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CAT - Q4 2016 Caterpillar Inc Earnings Call

EVENT DATE/TIME: JANUARY 26, 2017 / 4:00PM GMT

OVERVIEW:

Co. reported 2016 sales and revenues of about $38.5b and loss per share of $0.11. 4Q16 sales and revenues were about $9.6b and loss per share was $2.00. Expects 2017 sales to be $36-39b, all-in profit per share guidance, including restructuring costs, to be $2.30 and adjusted all-in profit per share to be about $2.90.

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CORPORATE PARTICIPANTS

Jim Umpleby *Caterpillar Inc. - CEO*

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

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

CONFERENCE CALL PARTICIPANTS

Nicole DeBlase *Deutsche Bank - Analyst*

Ross Gilardi *Bank of America Merrill Lynch - Analyst*

Jerry Revich *Goldman Sachs - Analyst*

Eli Lustgarten *Longbow Securities - Analyst*

Robert Wertheimer *Barclays Capital - Analyst*

Ann Duignan *JPMorgan Chase - Analyst*

David Raso *Evercore ISI - Analyst*

Jamie Cook *Credit Suisse - Analyst*

Andrew Casey *Wells Fargo Securities - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen and welcome to the Caterpillar year-end 2016 conference call. (Operator Instructions). It is now my pleasure to turn the floor over to your host, Brad Halverson, CFO. Sir, the floor is yours.

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

Thank you. Well, good morning and welcome to our year-end earnings call. I am Brad Halverson, Caterpillar's CFO. On the call with me this morning, we have our CEO, Jim Umpleby; Amy Campbell, our Director of Investor Relations; and as has been the case for 48 consecutive quarters, Mike DeWalt, our Vice President of Finance Services. This is Mike's last conference call. He will start his retirement on March 1 after 36 years with Caterpillar. Mike has led our quarterly earnings calls since early 2005. He is done it as the Director of IR, the Controller and now as the Vice President of Financial Services.

He has led this call through two peaks, the first one ending in 2008 and the second one in 2012 and he has been a steady hand through two down cycles, 2009 and the downturn that we find ourselves in at the moment. Mike has been a great value to this company. He knows our business extremely well. He is a very smart guy. He has been a good friend. He will continue to be a good friend and we wish him all the best. But, Mike, we thank you for everything you've done and this is your last call and those of you who can't see Mike, he is smiling right now. So with that, I'm going to turn the meeting over to our CEO, Jim Umpleby.

Jim Umpleby - *Caterpillar Inc. - CEO*

Good morning. Thank you, Brad and thanks to all of you for joining us this morning. After I make a few opening remarks, I will turn the meeting over to Mike and he will cover the Safe Harbor and also get into our results in more detail.

We had good operational performance in the fourth quarter and in 2016 despite challenging market conditions. Our sales and revenue were down $8.5 billion or 18%. Decremental margins were better than our target. We achieved over $2 billion of cost reduction in the year, which helped to offset the lower sales volume. We had strong operating cash flow and we continued to invest in key areas of our business that are critical for our future profitable growth. At the midpoint of our sales and revenue range, our sales will be down slightly in 2017. We continue to closely manage costs. We are also preserving capacity for a potential increase in business whenever that comes. There are positive signs in many of our markets, but we are not anticipating an impact in 2017.

Now I will turn it over to Mike to get into more detail and then we will have some wrapup comments after Q&A.

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

Okay, thanks, Jim. Everyone, today, we will handle this call much like we have the past few. We will be walking through a short slide deck and then we will move onto Q&A and if you don't have that slide deck in front of you at the moment, it's available at our Caterpillar.com website with the conference call webcast link. And as always, this call is copyrighted by Caterpillar Inc. and any use, recording or transmission of any portion of the call without the express written consent of Caterpillar is strictly prohibited. If you would like a copy of today's call transcript, we will be posting it in the investors section of our Caterpillar.com website and it will be in the section labeled results webcast.

So if you go to page 2 of the slide deck, you will see our forward-looking statements and this morning, for sure, we are going to be discussing forward-looking information that involves risks, uncertainties and assumptions that could cause our actual results to differ materially from the forward-looking information.

In addition to page 2 of the slide deck, there's a discussion of some of the factors that individually or in the aggregate could make our actual results differ materially from our projections and that can be found in our cautionary statements under Item 1A, Risk Factors, of our Form 10-K filed with the SEC and also in the forward-looking statements language in today's financial release.

In addition, there is a reconciliation of non-GAAP measures used in both our financial release and this presentation, which can be found in today's earnings release. And again, that's also posted on our Caterpillar.com website.

So with that, let's get into the quarter and turn to page 4 of our slide deck for today. And that's a high-level summary of fourth-quarter sales and profit. So sales and revenues for the quarter were about $9.6 billion and that's down about 13% from the fourth quarter of 2015, which was just a little over $11 billion. Now we lost $2 per share in the fourth quarter this year versus $0.16 a share last year in the fourth quarter and if you look at the primary drivers of profit, big contributors to that were the mark-to-market adjustments that we made for the pension liability. We impaired $595 million worth of goodwill and on that particular topic, there is a Q&A in the release, I think it's the first Q&A, and I think that does a pretty good job of talking through those adjustments.

In addition to that, we had a valuation allowance on deferred taxes. That was unfavorable. And those three items plus restructuring costs are the items that we're adjusting out between profit per share and adjusted profit per share and adjusted profit per share coincidently year-over-year was flat at $0.83 per share. And that is I think -- to Jim's point earlier, I think that is pretty good performance. On a 13% decline in sales, our adjusted profit was flat and that is because we had a lot of cost reduction in the quarter just like we had a lot of cost reduction in the year. Period and variable costs, and we will talk about this in a minute a little bit more, were favorable, just under $0.5 billion. So that was good performance.

Let's move on to page 5. It's a little more discussion about the sales change. So Energy & Transportation, which, by sales, is the largest segment, dropped about $695 million in sales and about half of that was transportation and that is rail and marine. Oil and gas was down a little and power gen was down a little as well. Power gen has been weak in particular in the Middle East.

Resource Industries, down $435 million from just under $1.9 billion to a little over $1.4 billion for the quarter and that's all new equipment. So aftermarket was actually up for the third quarter in a row sequentially and it was actually up a little bit year-over-year, so fourth quarter was a little higher than the fourth quarter of last year and that is a good signal. Price realization on the other hand was negative $62 million in the quarter.

If we go down to Construction, Construction sales were about $300 million lower and most of that is in North America and Europe/Africa/Middle East. Actually, Asia Pacific was up quarter-over-quarter and a lot of that came from strength in China that we've seen so far this year. So again, in total, we were down about $1.456 billion quarter-over-quarter.

If we move on to page 6, this is a waterfall chart that reconciles operating loss in the fourth quarter of last year to the fourth quarter of this year and it is everything all in. So a big negative was $463 million and that is on that $1.4 billion decline in sales. Price realization, which had been fairly significantly negative most of the year, moderated quarter-over-quarter in this quarter. It was negative $80 million and most of that was, as I mentioned on the prior page, Resource Industries.

Cost reduction variable, $91 million period, $401 million, so that is good. That's a continuation and I would mention that we had more incentive compensation in 2015 than we did in 2016, but, in the fourth quarter, it wasn't a factor. We had very little in both fourth quarters. So this $492 million, all of it was not affected hardly at all by the short-term incentive pay.

Currency was pretty neutral. Financial products was down a bit. They had less gains on the sale of securities in their insurance business. There was a little bit more loss and that's a result of I think lower used equipment prices on repossessed and returned equipment and their volume was lower. The earning assets were down and that's -- in some ways, it's a progression of what's happened to our sales over the last few years. Our sales are down, so the amount of what they are financing is down a bit as well.

Restructuring costs in the quarter were quite a bit less than the fourth quarter of 2015 and I'm going to talk a little bit more about restructuring costs here in a minute.

Then we have a couple of big negatives. Mark-to-market losses, that's essentially the present value of the future liability of our pension and benefit plans. It was a loss of $985 million this year versus $214 million a year ago and that's essentially because interest rates on high-quality, long-term bonds declined slightly in the year.

Goodwill impairment was $595 million and that was in our Surface Mining & Technology business. We impaired about half of the goodwill in their business and on the final other line, we had legal charges in the fourth quarter of last year that we didn't have this year and that is most of that difference. So that's a bit of a walk through.

Operating profit, let's turn to page 7. I will just make a few comments about the full year. Sales were down from -- and revenues -- from $47 billion to about $38.5 billion. That's an 18% drop. Profit per share in 2015 was $4.18 and again, this year, it was a loss of $0.11. If you take out the items that we are adjusting for and again, that is the mark-to-market, the goodwill, the restructuring costs and the tax impairment, we were at $3.42 and that's a little bit better than our final outlook of the year that we gave at the end of the third quarter. That was $3.25. We ended up at $3.42, so that is good.

Again, the drivers of the adjusted profit change on the bottom right are very similar to what happened in the quarter. We had lower sales volume, but a lot of cost reduction that offset that, or at least offset a part of it, about half, in fact. So that's a little on the full year.

Let's move to page 8 and talk a little more about cost reduction. I mentioned this earlier, but we had $492 million in the fourth quarter. For the year, it was over $2.3 billion of lower costs and if you go down to the bottom, the three little boxes that start on the right, there was a piece of that that is related to short-term incentive compensation and there is a Q&A in the back of the release that has all the numbers for the quarter and the year for that. But about a little over $300 million of that $2.3 billion was incentive compensation lower.

If you move into the middle, we had a good material cost reduction, again, for the year and it is a combination of commodity-related prices versus 2015 and then, as always, even without commodities, we do a lot of work every year on sourcing and design to lower costs and that was a positive.

And then on the most significant item on the left, our restructuring and that is reducing people, reducing floorspace, consolidating functions and facilities and we've done quite a lot of that. In fact, if you turn to page 9 here, we will cover restructuring, the big restructuring that we announced a little over a year ago.

I thought this might be a good recap on what's happened. On September 24 of 2015, we had a big press release that covered a number of fairly significant actions that we were planning to take. And in that release, we said we were going to close or consolidate about 20 facilities, which would reduce manufacturing floorspace by about 10% and take about 10,000 people out of our workforce. We said that it would cost about $2 billion to do that, about $1.6 billion of it cash and about $400 million non-cash, which would've been primarily asset-related expenses. And we also said when it was fully implemented we would save about $1.5 billion annually going forward and we thought that would take a few years to complete.

So if we go on to page 10, let's talk through a little bit what's happened, and I realize there are a lot of words on this page, but we have either completed or announced or are in the process of implementing virtually everything that was in our press release from the third quarter of 2015 and then some. That's involved the consolidation and closure of actually ended up more than 30 facilities and about 14% of floorspace. We said we were looking to take down the workforce by about 10,000. It's actually declined about 16,000 from the end of the third quarter of 2015. Now restructuring costs in 2015 and 2016 have been about $1.9 billion and our outlook today anticipates an additional $500 million in 2017.

Now if you add that up, that's a bit more than what we said in that release and that's because a little of it was actually for programs that predated that announcement and since then, we've actually done more. Just as an example, we announced the shutdown of our on-highway truck business earlier in 2016 and that was not something we had previously anticipated. So costs are a little bit more than we had talked about that September.

The flipside of that though is savings appear to be quite higher, so if you take out short-term incentive comp, that's really not cost-reduction related to any of the actions that we've taken and so it's not fair to count the benefit of that. So if you take that out, at the end of 2016, we had taken out about $1.5 billion from our period cost structure since 2014 and we -- if you go to the next page, page 11 -- we are expecting more reduction in our cost structure, again, not including inflation and short-term incentive of about another $500 million this year. So that means by the time we get to the end of 2017, we will be looking for our period cost structure to be down a couple billion dollars, which is a bit more than we said in the third quarter of 2015 and that's because we are doing more than we anticipated then.

Now, all those numbers, both on the cost side and the estimated benefit side, they do not include two large facilities that we are currently contemplating. We have announced both of these -- Gosselies, Belgium and Aurora, Illinois. If those two actions end up moving forward, they would add both to restructuring costs and potential benefits.

So that's a recap on restructuring. Actually quite a bit of progress there.

So if we move on to page 12, just a few points on the outlook and Jim touched on this earlier. Our outlook for next year has sales in a range of $36 billion to $39 billion. The midpoint of that is about $1 billion lower than 2016. We are actually seeing a number of positive signals. Commodity prices over the course of the past year have risen and that's good. If we get any continued improvement, any stabilization, I think that's important. That would be a positive for several of our businesses. In particular, gas compression has remained very strong. Solar had another good year this year and they have a strong backlog as we start 2017.

Construction in China has been positive and that's good, but, that said, it's dependent upon continued economic growth and government support for construction in China as we go into 2017. And then Construction, this might sound a little backwards, but Construction sales in other developing countries like Brazil, for example, are at extremely low levels; Brazil in particular. It's way off where we were a couple years ago. They have been involved in a pretty deep recession there and with any kind of a recovery, there certainly would be upside there.

Now in terms of concerns, and we talked about these in the release, mining customers, our estimates and what we have read -- we are seeing better sentiment for sure, but we are not seeing expectations for a big increase in CapEx in 2017, although it does look like that could occur in 2018. We've had weakness in North American construction over the past year. There has been a lot of used equipment in the market. The slide in oil and gas over the last couple of years has been a negative for our sales.

Economic growth in Europe, it's actually been not too bad. Our sales in Europe over the last year or so have been okay, but Brexit is still a risk. It's not happened yet and so I think we have to count that as a concern. And then for next year, it looks to us like rail, marine, power gen and industrial engine sales are going to be down.

So that's just a little summarization of the sales outlook. The profit outlook for next year is $2.30 all in including restructuring and about $2.90 at an adjusted level and the only thing that is being adjusted out of that is restructuring costs and those would be at the midpoint of the sales and revenues outlook.

So let's move on to 13, which is our last page and then we will jump into the Q&A. Our 2017 outlook we think is pretty consistent with what we said in early December. At that point, we made a statement that said that the $38 billion outlook that was in consensus we thought was pretty reasonable. Since then, we've had a bit of currency movement and so there's a bit of translation on sales that have caused us to peg the outlook at $37.5 billion, but that is not a result of any change in the underlying fundamentals the way we see the marketplace.

We've had good operational performance and we've talked about this quite a bit already in particular on cost reduction. We are on track with our restructuring actions and we maintain a pretty strong balance sheet. Our debt-to-cap ratio is within our targeted range for ME&T of 41%. We've generated good positive ME&T operating cash flow in 2016, which was more than enough to cover the dividend and CapEx and we would expect that to continue in 2017 and we ended the year with a cash balance over $7 billion, so that's good as well. So with that, Kate, we are ready to open the line for Q&A.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). Nicole DeBlase.

Nicole DeBlase - *Deutsche Bank - Analyst*

Thanks, it's Deutsche Bank. Good morning, guys. Starting with the revenue outlook, I know you gave some color about this in December, but the year-on-year decline that you are forecasting, what are you embedding by segment? Is it similar across all three segments, or are there certain segments where the decline is going to be steeper?

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

Good question. First off, the decline is not very much. It's $1 billion. Roughly half of that is currency translation-related, not an industry or volume decline and of what's left, probably the most significant decline is in Energy & Transportation. Again, it's not a lot, but like on my last slide I talked about transportation being weaker, so we see a bit of a decline in rail and marine.

Power gen, particularly in the Mideast, has been tough and industrial engines down a little bit for ag and loose engines we sell to gen set packagers. So probably of the piece that's not currency translation, it's probably a little heavier E&T. Construction we would see as relatively flat and Resource Industries, I think the mining part of it should be pretty close to flat and we are still a little pessimistic on large construction equipment, which come out of Resource Industries. We had quite a bit of rental load and a higher level of sales in late 2015 and throughout much of the first half of 2017 and that's tailed off in the second half of -- I'm sorry, 2016 -- tailed off in the last half of 2016 and we are not overly optimistic about that in 2017. So I hope that helps, Nicole.

Nicole DeBlase - *Deutsche Bank - Analyst*

Yes, that's really helpful, Mike and just for my follow-up, I guess thinking about restructuring costs, you are stepping up your efforts again in 2017, $500 million. I know that there's those two plants that you talked about that could actually present upside to that, but do you see additional restructuring actions coming through in 2018 or do you think that we are coming to the end of the restructuring initiative?

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

Well, you never want to say never. We did more in 2016 than we had expected when we announced the big program in late 2015. So it's hard to say that nothing else would come up. You don't have a crystal ball. I think much of what is actually in 2017 as a cost is just a continuation of the things that are already in flight.

And the two things, the two that we announced that we are contemplating, Aurora and Gosselies, would certainly add to that, some in 2017 and probably still some in 2018. But beyond that, on the books right now, there's nothing else substantial that we are contemplating that hasn't happened. But, again, I certainly wouldn't want to try to make it sound like that's an ironclad nothing else will come up and nothing else will happen. We just don't know what the world is going to do and -- but those two items would be -- other than the things that are already in flight, the only big new things that are currently on the horizon.

Nicole DeBlase - *Deutsche Bank - Analyst*

Okay. Thanks, Mike. I will pass it on.

Operator

Ross Gilardi.

Ross Gilardi - *Bank of America Merrill Lynch - Analyst*

Good morning, Bank of America. Just a couple questions, guys. Just first on Construction, it's great to see the pricing flattening out, which has been a big headwind this year, but your closest competitor in North America is out there guiding to a 3.5% margin and basically lost money last quarter and you guys are still putting up 9.3%, which more power to you for that, but you are flagging ongoing challenges in the North American market. Is the issue that you just need to cut production a lot more aggressively to rebalance where we are in the US because I would think given all the headwinds you have flagged that your margins would be a lot lower right now than they actually are?

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

Let me try to address that, Ross. We are not looking for major declines in North America next year. On balance, Construction looks -- our Construction Industries segment -- looks fairly neutral year-to-year. Our view is that the Middle East and North America will be a little softer and Asia-Pacific may be up a little bit. We are not signaling some large continuing decline. I wouldn't want to give you that impression whatsoever. And we have a range out there and you never know if economic growth is faster than we think, if tax reform comes sooner, if infrastructure spending comes sooner, maybe we can be towards the high end. So I don't want to make it sound like we are super negative on Construction because that's not the case.

In terms of the margins, I'm not sure what our competitors are doing, but I can tell you we've been out there working the cost reduction pretty substantially in Construction, in E&T and in Resource Industries and in corporate elements. We've been taking out costs pretty aggressively and I think that has contributed to the Construction margins that you see. I don't think there's production that needs to be cut substantially to make it better. Dealers took out inventory in the fourth quarter about the same as they normally do, about the same as they took out in the prior year. So I think inventories are in reasonable shape. I think production is in reasonable shape and when a little volume comes back, I think those margins will go up.

Ross Gilardi - *Bank of America Merrill Lynch - Analyst*

Okay, great. Thank you, Mike. And then just my follow-up is on the backlog and the sequential pickup that you noted in Construction and Resources. Resources has obviously been through a tough time for many years, but, on Construction, is that a seasonal move or could you give any more color on where that is coming from? Are you seeing an actual pickup in order intake in North America, or anything you can provide there would be helpful?

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

Yes, we did. Actually we had decent orders in the fourth quarter. Obviously, we've built backlog and they were up from prior year reasonable double digits. So that's a good sign, but between -- that's machines, that's RI and CI, so that's good. Hopefully that will continue.

Ross Gilardi - *Bank of America Merrill Lynch - Analyst*

Got it. Thanks very much, Mike, for everything and best of luck on your retirement.

Operator

Jerry Revich.

Jerry Revich - *Goldman Sachs - Analyst*

Hi, good morning. It's Goldman Sachs. And congratulations, Mike; it's been really nice working with you. I'm wondering if you could talk about the timing of the final decision on the Aurora and Belgium facilities and separately, can you talk about the cost-reduction carryover that you expect in 2018 from actions that will be completed this year?

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

On the first one, we will just take them separately. With Aurora, we need to provide -- between the time of our announcement and the time that it's finalized, we need to provide time for the local unions to look at it and see if there's anything they can do to contribute to that. You have a waiting period there.

In Belgium, it's a little bit kind of the same way except the government is involved in addition to the local unions. So we will hopefully get the decisions made on both of those as soon as we can. What was the second part of that again, Ross?

Jerry Revich - *Goldman Sachs - Analyst*

It's Jerry, Mike. The second part of the question was the carryover benefit 2018 versus 2017 from the restructuring actions that will be completed this year?

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

Yes, we have about $500 million of period cost reductions in for next year and a lot of that is carryover from the actions taken this year.

Jerry Revich - *Goldman Sachs - Analyst*

Sorry, so that's $500 million carryover 2018 versus 2017?

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

Well, we have $500 million of additional period cost reduction next year and again, that doesn't include a little labor inflation and incentive pay. Outside of those two items, we have our period costs coming down $500 million and what I'm saying is a decent part of that would be carryover from actions that we took in 2016.

Jerry Revich - *Goldman Sachs - Analyst*

Sorry, Mike, the question was on 2018 versus 2017. Are you able to comment on it?

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

Oh, I'm sorry, I'm sorry. No, I don't have -- certainly 2018 would definitely be higher in terms of benefits from restructuring. But, at this point, we don't have a number for 2018. It will depend on what happens in Aurora and Gosselies and whether or not a decision actually gets made to close them or not.

Jerry Revich - *Goldman Sachs - Analyst*

Thank you.

Operator

Eli Lustgarten.

Eli Lustgarten - *Longbow Securities - Analyst*

Longbow Securities. Good morning, everyone and welcome, Jim, to our club and we are going to miss you, Mike, but that's what happens when you get to middle age I guess.

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

Eli, you are probably the only guy on today that's actually older than me.

Eli Lustgarten - *Longbow Securities - Analyst*

Probably. Don't remind me. You went through the segment outlook by revenue or the impact from the low sales. Can you talk a little bit about profitability? Your press release says that you expect dealers to take less inventory out in 2017 than 2016. Does that hold up the Construction margins, so margins basically could be similar or up a little bit? Same thing with the lower volume coming and the impact in Energy & Transportation. How weak should we expect that to get or is that just -- just take the 30% flowthrough that you suggest and how close can Resources get towards the breakeven level given the outlook that is taking place?

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

Good questions, Eli. On dealer inventory, I talked a little bit about 2016 and 2015. For 2017, in reality, when we get towards the end of the year, what's actually going to happen with dealer inventory will depend a lot on how dealers feel about 2018. You could paint a scenario with, again, tax reform and infrastructure spending and lesser regulation and more investment in energy. If all that happens, maybe dealers will be more bullish about 2018 and want to add inventory. So it's a little bit hard at this juncture to get very definitive about that.

And I would say in our sales forecasts, right now, again, we are looking for each of the segments to not be far from flat. E&T down a bit on volume, RI down a little bit on volume. We are counting on a little more cost reduction, but the flip side of that is we do have a pretty sizable increase in incentive pay and cost reduction and incentive pay is universal across the company. So I wouldn't expect big variations in each of the segments.

You specifically asked about RI profitability. They have -- relative to their sales, they've done a lot of cost reduction and given where their sales are -- I won't comment on whether they are right at or more or less breakeven at the sales level, but it would be pretty close. They are not far from breakeven at what's in the outlook for next year, which is 2016 probably minus a couple hundred million. So they are getting pretty close and it's a result of a lot of good work on cost reduction, a lot of capacity -- not capacity -- floorspace taken out, a lot of headcount reduction.

Eli Lustgarten - *Longbow Securities - Analyst*

Just a quick follow-up. What our surveys show when we talk to Cat dealers is they are extremely optimistic about end markets, but most of the dealers have indicated that because of the uncertainty that we talk about because of politics that they are planning to age their rental fleet this year waiting for more definitive action. Are you seeing any of that or hearing that, that the problems with the construction industry, if there is a problem this year in the US, is more on the rental side than it is in the end-user side?

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

Well, certainly, on some of the larger construction equipment, we had a higher rental load earlier in 2016, so I think we see that being down a little bit, particularly on large product. But I think the sentiment is what's important, not so much just the rental fleet age point. I think there are a lot of positive signals out there, but it's not really turned into higher equipment sales yet and I think there's still a bit to play out. But I think we see and we hear the sort of general optimism about end markets. We hear that as well. Quoting activity, orders a little bit have been more positive in RI and again, those are longer leadtimes, so it's probably more of a 2018 story than a 2017 story. But, yes, I think we sense more optimism.

Eli Lustgarten - *Longbow Securities - Analyst*

All right. Thank you very much.

Operator

Robert Wertheimer.

Robert Wertheimer - *Barclays Capital - Analyst*

It's Barclays and good morning. My question is on Solar really. If you look across Caterpillar, you've got a lot of businesses that are well below normal troughs, whether you want to do Brazil, as you mentioned, or Resources or locomotives probably in the US, or just a bunch of them. And Solar is probably the one that's hung on and you mentioned that the backlog was pretty good in the press release. But could you give a sense as you look at permitting, or you look at pipeline activity a couple years out, or you think about how much you have delivered into offshore oil this year that maybe was speced out two or three years ago? Do you feel like you are still at risk of having that business slide or is it just at the right level, not just the backlog, but when you look at the activity level further out?

Jim Umpleby - *Caterpillar Inc. - CEO*

I will take that one. If you think about Solar's business, there is a variety of elements to it. One is -- and what we talked about earlier on the call -- is the gas compression business in North America, and that business has continued to be quite strong and people will often look at the CapEx in the pipeline industry and try to make a correlation with Solar's business.

While there is some correlation, I would urge caution there because much of the CapEx is driven by new pipeline construction and much of Solar's sales into gas compression in North America is adding horsepower to existing pipelines. So Solar can still have a strong level of business and it wouldn't necessarily be reflected in the macrolevel CapEx number for the industry.

So Solar's business again, gas compression has hung in there. Their oil-related businesses generally, gas turbine-driven, gen sets for offshore oil and gas production facilities has been down for some time, for obvious reasons with the decline in oil prices. Their customer services business, of course, Solar has a direct business. They handle both the parts and the service directly and that business has been relatively stable as well. So I think to put it all together, it's not a situation where Solar has been living off of backlogs for oil, like you mentioned. It's really been a strong gas compression story and again, we think that business is stable.

Robert Wertheimer - *Barclays Capital - Analyst*

Thanks very much. That's great. Mike, congratulations and well deserved. Thanks.

Operator

Ann Duignan.

Ann Duignan - *JPMorgan Chase - Analyst*

Hi, JPMorgan and same thoughts from me here, Mike. I'm jealous. Anyway, my question is more related to the new administration and if you could -- you gave us on slide 12 the positives and the concerns with regard to what you are looking at as you move into 2017 from a sales and profitability standpoint, but could you create two buckets of the new administration and what the net positives you might be contemplating versus the net negatives? We think of things like what if net interest expense goes away, what does that do to your financial services business? What does a strong dollar do? Are you a net exporter? If you could just break down two buckets for us, that would be fantastic.

Jim Umpleby - *Caterpillar Inc. - CEO*

I will take part of that. As we look at what's happening in the conversation in Washington, both within the administration and Congress, there's a number of things that we are very encouraged by. We have long been an advocate for, of course, infrastructure. The infrastructure in the US is in dire need of maintenance and modernization and we are very encouraged by the bipartisan support for a much-needed infrastructure bill. It would be good for both the country and for Caterpillar. Obviously, there's timing issues there in terms of if in fact that happens and when it could occur.

We are also encouraged by discussions around taxes. We've been a long-standing advocate for overhauling the US tax code. Many of our competitors, of course, are outside the United States and we need a tax policy in the US that puts us on a level playing field so we can compete fairly. So again, we are encouraged by that as well. Smart regulations, again another positive thing.

So again, generally, all in, given the conversations that are going on in Washington, we think it's positive for economic growth, jobs growth and we are encouraged by that.

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

Ann, you made a point about FX currency and again (multiple speakers).

Ann Duignan - *JPMorgan Chase - Analyst*

Can you talk a little bit about the risks, if net interest expensing goes away, if the dollar strengthens, what that does to competitiveness? Are you a net exporter? A little bit more balanced view, if you like.

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

Yes, so I would just add a couple of things to Jim. One, we have a cost structure that's spread around the world, so -- and you can see that in today's release. Well, actually there is not a lot of movement, but over the last few quarters. The moving value of the US dollar, it can change our sales, translate into more or less. From a translation standpoint, we have a lot of costs outside the US, as well as sales. So it has not had that big an impact on our financial results. So that's been a good thing and the result of work over, it will be 40 years, to diversify the currency that the cost base is in. So I think to a large degree currency doesn't have too huge an impact. Now, certainly, there's some competitive impacts like Komatsu, if they are producing more in Japan and exporting to the US. So a particularly strong dollar against the yen can impact competitiveness, but, in the ranges that we are at now, it's not something that's abnormal.

Ann Duignan - *JPMorgan Chase - Analyst*

Okay, Mike. Thanks. I appreciate that, but really what I was getting at is would you be willing to share whether Cat is a net exporter?

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

Absolutely, we are in a net exporter. Absolutely. No doubt.

Ann Duignan - *JPMorgan Chase - Analyst*

Okay. And net interest expensing on the financial services part of your business?

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

Sorry, don't know the answer to that, Ann.

Ann Duignan - *JPMorgan Chase - Analyst*

Okay. No problem. I will leave it there. Thank you and best wishes.

Operator

David Raso.

David Raso - *Evercore ISI - Analyst*

Evercore ISI. First question, the sales cadence for 2017 in the context of the down 3% or so midpoint, do you see a quarter in 2017 where sales turn positive and if you maybe give us some idea if you think it is midyear or late in the year? Just some perspective.

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

Yes, I think if you look at the things we mentioned in the release and I have talked about today, I think you can probably get your mind around the idea that the second half of the year probably has the most upside. All the things that we've talked about -- tax reform, better economic growth -- that's certainly not impacting what's on the books, getting produced and shipped here early in the year. In fact, probably for the first quarter, I think you can play into your first-quarter thoughts -- basically what's happening for the year will probably happen for the first quarter, so sales down a little, profit down a little versus a year ago. So I think if there's upside, it will probably come later in the year, particularly if we start seeing better economic growth; we get tax reform nailed down so people actually know what's coming. The more of that happens, the sooner, the better.

David Raso - *Evercore ISI - Analyst*

And then regarding the segment margins, the framework here is you're saying sales are down 3%; EPS is down 15%, excluding extraordinary items. And thinking of it as an equipment company, Cat Financial is probably -- say it's worth 4% of that down 15%. Tax rate up a little bit is worth call it 1%. So we are still saying the equipment company is down 3%; EBIT basically implied about down 10%, but when you think about your comments on Resource Industries, you are saying they will cut their losses. You didn't say breakeven, but you said call it losing $150 million. And if CI margins then are flat on flat revs, it is implying a pretty big decremental on E&T. So just so we walk off the call understanding I guess really the interplay between RI and the E&T, are we saying the E&T margins are down fairly notably?

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

No, we didn't provide any guidance on any margin by segment. I was just reacting to -- on RI, is it going to be at breakeven. My comment was probably not, but probably not far from it. And another point, David, and this doesn't really relate to your question, but I just wanted to -- of all the year-end adjustments that we had, the one that was included in segment margins was the goodwill adjustment and I know you know that.

So we have about 30% decrementals for the Company next year on the lower sales and we have a higher tax rate, as you mentioned. Those two items -- and the 30% decremental is a little bit higher than we've had over the last couple of years and that's mostly because we have a lot more incentive comp. We've paid very little this year and you know how that is a little bit of a moving target. Each year, it gets reset at the beginning of the year. So at this point, that is a headwind for next year.

Outside of that, I think margins will be overall fairly similar to last year.

David Raso - *Evercore ISI - Analyst*

That's what I'm saying. I'm not trying to paint a rosy picture here on your guidance, but it doesn't seem -- if you get any RI improvement and given all the restructuring and even take your comment of not quite breakeven, but again let's say we lose $150 million, you would think CI profits should be steady versus a flat sales, so we are saying the hit on the EBIT has got to be E&T and I'm not sure why the hit should be that big.

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

Yes. Again, we have not provided any separate guidance on any of the segment margins and remember that incentive pay is going to be a headwind for all of them.

David Raso - *Evercore ISI - Analyst*

Okay. I appreciate it. Good luck, Mike. I appreciate it.

Operator

Jamie Cook.

Jamie Cook - *Credit Suisse - Analyst*

Hi, good morning. Credit Suisse. And congrats, Mike. I get the sense that we will miss you more than you will miss us and also congratulations, Jim. I guess two questions, one for Mike and one for Jim. Jim, I guess as you sit here as the new CEO, can you talk about your approach to guidance relative to Cat historically and how we should think about that and the precedent that you want to set here coming in as the new CEO?

And then I guess my follow-up question, Mike or Jim, because you will know this as well, on the oil and gas side, you guys talked about Solar and the visibility that you have there, but what are you seeing on the reciprocating engine side? I know orders had been down dramatically; I'm just wondering if we are seeing any improvement there or quoting activity? Any color you could provide? Thank you.

Jim Umpleby - *Caterpillar Inc. - CEO*

Good morning, Jamie. First part of your question, our outlook is based on input we receive from customers, dealers, market trends. Maybe the short answer to your question is it's not our intent to be overly optimistic or pessimistic. We will hit it down the middle of the fairway to use a golf analogy and give you our best view based on all the various inputs that we receive.

In terms of the oil and gas question, we expect our recip business to be up slightly. As you know, there was a lot of carnage in that industry over the last few years; a lot of equipment was stacked, but we are seeing more activity in that area, which is positive, but we will have to wait and see how it all plays out. Stability of oil prices is very important and it would certainly help to have the price go up a bit more.

Jamie Cook - *Credit Suisse - Analyst*

Alrighty. Thanks. I will get back in queue.

Operator

Andrew Casey.

Andrew Casey - *Wells Fargo Securities - Analyst*

Couldn't miss an opportunity to say goodbye, Mike. Good luck.

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

It's been a long time.

Andrew Casey - *Wells Fargo Securities - Analyst*

No kidding. Welcome, Jim. A question on the flattish pricing in Construction. Is that a reflection of the competitive environment getting less aggressive, the year-over-year comps getting easier, or is it potentially a shift in how the company is looking at the balance between profitability and marketshare?

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

Wow, that is a very good question and I guess in some ways it's probably a little bit of all of it. We had I would say better comps. If you look at the pricing environment, I wouldn't be saying that it's gotten better, or it's easier, or competitors are out there raising prices. That's not the case. It was worse in total -- I don't remember what the separate number was for the year, but, for the company for the year, we were over $700 million-ish negative.

I think what's happened is that has stabilized; it doesn't look like it's getting any worse. I don't think the pricing environment is any better on an absolute basis, but we don't see it getting worse from here. We do use our operating and execution model and you don't want to be doing silly things. You don't want to, for example, have big sales discounts on products you don't make much money on. So I think we are trying to have the operating and execution model guide us on where to spend our money on sales variance and discounting. But I think the main answer to your question is the comps have started to flatten out.

Andrew Casey - *Wells Fargo Securities - Analyst*

Okay, thanks. And then a separate question on Resource Industries. You mentioned the parts demand continued to sequentially increase. Did you see that same sort of sequential increase in rebuild activity? And then for the backlog improvement, can you talk about if that was concentrated in a particular region or more broad-based?

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

Yes. So I don't get actual reporting on rebuild, but I can tell you, for RI, rebuild is the major driver of -- is a major driver of part sales. So if I had to speculate here, I would say the answer to that is probably yes because that's a good driver of part sales. I don't think there's been enough of an increase in the backlog for regional differences to matter that much and I don't have the numbers in front of me, but I did look at them and it wasn't enough for me to say, ah, we need to make this point that was all here or here. So probably nothing yet there to get too excited about.

Andrew Casey - *Wells Fargo Securities - Analyst*

Okay. Thanks and good luck, Mike.

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

So I think we are going to stop the Q&A there for a moment. I want to turn the floor -- we have a couple minutes left -- I want to turn the floor back over to our CEO, Jim Umpleby, for some closing comments.

Jim Umpleby - *Caterpillar Inc. - CEO*

All right, thanks, Mike. I just wanted to take a moment to add my thanks to Mike for all his contributions to Cat over the last 35, 36 years and we wish you all the best in retirement. And for everyone on the call, thank you for calling in this morning. We certainly appreciate your interest. Thank you.

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

Alrighty, with that, we will sign off. Thank you very much, everyone.

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.