$1.7 billion of stock repurchase that we are expecting in the first quarter and the new \$10 billion stock repurchase authorization that we announced this morning.



Now to set the stage for stock repurchase, it's good to know that we had a great year for cash flow in 2013 and finished the year with a strong balance sheet. We set a new record for Machinery and Power Systems operating cash flow at about \$9 billion, and that was about \$1 billion more than the previous record from 2011.

We ended 2013 with a Machinery and Power Systems debt-to-capital ratio of 29.7%. That is almost 8 full percentage points below where we ended 2012 and our lowest debt-to-cap in more than 25 years. You have to go back to 1987 to find a lower one.

2013 was also a year where we repurchased \$2 billion in Caterpillar stock and last year we raised the quarterly dividend by 15%. 2013's cash flow and the strength of our balance sheet underpin this morning's announcement that we expect to complete our existing stock repurchase authorization and our Board's approval for a new \$10 billion program.

So, record cash flow, strong balance sheet, \$2 billion of share repurchase in 2013 plus another \$1.7 billion expected this quarter, and a new \$10 billion authorization. We think that is all great news for shareholders and a reflection of strong operational performance in 2013 and our confidence in the long term.

Okay, let's move on to fourth-quarter results. Certainly, while 2013 was a tough year, we are pleased to be ending it on a more positive note with sales and revenues nearly \$700 million above our outlook and profit \$0.25 a share above the outlook. For the quarter, sales and revenues were \$14.4 billion and that's about \$1.7 billion, or about 10%, below the fourth quarter of 2012 which was \$16.1 billion.

Profit per share was \$1.54 and that is up \$0.50 a share from the fourth quarter last year. Now while profit is up we did have two large items that occurred in the fourth quarter of 2012 that had a sizable impact on profit. We had the \$580 million goodwill impairment that was negative to profit about \$0.87 per share last year, but we had a \$300 million favorable tax settlement in 2012 and that helped profit by \$0.45 a share.

So if you exclude those two large items, our quarter-over-quarter profit per share improvement was about \$0.08. Now for sales, more than all the quarter-over-quarter sales decline was in Resource Industries, which is principally mining. Resource Industries sales were down 48% from the fourth quarter of 2012. That substantial decline was a result of both lower demand from mining customers and from changes in dealer inventory.

While Resource Industries' sales in the fourth quarter were well below the fourth quarter of 2012, they were about the same as the previous quarter, and that was the third quarter of 2013. Sales in each of the past two quarters have been roughly \$3 billion for Resource Industries.

And I'll talk about the 2014 outlook in a few minutes, but it's worth noting at this point that the \$3 billion a quarter that we have seen for the past couple of quarters for Resource Industries is about where we are expecting to average in the outlook for 2014. Probably a little below \$3 billion a quarter in the first half and a little better in the second half.

On a much more positive note, fourth-quarter sales in Construction Industries were up 20% from the fourth quarter of 2012. Power Systems sales were up 5% and Financial Products revenues were up 3%. That is great news and that demonstrates balance in our business. While we serve a number of cyclical industries, they don't all move the same way at the same time and it's great that Construction and Power Systems were up.

Now, excluding the goodwill impairment that happened in the fourth quarter of 2012, operating profit declined about \$166 million. That is \$166 million on a sales and revenues decline of about \$1.7 billion. There were certainly a number of puts and takes, but overall we are pleased with our operational performance and the decremental operating profit pullthrough of about 10% for the fourth quarter.

Manufacturing costs were favorable, \$480 million versus the fourth quarter of 2012, and SG&A and R&D were favorable combined about \$200 million. Cost performance was the main driver of the good decrementals. And that was in a quarter where we didn't get any help from price realization, which was about neutral, and our sales mix was unfavorable because more than all of the sales decline was in Resource Industries and because of mining.



Bottom line for the quarter, Resource Industries was down but Power Systems, Construction, and Financial Products were all better than the fourth quarter of 2012. Okay, so that's the quarter. Let's move on to a recap of the full year, which was a tough one, particularly for our Resource Industries segment.

Back in January of 2013, when we started the year and provided our first outlook, the midpoint of our 2013 range expected sales and revenues to be down from 2012. In fact, sales in 2013 were down and the decline in mining sales and our Resource Industries segment was much more significant than we had expected. As a result, we ended 2013 with sales about \$10 billion, or 16%, below 2012. And of that \$10 billion, about \$8 billion was in Resource Industries and about \$1 billion each was in Construction and Power Systems.

Now as a result of that \$10 billion sales decline, profit was down as well, from \$8.48 a share in 2012 to \$5.75 in 2013. While profit was down, our operational performance for the year was good. Our decremental operating profit pullthrough was less than 30% and that was despite a major headwind from product mix.

With most of the year's sales decline coming from relatively high-margin mining products, the sales mix headwind on profit was about \$750 million in 2013 versus 2012. We also had a sizable headwind from negative cost absorption and that was related to our large inventory reduction in 2013.

We had good performance despite those headwinds, because we took action on costs. Excluding the cost absorption impact from inventory, our manufacturing, R&D, and SG&A costs were collectively down \$1.2 billion in 2013. That \$1.2 billion improvement was a result of favorable material costs, lower incentive pay, short-term actions that we took, like temporary plant shutdowns and rolling layoffs.

And as the year progressed we started on more structural actions. The restructuring actions that we took in 2013 resulted in nearly 2,000 fewer management and support employees, 4,500 fewer production employees, and the closing, downsizing, or consolidation of a number of manufacturing facilities. While those restructuring actions spanned the Company, they were more concentrated in Resource Industries.

We incurred \$200 million of restructuring costs in 2013, of which about \$130 million was in the fourth quarter, and we are expecting another \$400 million to \$500 million in 2014. I'll talk a bit more about that when I cover the 2014 outlook, but before I do that I didn't want to end this recap of 2013 without giving a little rest of the story.

While 2013 was a year overshadowed by the big drop in mining, there were a lot of good things that happened at Caterpillar. First, while mining was negative, we are a diverse company; we serve a wide range of industries across the globe, and while sales declined in Construction and Power Systems that decline was small compared with Resource Industries.

Power Systems profit was within \$50 million of its 2012 record and our Financial Products segment delivered record profit for 2013. The fourth quarter of 2013 top line for Construction, Power Systems, and Financial Products, and their bottom lines were better than the fourth quarter of 2012.

I mentioned it earlier and I think it is worth mentioning again, it was a great year for cash flow. We set a new record for Machinery and Power Systems operating cash flow at \$9 billion.

We repurchased \$2 billion of Caterpillar stock in 2013 and we raised the dividend by 15%. We ended with a strong balance sheet with over \$6 billion in cash and the lowest debt-to-capital ratio in 25 years.

It was also a year of inventory correction for both us and for our dealers. We reduced our inventory almost \$3 billion and dealers reduced their inventories by more than \$3 billion. They were significant sales and production headwinds in 2013, but we think the significant impact on our sales is largely over. That doesn't mean that every quarter will be exactly flat, but overall for the Company we don't believe that inventory changes will be a big story in 2014 like it was in 2013.

In 2013 we also improved our market position for Cat Machines again and made particularly strong gains with excavators in China. And speaking of China, our total sales and revenues there in 2013 were about \$3.5 billion and that was up more than 20% from 2012.



From an operational perspective, we also continue to make improvements in safety and quality. And while we understand that quality improvement is continuous, our dealers and customers give us feedback that let us know they are seeing results.

So with that recap let's move on to the outlook. Overall, sales and revenues in 2014 are expected to be roughly similar with 2013 at about \$56 billion and that would be in a range of about plus or minus 5%. There are encouraging signs in the world economy, and we are seeing some in our own business. And that gives us optimism for sales in our Construction and Power Systems segments and we think they will each be up about 5% in 2014.

However, we continue to be cautious about the mining industry. Despite prospects for the improved economic climate and continued strong production of mines, we are expecting a sales decline in our Resource Industries segment of about 10% in 2014.

The good news is mine production has generally been up and improved in 2013, and we think it will likely be up again in 2014. The bad news is that orders for new equipment remain pretty low, but we don't think that can go on indefinitely and we remain positive on our long-term view of mining.

Based on the size and age of existing equipment fleets, we believe that miners are buying new equipment at a rate that is well below the average replacement level they'll need going forward. As an example, we think that our sales of large mining trucks in 2014 will be around half the long-term replacement level. That should be a positive for sales in the future.

In 2013, we took substantial actions to reduce costs and we are expecting to take more in 2014. That means that we are expecting additional restructuring actions and charges in 2014 of \$400 million to \$500 million, and that is in addition to the \$200 million of restructuring costs that we had in 2013.

Our most significant item in 2014 is the restructuring of our Gosselies, Belgium facility. We announced that program on December 23, 2013, and it is designed to improve the competitiveness of our European manufacturing footprint by refocusing our current Gosselies operations on final machine assembly test and paint with limited component and fabrication operations.

The actions there will include reshaping the supply base for more efficient sourcing, improving factory efficiencies, and workforce reductions. Our proposals are subject to Belgian ministerial approval and we think a decision by the Belgian Minister of Employment will occur in the first quarter of 2014. And, subject to that approval, we expect to recognize about \$300 million of employee-related separation charges throughout 2014.

The remaining restructuring costs of \$100 million to \$200 million that are anticipated in our outlook are related to a wide range of actions across the Company and they are part of our ongoing efforts to optimize our cost structure and improve the efficiency of our operations. While we're expecting numerous actions, we don't expect that individually the charges would be significant. We expect that the restructuring actions taken in 2013 and that we are anticipating for 2014 will be about \$200 million favorable to our ongoing costs in 2014 and \$400 million to \$500 million per year favorable to ongoing costs after 2015.

Now the most significant reason the 2014 impact is lower than the impact after 2015 is the timeframe involved in implementing the program in Gosselies, Belgium. It's extensive and it will take several years to complete. In addition, other actions that we are expecting to take in 2014 will occur over the course of the year, and as a result, we are expecting partial-year benefits in 2014. In total we estimate the after-tax impact of the restructuring charges in 2014 to be between \$0.50 and \$0.60 a share.

Our profit outlook for 2014 is \$5.85 a share at \$56 billion of sales and revenues, excluding the \$0.55 midpoint of the restructuring charges, and about \$5.30 per share all-in including the restructuring. Now, there are a number of reasonably important moving pieces that are factored into our 2014 outlook, and we have provided a listing of those key items in the profit outlook section of this morning's financial release. And if you haven't already, I would encourage you to read through that.

So, in summary on the outlook, \$56 billion of sales and revenues in 2014 that is relatively flat with 2013 in a range of plus or minus 5%. And \$5.85 a share without restructuring; \$5.30 all-in.

One last point on the outlook and that is around the first quarter. For the full year, our sales and revenues outlook expects roughly flat sales. And sales flat with the first quarter of 2013 is probably a reasonable ballpark for you to think about in Q1 2014.

However, as you think about first-quarter profit, you may be looking back to the first quarter of 2013 as a reference point. And if you do, there is one fairly significant item you need to consider and that's that last year we had an \$87 million favorable tax item in the first quarter and that was related to the research and development tax credit that was retroactively extended in 2013 for 2012. And that certainly won't be in the first quarter of 2014.

So that is the outlook and we are ready to move on to the Q&A portion of the call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Andrew Kaplowitz. Please announce your affiliation, then pose your question.

Andrew Kaplowitz - *Barclays Capital - Analyst*

From Barclays. Good morning, guys. Nice quarter.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services Division*

Hey, thanks, Andy.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Mike or Doug, can you talk about Cat's backlog declined to \$18 billion in 4Q; it was \$19.1 billion in 3Q and it is down \$2.2 billion in the year. Yet you are guiding to a 5% increase in Power Systems and you did mention in the release that some of the backlog decline was in Power Systems.

So can you talk about the conviction of your forecast here, especially -- you do have some decent emerging market exposure in this business; where is the growth coming from in Power Systems and why?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services Division*

I'm going to embellish that a little bit, Andy, and talk a little bit about Construction as well, if you don't mind. You know, for Construction we've seen end-user demand begin to improve in most regions, particularly in North America. Economically, we think a little better GDP around the world will help that as well. We've also seen, actually, our sales in China construction improve as well.

And it's probably worth noting that for Construction we still had a headwind in the fourth quarter on dealer inventory. Certainly not as much as it was in the fourth quarter a year ago, but the improvement in the fourth quarter, if we would've had flat dealer inventory, would have been a little bit more.

On Power Systems, we are not looking for a big increase next year. We are in the ballpark of about 5% and I would tell you that it is not any one sector.



If you look at what is in Power Systems, you've got industrial, you have got oil and gas, recip and turbines. You've got electric power, you've got marine, you got rail, and we don't really have any one of those sectors that's up a lot. In fact, probably one of the smallest, which is marine in the transportation piece, is probably a little bit stronger than the rest but I wouldn't really call that out too much. They are all kind of in the same ballpark.

You asked about conviction and backlog. When we do our outlook we try to give you our best guess at what we see in our backlog, what we are hearing from customers, what we think is going to happen in the economy, and we try to put that together and do our best shot. So I would say it's an outlook. It's not a sure thing, but I would say we are as confident as we usually are in an outlook.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Okay, Mike, that's helpful. Just shifting gears, in 3Q you said that you are not expecting a significant inventory change at the Company level, but it still looks like, if I am doing the math right, that you lowered company inventories by about \$700 million in the quarter. Was this mostly in Resource Industries and that is why your margins were so weak there? And how do you get conviction that these kinds of declines are behind you when you kind of had similar issues all year with company inventory destock?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services Division*

Well, I would say one thing is our sales in the fourth quarter were higher than we thought and the change in dealer inventory was about the same as we expected. With production schedules relatively not changing a lot in the short term, some of that came from inventory.

I'll tell you what gives us a little bit of conviction that it is not going to go down as much as last year is essentially the amount of our inventory that is finished goods. We have got the PDCs, for example. A year ago we had a lot of inventory in the PDCs and it has come down substantially. I don't have the numbers in front of me, but my recollection is it is down more than half.

So I think that we expected that to happen this year. It's down to levels right now that I think are -- there will be kind of seasonal fluctuations, but by and large, I just don't think there is the likelihood that that finished inventory would come down as much as it did in 2013.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Thank you, Mike.

Operator

Ross Gilardi.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Good morning. Just a couple of questions, guys. Just first on mining, can you talk a bit more about what happened to both OE and aftermarket orders from Q3 to Q4? And do you need a major pickup in orders in the second half of 2014 to deliver minus 10% for the year on the top line?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services Division*

Orders have -- I am going to pull aftermarket out of this because, for us, aftermarket is kind of a daily thing. Our order board, if you will, is about 24 hours so customers order, we fulfill, and send. So that's -- sales are probably a better indicator of the future than what happened on the last day of the year.



I think if you look at order rates for new equipment they have remain very, very low and that is despite mine production. Our customers, they've actually had pretty decent years. Mine production has been up and we think it will be up again overall in 2014.

Despite that, they are not ordering much and we haven't really seen much of a pickup. Certainly order rates were, for Resource Industries, a little better in the fourth quarter than they were in the fourth quarter in the prior year, but that is not saying much. So I think to answer your question, we do need some improvement in order rates to be at minus 10%, but I wouldn't describe it as anything like robust or good or like 2012. But, yes, some improvement.

Doug Oberhelman - *Caterpillar Inc. - Chairman & CEO*

Maybe it's time for me to just add a comment on mining here in general -- it's Doug Oberhelman speaking. The interesting thing with our mining customers -- and I have met in the last, oh, 60 to 90 days with several of my counterpart CEOs at the mining customers. And all of our mining team has been with them, with all of our alliance customer certainly, in the last 60 to 90 days in some way or another.

The feedback is fairly consistent and it's not illogical at all. Their mining production continues. They are pulling ores out of the ground at faster and faster rates. They are just doing what we did, frankly, in 2013 and that is pull our horns in, pull their horns in with CapEx. We see that again in 2014.

But what they all have cautioned us on is that at some point in the future, because we are extending cycles, duty cycles, because we have cut back on new acquisitions and even some parts in some cases, be ready for us at some point in the future. None of them can predict when that is and I can't either, but this is sort of typical with what we hear through these deep cycles -- when it's over it tends to come back fairly quickly.

I'm not making that prediction here today. I hope it is in 2014. I know it will happen in 2014 or 2015, but that is kind of the quandary we are in as well trying to judge from our customers when they feel comfortable kicking back in with new purchases.

Now CapEx is going down with miners in 2014 and you have all seen the numbers; we watch that, too. A lot of that is around -- a big part of CapEx in mining is not around mobile equipment. So we will see -- when that turns I'm convinced we will see, not as Mike said, a 2012-style ordering. I hope we don't, but we should see a fairly prominent turn when it happens.

And as Mike said, we should see something in 2014 to make our forecasts, but it's out there; we just don't know when. And I can't provide any more clarity than that. That is the feedback we get from our customers.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Thanks, Doug, that's really helpful. Then just my follow-up question on construction equipment. How did you get such a dramatic improvement from Q3 to Q4 in EBIT on essentially a \$300 million sequential increase in revenues?

And then more importantly, do you think that \$500 million of quarterly EBIT for construction is a sustainable run rate into 2014, particularly as you mentioned with some lingering pricing pressure in the business?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services Division*

I think for Construction I will say a couple of things. They had pretty good incrementals from third to fourth quarter and there are a couple of things going on in there.

Their pricing was a little bit better in the fourth quarter. They had more of this big order from Brazil in the third quarter that kind of dampened price realization a little bit. Again, sales were up.



They actually did a great job on costs in the fourth quarter and the impact on absorption of inventory decline for them was not a big deal in the fourth quarter. There was a little more of that in the third quarter. But no doubt about it, they had a pretty good quarter.

In terms of going forward, you know I won't -- I'm going to try not to give any specific guidance on profit by segment, but they were around 10% in the fourth quarter. And that's probably in the ballpark of -- we are not looking for a big decline. They were hurt this year by inventory decline and we don't see that happening in 2014, so their margins in 2014 ought to be better.

Ross Gilardi - BofA Merrill Lynch - Analyst

Okay, thanks very much.

Operator

Jamie Cook.

Jamie Cook - Credit Suisse - Analyst

Good morning; Credit Suisse. I guess two questions. One, Doug, just philosophically, how should we think about the message you are trying to send here with the share repurchase?

Your view has changed quite dramatically since you first became CEO, so should we think about the \$10 billion over a five-year like \$2 billion a year? Would it be more front-end loaded? Would you look to be more opportunistic than the \$1.7 billion you already talked about I guess?

And then just my second question, Mike, as it relates to guidance. You gave some color on the first quarter; I guess outside of that is there anything unusual we should think about as we think about the progression of earnings throughout the year?

Anything not in line with your typical seasonality, just given we have restructuring benefits that are going to hit? I'm not sure how that happens in terms of you are saying you are expecting mining orders to pick up. I am just trying to make sure we have the quarters correct. Thanks.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services Division

How about I will take the second part of that on the guidance? Of the \$200 million ongoing benefit that we kind of expected for this year, a lot of that is based on the things that we did in 2013. So those kind of things are in place, the big reductions in people that we had.

So I think that \$200 million, I probably wouldn't divide it by four because we are doing more in 2014. But, you know, I would say if you divided it by four and then favored the second half of the year a little bit more than the first half that is probably reasonable.

Outside of -- probably the biggest issue on timing that we are going to have during the year is when the actual restructuring charges for 2014 hit. I mentioned in kind of the preamble that we need to have the Belgian government approve our program, and so until that happens we won't be booking the charges for Gosselies. So that needs to happen.

Outside of that, I don't know of any real big items. I do think that the first quarter, for example, will have more negative sales mix likely than the second half a little bit. The first quarter of last year mining was still quite a bit higher than it is right now, so I kind of was talking about the first quarter sales being relatively flat. But that's with mining being down a bit and construction being up.



Doug Oberhelman - *Caterpillar Inc. - Chairman & CEO*

Jamie, thanks for a thoughtful question on our buyback and cash and let me give you a fairly broad answer to that and I hope complete. I have changed my position since I became CEO.

You will recall when that announcement was made it was the end of 2009. Our debt to cap was about 50% at that time. We struggled with our -- to be sure we kept our credit rating and we vowed not to cut the dividend at that time. And both of those came true.

But as we looked forward we all agreed that we had to have a strong balance sheet. A cycle like we saw in 2009 and now another mining cycle like we saw in 2013 really puts pressure on our balance sheet, and we decided we have got to have a rock-solid balance sheet, which we do today. You noticed at the end of the year it dropped below 30% debt to cap. If you take our cash into consideration of about \$6 billion at the end of the year, it was down 16%, 17% and in my definition that's a pretty solid balance sheet. So we accomplished that.

The second thing that we needed to do in the early days of me being CEO was to build up our capacity. We struggled with capacity. We did not have adequate capacity in the upturn of the 2000s.

We gave up market share around the world and our business model purely runs on field population, which allows our dealers to do what they do in a downturn better than anybody else by servicing the field population that is out there. We accomplished that one.

We have got capacity in place today, obviously far above \$55 billion. We did \$66 billion in 2012 so somewhere north of that we have operating capacity today. We are capacitized just right.

Our CapEx has come down substantially as a result of that. So I think where we are positioned today going forward is significantly different than where we have been for a while, and as a result, seeing cash build up on the balance sheet is not helping. That is one of the reasons, when we had strong cash last year, the two quarters we announced buyback we spent \$2 billion.

As we announced today, we will spend \$1.7 billion more this year -- or this quarter, which will take full advantage of our 2007 buyback program. And we announced another \$10 billion today, of course, over the next five years or so.

I'm not going to make any prediction on when we are going to do that, but as long as we see fairly stable and consistent cash flow, which I expect we would, as long as we keep our debt to cap in the low 30s, that allows us to acquire, if we choose to do so. And that is another question that is kind of embedded in yours.

We do not have anything at all big on the horizon. I'd say we'd be back in the mode we have been for many years; a number of acquisitions possible, all relatively small in size. In fact, we hold a placeholder every year of about \$1 billion for acquisitions. Sometimes we go that high, sometimes we don't, but we will be looking for acquisition opportunities so I would say particularly around Power Systems.

That is a great business for us; it's very stable obviously. There are some places to expand. We have got lots of opportunity around the world, so that might be a place. Again, in a smaller way, not a huge way that we might do it.

And so I would say that if we get lucky that every year we buy a little bit back, but I'll make no forecast on that. If we have cash, we will probably use it. If we don't, we will probably wait.

And that is kind of how I would look at all that, Jamie. Great question, thank you.

Jamie Cook - *Credit Suisse - Analyst*

Thank you.



Operator

David Raso.

David Raso - *ISI Group - Analyst*

ISI. Regarding Resource Industries, if you add back the restructuring in the fourth quarter the margin was about 7%. Can you give us some help on how you are thinking about the margins for RI if the revenue, as you have said earlier, would stay around the same level that we saw in the fourth quarter?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services Division*

I would say, David, that fourth quarter usually has a little higher cost levels than the rest of the year, and with sales for Resource Industries kind of coming down to this \$3 million level, it has a little bit bigger impact on margin. So they had a little more of an inventory decline; that hurt them in the fourth quarter. Then costs that were up a little bit in the fourth quarter, so that was a little negative from the third quarter. And as you mentioned, the restructuring charges that they had in the fourth quarter.

In terms of going forward at this volume level, if you were to take the sort of average margin for the year, it's probably not far off of what you would think for next year. There will be puts and takes, though. They have done a lot of work on cost reduction, so that would be a positive. They would like to spend a little bit more to drive synergy benefits and spend a little more on R&D, so that will go the other way.

But I think, by and large, their margins from 2013 are not significantly out of line at this kind of sales level.

David Raso - *ISI Group - Analyst*

It's a little tricky, though. If you think construction margins can be 10%, just roughly, in 2014 that implies an incremental margin for CI of 65% next year. That seems aggressive.

But then, if you really think RI can do margins of 11% in 2014, it implies Power Systems margins are down to 13% next year after being 15%. So the math is not squaring --

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services Division*

I am not trying to give you specific numbers. I didn't say that Construction would be 10%. I just said I think it will be probably closer to that than the 5%, 6% that they had earlier in the year.

I think also one of the things that you need to remember kind of year over year, too, is there are other things that are maybe not in the segments. We had pretty substantial negative below operating profit currency losses in 2013 that we are not expecting for 2014. So I don't think from an operating profit standpoint there will be major changes, but I'm not suggesting it will be exactly the same in each segment as it was in the fourth quarter.

David Raso - *ISI Group - Analyst*

How about just qualitatively then Power Systems? How do you think of their margins off of the 15.4% you reported for 2013?



Mike DeWalt - Caterpillar Inc. - VP, Strategic Services Division

Again, I don't think it will be substantially different. Again, I'm not trying to do a forecast by segment, but probably not substantially different. I mean it was a great quarter, and I don't want to pick on the quarter, but if you were to take the year I don't think their profit is going to be dramatically different year over year.

David Raso - ISI Group - Analyst

Okay, we can talk offline more the exact numbers. And, lastly, for CONEXPO, just any framework we should be thinking about going into a meeting like this? I mean historically you've spoken of long-term targets before at settings like this. Can you give us a little framework for this year?

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services Division

Yes, I think generically what we will talk about is our strategy update. We have been working on that for the last, oh, last several months of 2013, so we'll spend time updating you on the changes that we have made to the strategy and we'll talk a little bit about each of the major segments.

To your point, it will be kind of a longer-term view, what we expect for the future. But coming out of such a tough year in 2013, I remember this back in 2009 when we had a similar meeting. We kind of gave specific number targets and it was -- let's say it was tough to get anybody to think that business could be that big or that good.

So I think what you will probably hear from us at CONEXPO is more around strategy, business conditions, and the things that we expect to do going forward. It probably won't be so much here is a forecast for a particular year.

David Raso - ISI Group - Analyst

(multiple speakers)

Doug Oberhelman - Caterpillar Inc. - Chairman & CEO

David, it's Doug Oberhelman. That's right. A couple of things. We'll talk about how our business has changed since 2010 and how we see it kind of, to use your word, qualitatively going forward.

But one other thing I'd ask all of you to do while you are out there, those of you that are attending, is go down on the floor and look at our product offering. You will be seeing a couple of things that you haven't seen from us before. Number one, fuel economy.

Frankly, we have struggled in the past to get some of our competition on fuel economy. That period is over. Our Tier 4 interim and final machines that you'll see out there are in almost every case best in class and best in class by quite a margin. So I'd really like you to spend time with our people on the floor.

Secondly, equipment technology. Condition monitoring, jobsite controls, everything around the electronics. We'll offer a live dealer control room there. It's live, but it would look like a dealer, a control room like we have all over the world today, monitoring our machines and what we can offer customers. And those two are very different than what we have talked about in the past.

Then in our meeting I think you'll enjoy kind of a little look back at how we have changed the Company, where we are going, as Mike said, between here and the next few years out.



David Raso - *ISI Group - Analyst*

Doug, if you can help us at CONEXPO or even right now, the strategy comment reminded me of it appears a majority of your dealers in China have dropped the SEM brand. You still have the original SEM dealers selling. That is partly why you are still doing okay in China, but SEM has obviously been lagging the industry data. I guess in part because the traditional Cat dealers a majority have dropped it.

And thinking of SEM as may be a lower cost solution, cost structure around the world, do you care to maybe comment a little bit on that SEM decision by the Cat dealers, how it makes you rethink your kind of lower-value price point and strategy?

Doug Oberhelman And I will take it. And I'll make sure that Ed addresses that at CONEXPO, but generally we encourage that change from here. The market is huge over there for excavators and the things that Cat brand does. We decided over the last year that that is really where we want them to focus.

We went kind of back to a strategy of SEM brand for SEM products inside and outside, although we still have quite a few dealers outside of China representing SEM. That has worked well for us. We will concentrate on that as a brand.

It is a value brand and, of course, we have been upgrading that technology a little bit within the value offering against SEM's competitors. So we think we are in a better position with that going forward. Again, that will be a relatively small play in the scheme of things, but it's important inside China.

David Raso - *ISI Group - Analyst*

All right, thank you. I appreciate it.

Operator

Nicole DeBlase.

Nicole DeBlase - *Morgan Stanley - Analyst*

Yes, it's Morgan Stanley. Thanks, guys, good morning. So I just wanted to ask a question on material costs.

I think you guys noted in the 2014 outlook [in the release] that you expect material costs to be favorable in 2014, but you are also looking for an improving economic environment and usually that causes commodity prices to increase. So I am just curious what you are expecting for material costs and what you why you expect a decline?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services Division*

Yes, this is Mike, Nicole. We didn't actually put it in the economic part of the release, but generally speaking, I would say for mine commodities, like copper for example, we are expecting commodity prices in 2014 to be, by and large, around the 2013 average. So we are not likely to get big increases or decreases in commodity prices; at least that's our view.

And so for material costs you kind of have to look a little bit at how things have trended for the year. We've gotten kind of better and better as we've gone through the year. We are exiting the year, 2013, at a lower level than where we came into the year. So even if we don't get any other cost reductions at all, we have a bit of a carryover benefit that comes from the prior year so that should be positive.

In addition to that, most of what we buy is not commodities, believe it or not. It's components that have a lot of value added in it. And based on what we've negotiated with suppliers, the changes that we've made, we are looking for overall material costs to be lower.

Again, the bulk of what we buy is not commodities. It includes somebody else's value added. And so a combination of reductions there and what we are coming out of 2013 with already give us pretty good confidence on material costs for 2014.

Nicole DeBlase - *Morgan Stanley - Analyst*

Okay, understood. Thanks.

Brad Halverson - *Caterpillar Inc. - Group President & CFO*

I may just add quickly, coming out of the strategy with Doug, a big part of it was supplier collaboration and the idea that we would get to know our suppliers as well as we know our dealers. We spent a significant amount of time on that coming out of the strategy, so what we see in terms of our material cost reduction is really a benefit of coming out with stronger supplier collaboration. Their resources, their expertise combined with ours is producing a lot better decisions for us and a big piece of that reduction.

Nicole DeBlase - *Morgan Stanley - Analyst*

Okay, got it. Thank you. Then just on construction with respect to pricing. I saw in the release that you guys called out that there was some pricing degradation or challenges in the North American market, too, which I think was isolated to Europe before. So if you could just provide us with an update on what you are seeing in the competitive environment in North America that would be helpful.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services Division*

I think overall I think for construction there has not really been anywhere where we've had a lot of strength. I think it has been a tough environment around the world, North America included.

We have had some issues here and there where we came out with Tier 4 products in North America before some of our competitors. Some of our competitors had credits that they were using to sell Tier 3 products for a longer period of time. So as that expires, as let's say everybody gets on a more equal footing with regard to Tier 4, I think that will probably help us a little bit in North America because it has been a little bit of a drag.

Nicole DeBlase - *Morgan Stanley - Analyst*

Okay, thanks. I'll pass it on.

Operator

Alex Potter.

Alex Potter - *Piper Jaffray - Analyst*

Thanks, guys; Piper Jaffray. So I had a question here on China in general.

There has been this downtick in PMI. Obviously bearishness around emerging markets that has surfaced here just over the last, call it, week or so, but your commentary on China seemed at least relatively upbeat. Asia Pacific construction business was up really nicely in Q4. PowerGen seem to be holding up okay sequentially.

So basically I'm just trying to see if you've seen anything recently to substantiate these initial signs of weakness in China.



Mike DeWalt - Caterpillar Inc. - VP, Strategic Services Division

Yes, that has occurred -- the market reactions really over the past week or 10 days or so. I think in our business it has been pretty positive. We've seen the construction -- not just our sales, but kind of the overall construction equipment group sales in the industry ticking up year over year and over the past few months. And we saw that again in December, so I think what we've seen has been pretty good.

We've done better than the market there as well. Our sales in China were up more than 20% this year. They were up in the quarter. So, you know, it has not been a big negative for us.

Now the flipside of that is we are not looking for improvements in overall GDP for China. Then we're expecting 2014 to be another year like 2013, like 2012, in that sort of 7.5%-ish range. So that is what we are seeing in China anyway.

Doug Oberhelman - Caterpillar Inc. - Chairman & CEO

Let me add a little bit, Mike -- Oberhelman again -- on China. We are watching it very, very closely from a couple of aspects. Obviously, liquidity in the banking system and we keep a close eye on that, as well as their reform efforts.

We have been laser focused on being a leader in China and that is again around building field populations. So we have seen our market share go up, our field population go up, and our business go up as a result. That is not to say China is not without lots of caution, which we are very much aware of and we watch that every day. But at the same time we have to have our dealers with a field population they can work on when times are bad or good, so that is really our focus is that business model inside China.

Alex Potter - Piper Jaffray - Analyst

Okay, fair enough. Last question here; was just wondering if you could comment a little bit on Power Systems, maybe just qualitatively which segments looking into 2014 you expect to perform better or perform worse and some of the justification or reasoning behind that.

Mike DeWalt - Caterpillar Inc. - VP, Strategic Services Division

Yes, this is Mike. I think with the exception of Industrial, which has been up this year and is going to have really tough comps as a result, I think we are essentially looking year over year 2014 versus 2013 no real outliers. We have Power Systems overall, up we think about 5%. And between like for the big kind of subsectors, it's not going to veer far that.

So with the exception of maybe Marine might be a little bit better and Industrial might be a little bit worse, the rest of them, oil and gas overall, electric power overall, rail overall, kind of up a little.

Doug Oberhelman - Caterpillar Inc. - Chairman & CEO

Yes, just a comment, a qualitative comment about Power Systems; really sparkled in a tough year like 2013. If you look back over the years, Power Systems has done that because there is a fairly wide array of businesses in there. Take our rail business between Progress Rail and EMD. EMD in our third year of ownership is just getting it done. We have seen a lot of cost reduction in locomotives. We have seen a lot of work around the aftermarket and of building out the Caterpillar DNA into locomotives, and we are very, very happy with that acquisition and our current market position.

Electric power has been very anemic, as you all know, but within that is our acquisition of MWM in Germany which brings us a natural gas and a gas in any form offering. We are building that out expanding through Cat dealers. Long-term that is going to be a very good piece of business for us and is, again, kind of countercyclical to everything else in the Power Systems business.



Our Industrial business which is really the reciprocating engines that we sell to everybody from ag to lift trucks to other construction equipment makers saw an increase in 2013 to make up for some of the shortfalls in the other segments. So within that Power Systems business, there is an array of diversity.

And then finally the turbine business which has just been fantastic for us really the whole time we have owned it, going back to the mid-'80s. But with the oil and gas boom, the fracking boom around this country and elsewhere, that has been a real stellar performer the last few years and I expect it to continue.

Then just an anecdote, I just returned from Eagle Ford area actually last week. I had my ears to the ground on what they are seeing down there and actually our dealers there are a bit more optimistic than I expected. I am not going to say wildly at all, but there is still activity going on and they feel like 2014 could be another solid year.

So that is anecdotal, but certainly a positive thing at this point in time. But our Power Systems business is one that we are very happy with. Again, within that it is kind of a complete array, various array of businesses in itself.

Alex Potter - *Piper Jaffray - Analyst*

Thanks very much, guys.

Operator

Robert Wertheimer.

Robert Wertheimer - *Vertical Research Partners - Analyst*

It's Vertical Research Partners and thank you. I wonder if I could follow up on what Doug was just mentioning.

There's a little bit of consternation in the market with some of the big oil majors talking about maybe declining returns on some of the expense of CapEx, maybe cutting back, and maybe some of the other segments of oil and gas being strong. Are you able to, I don't know, delineate your exposure to the big international oil companies? And maybe you could just say is Solar set to have another record year? Thank you.

Doug Oberhelman - *Caterpillar Inc. - Chairman & CEO*

Yes, I'd say at this point in time, as Mike said also, our Power Systems in 2014 ought to look a lot like it did in 2013. We're hopeful for a very modest increase, but that is after a lot of gives and takes across that business.

As you all know, the fracking business has changed the gas pipeline and gas compression business immensely in this country. There is still a lot of buildout on getting that gas out of the ground and that is what I think we are seeing primarily around Solar. The big nationals around the world certainly are questioning where they are going and we see that.

I have got to believe the opening in Mexico, if that or when that starts, but I do think they will pull that off, is going to change the dynamics completely again. And that could be some upside, although I don't know how much of that we see in 2014 at other starts. It is really a mixed -- I think you got to almost have to look at it country by country and see where that goes. But we are not wildly optimistic about it, nor are we that pessimistic for 2014.

Now I have been surprised with gas here the last month or so going above \$5. I would not have predicted that at all, but it's quite interesting. I don't know what that will do, but I think it is probably a fairly short-term phenomenon based on the cold weather.



Robert Wertheimer - *Vertical Research Partners - Analyst*

Okay, great. Thank you, Doug. And then I don't know if you are willing to answer this or not and you have given a decent amount of mining information, but there is concerns that there is a couple more years of CapEx decline out there. And obviously your sales have already maybe frontloaded some of that decline having fallen so far.

Are you willing to say how far your unit deliveries in mining have fallen from peak in 2012 to what your outlook is in 2014? It's more than 50%, I'm sure. It's probably more than 60%, maybe it's more than 70%, I don't know. Maybe you can help out?

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services Division*

Yes, I'll help you maybe a little bit, Rob. You know in a lot of ways -- and we have a varied business. It's everything from drag lines to drills to big trucks to shovels.

The largest selling product category for us is large mining trucks. And if you look at large mining trucks and you look at what we've shipped this year, which would be relatively lined up with what our sales are, we are down probably close to 60% this year -- 2013, I'm sorry. Not last year, 2013 versus the peak. And if you look at what we kind of have baked in to 2014, you are looking at something like 75% below the 2013 peak for our shipments.

Robert Wertheimer - *Vertical Research Partners - Analyst*

That's what I thought and that's very helpful. Thank you very much, Mike.

Brad Halverson - *Caterpillar Inc. - Group President & CFO*

This is Brad. (multiple speakers) I was just going to comment; when we look at our resource industry business, we will give you a forecast which is our best estimate in terms of that particular time. But from an operational standpoint, we clearly understand there is risk.

We knew there was risk in 2013 if you were in the resource industry business and in that business unit they started taking action in the first quarter. The Company has joined in and we really focused on structural cost reduction, and with that we were able to deliver the \$1.2 billion of cost reduction.

And I'll tell you that we are bullish in mining on the long term. Mike talked about our orders need to increase for the 10% down scenario. We will walk into the first quarter in a cautious standpoint and we will remain focused on cost reduction around here. But, clearly, longer term we see that as a great business for us, but we remain cautious and we will remain focused on the structural cost reduction in 2014.

Robert Wertheimer - *Vertical Research Partners - Analyst*

Thank you.

Mike DeWalt - *Caterpillar Inc. - VP, Strategic Services Division*

Okay, with that we are just past the top of the hour and we'll sign off. Thank you very much for joining us today. We look forward to seeing many of you at CONEXPO in March.



Operator

Thank you. Ladies and gentlemen, this does conclude today's conference call. You may disconnect your phone lines at this time and have a wonderful day. Thank you for your participation.

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