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EDITED TRANSCRIPT

CAT - Q3 2017 Caterpillar Inc Earnings Call

EVENT DATE/TIME: OCTOBER 24, 2017 / 3:00PM GMT

OVERVIEW:

Co. reported 3Q17 sales and revenues of $11.4b, operating profit of $1.577b and adjusted profit per share of $1.95. Expects full-year 2017 sales and revenues to be about $44b and adjusted profit per share to be about $6.25. Expects 4Q17 sales and revenues to be about $11.4b and adjusted profit per share to be $1.53.

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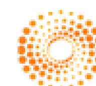

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Caterpillar 3Q 2017 Results Conference Call. (Operator Instructions)

It is now my pleasure to turn the floor over to your host, Amy Campbell, Director of Investor Relations. Ma'am, the floor is yours.

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

Thank you, Kate. Good morning, and welcome, everyone, to our third quarter earnings call. I'm Amy Campbell, Caterpillar's Director of Investor Relations. And on the call today, I'm pleased to have our CEO, Jim Umpleby; our Group President and CFO, Brad Halverson; and our Vice President of Financial Services, Joe Creed.

Remember, this call is copyrighted by Caterpillar, and any use, recording or transmission of any portion of the call without the expressed written consent of Caterpillar is strictly prohibited. If you'd like a copy of today's call transcript, we'll be posting it to the Investors section of our caterpillar.com website. It will be in the section labeled Results Webcast.

This morning, we will be discussing forward-looking information that involves risks, uncertainties and assumptions that could cause our actual results to differ materially from the forward-looking information. A discussion of some of the factors that either individually or in the aggregate could make actual results differ materially from our projections can be found in our cautionary statements filed with the SEC and is also in our forward-looking statement language included in today's financial release and in today's presentation. In addition, there's a reconciliation of non-GAAP measures that can also be found in this morning's release and is posted at caterpillar.com/earnings.

We're going to start the call this morning with a few words from Jim, and then Brad will walk us through third quarter results and our revised outlook, and then we will begin the Q&A portion of the call. Jim?

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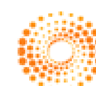

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D. James Umpleby - *Caterpillar Inc. - CEO*

Thank you, Amy. I'd like to start by thanking and congratulating our team for excellent results this quarter. Sales and revenues were up 25% from the third quarter of 2016, and adjusted profit per share is well over double what it was 1 year ago. Overall, we're seeing broad-based sales increases across a number of industries in all regions.

We continue to see strength in China construction. Onshore oil and gas in North America is also strong. Construction activity in North America was up compared to last year, and we are seeing increased order activity by mining customers. Our profit margins continue to improve in our 3 primary segments. The improved margins are driven by higher sales volume, price realization, primarily in Construction Industries, and our team's focus on cost discipline. Material costs were a slight headwind in the third quarter, and we expect this trend to continue.

With this more widespread increase in sales, we have raised our full year top line outlook. We now expect full year 2017 sales and revenues of about $44 billion. And as a result of our team's strong performance, we are raising our 2017 adjusted profit per share outlook to about $6.25.

We know product availability is a concern in some areas. We continue to work with our supply chain to increase production levels to satisfy customer demand for those markets that are improving. I'm also pleased with our progress in executing our new strategy for profitable growth based on operational excellence, expanded offerings and services. We presented this strategy in September, but I'm going to take a minute to recap the main components for you again today. We are pursuing profitable growth by reinvesting in our strengths. We are running our business using our Operating & Execution Model as we have been for some time in select areas of the company. Now we're expanding it across the enterprise and strengthening its governance. We're expanding services with an emphasis on the aftermarket and are investing in our digital capabilities. We're also extending our product offerings.

We're fully committed to our lean manufacturing journey and excelling in the fundamentals of safety, quality and cost control. We want to ensure our customers are more successful using our products than they are using our competitors'. Finally and above all else, we'll be guided by our values in action. We'll measure the success of this new strategy by the value we bring to our customers, the profits we generate to fund reinvestment and the returns we generate for our shareholders. I'm confident in our team's ability to execute the strategy and confident Caterpillar is well positioned to compete and grow profitably.

With that, I'll turn it over to Brad.

Bradley M. Halverson - *Caterpillar Inc. - CFO and Group President*

Well, thanks, Jim, and good morning to everybody. As Jim stated, it was a strong quarter with higher sales across all regions and improved margins, and we raised the profit outlook. Our commitment to running the business using the Operating & Execution Model is evident in the team's focus on profitable growth and cost discipline, building on our restructuring efforts.

Let's turn to Slide 4, and I'll quickly walk through the numbers. Sales and revenues of $11.4 billion were up 25% from the third quarter of last year, our strongest quarter-over-quarter in terms of sales and revenue growth since the fourth quarter of 2011. About half of the increase in sales volume was from higher end-user demand. The other half was from favorable changes to dealer inventory. The favorable change to dealer inventory was mostly due to the absence of dealer inventory reductions that occurred last year during a 4 year run of dealers reducing inventory by over $6 billion, not from dealers building significant inventory this year. Dealers reduced inventory $700 million in the third quarter of last year as compared to a $200 million dealer inventory increase in the third quarter this year, a net change of $900 million.

While changes to dealer inventory were favorable, it's important to note that dealer inventory in terms of months of sales are low based on historical levels and are lower than at the end of the second quarter. Profit per share was up $1.29, from $0.48 to $1.77. Adjusted profit per share more than doubled, up $1.10, from $0.85 in the third quarter 2016 to $1.95. Higher sales volume and favorable price realization were the largest drivers to the increase in profit.

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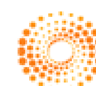

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Let's turn to Slide 5. Third quarter operating profit was $1,577,000,000 as compared with $481 million in 2016, up almost $1.1 billion. Positive changes to operating profit came from several areas. The largest increase to profit was a result of higher sales volume. About half of the change was from higher end-user demand and half was from a favorable change to dealer inventories. All 4 geographic regions saw sales and revenues increase -- increases, ranging from 20% to 29% versus a year ago. However, keep in mind that, in some cases, this was off a very low base, especially in Latin America. Dollar sales increase was highest in North America, primarily due to higher end-user demand for both new equipment and aftermarket parts as well as favorable changes to dealer inventories as dealers in North America held inventory about flat in the quarter versus reducing inventories in the third quarter a year ago. Asia Pacific saw the second highest increase in dollar sales, primarily due to higher end-user demand for construction equipment. About half of the increase was in China with strength also broadening to other countries in the region.

Price improved $343 million in the quarter. The favorable change was primarily due to Construction Industries. Variable manufacturing costs were favorable $143 million largely due to the favorable impact of period costs absorbed as inventories increased in many of our factories to support higher production levels. As we ramp up production, we remain focused on lean principles, and the inventory turns improved in all 3 primary segments. As we ramp, we are working closely with our supply base to reduce lead times and raise production levels, in some cases, off of a very low base. Our focus is getting product to customers quickly but also efficiently. However, we are focused on improving availability to meet higher end-user demand. For the first time in several years, material costs increased in the quarter. We expect higher steel costs to put pressure on material costs moving forward.

Total period costs were higher by $349 million. When you exclude the higher short-term incentive accrual, period costs were about flat despite a significant increase in sales volume. This is a reflection of our continued cost discipline that has enabled us to control costs while making targeted investments in key areas to drive future profitable growth.

Restructuring actions continue. These actions are important to achieving the flexible cost structure required to remain profitable through the cycles. Restructuring costs were $90 million in the quarter, $234 million less than in the third quarter of 2016.

Before we walk through the segments, I want to touch on the balance sheet. ME&T debt-to-capital at the end of the second quarter was 36.1%, an improvement from 38.6% at the end of the second quarter. Year-to-date, ME&T operating cash flow was $4.2 billion, $2.4 billion higher than the first 9 months of last year. Enterprise cash at the end of the quarter was $9.6 billion.

Now let's move on, and we'll go through the segments, starting on Slide 6, and we'll start with Construction Industries. Construction Industries sales were up 37% to $4.9 billion. Higher sales in all regions and favorable price realization contributed to the increase. Order activity was strong in the quarter across all regions, and the backlog increased about $500 million. About half of the sales volume increase was from favorable changes to dealer inventories. Most of this favorable dealer inventory change occurred in North America and EAME where there were significant reductions to dealer inventory in the third quarter of last year. Asia Pacific and EAME dealers increased inventory in the quarter. Construction Industries dealer inventory is up about $300 million from the start of the year, but from a month of sales metric, they're low versus historical levels. The other half of the sales volume increase was a result of higher end-user demand. North America end-user demand increased primarily due to increasing activity in the oil and gas industry, including an uptick in pipeline construction, and improving residential and nonresidential construction. Asia Pacific saw strength across the region. However, China continues to be a bright spot and a surprise to the upside. Our current estimate for 2017 is for the 10-ton-and-above excavator industry in China to more than double versus last year, which would result in sales that are higher than our estimate of normal replacement demand for the region. We believe that some demand has been pulled forward into 2017, so that construction projects can be completed before activity slows in the winter months. While we are seeing strengthening fundamentals in parts of EAME, the favorable sales increase was primarily due to favorable dealer inventory changes, not end-user demand. Price realization also contributed to the increase.

Latin America, especially Brazil, remains challenged, and sales are still at very low levels. However, end-user demand did increase due to stabilizing economic conditions in several countries in the region.

Construction Industries segment profit of $884 million was favorable $558 million driven by higher sales volume and favorable price realization. The increase in period costs was due to higher short-term incentive compensation. Excluding the short-term incentive compensation, period costs were about flat. Segment profit margin in the quarter was 18.1%, an increase of about 900 basis points from the third quarter of last year and about flat with the second quarter of this year.

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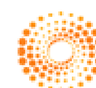

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Let's move to Resource Industries on Slide 7. Favorable changes to dealer inventories, combined with strong demand for aftermarket parts to support overhauls and maintenance work, as well as improved price realization, were the primary drivers of the $500 million increase in sales and revenues for Resource Industries, an increase of 36%. Dealer deliveries of new equipment increased slightly. As we have stated previously, the mining cycle has started to turn. The parked fleet has come down from its peak and stabilized for several months. The initial surge earlier this year in trucks coming into service bays for overhauls has started to subside, especially in Australia where we first saw demand increase. But demand for aftermarket parts remains at a healthy level. Utilization on trucks has steadily trended higher over the past 8 months and recently achieved a 5-year high. While the number of trucks being overhauled has come down, the higher utilization and number of trucks working in the mines has also contributed to an increase in aftermarket parts demand. For the third quarter in a row and after 4 years of dealers reducing their inventories and our factories producing below retail demand, dealer inventories were about flat in the quarter, driving a favorable change to sales. Year-to-date, Resource Industries dealer inventory is up just slightly from the end of 2016.

Although price realization was favorable in the quarter, the competitive environment in Resource Industries continues to put pressure on pricing for many of our products. Order activity across all regions remained strong in the quarter, and the backlog increased about $300 million from the second quarter. However, Resource Industries new equipment sales and production levels still remain at historically low levels.

Segment profit was $226 million, up $303 million from a loss of $77 million in 2016. The improvement in profit resulted from higher sales volume, favorable price realizations, lower manufacturing cost primarily due to cost absorption as inventories increased in the quarter and were about flat a year ago. Period costs were about flat as the benefits from a number of restructuring and cost-reduction action -- actions offset higher short-term incentive compensation. Segment profit as a percent of sales improved to 11.6% from a loss position a year ago. It was the best quarter this year for Resource Industries in terms of both segment profit and profit as a percent of sales.

Now we'll move to Energy & Transportation on Slide 8. Energy & Transportation sales, including intersegment sales, were up about $600 million or 16% in the quarter to $4.8 billion. Sales were higher across all applications. New engines and aftermarket sales for industrial applications increased in all regions to support higher equipment demand across several industrial customers' end markets. In oil and gas, demand for aftermarket parts to support well-servicing applications increased in the quarter. In addition, the build-out of North American natural gas infrastructure, combined with new wells that have had a higher concentration of natural gas than previous wells, continued to drive strong demand in midstream gas compression. Sales into power generation were up largely due to timing of projects in North America and EAME. Transportation sales were also up as rail services demand increased to support higher North America rail traffic in the quarter.

Segment profit for Energy & Transportation was up $178 million, from $572 million to $750 million. This was largely attributable to higher sales volume and a favorable impact from cost absorption as inventories increased in the third quarter of this year to support higher production levels and were flat last year. Period costs increased in the quarter primarily driven by higher short-term incentive compensation. Segment profit as a percent of sales improved 180 basis points to 15.5% from 13.7%.

Before I move on to the outlook, a few comments on financial products. Operating profit was about flat versus the third quarter of last year. The portfolio remains healthy with past dues down 4 basis points from the third quarter of 2016, and used equipment prices continued to improve.

Now let's move on to the outlook on Slide 9. In July, we provided an outlook for sales and revenues of $42 billion to $44 billion. As a result of encouraging order rates, good economic indicators and an increasing backlog, we are providing new guidance for sales and revenues of about $44 billion. We have raised the profit per share outlook to about $4.60 and raised the adjusted profit per share outlook from $5 at the midpoint of the previous sales and revenue range to about $6.25. The increase on the profit outlook is largely a result of a higher estimate for sales, combined with a favorable mix, improved price realization and the slower ramp of period costs spend for targeted investments. These positives are slightly offset by an increase in short-term incentive compensation expense and higher material costs.

Sales and revenues in 2016 were $38.5 billion, and profit per share was a loss of $0.11 with adjusted profit per share of $3.42. Our revised outlook is sales and revenues of about $44 billion, profit per share of $4.60 and adjusted profit per share of $6.25. This equates to adjusted profit per share up more than 80% on about a 14% sales and revenues increase. The implied fourth quarter is for sales and revenues of about $11.4 billion and adjusted profit per share of $1.53. We expect higher material costs and period cost spend for targeted investments will negatively impact operating leverage in the fourth quarter.

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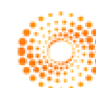

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Now let's discuss the sales outlook, starting on Slide 10. We now expect Construction Industries sales for the year to be up about 20% versus the previous outlook of up 10% to 15%, driven largely by higher end-user demand across all regions. The increase in the sales outlook is driven primarily by a higher sales forecast for Asia Pacific and North America, the strength in Asia Pacific expanding beyond just China. Order rate for Construction Industries have been strong across all regions, although, in many cases, off a very low base. The backlog is up significantly from the third quarter of 2016 and also up from the second quarter of 2017.

For Resource Industries, we now expect sales to be up about 30% for the full year versus the previous outlook of up 20% to 25%. In our prior outlook, we expected aftermarket part sales to decline in the second half of the year as machine rebuilds were expected to slow and for sale of new equipment to offset this decrease. As predicted, we did see some slowing in aftermarket parts sales in the third quarter, however, not to the pace that was anticipated. The increase to the sales outlook for Resource Industries is largely driven by our higher expectation for aftermarket parts sales. Our forecast for new equipment sales has not changed from our previous outlook. We continue to see strong order activity for Resource Industries and a backlog increase from both the third quarter 2016 and the second quarter of this year.

Energy & Transportation sales are forecasted to be up about 10% for the year versus the previous outlook of up 5% to 10%. The largest driver of the increase in the sales outlook for Energy & Transportation is a higher forecast for the sale of engines into industrial applications as our customers across several industrial end markets are seeing strength in their industries. Energy & Transportation 2017 sales growth is largely due to the strength in onshore North America oil and gas.

We continue to see strong rebuild activity in well-servicing for engines, transmissions, pumps and flow iron as well as demand for new equipment. We also expect shipments to North America gas compression customers to be higher this year, driven largely by demand for reciprocating engines as solar sales into oil and gas applications are expected to be flat for the full year. Transportation is now expected to be up as higher rail traffic has driven higher demand for rail services.

Power generation industry remains challenged, and we anticipate sales to be about flat to slightly up for the full year.

While order activity has been strong for the first 3 quarters of 2017 and the backlog is up, geopolitical uncertainty, global and regional GDP growth and commodity volatility will be risks as we move into 2018. Potential tax reform and an infrastructure bill would be positives for the long term. At this time, we are focused on operational excellence, and our segments are in the process of planning and implementing strategies to drive profitable growth. It is too early to comment on 2018, and we will share more on 2018 in January.

So let's wrap up with a few takeaways on Slide 11. In the third quarter, we saw encouraging order rates and an increasing backlog in the quarter. Year-over-year sales and revenues were higher by more than $2 billion. Operational performance for the year has been strong as third quarter segment margins continued to improve as a result of our commitment to the O&E Model, operational excellence and profitable growth. The balance sheet remains strong with $9.6 billion of enterprise cash on hand and a debt-to-cap ratio of 36.1%. Given year-to-date performance and confidence in our end markets, we raised the 2017 profit outlook. We are focused on delivering the new strategy that Jim rolled out in September at Investor Day and are focused on driving profitable growth through margin expansion, asset efficiency and expanded offerings, especially services.

With that, I'll now turn it back to you, Amy.

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

All right. Thanks, Brad. And Kate, let's open up the phones for the Q&A portion of the call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today is coming from Joseph O'Dea.

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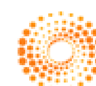

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Joseph O'Dea - *Vertical Research Partners, LLC - VP*

It's Vertical Research. First question, on dealer inventory, in the first half of the year, the trends were pretty similar to what you had seen in the first half of '16. So this quarter marks the first real change we've seen there. And I guess just to understand a little bit better about why we saw that sudden change, the support behind that. And then maybe in addition, if you could just talk a little bit to the month of inventory across the segments. You touched that there are really no warning signs that, that's still below averages but just a little context there.

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

Sure. Good morning, Joe. So if you look at dealer inventory first half versus second half this year versus last year, I think what you saw on the first half of 2017 was pretty typical dealer inventory behavior with dealers building inventory in the first quarter in preparation of the spring selling -- spring and summer selling season and then working through that inventory in the second quarter. However, I would say built -- the dealers did build a little bit less inventory in the first quarter of this year than they did on the year prior, and that was primarily due to what was a really strong first quarter in China, some due to just what has continued to be an extremely strong industry and some also having to do with the timing of the Chinese New Year. So I think the first half of the year looked like what we have seasonally seen. If you go back into 2016 and even the 2 years prior to that, we have seen dealers take significant inventory out in the back half of the year, both in the third and the fourth quarters. I think if you look back last year, we also saw the backlog coming down in the third quarter or maybe even just about flat, so I think that is pretty normal activity. What we're seeing on the third quarter of this year is the backlog going up. And so I think the strength currently in the end markets, which is -- for Construction Industries and Resource Industries is pretty broad based regionally, is what's driving dealers to not pull inventory out as much. Certainly, they are working hard to satisfy end-user demand, turn that around and look at month of sales. So even though dealer inventory didn't come out nearly as much as it did third quarter of last year, month of sales are quite a bit lower than where we ended the third quarter of 2016. Our normal targeted range for month of sales is about 3.5 to 4 months. We're below that. Dealers are sending many products straight through the customers, and not building inventory up. So I think it really has to do with the strength in Construction and Resource end markets that they're not pulling inventory down as much. And I guess, I would say, their order rates are up, so they're ordering and refilling dealer inventory as opposed to a year ago, their order rates were starting to decline.

Joseph O'Dea - *Vertical Research Partners, LLC - VP*

Got it. And then on the pricing front, really strong pricing in both Construction and Resources. How much of that was linked to the opportunity to move prices in the middle of the year as some of this restock was underway and something that you wouldn't have necessarily been able to anticipate earlier in the year but just to try to understand the ability to get the kind of pricing you got in the quarter?

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

Yes. I think if you look at the pricing in the quarter, it's largely a story of comps versus 2016, especially for Construction Industries, but even for Resource Industries, to some extent. If you look at 2016, I think prices were down about 4% or so for the full year. We've largely clawed that negative price realization back through the third quarter of 2016. And so if you look over a couple of year trend for Construction Industries pricing, it's really been fairly flat. I think you need to go back, since 2014, our price realization in Construction Industries has been fairly flat. So we have a -- what we see over the medium term a very competitive pricing situation, but 2016, as we all know, was difficult for Construction Industries from a price realization perspective. And so it's not so much that we're really seeing a market that's conducive to taking price increases. In fact, I think we would say the opposite. The market continues to be extremely competitive. The continued strong dollar is competitive. And Resource Industries, about half of that change was from a -- just from a comp basis. Some of the others was just particular deals and where those were located around the world. So there's not much story in Resource Industries either. We also see in the Resource Industries end markets very competitive pricing situation and don't see a lot of opportunity to able to take price increases there as well.

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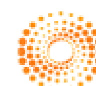

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Operator

Our next call today is coming from Stephen Volkmann.

Stephen Edward Volkmann - *Jefferies LLC, Research Division - Equity Analyst*

It's Jefferies. I'm wondering if we can dig in a little bit more on this inventory thing, too. And I guess my head is spinning a little bit because it looks like you're not -- as you say, the dealers aren't really building. And yet, the retail sales numbers that you've been giving us are basically double what you -- or sorry, CAT's reported sales are basically double what the retail sales that you gave us yesterday are. And so clearly, theres' something going on there that I'm trying to kind of square up. Any insights?

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

Yes. I think -- it is a complicated story, and I'll attempt to walk through it kind of in the few drivers that are driving the disconnect. And so if you look at retail sales, those are neutralized for price and currency, and they don't include, generally speaking, aftermarket parts increases. And then there is the dealer inventory change. So of the sales increase for the quarter, if you look at, and Brad talked about this, about a $200 million dealer inventory increase versus a $700 million dealer decrease a year ago, that's $900 million favorable to the top line, you won't see that translate through retail stats. Price realization, a little over $300 million favorable in the quarter. That's also not going to translate into retail stats. And then lastly, as we talked, it's been a good quarter and a good year for aftermarket parts for mining as well as in North American oil and gas applications. And those also aren't going to translate into retail sales. So those are the 3 big differences where you're seeing on a reported sales and revenues increase being significantly higher than those that are coming through retail stats.

Stephen Edward Volkmann - *Jefferies LLC, Research Division - Equity Analyst*

Okay. Yes, that's helpful. And then maybe the next step is, how should I think about this impacting margins? Because obviously, your margins are very high here. Should I think that you were basically over-absorbing last year's, so your margins were artificially low, and this is what normal looks like? Or are you actually over-absorbing today due to these changes in inventory, and sort of the normal would be maybe a little lower than it currently is?

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

By over-absorbing, are you referencing the inventory numbers, Steve?

Stephen Edward Volkmann - *Jefferies LLC, Research Division - Equity Analyst*

Yes.

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

Yes. So I mean, those inventory numbers are dealer inventory, so they don't translate back into the cost absorption we see for Caterpillar inventory. We do have favorable cost absorption due to inventory increases. I don't know that I can say if that's normal or not, and I don't have -- I mean, you can calculate that. That is what drove most of the variable manufacturing cost improvement in the quarter. But with these higher production levels, I think, as we would expect, we are seeing CAT inventory go up to support the higher production levels. But even with that, continuing to see inventory turns improve. So we definitely had some favorable cost absorption into the quarter as those inventories went up. I think, as we look into the fourth quarter, that is and in the implied, a little bit of profit erosion in the fourth quarter, a piece of that comes from -- especially with some large shipments of assorted turbines and locomotives, you will see some inventory come down in E&T and we have some negative impact that -- expected from that in the fourth quarter.

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Operator

Our next question today is coming from Jerry Revich.

Jerry David Revich - *Goldman Sachs Group Inc., Research Division - VP*

It's Goldman Sachs. I'm wondering if you could just talk a little bit more about the supply chain performance, if you can touch on supplier on-time deliveries, if you can quantify that for us. And overall, what's the level of production growth over the next 12 to 24 months? Do you folks feel comfortable the supply base can underwrite? As you pointed out in the prepared remarks, it's been volatile a couple of years for a big chunk of the supply base. I'm wondering how comfortable you are with their ability to ramp.

D. James Umpleby - *Caterpillar Inc. - CEO*

Jerry, it's Jim. I'll take that one. As we mentioned at the end of the last quarter, we have a couple of areas, in particular, a couple of products where we've had very large demand increases year-over-year. We highlighted 3600 engines for gas compression in North America, and we also talked about large mining trucks. Those are the 2 areas that we are work -- that are struggling with a bit and working with our suppliers to be able to meet the very large increases on a percent basis in demand. Keep in mind, both of those products came off a very low base in 2016. So we're working with our suppliers to meet the increased demand that we've seen this year. Won't really comment on next year in terms of -- I don't want to quantify that for next year, but we are working with our suppliers to ensure that we satisfy what we believe will be customer demand moving forward.

Jerry David Revich - *Goldman Sachs Group Inc., Research Division - VP*

Okay. And then separately, in dealer inventories, you folks have -- with your dealers taken out over $6 billion of inventory out of the channel, I'm wondering what's your view of normalized level of dealer inventories. So Amy, if you go back to normalized months of supply basis, what level of increase in dealer inventory should we be thinking about off of these trough levels here?

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

Yes. I mean, Jerry, as you know, it's difficult to predict dealer inventories precisely. And certainly, the dealers control their inventory decisions and where they want to put inventory at. I think there is also, as we think out over the next few quarters and the demand, the end-user demand, which is where most of our efforts are going to be focused, certainly, in the fourth quarter, and then we'll have to see how the first half of 2018 plays out. The thing is, it's difficult and probably not appropriate to forecast where dealer inventory is going to land. As I talked about 3.5 to 4 months of sales is where we have normally worked with our dealers given our availability and supply chains to target dealer inventory. We do believe there's opportunity to bring that down some with our focus on lean and reducing lead times. But even with that, dealer inventories are probably a little bit lower than the dealers would like them to be, we'd like them to be. So over time, and I think it all depends on where end-user demand goes and where the market goes, so those are kind of decisions in numbers that move with a lot of different moving variables. Where we sit right now at the end of the third quarter, dealer inventory levels are at a lower level than we've normally targeted, but exactly how much dealer inventory there is to bring back, I think is just difficult to estimate.

Operator

Our next question today is coming from Jamie Cook.

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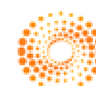

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Jamie Lyn Cook - *Crédit Suisse AG, Research Division - MD, Sector Head of United States Capital Goods Research, and Analyst*

Crédit Suisse. I guess 2 questions. I mean, Jerry just asked the question on sort of the supply chain. But from talking to the dealers, too, they seem to think some of the issues isn't just the supply chain. It's CAT's not willing yet to really ramp production. So can you just talk about sort of lead times by product line, where the biggest bottlenecks are? And just sort of do we think the -- these issues could start to work -- could work -- could be more favorable in 2018 versus where we were in 2017? And then, I guess, my second question, Amy. I understand you guys don't want to talk about 2018 in terms of at least the top line, which we can make our own assumptions there. But if you look at the back half of the year, your run rate increased '15 earnings. So is there anything sort of unusual items that we should think about that could impact incremental margins in 2018, on the positive? I'm assuming you'd be getting savings from restructuring. Any other onetime things you could point out that could help -- at least help us think about 2018, assuming we make our own top line assumptions?

D. James Umpleby - *Caterpillar Inc. - CEO*

Jamie, it's Jim again. Well, certainly, CAT is willing to ramp up production. There's no issue there. I think the only product where we really have an issue in terms of our ability to meet demand is 3600 engines from a manufacturing capacity perspective. All the other issues that we're dealing with have to do with supplier capacity. So there's no reluctance on our part to ramp up production to meet demand, and we do believe we have enough manufacturing capacity to meet what we see in terms of demand for the next few years. So really, it's a matter of working with our suppliers. And a lot of this is an industry problem. It's not just us. As I'm sure you've learned through your research that a number of our competitors are dealing with the same kinds of issues with the supply base. So again, we're working that hard and believe that we are seeing improvements and will continue to see improvements on that front. In terms of visibility for next year, again, we decided not to give a top line estimate for 2018 at this time, really want to keep the team focused on executing our strategy. We -- in terms of your question on margins, we will continue to make targeted investments to grow our business in the long term. So we've talked about some of the investments at Investor Day, whether they be in our digital capabilities in various products. So again, we will be making targeted investments moving forward. Amy, I don't know if you want to add to that at all.

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

Yes, I think, probably just a couple of other -- Jim had kind of the high level -- a couple of other, maybe small points to think about as you think about 2018. We do look at the competitive pricing situation. We've talked about it all year. We don't think it's changed. We continue to think that pricing will be very competitive as we move into 2018. And exactly what does that translate to dollars, we're not ready to have a forecast for, but that is something we're keeping our eye on. Material costs, we have started to see those turn negative, especially due to steel prices. And while our teams continue to work on redesign and other supply chain actions to bring down material costs, we do see steel costs, the material costs as we move into 2018 to be a headwind. And then I think the big tailwind that's out there, is short-term incentive compensation expense, we're accruing at a rate of $1.4 billion this year. A more normal payout is probably closer to $800 million to $850 million. So there's a little bit of a nice tailwind there. But as Jim alluded to, we are going to continue to make targeted investments, work towards delivering our margins that we showed at Investor Day, but making sure that we're making the long-term investments that we need to make to grow profitably over the long term.

Operator

Our next question today is coming from David Raso.

David Michael Raso - *Evercore ISI, Research Division - Senior MD, Head of Industrial Research Team and Fundamental Research Analyst*

Evercore ISI. Just trying to level set the look at the '17, just so we know where we're growing from in '18. A clarification, when you look at total company revenue guidance, you're right, that implies the fourth quarter at $11.4 billion. But then, when you look at your business segment guidance, it implies the fourth quarter is more like $12.4 billion. And I'm just trying to make sure we level set what we're thinking about for the fourth quarter. Because obviously, an extra $1 billion with a reasonable incremental margin could add another $0.35, $0.40 to 2017. So if we can just clarify why the gap in those 2 guidances?

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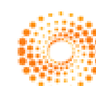

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Amy A. Campbell - *Caterpillar Inc. - Director of IR*

Yes. I think the gap, David, honestly, it just really has to do with rounding. So we thought about putting ranges in there. We stuck with kind of a single number for each one of the 3 segments. We will likely have a little bit higher shipments in E&T just due to normal seasonality of solar shipments. But I think, generally, when you look -- with that exception, you look at the 3 segments' sales and revenues about flat third quarter to fourth quarter.

David Michael Raso - *Evercore ISI, Research Division - Senior MD, Head of Industrial Research Team and Fundamental Research Analyst*

I mean, the business segment guidance do not imply that? That's all I'm making sure. I mean, CI, you're right. It implies flat. But RI, you have it up almost $400 million and E&T up almost $600 million, sequentially. And I'm just making sure we level set the revenue thought. And then also, I'm going to ask you about the margins, just so we understand where we're exiting the year.

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

So David, why don't we come back to that? I'll have to look at the math. I don't know if it's the fact that it excludes the intercompany transfer, so we got the intersegment sales that are excluded in those numbers.

David Michael Raso - *Evercore ISI, Research Division - Senior MD, Head of Industrial Research Team and Fundamental Research Analyst*

Yes. But now it's -- your guidance is clear. It says excluding intersegment sales. So -- and then, in that same vein then, for the margins for the year, again, just so we can level set everybody thinking about '18 and all the puts and takes, how are we thinking about margins now for the year? I know there are prior comments about each segment. Can you update us on those?

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

Yes. I think if you think about margins for the year and maybe to level set, I think, largely speaking, the third quarter will be the high-water mark. CI segment margins present a little bit higher, 18.2% in the second quarter, 18.1% on the third quarter, but third quarter clearly the high-water mark. Probably better to step back and look at kind of September year-to-date segment margin percent for all 3 segments. I think, generally speaking, resource energy -- Resource Industries, excuse me, Energy & Transportation segment margins for the full year should be pretty close to what they were September year-to-date, and that implies a little bit improvement in the fourth quarter for Energy & Transportation. And that's on those higher sales, just some leverage on those higher sales, which we typically see in the fourth quarter for Energy & Transportation. And then Construction Industries, segment margin percentage is down just slightly for the full year versus where we ended the third quarter, which then implies a softer fourth quarter than where we are year-to-date. And that's being driven by some of this price starting to come through that we've been talking about year-to-date. We did start to see price realizations get less favorable towards the end of the third quarter, some material cost headwinds, and we also started to see those get more unfavorable towards the end of the third quarter, and then also some targeted investments like Construction Industries had. They -- one of those, for one example, they just launched the next-gen excavator, an exciting product, that and many other things they've got in play are driving some additional costs in the fourth quarter.

David Michael Raso - *Evercore ISI, Research Division - Senior MD, Head of Industrial Research Team and Fundamental Research Analyst*

And I'm sorry, just to clarify, on Resource Industries, it was the year-to-date is where we think the full year shall be? Or...

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

Yes. Correct.

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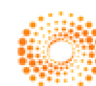

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David Michael Raso - *Evercore ISI, Research Division - Senior MD, Head of Industrial Research Team and Fundamental Research Analyst*

Okay. I mean, that does imply 8.7% in the fourth quarter just by revenues up sequentially. Should we expect RI margins to fall sequentially that much on up res? Is that -- is there a mix issue or?

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

Well, they also have some material cost issues, and they've got a fair number of -- their R&D expenses are also increasing in the fourth quarter for some pilot products they're sending out there. So they have some higher cost in the fourth quarter as well for some of their targeted investments.

Operator

Our next question today is coming from Ann Duignan.

Ann P. Duignan - *JP Morgan Chase & Co, Research Division - MD*

JPMorgan. My question is around -- Jim, maybe it's a question for you, kind of more philosophical question. I mean, if we look at the increase in your forecast by segment year-to-date, it reminds me of what we used to all would say about Caterpillar is that it is not great at forecasting. Can you talk a little bit philosophically about how you do forecast demand? And should investors be concerned at all that, given that a lot of the volume increase is simply dealer inventories, is there anything different about the relationship with your dealers or the way you communicate with your dealers that investors should be concerned about going forward?

D. James Umpleby - *Caterpillar Inc. - CEO*

Yes, Ann. I don't think there's anything that investors should be concerned about. Obviously, our forecast is based upon a number of factors. It's certainly what we hear from our dealers. It's also what we monitor the industries. We have direct contact with customers. So we take into account a number of factors when we forecast demand.

Ann P. Duignan - *JP Morgan Chase & Co, Research Division - MD*

Okay. And then follow-up question is around -- you mentioned pull-forward of demand in China. Was there any pull-forward of demand from your Canadian customers or dealers ahead of Tier 4 final in that region?

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

Yes. And I think if you look at -- maybe I'll step back to your last question, if you look at 2017, Ann, and we can talk about China pull-forward, we started the year thinking that the China industry, us, and I think, along with everyone, would be up, but up, and I don't remember the number, 20%, 25%. I think something like that. We now think it'll be more than double. So that's been huge driver of the strength this year as long as some other things. Canadian Tier 4, Ann, it's really difficult to know what the buying decisions of our customers are. We have Tier 3 and Tier 4 product ready to go. We have seen strong demand all year in Canada for construction equipment, and so I don't think there's anything of particular note there.

Operator

Our next question today is coming from Ross Gilardi.

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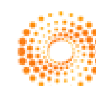

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Ross Paul Gilardi - *BofA Merrill Lynch, Research Division - Director*

Bank of America Merrill Lynch. Yes, just had a question on -- first one on mining. You noted spare parts coming off a little bit into the second half. But obviously, it held up better than you originally thought. But what -- can you talk a little more about what you're seeing on new equipment from mining customers? I mean, is the demand recovery coming -- becoming more pervasive? And I think this year, you've seen it in places like Russia and India for some smaller mining trucks. But I'm wondering now, are you seeing demand for big or new equipment in places like Western Australia and Chile? And what are you seeing on the Bucyrus side of the business?

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

Yes. I don't have it really split out by product, Ross. I think your point is a good one. When it looks at actual shipments for Resource Industries, they're really only starting to be up slightly in the third quarter. That said, we have seen good order activity, I'd really say, across the board for most of our products in Resource Industries. And that strength has also broadly been around the globe. So whether it's been Australia; I think South Africa was the last to go into the downturn. They were the last to come out, but we've started to see some strength there as well. I mean, I think I only picked those 2 out. I think it really has been a fairly broad improvement for Resource Industries without anything particular to note of one area doing better than another.

Ross Paul Gilardi - *BofA Merrill Lynch, Research Division - Director*

Okay, Amy. And then I'm just curious about the large engines for oil and gas. I mean, it sounds like you guys are really backed up there and have got some -- I think some capacity constraints, is what you were suggesting. I'm just -- do you have enough in backlog now essentially to carry you through a lot of 2018 in that area?

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

If you look at -- I mean, we were talking about the 3600 engine, specifically. And if you look at the backlog for that particular product, which is only a percentage of Energy & Transportation backlog, we are taking orders well into next year for that product. But I think I would be hesitant to draw too much conclusions from that for the broader Energy & Transportation segment, which has many other industries and many other products in there as well. And in those cases, the backlog would not be completely filled out for next year.

Operator

Our next question today is coming from Rob Wertheimer.

Robert Cameron Wertheimer - *Melius Research LLC - Research Analyst*

It's Melius Research. Just wanted to ask one more on production capacity. As you guys have ramped into this solid recovery, how do your internal indicators look on your progress on lean, on safety, on quality? I mean, is there any warning signs flashing like you might have seen back in '04, '05, '06? And then, Jim mentioned ample capacity, I think. I mean, can you do up to prior peak levels and/or better as your production improves with the current production side? Or do you need to think about if this continues another year or 2 adding capacity?

D. James Umpleby - *Caterpillar Inc. - CEO*

Yes, Rob. I'll answer your last question first. We certainly have enough manufacturing capacity to meet the demand that we see over the next few years. Again, our issues have been with suppliers, and we're working our way through that. And answer your first question, no, we don't see warning

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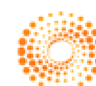

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signs in terms of safety, quality, lean. We're very pleased with our performance there, and we just had a number of dealer meetings, and all the feedback is very, very positive about our quality, so.

Operator

Our next question today is coming from Andrew Casey.

Andrew Millard Casey - *Wells Fargo Securities, LLC, Research Division - Senior Machinery Analyst*

Wells Fargo Securities. A question -- I want to go back to the margin performance. I know it's only 1 quarter, but compared to the longer-term potential ranges that you outlined in September, construction was above; E&T, kind of within in the range; Resource, slightly beneath, even though volumes remain at really low levels. How should we look at this short-term performance in the context of the longer-term potential? I mean, you kind of demonstrated that you can hit those margins on lower run rate revenue. Should we expect lower incrementals going forward as you reinvest in the growth initiatives? Or should we kind of view this as potential there might be upside?

D. James Umpleby - *Caterpillar Inc. - CEO*

Yes, Andy, it's Jim. I think, just to clarify, I believe the only 1 of our 3 primary segments that is in or above the ranges is Construction Industries. If you look at the third quarter in RI and in E&T as well, they're actually both below the ranges that we outlined at Investor Day, and certainly, the year-to-dates are as well. But then, to answer your bigger question, our intent is to grow the company. And if, in fact, we're -- use CI, as an example, we're within that range or a bit above that range, our intent is to invest to grow as opposed to try to just simply have higher margins every quarter. So we want to grow the business at a healthy margin rate, and that's really our focus. And also, I'd caution you, we would expect to see some variation quarter-to-quarter. Some of our businesses are more lumpy than others. E&T and RI are more lumpy than CI, as an example. So we would expect to see margins jump around a bit and as -- due to mix and a whole variety of other issues. But again, our intent is to grow within our targeted ranges.

Andrew Millard Casey - *Wells Fargo Securities, LLC, Research Division - Senior Machinery Analyst*

Okay, Jim. And then last one, again, on margin. Q4, a few different questions have asked this. But the margins are going down sequentially and kind flattish revenue. You identified price cost as one of the headwinds. Could you quantify that? Is it a couple of hundred million or even higher?

Amy A. Campbell - *Caterpillar Inc. - Director of IR*

So I mean, price -- I'm not going to quantify it, Andy. Price and material costs, they're both negative. The biggest of the 3 would actually be investments in these targeted initiatives that we have. We've got several things. We talked about this. We're connecting more assets, got some R&D programs, the launch of the next-gen excavator that we're excited about. And so the bigger of the 3 increases are these targeted investments that started to pick up towards the end of the third quarter, will roll into the fourth quarter and then roll into 2018 as well.

I think that's going to have to be the last question.

Operator

Thank you. We have no more questions for today.

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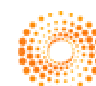

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Amy A. Campbell - *Caterpillar Inc. - Director of IR*

All right. Thanks, Kate.

D. James Umpleby - *Caterpillar Inc. - CEO*

Thank you.

Operator

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

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