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CAT - Q2 2019 Caterpillar Inc Earnings Call

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OVERVIEW:

Co. reported 2Q19 sales and revenues of $14.4b and profit per share of $2.83. 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 2Q 2019 analyst conference. (Operator Instructions)

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

Jennifer K. Driscoll - *Caterpillar Inc. - Director of IR*

Thank you, Catherine. Good morning, everyone, and welcome to Caterpillar's second quarter earnings call. Joining us today are Jim Umpleby, Chairman of the Board and CEO; Andrew Bonfield, CFO; and Kyle Epley, Vice President of our Global Finance Services Division.

We've provided slides to accompany the presentation. You can find them, along with our earnings news release, in the Investors section of caterpillar.com under Events & Presentations.

Today, we will make forward-looking statements which are subject to risks and uncertainties. We will also make 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 recent SEC filings and the forward-looking statements reminder in today's news release.

As indicated on last quarter's call, we're not reporting adjusted profit per share again this quarter as restructuring costs are expected to be lower in 2019. It's our intention to report adjusted profit per share at the end of the fourth quarter of 2019 to exclude any mark-to-market gain or loss for the remeasurement of pension and any other post-employment benefit plan as well as any other discrete items. As a reminder, our U.S. GAAP-based guidance for profit per share continues to include the benefit of the $0.31 discrete tax item we recognized in the first quarter.

Please keep in mind that Caterpillar has copyrighted this call. We expressly prohibit use of any portion of the call without our written approval.

Before I turn the call over to Jim, let me inform you about a change we're making due to investor preferences around the timing of earnings calls. Beginning next quarter, we plan to shift our earnings calls to begin at 8:30 a.m. Eastern Time. This timing allows us to conclude our call before the U.S. stock market opens. Accordingly, we also plan to accelerate the news release timing to 6:30 a.m. Eastern Time beginning next quarter.

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

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

Thank you, Jennifer. Good morning to everyone on the call. Please turn to Slide 3 for our second quarter highlights.

Sales and revenues this quarter rose 3% to $14.4 billion. Operating profit rose 2% to $2.2 billion. Profit per share of $2.83 was slightly ahead of last year's record second quarter of $2.82. We delivered strong operating cash flow of $2 billion in the quarter. At our Investor Day in May, we announced our intention to return substantially all free cash flow to shareholders through a combination of dividend growth and more consistent share repurchases. As previously announced, we recently increased the quarterly dividend by 20% to $1.03 per share or $4.12 on an annualized basis. So far in 2019, we paid dividends of almost $1 billion. In addition, we repurchased about $1.4 billion in company stock this quarter, which brings the total to about $2.1 billion for the year.

From a top line perspective, we experienced strong sales in the quarter. Overall demand remains positive. While some customers appear to be more cautious about making large capital expenditures, including in oil and gas, we continue to expect modest sales growth for the year. We are only 2.5 years into a recovery in many of our end markets. While we had strong top line sales, we experienced some unfavorable changes in mix and higher-than-expected restructuring charges. Andrew will discuss both of these items later in the call. Although we are guiding you to the lower end of the profit per share range, we still expect 2019 profit per share to be higher than the record we set in 2018.

Now let's review our 2019 expectations for the external environment on Slide 4. In Construction Industries, we continue to expect North America will be a positive for us. This is due in part to infrastructure spending at the state and local level, although we expect that to be partly offset by weakness in residential construction.

Turning to Asia Pacific. We expect continued pressure from competitive pricing in China, partly offset by growth in other areas in Asia Pacific. EAME is a mixed bag. Sales in Europe are projected to be steady while Africa and the Middle East remain weak. Latin America continues to improve from very low levels.

We expect demand for heavy construction as well as quarry and aggregate equipment to remain strong in Resource Industries this year. Most commodity prices remain at investable levels. Mining equipment sales continue to improve and large mining truck sales have further room for growth to reach their normal replacement levels. We continue to anticipate that miners will remain disciplined in their capital expenditures in these early stages of their multiyear recovery.

The Energy & Transportation space is more mixed amid continued volatility in oil prices and tightened oil and gas capital spending. In reciprocating engines, we expect our sales into the Permian Basin will strengthen in the fourth quarter as takeaway capacity improves. We expect Solar Turbines to have a strong fourth quarter as will Progress Rail. Power generation continues to be an area of expected growth.

Please turn to Slide 5 for a progress update on our strategy for profitable growth. We continue to execute our strategy by investing in services and expanded offerings while improving operational excellence. We've been working hard to improve product lead times. Due to the significant increase in volume during the past 2.5 years, we struggle to keep up with demand for some products. This was primarily due to ramp-up issues at our suppliers. We're pleased that product lead times have improved even though volume remained strong. We have achieved or are close to achieving target lead times for the vast majority of our products. In Resource Industries, for example, our current scheduled average lead time now is just 12 weeks, more than a 50% improvement compared to March of 2018 when we had a weighted average of 26 weeks for the entire portfolio. Shorter lead times allow customers and dealers more flexibility on when to initiate orders.

We also continue to focus on enhancing operational excellence, including safety. Our safety goal is always 0 incidents. We want our people to return home safely every day. One of the metrics we track is the number of recordable injuries per 200,000 hours worked. May and June were 2 of our best safety months on record. We intend to keep the momentum going and make it a great year for safety.

Earlier this year, we announced a goal to double ME&T services sales to $28 billion by 2026. Services increase customer value by improving asset utilization and availability while reducing owning and operating costs. We continue to invest to expand our digital capabilities, enabling services growth, and we remain on track toward our goal of 1 million connected assets by the end of the year.

Product rebuilds and repowers are just one of our services helping customers be more successful. Progress Rail recently won a contract to repower several locomotives for a U.K. rail customer. The new EMD engines will meet EU emission standards and the first repower is expected to be delivered next year. Repowers and modernizations are growth areas as our locomotive customers seek greater utilization of existing fleets.

Many of our meetings with mining customers these days include discussions around technologies like autonomy and automation and how they improve safety and productivity. We have recently been selected for 3 greenfield projects that will further grow our penetration of autonomy with mining customers in South America and Australia. More than 220 trucks have accumulated 50 million kilometers of autonomous driving in fleets already deployed. Our autonomous solutions are now being utilized by 7 customers across 11 sites in 3 continents. We believe that we are at a tipping point for adoption of autonomy in mining.

For example, this quarter, we announced that we will be working with Rio Tinto to create a technologically advanced iron ore mine in Western Australia. We will supply and support mining machines, automation and enterprise technology systems for this project. Working closely with WesTrac, our local dealer, Rio Tinto plans to create an automated mine operation using data analytics and integration to enhance safety, optimize production, boost mining machine utilization and lower costs.

We also continue to expand our offerings, enabling us to continue to grow by addressing the diverse needs of our customers around the world. This year, we introduced the first Cat articulated truck GC model, the 740 GC. As you may know, the GC designation means the machine targets a segment that we refer to as life cycle value. This segment is for customers who have lighter duty applications or work in less extreme conditions. They value simple, tough machines that perform well with Caterpillar quality and product support. The 740 is particularly attractive in the North American rental market where it offers an additional value proposition in its size class. That said, the machine is also gaining traction in every region of the world. Interest in the 740 GC has been strong with year-to-date demand exceeding our initial forecast.

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. Starting with Slide 6, I will begin with a closer look at results, then I'll touch on backlog and dealer inventories before turning to our outlook for the second half and full year.

Starting with the headlines. Sales and revenues for the quarter totaled $14.4 billion, up 3% from last year's quarter driven by Construction Industries and Resource Industries. Overall operating profit increased by 2% or $46 million to $2.213 billion. Second quarter profit per share of $2.83 was up by $0.01 versus the prior year's record second quarter.

There were a number of factors which impacted the overall performance for the quarter. First, negative mix had an unfavorable impact on profits. This was both at the product and the segment level. Second, oil and gas sales remained weak as we wait for the Permian takeaway issues to be resolved. We now expect this to occur in the fourth quarter. Finally, we booked significant restructuring expenses in the quarter, which means that we expect the spend to be immaterial for the rest of the year.

We completed $1.4 billion in share repurchases in the second quarter and paid $492 million in dividends as part of our commitment to returning substantially all of our free cash flow to shareholders. We also announced a 20% increase in the dividend effective from the third quarter, which reflects our confidence in the company's ability to continue to grow cash flows. We ended the quarter with strong liquidity, including $7.4 billion of cash on hand.

Let me dive deeper into the top line on Slide 7. Consolidated sales growth was 3%, reflecting price realization in ME&T of 3% with gains in the 3 primary segments. Volumes grew by 2% and the demand environment remains strong. As we reported this morning, machine retail sales to users grew by 4% during the quarter.

Looking by segment. Construction Industries sales and revenues rose 5%, led by price realization, including the 2019 midyear increase as well as the increase on the 1st of January. Sales and revenues from Resource Industries increased by 11% fueled by higher equipment demand and favorable price realization. Energy & Transportation sales and revenues declined by 4%, primarily due to continued softness in oil and gas as well as timing challenges from project and locomotive deliveries. Our Financial Products segment revenue rose 5%. Currency pressures reflected the dollar strengthening principally against euro and Australian dollar. Overall, our top line growth reflected customers and dealers' confidence in the value proposition of our equipment.

If you move to Slide 8, I will walk through the changes in operating profit. As shown on the chart, price realization and low SG&A and R&D expenses drove the operating profit increase, contributing $427 million and $118 million, respectively. Financial Products also added $14 million to operating profit for the quarter. Manufacturing costs increased by $328 million due to higher material costs, including $70 million in tariffs, variable labor and burden, including the loss of Brazil incentives and warranty expense. Unfavorable sales volume is about $190 million primarily due to mix changes in both Construction Industries and Energy & Transportation. In Construction Industries, the mix of sales reflected an increase in smaller products in North America. The mix in E&T reflected changes in the application mix, including smaller engines. Importantly, price realization more than covered higher manufacturing costs this quarter, an improvement versus Q1. We also continue to expect price realization to fully cover higher manufacturing costs for the full year. It's now been a year since tariffs were implemented and input prices are moderating. Freight costs have also stabilized. Currency lowered sales by 2 percentage points and reduced operating profit by about $20 million.

Moving down the P&L. Low short-term incentive compensation expense impacted SG&A and R&D favorably while also benefiting manufacturing costs. We expect 2019 short-term incentive compensation expense to be about $600 million lower than in 2018.

Before taking a look at the segment results, I want to comment on how the second quarter trended against our first quarter performance. Second quarter sales rose versus the first quarter driven by seasonal trends, higher North American Construction Industries sales, sales of original equipment in Resource Industries and higher rail service revenue.

From an operating profit perspective, the second quarter was about flat compared to the first quarter. The favorable sales performance was offset by negative mix and negative operating leverage due to low absorption cost into inventories driven by the reduction in production levels as we reduce Caterpillar inventories. The operating profit margin contracted by 110 basis points.

From a segment perspective, the sequential margin deterioration was highest in Resource Industries, which as you know had a very strong first quarter. The change in Resource Industries operating margin is due to unfavorable operating leverage from inventory changes, coupled with higher warranty expenses. To keep it in perspective, Resource Industries in the first and second quarters had the highest profit margins since 2012, a year when sales were twice as high as they are now.

Year-to-date restructuring charges are $158 million. We don't expect these to recur at these levels in the second half. We still expect a maximum of $200 million of restructuring expenses for the full year.

Now let's look at the performance of each segment in the second quarter versus the prior year, beginning with Construction Industries on Slide 9. Construction Industries had a record quarter for both sales and profit. Sales and revenues totaled $6.5 billion, a gain of 5% versus the prior year. Construction sales increased in North America by $774 million due to demand changes, including dealer inventories and price realization. Sales were flat in Latin America where construction remained at low levels. Declines in Asia Pacific reflect a continued aggressive competitor pricing, the timing of the selling season as well as unfavorable currency impacts. Weakness in EAME was primarily due to a weaker euro. Construction

Industries' profit increased by $93 million or 8% to a record $1.247 billion. The segment profit margin of 19.3% increased by 60 basis points. The favorable impact of higher volume and price realization was mostly offset by higher manufacturing costs plus unfavorable mix.

Now let's go to Slide 10 and look at Resource Industries. Resource Industries sales were $2.8 billion, up 11% from the second quarter of 2018. The $274 million sales uplift reflects increases in demand and favorable price realization. Sales growth for Resource Industries was driven by a strong mining market, nonresidential construction and quarry and aggregate customers. Segment profit of $481 million rose 17%. Resource Industries' profit margin improved to 17.2%, up 90 basis points. The improvement was primarily due to favorable price realization and higher sales volume. Growth in original equipment remains strong as miners look to replace aging equipment.

If you turn to Slide 11, Energy & Transportation sales in the second quarter were $5.5 billion, down 4%. Power generation sales increased by 3% on continued demand for large diesel reciprocating engines. The other applications were lower sales volume and unfavorable currency impacts. Of note, sales into oil and gas applications decreased by $162 million or 11% due to the timing of turbine project deliveries in North America in last year's quarter, lower demand for new equipment in the Permian Basin, which were partly offset by higher turbine sales for production applications in EAME. Industrial sales declined by 1% with gains in most regions more than offset by currency-related impacts in EAME. Transportation sales declined by 3% primarily due to the timing of locomotive deliveries and reduced marine activity in North America, partially offset by higher sales in rail services. Segment profit for Energy & Transportation totaled $886 million, down $126 million or 12%. The segment profit margin contracted by 150 basis points to 16.2%. Energy & Transportation margins reflected lower sales volume, including an unfavorable mix of products and slightly higher manufacturing costs, partially offset by price realization.

Turning to Slide 12. Let me touch on dealer inventories and backlog which play into our assumptions for the year. Dealer machines and engine inventories increased by about $500 million during the second quarter compared with an increase of about $100 million during the second quarter of 2018. The largest impact was in Construction Industries where dealers decreased inventory in the prior year's period. We previously have projected that total dealer inventories would be about flat for the full year. Based on current inventory levels, we now expect that dealer inventories will increase for the full year by about $900 million driven by Construction Industries and Resource Industries. Whilst dealer inventory levels are closer to the top end of our range, at this time, we are comfortable that this level is supported by positive end-user demand.

At the end of the second quarter of 2019, the order backlog was $15 billion, about $1.9 billion lower than the first quarter of 2019 and down $2.7 billion from the balance at the end of the second quarter of 2018. The order backlog decreased across all 3 primary segments with the largest declines in Construction Industries and Resource Industries. In Construction Industries, we connect the backlog decline to slowing orders due to growth in dealer inventory. Also keep in mind that Construction Industries had a record quarter and it's not unusual for backlog to decline in CI in the second quarter itself. In Resource Industries, we improved throughput in factories and improved lead times, as Jim has described. And remember, orders do tend to be lumpy. As a point of reference, the total decline in the backlog of $2.7 billion since Q2 last year is about offset by the increase in dealer inventories for the same time period.

Now let's walk through our assumptions for the 2019 outlook. We now expect profit per share to be near the low end of our range of $12.06 to $13.06, assuming a recovery in oil and gas near the end of the year and dealers working through part of the higher machine inventory levels. Quotation activity is unchanged. We assume price realization offsets manufacturing costs. And as I said, restructuring costs for the remainder of the year will be significantly lower with a maximum spend of $200 million.

Other key assumptions are broadly unchanged, including $250 million to $350 million in tariffs for the year. We expect short-term incentive compensation to be a tailwind of about $600 million. We now project capital expenditures of about $1.3 billion. The estimated annual tax rate is unchanged at 26%, excluding discrete tax items.

Consistent with our intention to return substantially all free cash flow to shareholders, we are now projecting share repurchases in the second half to be similar to the first half. In fact, including all shares repurchased since the 1st of January 2019, we expect to reduce our total shares outstanding by about 9% by the end of 2019, all the while executing our strategy and investing for long-term profitable growth. This reduction in share count is fully reflected in our guidance.

Looking ahead to the third quarter, we will continue to execute our strategy, including making appropriate additional investments for longer term profitable growth. We anticipate stronger results in the fourth quarter, including increases in demand from oil and gas and rail customers.

So finally, let's turn to Slide 13 and recap today's key takeaways. We grew sales 3%. Operating profit rose 2%. Profit per share was comparable with the second quarter of last year. We have maintained our profit per share outlook, although we'd expect to be at the lower end of the range of $12.06 to $13.06. Again, this adjustment reflects mix changes, a fourth quarter recovery in oil and gas and dealers working through higher machine inventory levels, partially offset by lower restructuring charges in the second half of the year. We still expect modest sales growth this year and profit growth on top of last year's record results. We are also on track, including 2019 buybacks, to retire a total of about 9% of our shares outstanding by the 31st of December. And our financial position remains strong.

With that, let me hand it back to Jennifer to begin the question-and-answer portion of the call.

Jennifer K. Driscoll - *Caterpillar Inc. - Director of IR*

Catherine, thank you. If you can now queue up the questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question is coming from Rob Wertheimer from Millennium Capital (sic) [Melius Research].

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

So thanks for the color on dealer inventory. I think that will be something investors want to talk about. I wanted to ask for just a little bit more clarity around it. I mean obviously, you don't control what the dealers do and it's their own decisions. But do you have a sense of what led to the sort of change to the building a little bit of inventory through the year versus the prior expectation? It doesn't seem like sales inflected up sharply since then. And then I can just wrap my follow-up into it. I mean, is the $900 million gap between what you thought and what sounds like it will be, is that the difference between your ideal level and where it may end? In other words, is that the downside risk for ongoing or maybe you could just characterize how big that gap is versus ideal?

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

Okay. Rob, it's Jim. I'll take the first part of that question and maybe ask Andrew to do the second part. So as you mentioned, dealers are independent businesses and they control their own inventory levels. Inventory levels were lower than they normally are. And with that increase, we're back up to what is considered more of a normal level. I did talk about the fact that we had been successful in reducing our product lead times which also has an impact here as well. So that gives dealers a lot more flexibility in terms of where they place orders. Andrew, I'll let you do the second there.

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

Yes. On the $900 million reduction we expect for the remainder of the year, reduction to about $900 million. I mean we are slightly at the high end. We'd like to be in the middle of the range. We keep a range for each segment. We're always comfortable being in sort of midpoint of the range. This gets us to around about the midpoint from our perspective, Rob. So there would be potentially further reduction, but we were very low in that range previously. And as Jim indicated, that did have some impact on availability. Ultimately, at the end of the day, you want to make sure that dealers have the right amount of inventory to be able to meet customer demand. And probably given the challenges we've had previously, there may have been some loss of sales at dealer level as a result of not being able to supply quickly enough.

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

Okay. I beg your pardon. So with the, I guess, reduction from here to the end of the year, you're saying you're going to be kind of roughly in the middle of the range, not necessarily low of where you'd like to be? Is that what you're saying?

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

Yes, that would characterize it. Yes, Rob.

Operator

Your next question is coming from Jamie Cook from Crédit Suisse.

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

I just wanted to follow up on the mix issues in the second quarter, how much that hurt earnings and what's implied for the back part of the year. And then just within oil and gas specifically, I think before you said you had expected orders to pick up in the back part of the year, in the second half, now you're saying the fourth quarter. I guess just sort of what gives you confidence that you should see that acceleration? And how much cushion could we potentially get from Solar in the fourth quarter?

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

Jamie, it's Jim. So our oil and gas guidance for the year is dependent on certainly Solar having a strong fourth quarter. Solar has, as you know, the lead times are relatively long. They have the orders in hand for the new equipment side to execute that. There's always some variability in service, but we are expecting a big fourth quarter from Solar and fully expect them to make that happen. We are also expecting in the fourth quarter some recovery in recip engine sales in North America as the Permian constraint issues continue to be resolved.

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

And Jamie, on the mix issues, obviously, the mix did have quite an impact in the quarter. If you look at -- we saw a small increase in volume, the sales level, but a negative move in the operating profit level. Principally, in CI, that was mostly due to the fact that we actually sold more small machines in the quarter. While they have similar margins, that can be quite sensitive to the overall mix impact. And then obviously, there's also a segmental mix. And the mix within E&T, similar mix issue in E&T particularly with the smaller engines being sold. And then also there's a segmental mix impact obviously because E&T does have very strong margins. And obviously, the margin deterioration impacted the reported mix as we look at variable margin in that business. All of those factors have been built into our guidance. So we have put that into why we expect to be at the low end of the range, along with the delay, particularly in oil and gas sales.

Operator

Your next question is coming from David Raso from Evercore ISI.

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

I'm trying to think through the second half implied guidance. Just so we set the framework, it looks like you're implying revenues down, say, about $500 million first half to second half, but the EPS grows about $0.25 to $0.50. And I'm just trying to understand, I can see about $0.15 from lower restructuring sequentially and maybe about $0.05 from the lower share count, so that's about $0.20. But then I would have figured the rest would have been, you see better price/cost second half than first half more than offsetting some overhead absorption issues with the lower volume. But I thought earlier you made a comment price/cost, maybe I missed it, sort of neutral the rest of the year. Can you clarify that? Just want to get the EPS walk first half to second half.

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

Yes. Thanks, David. And yes, so first of all, we don't give sales guidance. So your assumption around sales may be slightly different from our assumptions. So that may have been part of the impact that we're seeing. As Jim indicated, we do expect both rail and solar and oil and gas to pick up in the fourth quarter. All of those will have an impact and remember that obviously E&T is down for the first half of the year when you look at that. So as you think about it from a top line perspective, there may be some variability we see versus where you are on your top line.

With regards to margins and operating margins, obviously, there are seasonal factors that come into play. But as we did indicate, we are starting to see a little bit of relief from underlying manufacturing cost increases. Obviously, the tariffs, we start now anniversary-ing. Freight costs have started to pick up in the second quarter of last year. So those factors will have less of an impact on overall manufacturing cost. Offset against that a little bit will be some variability. If we do actually take down some production, obviously, we'll have a little bit lower inventory absorption. So those are all factors which we've weighed into our guidance. Then obviously, we are starting to see some things like steel costs come down. Steel, obviously, we do a lot of our steel buying on a contractual basis and there is a lag, but we are starting to see some of those things flow through as well into the second half.

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

And then trying to set up the look into 2020. We've already discussed the inventory. But for the backlog, seasonally, you can see how CI might continue to go down. But when you think about your commentary the rest of the year on mining and engines, E&T, are we making the assumption then that the backlog is somewhat bottoming out here because RI and E&T offset CI sequentially? We're just trying to sort of get a baseline kind of exiting the year. Have we seen, generally speaking, the bottom of the backlog with this $15 billion?

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

Yes. I mean I think, David, one of the problems with focusing very much on the backlog is, remind you, that this is reflected with dealer demand. There will have been some elements as a result of an ability to or delays in supplying orders, availability of product that dealers may actually have been putting slots in the queue. And we have seen that happen before and that may have happened this time as well. Obviously, what does happen with the order backlog is it is lumpy, particularly in places like RI, rail, Solar. So we are keeping an eye on it. There's nothing indicating that from a retail, if you look at the retail stats, just remind you, they are up again. So there's nothing indicating underlying customer demand is changing. This may be behavior by dealers and their ordering patterns as well.

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

And again, just to expand upon how you think about the lumpiness in Solar and rail. Obviously, if you have a big fourth quarter, there's a lot of shipments that were in the backlog, obviously, the backlog will go down. Again, that happens every year. That's the nature of the beast.

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

Okay. I'm sorry, Jim. So part of the $15 billion, you would argue, is reflective of why you're confident in the fourth quarter shipments of those businesses, but at the same time it could help draw the backlog down from here if there aren't new orders to fill it in, so to speak?

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

Yes. And certainly, and again, that happens every year, well, say, every year, typically. Solar, in particular, has a big fourth quarter, so we would expect again shipments occur, backlog goes down. But again, the business continues to be healthy and good quotation activity. So we would expect that there'll be a normal seasonal pattern at Solar in terms of backlog and inventory.

Operator

Your next question is coming from Ross Gilardi from Bank of America.

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

I was just wondering if you'd give a little more color on the 3 new greenfield sites for autonomous and the timing there. Are these retrofits or new trucks and equipment? And is that a positive driver into 2020 or is it much further out?

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

Yes, it's a multiyear. We're going to make deliveries over a number of years and so they are new trucks. Again, these are greenfield sites. So again, a lot of new technology, but the deliveries will occur not just in 1 year, it'll be over more than 1 year.

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

Okay. And then can you talk a little bit about your confidence in the China excavator outlook for the second half of '19? I mean it sounds like your full year outlook is broadly unchanged. And as you cited, there's some competitive pressures there. I mean how much visibility do you have on that business for the rest of '19?

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

Yes. Based on everything that we see, we believe that overall the market demand will be stable. We have mentioned the fact that we have some competitive pricing pressures from local competitors. We're certainly taking steps to ensure our competitiveness long term in China. We're introducing a number of new GC products that will help us compete as well. But again, we feel good about our forecast there in China.

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

Okay. Just lastly, Andrew, you mentioned that your share count should be down 9% by the end of this year with the buybacks. Beyond '19, if you did $4 billion to $5 billion in buybacks, I think that will retire about 6% of the share count at today's price. I'm just wondering how much of that 6% is fair to assume is offset by share issuance for employees, options, et cetera, just net of equity issuance. I'm just trying to get a better sense for how much the share count should be falling each year beyond this year.

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

Yes. So obviously, the 9% -- around 9% is a net number, so that's net of new issuance. So effectively given that we had spent $3.8 billion last year, we expect somewhat to be in the sort of or at least the $2.1 billion in the first half, something similar in the second half. If you're doing about $4 billion, you generally retire about 4.5% of the share capital each year.

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

Okay. So share count just sort of as a base case assumption at the current stock price is probably falling 4% to 5% a year beyond 2019?

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

Yes. Yes.

Operator

Your next question is coming from Joel Tiss from BMO Capital.

Joel Gifford Tiss - *BMO Capital Markets Equity Research - MD & Senior Research Analyst*

So just it sounds like some pieces are setting up 2020 to be a little bit more of a difficult year with the incentive comp down so much this year and the dealer inventory is up a little more. Can you give us some of the pieces that -- to kind of balance that out? What would be on the other side of that? I'm not asking for forecast, just kind of a couple of bigger factors to think about.

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

Yes. I mean let's remember that we have had quite a tough year in E&T so far. Obviously, if Permian takeaway issues are resolved and drilling activity goes up, that will be one area where we'd see some upside in 2020. I think if you look also at underlying demand for machines, it remains strong. So again, that's other opportunities for us as we move into 2020. We will always retain our focus on a flexible and competitive cost structure. We want to invest in the right things for the business to drive long-term profitable growth, but we still always do need to make sure that we are operating as efficiently as possible, and those are other areas where we will continue to see some opportunity to drive growth as we move forward.

Joel Gifford Tiss - *BMO Capital Markets Equity Research - MD & Senior Research Analyst*

That's great. And then my second question is about something you mentioned there, too. The cost reductions, like it's you guys have done a lot, a lot of work there. And it seems like the cost structure is seemingly not as responsive to the fluctuations, like quarterly fluctuations in the business. Is that more structural or is it cyclical just that you're kind of scrambling to get stuff out the door? Can you give us any color behind the scenes of what to think about or are those kind of more long-term changes to the company and we can't worry about the near-term results?

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

Yes. I think we don't respond to quarterly -- by quarter movements. We're trying to drive the business for the long term. So Joel, as we look at the cost structure, we do try to make sure we've got a long-term focus on that and don't do things just for short term cost-cutting measures. We can all do those. We've all seen people do those. Longer term, it's not what drives you well because what tends to happen is investment then gets cut off, which isn't the right thing to do for long-term shareholder value creation.

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

But I would say that, Joel, we certainly challenge all of our leaders to find ways to become more efficient and reduce cost. So we still believe we have opportunities over the next few years to continue to improve our cost structure. So again, as Andrew mentioned, while continuing to invest in those areas, particularly like services, like our digital capabilities that drive long-term profitable growth.

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

And sorry, Joel, just to add one thing on 2020 which I did forget was about Resource Industries. I mean obviously mining, we are only in the start of the recovery phase and replacement cycle. There is a lot of potential still of areas to run as miners start actually bumping up CapEx. All commodities remain at investable levels, so we do expect that to continue to improve as we look out as well.

Operator

Your next question is coming from Jairam Nathan from Daiwa Capital.

Jairam Nathan - *Daiwa Securities Co. Ltd., Research Division - Research Analyst*

My question was regarding rail. You mentioned a strong 4Q but we are seeing some of the implementation of PSR on the railroad side. They are cutting down the number of locomotives they use. And at the same time, volumes are starting to decline as well, rail volumes. So just wondering, is this expectation of the U.S. or more international?

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

Yes. It's really based overall on the backlog that we have in rail for new locomotives. But certainly, I mentioned earlier, the one example we gave of repower. So our rail business is a direct business and there's a large service element to it as well. So it is not completely dependent upon new locomotive sales. Having said that, of course, we are expanding internationally. We've shipped our first transit locomotives since we made the acquisition of EMD a number of years ago. So again, we are not totally dependent upon new locomotives in North America. We certainly understand the environment in which we're operating. But again, what we're talking about is an expected strong fourth quarter based on backlog on hand for rail.

Jairam Nathan - *Daiwa Securities Co. Ltd., Research Division - Research Analyst*

And my last question was on margins on resource. You mentioned warranty expense increase. Can you expand on that? Is that more volume-related or is there something else there?

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

It was a particular issue with a particular product that happened. These things do happen. They do tend to be lumpy. And that's been a driver in this quarter.

Operator

Your next question is coming from Sameer Rathod from Macquarie Research.

Sameer Rathod - *Macquarie Research - Analyst*

There's some interesting developments made in electrifying the frac fleet. So my question is, how does Caterpillar see this market evolving? Do you think it could pose a risk longer term to the diesel engine and parts business or do you think the applications are limited?

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

And I'm sorry, I can barely hear you. Did you say electrification in fracking? Is that the question?

Sameer Rathod - *Macquarie Research - Analyst*

Yes. Electrification in fracking.

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

Yes. You bet. So we have been very involved working with customers both on the recip engine side and on the gas turbine side on what people call the e-fracking opportunity. So we are well positioned to participate in both of those areas. We have sold some gas turbines which are generator sets that allow customers to do e-fracking. We're also working on recip solutions as well working with customers. So I believe it will be a mix market with both, and we'll see which one is stronger in the end, but we participate in both ways, both for electrification and non and also both in our recip engines and with gas turbines. So we're well positioned to play across that value chain.

Operator

Your next question is coming from Jerry Revich from Goldman Sachs.

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

You folks sounded more positive tone on large mining truck order cadence than I think we've heard from you in a while. Can you just talk about what in your view has driven a slower replacement cycle in this recovery so far? Is it the autonomous decisions that have to be made? And can you just expand a bit more, Andrew, on your comments that there's scope for move towards replacement as you think about the moving piece around '20? So it does sound like you expect order decisions to be made obviously in advance of '20 for that to play out. So maybe I can get you to expand on that, too.

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

Jerry, this is Jim. I'll take it. So we see strong quotation activity on a global basis for all commodities. So as we work directly with our customers and with our dealers, there is increasing quotation activity. There's a lot of projects that are being developed. We've talked about some orders that we've received. Certainly, I believe and I actually hope there'll be less volatility than there has been in the past. It will be more of a slow steady ramp up, but the quotation activity is quite strong. And again, it's across all commodities.

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

And just to add, I mean, the parked fleet is at an all-time low since we've been tracking that number in 2013. So it is an opportunity definitely. We do believe that now we will be starting to see replacements starting to come through.

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

And we do expect our mining customers to be disciplined in their capital expenditures. So again, that ties into my earlier comment about more of a slow steady increase than a volatile increase. They will be, again, cautious and disciplined, but we expect the business to continue to improve on a slow and steady basis.

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

Okay. And in Construction Industries, you folks have worked really hard to get the cost structure to where it is today. Given the dealer inventory build both across new equipment, used equipment and the utilization pressures, I guess can you talk about what's the potential for you folks to more actively manage orders. You mentioned there are some slots that are potentially placeholders, et cetera, so what's the opportunity for you folks to get ahead of the eventual order declines given what some of the leading indicators are doing, cut production earlier to keep the swings from being really painful on the manufacturing base.

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

Yes. Just to be clear, so firstly, let me start with, we released our retail stats this morning. And so business is improving, so let's start with that. But certainly, shorter lead times is very important. We've been on this lean journey for a long time and having shorter lead times allows us to respond much more quickly to changes in demand.

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

Andrew, the comment was, I guess, more focused on North America than overall. So the retail sales were up 7%. The company sales were up 28%. So we're building inventories in North America specifically. So I'm wondering what's the potential to get out in front and cut production earlier in the cycle.

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

Yes. So Jerry, as I spoke in my comments, we did see some takedown of Caterpillar inventory, finished goods inventory, so we do continue to focus on that. Obviously, with lean manufacturing, we are obviously -- we don't hold a lot of finished goods inventory. Most of the inventories are held actually in the component level, so actually bought in. So actually that is one thing we continue to focus on. But obviously, we will look at making sure that we don't -- as we said, we will take down dealer inventory in the second half and then we'll have some impact on production base.

Operator

Your next question is coming from Ann Duignan from JPMorgan.

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

If I could turn back to oil and gas. I'd like to really understand your confidence in the fourth quarter pickup in sales. Is this products that dealers have ordered? So it's shipments to dealers or is it real end-market demand? And if you could just talk about your mix in oil and gas, well completions versus drilling, so we know which one is more important to demand for your products.

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

Ann, again, starting -- part of the oil and gas pickup, as I mentioned earlier, is due to Solar, where we have the backlog and the orders in hand and it's a matter of executing, but with some variability in service but we feel good about that. So that is part of it. If you go to the recip side of it, gas compression remains strong. We are expecting an increase in end-user demand for fracking that will impact our business towards the end of the year.

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

And on the fracking side, is that actually drilling or is that well completions? I'm trying to understand which one drives your business more.

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

It's mostly well service.

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

Okay. I appreciate that. And then my follow-up question is more, if we look back at year-to-date performance, sales are up, but in fact adjusted net income is down. So Jim, should we be growing concern, should investors be growing concerned about your commitment to profitable growth? I mean I know you can say you're at record levels, but net income is actually down on adjusted basis year-to-date.

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

Yes. So we are so very committed to profitably growing our business, and we're making investments to make that happen. We talked about this in Investor Day as well, that we do expect quarterly variability in our performance, but we're very much focused on improving year to year. We've talked in our call this morning about some of the issues we had in terms of lumpiness in restructuring charges and we had some inventory impact. We did have some mix impact. And we will have, just given the nature of our business, we will have quarterly deviations in our performance. But we're really driving for is medium and long-term profitable growth and we're investing to make that happen. We're committed to continue to improve our cost structure structurally. I talked about that earlier. And we believe we have opportunities there over the next few years to take that on, and we're very committed to that profitable growth story. But again, we will have quarterly deviations, there's no question.

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

And yes, but if I look at 6 of the last 7 quarters, your stock has underperformed. So is there something you can do structurally going forward to help us understand this variability?

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

Yes. Again, what we're driving towards is profitably growing our company. And if we profitably grow our company, I believe that will be reflected in the stock price. And we're going to have, again, as we talked earlier, we expect to have another record year in earnings per share this year, another record year.

Operator

Your next question is coming from Timothy Thein from Citigroup.

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

The first question is on RI and specifically, Andrew, you had mentioned earlier that OE was a big driver or a driver for growth in the quarter. So I'm not sure exactly what that means for part sales. But really the question relates to the sustainability of pricing which was up against some pretty tough comp again in the second quarter. And just as you see, basically, the question is the trade-off on as your OE volumes presumably capture a bigger part of the total within mining, how should we expect that trade-off to play out in terms of pricing on OE relative to parts?

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

Yes. So obviously, we did have, in the first quarter actually, we had a really strong quarter. I think it was a record quarter for part sales within Resource Industries and part of that was driven by the fact, obviously, rebuilds are still continuing. Yes, there will be a mix impact. It depends on what equipment was selling and the relative mix of parts and services versus OE. That will be part of how we manage that business. Obviously, the advantage you have on OE is as you improve throughput, you do improve operating leverage. As I say, we actually have seen these 2 quarters, the first and the second quarter have been the 2 best quarters in our eyes since 2012 when actually sales were -- revenues were nearly double what they are today. So I think we will see lumpiness. We will see movement. That's the nature of that business particularly given the way we actually deliver our products to customers, but we're quite comfortable with the sort of the relative margin performance. And again, we will look at them over time rather than just purely quarter-to-quarter.

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

Okay. Got it. And Jim, maybe one last one on oil and gas and specifically your comments to a question recently just on well servicing. A number of the big service companies have commented just in the past few days about cutting CapEx budgets, some of them pretty significantly. So I just want to come back in terms of kind of what's underlying that assumption that we do get this pickup of recovery in the fourth quarter.

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

Yes. Again, it's our perception of what's going to happen as the takeaway issues in the Permian are resolved. So I'll leave it there.

Operator

Your last question is coming from Courtney Yakavonis from Morgan Stanley.

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

Just a couple of clarifications. First on restructuring. Can you just help us understand. I think the first quarter you said was pretty minimal. So how much of that $158 million was hitting this quarter? And in which segments it was showing up? And then if you can also quantify the warranty charge that was in resources. And then just more broadly when we think about your China business. With APAC sales down as much as they were this quarter in construction, how should we be thinking about the margin for that business as you're continuing to introduce these GC products relative to what you had been getting in light of all these competitive pricing pressures?

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

Yes. Courtney, maybe start with restructuring. The charge in the first quarter was $48 million and the second quarter was $110 million. The $48 million is in our Q so you can always refer back to that. Most of it actually was incurred and this is held within the corporate item. There is some move back into the businesses but very limited and very small, not materially impacting their reported margins.

With regards to warranty expense, we don't actually break down the analysis of manufacturing cost, but the fact we're calling it out just shows it was a significant item in the quarter. But obviously, and it did have an impact on the overall performance in RI in the comparison in Q1 versus Q2.

Jennifer K. Driscoll - *Caterpillar Inc. - Director of IR*

China, new products?

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

Yes, sorry. On China new products, obviously, GC products are a lower price point but have similar margins as we said before. So overall, this shouldn't impact reported margins as much. Obviously, the most important thing is making sure we retain a good competitive position. This quarter was impacted in part -- the reported revenues were impacted in part by the timing of Chinese New Year. We did see the benefit of that in Q1 which did have a negative impact in Q2.

Jennifer K. Driscoll - *Caterpillar Inc. - Director of IR*

And with that, we'll turn it back to Jim.

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

Well, thank you, everyone, for joining us on the call today. Just a few closing comments.

We view our competitive position as very strong. We're continuing to invest to achieve our strategy of long-term profitable growth, including doubling services sales in ME&T by 2026. We expect record profits this year, the second consecutive record from an EPS perspective. And as we talked about, we continue to generate strong cash flow, which underpins our commitment to return substantially all free cash to shareholders through buybacks and dividends. And as Andrew talked about, if you take into account 2018 and 2019, by the end of the year, we expect to have a 9% share count reduction by the end of the year.

With that, I thank you for your questions and we look forward to chatting with you next quarter.

Jennifer K. Driscoll - *Caterpillar Inc. - Director of IR*

Thank you, Jim, and thanks, everyone, who joined us today. We appreciate your interest in Caterpillar. If you have any questions, please reach out to me or Rob Rengel in IR and e-mail him at Driscoll_Jennifer@cat.com or Rengel_Rob@cat.com.

And now let me ask Catherine to conclude 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.