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CAT - Q1 2020 Caterpillar Inc Earnings Call

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OVERVIEW:

Co. reported 1Q20 sales and revenue of $10.6b, operating profit of $1.4b and profit per share of $1.98.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Q1 2020 Caterpillar Inc. Earnings Conference Call. (Operator Instructions) I would now like to hand the conference over to your speaker today, Jennifer Driscoll. Please go ahead, ma'am.

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

Thanks, Jacqueline. Good morning, everyone. Welcome to Caterpillar's first quarter earnings call. Joining the call today are Jim Umpleby, Chairman of the Board and CEO; Andrew Bonfield, CFO; Kyle Epley, Vice President of our Global Finance Services Division; and Rob Rengel, Senior IR manager.

Our call today expands on our earnings news release, which we issued earlier this morning. You can find the slides accompanying today's presentation, along with the news release in the Investors section of caterpillar.com under Events and Presentations. The forward-looking statements we make today are subject to risks and uncertainties. We'll also make assumptions that could cause our actual results to be different than the information we discuss today. Please refer to our recent SEC filings and the forward-looking statements reminder in the news release for details on factors that, individually or combined, could cause our actual results to vary materially from our forecast. Caterpillar has copyrighted this call. We prohibit use of any portion of it without our prior written approval.

This year's quarter included a $0.38 per share benefit from a remeasurement gain, while last year's quarter included a discrete tax benefit of $0.31 per share. There is a non-GAAP reconciliation in the appendix to this morning's news release.

In a moment, you'll hear from Andrew about the first quarter results, the actions we've taken to boost our liquidity and a few key financial assumptions for the rest of 2020. But first, please turn to Slide 3 as we turn the call over to our Chairman and CEO, Jim Umpleby. Jim?

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

Thank you, Jennifer. Good morning, and welcome to Caterpillar's first quarter earnings call.

During this difficult time, our thoughts are with those affected by COVID-19. We extend our deepest sympathies to those who have lost a loved one during the pandemic. We thank those individuals in health care as well as the first responders helping fight the pandemic on the front line. I also want to thank Caterpillar's global workforce. This month, we are celebrating 95 years of operation at Caterpillar. For nearly a century, we have faced and overcome many challenges. As in the past, our employees are rising to the occasion. I appreciate their commitment to support our customers while keeping our facilities and coworkers safe.

As the COVID-19 pandemic spread around the world, many governments classified Caterpillar's operations as essential activity for support of critical infrastructure. Working with our dealers, Caterpillar is delivering products and services that enable our customers to provide critical infrastructure that is essential to support society during the COVID-19 pandemic. Customers use our products to provide prime and standby power for hospitals, grocery stores and data centers to transport food and critical supplies in trucks, ships and locomotives, to maintain clean water and sewer systems and to mine commodities and extractive fuels essential to satisfy global energy demand.

While we are serving these important needs, Caterpillar remains dedicated to the safety, health and well-being of our employees. The Caterpillar team achieved our best safety performance on record in 2019, and we are leveraging our strong safety culture during the pandemic. Employees who can work from home are doing so. In our facilities that remain open, Caterpillar is implementing safeguards to protect our team members in accordance with regulatory requirements and guidance from health authorities. We've also introduced a number of enhanced employee benefits to help them deal with the pandemic. These benefits vary by country based on local medical care systems and various regulatory requirements.

Since Caterpillar was founded, our world-class global dealer network has provided us with a competitive advantage. And during this pandemic, our 165 dealers and their employees around the world continue to support our customers as they maintain critical infrastructure. Our team at Cat Financial also continues to support our customers, as Andrew will describe in more detail. Cat Finance supports our customers through good times and challenging times, which is one of the reasons we have so many loyal customers. The Caterpillar Foundation has also committed $10 million to support COVID-19 response activities being taken by organizations around the world.

Now turning to Slide 4. Caterpillar is well positioned to navigate the COVID-19 pandemic. Our financial position is strong, and we are confident in our ability to continue serving our global customers. We will continue to execute the strategy we introduced in 2017, which is based on growing services and expanded offerings while improving operational excellence. The execution of our strategy during the last 3 years positions us well for these challenging times. Our disciplined management of structural costs will help us weather the storm created by COVID-19.

We held our period costs of SG&A, R&D and manufacturing along with our salaried and management headcount flat from the end of 2016 to 2019, even though sales and revenues increased 40% during the same time frame. While this leaves us less to cut in a downturn, the lower cost base and the need for significantly less restructuring costs mean that our absolute margins and cash flow will be higher than they would have been had we allowed period costs and salaried management headcount to increase during the last 3 years.

In response to the pandemic, we've taken actions to improve our already strong financial position and increased liquidity. On a consolidated basis, Caterpillar ended the first quarter with $7.1 billion of cash and available global credit facilities of $10.5 billion. In April, we raised $2 billion of incremental cash by issuing new 10 and 30-year bonds and arranged $8 billion of additional backup facilities to supplement the company's liquidity position. We've reduced discretionary expenses, including consulting, travel and entertainment. We suspended 2020 base salary increases and short-term incentive compensation plans for most salary management employees and all senior executives. We are also reducing production costs to match customer demand. We continue to focus on improving operational excellence, which includes making our cost structure more flexible and competitive.

We are working through a number of operational challenges related to the pandemic and have suspended operations at certain facilities due to a combination of supply chain issues, weak customer demand and government regulations. As of mid-April, approximately 75% of our primary production facilities across our 3 main segments continue to operate. Some facilities that were temporarily closed have reopened, such as in China.

We have worked quickly to mitigate disruption to our supply chain by using alternative sources, increasing air freight as needed, redirecting orders to other distribution centers and prioritizing the redistribution of the most impactful parts. Our employees and dealers continue to serve our customers.

Now I'll give you a summary of the first quarter's results on Slide 5. Sales and revenues of $10.6 billion decreased by 21%. The decline was mainly due to lower sales volume, including lower end-user demand and the impact from changes in dealer inventories. End-user demand was below our internal expectations for the quarter. Sales to users for the first quarter declined by 16%. The decline was most pronounced in Asia Pacific, where we compete primarily in construction industries; and in North America, which had weakness from machines and energy and transportation engines. Oil and gas declined 24% for the quarter. Small bright spots included construction in Latin America, mining in Asia Pacific and EAME and power generation.

During the first quarter of 2020, dealers increased inventory by $100 million in anticipation of normal seasonal demand from end users. This compares with a $1.3 billion increase in dealer inventory during the first quarter of 2019. The year-over-year change of $1.2 billion in dealer inventory also placed pressure on our sales.

Our first quarter operating profit margin was 13.2%, down 320 basis points. The decline was primarily driven by lower sales volume. Favorable SG&A, R&D and manufacturing costs partially offset the volume decline. The R&D decline was mostly due to lower short-term incentive compensation as most of our R&D projects are proceeding consistent with our strategy. Profit per share was $1.98 compared with $3.25 in the prior year's period. This year's quarter included a $0.38 per share benefit from a remeasurement gain, while last year's quarter included a discrete tax benefit of $0.31 per share.

Now moving to Slide 6. In the first quarter, we returned $1.6 billion to shareholders through dividends and share repurchases. In addition, we declared our normal quarterly dividend earlier this month, and we continue to expect our strong financial position to support the dividend. As a reminder, Caterpillar has paid a quarterly dividend every year since 1933 through a variety of changing -- challenging business conditions. We remain committed to returning substantially our free cash flow to shareholders through the cycles. We are temporarily suspending our share repurchase program upon completion of the 10b5-1 program that we established in January. We retain the balance sheet to do M&A for compelling opportunities.

Our focus on operational excellence, shorter lead times and flexibility in manufacturing operations will allow us to react quickly to future changes in market conditions, either positive or negative. The ultimate impact of the pandemic on our 2020 results remains uncertain and will be based on the duration of the virus and the magnitude of the economic impact on global demand for our products. We expect the impacts of the pandemic on our results to be more significant in the second quarter and to linger until global economic conditions improve. Due to the uncertainty associated with COVID-19 and its effects, we withdrew our financial outlook for 2020 on March 26 and are not providing one today.

At our Investor Day in May 2019, we discussed our strategy based on services, expanded offerings and operational excellence. We highlighted our focus on operational excellence and our goal to be profitable and operate more efficiently through the cycles as we leveraged our foundational strengths, our competitive and flexible cost structure, lean processes, the safety first culture, and quality, including product reliability and durability. We described our success delivering the targets we had set out during our 2017 Investor Day, and we laid out new targets based on the improvements we've made in structural costs that I described earlier.

One was to improve annual adjusted operating margin by 300 to 600 basis points versus 2010 and 2016 when margins ranged from 7% to 15%. The second was to increase annual ME&T free cash flow by $1 billion to $2 billion above our actual 2010 through 2016 performance to a range of $4 billion to $8 billion per year. However, the impact of COVID-19 on our business has been significantly more severe and chaotic than any cyclical downturn we had envisioned. Governments have closed suppliers with little or no notice, impacting Caterpillar's operational efficiency. Importantly, while we have taken actions to reduce costs, we have made a conscious decision to continue to invest in enablers of services growth and expanded offerings, key elements of our strategy for long-term profitable growth.

As a result, in 2020, depending upon how the pandemic unfolds, while we expect our margins and free cash flows to be better than our historical performance of 2010 to 2016, it will be challenging for us to achieve the margin and cash flow targets communicated during our 2019 Investor Day. Our goal is to emerge from this crisis as an even stronger company, better positioned for long-term profitable growth.

Now let me turn the call over to Andrew for a recap of our first quarter results, short-term actions we've taken and the strength of our balance sheet.

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

Thank you, Jim, and good morning, everyone. I'll begin on Slide 7 with our first quarter results. Then I'll discuss some of the actions we're taking in response to the COVID-19 pandemic before turning to our cash and liquidity position. In total, sales and revenue for the first quarter declined by 21% to $10.6 billion. Operating profit decreased by 36% to $1.4 billion. Profit per share for the quarter decreased by 39% to $1.98. The decline was driven by lower volume as the cost reductions taken to mitigate the pandemic were offset by the impacts of a higher tax rate and negative currency movements. This year's quarter included a $0.38 per share remeasurement gain that resulted from the settlement of an international pension obligation. Last year's quarter included the $0.31 benefit from a discrete tax item.

As you see on Slide 8, the results this quarter were primarily driven by volume. Currency and price had a small impact from volume decreased sales by $2.6 billion. The volume decline reflected weaknesses in end-user demand, coupled with changes in dealer inventories. Geographically, sales declines were led by North America and Asia Pacific. Machine sales to users, including construction industries and resource industries, decreased by 17% for the quarter while energy and transportation sales to users decreased by 12%. You may recall that we expected a decline of 4% to 9% for the year with a stronger second half. Nevertheless, first quarter sales to users were below our expectations.

Demand in Asia Pacific was weaker than we expected, including a direct impact from COVID-19 on sales to users in China. In January, we indicated that we expected a small seasonal build of dealer inventory in the first quarter. Dealers increased the inventories by about $100 million this quarter compared with an increase of -- in dealer inventories of $1.3 billion in the first quarter of 2019. This resulted in a $1.2 billion swing in revenues, which was nearly half of our sales decline. Also, it is important to note that we reduced shipments to dealers in the quarter because of the lower sales for users.

Order backlog increased by about $400 million since year-end, again, following our normal seasonal pattern. Compared with the year ago, backlog was down by $2.8 billion. As I've said before, I view our retail sales data as a better indicator of demand of the backlog. And whilst there is a lag in sales to users, I believe that data better represents underlying customer demand for machines and engines.

Moving to Slide 9. Operating profit for the first quarter fell by 36% to $1.4 billion. Volume declines were the main driver of the $803 million decrease in operating profit. Operating margins fell by 320 basis points. Favorable short-term incentive compensation expense and lower manufacturing costs only partially offset the impact of the lower volume. For comparison, incentive compensation expense in last year's first quarter was $220 million.

Now I'll discuss the individual segments' results for the first quarter, starting on Slide 10. First quarter sales of Energy & Transportation declined by 17% to $4.3 billion, driven by a 24% decline in oil and gas sales. Demand for reciprocating engines in North America slowed significantly as oil prices fell. Within oil and gas, solar sales remained steady with the prior year's first quarter. Power generation sales weakened as well, primarily in Asia Pacific and North America. Industrial and transportation sales both decreased. Profit for the segment decreased by 28%, driven by lower volume, partially offset by the lower short-term incentive compensation expense. The segment's operating margin declined by 320 basis points to 13.8%.

As shown on Slide 11, Resource Industries sales decreased by 24% in the first quarter to $2.1 billion. Changes in dealer inventories and lower end-user demand drove the first quarter sales decline. Dealer inventories decreased in the first quarter of this year after increasing in the same period of 2019. We experienced lower end-user demand across most of the industries we serve. Specific to mining, sales were lower as miners remain disciplined in their CapEx deployment amid commodity volatility. However, fleet age is the highest since we began tracking it and utilization rates remain high. While we expect that this current uncertainty may delay fleet replacements, we remain positive on mining prospects in the medium and long term. In addition, we saw declines in heavy construction and quarry in aggregates, particularly in North America.

During the first quarter, Newmont's Boddington became the first gold mine to move completely to autonomous hauling. We expect to begin shipping Newmont the first of its Caterpillar 793F autonomous trucks next year. Currently, Caterpillar has 282 trucks running autonomously using Cat Command for hauling. Recall that Resource Industries' profit margin in the first quarter of 2019 was very high, as you saw the benefits from double-digit volume growth and favorable price realization. Lower volume was the primary driver of the 47% profit decrease. That resulted in a 630 basis point decrease in the segment's profit margin, which finished at 14.6%.

Now turning to Slide 12. For Construction Industries, sales decreased by 27% to $4.3 billion. The lower volume was driven by lower end-user demand and a change in dealer inventory movements. Sales to users declined by 18% compared with the prior year, including a 28% decrease in Asia Pacific, driven by China. Although dealers increased inventories during the quarter, the increase was much lower than in the prior period. This had a particularly notable impact on sales in North America. The segment's first quarter profit decreased by 41% due to the volume decrease and negative mix. Lower short-term incentive compensation expense and favorable material and period costs provided a slight offset. The margin declined by 360 basis points to 14.9%.

Moving to Slide 13. Financial Products revenue decreased by 4% to $814 million on lower average earning assets. Profitability decreased by 50% in the first quarter to $105 million, led by the mark-to-market impact on equity securities in the Insurance Services portfolio. Cat Financial has taken important steps to support our dealers and customers during this challenging time.

As shown on Slide 14, we launched customer care programs in all regions, allowing customers to apply for payment relief through a simplified and streamlined process. It's an approach we've learned from helping customers after natural disasters. Typically, we provide principal and interest deferral for 90 days. Interest continues to accrue, and the deferred payments added to the end of the loan. When we took similar actions in 2009, there was a noticeable boost in customer loyalty.

Past dues did increase in the quarter to 4.13%, and we increased our loan loss reserve moderately this quarter due to elevated risk associated with COVID-19. However, there are 2 points to keep in mind. First, most of our customers went into the downturn financially healthy and current on their loans. I'll provide you with a comparison. Past dues in both North America and China at the end of 2019 were 1.3%, whereas at the start of the financial crisis, past dues in those regions were 4.3% and 8.5%, respectively. Second, our loans are secured by our machines. These are working assets and are critical to our customers' businesses, which means they normally prioritize payments to Cat Financial.

From a funding perspective, the strong action from central banks around the world means we are maintaining a broad and diverse mix of global liquidity sources, including access to global commercial paper and debt financing.

On a positive note, our new business volume rose 17% quarter-over-quarter in North America and was flat across all regions as we continue to provide financial solutions to qualify customers around the globe.

Turning to cash flow. ME&T free cash flow the quarter, while slightly positive, was lower than last year. Lower profits as well as higher Caterpillar inventory levels, which increased from the year-end, were partly offset by benefits from lower short-term incentive compensation payouts. The first quarter is typically our weakest of the year from a cash flow perspective due to the payout of annual short-term incentive. We paid out approximately $700 million in short-term incentive compensation in this quarter, about half of the amount paid in 2019. Caterpillar inventory levels rose, as reported in production stores, in anticipation of higher production levels for the quarter. We will now work these down.

Now turning to Slide 15. As Jim mentioned, the pandemic and its impacts were unprecedented in their speed, depth and level of complexity. Here's more color on some of the actions we have taken thus far. From a demand perspective, we've executed business continuity plans and work to optimize availability in areas where demand remains relatively strong, such as for parts. We are managing our production by segment to ensure we do not overproduce whilst we take care of our dealers and customer needs. We're adjusting our workforce by facility and by segment. From a stewardship perspective, we have completed a scenario analysis aiming to ensure that we're prepared for different potential lengths and depths of this pandemic. We've also taken steps to strengthen our cash position, and I'll describe more about those in a moment, whilst reducing capital expenditures and delaying R&D projects with less visible returns. From a cost control perspective, we reduced discretionary expenses, including consulting, travel and entertainment.

Given the COVID-19 environment, we suspended 2020 base salary increases and short-term incentive compensation plans for many employees and all our senior executives. We'll continue to look for ways to make our cost structure more flexible and competitive.

Turning to our suppliers. We keep a close eye on their financial health as well. In the event that a supplier faces financial distress, we identify solutions to support them whilst also ensuring supply for Caterpillar's products. In particular, our suppliers have access to working capital support through a partnership with one of our third-party banks. This can provide quick access to cash flow to help them cover their payment commitments, all of no risk to Caterpillar.

Separately, as we stated last quarter, in addition to our normal restructuring programs, we continue to address our challenged products, those that don't meet our goals for OPACC. We recently began a contemplation process that could potentially result in the closing of 2 mining facilities in Germany. We have also taken an impairment charge against one of the other challenged products. By addressing these challenged products, we can move forward with a slightly smaller portfolio and deliver a higher level of performance, including better margins and better cash flows. Meanwhile, we continue to drive ongoing cost reduction efforts, including preparing for the outsourcing of certain back-office functions and launching a program to reduce our procurements costs, although as we said in January, these benefits will be more impactful in 2021.

Let's turn to Slide 16. And while we aren't providing profit per share guidance, I will talk about a few key thoughts for 2020. We remain focused on working with dealers to optimize their inventory levels. Our expectation that the decline in dealer inventory by the year-end will be at the higher end of our prior range, which was $1.10 to $1.5 billion. We now anticipate a higher tax rate in 2020 as well due to changes in the expected geographic mix of profits and the impact of certain U.S. tax provisions on non-U.S. income. As you model the second quarter, please remember that deal inventory grew by $500 million in the second quarter last year, setting up a different comparison in the short term. Also, as Jim said, the impact of the virus will be greater in the second quarter. All in all, the situation remains very fluid. Until it becomes clearer, we do not anticipate being able to provide guidance as per our normal practice.

Turning to Slide 17. I'll touch on our capital allocation and our cash and liquidity position. We recently declared our normal quarterly dividend. Due to uncertainties associated with COVID-19, we temporarily suspended our share repurchase program in mid-April upon completion of the 10b5-1 program that we established in January. We said at our Investor Day in May 2019 that we will return substantially all our free cash flow to shareholders through dividends and more consistent share repurchases. In the first quarter, we returned $1.6 billion to shareholders through dividends and share repurchases.

We ended the first quarter with a strong financial profile, including $7.1 billion in enterprise cash. Given the environment, we have had an incremental $3.9 billion short-term credit facility in addition to our existing $10.5 billion revolving credit facility. Both of these liquidity resources remain undrawn. In addition, we've registered for $4.1 billion in commercial paper support programs now available in the United States and Canada, which could provide supplemental liquidity should the need arise.

After the quarter end, we leveraged our strong balance sheet to raise $2 billion of incremental cash by issuing bonds at very attractive rates. Specifically, we issued $800 million in 10-year notes at 2.6% and $1.2 billion in 30-year bonds at 3.25%, the same coupon as our 2019 debt issuance. We currently have $11.2 billion in long-term debt with no maturities until 2021. Also, we're not required to make contributions to the U.S. pension plans for the foreseeable future. Following meetings with the credit rating agencies earlier this month, we retained our strong credit ratings. All of this gives us confidence in our ability to weather the storm and emerge from it an even stronger company.

So finally, let's turn to Slide 18 and recap today's key points. We have a strong financial position and are confident in our ability to continue serving our global customers during this difficult time. Our enterprise cash on hand is $7.1 billion, and we have a total of $20.5 billion in available liquidity. We remain committed to returning substantially all our free cash flow through dividends and share repurchases through the cycle, including $1.6 billion returned in the first quarter. We're actively monitoring customer demand and working closely with dealers on their inventory needs. Our factories remain agile, leveraging lean principles. We continue to manage our operations to respond to positive or negative changes in demand. Our strategy is unchanged, focusing on operational excellence, services and expanded offerings. We are energized by our role as a company to support some of the critical infrastructure, enabling the transportation of essentials, such as food and medicine, and satisfying global needs for energy. And once again, we thank our employees for how well they've been navigating this global pandemic and serving our customers.

With that, I'll hand it over to the operator to start the Q&A session.

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

Jagner?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Rob Wertheimer from Melius Research.

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

I think some of us have already started this sort of trend towards the low end or below some of your 2019 margin targets, just given the uncertainty with the virus. But I'd be curious to hear what, among the various uncertainties, may have kick you off that trend, whether it's aftermarket falling further you thought or mining doing something.

And then just I wanted to see if you'd talk about the trade-offs you're choosing to make. Some companies have done salary cuts, temporary or otherwise. You're choosing to continue to focus on investment and growth. And I'd like to hear the positive trade-offs you expect to see from that and whether you might return to cutting more in you need to.

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

Rob, thanks for your question. In first -- the first part of your question about margin targets really comes down to the chaotic nature of this downturn. It was not a normal cyclical downturn. So it really wasn't so much a downturn in one area of our business versus another. It's just the way it happened. So government shut down suppliers with little or no notice, which had an impact on our operational efficiency. Now we're continuing to serve our customers and work our way through it by redirecting things, but it really has created havoc with our manufacturing operations that we've overcome, but it's not, again, a normal cyclical downturn. And as we've looked at the various levers we could pull, we're striking a balance that we think is appropriate between short-term performance and investment for the long term. We have taken a number of actions to reduce discretionary costs.

And one of the things I will remind you of, as I mentioned in my remarks, is we really have managed the business differently during the last 3, 3.5 years. We kept our period costs flat and our sovereign management headcount flat between the end of 2016 and at the end of 2019 even though our sales went up 40%. And we talked a lot in our Investor Day presentations about the fact that we're driving to produce higher absolute margins and higher absolute cash flow at all points in the cycle compared to that historical performance between 2010 and 2016, and we still intend to do that. Just -- but, again, given the chaotic nature of this downturn, what's happening with suppliers, we're saying that it will be challenging for us to achieve those new targets that we established in May of 2019. But we do expect absolute margins and cash flow to be higher. And I believe our strategy will serve us well during these times. Cash is obviously king in this environment. And the fact that we will not incur large amounts of severance costs with large restructuring, I think, will serve us well. So the fact that we maintain costs and headcount between end of '16 and '19, I think, again, positions us very well.

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

And for clarity, does that supply chain disruption seem to have reached a temporary maximum? Or is it still rising or ongoing?

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

Yes. We're working our way through it. I mean, obviously, the situation -- it's geographic. The situation in China has obviously improved as the pandemic has lessened in that country. And so all of our facilities are operating in China again, and our suppliers are doing much better in China as well. But it's a rolling kind of situation. So depending on how the pandemic unfolds across the world. But again, we are finding ways to continue to serve our customers, continue to ship products and parts. Our dealers are supporting their customers, but it is making it more challenging, and it's having an impact on our operational efficiency, as you would expect.

Operator

(Operator Instructions) Your next question comes from Mig Dobre from Robert Baird.

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

Yes. Just to maybe follow up on Rob's question there. As you look at the second quarter, you've provided some color and detail there, but maybe you can put the second quarter within the context of the full year, is it fair to assume that this is maybe the most challenging quarter from a production standpoint? Or do you sort of foresee these effects lingering beyond the second quarter, given the changes in backlog and what you're seeing in terms of demand?

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

From a financial performance perspective, we certainly expect the second quarter to be weaker than the first quarter. And as we said, we believe that the impact -- the financial impact on Caterpillar will linger as long as the pandemic continues, until those effects wear off. In terms of trying to quantify or give you a description of Q2, 3, 4 in terms of our operations, it really is a fluid situation. So it's very difficult for me to make that judgment. But again, we're finding ways to work our way through it.

Operator

Your next question comes 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 guess my question centers around dealer inventory. You cited that the declines will be at the higher end of the range that you provided last quarter. But I guess, why not more significant? And is the goal still to be able to produce in line with retail as you exit 2020. So that goal, I guess, could we see bigger declines in that? Or maybe you could just comment on what you saw in April to support what we're saying about the dealer inventory decline.

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

Yes. Thanks, Jamie. It's Andrew. So yes, obviously, what we're pointing to is we had the range at the -- in January of $1 billion to $1.5 billion. Based on what we see from a demand perspective, obviously, we expect that to be at the higher end of that range. Always remember when dealers are looking out, they're making their plans based on what they're seeing going forward. So it depends what happens in 2021 and what their viewpoint is of 2021, which is far too early, as Jim just said, for us to have any view even beyond the end of this quarter. That will determine their final numbers.

So yes, it may be more flexible. And obviously, depending on what the outlook is, that may determine whether they would like to go lower. But we're just pointing out, we would expect that, at the minimum, it would be at the higher end of that range.

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

And sorry, can you comment on trends you saw in April if you're able to?

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

I mean, it's really too early to say. I mean, obviously, we are still in April. We don't have April results yet. With remote working, it's hard to get data. But obviously, we are expecting that April will be a challenging month, and just purely given the lockdown impact and the impact on particularly things like oil and gas. Remember, we are in a situation where, if we're reciprocating engines, oil and gas prices have been negative in the month.

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

Okay. I hope everyone stay healthy.

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

Same to you, Jamie. Thank you.

Operator

Your next question comes from Ann Duignan from JPMorgan.

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

Maybe on the oil and gas, can you talk about your expectations for permanently impaired impairments in that business? And talk about the impact of oil and gas across your various businesses, we'll say oil sands in resource and construction equipment in the construction segment. If you could just give us what you're contemplating in terms of the longer-term outlook in those businesses and how weaker oil and gas may impact you more permanently.

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

Yes, I'll Start with maybe the short-term impact, then I'll talk about some of the longer term. On the short term, obviously, that we'll have a -- that the oil and gas decline, particularly in WTI, will have an impact on our reciprocating engine businesses for North America, things like well servicing, drilling, gas compression. And so we went into the year expecting that our 2020 recip oil and gas sales would be lower. And now, obviously, we're expecting they will be even lower than that. So our solar gas turbine business, midstream is holding up well. If you stop and think about the last downturn we hit in oil and gas, the solar turbines compression business continued to hang in there. And of course, a large part of solar's sales are services related. And the turbines continue to run even during low oil prices. So that provides a cushion there. I don't anticipate a permanent impairment in our business. The old -- I believe this is my fifth, I think, oil cycle in my 40-year career. And when things are really, really good, people think it will never get worse again. And when things are really bad, they think it will never get better again. I do believe that the market will recover at some point. It might take a while, but I don't perceive there'll be any kind of permanent impairment on our business.

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

Not even in non-oil and gas like oil sands?

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

Yes. So there certainly could be an impact in terms of a short-term impact on our business. But again, I don't see anything major that is significant, that will be a permanent impairment on our business. And you asked about construction as well. So we do sell a certain amount of construction equipment in North America that's related to oil and gas. So obviously, that business will be slow as well.

Operator

Your next question comes from David Raso from Evercore.

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

Related to your comment, chaotic nature, the decremental margins, the first quarter at 29% were a little better than I would have thought. I assume the second quarter with the shutdowns would be more challenging, but can you help us a little bit how to think about the decrementals versus what you saw in the first quarter? And related to that cat nature question related to the margins, what are local and national governments telling you about the reopening? How are you planning for those reopenings, things that we should be thoughtful about on your ability to ramp up a bit as things open?

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

Maybe I'll take your second part of your question first. So the closures we've had are temporary, and they're due to a combination of supply chain constraints, weak customer demand and government mandates. So many of the facilities that were closed have reopened. We're probably going to close some that are open now. Again, we look at customer demand, and we look at supply chain constraints. Even in the non-pandemic situation, we sometimes have facility closures just to align production with customer demand. So we're -- this is not new for us. We understand how to bring facilities up. So I really don't see a big issue there.

And so we've been able to work with local governments and implemented the guidelines that they have provided to us and also best practices by authorities around the world. In terms of social distancing, we've done things like stagger shifts. We've extended lunch hours. We were taking temperatures. We're doing a whole variety of things that are -- that have been recommended as best practices. So we're continuing to implement those as they come out.

And as I mentioned earlier, we're really focused on achieving higher margins at each point in the cycle compared to what we did between 2010 and 2016. And so rather than think about it from an incremental and decremental perspective, what we laid out at our 2 investor days in 2017 and 2019 was our ability to achieve higher absolute margins and absolute cash flows at each point in the cycle. And as I mentioned earlier, I believe that will serve us well in a period where cash is king.

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

Yes. And David, it's Andrew, just to add to that, obviously, the volume decline in the first quarter was somewhere around about 20%. Obviously, anything average is still the biggest factor in what your incrementals and decrementals will be if you think about in net terms because leverage is the single biggest factor. Also just remind you that, obviously, in the first quarter last year, the actual amount of short-term incentive competition was slightly higher than the average for the remainder of the year. So that will be slightly on margins going forward because we obviously won't have as much to offset against that as we go through the remaining quarters of the year. So it will vary a little bit.

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

So to clarify what you're saying, a little bit related to last May's analyst meeting, whatever we think the revenues will be this year versus history, similar revenues, you would expect the margins to be higher, be it 2016 when equipment sales were $36 billion or 2017 when they were $42 billion, $43 billion. What you're saying is you expect your margins to be higher at the same revenues this year versus then? Is that...

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

That is correct. That is correct. That's what I said.

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

All right. I appreciate it.

Operator

Your next question comes from Adam Uhlman from Cleveland Research.

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

I hope you're all staying healthy. I had a question about the service sales. Could you expand your thoughts on what you're seeing there, how the revenues are holding up? And with the growth efforts that you have in place, do you think you could keep the sales declines there in something like a mid-single-digit range? Or does it get dragged down a bunch like the new equipment sales?

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

Adam, it's Andrew. Actually, the services sales in the first quarter were down marginally. Part of that was due to inventory movements year-on-year. Last year, we saw a small build in services and parts revenues in channels and, obviously, a slight decreased down. Obviously, we anticipate that services revenues will hold up better than original equipment revenues as we go through the cycle. Obviously, if you look at the history, that has always been the way. At this stage, it's too early to predict what percentage they will change by. But obviously -- and it's going to depend on customer-by-customer, where they're open, are they able to use -- what machine utilization rates are and so forth. So we need to see how all that pans out and get a few more date points before we start making predictions in that regard.

Operator

And your next question comes from Steven Fisher from UBS.

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

Just wanted to ask you about pricing because it seemed to be a little bit more resilient than I would have expected really across the board, but particularly in E&T. So maybe can you just give us a sense of where that strength came from in E&T and how sustainable you think it is? And then maybe just some other comments about competitive dynamics in the other various segments.

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

Yes. Steven, it's Andrew. So obviously, overall, if you look at pricing, it was negative in the quarter. Most of that was mostly in construction industries. And that was really geo mix rather than actually pricing per se, although we did see some competitive pricing pressure in China. Just, again, to remind you, geo mix does come through, which does distort the pricing mix. So obviously, if you do see favorable sales in different regions, that does have an impact on the mix. So we don't go down into that level of granularity by discussing by segment. But generally, it has been -- it has held up. We did put price increases through on the first of January, but the geo mix was what we were expecting, competitive position in Asia Pacific hasn't changed.

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

But in E&T, it was actually up. So I was just curious. I mean that seems a bit surprising.

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

Yes, well, that's related to the pricing. Yes, that is the price increase across -- that was put through in the first of January.

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

And also in E&T, things have been kind of lumpy as well. So all our results.

Operator

Your next question comes from Ross Gilardi from Bank of America.

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

I just -- I had a question on capital allocation. In the presentation, you say that you're going to return all of your cash, but yet you're suspending the buyback program for now. Does that mean that free cash flow is unlikely to exceed the $2.3 billion that gets paid out in the dividend this year?

And then the follow-up question to that is, are you still committed to raising the dividend by a high single-digit percentage for the next 4 years, given this unforeseeable situation that you couldn't have predicted when you made that commitment?

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

Yes. So I think I'll answer the dividend question first, and I'll pitch it back to Andrew. So obviously, the dividend is a priority for us. You saw that we raised our dividend already this year even in this situation. We are not making a prediction as to what we'll do with the dividend for the rest of the year. Obviously, it's a priority, and we feel comfortable in our ability to support the dividend. But in terms of future increases, we'll keep you posted. It's obviously a Board decision, and we'll make a recommendation to the Board later in the year, and we'll keep you posted.

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

Ross, and as far as free cash flow, so if you look in the first quarter, we actually paid out $1.6 billion if you take the buyback into account plus the dividend. If you then extrapolate that across the remaining 3 quarters of dividends, that implies free cash flow of around about $3.5 billion for the full year or $3.5 billion of distribution to shareholders for the remainder of the year.

Question at the moment is while we're uncertain as to what free cash flow will be, we've decided to put a pause on the buybacks because, obviously, we're not yet certain whether we are in a position where we are distributing substantially or maybe even slightly more than our free cash flow for the year. So that's the uncertainty which causes us to put suspension. As things become clearer, we'll make decisions. Yes, we are in a strong financial position. As I said, we had $7.1 billion of cash on the balance sheet at the end of the first quarter. And if you remember last year, we actually distributed slightly more than our free cash flow for the year.

Operator

(Operator Instructions) Your next question comes from Jerry Revich from Goldman Sachs.

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

Yes. Andrew, I'm wondering if you could expand on your prepared comments on the restructuring program. Presumably the range of restructuring spending is wider than what we were contemplating a quarter ago. Can you just expand what the range of investment could be this year? And what kind of payback periods are we targeting? And for the discontinued product lines, what are the plans to replace those product lines to provide continuity for your dealers?

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

Yes. So first of all, our expectation at the beginning of the year was that we would have somewhere in the region of $100 million to $200 million of normal restructuring expense. And we've put a placeholder in place for the $200 million of restructuring for the challenged products. At this stage,, we don't see that it's going beyond that at this stage, but that's -- obviously, we'll update you and keep you posted as time goes on. Obviously, again, the timing of that -- timing of these issues -- timing for these actions is a significant factor on the charge for the year. So for example, as we said in my remarks, we started the contemplation process in Germany. That may take a while, and that will determine how much we charge in the financial year relating to those challenged products. Similarly, the impairment was taken along the lines of actually the asset. We do view the asset as being impaired in value. And so the action -- we took that action in Q1. So we'll keep you posted, obviously, and make sure. If we do believe it's outside that range, we'll update. At this stage, we're still within the original range we talked about in January.

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

And maybe just to add additional comment about costs. I mean, we continually ask our managers to focus on costs, to find ways to be more efficient. And obviously, during this environment, we've amped that up. So whether or not it falls into a restructuring bucket regardless, we are really focusing on finding ways to be more efficient and reduce costs.

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

And the dealer product line part of the question?

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

I'm sorry?

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

What are the plans to replace the product lines, I think he said, of any exited businesses?

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

Well, the point is, actually, we haven't made decisions to exit any of those businesses at this stage. So that's why, as far as dealers are concerned, obviously, it's not an issue for them at this stage.

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

And there are ways to restructure without exiting. So I'll just leave it there.

Operator

And your next question comes from Courtney Yakavonis from Morgan Stanley.

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

I just wanted to follow up, Jim, with some of your comments on the positive or medium long-term positive outlook for mining. But you're seeing some uncertainty in the near-term and more restrictive CapEx from some of the miners. So can you just comment on that? And then I think you did see dealer inventories decline in resources this quarter. So if you can just help us understand how big of an impact that is, and how big the overhang in resources, the pressure on the heavy construction and quarrying aggregate side.

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

Yes. Sorry, Courtney, it's Andrew. On the dealer inventory side, actually, the dealer inventory reductions quarter-on-quarter were the most significant impact on RI sales. It was a small majority of it. We don't disclose a specific number, but it was over half of the decline in revenues for the quarter.

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

And maybe just a comment on mining. I mean, it wouldn't be surprising if the pandemic were to have an impact on our mining business short term. However, based on the state of the industry, the replacement cycle, we still feel positive about mining in the medium and long term.

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

Okay. And then just can you give us any more color on just the geographic discrepancies you're seeing between North America and Europe? I think some of your peers have talked about Europe being a little bit weaker because of some of the more -- or worse restrictions over there. But it seems like Europe has actually been holding up fairly well for you based on your retail sales data. So if you can just share on what you're seeing there in April -- or not in April, but just in general.

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

Yes. I think, Courtney, there are a couple of factors, one, which is -- obviously is dependent on how strong the comparative period was. And if you remember last year, Europe was not particularly strong in the first quarter of last year. So I think that is why, year-on-year, some of that data looks a little bit better in Europe. On the retail side, obviously, we are starting to see in the U.S., where we obviously had a very strong particularly non-residential construction cycle. That has started to diminish. That hadn't -- we hadn't seen the strength in nonresidential construction in Europe, which is another factor.

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

This is Jim. I just want to make a statement. I've been informed that I mistakenly used the word, raised, when I talked about the dividend earlier this year. We did not raise the dividend. We maintained the dividend. So my apologies for that mistake.

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

And we now have time for one more question before we go to Jim's wrap-up.

Operator

Your final question is from Joe O'Dea from Vertical Research.

Joseph John O'Dea - *Vertical Research Partners, LLC - Partner*

Can you just comment on financial services with past dues up about 100 bps sequentially? And allowance is up 20 bps, and your comfort level overall with where that allowance figure stands. And I think, most importantly, your thoughts on the direction of provisions over the next quarter or 2, whether it's more likely that those provisions are moving up before they start to move down.

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

Joe, it's Andrew. And obviously, I mentioned kind of this a little bit in my remarks. But the -- if you look at the 4.13% of past dues at the end of the quarter, significant drivers of that were the legacy Cat Power Financial portfolio, and then also some hot spots around Middle East and Latin America, both of which were issues which we were dealing with historically and have been factors where actually the reserve has been quite significant in the past. So those are ongoing issues which we're dealing with.

As I mentioned in my remarks, actually, our customers came into the crisis in a very healthy position. So past dues in North America at the end of last year were 1.3%. At the time of the financial crisis, they were 4.3%. So that gives you an indication of the health of our customer base. And in China, they were 1.3% versus 8.3% in the financial crisis. So again, that is a very different scenario. We did modestly increase the reserves in the quarter. Obviously, the difference is, obviously, we now have the CECL process that we are required to reserve against. The reason why our loan reserves will be lower than you would see in many other financial institutions is because of the security we have over the loan, which is the loan is secured on the machine itself. And that reduces your risk from a write-off perspective. So that is -- again, gives us comfort. But whilst, yes, we do expect we inevitably will see some write-offs as we go through the remainder of the year, we do think that will be a lot lower than it would have been historically.

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

And I'll turn it back to Jim for closing remarks.

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

All right. Well, thank you, everyone, for your questions.

Just to wrap up here, Caterpillar has been in operation for 95 years, and we faced it, overcome many challenges. We have a very strong financial position, which we described to you this morning. We're continuing to pursue our strategy focused on services, expanded offerings and operational excellence.

Once again, I'd like to thank my Caterpillar colleagues around the world for staying focused on their safety and for working with our dealers to deliver products and services that enable our customers to fight the good fight against COVID-19. Our goal is to emerge from the pandemic even stronger than before, better positioned for long-term profitable growth. Thank you again. And with that, I'll turn it back to Jennifer for some closing reminders.

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

Thanks, Jim, and Andrew and everyone who joined us today. If you miss any portion of the call, you can catch it by replay online later this morning. We will post a transcript on the Investor Relations website within 1 business day. If you have any questions, please reach out to Rob or me. You can reach Rob at rengel_rob@cat.com. I'm driscoll_jennifer@cat.com. The Investor Relations general phone number is (309) 675-4549.

And now let me ask Jacqueline to conclude our call.

Operator

Thank you. Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.
