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CAT - Q3 2014 Caterpillar Inc Earnings Call

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OVERVIEW:

Co. reported 3Q14 sales and revenues of $13.5b and profit per share of $1.63.

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PRESENTATION

Operator

Good morning, ladies and gentlemen and welcome to the Caterpillar third-quarter 2014 earnings results conference call. (Operator Instructions). Now I'd like to turn the floor over to your host, Mike DeWalt. Sir, the floor is yours.

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

Hey, good morning, everyone and we're very happy to have you with us this morning for our third-quarter earnings call. I'm Mike DeWalt, Caterpillar's Vice President of Strategic Services. And on the call today, I'm pleased to have our Chairman and CEO, Doug Oberhelman and our Group President and CFO, Brad Halverson.

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Now this morning for sure we'll be discussing forward-looking information and that involves risks, uncertainties and assumptions that could cause our actual results to differ materially from the forward-looking information. A discussion of some of the factors that either individually or in the aggregate we believe could make actual results differ materially from our projections, that can be found in the cautionary statements under Item 1A, Risk Factors, of our Form 10-K filed with the SEC in February of 2014 and our 10-Q filed with the SEC in August of 2014 and it's also in the forward-looking statements language contained in this morning's financial release. In addition, a reconciliation of non-GAAP measures can be found in our financial release this morning and again, that's been posted on our website at Caterpillar.com.

So let's get started. I'll be covering three things this morning -- our third-quarter results, the increase in our profit outlook for 2014 and our preliminary outlook for 2015 sales and revenues. Now before I get into the quarter though, I thought it might be helpful to summarize just a couple of themes from this morning's financial release, key points that we were trying to get across. And the first one is around stability and consistency.

Last year at about this time, we provided our first view of 2014. That was our preliminary outlook of sales and revenues for 2014 that we did with our third-quarter release. Back then, we said it looked to us like 2014 would be a relatively flat year with 2013. That was the case then, that's about what's happened through the first nine months of this year and that's still our full-year view today. So consistency.

The second point is around profit. While sales and revenues for the first nine months of both 2013 and 2014 have been around $41 billion, profit per share is up year-to-date and every quarter of this year, it has been higher than the corresponding quarter of 2013. Profit per share so far through the first nine months of 2014 are $4.64 all in and $5.03, excluding restructuring. And both of those are up from the first nine months of last year, which was $4.21. So while there are a number of puts and takes, the point is we've worked hard on operational execution and cost management and that's helped results.

Okay, with that, let's turn to the third quarter. Sales and revenues were $13.5 billion and that was up about $100 million from $13.4 billion in the third quarter of last year. While sales and revenues didn't change much, profit per share rose from $1.45 last year to $1.63 this year or $1.72 without restructuring costs. The increase in profit per share -- in that increase, there were a number of puts and takes. On the positive side, price realization was up. Currency impacts both in operating profit and below-the-line and other income and expense were positive. Our share count was lower and that was positive for profit per share as well.

On the other side, SG&A, R&D and manufacturing costs were a little higher. Positives included material costs, which were favorable, but more than offset by higher employee incentive compensation expense and a little higher warranty costs. The incentive compensation increase is a result of 2014 performance being well ahead of the targets we set when we started the year.

Now results by segment, Energy & Transportation, sales were up $663 million or about 13%. Their profit was up $250 million or about 29%. Most of that sales increase was from improved volume. And in Energy & Transportation, remember we have several different industries that we're serving -- oil and gas, power gen, transportation and that's rail and marine and industrial and that's where we sell engines to other equipment manufacturers. Sales were up in all of those industries. Oil and gas and industrial were up relatively in line with the segment average. Transportation grew a little faster than the segment average and power gen a little less than the average. The profit increase for Energy & Transportation in the quarter was largely a result of the higher sales.

Now for Construction Industries, sales were down $98 million, but profit improved $194 million or about 67%. Now for sales, on the plus side, Construction had positive price realization. On the down side, volume was a little lower and most of that was from dealer inventory reductions as dealers lowered inventories a little more in the third quarter this year than they did in the third quarter of 2013 for Construction. End-user demand was also down slightly from the absence of a large sale to the Brazilian government that we had last year and I mentioned that in our second-quarter financial release. We also had a little lower demand throughout most of Asia, including China and weakness in the Middle East and in the CIS. On the plus side, demand was up in North America and we had a small improvement in Europe. The profit improvement was a result of the positive price realization, some of the currency impacts and favorable manufacturing costs.

In Resource Industries, which is principally mining, sales were down $496 million or about 19% from the third quarter of last year and profit was off $239 million or about 62%. The decline in sales was primarily lower volume. Price realization wasn't significantly different one way or the other. The volume decline was largely a continuation of what we've been seeing all year. While overall mine production has been good and many of the global mining companies are improving their performance, their purchases of new equipment are at low levels.

While sales this year are below last year, the 2014 quarterly sales trend has been pretty stable with $2.1 billion in the first quarter, $2.2 billion in the second quarter and $2.2 billion in the third quarter. Not a lot of change quarter to quarter as we progressed through the year. The decline in profit from the third quarter of last year was primarily a result of the lower sales. While profit in Resource Industries is down from a year ago, much like the sales, it's been in a fairly tight band throughout 2014. In the first quarter, profit was $149 million, second quarter was $133 million and the third quarter was $147 million. Again, similar to sales, it's been pretty stable, but at a low level.

Our Financial Products segment, revenues were up $44 million and operating profit was up $2 million, so not much change from a year ago.

Now before I move onto the outlook, I'd like to touch on the balance sheet and cash flow. We generated another $1.4 billion of Machinery and Energy & Transportation operating cash flow this quarter and are $5.4 billion through the first three quarters of 2014. Our balance sheet remains strong with the Machinery, Energy & Transportation debt to total capital ratio less than 35%, which is comfortably towards the low end of our desired range.

Given the current demand environment, we generally have the capacity we need and CapEx expectations this year are less than $2 billion. Our strong cash flows enabled us to repurchase $4.2 billion of stock so far this year and we announced an increase of 17% in the quarterly dividend last June. And we've maintained a healthy cash balance at about $6 billion with the ability to invest.

With that, let's turn to the outlook. For 2014, we now expect sales and revenues to be about $55 billion, which was the midpoint of our previous $54 billion to $56 billion outlook range. We have, however, increased our profit outlook for the year. Previously, at the $55 billion midpoint of our sales and revenues range, we'd expected profit of about $5.75 a share, or $6.20 excluding the restructuring costs. We're pleased this morning to have announced that we've raised that to $6 a share all in and $6.50, excluding the restructuring costs.

Now in addition to the outlook for 2014, as we typically do on our third-quarter financial release, we provided what we call a preliminary outlook for next year's sales and revenues. As we look towards 2015 from an economic perspective, we think there's a reasonable likelihood that world economic growth could improve a bit in 2015. In the developed countries, growth-oriented monetary policies we think could support continued modest improvement. In developing countries, several governments raised interest rates or constrained liquidity in 2013 to either control inflation or protect exchange rates and those measures slowed growth in 2014. More recently, interest rates in some of those countries have stabilized and we've seen the first monetary policy easings in the third quarter of 2014.

In addition, we think there's some potential for increased investment in infrastructure, particularly in countries like the United States if we could get a Highway Bill, India and Turkey. Despite cautious optimism for improved global economic growth, significant risks and uncertainties remain and that could temper growth in 2015. Political conflicts and social unrest continue to disrupt economic activity in several regions, in particular in the CIS, Africa and the Middle East. In addition, the Chinese government's push for structural reform has slowed growth some and the ongoing uncertainty around the direction and timing of fiscal policy and monetary policy in the US could temper business confidence. As a result of all that, our preliminary outlook for 2015 sales and revenues is flat to slightly up.

Now one thing you won't find in this morning's release is a discussion about 2015 profit. That's typical for this time of year. We start our planning process with sales, we provide a top line view of next year's sales with our third-quarter release. We complete our planning process in the fourth quarter and we'll provide a more complete view of 2015 in our January release, along with our year-end 2014 results.

So in summary, profit per share was up in the third quarter. We had another good solid quarter of cash flow. Our sales outlook for 2014 is similar to our previous outlook and we raised the profit outlook for 2014. Our preliminary outlook for 2015 is flat to slightly up. So with that, we're ready to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Ted Grace. Please announce your affiliation then pose your question.

Ted Grace - *Susquehanna Financial Group - Analyst*

Hey, guys, Susquehanna. Congratulations on the quarter. Mike, I know you said that you didn't want to give too much on -- or really any guidance on profitability, but could you speak to at least --?

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

But you are going to ask anyway, right?

Ted Grace - *Susquehanna Financial Group - Analyst*

Well, no, what I was going to say, as a starting point, could you frame out at least across the three segments how you're thinking about each in the context of sales being flat to up slightly? Where would you have the most optimism, the most caution and maybe start there?

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

Yes, I think in the scheme of things, our view around each of the segments is much like the total -- we don't see big swings up or down really in any of the segments. It's always, as you know, looking out that far, it's tough to always be exact, but -- or ever be exact, I guess, but, by and large, we don't see a lot of change going forward in any of the three segments.

Ted Grace - *Susquehanna Financial Group - Analyst*

Okay. And the second thing I was hoping to ask either you or Doug is one of the big initiatives you've talked a lot about is making the Company a lot more nimble and kind of reactive to the demand environment that gets served to the Company, something that's outside your control. Can you just speak to the progress you've made in 2014 and how you think that sets you up for 2015 and to the degree you can talk about specific metrics whether it's cycle times or philosophy, that would be great?

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

Yes, that actually is to be a quite long answer delving into operations. I think what I'll do is kind of summarize it for you a little bit. One of the key metrics that we have that measures the success or failure of that is the incremental operating profit pullthrough. We've had a target of around 25%. We've taken the actions needed to be flexible enough to achieve that. But embedded in that, there are -- lean helps, if you improve cycle times. That helps. We're down that path. But I think the ultimate measure of this is when either profit goes up or goes down, do we have the flexibility to take costs out going down and I think we've shown that we do.

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

I'll just add to that, Mike. It's Doug here and I agree with that completely. In terms of really lean manufacturing, lean Six Sigma, standard work, I think we're still early in the process here. We've probably got about a third of our sales, manufacturing anyway, covered to some degree with where we want to be in our first wave of lean, really deep lean manufacturing. In every one of those cases, whether it's a medium wheel loader line in Aurora, Illinois, wheeled excavators in Grenoble, France and I can go on, certainly Solar is a good example of that too, we've seen really tremendous improvements in quality, in throughput, in inventory in almost all metrics and we're encouraged. But there's a lot more work to do and as I've said to you all many times, we really expect to see big chunks of this come in 2014 and 2015.

I think we saw some of that in the year-to-date numbers. We've certainly seen it in the quality of margins in the third quarter, but, in my mind, we've still got plenty of work to do on that. I also said earlier today that, in a way, flat production really gives us time, flat production output gives us time to get to work on this. When things are booming, it's hard to work on efficiency because we're trying to satisfy the market. In 2013 when the bottom fell out in mining, we're cutting costs at every moment and we really can't think about how we want to organize a manufacturing line. Well, since mid-2012 or so, certainly in 2013 and now 2014 in Construction and in Energy & Transportation, that team is been doing that and it shows in the margins.

Mining will be next. When mining recovers, we'll really I think prove what we can do with that because a lot of that work is being done now too. So I think we've seen a down payment on it, but, in my mind, there's more to come.

Operator

Eli Lustgarten.

Eli Lustgarten - *Longbow Research - Analyst*

(inaudible). Good morning, everyone. Can we first talk a little bit about the fourth quarter as we look out? You're sort of giving us guidance of about a little over $14 billion and while I recognize there is about $0.15, $0.16 from lower taxes and foreign currency in this quarter, your guidance, your midpoint of guidance, $1.47 or so for the numbers, can you give us a bridge why the fourth quarter will be -- with higher volume -- will be somewhat weaker profitability because you've been pretty stable (inaudible) production, pretty stable in profitability for the year? Hello? Hello?

Operator

(Operator Instructions). Okay, gentlemen, we are live.

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

Eli, could you ask it again? We got cut off. It was not --.

Eli Lustgarten - *Longbow Research - Analyst*

I was wondering if I did something wrong or not. Okay, the first question very quickly, on the fourth quarter, you're guiding to a little bit over $14 billion. You've been very stable in production, very stable in profits almost for the year. You're guiding us to lower numbers in the fourth quarter on profitability and I know there's like $0.16 of lower taxes and benefits and some currency in the quarter. Can you give us a bridge of what you're expecting in the fourth quarter that's different that drops the profitability to under $1.50 from the $1.60 level that you've been doing.

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

Yes, Eli. I will. You're right. With our fourth-quarter outlook, the -- or our full-year outlook, it's not too hard to turn that into a forecast for the quarter and we do expect profit to be down a little bit in the fourth quarter. A couple of the things that you mentioned, we had currency gains in the quarter and there are a lot of things that we think we can do a decent job of forecasting. Exchange rates is not one of them. So we're not forecasting changes in exchange rates from here, so there's no continuation of the gains.

We had a favorable tax item in the quarter. That goes away as well. So those are two positives that were in the third quarter that won't be in the fourth. We typically have seasonally higher costs in the fourth quarter. We're wrapping up the year and discretionary spending tends to rise a bit. So that happens essentially about almost every year that I can remember since I've been at the Company. So we've got that worked in.

One other item probably of note is we expect a little bit of negative mix in the fourth quarter. We'll have a couple of big -- a big electric power sale that we think will be completed in the fourth quarter at quite a bit lower margins than the total. So I think I would say mix, seasonal costs and absence of a couple of the favorable items from the third quarter. That pretty much bridges it I think.

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Eli Lustgarten - *Longbow Research - Analyst*

Okay. And can we talk about the Construction Industries segment? You warned us in the second quarter about lower emerging market business taking $1 billion out of production. But we're hearing strong things, particularly in the US in the quarter. We have emissions coming next year, so the dealers are saying that they're having trouble even getting inventory out of Caterpillar for some of the demands that they would want. Can you give us some insight of what you expect for the Construction Industries in the fourth quarter, and particularly as you go into next year because that should be one of your better quarters, particularly North America.

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

I'll try and answer your question, but I'm going to try and answer another one that you kind of touched on, but didn't actually ask directly and that's on inventories. Sometimes I think there is confusion around dealer inventories. Since we sell through dealers, we frequently talk about changes in dealer inventory to kind of help give a complete picture of what's going on. But just because inventories go up or down doesn't mean that they're -- in and of themselves that doesn't mean that it's well-managed or poorly managed. There are a lot of seasonal impacts that go on during the year. In Construction for example, we had a sizable increase in the first quarter in inventory. That kind of builds up for the spring and summer selling season and then it gets worked on for the rest of the year. That happened in the third quarter last year, that happened in the third quarter of this year.

Fourth quarter, that usually tends to happen as well. Dealers tend to sell a little more than we ship them. So that occurred in the third quarter. That will probably occur again next quarter.

In terms of Construction, it's a mixed bag around the world. We live in the US and we get influenced by what we hear in the US a lot and that's been actually pretty positive. It's been quite a bright spot. Although I would make the pitch that, while it's better, that doesn't mean it's great. We are I guess seven, eight years now past where the peak was and that was 2006 and 2007. So we still have a ways to go to get to where we would think it's really, really good, but it has been better.

Other parts of the world, it's a little bit of a different story and China has been weak. Our share there has been pretty good and rising, but that doesn't offset a weaker industry. Europe has been flat to slightly up for us, which I think is a surprise to a lot of people. But, again, you kind of have to think back to where it's come from and how low it got. My comment about the US not being back to peak goes even more so for Europe. There's a lot of room for Europe I think to improve if they can ever get economic growth kicked back in there. So that's a little bit of a rundown through the world.

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

Hi, Eli, it's Doug here. I want to talk about the Tier 4 that you alluded to also and there's -- we're in the throes of 2014/2015. By the end of 2015, virtually all construction equipment will have been -- will be Tier 4 final compliant. And as we go through that, we're about halfway done, maybe a little bit more than that in terms of individual models. That has, as we phase out of Tier 4 interim and phase into Tier 4 final, and again, it's depending on horsepower, size or kilowatt class, that has doubled the degree of difficulty in some of those assembly lines certainly around implementation and we're seeing some of that availability go out and you mentioned you heard that from dealers. I do too. I would expect that to continue for a little bit more, but all of our product managers are all over it and I suspect by the time we're done with Tier 4 final by the end of next year, if not before, this will work its way through as well. We're really happy by the way with the Tier 4 final machines that are out there. A lot of them are running up a lot of hours and doing very, very well in the marketplace. So as soon as we work through this kind of bubble of introductions, I think we'll like what we see, but it's a bit of a challenge right now. You are right.

Eli Lustgarten - *Longbow Research - Analyst*

Thank you very much.

Operator

Andrew Casey.

Andrew Casey - *Wells Fargo Securities - Analyst*

Wells Fargo Securities. Good morning, everyone. A couple of questions. First on E&T margin performance, Q3 obviously very strong at 20.1. You talked about volume helping the quarter and then a negative mix going forward into Q4 because of the electric power contract. I'm just trying to understand how to handicap the impact of presumably lower US locomotive sales in 2015 on mix. Was there a positive mix in Q3 or was it all due to volume?

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

Well, there are several questions wrapped in there. If we take locomotive specifically, no doubt next year is going to be lower, but that would -- if you're just looking at locomotives, that would actually be a positive for mix. The margin of a locomotive would be not the same as the segment average. So no, I don't think that would have a -- that would not have a negative mix impact next year. In fact, big sales of that in the fourth quarter would likely have a -- would be another reason that fourth-quarter mix might be a little weaker.

I think it's probably a good time to take that whole rail sector and frame a bit how it could impact next year. Our view at least at this point is that certainly locomotive sales will be down, but remember our rail sector or our -- that industry, our business there has more than just new locomotives. We have a very large service business and then we have a pretty sizable parts business for locomotives and we have a healthy international business that we expect to be up actually next year. So overall, our view is that rail will have a negative, but probably less than 2% impact on Energy & Transportation next year. I hope that helps.

Andrew Casey - *Wells Fargo Securities - Analyst*

It does, Mike. Thank you. And then if I could ask another question within E&T. There's been a lot of concern about some recent changes in commodity prices as it relates to oil. Could you comment on maybe what percent of revenue is exposed to upstream production for oil and nat gas and then is there any point at which oil prices may start to impact demand? Thanks.

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

Yes, that's a good question, Andy and I know that's certainly been on everyone's mind with what's happened to oil prices over the last few weeks. And certainly lower oil prices aren't a particular help, but they are about where they were right now a couple of years ago and our business didn't fall apart two years ago in oil and gas. So while it's not a big positive, we don't think it's going to be a significant negative as well, at least not where it's at now.

You asked a question about how low would oil prices have to go and that's always a sliding question. It would depend a lot on where they were, how long they stay -- it's a very difficult question to answer. I can say that we're at now where we have been over the last -- not last year, but a couple years ago, we were down at this level and again, it wasn't all that negative. Remember the majority of our oil and gas business is gas compression and oil and gas production and transmission. So production is a big driver in our business.

Also particularly for our turbine business, it tends to be pretty long term. The kind of projects that our customers are doing are big, many of them multibillion dollar projects that go several years and most of those big oil companies, they understand that there are short-term fluctuations in price and on those big investment projects that they have in-flight, which would effectively be in our backlog at the moment, they generally don't change those based on short-term fluctuations. So all in all, I would say we'd like to see a little higher oil price, but kind of where it's at now, we don't see it having a big negative impact.

One other just minor point maybe around that and that is the dividend that could play through potentially in other parts of the business. When oil prices are down, there's usually a pretty direct consumer impact of that. People purchasing gasoline and the lower price of oil leads to a lower pump price, which puts a little more money in everybody's pockets. So maybe that would be helpful for the economy overall.

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

I just want to add here, it's Doug here again, and we're obviously watching oil and gas prices very closely. We're talking to -- trying to stay close to our customers on this and what they're saying and I think you are seeing their quarterly announcements come out and generally the feedback we've been getting that say mid-80s, low -- or say 80 to 90, somewhere in there, on a sustained basis certainly will take the really agitated top off of it, but there is still plenty of room for reinvestment. Like Mike said, it's still where it was a couple years ago. I think if you see low 70s on a sustained basis, there would be a chill across the market and I'd say gas coming down below $3 substantially on a sustained basis may do that as well.

The other wildcard here that we're really anxious about and looking forward to is Mexico opening and the oil and gas industry there is about to go. We're confident it will. They've passed laws down there, they've made changes in the industry. That's going to go at almost any oil or gas price. So there's so many moving parts on this all over the world that it's just hard to predict. But basically in the US, mid-80s we think is on a sustainable level we can all live with.

Andrew Casey - *Wells Fargo Securities - Analyst*

Thank you very much.

Operator

Ann Duignan.

Ann Duignan - *JPMorganChase - Analyst*

Yes, good morning, JPMorgan. I think just following up on that theme, one of the things that Komatsu has said recently and not to quote a competitor, but I'd be interested in your comments on it, is that a lot of their construction equipment is being supported by domestic oil and gas also. Can you talk about that a little bit, Doug and then what indirect impact might that have if oil prices were to fall to the low 70s?

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

Yes, sure, Ann and I think that's right. We've seen everything from pad preparation to roadbuilding around all the shale zones in the country and that has impacted to some degree our construction equipment. I don't think it is probably going to move the needle; I don't think it's material, but it would certainly impact that a little bit in our case. Again, if we get down to the low 70s, a lot of bets are going to change on a lot of things and there's no doubt that would be impacted to some degree. I would agree with that.

Ann Duignan - *JPMorganChase - Analyst*

So in your view, Doug, and most of the increase in construction equipment plans you're seeing now in the US are pure resi and nonresi construction-driven?

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

Yes, I would say it's across the table or I mean across the board, yes, yes.

Ann Duignan - *JPMorganChase - Analyst*

Okay.

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

Certainly the fracking site preparation has been a help, but, boy, we're seeing kind of across the board steady growth, lower than we'd like, but steady growth in the other businesses as well for construction equipment.

Ann Duignan - *JPMorganChase - Analyst*

Okay, thank you. Just a clarification on your outlook for 2015. You said in the US you were hopeful that we would get a Highway Bill. Is that included in your outlook or would that be upside to your outlook?

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

I don't know that I said I was hopeful, but I said it could be upside, but there's a possibility and it depends on a lot of things in Congress. I think in terms of India, we're definitely going to see infrastructure spending increase at a significant rate. We mentioned Turkey in the writeup. I'm also optimistic in Brazil, although there's an election there this weekend, but both candidates, both parties are talking about reflating the economy and Brazil has always used infrastructure as a way to do that. In our case, we could see some kind of -- either a steady extension of what we're doing or a bit up as Congress tries to stimulate the economy or do what they do. But I wouldn't say I'm hopeful, but it could happen. I'll put it that way, Ann.

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

Yes, Ann, I made the comment a few minutes ago and I think there's been a lot of elections this year. The one in the US is coming up, so hopefully we'll have a window where the government can work together to make some progress before the next election.

Ann Duignan - *JPMorganChase - Analyst*

In a lame-duck session indeed.

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

No, I don't think it would happen in a lame-duck, although anything can happen. But I would say it's more going into post-election in 2015 as maybe there's some consensus to try to get after job creation, grow the economy faster. That could push on some element of tax reform a little bit and infrastructure. Those would be the two things that have an outside chance of something happening. Bigger than right now, but I'm not going to call it it's going to happen.

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

Back to your original point, Ann, we're not counting on a big --

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

Yes, right.

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

We're not counting on a big upswing as a result of that, no.

Ann Duignan - *JPMorganChase - Analyst*

Okay, I'll leave it there. Thanks. I appreciate it. I'll leave my questions for off-line.

Operator

Seth Weber.

Seth Weber - *RBC Capital Markets - Analyst*

Hey, good morning. It's RBC. Mike, it sounds like you bumped up your restructuring cost expense a little bit this year to $450 million from $400 million. And it sounds like that's targeted at the mining -- the Resource business. Can you give us any color on the incremental details or where you're stepping up the spending there?

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

Yes, actually I won't point to any one thing. We started the year by saying $400 million to $500 million and some of the projects we understood very specifically, some were being studied and that was the reason we had a range. There were some that we might do, some that we might not do. Last quarter, our estimate was closer to $400 million, so we kind of revised it down a little bit. That estimate right now is closer to $450 million, so there are a couple more things that we're doing. None of them are material. None of them would we want to call out separately. About the only thing we've talked about separately that individually is pretty material is the European restructuring we did in Construction. So again, we started out the year saying $400 million to $500 million and I think we're going to basically come in there.

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

But just to clarify, the vast majority of that is not Resource Industries or Mining. It is in and around the construction equipment business. In fact, Resource Industries' restructuring in 2014 of the $450 million is one of the smaller pieces.

Seth Weber - *RBC Capital Markets - Analyst*

Okay, thanks for that clarification. And then just on the performance of the business, I think you called out the mining -- the aftermarket parts sales were down. Could you talk about any color on the aftermarket order activity in the Resource business?

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

For us, sales and orders are pretty much the same thing. We turn around parts orders usually in about 24 hours, so there's no significant backlog there. So one is about the same as the other. For the Company overall, parts sales were positive and I think seem to be starting to build some momentum and that's a good thing. Mining is still I would say weak and really not much changed one way or the other.

Seth Weber - *RBC Capital Markets - Analyst*

Did you see any pickup sequentially in orders, aftermarket orders?

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

No, no, we did not.

Seth Weber - *RBC Capital Markets - Analyst*

Okay, that's all I had. Thank you, guys.

Operator

Stephen Volkmann.

Stephen Volkmann - *Jefferies & Co. - Analyst*

Good morning, guys, it's Jefferies. And I'd like to actually go back. Doug, you were just talking about the restructuring that was mostly done in Construction. And I guess I was under the impression certainly that the first half of 2014, Construction margins were probably overearning a little bit. You guys built a fair amount of inventory I think. And so I guess I had assumed that those numbers were sort of not something I should think about as we move forward and yet there's a fair amount of restructuring going on here. I guess I'm just having trouble trying to parse out how much of the restructuring has sort of permanently improved those Construction margins and how much you had temporary things going on in 2014.

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

Yes, I'll answer that. This is Mike. So we're talking about Construction here. So in 2014, I think -- this is maybe an odd way to say it -- but I think Construction is a little bit -- this is probably not the right choice of words, but more back to normal. If you go back to starting in late 2012 and throughout much of 2013, in Construction, we were reducing inventory, both ours and dealers and that had negative impacts on production. It made price realization tougher. So I think 2013 was a very tough year for construction because of that. And I think this year, if you look at dealer inventory changes, there has been changes by quarter, but by and large they are likely to end the year about where they started. Production levels are kind of matching demand in other words and have been pretty stable.

To the point that Doug made earlier, that has really helped efficiency and we don't have the downward changes if you will. And in fact, you see part of that in their price realization this quarter versus a year ago. I think in terms of the restructuring charges, there is a little bit of benefit in this year, but, again, much of it is around restructuring our Belgium facility and some of the benefits are in this year and more will be added in next year a bit and then after. So I think there's more to come in terms of restructuring benefits for Construction.

Stephen Volkmann - *Jefferies & Co. - Analyst*

Okay, great. That's helpful. Can you just update us, Mike? I thought I remembered you were going to try to reduce inventories in Construction. Maybe it was more broad than that, but something like $800 million this quarter and Q4 and it looks like maybe you didn't quite get there. Can you just talk about how you feel about all that?

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

Yes, again, this goes back -- what we're talking about here is dealer inventory. Last quarter, we said we thought that dealer inventory was going to come down somewhere around $800 million and this quarter, dealer inventory went down $600 million. I would call that, given your ability to forecast all the moving parts of that side actually, pretty good. I think it's directionally what we thought it was going to be. I think the fourth quarter is probably going to be directionally what we thought it would be.

And it's a couple of things. Part of it is seasonality. Construction adds to inventory. If you think about the northern hemisphere where you're in winter, not a lot of activity going on then and so we tend to produce more and dealers tend to stock up. You can kind of smooth load things a little bit better and then it gets sold throughout the rest of the year. That's pretty common, that's happened, that's happened this year.

We've had absolute reductions that I wouldn't call seasonal in mining and that has continued. Although the reductions are a little bit maybe less than they were a year ago. That dealer inventory is coming down and it's at a pretty low level right now. If I look at dealer inventory overall, I would say it's in pretty -- barring the seasonal changes that occur, I would say it's in pretty good shape. We do not have a dealer inventory problem per se.

Stephen Volkmann - *Jefferies & Co. - Analyst*

Okay, I appreciate it.

Operator

David Raso.

David Raso - *ISI Group - Analyst*

ISI Group. Good morning. The question is on oil and gas, the order book. Can you give us some feel for where the order book is year-over-year and how far does it extend into 2015? And also how are you extrapolating that order book when you lay out your 2015 sales guidance?

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

Yes, okay, David. So I would say overall, and this is one of the industries where we actually do have a little bit better visibility than say Construction where, relative to sales, the order book is usually a little less. It turns over quicker. I'd say it's pretty healthy and in fact, if you look at Solar, it's actually roughly where it was a year ago. It's not changed much during the year. If you look at the rest of Energy & Transportation -- in the reciprocating engine piece of it, it's up. We had a nice increase in the third quarter and I'd say it's at pretty healthy levels.

When we forecast next year, we don't just look at the backlog and forecast forward. It's more like we're out there trying to figure out what we think will actually happen in terms of sales and then we use the backlog as maybe kind of a reality check to see if that makes sense. So I would say, for Energy & Transportation, we still have a pretty good backlog.

David Raso - *ISI Group - Analyst*

And to be clear though, oil and gas within E&T was my questions. So can I take that reciprocating comment as similar to what you have in oil and gas, up on recip and flat on Solar?

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

I gave you solar because that's mostly oil and gas. The recip -- remember, think factories. We build engines and they get sold into different applications, so the data that I see around backlog is around product, not end market necessarily. But I would tell you I think anecdotally a lot of the strength has actually been oil and gas.

David Raso - *ISI Group - Analyst*

Okay. And then lastly, on the puts and takes for 2015, I know we're not giving an earnings guidance, but just trying to think of the moving parts, things we've said in the past. Do they still stand for restructuring savings for next year? Any carryover or incremental benefits from repo, the short-term incentive comp? I know you bumped it up to $1.3 billion today for this year. Just trying to think about those puts and takes and maybe a comment on pension. Just something to frame the puts and takes for the 2015 earnings model.

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

Yes, David, this is Brad Halverson. I'll take a shot at this without giving you guidance for 2015, but try to tell you how we think about it internally. We remain very committed to our pullthrough targets and operating profit of 25% on the way up and 25% to 30% on the way down. We've demonstrated that as well this year with our profit being up year-to-date with sales being down. And that's driving focus across all the units in terms of restructuring lean, I'd say also improved (technical difficulty).

Operator

(Operator Instructions).

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

David, we lost the line again; we're not sure why. I'm not sure how far we got before we lost you.

David Raso - *ISI Group - Analyst*

Brad, if you can hear me, I basically -- you started to talk about a little bit beyond the comment of incremental is 25% on the way up, 25% to 30% on the way down and just how the segments (multiple speakers).

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

Yes, I'll just try to give you a flavor of how we're looking at it without giving guidance. And if I repeat something, we'll just do that since we're starting over here. But we talked a little bit about being nimble. Earlier somebody made the comment; we feel that internally and we think it's driving our flexible cost structure. It's driving our delivery around incrementals and decrementals. Again, we're happy that profit is up with sales actually being down on a year-to-date basis and so it's driving the lean initiative, it is driving the restructuring efforts division by division and it is driving I would say pretty strong supplier collaboration as we look to improve our margins. So if we look out to next year, we have targets across each of our segments for incremental and decremental margins. If we were to get some sales growth next year, as we said, sales could be flat to up slightly. Assuming we get some sales growth, we remain committed to that 25% incremental pullthrough.

I think the other question you had commented about pension and we wouldn't see much of a change in pension year-over-year in terms of our pension costs.

David Raso - *ISI Group - Analyst*

Obviously flat sales or sales don't move up or down much, incrementals are a little less telling. It's a law of small numbers. So I think what we are just trying to figure out -- we used to speak of restructuring savings over time being $400 million to $500 million with -- a lot of the savings after 2015 would be significant, but even 2014 I think we used to speak of maybe a couple hundred million of savings, trying to think what that number could be in savings for next year, again, trying to think through the repo. And we can all make our own projections around sales, but we're just trying to think of non-volume-sensitive items.

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

Yes, I think in terms of giving more guidance, again, if you look at this year and you look at our original outlook, again, we've been pleasantly surprised with some operational items, particularly our margin and we've also been helped in the last quarter by currency, but I think clearly on an operational basis, we're really happy with where our margins are relative to flat sales and we see them moving forward, we see to be absolutely committed to the 25% pullthrough, which we think is a pretty good number.

David Raso - *ISI Group - Analyst*

All right. I appreciate the nonanswer.

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

David, we're not trying to be tricky on profit; we just didn't make a profit outlook. And we're trying really hard not to give all the pieces that make a profit outlook for next year. That doesn't mean that it's terrible, that doesn't mean it's great; it just means we didn't give an outlook.

David Raso - *ISI Group - Analyst*

But can you at least -- the one thing though, the restructuring savings that we used to speak to $400 million to $500 million by exiting 2015. How much of those savings do you think you will have captured in 2014 and at least some concept of 2015 just on that one item?

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

I suspect we'll talk more about that in January. We had savings in 2014 and we'll certainly have more in 2015.

David Raso - *ISI Group - Analyst*

Okay, I appreciate it. All right, thank you.

Operator

Steven Fisher.

Steven Fisher - *UBS - Analyst*

Great, thanks, it's UBS. Can you guys talk about how the rental channel is influencing your Construction sales in 2014 and how do you see that in 2015? And I guess how is demand in Construction outside the rental channel?

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

Wow, that's a good question. Actually rental has been affecting the business, I would say increasingly for, I don't know, 10, 15 years. Particularly when times are more uncertain, customers have a tendency to rent more. Remember, we tend to not sell through rental houses. We sell to Cat dealers who are in the rental business and we've had -- particularly in the US, we've had positive sales through the rental channel and positive sales through the end-user owner channel. I don't think there is anything out there that's driving a big structural change that impacted 2014 or that will drive a big directional change in 2015. But I think it is true that, as customers get more and more focused on asset utilization, the rental channel can be more attractive. That's why we're big time in the rental business. It's a key element of the Across the Table initiative. It's a definite part of the channel and here to stay.

Steven Fisher - *UBS - Analyst*

Okay, so both channels sound like they're up this year, is that right?

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

Yes, for North America.

Steven Fisher - *UBS - Analyst*

Right, sure. And then, Mike, you mentioned a lot of room for growth in European Construction. How do you feel about the visibility of European Construction right now? Is your base case for next year that that's maybe flat?

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

Yes, so when you look at Construction, and I kind of touched on this a little bit a bit ago, there are two parts of the business, parts, for example, where we have little to no backlog because we get an order, we ship it, we get an order, we ship it. So it's not the kind of thing that lends to a lot of visibility based on a backlog. And Construction is a little bit like that too. Generally when a customer or when a dealer orders on average, they get it in a few months, so the backlog isn't quite like it would be for maybe a big turbine or a big mining truck.

So again, I would say in Construction we forecast based on what we think is going to happen economically, where the market is relative to replacements. We look at where dealer inventory is -- we take in a lot of factors. Backlog and short-term visibility don't play into Construction or parts sales at all as much as they do in some of the other parts of the business. So I guess bottom line -- so it's a long-winded answer to say within Construction, it's normal not to have a lot of concrete visibility through a backlog.

Steven Fisher - *UBS - Analyst*

So the baseline probably would be about flat is your expectation for next year in Europe?

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

Yes, I think that's the case for all of our -- this is a worldwide comment, but for all of our segments. We said flat to slightly up next year and we don't see either Energy & Transportation, Construction or Resource Industries being far from that. It looks pretty flat to up a little for much of the business.

Steven Fisher - *UBS - Analyst*

Terrific. Thank you very much.

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

We're at the top of the hour, so we'll sign off. Thank you very much for joining us on our conference call today. We'll talk to you next quarter.

Operator

Thank you very much, ladies and gentlemen. This concludes today's presentation. You may disconnect your lines and have a wonderful day. Thank you for your participation.
