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CAT - Q1 2019 Caterpillar Inc Earnings Call

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OVERVIEW:

Co. reported 1Q19 sales and revenues of $13.5b and profit per share of $3.25. Expects 2019 profit per share to be $12.06-13.06.

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Caterpillar 1Q 2018 Analyst Conference Call. (Operator Instructions)

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

Jennifer Driscoll

Thanks, Kate. Good morning, everyone, and welcome to the first quarter earnings call for Caterpillar. I'm Jennifer Driscoll from Investor Relations of Caterpillar. I'm pleased to have with me here in the room Jim Umpleby, Chairman of the Board and CEO; Andrew Bonfield, CFO; and Kyle Epley, Vice President of Global Finance Services Division.

We've provided slides to accompany the presentation. You can find the slides, along with our earnings release and a glossary, on the Investor Relations section of the caterpillar.com website under Quarterly Financial Results.

Today, we plan to make forward-looking statements, which are subject to risks and uncertainties as well as assumptions that could cause our actual results to be different than the information discussed. For details on factors that individually or in aggregate could cause actual results to vary materially from our projections, please refer to our most recent SEC filing and forward-looking statements included in today's earnings release.

As indicated earlier, we are not reporting adjusted profit per share in the first quarter as restructuring costs are expected to be lower this year. It's our intention to report adjusted profit per share in the fourth quarter of 2019 to exclude mark-to-market gain or loss for the remeasurement of pension and any other post-employment benefit plan and any other discrete items.

Please keep in mind that today's call is copyrighted by the company. Any use of any portion of the call without our written approval is strictly prohibited.

Before I turn the call over to Jim, let me remind you that we'll be webcasting an Investor Day presentation next week, May 2, from 1 p.m. to 3:30 p.m. Eastern Time. We intend to defer until then any questions about capital allocation or long-term target. To access the webcast or the transcript, please visit caterpillar.com, click on Investors and then Events and Presentation.

And with that, I will now turn the call over to Jim.

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

Thank you, Jennifer. We're happy to have you with us at Caterpillar, and good morning to everyone on the call. As Jennifer mentioned, we hope to see many of you at our Investor Day next week in Clayton, North Carolina, where we will provide an update on our enterprise strategy, financial targets and capital deployment plans.

Turning to the first quarter highlights on Slide 3. I'd like to thank our global team for delivering another strong first quarter. Profit per share was a first quarter record of $3.25, rising 19%. This result included the contribution of $0.31 per share of a discrete tax benefit. Consolidated sales and revenues grew 5%. Resource Industries led the way driven by higher demand for equipment and services and favorable price realization. Growth from Construction Industries was fueled by higher end-user demand for construction equipment and price realization.

Operating profit rose 5%. We've benefited from favorable price realization, volume gains and shorter -- and lower short-term incentive compensation expenses, which more than offset higher manufacturing costs as well as investments in SG&A and R&D for future growth.

Strong operating cash flow of $860 million allowed us to repurchase $750 million in company stock in addition to paying the dividend as part of our continued commitment to shareholder returns. These strong first quarter results are a reflection of stronger demand and the benefit of executing our strategy for profitable growth by investing in services, expanding our offerings and improving operational excellence.

Growing services is a critical element of our strategy. Services allows us to provide additional customer value in a variety of ways, including reducing downtime and maximizing machine availability. Digital is an enabler of this strategy with connectivity at the foundation. Last year, we added about 250,000 new connected assets, bringing our total to about 850,000 assets connected worldwide. We look forward to sharing more in how we think about services during our upcoming Investor Day.

Expanding our offerings enables us to grow our business and reflects our commitment to create greater customer value by providing solutions to meet diverse customer needs in different markets around the world. Some of our progress was on display earlier this month at bauma, the construction industry's largest trade show held in Munich, Germany every 3 years. I was proud to walk the floor of the Caterpillar exhibit and engaged with our dedicated employees and valued customers. Among the highlights were the next-generation hydraulic excavators with new semi-autonomous features, which give operators more information and insight than ever before.

We also displayed the world's first high drive Electric Drive dozer, the D6 XE. It offers up to 35% better fuel efficiency than its predecessor. We also showcased new hybrid technologies on 3 Perkins engines as well as 5 new engines from its range of EU Stage V engines designed to meet new emission standards, increased productivity and lower life cycle costs. To complement these expanded offerings on the stand, customers also learned about new services, including aftermarket products, customer service agreements and our new Cat app, which allows customers to easily track critical machine operating data from the field.

We continue to focus on enhancing operational excellence, including safety. Our safety goal is always 0 incidents. We want all of our employees to return home safely everyday. One of the metrics we track is the number of recordable injuries per 200,000 hours worked. So far this year, we are tracking 9% better than 2018, and we will not lose focus on this priority to prevent injuries and keep our people safe.

Executing our strategy is allowing us to improve operating profit and free cash flow, which we define as operating cash flow less capital expenditures. During our Investor Day on May 2, we will discuss our expectations for operating margins and free cash flow.

Now turning to the 2019 outlook on Slide 4. We continue to have confidence in the fundamentals of our diverse end markets, and the expectations for 2019 performance are unchanged. However, we adjusted our range of $11.75 to $12.75 by the amount of the discrete tax benefit we realized in the first quarter. That brings our 2019 outlook to $12.06 to $13.06 in profit per share. We continue to expect modest sales growth and continue cost discipline for full year 2019.

Now let's walk through what we're seeing in the external environment. In Construction Industries, we continue to believe that a healthy U.S. economy, along with state and local funding for infrastructure development, will be a positive for us, partly offset by weakness in residential construction. We continue to expect demand to remain low in Latin America this year.

In the Europe, Africa and Middle East region, demand remains steady despite the political and economic uncertainties. In Asia Pacific, infrastructure activity remains strong. Within China, we continue to expect our sales to be flat with last year.

For Resource Industries, we continue to expect most commodity prices to remain at investable levels. We are seeing mining companies becoming increasingly willing to invest in CapEx. While that is encouraging, miners remain disciplined in their CapEx deployment. We expect demand for heavy construction and quarrying aggregate equipment to remain strong.

In Energy & Transportation, oil prices are recovering, but the volatility in oil prices and takeaway constraints in the Permian are impacting demand for well servicing equipment in the first half of the year. Later in the year, U.S. pipeline constraints are expected to ease, and we anticipate an increase in demand. Gas compression should remain healthy.

Demand for power generation equipment continues to be a positive. Finally, in transportation, we expect improvements in our rail business, including services.

With that, I will turn the call over to Andrew for a closer look at our financials.

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

Thank you, Jim, and good morning, everyone. We have reported record first quarter results today as we continue to execute our strategy and use our Operating & Execution Model to drive profitable growth. I will walk through the results, starting on Slide 5 before turning to our updated outlook for the full year.

Sales and revenues for the quarter totaled $13.5 billion, up 5% from last year driven by both volume gains and price realization, with Resource Industries having a strong first quarter in particular. First quarter profit per share of $3.25 included a $0.31 per share discrete tax benefit increased 19% from the previous -- prior year's first quarter. This was driven by higher sales, partly offset by higher manufacturing costs and higher spending on SG&A and R&D due to increased investments versus the first quarter of last year.

Now let's turn to top line on Slide 6. Sales and revenue growth in the quarter was driven by volume gains and price realization partially offset by currency. Volume gains primarily reflected strong demand in both Resource Industries and Construction Industries. Resource Industries' strong demand was due to growth in original equipment and services. For Construction Industries, sales in North America rose double digits this quarter. Energy & Transportation sales were flat versus the prior year. Currency pressures reflected dollar strengthening principally -- primarily against the euro, the Australian dollar and the Chinese yuan.

If you move to Slide 7, I will walk through the changes in operating profit. As shown on the chart, price realization and sales volume drove the operating profit increase, contributing $292 million and $265 million, respectively. Financial Products also added $26 million to operating profits for the quarter. Manufacturing costs increased by $375 million due to higher material costs, freight and variable labor. These higher costs, while unfavorable, were improved from the fourth quarter levels. Material costs included a direct tariff expense in the first quarter of about $70 million, in line with what we expected. Remember tariffs only started in July of last year, so these will have an impact in Q1 and Q2 until we are past their original implementation date. Also, while steel prices have moderated, after procurement contracts have a lagged effect so these are still rising for us. Labor costs are impacted by production bottlenecks as our suppliers continue to ramp up volumes.

SG&A and R&D spending increased despite lower levels of short-term incentive compensation expense primarily due to investments in growth areas, including services and expanded offerings as well as some corporate-level items. The comparators are also set against a low level of spend in Q1 last year.

Currency was unfavorable by about $20 million. Restructuring costs were not material for the quarter.

Now let's look at the performance of each segment in Q1, beginning with Construction Industries on Slide 8. Sales were $5.9 billion, an increase of $196 million or 3%. Construction sales increased in North America by $345 million due to higher demand for new equipment, particularly for road construction activities. Sales declined in Asia Pacific, EAME and Latin America. Asia Pacific sales were down 4% or $66 million. Currency was the driver as volume in China was about flat, which is what we expected.

In EAME, sales declined by 6% or $61 million due to a small increase in dealer inventories and a weaker euro, partly offset by favorable price realization. Lastly, macroeconomic factors in Latin America contributed to a decline in sales of 7% or $25 million off of a very low base.

Turning to profit. Construction Industries segment profit declined by 3%. The segment profit margin of 18.5% was a decrease of 120 basis points from the first quarter of 2018. The favorable impact of higher price realization was more than offset by higher manufacturing costs. This increase in costs was led by higher material labor and freight costs. While these costs increase, the magnitude was less we saw in the fourth quarter and were driven by the same factors I mentioned a moment ago.

The backlog for Construction Industries rose as higher production levels supported an increase in order rates. We continue to have most CI products from managed distribution.

Now let's go to Slide 9 and look at Resource Industries. Resource Industries sales were $2.7 billion, up 18% from the first quarter of 2018. The $418 million increase in sales of the quarter reflected higher equipment demand, favorable price realization and increased services. We saw solid demand from mining and heavy construction equipment, including quarry and aggregate. Asia Pacific was particularly strong with sales up $275 million or about 52%. The backlog declined in Resource Industries as our factories continued to ramp up production, which resulted in an increase in dealer inventories. First quarter orders were higher than in Q4 2018. We continue to expect higher mining CapEx in 2019, leading us to expect higher sales in new equipment this year.

Segment profit of $576 million rose 52% versus first quarter of last year. Segment profit margin improved to about 21%, up 470 basis points from 2018. Resource Industries' improved performance and margin expansion were primarily due to higher sales volumes. Favorable price realization was partially offset by higher manufacturing costs, including increased material and freight costs as well as slightly higher warranty expense.

Turning to Slide 10 where we will review Energy & Transportation results. Energy & Transportation sales in the first quarter were $5.2 billion, comparable with the same quarter last year. Favorable price realization and higher sales volumes were more than offset by unfavorable currency.

Sales into oil and gas applications decreased by $84 million or 7% primarily due to the timing of turbine project deliveries in North America. Sales in power generation rose by $67 million or 7% due to higher demand for large diesel reciprocating engine applications.

Industrial sales were similar to last year's first quarter, with gains in North America more than offset by an increase in EAME. Transportation sales declined [3%]. We recently marked the 1-year anniversary of our acquisition of 2 rail subs businesses in January 2018. Segment profit for Energy & Transportation was $838 million, down $36 million or 4%. The segment profit margin contracted by 60 basis points to about 16%. Energy & Transportation margins reflected higher manufacturing costs driven by freight costs and warranty expense. The increase in backlog in E&T was driven by rail-related services and turbines, which were partially offset by reciprocating engines due to softness in oil and gas that Jim referred to earlier.

Now let's move to Slide 11, and I will walk through our assumptions for 2019 outlook. Our profit per share outlook range for 2019 is now $12.06 to $13.06. The change from our prior range of $11.75 to $12.75 reflects the discrete tax item mentioned earlier. Our assumptions for the business are largely unchanged. We continue to have confidence in the fundamentals of our diverse end markets, and we expect sales to increase modestly this year. We also anticipate the price realization will offset higher manufacturing costs. Short-term incentive compensation is expected to be a tailwind of about $500 million. We project restructuring costs of about $100 million to $200 million for the full year. The estimated annual tax rate is unchanged at 26%, except for the discrete tax item we called out. We see capital expenditures in the range of $1.3 billion to $1.5 billion. Our outlook assumes that the macroeconomic and geopolitical environment is largely unchanged.

Looking ahead to the second quarter. We expect to continue the execution of our strategy, including additional investments for long-term profitable growth where appropriate. We anticipate stronger results in the back half of the year, including better variable margins and stronger demand from oil and gas customers in North America. Depending on markets and based on an internal assessment of enterprise intrinsic value, we expect to be active in the market and repurchase another $750 million of company stock in the second quarter of 2019. Any additional share repurchases will depend upon cash generation and alignment with our capital allocation priorities. We do not expect to make any additional voluntary pension contributions due to the $1 billion discretionary pension contribution we made in the third quarter of last year.

So finally, let's turn to Slide 12 and recap today's results. It was a record first quarter profit per share, following a record first quarter last year. We have updated our guidance to $12.06 to $13.06 in profit per share. Given our strong financial profile, we were able to return $1.2 billion to shareholders in the quarter while executing our strategy and investing for long-term profitable growth.

With that, I will hand it back to Kate, our operator, to bring -- to begin the question-and-answer portion of the call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today is coming from Jerry Revich at Goldman Sachs.

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

In Resources, I'm wondering if you could update us on your expectations on when large project prospects are expected to turn into orders? Over the past year, we've seen CapEx budgets and truck utilization move in the right direction, and I'm wondering what do you expect that to translate to backlog growth for your resource business.

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

It's Jim. I'll take that one on. So we're seeing healthy levels of business from our mining customers. As you know, we had some issues in terms of ramping up production, particularly with our suppliers over the last few months. And our backlog change really is a reflection of the fact that we've been able to ramp up production as opposed to any softening of demand. So again, the market's strong. We expect to continue to have good market activity here, and we're ramping up production, which has resulted in a reduction in our backlog.

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

Okay. And then I'm wondering if you could just expand on your dealer inventory comment. So healthy dealer inventory build in the first quarter. You mentioned resources still at low levels of dealer inventories, and you're looking for the business to be up low single digits organically. This year, is the flat dealer inventory comment really at expectation? Or is that a placeholder as we see activity ramp up? In other words, it sounds like you either expect to reduce production over the course of the year or retail sales to accelerate if we do indeed see flat dealer inventories year-end '19 versus year-end '18.

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

Yes. So Jerry, obviously, keep in mind the way dealers own and control their inventory. So our expectations are based on what we expect their order levels to be. Obviously, we did see an increase in inventory levels in the first quarter for usual seasonal regions. Obviously, we are making sure that we work closely with our dealers to make sure we align their inventory with current market demands so we believe that is about appropriate. And we believe actually flat at the end of the year is a reasonable assumption to be making at this stage.

Operator

Our next question today is coming from Jamie Cook at Credit Suisse.

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

First question, just on the resource margins, they were much higher than expectation. I know volume and price helped, but was there any benefit in there from sort of restructuring or mix? And given the strength in the first quarter, how do we think about sort of full year margins? And then just a follow-up question on the dealer inventory levels. Can you comment on dealer inventory levels, months of dealer inventory level, either by region or product?

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

Jamie, it's Jim. As you know, we don't guide segment -- we don't give segment margin guidance. But yes, the first quarter margins are quite strong. A lot of that was driven by volume leverage. We had good price as well and also just looking at the timing of investments that we had throughout the year was relatively low in the first quarter.

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

And with regards to dealer inventories, generally, obviously, we try to keep dealer inventories to this sort of 3- to 4-month level, it's the sort of target guide -- range, and we would try to do that across everywhere and across all product groups. It would be our biggest guide. Obviously, in some areas, as you know, in CI, we are on managed distribution. So obviously, some inventory levels are lower, and it grows higher over time once we get those products off managed distribution.

Operator

Our next question today is coming from Rob Wertheimer at Melius Research.

Robert Cameron Wertheimer - *Melius Research LLC - Founding Partner, Director of Research & Research Analyst of Global Machinery*

If you look at your market share in China construction over the last 10 years, I think you've more or less doubled it if you use a tonnage basis as opposed to units, you do well in the bigger machines and you've done well in growing that category. Could you sort of talk about what's driven that and then what's changed in the last 3, 4 months to cause some ebbing of those gains?

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

Yes. So China, obviously, this year, we saw a relatively flat first quarter sales in China, which is consistent, obviously, with -- the sales level were consistent with the prior year. Spring season, as you know, is usually a strong selling season in China and was stronger than normal across the whole of the sector, mainly due to the timing of Chinese New Year, but there's also been some very competitive pricing, and that has had some impact on our relative market shares. We now expect the industry -- our expectation for the industry for the full year is for China to be up. We expect ourselves to be flattish for the year. So we will lose some -- we did lose some market share in Q1, but we're taking actions to gain it back, working with dealers and also launching new models, which is a key part of the strategy, which we think is the right strategy which I know was to compete.

Operator

Our next question today is coming from Ann Duignan at JPMorgan Securities.

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

I was just wondering if you could give us an update on your 1% to 4% price increase targets across your different segments and regions.

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

Yes. So Ann, you saw that for the full year or for the full first quarter, we had saw price of about $292 million. That's about 2% on net revenues. Obviously, that was stronger in CI and RI than it was in E&T. That effect is basically partly some impact because of the mid-year price increase which was mostly in Construction Industries last year. And then obviously, the price increase, which was more broadly brushed across the whole of the segments on the 1st of January. We expect Q1 and Q2 to have better price realization, but once we get past the anniversary of the mid-year price increase, CI in particular, will be less price realized than the second half of the year. But so far, we're holding on to good level of the price increases we've put through.

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

Okay. And then in that context, just one quick follow-up on CI. Were you comfortable with your incremental margins even though they weren't incremental? Or did anything specific happen in Q1 to cause Construction Industry margins to be worse than you might have expected? And how should we think about those margins going forward?

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

Yes. So I'll talk about comparables, again, just rather than actually -- because we don't give, as I say, a detailed guidance for the individual segments. But if you look at the comparables for CI, we are effectively seeing some material price increases. Both steel and tariffs had an impact as we talked about more broadly. They particularly impacted CI. Freight costs did start to rise towards the end of the -- in the middle of second quarter last year, so we're still ramping past those. Obviously, as we get past those comparable increases, our margins should stabilize and be better for the remainder of the year.

Operator

Our next question today is coming from Steven Fisher at UBS Securities.

Steven Fisher - *UBS Investment Bank, Research Division - Executive Director and Senior Analyst*

Just curious how you're thinking about the guidance for the year and the visibility for the second half in general. Obviously, you hit your Q1 buyback plan, still have plenty of cash to do more buybacks. I think you mentioned another similar quarter buyback in the second quarter. So do you think the guidance is conservative given that you don't have a lot more buyback in guidance and may be clarify if that next $750 million is in guidance. Or is there something about the visibility in the second half of the year, whereby it's making you cautious you might need the buybacks as an offset?

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

Yes. At this point of the year, in terms of our guidance for our profitability, it's early in the year so we're maintaining our range. In terms of buybacks, one of the things we are going to discuss a bit next week at our Investor Day is our plans for capital deployment. So we look forward to seeing you there and having that conversation.

Steven Fisher - *UBS Investment Bank, Research Division - Executive Director and Senior Analyst*

Okay. But just to clarify, is the $750 million for Q2, I think you said, is that now baked into guidance?

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

Yes. That guidance assumes that we have a consistent level of buyback activity quarter-on-quarter.

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

Correct.

Steven Fisher - *UBS Investment Bank, Research Division - Executive Director and Senior Analyst*

Okay. Great. And then just a follow-up on the North American construction business. You cited higher demand on road building. Can you just talk about what you're seeing outside of road construction and what you think about the mix later in the year?

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

Again, we've talked about the fact that we have strong infrastructures, and local and state infrastructure investment is helping drive sales. Residential was a bit soft. We don't see -- we don't expect a major mix change for the remainder of the year.

Steven Fisher - *UBS Investment Bank, Research Division - Executive Director and Senior Analyst*

Anything on the commercial side?

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

We don't have anything to add.

Operator

Our next question today is coming from David Raso at Evercore ISI Institutional Equities.

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

If I look at your implied sales guidance for the rest of the year and I utilize your historical sequential changes in your backlog, it would imply that year-over-year backlog does stay down year-over-year for most of the year. It may be back to flat in the fourth quarter. But that also does imply your orders turn positive year-over-year in the third quarter and for the full second half. Is that what you're hearing from your customers and dealers, that we should be seeing the orders growing year-over-year in the second half of 2019?

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

Yes, David, I mean, a couple of things. One, which is obviously mining CapEx is one area where, obviously, we are expecting the order rate to continue to accelerate over the year, particularly given we are to expect an increase in mining CapEx for the full year. And as the replacement cycle starts to move ahead, obviously, that will help us on from a backlog perspective. In E&T, as we've indicated, where we do expect to see some order improvement in the second half of the year is around oil and gas, reciprocating engines in particular, particularly as the Permian takeaway issues have started to moderate. So those are probably the 2 big factors, which we would say would drive orders in the second half of the year.

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

And that should then be in aggregate driving the total company orders up year-over-year, I guess, is the key question? Is that what you're seeing? And obviously, thinking about in your guidance. But that's what the numbers imply.

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

Yes. That is what we're thinking and our guidance implies.

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

And in that same regard, if orders are up in the second half of the year, price/cost, the way you're guiding the year, that would imply the first quarter was the worst of the price/cost for the full year. Can we extrapolate that into your thoughts on margins year-over-year in aggregate? (inaudible) in the second half.

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

So David, can I just clarify, price/cost, you mean price realization?

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

Price as in a waterfall chart, yes, price versus the manufacturing cost in this quarter was, to be fair, was down -- it was $83 million negative, which is actually worse than we saw at any quarter last year. I'm just making sure the way you're laying it out, does that then set up the margins year-over-year go back to growing? (inaudible)

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

Yes. Well, basically, as we've -- yes, what we've said and guidance assumes is that price offsets material cost increases or manufacturing cost increases for the full year. So yes, that would imply an improvement from that part of the factor for the remainder of the year.

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

And my last quick one, this might be a May 2 question, I apologize. But when you think about cash flow and use of it, that's fine. But even on the balance sheet, the amount of cash you're carrying, you can define it as you wish, cash to total debt, cash to shareholder equity, cash to total assets how ever you want to do it. The cash on the equipment company seems very high. So when I hear a share repo number of $750 million, which isn't even pushing the cash flow usage, can you help us understand, especially as the new CFO to the company, Andrew, what do you think the appropriate cash level should be for the equipment company?

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

Yes. I think we'll talk about that on May 2, Dave.

Jennifer Driscoll

(Operator Instructions)

Operator

Our next question today is coming from Ross Gilardi at Bank of America Merrill Lynch.

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

Jim, I'm just wondering, across your overall portfolio, what are you hearing from your biggest customers with respect to the trade war? And does it feel, in general, like there's pent-up demand for capital spending projects around the world into next year if this whole thing is resolved?

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

Yes. I think most of our large customers are, as we are, cautiously optimistic that we will work our way through these trade issues. Certainly, anytime there's trade tensions of this kind, it does put a certain amount of conservatism, I think, into all of our plans for capital spending. So I would expect if, in fact, the trade tensions get resolved, that would be a positive for global economic growth and a positive for us. Now...

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

Okay. Got it. And just on the order trends, you had originally obviously guided in January, I mean some of the macro data feel a little bit better more recently. Did you see any type of reacceleration in order trends? Would you say, as the quarter unfolded and as commodity prices recovered or anything you could say kind of more March, April to date versus Jan, Feb?

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

As you know, we're a very diverse business. So just to talk about some of the areas in oil and gas and recip, much has been written about the fact that there's constraints in the Permian and that did have a bit of a negative impact on order rates for our reciprocating engines sold into oil and gas. As you mentioned earlier, mining activity, both in the aftermarket and for new equipment, that quotation activity is quite strong. Obviously, again miners are being cautious based on what the cycle of the past. But generally, we feel good about our business, and we feel good about the quotation activity and the signals we're getting from our customers.

Operator

Our next question today is coming from Noah Kaye at Oppenheimer & Co.

Noah Duke Kaye - *Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst*

Just on your comments on CapEx budgets, I think the company previously guided for CapEx to be about flat year-over-year. The guidance you provided in the slide suggests an increase of about 10% at the midpoint. Is there anything in particular we should think about driving that? Are you having to ramp up your production infrastructure, in particular segments?

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

No. Generally, I would say CapEx is still below book depreciation. I'll remind you that, that is a positive from a cash flow perspective. And we are -- we're expecting it to be flattish. I think last year it was about 1.3, so the bottom end of that range. There's no significant big buildup of incremental production required.

Operator

Our next question today is coming from Andrew Casey at Wells Fargo Securities.

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

I'm trying to understand the comments about manufacturing costs gone down a little bit in Q1 versus Q4 and then the back half improvement and juxtaposing against last year in a seasonally atypical period where margins decline in Q2 from Q1. You might have answered it, but I'm still a little unclear. Should we expect Q2 manufacturing margin to be higher than Q1 and then further improvement in the second half?

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

No. What it will be is, comparing to the comps for last year, if you look at Q1, obviously, this year margin was lower as a result of the steel tariff and freight costs. We expect those to moderate as we go through -- there'll be similar impact on Q2 because obviously those increases weren't fully in effect for most of Q2 last year and then obviously will moderate in the second half of the year.

Operator

Our next question today is coming from Joe O'Dea at Vertical Research Partners.

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

A related question on the manufacturing costs and just I think you talked to the tariff-related costs. If you could break that $375 million down at all anymore, it doesn't sound like there are any sort of mitigating actions and process to take that down. It's more about a wait and see, and then the comps get easier. But I just wanted to understand if there are some opportunities for you to address those, whether that's rerouting supplies, whether that's any other kind of opportunities you have. But just given that, that was a pretty substantial headwind in the quarter, kind of what kind of mitigation we could see.

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

Yes. So there are 2 areas where we do expect some mitigation probably later this year, one, which is around steel prices, just purely because we lag behind because of the effects of, as I said, our procurement practices. And as we look currently, obviously, with the Vale issues or prices are looking slightly higher, but there should be some benefit of slightly lower steel prices coming through later this year. And that's one of the areas where we're going to obviously be looking for some potential cost savings. The other area, which is also an issue is around variable labor burden, which basically is really around the fact that obviously as we built up -- building up production, having some bottlenecks as a result of supplier issues. And we expect those to mitigate during the rest of the year as well. So we do expect some of these not just to be mitigated by the comp period, but also by actual actions we are taking.

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

And then also just on lag effects and related to the pricing, I mean, when we think about midyear '18, you implemented some price increases and then again on Jan 1. Presumably 1Q doesn't fully reflect at least what happened on Jan 1 because of some things that might have already been in backlog. But could you just talk about the degree to which there is still some lag effect of seeing those price actions that were implemented.

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

Yes. We do expect the second half price realization to be lower than the first half because of the mid-year price increase last year. That was the -- that is one of the biggest factors in the -- in about 2% rise. Because obviously, that's fully baked in into pricing now. So we would expect second half to be lower. And as I said, we have guided over the year to have basically price offset manufacturing cost increases.

Operator

Our next question today is coming from Seth Weber at RBC Capital Markets.

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

I guess first, just a clarification on -- Jim, your comment that the RI orders were up in the first quarter versus the fourth quarter, does that include traditional mining equipment? Or is that more skewed towards quarrying or big construction?

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

Yes. I think what I said was that our order activity remains strong in RI, so I don't believe I gave a quarter-to-quarter comparison. But again, quotation activity is strong and just general quotation activity and order activity is healthy in RI.

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

Yes. I think from an overall perspective, actually, it was in my comment. I think I did say actually order rate in Q4 was higher -- Q1 was higher than Q4 2018. So we did see that increase -- some increase coming through. That was in mining, and there was -- we're still strong though in quarry and ag at the moment.

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

Okay. And then my question is really just on RI again. It sounds like a lot of the sales today are really on the OE side. I mean would you expect the mix to tilt more towards parts and service as you get -- as equipment usage starts picking up more? And so I guess I'm just wondering could mix become more favorable later in the year or even next year?

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

We didn't mean to give the impression that it's skewed towards OE at this point. So both are quite healthy at the moment.

Operator

Our next question today is coming from Stephen Volkmann at Jefferies & Company.

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

Most of it's been answered, but I think there were some commentary about SG&A spending being a little bit elevated due to some growth initiatives. And I'm curious if there's any detail you can give around that. And then does that sort of fade also in the second half as well?

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

We continue to make investments -- targeted investments for long-term profitable growth in the area of services and in expanded offerings. In services, we continue to connect more assets. We're investing in our digital platform. We're investing in our analytics. And we continue to develop expanded product offerings as well to ensure that we have the right product offering at the right price point for different markets around the world. So again, we're in this for the long haul obviously, and we're making those targeted investments to grow services and expanded offerings.

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

Yes. And the run rate was slightly higher than you would normally -- remember, you got the short-term incentive compensation credit coming through this year in SG&A. So some of that was also -- there was some corporate onetime items relating to some compensation items, which are held at the corporate level. And there were also, obviously, as Jim said, those investments that we've made in the business itself, which helped through that. We also had very low comps last year for SG&A and R&D in the first quarter of last year. We had a very low -- slow ramp up of spend.

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

Okay. And looking forward, is it sort of steady? Or is this front half loaded?

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

I mean the first quarter is one of the high -- will be one of the highest levels of SG&A spend from an increased perspective through the remainder of the year.

Operator

Our next question today is coming from Adam Uhlman at Cleveland Research Company.

Adam William Uhlman - *Cleveland Research Company - Partner & Senior Research Analyst*

I was wondering if you could talk about the order trends that you're seeing across the Power Gen business. That was the one area of sales growth within E&T this quarter, but the retail sales have slowed here almost to flat. So I was wondering if you could talk about what you're seeing by geography and product line in the order book for that chunk of the business.

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

We have seen a recovery in Power Gen over the last few months, and we expect that to continue. It is an area of strength for us. Obviously, that business is typical, and we had a bit of a downturn previously that we're now recovering from. But we expect that business to continue to be healthy.

Adam William Uhlman - *Cleveland Research Company - Partner & Senior Research Analyst*

Okay. And then related to that, in E&T, you had mentioned earlier that you expect your order trends across oil and gas for recent pensions to improve in the second half. Have you seen any of that improvement yet so far? Or that's still on to come?

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

Again, gas compression has remained strong and steady. We haven't seen a pickup in order rates for well servicing in the recent portion of oil and gas yet. But again, we expect that to come. Other part of our oil and gas business is, of course, Solar Turbines, and that business has remained steady. We've seen a pickup there in international orders, which are typically tied more to big CapEx projects and elevated oil prices. So that business is starting to pick up so...

Operator

Our next question today is coming from Larry De Maria at William Blair.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure*

First question, can you just provide the year incentive comp benefit? And then secondly, just a broader question I have is CI dealer managed distribution. I'm just curious how much is being restrained. And when should we think about that getting maybe more in balance, perhaps after the spring selling season when things come down. But how restrained is that? And when does that get more imbalanced? How do we think about that?

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

So the first question on incentive comps, we expect about a $500 million benefit there this year compared to last year. And in terms of managed distribution for CI, again, it's obviously a dynamic situation based on how we ramp up supply and what's happening in the marketplace. I don't anticipate a major change over the next few months in that situation.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Co-Group Head of Global Industrial Infrastructure*

Okay. But based on the CI orders, it probably shouldn't get more out of whack than it is already now where we may get more towards a more equilibrium situation maybe later in this year. Is that fair?

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

Yes. We expect it to be broadly flattish for the remainder of the year, yes.

Operator

Our next question today is coming from Chad Dillard at Deutsche Bank Securities.

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

So I want to dig into the price realization seen in Resource Industries' past quarter. I just want to understand how broad-based it was and to what extent it was driven by mix and how should we think about that and how sustainable it is on a go-forward basis.

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

Yes. I mean price realization, again, was very strong in RI in Q1, and we do expect it to be the highest quarter for the year. So yes, I mean, it wasn't a little bit -- there's a little bit of an element of mix in that number, which could come through, so yes.

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

RI, because it's a project-based business and quite lumpy, you'll see certain metrics jump around quarter to quarter. It's just the nature of the beast for -- for solar, for rail and for RI.

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

Got it. And then just a question on Cat Financial. It seems like there's a little bit of uptick on credit loss allowances. I was just hoping to get a little bit additional color on that. What's driving it, either from a regional perspective or end markets?

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

Yes. So I mean in Cat Financial, the actual past dues actually were up from 3.55% in Q4 to 3.61% in Q1, so very small increase. Obviously, it was a big increase year-on-year, and that mostly reflects the Cat Financial portfolio, which we talked about in Q4, which obviously has had an impact on the quality of the overall past dues. You also have probably have seen that we had a mark-to-market gain in Cat Financial this quarter. If you remember in the last quarter, we had a loss -- a mark-to-market loss on that and this effectively just an offset quarter-on-quarter.

Operator

Our next question today is coming from Courtney Yakavonis at Morgan Stanley.

Courtney Yakavonis - *Morgan Stanley, Research Division - Research Associate*

Andrew, I think you outlined a little bit about how we should be affecting mitigation in steel prices and some of the variable labor in the back half of the year in addition to lapping over the higher cost from last year. Can you just comment a little bit on freight costs and whether we've obviously seen spot rates drop but whether we should see that mitigate in the back half as well and maybe just talk a little bit about how your freight costs are contracted out.

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

Yes. So obviously, there were 2 factors driving freight costs. One, which is actually cost itself, which did rise probably mostly from the second quarter of last year. So again, we should get past that on a comparable basis some time in the second half of the year. The other factor, which was a big issue for us last year and is becoming less of an issue is around backlog of orders. So as we have past few orders that we need to fill, we have had some freight inefficiencies. And again, we're working to make sure we mitigate that as best as we can going forward.

Courtney Yakavonis - *Morgan Stanley, Research Division - Research Associate*

Okay. And then just probably one other clarification. I think you had mentioned oil and gas, some of the weaknesses due to some timing of turbine product deliveries. Just want to understand how that should impact the back half of this year, especially given that you're expecting recip -- or gas compression or reciprocating engines still up this quarter? So just trying to understand when you expect that acceleration in the back half to come when the Permian takeaway issues, just all the moves and takes in the oil and gas segment.

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

Yes. I would look at those separately. That's why I'd try to separate in your mind recip versus turbines. So again, the turbine business is very lumpy. So that you can revenue-rec one large project in a quarter and it has a very big impact. And you do have that large pressure the next quarter, it looks like there's a decline. So again, our Solar Turbines business is solid and we expect a good year on the recips. And as I mentioned earlier, we have seen, again, oil and gas compression strong. We saw a bit of a slowdown in order intake in well servicing, and we expect that to recover later in the year.

Operator

Our next question today is coming from Neil Frohnapple at Buckingham Research.

THOMSON REUTERS

Neil Andrew Frohnapple - *The Buckingham Research Group Incorporated - Analyst*

Within CI, can you talk about what you're seeing from a used equipment price standpoint? Are you seeing weakness creeping at all for any of the major equipment categories that give you concern as you look out?

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

I mean dumbing down the world, there was one auction down in Orlando where there was weakness in prices but generally aside from that, it's actually been flattish. So used price equipment seems to be holding up reasonably well apart from that one particular auction.

Operator

Our final question today is coming from Mig Dobre at Robert W. Baird.

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

So going back to resources, I don't want to put words in your mouth here, but to me, it sounds like you're more positive this quarter than you have been, say, in the fourth quarter at the back half of 2018 in terms of your commentary and kind of how you're talking about demand going forward. I want to make sure that I get that message properly here and maybe have you expand this to kind of what's driving this incremental positivity. And related to this, as replacement demand is starting to come through from some of your customers eventually, do you feel that the industry has the right amount of capacity available to serve that?

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

Yes. So again, I mean, we feel good about just to say that the business, our quotation activity is good. The aftermarket activity is good. We have certain terms of thinking about parked equipment, and that has certainly come down. And so I won't be so presumptuous as to make a statement about how our customers are positioned. But we believe, based on all of our conversations, that we expect this recovery to continue. And obviously, there's timing issues and let's make a judgment call as to what you think will happen this year, what I think will happen next year. But generally, we feel positive about the RI business and the activity that we're seeing.

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

And from a capacity standpoint?

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

Yes. It's very -- it's situational, right? So it's geographic, and it also depends on the kind of commodities that is being mined. In certain areas, there's still a bit of excess capacity; other areas, there's not. And so it's really -- it's a mixed bag. I can't really give one answer to that question.

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

And just to remind you, we are still significantly below levels, which we saw in the previous peak. So we believe we have sufficient capacity to meet most all demand.

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

Right. It's just that there's been a lot of restructuring that's been done in the downturn as well, which is why I was asking. And then one last question on E&T pricing, obviously, a little weaker versus the rest of the company. And I'm wondering, is there any perspective you can provide on various businesses in that segment where there might be some pricing deviation from the average reported, either positive or negative.

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

No. I mean I think, generally, obviously, the pricing actions that occurred in E&T. E&T probably has a higher mix of services as well, some not all of that was fed through the price increase. So that would be a significant factor. There's obviously machines, particularly in parts, in particular for CI and RI were more broadly based.

Jennifer Driscoll

Jim, can we throw it back to you for some closing comments?

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

Sure. Well, thanks, everyone, for joining us today. We appreciate your questions. We're pleased with our team's performance, including another record first quarter for profit per share. We are executing our strategy of profitable growth that we laid out in our Investor Day in 2017 by investing in services, expanding our offerings and improving operational excellence. We do look forward to seeing many of you at our Investor Day next week. And again, we'll give you an update there about where we are in the strategy, we'll talk a bit about financial targets and also our priorities for capital deployment.

With that, I'll turn it back over to Jennifer.

Jennifer Driscoll

Thank you, Jim and Andrew. And thanks, everyone, for joining us today. We appreciate your interest in the company. If you have questions, you can reach me at driscoll_jennifer@cat.com.

If you'd like a transcript of today's earnings call, you may find it posted later today on the Investor Relations section of our website at caterpillar.com. Next week, on May 2, we'll be hosting an Investor Day. As we mentioned, it will be webcast, and we'll post a transcript of that event after the event on the same website. And with that, let me turn the call back to Kate, our operator, to include 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.
