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CAT - Q4 2014 Caterpillar Inc Earnings Call

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OVERVIEW:

Co. reported 4Q14 sales and revenues of $14.2b and profit per share, all-in, of $1.23. Expects 2015 sales and revenues to be about $50b and profit per share, all-in to be $4.60.

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Caterpillar year-end 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 Financial Services Division*

Thank you very much and good morning everyone and welcome to our year-end conference call. I'm Mike DeWalt, Caterpillar's Vice President of Finance Services. 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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This morning we will be discussing forward-looking information that involve risks, uncertainties, and assumptions that could cause our actual results to differ materially from the forward-looking information. A discussion of some of those factors that either individually or in the aggregate could make actual results differ materially from our projections, that can be found in our cautionary statements under Item 1A, Risk Factors, of our Form 10-K filed with the SEC in February of 2014 and with our 10-Q filed with the SEC in August of 2014. It is also in the forward-looking statements language in today's release.

In addition to that, there's a reconciliation of non-GAAP measures; and that can also be found in our financial release, which again is on our Caterpillar.com website. Okay. With that, let's get started.

This morning we'll be reviewing our financial results for the quarter, for the full-year of 2014, and we'll spend some time on our 2015 outlook. Now, as I do each of those I just want to go through the major themes right now.

For the quarter, sales were about as expected but we were disappointed with lower profit in the quarter than our outlook. The significant decline in inventory in the quarter, more so than we anticipated, was a large contributing factor to that.

For the full year of 2014, the major theme continues to be around execution and better profit per share than in 2013 and the outlook that we started the year with. We're pleased with what we've accomplished in 2014, given the continued weak economic conditions in most of the world and the decline in commodity prices.

Now for the 2015 outlook, well, it's shaping up to be a much tougher year than we were expecting when we went through our preliminary view of 2015 with you all last October. It's been definitely a developing story as oil prices have continued to decline. No doubt it will be a major topic of discussion when we get to the Q&A in a few minutes.

With that quick recap of the themes, let's start with the review of the fourth quarter. Sales and revenues were $14.2 billion, and that was close to last year -- actually down about 1% from $14.4 billion in the fourth quarter of 2013.

Profit per share all-in was $1.23, and $1.35 excluding restructuring costs. That is down from $1.54 all-in and $1.68 excluding restructuring costs in the fourth quarter of 2013.

Quarter-to-quarter restructuring costs were a little lower in 2014, about $100 million in the fourth quarter versus about $130 million in Q4 of 2013. So not a lot of change there.

Excluding restructuring costs, profit per share from the fourth quarter of a year ago to this fourth quarter declined $0.33. There were several things that contributed to the lower profit.

First, we had an absence of several favorable items from the fourth quarter of 2013. We had $115 million of LIFO benefits in the fourth quarter of 2013; we had a favorable legal settlement that was close to $70 million.

We had gains on the sale of securities and currency gains in our Financial Product segment, and in the fourth quarter of 2013 Financial Products also had a favorable adjustment for their allowance. Now, they had another favorable allowance in 2014, but it was quite a bit less.

Now, in addition to the absence of those favorable items we also had higher employee incentive compensation. That was about $110 million up in the quarter. That was because our incentive compensation metrics for the full year turned out better than we expected when we set them at the beginning of the year.

Excluding incentive compensation, SG&A and R&D combined were up in the quarter, but were down for the full year. While R&D was about flat for 2014, we'll talk about this in a bit, in the outlook; but we are expecting some increase in 2015.

We also had unfavorable inventory absorption in the quarter. That's a result of a more significant inventory reduction in the fourth quarter of 2014 than the fourth quarter of 2013.

Now, we also had some positives in the quarter. Income tax versus Q4 2013 was positive about $0.11 a share; material costs were favorable; and price realization, while up less than 1%, was a small positive. Profit per share also benefited from a lower share count, and that was a result of share purchases in 2014.

So that's the fourth quarter versus the fourth quarter of 2013. Let's take a look at how we did versus the outlook.

We ended nearly spot on with sales and revenues, but profit per share was $0.12 lower than the outlook that we provided last October. We did have one positive item in the quarter, and that was the passage of the tax extenders. The major 2014 benefit for us was the R&D tax credit included in that.

More than offsetting the favorable tax, we had some negatives, the most significant being the impact of negative inventory absorption. We were expecting a small inventory reduction in the fourth quarter, and we actually ended up taking inventory down $1.1 billion. That resulted in a substantial cost absorption headwind versus our outlook.

While it was a hit to profit, we want lower inventory. We've been working to reduce it and are happy to have it lower.

Now, in addition price realization and sales mix were not quite as positive as we had expected, and we had modest hedging losses. None of those were what I would describe as major all on their own, but they all kind of went in the same direction.

When you forecast, you almost never get everything right. And even when you're close in total, there are always puts and takes. In the fourth quarter, other than the R&D tax credit, most of the elements of our forecast went the other way.

In summary, Q4 was right on with sales. We had a major reduction in inventory, and we like that; but it continued to lower-than-expected profit.

Okay, that's a quick runthrough of the fourth quarter versus the outlook. And before we get into the 2015 outlook, I would just like to do a quick recap of the full-year 2014.

To help put it in perspective, I'm going to go back in time a little bit to 2012 to set the stage. In 2012, that was before the substantial decline in mining. Our sales and revenues were about $66 billion.

As we ended 2012 we expected 2013 to be down because of mining, and we got that and a lot more than we expected. We revised 2013 down every quarter in 2013, looking for a bottom in mining. We ended 2013 with sales down $10 billion from 2012.

At the end of 2013 we would have liked to have predicted a sales increase and recovery in 2014, but we started with a view that that wasn't in the cards for 2014, with mining remaining weak and the global economy continuing with below par growth. We expected, as a result, 2014 sales to be about flat with 2013.

And that's actually about what happened. The bad news is we weren't surprised by a large rebound in the global economy. The good news is we called it pretty close to what happened and didn't get surprised with continuing bad news.

As we started 2014, we were expecting a relatively flat top line and relatively flat profit per share, excluding restructuring costs. We accomplished that and a bit more.

Excluding restructuring, profit per share was $6.38; and that's up from $5.97 in 2013, again excluding restructuring. And it was better than our original outlook of $5.85.

We also did better than we expected with operating cash flow. Our Machinery, Energy & Transportation operating cash flow was $7.5 billion in 2014. In fact, two of the best three years we've ever had were 2013 and 2014.

That helped enable us to repurchase $2 billion of Caterpillar stock in 2013 and another $4.2 billion in 2014, and it helped set us up for increases in the dividend. We took the dividend up 15% in 2013 and 17% in 2014.

Now, in addition to the financial performance we improved inventory turns in 2014. We improved our market position for Cat machines as well; in fact, it was our fourth consecutive year.

We've done that by holding price realization low. 2014 was another year well below 1%.

And we've done it by providing customers with great products. While our Tier 4 introductions aren't over, we're very pleased with what's been introduced so far, and customer and dealer feedback has been positive.

Quality is also helping. 2014 was the fourth consecutive year that the quality of the machines that we deliver to our customers has improved.

I already mentioned better inventory turns, and that was great. We're on a Lean journey, and certainly we have more room to improve there.

I'll end this recap of 2014 with safety. We probably don't really talk enough about it, but it really is a high priority. For the last decade we've made steady progress on improving safety, and I'm happy to say that improvement continued in 2014.

So all in all, fourth-quarter profit was disappointing but 2014 overall was a pretty good year financially, particularly considering the economic and industry dynamics we had to work with.

Okay. With that, let's go through the 2015 outlook.

As I'm sure you picked up from our financial release this morning, we are more negative on prospects for 2015 than we were three months ago when we provided you with our preliminary view of 2015 sales and revenues. In recent weeks, with commodity price declines, our view of 2015 has certainly been a work in progress; and we've just recently finalized the outlook.

Back in October, we expected sales and revenues would be flat to slightly up. Our current view is that sales and revenues will be about $50 billion, and that's down over 9% from 2014.

Without a doubt, the impact of substantially lower oil and gas prices is the most significant reason we're expecting lower sales in 2015. From mid-October to today, oil prices have dropped from the mid $80s to the high $40s, and that's off prices that were around $100 for most of the first half of last year. With oil this low, we expect substantial reductions in producers' CapEx and that it will be negative for our sales.

Now I'm going to take a minute to put what we do in oil and gas into some perspective. Most of our oil and gas related sales are in our Energy & Transportation segment. To scale that a bit, in 2014 about a third of Energy & Transportation's $22 billion in sales were directly related to oil and gas.

Their oil and gas exposure is, however, diverse. They are on the front-end with engines for drilling; engines, transmission, and pressure pumps for well servicing; we have engines that go into compressor sets for gas gathering; we have engines and turbines that move oil and gas along a pipeline. And our turbines are used extensively on offshore production platforms.

Now, in addition to those direct exposures in Energy & Transportation there are some indirect exposures that are real, but a little bit more difficult to put a specific number on. For example, we sell marine engines and some go into vessels that service offshore oil and gas platforms. We're in the rail business, with services in locomotives; and oil transport has become an increasing business for our rail customers.

In terms of the 2015 outlook, we believe the direct part of oil and gas that will be hurt the earliest and most significantly will be drilling and well servicing, particularly in the second half of the year. At this point, because of the scale and long-term nature of projects that use turbines, we don't expect much impact there in 2015. However, if oil and gas prices stay this depressed throughout 2015, there could be a negative impact for the turbine business after 2015.

So those are the more direct impacts. Now, there are other indirect impacts from substantially lower oil prices that we think can play into 2015.

In countries -- and, in fact, in some areas of the US -- where oil production is significant for government entities and local economies, it will likely be a negative for the sales of construction equipment and our electric power generation business. In some cases it can be fairly direct, like building roads to service new wells; or it can be very indirect, like construction spending in a country where the government relies on oil revenue to fund government spending.

Order of magnitude, roughly half of our expected year-over-year decline in sales is from these both direct and indirect impacts from the fairly dramatic decline in oil prices. Now, in addition to the impact of oil and gas, there are several other factors that are contributing to the decline in the sales and revenues outlook.

Year over year, we expect a stronger dollar to be a sales headwind. Commodity prices in mining have also taken another leg down over the past few months. For example, when we provided our preliminary outlook last October, copper was still over $3 a pound; today it is in the mid $2.50s.

Order rates for our Resource Industries segment have been reasonably stable at low levels. But the continued decline in commodity prices and continued efficiency improvements by our mining customers have caused us to lower our sales estimate for Resource Industries in 2015.

With weakness in agriculture, we're also expecting lower sales of industrial engines. And we expect our rail business to be down in 2015 after a great year in 2014. Now, that's not a new development; we anticipated that and discussed that last October.

Our expectation for the construction industry in China is also lower. Our sales over the past year have held up better in China than the industry overall; but with lower expectations for China construction, we think our 2015 sales in China will be down.

Okay, that's a runthrough of 2015 sales, the direct and some of the indirect impacts from dramatically lower oil, lower mining sales, a stronger dollar, lower sales in our rail business, and weakness in construction outside the US, including China. So let's shift over to profit.

We're expecting $4.60 a share all-in for 2015 and $4.75 excluding restructuring. We are expecting to continue with restructuring actions in 2015, but with less cost than in 2014. In 2014 restructuring, costs were $441 million; and we're expecting around another $150 million in 2015.

Now, excluding the restructuring, profit per share is expected to decline from $6.38 to $4.75. That's a drop of about $1.63.

I'm going to go through the headwinds and tailwinds in a moment. But before I do that, I'd just like to put the drop in profit in perspective with the sales.

Much of the sales change between 2014 and 2015 is related to oil and gas and mining. Those are two areas with higher than average variable margins.

Despite that, our $4.75 per share profit outlook -- again, excluding restructuring -- reflects a decremental operating margin close to 25% and the impact of the higher tax rate. That's mostly because the R&D tax credit wasn't extended past 2014.

Now, our target range for decremental operating margin is 25% to 30%. Our 2015 has us closer to the bottom end of that, which is good; but as you might expect, there are plenty of pluses and minuses that go into that.

On the positive side, we expect lower incentive compensation in 2015. In 2014 incentive compensation was higher than target, and that's because we exceeded our incentive metrics that we had set earlier in the year.

We're expecting variable manufacturing costs to be favorable in 2015. That's a result of our continuing work to remove costs and improve efficiency and lower material costs.

Now, this might be counterintuitive for some, but the stronger dollar, while negative for our sales, is positive for our costs overall. That's because of our non-US operations and our material purchases outside the US.

Overall, that's expected to be a positive for profit. We're planning another small but positive contribution from price realizations; we're expecting an increase of less than half a percent.

Now, the headwinds to 2015 profit include higher R&D expense. Now, for the Company in total -- I'm going back a couple of years here again. For the Company in total we lowered R&D 17% in 2013 from 2012, and that was in response to the decline in sales. Now, excluding the impact of incentive compensation, R&D remained at about that level in 2014.

In 2015 we are planning to increase R&D. We are in a very competitive and changing world, and products and services do matter. We understand the need for profit in the short term, but we also need to invest in the future.

That's the main reason R&D is increasing. It's primarily for new and updated products and more work on new technologies that have application across the Company.

In addition to R&D, cost absorption from lower inventory is also expected to be a headwind. With the decline in sales we expect more inventory reduction in 2015 than we had in 2014. And while that's a positive for cash flow, it will have a negative impact on costs.

As I mentioned a minute ago, with a greater proportion of our expected decline in sales occurring in the higher-margin products we anticipate an unfavorable mix impact from sales on our operating margin. We also have higher pension expense for our defined-benefit plans, and that's a result of lower interest rates at the end of 2014 and a revision in the estimate of lifespans for the folks in our plans.

Okay, that's a runthrough of what we expect for 2015. The bottom line for us in our business is: it has been and continues to be a tough environment for many of the industries that we're in. Mining is weak and operating below what we think a normal level is and far below the prior peak.

From an industry volume standpoint, North American construction, while better than it was a couple years ago, is still about 15% below the prior peak; Europe is about over 40% off its prior peak; and China is still 60% off its prior peak. So room to grow in all those areas.

Energy & Transportation -- it's a diverse business serving oil and gas, transportation, power generation, and industrial applications. It's been a great business for us, and we are expecting another good year in 2015. It will be good, but not quite as good as 2014.

Based on our outlook for 2015 sales and revenues, 2015 is going to be our third consecutive year of sales decline. To put that in some perspective, that's happened only one other time in the history of our Company, and that was during the Great Depression in 1930, 1931, and 1932.

Overall we think we've done pretty well with the economic and industry climate we have to work with. We have improved our market position and our operations. But we would certainly like to see a better global economy.

So that's it, and with that we are ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Andrew Kaplowitz, Barclays.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Good morning, guys. Mike, I think you did a good job on the puts and takes of the 2015 profit guidance, but let me push you a little bit here. Like, you talked about being in the range that you usually have and 25% to 30% decrementals; but you are enjoying that $400 million tailwind from stock comp expense.

We've talked about restructuring benefits starting to ramp up in 2015, and I'm not sure how much that's going to help. Then obviously you mentioned the stronger dollar helping you.

I know you've talked about mix and I know you've talked about inventory destocking. But maybe you could quantify something like inventory destocking or -- what I'm really trying to figure out, Mike, is if there is an element of conservatism at all in this guidance.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

You know we try to be prudent. There are always upsides and downsides to the forecast. We always attempt to try, if we can, to pick a middle, reasonable ground.

You did pick out currency as a modest positive; and you're right, the incentive comp is positive as well. But -- and on the restructuring we do expect favorable variable cost next year, above and beyond just material costs. So we do have some improvement baked in for that.

But we do have, again -- and I'm just a little bit repeating what you said. Mix is negative. We've got a $5 billion decline in sales.

And that is -- I think between that and the continuation of our Lean journey, we are likely to take inventory down more next year. We have somewhere around a 15% to 18% negative hit to profit from cost absorption on that, so that's going to be negative for the year.

R&D is probably not going to be quite back to the 2012 levels, but we do need to fund some more. We've got a ton of exciting programs for the future that we need to get on with now, and so we plan to do some funding of that.

Again, the two tailwinds are stiff, and the incentive compensation and a little bit from currency to the bottom line. I don't feel like I added a lot more for you there, but --

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Andrew Kaplowitz - *Barclays Capital - Analyst*

Okay, Mike. Is it possible to quantify restructuring benefit that you expect? You've given us in the past. Is it possible to quantify that?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

For next year?

Andrew Kaplowitz - *Barclays Capital - Analyst*

For 2015.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Actually, after this last decline in volume for us we're reworking the detailed plans. Before that we were looking at somewhere around I think an increment of somewhere around $100 million.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Okay. Then just shifting gears, can you give us more color on construction, global construction demand in general? At least what's baked into your forecast in 2015.

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Do you believe North American construction will be up in 2015? Or at least what's in your guidance for that geography.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

If we look at sales for construction, if we just talk about it generically, regionally, we are looking to be up in the US next year -- North America, mostly the US. Probably a little less than we thought before the oil price drop; so we're looking ahead to some headwinds in the oil-producing areas: Texas, South Dakota, Pennsylvania.

So US still positive but probably not quite as positive as we thought before. Almost every place else in the world to some degree negative.

We're still not getting any decent economic growth in Europe. The developing countries, Brazil, China, are still let's just say challenged. We're actually expecting a little lower GDP growth in China next year in 2015 than we had in 2014. So we are looking for the outside-the-US construction to be weak.

We also have quite a bit of the sales impact from the stronger dollar showing up in construction as well. So it will bear most of the brunt of that.

We've taken a stab at trying to estimate the impact of lower oil in the oil-producing regions. I will say that's probably -- that's tough to forecast.

We don't exactly know what the Saudis, the Nigerians are going to do, but -- just using those two oil exporting countries as an example; there are certainly many more. We don't exactly know what they are going to do, but we've taken our best shot. So we have taken sales out of those regions as well.

But I think if you were to combine it into a nutshell, we're looking down 5% to 10%; currency is a chunk of that. Outside the US generally oil-producing regions weaker; US not including oil, stronger.

Andrew Kaplowitz - *Barclays Capital - Analyst*

Okay. Thanks, Mike.

Operator

Nicole DeBlase, Morgan Stanley.

Nicole DeBlase - *Morgan Stanley - Analyst*

Yes, thanks guys, good morning. Maybe just starting a little bit with oil, I'm just curious what exactly you are hearing from your customers. I think if we looked back to 2010 it took several quarters for this impact to start bleeding through to your results. So I'm just curious how soon we'll start to see the weakness come through, both in your retail sales and in Cat's reported results.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, that's actually a great question, Nicole, because if you looked at the 2014 fourth quarter -- or December even -- retail sales statistics, oil and gas was still pretty strong. And it will probably continue that way for a while. We're selling out of a backlog.

So what we'll be seeing first is -- and we're actually starting to see it now, so I guess this is what we're hearing from customers -- is a decline in order rates for oil and gas. It probably won't show up in our sales for at least a quarter, maybe a bit more than a quarter, in the second half of the year.

Particularly for recip engines -- you know, piston-based engines -- for drilling and well servicing. Our sales are likely to fall off quite dramatically for that kind of product and certainly in the second half of the year.

Nicole DeBlase - *Morgan Stanley - Analyst*

Okay, got it. That makes sense. Then I guess maybe a somewhat philosophical question. How much does a strong US dollar concern Cat generally, given that you have such a strong base of sales in international markets? And to that point, are you seeing increased competitive intensity yet from Japanese or European OEMs?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, that's a great question, too. Generically what we've done over the last -- I don't know, 30 years basically, is try to diversify our cost base to try to help it match up a little bit better with sales. So if you take 2015 for example, the stronger dollar as we convert all those sales from local currencies around the world into dollars is going to translate into fewer dollars.

The flipside of that is we have substantial manufacturing operations outside the US, and that largely mitigates the profit impact. So we have in the case of a stronger dollar a decent, sizable negative impact on sales but a positive impact on costs.

Usually it's not too big of an impact one way or the other on profit. Although it can depend on which currency moves and how much.

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

It's Doug Oberhelman here. I will just add a little bit broader perspective on that, the rising dollar. I would expect that 2015 would see more of that.

It will not be good for US manufacturing, nor the US economy. How that is offset against the lower oil, diesel, gasoline price I don't know how it works out. But certainly anybody producing in Japan, the UK, or Europe, particularly Germany, is going to have and has had quite an advantage over their American competitors. And I would expect that to have an impact on the US in some way.

We have worked hard, as Mike said, to diversify our manufacturing footprint. We're large exporters and have a large cost base in Japan, Europe, UK as well; so we're taking advantage of that, as he mentioned, when it works its way through to the bottom line. But overall I don't think it's a very good positive for US manufacturing, and it's a policy issue I think that is concerning.

Nicole DeBlase - *Morgan Stanley - Analyst*

Okay, great. I really appreciate the commentary, Doug and Mike. I will pass it on.

Operator

Robert Wertheimer.

Robert Wertheimer - *Vertical Research Partners - Analyst*

Thanks, Mike. Just wanted to follow-up on oil and gas. Obviously you've taken a big whack to the drilling and the completions, the pressure pumping. But have you heard anything on production platforms on maintenance for Solar turbines in the Gulf or in Nigeria or wherever? Have you factored any weakness in either production or maintenance into the account -- into the outlook? And if not, do you expect any could develop later into 2016?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

I think from a service standpoint, no; we haven't been hearing that. Once a platform is up and producing, they've got all that fixed cost sunk into it, so it's likely to continue to produce.

So no. And even on Turbo machinery projects, not just service for Solar, the nature of that business is they're long-term projects. By the time we produce a turbine the project is pretty far along.

So considering the lead times there and the kind of projects that are there, you tend not to get big short-term swings. It's not like somebody is coming in and buying something out of inventory off the shelf.

So we don't really see much of an impact with Solar for 2015. But -- and I mentioned this a bit in my lengthy preamble, that oil prices and gas prices stay this low, Solar is not immune; it's just delayed.

Robert Wertheimer - *Vertical Research Partners - Analyst*

All right, perfect. That was very helpful, Mike. Thank you. Then just a quick one.

It seems as though 1Q will still have some deliveries on the 3500s or whatever to the drilling and pressure pumping. Should we assume that the back half of the year has basically almost nothing in it?

I mean, the fleet has grown tremendously over the last 10 years. Maybe replacement sales continue to grow. I'm not sure if we should consider the back half to be the bottom or not on the drilling and completion side. And I will stop; thanks.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, it certainly won't be the first quarter or second quarter. Probably start tailing off as we get towards the end of the first half.

But yes, we've had actually some cancellations, so the backlog has come down. There have been some cancellations.

But that seems to have tailed off. So we're scheduled out reasonably for the first quarter.

We think some of that is -- if you have a well that's getting drilled you will want to frac it. So we think that what's in the order book here certainly for the first quarter is probably going to continue.

But orders have largely dried up for that kind of business, so the back half of the year is going to drop a lot for the drilling and well servicing.

Robert Wertheimer - *Vertical Research Partners - Analyst*

Okay. Thanks, Mike.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Probably not so much gas compression; certainly not for the turbine projects. But for the drilling and well servicing around oil in particular, yes.

Operator

Joel Tiss.

Joel Tiss - *BMO Capital Markets - Analyst*

Hi, I'm with BMO. Instead of beating up energy anymore, I wonder if you can give us a sense of why the resource industry dealer inventory went up a little bit, it sounds like in the press release. I just wonder if you're seeing anything positive there, or just what's going on.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

No, actually dealer inventory went down. It just didn't go down quite as much as it did in the fourth quarter of 2013. It's just a very challenged business.

If you look at order rates from customers, they've been -- I mean they bounce around a little bit here and there month-to-month. But if you look at the moving average they've been pretty stable here recently.

But it's actually been below our sales level. We've been selling a bit out of the backlog, and the backlog in mining is getting to a point where we just don't have the capability to continue to do that.

So in light of copper coming down around $2.50, iron ore prices severely depressed, and coal prices down, we're taking a cautious view of 2014 for mining. We were hoping that 2014 was the bottom. But given everything else that's going on in the world, at least our estimate of China GDP being a little lower next year than this year, I think the prospects for a rebound in 2015 are just probably not there.

So that's negative. There's also probably a small negative in there -- I don't want to over-play this, but we do sell into the oil sands in Canada, and we think there is not a -- in the scheme of next year's business it's not huge. But we do think there is a little bit of risk there as well.

Joel Tiss - *BMO Capital Markets - Analyst*

I wonder if you can share with us the overall Company OEM versus aftermarket at this point, or over the course of 2015. I think it's a fuzzed-up enough number where you wouldn't really be giving anything away, but you'd help us understand the resiliency of Cat's earnings a little better.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes. What I would tell you is as we've -- as I've talked about this outlook change I've tried to frame it in a couple different ways. What are the causes, like oil prices? And that goes across segments.

Then we tried to give you a view by segment: RI down 10%; E&T 10% to 15%; construction 5% to 10%.

But your point about original equipment and parts is a good one. I won't give you a complete split, but I would tell you that we would expect aftermarket parts to be pretty flat next year with this year. We're not taking that down, so the decline for the most part is coming out of new equipment.

Joel Tiss - *BMO Capital Markets - Analyst*

But you can't give us any sense if it's half of the overall business or anything?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

No, we've never done that, Joel, and probably not going to start today.

Joel Tiss - *BMO Capital Markets - Analyst*

All right, thank you very much.

Operator

Ross Gilardi.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Yes, good morning, Bank of America. Gentlemen, I'm just comparing your comments on construction to what we were hearing from the large rental houses, who are substantially more positive. Obviously your business model is different, and also for Cat Rental the fleet mix is different. But do you think dealers are losing marketshare to the bigger rental houses who've improved their footprint, are getting better at servicing the national account customers, and just their overall service offerings dramatically in recent years?

Anything you feel like you need to do from just a business model standpoint to deal with them?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Well, first off, Ross, I would start by saying we're actually pretty constructive about US construction. So we have US construction actually going up.

I think probably the major rental houses that you're talking about are US-based. They're probably not feeding back what's going on in Brazil, the rest of Latin America, China, Europe. So that is the -- that plus currency impacts, which they are also not seeing, are the two principal reasons that construction would be down next year.

So I think from a North American standpoint, honestly, I don't know what the rental houses are actually telling you in terms of volume. But we're up probably mid-single digits in North America construction, despite a little headwind we think from oil.

I think the dealers are actually doing a pretty good job on rental. It's been an increasing piece of their business.

It's a big focus, particularly in the US and Europe; it's how a lot of business gets done. It's a key element of our across-the-table initiative and we'll probably do more. So it's a big focus.

I think if you parse out how we're describing construction around the world, probably not that far off with what the rental houses are saying.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Yes, okay. I mean, I realize there are big geographic differences in your overall footprint. I was more isolating just the commentary around North America; but thanks for clarifying that.

Then given what you're saying about demand and the overall environment for Caterpillar in your various end markets, what are you thinking now about capacity rationalization across your footprint right now? Should we be expecting to see some bigger facility closures as 2015 unfolds, to better align supply and demand for the medium to longer term?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

How do I say this with the right tone here? We're a cyclical Company. Our sales in these industries, as we've seen by mining and certainly oil and gas, go up and down.

What we try to do is manage the best we can the fixed cost structure, the physical bricks-and-mortar capacity. You need that for when the business recovers.

So we have another $150 million in for restructuring costs in 2015, but I wouldn't say there are any large-scale plant closures in there. Certainly $150 million wouldn't cover that.

We have done a pretty good job on trying to flex our period costs down. So that's where we're really focused, not so much on bricks and mortar.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Got it. Thank you.

Operator

Kwame Webb.

Kwame Webb - *Morningstar - Analyst*

Hello, this is Kwame Webb from Morningstar. Thanks for taking my question today. For me on the Caterpillar Financial side, I was curious to know: what are you guys thinking in terms of loss allowances for 2015?

And then on a related note, I'd imagine the dealers are going to help you with repositioning some used equipment. What do dealer used inventories look like right now?

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

Yes, this is Brad Halverson. Cat Financial had another good year in 2014. In fact, if you look at the credit metrics in 2014 you'll see a positive story. Our write-offs were down; our past dues moved down to 2.17 from about 2.4 last year.

We get this question every now and then, and our China business continued to perform well. Their past dues were also down.

So we are seeing some softening in the used equipment market in the last few months. Mining has actually held up pretty well during the year. We'll see how that carries forward into next year.

But at this moment I would say that we don't have any concerns relative to our portfolio performance and past-dues, coming off another year of improvement, and I'd say be pretty stable heading into 2015.

Kwame Webb - *Morningstar - Analyst*

Then just a follow-up on the Resources business. There was some commentary about aftermarket sales improving. I think you guys actually said that you expect 2015 aftermarket to be flat with 2014. Could you comment on what specific product lines you're seeing strength or stability?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

For aftermarket just generically, the rate of change is much, much less cyclical than new equipment. So even in the areas over the last -- like mining, where it's been down over the last couple years, it's been down much, much less than the new equipment sales would be.

As we look forward to next year, I would say we don't see any material changes in any of the segments. There might be a little change around the edges, but nothing significant up or down by segment.

Kwame Webb - *Morningstar - Analyst*

Okay, thank you.

Operator

Ann Duignan.

Ann Duignan - *JPMorgan - Analyst*

Hi, good morning, JPMorgan. My question is around capital spending. You're keeping your CapEx budget flat year over year; R&D is going up.

Should we be a little bit concerned that Caterpillar is expecting a quick recovery in the oil business? Or can you just dig a little bit deeper into why you're holding CapEx flat? We would have expected with earnings down this much that CapEx will be down significantly also.

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

Ann, this is Brad Halverson. Maybe I'll talk just a little bit about cash, just to answer your question directly as well. We've talked a lot with you guys about improving our balance sheet coming out of 2008; and when we got to the end of 2013 we were very happy with our balance sheet in terms of our debt-to-cap, net debt-to-cap being around 17%, and carrying about $6 billion in cash.

We had another very good year, $7.5 billion of operating cash flow, and our CapEx was fairly well below our plan level for the year. I think you'll find $1.6 billion being a fairly low number for us and well below what we thought in 2014.

So we finished the year with net debt-to-cap around 18, and around $7 billion in cash, and so we're very happy with where the balance sheet is. In fact our working capital as a percent of sales, as we have worked on Lean and other initiatives, is at a record low, around 12%.

So all that said is that we feel really good about where our balance sheet is positioned. Our priorities, outside of maintaining the debt rating, would be growth.

We talked a little bit earlier with Andy: we're spending a significant increase on R&D in 2015 over 2014, and that's a big part of how we want to deploy cash. And of course that hits the P&L.

I think CapEx around $1.6 billion is a reasonable number going into 2015. There's a decent amount of that that's normal replacement-type activities that go in our manufacturing facilities. As you know we're fairly highly vertically integrated, which creates a little higher replacement kind of demand for capital. So I would say that's fairly reasonable going into that.

You may want to ask a little bit -- and I'll just jump to it -- around deployment of cash. I would say that we're continuing to look for growth opportunities.

We're not announcing anything today, but that activity remains very important to us and we're continuing to focus on that. The energy valuation has typically dropped, and so that's something that many are looking at, including us.

But we're really happy with the balance sheet position. We'll consider stock repurchase as we head into 2015. But again, those priorities remain pretty well the same for us, Ann.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Ann, I think I'll just embellish one thing on what Brad said. If you look at the CapEx that we do have, a lot of it's NPI; it's maintenance; it's not focused around capacity.

Ann Duignan - *JPMorgan - Analyst*

Yes. Okay, I did pick up on that. So that's at least valuable to understand.

Then my follow-up question is getting more philosophical. A lot of the restructuring spend that you have been doing the last few years has been in Europe, to set up Europe for Europe, I think is what the program was called.

Given where currencies stand now if you were embarking on that restructuring, would you do anything different? If we get to parity, euro versus dollar, would it make sense to be keeping manufacturing in Europe?

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

I'll comment here, Ann; it's Doug. We had some fundamentally I would say dysfunctional and not working operations in Europe. Not productive, not efficient, that we really needed to work through.

Where we will land up when we are done there, and we're closing in on that, is a really lean manufacturing system and operations that are sized for that business. And a euro at parity will just be a great tailwind for that.

I would point out our Grenoble plant in France that we downsized makes wheeled excavators today. It's one of the models we have in the world in terms of throughput, high-quality machines, and lower lead time. So we like that, and I think the currency benefit will just be gravy on that.

Ann Duignan - *JPMorgan - Analyst*

Okay, I'll leave it there and get back in line. I appreciate the color.

Operator

Vishal Shah.

Vishal Shah - *Deutsche Bank - Analyst*

Yes, hi; thanks for taking my question. How much of a headwind would you expect the dealer inventory to represent in 2015? And how much of that excess inventory is in oil and gas versus construction and mining?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, good question. The majority of the inventory by far is machines. The actual engine inventory is quite a bit less. It's not that they don't have any, but just in terms of scale it's quite a bit less.

We're likely to have -- and also embedded into our forecast for next year -- is further decline in dealer inventory. I think it's a case where we had sales coming down $5 billion; dealers try to peg their inventory around what expected sales are; and so when sales come down they take inventory down.

We expect that to happen next year. So I think it will probably be at least as much as we had this year.

Vishal Shah - *Deutsche Bank - Analyst*

Okay, that's helpful. Just on the E&T business, I know you mentioned 10% to 15% decline in sales. As you think about the decremental margin for that business, should we be assuming the decrementals to be above the 30% or 25% target in 2015?

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, again it depends on the products in E&T. I think certainly in the oil and gas area, the margins there would be above average, and so that would be negative to their decrementals.

Locomotives would probably be on the -- new locomotives, the service business is very profitable. But locomotives less so.

So there are some -- industrial engines as well are down. Again that's probably a little below average on margins.

So on balance I would think that E&T has it going both ways and probably not dramatic in total.

Vishal Shah - *Deutsche Bank - Analyst*

Thank you so much.

Operator

David Raso.

David Raso - *Evercore ISI - Analyst*

Evercore ISI. My question is about especially the lag of some of these adverse impacts. I'm just trying to think of Cat's earnings power run rate exiting 2015. I think people are just trying to figure out where 2015 sets up going into 2016.

Just seeing the lag impact, can you maybe give us some cadence on how you're seeing the EPS play out for the rest of the year? It just seems like the back half of the year maybe we're looking at $2 in the back half, or less; or the fourth quarter at least running below $1. I'm just trying to make sure we understand how you see your earnings power exiting 2015, as it reflects on people's thoughts on 2016.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Good questions, David. If I think forward to 2016, there are just so many things that we don't yet know the answer to. And I'll just give you a couple here.

One, with lower oil prices it's driving lower gasoline prices. That ought to be an economic stimulus from a consumer standpoint.

How that plays out in world economic growth; what the actions that the ECB are taking, how that plays into world growth; whether or not China remains satisfied around 7% or tries to push it up -- all those things right now we don't really know the answer to. They could be positive. They could be negative. At this point it's hard to say on 2016.

David Raso - *Evercore ISI - Analyst*

Yes. I'm not asking you to predict 2016. Right now --

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

No, no, no, no.

David Raso - *Evercore ISI - Analyst*

If I could predict that we'd all retire tomorrow. I'm just trying to figure out the idea of -- are we exiting the back half of 2015 at a $2 back half, or a $1 per quarter run rate?

And then however we view 2016 is predicated on how you see commodity prices through 2015. I'm just trying to make sure we understand the earnings power run rate exiting 2015.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

I think if oil and gas, if oil prices and gas prices don't go up -- and we're not forecasting them to -- we would have much more of a falloff of the oil and gas sales in the back half of the year, which would imply more of a negative in the back half.

David Raso - *Evercore ISI - Analyst*

Well, maybe just said another way, the greatest sales decline in 2015, is it the fourth quarter? The EPS sets up to be the lowest for the year? I'm just trying to figure out.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Yes, probably third and fourth quarter. Yes, third and fourth quarter. We'll start exhausting a backlog of drilling and well servicing probably sometime in the second quarter, I would guess.

David Raso - *Evercore ISI - Analyst*

Okay. I really appreciate it. Thank you.

Operator

Our next question --

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

I'm sorry I think we have time for -- we'll do one more.

Operator

Jamie Cook.

Jamie Cook - *Credit Suisse - Analyst*

Hi, I guess most of my questions have been asked. But Doug, I just don't know if you'll be willing to provide to the Street your -- I mean, there's the concern the oil and gas cycle is the next mining cycle that we had. So can you just provide your view on what that risk is and how would you would manage your business differently given what we learned from mining?

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

I'd say -- that's a tough question obviously. We saw mining lose half of its sales in our segment in really under a year, about a year.

Our Energy & Transportation business last year was $20 billion-plus. I would not see that happening on that scale at all, because we don't have the exposure to oil and gas in that segment as we did with mining and the Resource segment.

And that's probably about as far as I will go. Because as I sit here today, if we see oil -- and there are those that are forecasting oil at $20 and there are those that are forecasting gas at $1.50, some forecasting higher gas and higher oil -- I'm not going to make a commitment or even a forecast on that. But what our commitment is to you all is that 25% to 30% decrement on the way down and 25% on the way up.

We've done pretty well with that. I don't like these top-line gyrations that we're getting and we've seen; but our managing of those up-and-downs have been, I think, pretty well in the last few years. And that's what we would commit to if we have to go further down, or if we get lucky and it goes up.

Jamie Cook - *Credit Suisse - Analyst*

All right. Thanks. I will get back in queue.

Mike DeWalt - *Caterpillar Inc. - VP Financial Services Division*

Thanks, Jamie. Thank you all very much and we'll talk with you again at the end of the first 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.