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CAT - Q4 2018 Caterpillar Inc Earnings Call

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OVERVIEW:

Co. reported 4Q18 sales and revenues of $14.3b, profit per share of $1.78 and adjusted profit per share of $2.55. Expects 2019 profit per share to be $11.75-12.75.

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Caterpillar 4Q 2018 Analyst Conference Call. (Operator Instructions)

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

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

Thank you, Kate. Good morning, and welcome, everyone, to our fourth quarter earnings call. On the call today, I'm pleased to have our Chairman and CEO, Jim Umpleby; our CFO, Andrew Bonfield; and Vice President of Finance Services, Joe Creed.

Remember, this call is copyrighted by Caterpillar, and any use 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 will be posting it in the Investor Relations section of our caterpillar.com website.

This morning, we will be discussing forward-looking information that involves risks, uncertainties and assumptions that could cause our actual results to be different than the information discussed. Details on the factors that either individually or in the aggregate could make actual results differ materially from our projections can be found in our filings with the SEC and in our forward-looking statements included in today's financial release.

In addition, a reconciliation of non-GAAP measures can be found in the appendix of this morning's presentation and in our release, which is posted at caterpillar.com/earnings.

And with that, I'll turn the floor over to Jim.

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D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Thank you, Amy, and good morning. I'd like to begin today by thanking our global team for delivering an outstanding year in 2018. It was the best profit per share performance in our company's history, which allowed us to return $5.8 billion of capital to shareholders.

In 2018, we remained focused on making our customers more successful in executing our enterprise strategy, which centers around achieving long-term profitable growth through operational excellence and investing in services and expanded offerings.

Revenue for the year was up 20% to $54.7 billion as favorable economic conditions drove growth across many of our end markets. We delivered record adjusted profit per share of $11.22 and strong operating cash flow of $6.3 billion, which allowed us to repurchase $3.8 billion of company stock, raise the dividend by 10% and make a discretionary pension contribution of $1 billion.

2018 marked the 25th consecutive year we paid higher dividends to our shareholders, earning us recognition as a member of the elite Aristocrats Dividend Fund.

Our fourth quarter adjusted operating margin was 13.8%. This was lower than our expectations and was impacted primarily by write-offs at Cat Financial and higher-than-expected material and freight costs.

However, our full year 2018 adjusted operating margin was 15.9%, 340 basis points higher than in 2017 and solidly in line with our Investor Day target range. We're continuing to execute our enterprise strategy with the Operating & Execution Model guiding our investments to those areas with the best opportunity for future profitable growth.

I've talked frequently about 2 components of the strategy: expanded offerings and services. Let me walk you through a few successes from them last year in both of those areas.

On our October call, I talked about our expanded offerings of next-generation articulated trucks and mini excavators. We've continued to roll out next-gen machines, including the 120 motor grader that offers up to 15% greater fuel efficiency and saves customers up to 15% in maintenance costs with new filtration technology.

In December, we announced the next-generation 36-ton class excavators. These machines increase operating efficiency, lower fuel and maintenance costs and improve operator comfort.

We also launched our next-generation D6 dozer, offering customers the world's first high drive Electric Drive dozer, with 35% better fuel efficiency and increased agility compared to the previous electric drive models.

We are expanding our engine offerings as well, including the CG Series of generator sets, increasing power output, offering higher reliability and improving return on investment for our customers as they operate on natural gas and biogas, making them more economical.

Thanks to the combination of Caterpillar technology and the customer's initiative, the world's first cruise ship powered by liquefied natural gas set sail in 2018. This is another great example of an expanded offering. We offered our customer an integrated solution utilizing our MaK dual fuel engines to operate -- to fully operate this cruise ship using LNG.

Now a few examples of services, including technology solutions that support our dealers and customers at the initial point of sale and in the aftermarket. As of November, Cat mining trucks using our MineStar Command for hauling autonomous technology reached a milestone of moving 1 billion tons of material. We deployed our first 6 commercial autonomous trucks in 2013, and the fleet now has grown to more than 150. Six different mining companies are operating Command for hauling on sites in Australia and North and South America. We are working with customers who operate mixed fleets and have successfully deployed our autonomous technology to retrofit competitor haul trucks. We're leveraging our success with autonomy and are collaborating with the customer to pilot remote control operator stations for landfill operations, which could transform, even revolutionize, many aspects of the landfill industry.

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We've also introduced an equipment management app that allows our customers to monitor fleet data, request parts and service, and connect with their dealer via mobile devices. These are a few of the many examples of our global team helping our customers be more successful, working with Caterpillar than with any of our competitors.

Now for the outlook. Following a record year in 2018, we expect further growth in profit per share in 2019 to a range of $11.75 to $12.75. Our outlook assumes a modest sales increase based on the fundamentals of our diverse end markets as well as macroeconomic and geopolitical environment. We will continue to focus on operational excellence, including cost discipline, while investing in expanded offerings and services to drive long-term profitable growth.

In Construction Industries, we believe a healthy U.S. economy, continued pipeline construction and state and local funding for infrastructure development will be favorable in 2019. Latin America is expected to continue with the recovery, but demand will remain at relatively low levels. In the Europe, Africa and Middle East region, demand remains in steady, but political and economic uncertainties exist.

In Asia Pacific, we expect construction growth in countries outside of China. Within China, the industry is very dynamic, and there are a variety of forecasts. We will continue to monitor the situation, but as of now, we are forecasting the overall China market to be roughly flat in 2019, following 2 years of significant growth. China represents about 10% to 15% of our total construction industry sales and about 5% to 10% of total Caterpillar sales and revenues.

For Resource Industries, we believe commodity prices will remain supportive for investment, and mining companies will increase their CapEx budgets in 2019. Demand for heavy construction and quarry and aggregate equipment should also remain strong.

In Energy & Transportation, we expect the recent volatility in oil prices and takeaway constraints in the Permian to negatively impact demand for well servicing equipment in the first part of the year. Gas compression should remain strong. Demand for power generation equipment should continue positive momentum that started in 2018.

For industrial engines, the strong U.S. economy remains a positive for demand, but we expect some headwinds in EAME.

Finally, in transportation, we expect our rail business to improve in 2019.

In summary, 2018 was an excellent year for Caterpillar and one that demonstrates the power of our strategy. We achieved record profit per share, returned significant capital to shareholders and continued investment in expanded offerings and services to drive long-term profitable growth.

Once again, I'd like to thank our global team. Now that 2018 is in the record books, we are focused on delivering another great year. We continue to feel good about our business and have increased our profit outlook for 2019.

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

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Thank you, Jim, and good morning, everyone.

This year's record profits and strong cash flows are a clear reflection of the hard work and cost discipline that stems from the company's focus on delivering our strategy using the Operating & Execution Model.

Today I'm going to walk through at a high level both the quarter and full year 2019 results, and then I will discuss our outlook and highlight some of the key -- our key financial assumptions for 2019. So please turn to Slide 5 to look at the results for Q4.

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Sales and revenues were $14.3 billion, up 11% from last year, with continued growth across all regions and in all 3 primary segments. Increased amount for Resource Industries machines, higher sales in North America for construction equipment and higher demand for reciprocating engines to support well servicing and gas compression applications in North America were all significant drivers of this increase.

Fourth quarter profit per share of $1.78 and adjusted profit per share of $2.55 were both up from a year ago. You will recall that in 2017, profit per share was impacted by U.S. tax reform. The 18% increase to adjusted profit per share year-over-year was largely driven by the higher sales volume along with continued cost discipline.

If you move to Slide 6, I will walk through the 36% increase in operating profit. As you can see from the chart, the operating profit contribution of the higher sales volume was most of the $496 million operating profit increase in the quarter. Price realization was $179 million or about 1% higher than the fourth quarter of last year. Positive price realization was offset by higher manufacturing costs, largely due to higher material and freight costs as steel prices, tariffs and supply chain inefficiencies continued to impact our results.

Financial Products had a $73 million negative impact on operating profits for the quarter. I will walk through this in more detail when I cover that segment.

Lastly, restructuring costs were favorable by $144 million as restructuring actions continued to ramp down and are expected to return to normalized levels next year, which is why we will no longer exclude them from the adjusted profit per share calculation.

In short, whilst there are several puts and takes, price continues to largely offset cost headwinds. Period costs remain about flat, and higher sales volume remains the primary driver of the improvement in operating profit.

However, we did see declining operating margins in the quarter versus year-to-date run rates. Whilst the decline in the operating margin is typical in the fourth quarter, this year was greater than we expected and resulted from unplanned allowance increases and write-downs in Financial Products, higher manufacturing costs, including higher material and freight costs, as well as inventory changes. The negative impact from inventory occurred as inventory increased throughout the year and came slightly down in the fourth quarter, resulting in unfavorable operating leverage.

Now let's look at the performance of each segment in Q4, beginning with Construction Industries on Slide 7. Sales were $5.7 billion, an increase of $410 million or 8%. Construction sales increased in North America and EAME but were down slightly in Asia Pacific and Latin America. The sales increase in North America was $403 million, driving nearly all of the Construction Industries' sales growth for the quarter. We believe the North American economy remains robust, with much of the increase driven by oil and gas-related projects, including pipelines and other nonresidential construction activities.

In addition to higher end-user demand, dealer inventories also increased in North America. This increase follows several quarters of tight dealer inventory levels, and we now believe -- we believe it is now better aligned to meet current demand.

In EAME, sales in the region were up 9% as strong end user demand in Europe for infrastructure, road and nonresidential construction was partially offset by continued weakness in the Middle East.

Asia Pacific sales were down 4% or $64 million. The sales decline was driven by lower demand in China, partially offset by higher sales in other Asian countries.

While sales were down in China in the quarter, this was in part due to an unusual seasonal pattern in Q4 2017, with a return to a more normal pattern in 2018. I will remind you how strong the last 2 years have been, with industry sales for 10-ton and above excavators up about 40% in 2018 after doubling in 2017.

Lastly, several South -- Latin American countries continued to experience economic challenges. Sales were down $18 million or about 5% for the region.

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Turning to profit. CI segment profit was about flat versus a year ago, with an operating margin of 14.8%, down 100 basis points. The favorable impact of higher price realization and improved sales volume were about offset by higher material, labor and freight costs as well as adverse variable manufacturing costs.

The sequential decline in operating margins from the third quarter run rate was largely driven by high material costs and higher variable manufacturing costs.

Construction Industries backlog was up for the quarter and from a year ago as higher production levels supported in increasing order rates. Most CI equipment remains on managed distribution.

Now let's go to Slide 8 and look at Resource Industries. RI sales were $2.8 billion, up 21% from the fourth quarter 2017. Higher sales in the quarter were driven by robust demand from heavy construction and quarry and aggregate customers as well as higher shipments of machines to mining customers as mining companies increased capital expenditures. Demand for aftermarket parts to overhaul and maintain equipment remained robust in the quarter.

The decline in Resource Industries backlog was the result of several factors, including the lumpiness of mining orders and an increase in dealer inventory. Based on activities we are seeing in the market, we expect the slowdown in orders to be temporary and are expecting higher mining CapEx in 2019 to drive higher new equipment sales for the segment.

Segment profit of $400 million was up an impressive 90% versus the fourth quarter of last year. Segment operating margin improved 14.3%, up 520 basis from 2017. RI's improved performance and margin expansion was primarily due to higher sales, the operating leverage gained through several years of significant restructuring actions and the team's continued cost discipline. These gains were partially offset by higher material and freight costs in the quarter.

Now let's turn to Slide 9, where we will discuss Energy & Transportation. E&T sales in the fourth quarter was $6.3 billion, 11% higher than the same quarter last year. Sales into oil and gas applications were up by $222 million or 15% as strength in onshore activity in North America for reciprocating gas compression and well servicing applications continued. Sales for turbines and turbine-related services were about flat.

Power generation sales increased by $211 million or 20%, driven primarily by sales of reciprocating engines to support data center and other large power generation projects.

Industrial application sales were about flat, with higher sales in North America and Asia Pacific, about offset by lower sales in Latin America and EAME.

Transportation sales were up by 10%, driven primarily by our acquisition of 2 rail services businesses in January 2018.

Segment profit for Energy & Transportation was $1.08 billion, up $205 million or 23% from the fourth quarter of last year. The segment margin improved by 170 basis points to 17.2%. E&T's profit improvement was mostly due to the higher sales volume, partially offset by higher manufacturing costs, including freight. E&T's backlog was down from the third quarter but up when compared to the fourth quarter 2017. The growth in the backlog year-over-year is primarily attributed to higher turbine and reciprocating engine demand. About half the backlog decline in the quarter was related to large shipments for both reset engines and turbines. Another half resulted from the slowdown of orders to support oil and gas applications in light of recent oil price volatility.

Please move to Slide 10, and I'll walk through what caused the decline in Financial Products' profitability in the quarter. Financial Products fourth quarter profit was $29 million, down $204 million from Q4 2017. More than 85% of the unfavorable change was due to the impacts from equity securities in the Insurance Services investment portfolio and continued weakness with a small number of counts in the Cat Power Finance portfolio.

The unfavorable impact from Insurance Services was more than half of the change and was due to a $44 million mark-to-market loss in the fourth quarter of 2018 combined with the absence of a $68 million investment gain from the fourth quarter of 2017.

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Excluding these noncore impacts that are not indicative of the profit from ongoing business, Insurance Services would have been profitable with operating margin performance consistent with historical averages.

The unfavorable change from the Cat Power Finance portfolio was due to an increase in the provision for credit losses, primarily from a $72 million unfavorable impact due to an increase in the allowance rate and an increase in write-offs of $13 million.

Cat Financial's core asset portfolio continues to perform well. Excluding Cat Power Finance, Cat Financial's key credit quality metrics are in line with historical averages for past dues, write-offs and the allowance rate. A strategic assessment of Cat Power Finance was conducted in early 2018, which resulted in changes to the risk management of the portfolio. This includes working down the balance of old loans to reduce exposure, and that work has substantially progressed. We have also significantly reduced our risk exposure going forward and [have timed] our lending criteria to reduce risk.

Now let's quickly recap the year on Slide 11. As we look back, 2018 was a year of solid strategy execution, production increases across most of our product lines, disciplined cost control, investments in profitable growth initiatives and record profit per share.

For the year, sales and revenue of $54.7 billion were up 20% from 2017. Profit per share for the year -- full year was $10.26 versus $1.26 in 2017. Adjusted profit per share was $11.22, up 63% from 2017's adjusted profit per share of $6.88.

Please turn to Slide 12, and I'll walk you through the operating profit for the full year 2018. Operating profit was $8.3 billion, up 86% from $4.5 billion. The most significant driver to operating margins was higher sales volume, with sales and revenues up about $9.2 billion or 20%, representing sales growth across all 3 primary segments and in all geographic regions.

It was another good year for price realization, up $601 million or 1.2%. For the company, price realization more than offset manufacturing cost increases, which were primarily a result of higher material and freight costs.

Total SG&A and R&D expenses were higher by $249 million, largely driven by increased investments in initiatives to support profitable growth in services and expanded offerings.

Financial Products were unfavorable by $141 million, largely due to the absence of gains from the sale of securities, unfavorable impacts from the move to mark-to-market accounting for equity securities and weakness in the Cat Power Finance and Latin American portfolios.

Restructuring costs were favorable by $833 million, largely due to the absence of some expenses related to a European facility closure in 2017.

On Slide 13, you can see the significant improvements in adjusted operating margins across the enterprise in all 3 primary segments. These improvements were largely driven by higher sales volumes and continued cost discipline, which enable us to meet or exceed the ranges we committed to at our 2017 Investor Day.

Adjusted operating margin for the enterprise was 15.9%, 340 basis points higher in 2017, with significant improvement in each segment.

Now let's move on to Slide 14 to discuss cash flow. We ended the year with a strong balance sheet and $7.9 billion of enterprise cash. ME&T operating cash flow was $2.5 billion in the quarter and $6.3 billion for the full year. And during the year, the board raised the dividend per share by 10%.

In addition, given our financial position and strong cash flow, we bought back $1.8 billion of company stock in the fourth quarter, bringing our full year stock buyback to $3.8 billion.

Lastly, we were also able to make a $1 billion discretionary pension contribution in the third quarter.

In summary, we returned $5.8 billion of capital to shareholders and ended the year with an enterprise cash balance down just slightly from a year ago. It is this strong cash generation, which is a result of the discipline created by the O&E Model, that is one of the most impressive outcomes in

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2018. I will update you more on our refreshed capital allocation framework during the 2019 Investor Day we expect to hold in Clayton, North Carolina on May the 2nd.

Now let's move to Slide 15, and I will walk through our assumptions for the 2019 outlook. Our profit per share outlook range for 2019 is $11.75 to $12.75. This range reflects profit per share up between 5% and 14% over the 2018 adjusted profit per share.

Across the outlook range, we would expect sales to increase versus 2018. Jim has already taken you through each segment's end market assumptions, which are summarized on Slide 4, so I will highlight just a few key financial assumptions.

Short-term incentive compensation will be reset to about $800 million. We expect favorable price realization to be mostly offset by cost headwinds. Restructuring costs are included in the profit per share outlook as they are expected to return to normalized levels in 2019. Financial Products profit should revert to historic norms.

The outlook assumes a lower share count, driven largely by 2018 stock buybacks as well as anticipated additional repurchases for 2019. We expect to repurchase around $750 million of company stock in the first quarter of 2019, with the potential for additional share repurchases based on quarterly cash generation and alignment with our capital allocation priorities.

We expect a higher tax rate of 26%, up 2% from 2018. The increase in the tax rate is largely driven by the application of U.S. tax reform provisions to the earnings of certain non-U.S. subsidiaries, which don't have a calendar fiscal year-end. These provisions did not apply to these subsidiaries in 2018.

And for your cash flow modeling, we expect ME&T capital expenditures, along with Cat inventory, to remain about flat.

Finally, let's turn to Slide 16 and recap today's report. 2018 was a great year with record profit per share. Given our solid balance sheet and strong cash flow, we returned $5.8 billion to shareholders while increasing our investments to drive profitable growth in services and expanded offerings.

Looking ahead to 2019, we are going to continue the execution of our profitable growth strategy, and we are driving to further growth in profit per share.

With that, I will hand it back to Amy to begin the Q&A portion of the call.

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

Thanks, Andrew. Now we will turn it back to Kate to begin the Q&A portion of the call. (Operator Instructions)

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today is coming from Stephen Volkmann.

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

It's Jefferies. I'm hoping we can drill down a little bit more on Construction Industries. That seems to be sort of the biggest point of discussion this morning. Obviously, the margin there was somewhat lower than, I think, most of us were looking for and pretty minimal incremental margin. So it seems like price and cost were sort of a wash, if I'm understanding your remarks correctly. So I guess I'm trying to figure out what else was going

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on there that was sort of the big headwind for the margin. And then I'll just throw the follow-up, obviously, right in there, which is how do we think about that in 2019 from an incremental margin perspective?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Thanks, Steve. Obviously, the margins were a little bit lower than we anticipated as well when we gave -- when we talked in the third quarter. There were a couple of factors underpinning that. One, we actually did expect material price actually to exceed our manufacturing cost increases in CI. There was a normal seasonal decline in CI margins, but that was one of the things we were expecting to partially offset that. That didn't materialize, partly because of material cost increases and also because of other manufacturing variances that did occur in the quarter. These included things like the absence of some incentives in Brazil, some variable labor inefficiencies, which all accumulated to that impact. As we look forward to 2019, I'll point out a couple of things about our CI margins, which give us confidence as we move forward. First of all, we did -- we put through the price increase on the 1st of January. Obviously, that will impact positively our margins and offset some of that weakness that we saw in the fourth quarter. And secondly, we do see the reset of incentive compensation, which will have a positive impact as we move through the year.

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

Okay. So incremental margins next year in a sort of more normal 25% range? Or is that a bridge too far?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

We don't give margin guidance by segment, but we would expect next year to see that Construction Industries margins will be strong. And given the things like the price increase and the incentive compensation, obviously, those are tailwinds which should help us improve them.

Operator

Our next question today is coming from Timothy Thein.

Timothy Thein - *Citigroup Inc, Research Division - Director and U.S. Machinery Analyst*

Citigroup. Andrew, maybe just to follow up on the last thread there. Just on pricing for the enterprise as a whole. I think you talked last quarter about a 1% to 4% announced increase to dealers. And just -- given that some time has lapsed and then maybe some of the end market conditions have changed, just how are you thinking about an overall yield relative to that 1% to 4% increase for 2019?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes. I mean, there were a couple of other factors also, which might be able to help you, Tim. Just to remind you, obviously, the midyear price increase we had put that through, and some of that will also come through into next year as well. Overall, though, we do expect -- we've taken into account, as Jim said, the macroeconomic environment and geopolitical factors when we set our guidance range. We do anticipate, obviously, that you never get 100% (inaudible), but we do expect good price realization next year. And that will offset any manufacturing cost variances we expect.

Timothy Thein - *Citigroup Inc, Research Division - Director and U.S. Machinery Analyst*

Okay. I mean, just to take a midpoint, if I threw 2% out, that's $1 billion. I mean, do you think at this point, based on what you've seen in commodity markets and just some of your transportation and logistics experience in recent months, would you expect that level of variable cost inflation? Or it's just too many moving parts at this point to pin that down?

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Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

I think there are a number of moving parts, but our expectation, as I said, was that price would offset material cost increases.

Operator

Our next question today is coming from Chad Dillard.

Chad Dillard - *Deutsche Bank AG, Research Division - Research Associate*

It's Deutsche Bank. So I just want to go back to the tariff discussion. Can you quantify how much impact was in the fourth quarter? And how are you thinking about how that's embedded in the 2019 guide? And what should we think about in terms of cadence as we go through the year?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes. So Chad, it's Andrew again. So if you remember, the third quarter, we talked about the range. We're expecting to be at the bottom end of the $100 million range. We ended up just over $100 million. Our expectation is that at this stage, we don't see a rate change in the tariffs. That's our expectation. And obviously, then, because you would just extrapolate that out based on 12 months versus 5 months for 2018.

Chad Dillard - *Deutsche Bank AG, Research Division - Research Associate*

Great. That's helpful. And then could you provide a little bit more color on the dealer inventory build? I think it was up about $2.3 billion for 2018. And if you can comment on whether you expect that to unwind in 2019. And can you take that entire amount out by the full year-end?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes. Our assumption is, obviously, as we said consistently, our dealer inventory has been constrained, and obviously, we've been on managed distribution in CI for most of the year. We could have seen about -- as you say, the $2.3 billion increase. Keep in mind that dealers own and control their own inventory, so that is based on their expectations. We believe that the growth is directly aligned with current market demand and more normal ranges versus historic trends. We expect dealer inventory to be flat. We don't expect any -- our assumptions for guidance assume that there will be no further increase in dealer inventory from our shipments in 2019.

Operator

Our next question today is coming from David Raso.

David Michael Raso - *Evercore ISI Institutional Equities, Research Division - Senior MD & Head of Industrial Research Team*

Evercore ISI. My question relates to the sales guidance. You're staying up modestly. And I'm just trying to get some sense of maybe cadence or where your confidence is from that sales guidance. The backlog's currently up only 4.4%. The implied orders are up like 2%. And if you lose the $2.3 billion of inventory benefit to '18, right, you just said inventory is flat, that's over a 4% drag on your sales growth right there, right, for not getting the $2.3 billion that you got in '18. So can you help us with your comfort level where you're currently are in your order rates, your backlog, that lack of inventory growth in '19 that sales should be up modestly however you want to quantify that.

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D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Dave, this is Jim. So obviously, our sales guide is dependent on a whole variety of factors, but we are in constant contact with our dealers. We look at industry trends. We have a bottoms up process. And based on everything that we see, we believe that, again, sales will be up modestly in 2019. If we just think about our different market segments, and you can go around the world, we talked about China a lot, and we expect China to be flat after. In Construction Industries, it's a very good increase. We were up 40% in 2018. The industry demand was up 40% in 2018 after doubling in 2017. Oil and gas, gas compression remains strong, both through our recip and solar businesses. We do -- we are seeing some weakness in well servicing in recip, but as I mentioned earlier, we expect that to resolve itself in the next 6 months of the year after the takeaway issues in the Permian get resolved. We've got positive momentum in power generation. The U.S. economy continues to be strong, and that has an impact on both industrial and on our construction business. Transportation, we expect our rail business to be better in 2019 than in 2018. As you know, there's a lot of pipeline construction going on in North America. That's a positive for us. So again, we just go through industry by industry, country by country and develop a forecast. And we believe it will be up in 2019 modestly.

David Michael Raso - *Evercore ISI Institutional Equities, Research Division - Senior MD & Head of Industrial Research Team*

But for the cadence question, I think what people are trying to figure out, are we starting the year with any growth rate cushion to be able to absorb second half of '19, if it is flat to down? We're just trying to get a sense of starting the year versus what's sort of baked in for the back half. And we all can speculate, but I was hoping you'll have a little more cushion to start the year from the backlog growth and what you just reported. I think we're just trying to get a sense of the cadence and what kind of (inaudible) around orders are needed later in the year.

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

David, just to point out a couple of things. I mean, the increase in the backlog is -- the backlog at the end of the year was $16.5 billion versus $15.8 billion last year. That is despite putting more inventory into the channel, because don't forget, these are dealer backlog orders effectively, so dealers have built inventory. And they still expect -- even though they built it, they are still asking us for $1 billion more in orders than we were at this time last year. So that does give us that confidence. I think, as Jim said, yes, we also will look around end markets. We take all of these things into account. And that does give us the confidence to be able to say we expect sales to be up modestly next year.

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

And we do -- certainly, as you know, we have lumpiness in both our oil and gas business and in our rail business and in our mining business, frankly, so there are variations quarter-to-quarter as we ship and financially recognize large orders.

Operator

Our next question today is coming from Ross Gilardi.

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

Ross Gilardi from Bank of America. Could you help us a little bit on the quarterly earnings cadence for 2019 that you're expecting? I mean, you did $2.55 in the fourth quarter. You did $2.82 in the first quarter of '18. I mean, are earnings up in the first quarter of '19? And if they are, can you help bridge with what you did in Q4 with what you would do in Q1?

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Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes. Ross, it's Andrew. Again, the $2.55 was impacted by the write-downs in Cat Power Finance, which we don't expect; and the mark-to-market losses in Cat Financial, which we don't expect to recur. if you added that back, that would be about $2.70. We don't give quarterly guidance on earnings. But that gives you -- then we've got on top of our price increases, hence the start of the selling season, which will impact Q1.

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

I'll also add in there is that you recall that we had a very strong Q1 in 2018, so from a comp perspective, that will be there as well.

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

Okay. Got it. And then can you help us all on either more on the mining OE side of the business and what you're expecting from a mining truck perspective? And assuming in your 2019 outlook, obviously, that number is still way, way below what, I think, you guys would consider normalized demand. But are we at a pause here? Or does that number continue to grow nicely this year?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

So certainly, machine utilization by our mining customers continue to increase. We anticipate that their CapEx budgets will increase in 2019. The quotation activity remains robust, and we expect our mining business to be higher in 2019 than '18. So that is a positive for us.

Operator

Our next question today is coming from Jamie Cook.

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

Just given the macro concerns out there, one, can you comment on specifically what -- are you taking any actions, whether it's production or additional cost actions? Given the concerns about the macro environment, I'm just trying to understand whether you guys are being proactive here or not. So first, if you could comment on that. And then my second question is, I know you said dealer inventories are expected to be sort of flat year-on-year. Are you doing anything as well with the dealers to make sure we're not over-ordering or to, again, prepare for a market that could potentially be weaker?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Yes, Jamie, certainly, we've kept a very close control of costs, and saw our period costs in the fourth quarter of '18 were actually less than they were in the fourth quarter of 2017. I do remind you, though, that we are guiding to a sales -- a modest sales increase in 2019, so we are not guiding to a sales increase. Having said that, we will continue to closely monitor costs, and we'll always be ready for whatever the market sends us. One of the things that we believe, we're in much better shape. At some point, there will be a market downturn. We're not calling that in '19, but whenever that does occur, we're certainly in a much better position to generate cash than we were in the last downturn. So again, we'll be very cost-disciplined here moving forward.

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

And then, sorry, just another one more follow-up. Just understanding restructuring is now part of GAAP, can you just help us understand what that number is? And then, also just to finance sub-contribution '19 versus '18, just given some of the one-offs that we had in '18.

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Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes. So we would -- obviously, we are going through a period where restructuring becomes much more normal this year. The charge was around $400 million. You should expect it to be substantially lower than that. Otherwise, we would still be adjusting it out of adjusted profit. I'm not going give you a number because, obviously, it depends on what activities we do or will be reported in the Q, and it depends on what actions we take in the business during the year, but it will be part of our normal operating earnings, and that's taken into account in our guidance. The other part of the question was Cat Financial. So this year, I think write-offs relating to the Cat Power Finance portfolio in Latin America have amounted to somewhere around about $150 million in total. That will be the area which we wouldn't expect to recur.

Operator

Our next question today is coming from Joe O'Dea.

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

It's Vertical Research. I wanted to understand some of the cost headwinds in the quarter a little bit better, so the degree to which you can expand on some of what happened on the materials and freight side that surprised you in the quarter. And then to understand how those work moving forward. Is that something that is corrected as of today and back to the kind of cost structure you expected to end 2018 with? Or are those things that persist as of today, and how long will that be the case?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes, yes. So I mean, obviously, things like manufacturing variances, which were attributable to absorption rates and so forth, obviously, they end at the end of that period. And they were a portion of that negative variance in the quarter. And obviously, they will be taken into account as we move into 2019 based on production, and we'll obviously continue to work those through. With regards to the material costs and freight costs, I mean, we did see some material cost increases in the fourth quarter, which we were, as we said, we weren't expecting. Part of that is due to the fact that obviously, we are in an environment of constrained supply still, and those did feed through into costs. Those will be built into our numbers for 2019 and into our guidance range, so effectively, we'll be part of that manufacturing cost being offset by price realization as we move forward. So those are the 2 big things regarding that.

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

And as of October, you were talking, I think, about price offsetting cost. And so is that meaning that a little bit more assertive on the price front to go after some of these costs? I'm just trying to understand that dynamic of price/cost neutrality. And I think that was expected 3 months ago. You've got higher costs today, but do you still expect to offset the end with price?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes, I think actually what we really expected was a little bit stronger performance in the fourth quarter, then we actually expected price to more than offset cost. It didn't happen. And so that was the challenge that actually happened there. As we look into 2019, as we said, we expect price to offset manufacturing cost increases.

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

Got it. And then just on the revenue expectations for the year and the modest growth. As you walk through some of the key end markets and the puts and takes there, it's unclear, I guess, the degree to which you're looking at a scenario where volumes are up. So I think most of the commentary

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leans a little bit more constructive. There are some clear pockets of headwinds. But overall, it leans a little bit more constructive. And so is that to suggest that the base case expectation here is that we've got a little bit of volume growth in 2019 on top of the pricing expectations?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Yes, yes. There is a modest amount of volume increase on top of the price. That's correct.

Operator

Our next question today is coming from Ann Duignan.

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

It's JPMorgan. I'd like to go back to the financial services business, and I was hoping you could give us some color on the unfavorable impact from returned or repossessed equipment in Europe and Latin America specifically. Should we now be concerned that residual value are set too high and that this is just the beginning of negative residual value risk for the finco as we go forward both in Europe and LATAM?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Actually, most of that -- and this is Andrew. Again, most of that related actually to the Cat Power Financial portfolio rather than to construction equipment. And that was specific items related to the portfolio I was talking about, where we have had some troubled loans, which we are making substantial progress. I'm actually working through those. We've taken write-offs in the second quarter and the fourth quarter. And the residual risk is being managed and also the portfolio is being managed going forward. This is now the reflection of construction industry residuals.

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

And those write-offs were associated with primarily the Marine portfolio for loans that were made quite some time ago.

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

Was there a surprise or had you that been anticipating those as you went through the year?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

I mean, as it always happens, and until you actually take a piece of equipment back, you don't actually know what the real value is. So you have an estimate, and some of those estimates were proven to be wrong.

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

Okay. And just real quick on my follow-up on the revenue guidance. Up modest, but pricing should be 2.5%, which, again, as others have pointed out, suggests sort of flat volume. Can you talk about what you're seeing broadly in Europe? I know Turkey was the source weakness, but are you seeing any broader weakness in Europe across the different regions?

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D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Yes. Ann, I don't believe we gave a 2.5% price guidance for '19, so I think that was...

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

Well, 1% to 4% average is 2.5%, right?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

That's fine. That's fine. So we talked about -- just going around the world, you asked about Europe, but again, Turkey has been an area of real concern. Just going around the world, Brazil has been tough. Argentina has been tough. South Africa has been tough. But in terms of pointing to a particular country in Europe that has created concern for us, no. Obviously, we're all waiting to see what happens with Brexit and how that will all shake out. But no, other than Turkey, that's the biggest concern.

Operator

Our next question today is coming from Mig Dobre.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Baird. I want to go back to maybe understanding what's going on, on the cost side a little bit better. If you're saying that volumes here are going to grow modestly next year, how should we think about the manufacturing costs that are currently embedded in your outlook in terms of the headwinds on that? And can you also maybe comment on how you're thinking about R&D, how you're thinking about SG&A? And I know somebody already asked the restructuring question, but what would you consider to be a normal restructuring level in terms of expense for the business going forward?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

So starting on, as I think we've tried to say, we expect price and manufacturing to offset each other. So that's our expectation. And obviously, the timing of how those price increases come through and how that feeds through into the business throughout the year will be something that we'll be reporting on. But overall, we expect the 2 to brush out through the year. We will continue to make targeted investments in both R&D and in SG&A to expand our service offering and also our other offerings as well. So those will -- but we will be disciplined about those increases, and they will reflect around things, which we expect to get a return on as we move forward. With regards to restructuring, the problem is, if I give you a number today in restructuring, I guarantee you that something will happen during the year which will change it because as we know, restructuring charges can only be taken once actually any announcements have been made of some restructuring event. But where we expect them to be is substantially below the $400 million this year, and therefore, that's why we were prepared to absorb it within our normal earnings -- our profit per share for the year.

Mircea Dobre - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

I see. Well, instead of asking a question, maybe I'll just make a comment. I don't know about the other participants on the call, but as far as I'm concerned, I can tell you, I'm having a really hard time equating exactly all that's baked into guidance, vis-à-vis where we're all kind of learning in terms of how commodity prices are progressing. Steel prices are progressing. And really kind of you're putting your overall outlook together for 2019. So I'm wondering if there is a way at the Analyst Day or maybe next call that we can get a little more granularity at segment level in terms of what you're thinking for revenue and what you're thinking for margins as well, I think that would be really helpful.

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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. Jim, I'm wondering if you could expand on your earlier comments in terms of pretty good quotation activity in Resource Industries. Can you just give us a flavor for in terms of commodities that are driving increase today? And when do you expect that to translate to seeing order and backlog growth in Resource Industries again? Are you hearing from your customers that we're going to need greater clarity on U.S.-China trade relations for them to place the orders. Any additional context along those points would be helpful, please.

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

What we've seen is the idle truck fleet continued to decline throughout 2018. As I mentioned earlier, the utilization of our machines continues to increase. We believe that most of the units have now been brought back online and of course we were in a situation for a number of years, where there was a very large fleet parked, and that's no longer the case. Most analysts are forecasting an average of 5% to 6% growth in miners' capital spending in 2019 compared to 2018. Certainly, mining companies are working to get the most out of their assets, and they're being cautious as to when they place orders. But activity -- quotation activity, as I mentioned, is quite robust. We are selling more product, and we expect to have a higher level of business in '19. Certainly, there is some softness in the areas like Indonesian coal. But again, that's being offset by demand in other regions.

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

And just to put a finer point on that, are you at a point where you think we're now that quotation activity, after hitting a pause in translating to orders in the back half of '18 we're see greater pace of new equipment orders in the first half on '19 based on the timing of the tenders that you're looking at?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Again, mining in particular was quite lumpy. And you can get orders -- a single order for a very large number of pieces of equipment that has an impact on the backlog. So again, I hesitate to try to quantify it in terms of a quarterly cadence. But again, year-on-year, 2019, we expect higher sales '19 than '18.

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

Okay. And Jim, the other area that you've mentioned that's positive in '19 is locomotives. Can you just frame for us based on the production plan and orders in hand how much of a production ramp are we thinking about '19 versus '18 compared to the healthy run rate this business was at prior to Tier 4?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Yes. We're not going to quantify it, but certainly, again, you know that rail traffic has, in fact, increased in 2018. I think we mentioned in a previous call that we had good growth in rail services with higher traffic. And also, we've made a couple of acquisitions, as we mentioned earlier this morning. So we expect continued growth in our service and parts business. We're seeing rebuilds. Again, we expect our business to increase in '19. I would hesitate to try to compare it to where we were in previous period, but it is getting better.

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Operator

Our next question today is coming from Seth Weber.

Seth Robert Weber - *RBC Capital Markets, LLC, Research Division - Analyst*

It's RBC. I wanted to just go back to China for a second. You did talk about expectations for the Chinese construction market, the industry being kind of flattish. But can you just talk about whether you're seeing anything unusual there from a competitive pricing perspective and whether that is something that kind of contributed to the lower-than-expected construction margins in the quarter?

D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

As I think Andrew mentioned, that really did not impact construction margins in the quarter. That's not one of the things that we cited. Certainly, we have competitors all over the world. We have competitors in China, but we are very well positioned in China. We have invested significantly. We have more than 20 manufacturing facilities. We have roughly 13,000 employees. We have local leadership teams. We've vertically integrated our supply chain in China. So we are very well positioned to compete and win in China. We're introducing new product, so we feel good about our competitive situation in China. And again, there's a variety of forecasts that are out there. But after 2 years of robust growth in CI for us in China, we expect it to be about flat next year.

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes. Can I just add a little bit of color on the Cat sales in China, actually relating to this because we did see very strong sales in the fourth quarter 2017, which then fed through into the first half of this year, where obviously China, as you wouldn't expect, in the normal selling season previous summer actually, were very, very strong. Third quarter and fourth quarter have diminished from those first 2 -- first half of the year, as you would expect a return to much more normal pattern. So actually, it wasn't actually an overall view of China for the year that impacted the quarter. It actually was just a weakness relating to a very strong comparator in 2017.

Seth Robert Weber - *RBC Capital Markets, LLC, Research Division - Analyst*

That's helpful. And then, Andrew, maybe just a follow-up on the -- I think you said share buyback, you're targeting about $750 million in the first quarter, which would be down from $1.8 billion here in the fourth quarter, and you're sitting on $8 billion of cash. Is there a reason why you're not being more aggressive, I guess, versus the $750 million outlook for the first quarter?

Andrew R. J. Bonfield - *Caterpillar Inc. - CFO*

Yes. A couple of things. One to think about, one, which is, obviously, we've always said we will be opportunistic and it will depend on market conditions and so forth as to when we're going to the market and our other uses of cash. The reality is actually in the first quarter, we have a lower cash flow, partially because of incentive compensation payments. So we do take that into account when we're considering the amount for the year. As you will know now, this will be the fourth quarter in a row which we will have done $750 million. Our aim is to be in the market on a more consistent basis rather than be in and out. But we will take opportunistic -- opportunities to actually go back and buy more, but that would depend on our free cash flow and other investment priorities.

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

And I think that's going to -- thanks. I think that's going to need to be our last question. Jim, do you have any final comments?

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D. James Umpleby - *Caterpillar Inc. - Chairman of the Board & CEO*

Well, thank you, Amy. Again, 2018 was a terrific year for Cat. We achieved a record profit per share, strong operating cash flow, returned significant capital to shareholders and continued to invest for long-term growth. Again, as I mentioned, we believe our enterprise strategy is working. Even though 2018 was a record year, we've increased our profit per share outlook for 2019 and look forward to continuing to serve our customers. Thanks for joining today's call. We look forward to speaking with you next quarter.

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

Thanks, Jim. And Kate, I think that concludes our call.

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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