THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

CAT - Q4 2015 Caterpillar Inc Earnings Call

EVENT DATE/TIME: JANUARY 28, 2016 / 4:00PM GMT

OVERVIEW:

Co. reported 4Q15 sales and revenues of $11b and loss per share of $0.15. Expects 2016 sales and revenues to be $40-44b and all-in profit per share to be $3.50.

THOMSON REUTERS

CORPORATE PARTICIPANTS

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

Doug Oberhelman *Caterpillar Inc. - Chairman and CEO*

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

CONFERENCE CALL PARTICIPANTS

Jerry Revich *Goldman Sachs - Analyst*

Robert Wertheimer *Barclays Capital - Analyst*

Joel Tiss *Bank of Montreal - Analyst*

Ross Gilardi *BofA Merrill Lynch - Analyst*

David Raso *Evercore ISI - Analyst*

Jamie Cook *Credit Suisse - Analyst*

Ann Duignan *JPMorgan - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Caterpillar full-year and 4Q 2015 results conference call. At this time, all participants have been placed on a listen-only mode, and we will open the floor for your questions and comments after the presentation.

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

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

Thank you, Paul, and good morning, everyone, and welcome to our year-end earnings call. I am Mike DeWalt, Caterpillar's Vice President of Finance Services.

On the call with me this morning we have Doug Oberhelman, our Chairman and CEO, and Brad Halverson, our Group President and CFO.

Now, this morning we are going to do the call similar to what we did last October. We will be going through a short slide deck before we get to the Q&A. And if you don't have it yet -- the slide deck -- it is available on our website at caterpillar.com, and it is with the conference call webcast link.

This call is copyrighted by Caterpillar Inc., and any use, recording or transmission of any portion of the call is strictly prohibited. If you would like a copy of today's call transcript, we will be posting that in the Investors section of our caterpillar.com website, and it will be in the section labeled Results Webcasts.

This morning we will be discussing forward-looking information that certainly involves risks and uncertainties and assumptions that could cause actual results to differ materially from the forward-looking information. A discussion of some of those factors, individually or in the aggregate, that could make actual results differ materially from our projections, well, that can be found in our cautionary statements under Item 1A, which is risk factors in our 10-K filed last February, and it is in the forward-looking statements language in today's financial release and near the front of this morning's slide deck.

In addition, a reconciliation of non-GAAP measures can also be found in today's financial release, and again, that has been posted on our website at caterpillar.com.

Okay. With that, let's get started. If I could ask you to pull out the slide deck and flip to page 4 -- or, I'm sorry, page 3, and that is the agenda of our slide deck. I will start this morning with a quick review of the fourth quarter and the full year of 2015 and the outlook for 2016. And then I will hand off to Doug, and he will cover a few of the key points that we were trying to make in this morning's financial release.

So with that, let's flip to what would be page 4 at the bottom of the slide deck, and this is the fourth-quarter 2015 results versus fourth-quarter 2014. And you can see on here that sales and revenues are down $3.2 billion from $14.2 billion to $11 billion. That is a 23% drop, and I will kind of talk about that two ways. First, about $2.7 billion of that was lower volume, selling fewer things, and most of that was lower end-user demand. About $400 million of it was related to reductions in dealer inventory. Price realization was negative in the quarter, about $124 million, and we did have a stronger dollar versus the fourth quarter of 2014, which causes our sales outside the US to translate into fewer dollars and, in this case, quarter over quarter, a negative of about $400 million. So that is the $3.2 billion.

If you look at that by segment, the biggest decline was Energy & Transportation. It was off $1.8 billion. About $0.8 billion of that was CI -- construction -- and about half of that -- a little more than half of that was where the dealer inventory impact was most concentrated. And then about $500 million was Resource Industries, and again, that is mostly mining. So the decline was across the board, but a bit more concentrated quarter over quarter in Energy & Transportation. And I think, given what has happened to oil prices over the course of the past year, that is probably not a big surprise.

Now, the profit impact of those changes, or that decline in sales volume, was about $940 million negative. The next largest item quarter over quarter is restructuring costs, and they were negative $585 million. They went from $97 million in the fourth quarter a year ago to $682 million

this year. And a lot of that increase is a result of the fairly significant actions that we announced last September and are in the middle of implementing right now.

Costs, though, were favorable, about $461 million, and that is pretty much all in, excluding restructuring versus a year ago. So that is good news.

Now, taxes -- I know it is probably a little hard to follow what is happening with taxes. It was a very low, kind of all in tax impact in both quarters. The rate this year is a little lower than last year, and we had $85 million of favorable tax items in the fourth quarter of 2014 and $77 million in the fourth quarter of 2015. So a little bit hard to follow, but not a massive impact quarter over quarter.

If we look at the profit numbers on the table up above, all in profit in the fourth quarter a year ago was $1.23. We actually had a loss of $0.15 in the fourth quarter of 2015, and a lot of that was because of the significant restructuring costs. So the all in change was a decline of $1.38 a share. Excluding the restructuring costs in 2014, the fourth quarter was $1.35, the fourth quarter of 2015 was $0.74, and we were down $0.61.

We continue to report our results, both with and without restructuring costs. We think it is important to help you kind of understand what is going on in the business.

So that is the fourth quarter. Let's flip to page 5. That is the full year. It was obviously a tough year for us in 2015. Sales were off $8.2 billion. Vast majority of that was lower sales volume, but the stronger dollar impacted the full year in kind of the same way it did the quarter.

In terms of segments, Energy & Transportation was the largest decliner at $3.8 billion. That was oil, rail, electric power. So fairly widespread within E&T. Construction Industries was down $2.8 billion and Resource Industries $1.4 billion.

So from a profit standpoint, all in, we were $5.88 in 2014. All in, including restructuring, we dropped to $3.50 in 2015, and that is a decline of $2.38 a share. More than all of that is the decline in volume. If you take out restructuring costs, we were $6.38 in 2014 and $4.64 in 2015, down $1.74. And I think the story for 2015 is big sales headwind, $8.2 billion, but we worked really hard on lowering costs. We took significant restructuring actions, and new restructuring actions began in the third quarter. Our costs were about $520 million favorable, and that is net of about $350 million of unfavorable cost absorption. So let me explain that a little bit.

In 2014, sales were pretty flat with 2013. Not a big change. So inventory didn't change much. It was down $400 million in 2014. So inventory absorption wasn't a big deal in 2014. In 2015, inventory declined $2.5 billion, so that is $2.1 billion more than it did in 2015. And there is a pretty significant cost impact of that sizable a decline in inventory. Order of magnitude, $350 million.

So without that, cost would have been even more favorable.

Share count was positive to profit year over year, about $0.16 a share, and that is -- a lot of that is the full year impact of the significant repurchases we did in 2014 and a partial year impact of the repurchases that we did in 2015.

Overall, bottom line, all in on tax, not much change year over year.

So that is the full year, and if you take out the restructuring costs, I would just mention that our decremental operating profit margins were about 20%, and we would consider that to be pretty good performance. It is better than our 25% to 30% target.

So let's flip to the next page, page 6. Now, page 6 is a little discussion on how we did versus our outlook. And, in this case, since so much transpired over the year, we are kind of taking a long look back. How did we do versus what we told you we thought we would do a year ago, right now, in our year-end call for 2014. And then, how did we come out versus the outlook that we had in place at the end of October -- the last conference call that we had -- the third-quarter financial release?

And so if you look down the numbers, in January a year ago, we were expecting sales and revenues this year to be $50 billion, profit per share to be $4.60, restructuring costs to be only another $150 million, and then profit per share, excluding those restructuring costs, to be around $4.75.

Now, what we actually had was sales and revenues that were $47 billion, and that is in the third column, which were $3 billion below where we thought they would be when we started the year. And I think everything that has happened with oil prices, commodities in general, increased weakness in China, most of the sales decline that we actually had in 2015, we had anticipated in that outlook, we were down from that about $3 billion.

Profit per share is lower by $1.10, and quite a bit of that is restructuring costs were a lot higher and, again, that is because we announced pretty substantial new actions in September. So excluding restructuring costs, we were at $4.64, and that is $0.11 a share shy of where our outlook was when we started the year. And I think our view would be on a $3 billion sales decline, even given all the puts and takes, that is a pretty good performance.

Now, versus the last outlook that we provided in late October of 2015, we said our outlook was going to be about $48 billion, and we kind of clarified that a little further as somewhere in the range of $47 billion and $48 billion. We were looking at profit per share of $3.70, and that included $800 million of restructuring costs. And then, excluding restructuring, we were looking at $4.60.

Well, what we actually did was a little worse on sales. It has been a continuing, challenging environment. Profit per share was lower, and that is largely because we had more restructuring costs than we expected at the time. Excluding restructuring, we ended up the year at $4.64, actually a little ahead of our outlook.

Now, I have seen a few of this morning's analyst reports, and for sure, we did not have the tax extenders in our previous outlook. So that was an unanticipated benefit for us, and several analyst reports I think have picked that up.

The flip side of that is we also had a fairly sizable charge for a legal matter in our fourth quarter. We didn't expect that, either, and it really wasn't related to operations, if you will, in the quarter. And those two items about offset each other. So I would say, all in, despite lower sales, we did a little bit better than our outlook, and we are pretty pleased with that.

So let's talk about 2016. A lot going on in 2016. So let's flip to page 7. First, we will do sales and revenues. It looks to us like another tough year. We don't really -- we are not forecasting any real improvement in the overall world economy. We are not banking on commodities getting better, and as a result of that, we are looking at $40 billion to $44 billion in sales and revenues. A midpoint there is about $42 billion.

Now, that is about $3.5 billion below where we were thinking last October when we gave a preliminary outlook, and I think that is probably not too surprising to most of you with the continued slide in oil prices to down around $30 a barrel and I would say continuing concern and worry around emerging markets, particularly China.

So, as we look at next year and what we think will happen with sales or what we are expecting, another down year for Energy & Transportation, down 10% to 15%.

Now, quite a bit of that decline is around timing. So we knew oil prices were coming down last year. We expected that to weaken pretty substantially in 2015 and it did. But most of that reduction was in the second half of the year. We started 2015 with a pretty sizable backlog, and we sold out of the backlog for the first half of the year in Energy & Transportation, particularly in the reciprocating engines for the oil customers.

So if you looked at Energy & Transportation, at their first half of 2014 -- or I'm sorry, the first half of 2015, they were only down 6% versus the prior year. The second half of the year was down 27%. That is kind of how we thought it would play in. It is what we signaled at the beginning of the year. Stronger first half, weaker second half, and now we see kind of that level of business continuing on with the recip oil and gas business out on into 2016.

Construction Industries, we are looking at being down 5% to 10% and Resource Industries down another 15% to 20%.

Now, on Resource Industries, the bad news is it looks like it is down another 15% to 20%. That is really a tough business in mining. Very few orders. Many of our customers are in sort of challenged financial conditions. But what I would say is sales of new equipment in that number are quite low. You never want to say never about upside and downside risk, but there is so little new equipment in there, I think it is fair to say that downside risk is somewhat limited.

In terms of profit per share, we put in a table here, and this is the table that was in our financial release. There is a lot of moving parts. So I thought it would help to walk through it piece by piece. So if you look at our outlook for 2016, all in, profit per share, we are looking at $3.50, and that includes restructuring costs, and that includes pension changes that we are making.

We are making a change in accounting principle. It relates to our defined benefit plans, primarily. It is positive to our results, about $.50 a share. And the way you want to think about this is we are moving from an accounting method that smoothes actuarial gains and losses from prior years into current year results. And we are moving from that to a method that is kind of more mark-to-market and will be a closer representation of what our current year costs really are. And that is favorable, about $425 million, in and of itself, and that is about $0.50 a share.

We also have another $400 million or so of restructuring costs in our outlook, and that is about $0.50. So all in, excluding restructuring, costs, we are at $4 a share.

So that is the outlook for 2016 on sales and profit. In terms of profit, the negatives are lower sales as we go into 2016 from $47 billion down to the midpoint would be $42 billion. So at midpoint, that is a $5 billion profit drop, offset by considerable cost reduction. A lot of that as a result of the restructuring actions that we started to put in place last September.

So with that, I will turn the floor over to Doug Oberhelman.

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

Okay. Good morning, everyone, and I do want to make a few key points as I look back on 2015 and forward into 2016. As Mike said, it was a very tough year, but when you think about everything that happened, the challenges, the chaos that sometime during the year with events around the world, a year ago today we were expecting $50 billion in sales. We ended up at $47 billion. That $3 billion is quite a drop, but we really only reduced our profit per share outside of restructuring by $0.11. And, as Mike said, there is a lot involved in that up and down, but basically I am pretty pleased with cost management, the restructuring actions we took in the fourth quarter. Actually, they were more aggressive than we had planned and announced, and we took about $100 million more because of it. But that will suit us up well for 2016.

So our team really did a good job, and it is tough to say, but we are getting used to cycles here. 2009 volume at $32 billion, we doubled the Company in three years to 2012. We are down about 30% from that now, and that will serve this team very well in the years and decades ahead as -- having to go through these kind of cycles in short dates.

Secondly, operationally, it was one of our -- 2015 was one of our better years. One thing -- and I have talked about this before -- one of the proxies I use for plant management is their safety record. And when I go to plants, I look at -- for that matter, when I go to customers' jobsites, it's the same thing. But if there is a safe environment, they tell me about it, and their numbers are good, chances are we are going to see high quality, we're going to see engaged employees and we're going to see a profitable plant. And safety, for us, hit a record level of recordable injury frequency in 2015 at 0.6, which is really world-class, we think, for heavy manufacturing.

Our market position, fifth year in a row of improvement around the world and virtually across all markets, for that matter, and most all products. I think that goes back to saying something about the quality of our product, the quality of our design, our Tier 4 implementation, as well as our dealer distribution organization, which, right now, is very strong.

And then, finally, Mike mentioned it, but I would point it out again, our decremental operating profit of 20%. And a lot of that, granted, happened in the fourth quarter, but that is what we wanted to do. So very happy with that, and again it sets us up for 2016 so well.

Our balance sheet is strong. We put some of the data in the release this morning. We saw a lot of ME&T operating cash flow, about $5.2 billion in 2015, another great year. Certainly, we will see another positive cash flow year this year, more than enough to cover our dividend and our CapEx.

I would say that we are scrubbing CapEx very hard and taking a really close look at every line item. We will get that number down below 2015, and we are still working through it.

Finally, our focus on use of cash, as you know, has been fairly well stated over the years, but at the moment, it is our balance sheet, our credit rating and protecting our dividend. And with the cash we have on the balance sheet, with the leverage we have today, which is the best it has ever been at this stage of a cycle, going back through many, many of our downturns, we feel pretty good about that. But that is really a high priority for us today is to protect that dividend and that balance sheet.

We did a little conference call in November around Cat Financial. We really like that business. It is strategic to us. We would not have the market position we have without Cat Financial and the loyalty with our customers.

Actually, in 2015, they hit a very high market share number for what they finance. The quality of that asset portfolio is very good. Past dues actually improved a little bit from 2014. And just to emphasize that we really at Cat Financial only used that captive finance company to finance Caterpillar product, yellow iron, or yellow iron inside other products where yellow iron is a big piece of it. We have not varied from that strategy. We won't vary from that strategy. It is so key and crucial to us in delivering our market performance around the world, and it is a really well-managed company and really helping us through the cycles as well.

Looking at 2016, tough market. I would expect bumps in the road all through the year. We have taken that outlook down to $42 billion, another drop of $5 billion. A little over 10% reduction. About 30% off our peak in 2012. And I expect to see, frankly, commodities of all stripes and all kinds in oil, for that matter, not to move too much. It could move up or down. We will see what happens, but we are really going into this with an eyes wide open realistic view that we are going to end up the year with what we would end up with and where we are in commodity markets and other economies as well.

Brazil, Russia, some of the areas where it has been really challenged. We are baking into this outlook continued tough times in a lot of those markets as well. So I really am hoping that this is a very realistic look. We have got some restructuring -- more restructuring coming to us that will help. We think we are about right-sized for right now. Of course, we've got some other restructuring that we will be announcing as early as tomorrow with another round that will fulfill some of the things we have talked about in September.

I also want to talk about inventory a little bit. We think we are pretty close and, really, not that excessive with inventory around the world. But we probably will see a slight -- some more reduction in dealer inventory. We have actually been producing at factory rates less than retail sales for a while. We've, as a result, seen dealer inventory drop $1 billion and our own drop $2.5 billion. So we have really seen a drop here in the last year, which, again, sets us up nicely into 2016.

Then, a little bit more on restructuring. I think we are committed to that pull-through through number of 25 to 30, up or down. As I said, we are 20 in 2015. We announced in September our goal was 4000 to 5000 positions eliminated by the end of the year. In fact, we were slightly over 5000 on the 1st of January. And with a few more to go yet early in 2016, which should fulfill that program and our cost reduction goals.

Finally, and this is the one that is good news and I feel really good about. I'm going to talk about it for a minute. That is our efforts around digital technology, innovation in R&D. We increased R&D slightly in 2015. We're going to hold it at about that level as long as we can in 2016, and I would just point out that we also did something similar to this in 2009 and 2010 at the depths of the recession. We cut R&D, but we didn't cut it to the bone. That was the one thing that we held onto as long as we could, and those efforts in research and development that we made at that time on new products have hit the marketplace in our Tier 4 interim and final products being introduced, the last of them this year, and we have seen a substantial increase in the quality of the products, the design of the products, and the acceptance in the marketplace, not to mention fuel economies across the board.

Today, we are in the same boat post Tier 4 with lots of powertrain development, all kinds of alternative propulsion methods coming through, which will be coming out in products in 2017, 2018 and 2019. We want to continue that because we have seen the benefits of that in market share, we will see the benefits of that in the future, and we are going to do all we can to hold that.

So while it is a high number, and subject to cut if we have to -- and we will -- we are doing all we can to preserve that.

And then, around the digital technology space, you have seen an awful lot of utterances from us last year, the formation of a joint venture with a key partner, closer ties with other existing and traditional partners as well. The digital transformation is occurring in reality, and we are going to lead this in our industry. While it is challenging and our cycle would probably -- if we had a better cycle, we would probably spend more. We are doing all we can to extend our leadership in this area.

What we are aiming at is quite a bit different than others. I would say we are aiming at the Internet of Caterpillar Things so that when we think about what we are doing with digital technology, what we are doing with site preparation and technology, machine guidance technology, machine health technology, it is all about our installed base of 3 million machines and engines. Rail, construction, mining, the things we do. We have no interest in going beyond that because we want to take care of our customers as we have been doing for 90 years. We have the domain knowledge of what our customers use our machines to do. We have knowledge of our machines. Our idea is to make a ready platform, lots of sensors across our machines and other brands, to make sure that our customer gets the most out of that construction equipment in his or her fleet.

I suspect that in the next year or two, five, this will be a tremendous add. We will be talking a lot more to you about it in our investor meetings and so on as we get there.

Just this month, we are commercializing our locomotive Internet technology. That led all of our segments, and it is now ready to go. We're in the middle stages of taking that to construction equipment. We will have some of that ready midyear and a lot of it by the end of the year. But the idea here is really a lot of value creation for customers, reducing downtime and lowering owning and operating costs by predicting failures by allowing them to take less passes across a parking lot, for example. Better fuel economies and efficiencies as a result, all through this overwhelming amount of data that we can now receive, process, and feed back to our customers, our dealers, and even our factories in a way that we have never been able to do it before.

We have a lot to say on this. There has been a lot written about it. I am really happy where we are, and our speed to market on this is un-Caterpillar-like in terms of our iron development. I am quite happy about that. That is why we have gone to outside partners.

So Mike, I will turn it back over to you with those comments.

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

All right. Thanks, Doug. Paul, we are ready to open the floor for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jerry Revich, Goldman Sachs.

Jerry Revich - *Goldman Sachs - Analyst*

I'm wondering if you could talk about your expectations for Solar, just flesh that out for us, if you could, Mike, this year and comment on cadence? Over the course of the year, within the past month, we have seen pipeline MLPs, cut CapEx, and I'm wondering if you could just calibrate us on what you are seeing in the order book?

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

Yes. Good question. Happy to do that. So, as usual, Solar -- as is almost usual, Solar had a great fourth quarter of 2015. We expected that and, in fact, they did. Backlog for Solar, despite that big shipping quarter in the fourth quarter, was about the same at year-end as it was at the end of the third quarter. So no noted deterioration in their backlog. In fact, if you look at Solar's total backlog, it is about the same as it was at the end of 2014.

What has happened to their business is the oil piece of it has declined quite a bit. The natural gas piece of it is holding up quite nicely. We kind of signaled that we would have some reduction in Solar. In the third quarter, when we did the preliminary outlook, we said they would likely decline but less than 10%, and nothing has really changed there.

Jerry Revich - *Goldman Sachs - Analyst*

Okay. And then, separately, Doug, the last point that you made, the Caterpillar Internet of Things. Can you talk about your expectations in five years? Are we looking at a significant revenue and profit pool for your business? What kind of business model should we be thinking about for you folks to monetize all of the valuable fleet that you have in the field and the opportunity to monetize that data? How should we think about the business model?

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

It will be -- it is not going to be a software chargeout system at all. We are going to measure it, and the benefit to us will be in aftermarket parts, aftermarket service, and connection to the customer through the products that we sell and service. And that is really where we are headed as opposed to a software for fee basis. Pretty simple.

And just as an adjunct to what we are already doing, in so many of our areas today, with aiming directly at our customers.

Operator

Robert Wertheimer, Barclays.

Robert Wertheimer - *Barclays Capital - Analyst*

A dual question on price and cost. You had a little bit of lower pricing, although I think under your leadership, Doug, you guys have been very, very competitive, gained a lot of share, and not maybe margin but price. So I get that. But you still had a little bit of contraction in price. So is there anything major going on with either currency, or is it an inventory flush, or what is doing that, and are you able to continue to get costs back from your suppliers? Are you sort of ahead of the curve there, or does that continue to flow through into 2017 and the materials moves we have already seen? Thanks.

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

Rob, this is Mike. I will start this out. I'm going to start a little bit with material costs. We have done, actually, very well over the last three or four years on material costs. I think we've, in combination, taken out over $1 billion. So over that timeframe -- and last year 2015 was a good chunk of that.

So there has been a combination of, actually, lower commodity prices have helped some. But all the work we have done on Lean, resourcing, engineered value chains, our investments in R&D, our partnerships with suppliers, have helped generate a pretty good chunk of that cost reduction as well.

So if you relate that to our price realization, that was a net benefit for us in 2015. I mean, we had continued good material cost reduction, and our pricing overall was pretty neutral. It was favorable in the first half of the year, unfavorable in the second half.

As we look ahead to 2016, that will probably shift down a little bit. I think, given where commodity prices are right now, we are not expecting as much benefit because we don't see another big leg down. So the material cost reduction that we have in has a bit more of a concentration on the things that we do to get it. And, by the same token, price realization is tougher. I think, in large part or a chunk of what is going on, particularly in construction, is -- and we have had a stronger dollar over the course of the past year. There are translation effects of that that happen immediately. We are selling in euros in Europe and that changes. But the competitive effects in the US and in countries where, say, we and Komatsu are competing against each other, whether it be Latin America or Europe, I think the impact of the stronger dollar is starting to bite a little bit.

Another thing that has hurt us on price a bit, and particularly the fourth quarter, and this might be a little bit hard to follow, but, actually, where we are selling product matters a bit. We have different price levels in different parts of the world. And I would tell you, if you look at construction in the fourth quarter, there was a large decline in Latin America, like 49%, I think, in CI. We tend to have better price realization there than we do in some other parts of the world, and so that hurt the overall average price in the quarter as well.

So bottom line, stronger dollar, I think. Very competitive environment with volumes lower. A little bit of negative geography for us. The flip side of that is still continued good work on material costs.

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

I would like to add a little philosophy here. You alluded to what we have tried to do over the last few years, and you are exactly right. That is raise our market share. We have done well with that. That won't change. This business is run on field population, and as long as that field population is building, it allows our dealers to really survive in tough times like these and thrive in good times. And that is going to continue. But we have baked a little bit more in, as Mike said, for price. We have got the dollar situation. We have got excess capacity with competitors all over the place, and we think we can juggle that in a way where we can continue to move our market position up while kind of guarding the margin as well. But it is a balance. It is the same balance we have been working on the last five or six years.

Operator

Joel Tiss, Bank of Montreal.

Joel Tiss - *Bank of Montreal - Analyst*

How is it going, guys? I just wonder if you can help us a little bit with some first-half, second-half color, especially in E&T. You are going to have tough comps, obviously, in the first half of the year. Can you give us any idea why revenue declined first half versus second half or anything to help us figure that out?

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

Yes, Joel. I mentioned -- I know I said a lot earlier, but if we look back at 2015, we had a lot more decline in the second half of the year than the first half of the year. And that is because the first half of last year was helped by the size of the backlog, particularly around drilling and well servicing. That is pretty well gone now, so I think it is safe to say that year over year, in that decline that we are expecting for Energy & Transportation, the 10% to 15%, it will probably be more than that in the first half and less than that in the second half.

We don't really do the quarterly breakdown, but your sentiment, what you're thinking, is absolutely correct. Year over year, a lot tougher in the first half than the second half. I know that wasn't detailed, but.

Joel Tiss - *Bank of Montreal - Analyst*

Yes but basically I get between the lines you are saying that that business is expected to be pretty much flat for the year. So we can just figure out what that means.

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

No, no, no. Down 10% to 15%, but probably down more than that in the first half and probably less than half in the second half.

Joel Tiss - *Bank of Montreal - Analyst*

Yes. Okay. And any signs of any aftermarket business stabilizing? That is usually the early warning signs that we are deep enough into a downturn that things are starting to stabilize.

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

Yes. Well, you know, on a percentage and even dollar basis, the change -- and aftermarket has gone down. No doubt about that over the last couple of years. But the decline is much less than what has happened in new equipment. And the fourth quarter was down again, so right now I would say there is no signs that that is really kicking up. But the longer customers work existing machines and don't replace and as long as the output tends to hold up, at some point here, that will need to happen. So far it hasn't.

Operator

Ross Gilardi, Bank of America.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Mike, I believe you guys normally have your annual impairment tests in the fourth quarter. It doesn't look like you have booked any impairments and even though you have had a Bucyrus competitor just write off 50% of its book value, so I'm just wondering if you could talk about that? I mean you are speaking very candidly about all the pressures in the mining business that you have now been feeling for four years in a row. So can you talk about the rationale for not writing down a big portion of goodwill on the back of this latest test?

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

Yes, I can do that. So first, the current mining business is weak. There is no doubt about that. Second, what I would tell you is we just in the fourth quarter, to your point, we completed an impairment test with what we believe is a pretty realistic forecast going forward, and we had no impairment. If there is an event that causes us or triggers us to do it again before the next fourth quarter, we will do that. But we did the math. There is no impairment.

But I think one thing you need to remember about this business is it is highly cyclical where the business is at today. At least from our piece of it, the sales of equipment to that industry, were well below the replacement level. It has to return. And to at least a replacement level over time. You do an impairment test, and that is a long-term view of what is going to happen. It is not based on what is going to happen next year. And we have done it consistent with the way we have. We didn't have an impairment.

I don't know what else to say about that. I am not on the inside in our competitors' accounting departments. So it is hard for me to comment on what they did.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Okay. Well, thanks for that. And then, Doug, I just had kind of a bigger picture question. In the last couple of days, we have Zoomlion bidding for Terex publicly, and while they might not be a huge direct competitor of Caterpillar's, does the prospect of a big Chinese OEM buying a listed US company potentially set a precedent that concerns Caterpillar?

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

We saw Sany buy Putzmeister three or four years ago become really a dominant player and maybe the dominant player in concrete pumping. The crane business is still pretty broad. I would guess we're going to see more Chinese investment in the United States in all kinds of things. We will see how this one sort out, if it actually closes up. But it wouldn't surprise me to see some of that. Yes, I expect that is probably a strategy. If I were sitting over there in China, I would be looking at some of this also.

So I would expect to see some of that. I don't think it is going to be an overwhelming wave of things, but certainly they are growing and we have always said we will see one, two or three emerging Chinese competitors of some kind, and maybe that is a move like that around our industry, certainly not in it. We don't really play too much against that anymore, although Terex is a good supplier through the Genie brand to our dealers.

Operator

David Raso, Evercore ISI.

David Raso - *Evercore ISI - Analyst*

I was wondering if you could just help us a bit with the cadence of the earnings for 2016, just given the moving parts around the restructuring savings, if you can give us some pace on that and even the accounting change. Is it simply a linear day one and just run it out per quarter? Just for some sense of the cadence exiting 2016.

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

Yes, David. Excellent question. So on the pension, that just plays into what the annual cost is, and that will be spread evenly, essentially, over the course of the year.

In terms of the restructuring, most of the -- at least the short-term benefit that we were expecting for 2016, it is a result of heads out, and that is, as Doug said, on target a little ahead of on target. So the vast majority of that will -- I mean, what we gave you was a full year number.

So the vast majority of that has already happened as of the first of the year. So that should be pretty good to divide by four. Probably not quite that. There is a bit more still to happen, but probably not massively off dividing by four because a lot of the actions are effective at the end of the year this year.

David Raso - *Evercore ISI - Analyst*

That is what I was trying to think about. With some of those savings upfront and the pension accounting help upfront, when you look at that $4 number ex-restructuring, any help at all on how you think about the cadence and through the year?

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

Yes. If you just look at our last couple of quarters, we have been right around $11 billion. Now the first and second quarter of 2015 were higher, but again that was before some of the declines that we were expecting, like oil and gas.

So I think, as we have kind of gone down for oil and gas, now that that is out of the backlog, I think if you look at the sales cadence for next year, it probably won't be massively off what a normal distribution is for us. So probably a little bit lower in the first quarter, a little bit higher in the fourth and second quarters, and a little bit lower in the third quarter.

From a profit standpoint, first quarter will have a little bit below average sales likely. It is the middle of winter. Not really the selling season. So probably a little weaker than average. So that will impact profits to the downside a little bit.

The flip side of that is the first quarter is usually a pretty good cost quarter. So that usually helps the first quarter a little bit. So we are not actually providing guidance for the quarter, but all in all, as you do your modeling, I would think about probably first quarter down a little bit from the average profit. Probably not massively far off it.

David Raso - *Evercore ISI - Analyst*

Okay. And last question, Doug, you spoke to commodity prices. You are not assuming much recovery. The end markets, not much recovery, but how are you managing for 2017? Saying it another way, if commodities are at the end of this year where they are today, thinking through the inventory reduction you are targeting, the $1 billion at dealers, just how should we think about 2017 if commodities are at the end of the year where they are today? Take us through your thoughts on replacement demand, inventory. We don't want to -- look at the dealer inventory. I mean, we went up $4.5 billion, $5 billion, coming out of the great recession. In the last three years, we have taken $5 billion out. So I can't say the inventory is down a lot over the last six years. We kind of went up; we are back down. Is taking $1 billion out enough and just, again, just to set the stage a little bit how you are managing for 2017?

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

Well, right now, it is all hands on deck for 2016, and hopefully we can get that done. I would say, around inventory and inventory turnover, as we have been implementing Lean and all of our initiatives around our Caterpillar Production System, I feel -- the fact that we have taken 30% off the top line and inventory down about the same amount or so, just to stay even with that in a falling cycle is pretty darned good. Once we get stable at a bottom to slightly rising turn, wherever that is, in the stable production schedule, I suspect our inventory turnover is going to be very, very acceptable and ought to help us.

That is about as far as I would go with that, David. Because I don't know if oil or commodities -- where they will be a year from now, and I really don't want to think about that. Other than inventory turnover and efficiency at the plants are variable margins, that is what is going to get us through that.

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

David, this is Brad. Maybe one comment around how we are approaching this relative to priorities. And so we didn't talk a lot about our actions up until September, but we had taken significant restructuring actions to that point. But, again, in June, really, of 2015, we started a process internally that led to our September restructuring effort. By and large, the cost reduction we are talking about and fewer costs has protected R&D and our digital spend and other priorities. So we have seen a significant reduction in a lot of the support areas in terms of consolidation and efficiency.

I bring this up because sometimes we get the question, what are you going to do if sales continue to drop? And I can tell you that we are continuing to work that plan. We understand and are committed to our decremental pull-throughs. And so if sales do drop, we may have to cut those some, but we have other restructuring efforts that we are continuing to look at and we will be prepared and take action on those.

Operator

Jamie Cook, Credit Suisse.

Jamie Cook - *Credit Suisse - Analyst*

I guess two questions. One, Doug, you addressed a lot of your confidence level with the balance sheet and protecting the dividend, but can you give any color on how you think about cash flow in 2016 if you look at over the last few years working capital has been a big source. I guess the concern is that is sort of running out, and if earnings are down in 2017, that the balance sheet is sort of at risk. So your thoughts on that.

And then, Mike, if you -- you gave us a lot of help on the top line. I am just trying to think about any color you are giving on margins by segment as I assume Resource is still not profitable and, in particular, E&T had to think about margins as we exit the year because I think that is a concern as we approach 2017 with Solar rolling off. Thanks.

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

There is a lot there. I will start with the cash flow. We will have reasonably good cash flow in 2016 at the outlook levels. We will cover our CapEx. Again, we are going to work hard to get that number down. We will cover our dividend and I suspect end up with positive cash flow above that. So we ought to be able to maintain our balance sheet about where it is, if not strengthen it a bit more this year. Again, I am not going to get into 2017 too much, but the same philosophy would hold in terms of the priorities of maintaining that. And, in fact, maybe if we have to get to a point in 2016 or 2017 to use the strength of the balance sheet to protect the dividend, we will.

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

Yes. I've commented before about that, and I think 2016 at the outlook numbers, we feel pretty good about in terms of cash flow, et cetera. Mike, you can handle the other ones.

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

Yes. On -- just a little bit by segment. We did talk a lot about the sales change and not much about the profit change by segment. So here is what I would say around that. So let's just backtrack a little bit and look at 2015. What happened in 2015 to decrementals? Construction had an awesome year. Decrementals in construction were 10%, so their sales were down about $2.8 billion. Their profit was down less than $300 million. And that was despite this legal charge that they got at the end of the year. So very good year on managing decrementals.

Resource Industries, their decrementals were 36%, and I think that was a little over our target range and partly because, despite sales going down, we spent more there on R&D. I mean, that is a business that we think will be good for the long-term, and we neededto spend investment money in R&D there and, in fact, we did.

Energy & Transportation, they had decrementals of 24%, which I think, given the mix of what was down for them, if you look at how much of their business was down because of oil and gas, which tended to be an above-average margin business, 24%, I think, for them is pretty good.

In total for the company -- and, again, this is excluding restructuring -- we had decrementals of about 20%.

That is kind of what we have got baked into next year. I won't comment so much -- I mean, overall, 20%. I won't comment so much on ROS by segment. I mean, like, Resource Industries, for example. They are at or below their breakeven point right now. So the ROS number, I think, is probably less meaningful than the decremental.

And I think, throughout the Company, we are working on delivering decent decrementals and a big cost reduction that we have planned for next year, both on material costs or variable costs in total, and big restructuring should help all the segments.

So I am not going to give ROS guidance, but I would say that, certainly as a company and I don't think any of our segments would be big outliers here, will be at or better than our target decrementals.

Operator

Ann Duignan, JPMorgan.

Ann Duignan - *JPMorgan - Analyst*

My first question is just a little bit more big picture. Given the strength of the dollar and the weak emerging market economic activity that we are seeing around the world, maybe specifically Canada and Latin America, is there any risk that we start to see, equipment either used or new, come flowing back into the US, and thus putting incremental pressure on new equipment sales in the US?

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

Actually, our EPA regulations have sort of helped that to some degree because of the requirements of low sulfur fuels on machines that are produced in this country and the EPA emissions level. So there may be some of that, and we worried about that for a number of years, and I think you are probably also alluding to the gray market that we have tended to see in times past where there is currencies that are a little bit out of line. I think the emissions thing between us and Europe and Japan for the most part, and Canada will be involved with that and there may be some flow from

Canada here, but Mexico is not in that, Latin America, I think we will probably have some amelioration of what we have seen in historical levels of that. But it is something we would keep an eye on.

Ann Duignan - *JPMorgan - Analyst*

Okay. Thank you. I appreciate that. And then, on the smoothing of the pension plan and going to mark-to-market, is there a reason why we smooth in the first place in order to reduce volatility. Are you concerned that moving to mark-to-market might end up adding to your earnings volatility through the course of the coming years?

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

Yes. Ann, this is Mike. A couple of things. Actually, I can't remember the year. Several years ago, we made a change to sunset our defined benefit plans at the end of 2019, and along the way, we have been on a path to de-risk the asset -- the fund balance. We have moved to more fixed incomes -- fixed income rather than equity, and that will likely continue. It is going to sunset again at the end of 2019. That doesn't completely take out volatility, but I think the combination of -- we stopped adding people to that plan a long time ago. People in that plan are retiring. We are not adding people to it. It will stop at the end of 2019 with a shift towards more fixed income. Probably be -- what we are thinking, it would reduce the volatility somewhat. It certainly won't take it away. Wouldn't suggest that at all.

But, as more companies have moved to this method, I think when they have a year-end adjustment for this, like we will at the end of this year, I think the market has done a decent job of understanding what is going on and that it is -- what it is for what it is. So I don't think it will -- I mean, our view, anyway, is that it is -- it wouldn't impact so much how people are viewing us if there is a year-end adjustment. And we like the change because it better matches what is actually happening from an expense standpoint rather than spreading it over years.

So in the current year, for example -- and I said this before -- this is not a big unique OTO [one time only] item that is happening in the year. It is taking out losses from prior years that were masking operating results in the current year. That is our view, anyway.

Ann Duignan - *JPMorgan - Analyst*

Okay. I appreciate it. I Know we are out of time, but just, where will we be and what inning will you be by the end of 2016 on restructuring? When we will be 100% done, or do we have costs in 2017 and 2018?

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

We will probably have some costs in 2017, and the plan that we announced last September, I think the last parts of it, I think we would expect to wrap up sometime in 2018.

Thanks, Ann, and thank you all for joining us. We will talk to you again at the end of the first quarter.

Operator

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