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CAT - Q1 2018 Caterpillar Inc Earnings Call

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OVERVIEW:

Co. reported 1Q18 sales and revenues of $12.9b and profit per share of $2.74. Expects 2018 profit per share to be $9.75-10.75 and adjusted profit per share to be $10.25-11.25.

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PRESENTATION

Operator

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

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

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

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

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

This morning, we will be discussing forward-looking information that involves risks, uncertainties and assumptions that could cause our actual results to differ materially from our forward-looking information. A discussion of factors that either individually or in the aggregate could make actual results differ materially from our projections can be found in our discussion of cautionary statements and significant risks to the company's business in Item 1A. Risk Factors in the 2017 Form 10-K filed with the SEC and also in our forward-looking statements included in today's financial release. A reconciliation of non-GAAP measures can be found in this morning's release and is also posted in caterpillar.com/earnings.

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

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

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

Thank you, Amy. Good morning, everyone. First, I'd like to thank our global Caterpillar team for outstanding first quarter results. I'm very proud of how our team capitalized on improving market conditions to deliver a 31% increase in sales and revenues compared to the first quarter of 2017. Our team also achieved the highest first quarter profit in Caterpillar's 93-year history.

We saw strength across many of our end markets in the first quarter, including higher demand for construction and mining equipment and for onshore North American oil and gas applications. We had a great start to the year, but higher sales volume wasn't the only contributor to these record first quarter results.

Operational excellence, which includes safety, quality, lean principles and our commitment to control structural costs, is one of the 3 key components of our enterprise strategy. Our team kept manufacturing cost about flat in the first quarter of 2018 despite a 31% increase in sales volume over 2017, which represents excellent performance by our team.

At Investor Day last September, we shared our target operating margin ranges for the company and for each business segment at reasonable sales levels that we have achieved in the recent past. These target ranges represented significant improvement compared to those achieved the last time we experienced similar sales volumes.

While operating margins are expected to fluctuate quarter-to-quarter, we are pleased that in the first quarter of 2018 Construction Industries and Resource Industries exceeded the targeted ranges communicated during Investor Day. Energy & Transportation's operating margin in the first quarter was squarely within its targeted range as was the total Caterpillar enterprise.

During the quarter, we made strategic investments in expanded offerings and services, the other 2 key components of our strategy. As we focus on delivering long-term, profitable growth and serving our customers, we will continue to make targeted investments through the remainder of the year.

Even with these additional targeted investments, we're raising our full year outlook by $2 per share, along with strong first quarter results, economic indicators generally remain positive and our backlog has grown.

Before I turn it over to Brad, I'd like to say a few words about our refreshed cash deployment priorities. As you'll see in the slide presentation, we've made some changes in support of our enterprise strategy, but some things, like our commitment to maintain the dividend and a strong balance sheet, haven't changed. We will change how we approach funding growth and share repurchases. Our growth initiatives will be primarily in the strategic priorities of expanded offerings and services, not in factory capacity. In the first quarter, we also repurchased $500 million of common stock. Moving forward, we intend to be in the market on a fairly consistent basis to offset the impact of share dilution over time.

We're off to a great start in 2018, but we also have lots of work to do. I'm confident our team will continue to execute our strategy as we move throughout the year.

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

Bradley M. Halverson - *Caterpillar Inc. - CFO & Group President of Finance, Human, Global Information Services Division & Corporate Auditing*

Thanks, Jim. What a great quarter. The strength in the global economy as well as favorable pricing for most commodities is benefiting many of our end markets. But what is even more exciting is that all of the hard work we have done over the last several years to restructure the business along with our continued cost discipline while investing for growth helped drive impressive margins, good cash flow and a strong balance sheet.

The strategy is delivering on what we intended, driving profitable growth. This morning, I'm going to walk you through the financial results for the quarter and our raised 2018 profit outlook, then I will take you through our cash deployment strategy that Jim mentioned.

If you'll turn to Slide 4, that's where we'll start. So let's start with the top line. Sales and revenues of $12.9 billion were up 31% from the first quarter of 2017. About half of the increase was in Construction Industries. And we continue to see strength in mining and North American onshore oil and gas for both new equipment and aftermarket parts. I will walk through more details on sales when we get to the segment slides.

Moving on to the bottom line. We delivered record first quarter profit per share of $2.74 versus $0.32 a year ago. Note that in 2017, profit per share reflected a large restructuring charge for the closure of our Gosselies, Belgium facility. Adjusted profit per share of $2.82 in the current quarter was more than double adjusted profit per share from last year on 31% higher sales and revenues.

We ended the quarter with $7.9 billion of cash on hand and repurchased $500 million of the company's common stock. As I said, a great quarter. Let's move on to Slide 5 and we'll review operating profit.

First quarter operating profit was $2.1 billion compared with operating profit of about $400 million in the first quarter of last year, an improvement of about $1.7 billion. Higher sales volume and the absence of the restructuring charge for Gosselies, combined with strong cost control as production volumes increase, explain the profit improvement.

The 3 primary segments saw strong sales growth. Construction Industries, up 38% with improvements across all 4 regions. Resource Industries, up 31%, reflective of a broad industry recovery. Energy & Transportation, up 26%, seeing growth across all applications. Both strong end-user demand and favorable changes to dealer inventories drove the sales volume growth. The favorable change to dealer inventories was primarily driven by Construction Industries as the factories work to get inventory to dealers in advance of the spring selling season.

As you may recall, this is normal activity for the first quarter, and we believe dealer inventories remain aligned with current demand levels. Price realization was favorable $186 million or 1.6%. Manufacturing costs were about flat in the quarter on a 31% sales and revenue growth. Lower warranty expense and a favorable impact from cost absorption were about offset by higher material and freight cost as well as higher short-term incentive compensation expense. The increase in material cost was driven largely by steel. We expect steel and other commodity cost to be a headwind all year.

However, at the end of the day, higher commodity cost benefit many of our customers, and they are one of the reasons we have seen several of our end markets begin to recover.

Financial Products was unfavorable $48 million, primarily due to an increase in the provision for credit losses at Cat Financial. Now let's move on to the segments starting with Construction Industries on Slide 6.

As I mentioned earlier, Construction Industries drove about half of the sales and revenues growth for the company this quarter. Construction Industries total sales were up 38% to $5.7 billion. Dealers preparing for the spring selling season resulted in favorable changes to dealer inventories. And we believe the increase is supported by current end-user demand. Months of sales continues to be low as it relates to inventories as you compare to historical levels.

And in China, as a result of very high demand, we believe dealer inventories are at levels that are leaner than what will be sustainable. Additionally, strong global growth drove improved end-user demand across all regions.

Order activity remained strong in the quarter, driving an increase in the backlog. If we look at each region, in North America, dealers prepared for what we expect to be a strong spring selling season, resulting in favorable changes to dealer inventory. In addition, end-user demand was higher on the strength in nonresidential, infrastructure and oil and gas construction activities, including the build-out of pipelines.

Asia Pacific saw strength across the region with sales up 46%. About half of the increase was due to higher end-user demand in China, which continues to be very robust with growth in building construction and infrastructure.

EAME sales benefit from favorable changes to dealer inventory, a stronger euro and higher end-user demand. Europe is experiencing high business confidence and robust growth, and the commodity-producing countries of Africa and the Middle East are experiencing some stabilization, which we believe is encouraging investment in infrastructure and building construction.

Latin America, while still at historically low levels, is starting to improve with sales up 38%. Stabilizing economic conditions and improving commodity prices are driving investment and construction activities.

Construction Industries segment profit of $1.1 billion was about $500 million more than last year and segment margins improved 4.2 points to 19.7%. Higher sales volume and favorable price realization contributed to the profit improvement. These were partially offset by higher cost for SG&A and R&D, material and freight. SG&A and R&D expenses were up due to higher short-term incentive compensation expense and targeted investments to grow the business. Let's move to Slide 7, and we'll go through Resource Industries.

Resource Industries sales of $2.3 billion increased 31% from the first quarter of last year. This was primarily due to higher end-user demand for new equipment across all regions. Strong commodity prices and improved market conditions have improved mining customers' profitability. As a result, miners are now investing in replacements for their fleet and initiating mine expansions, and this is driving improved demand for new equipment. In addition to strong demand for new equipment, demand for aftermarket parts increased as higher production levels resulted in higher machine utilization.

Segment profit more than doubled from last year to $378 million and segment margins improved from 9.1% to 16.4%, a significant improvement and above the Investor Day range of 12% to 16%. The improvement in profit was driven by higher sales volume, favorable price realization and favorable variable manufacturing cost, primarily driven by cost absorption. Resource Industries' disciplined cost structure enabled margin improvement. These were partially offset by higher short-term incentive compensation expense and a slightly unfavorable impact from currency.

Now let's move to Energy & Transportation on Slide 8. Energy & Transportation sales of $5.2 billion increased 26% from the first quarter of last year. Oil and gas, sales were up $400 million or 50%. Strength continues in North America specifically for onshore, unconventional oil and gas. While the Permian Basin is the area of highest activity, we are also seeing meaningful activity in other major basins. This continues to drive strong demand for both reciprocating engines and their associated aftermarket parts.

In addition, while demand for new equipment for onshore and offshore drilling remains weak, demand for transmissions, pressure pumps and high-pressure flow iron to support well servicing has improved. The delivery of turbines for midstream gas compression to support the build-out of North American natural gas infrastructure remains strong.

Sales into power generation were up 35% and improved in all regions. We are seeing demand increases after a multiyear downturn in sales. The largest increase was in the EAME region due to the timing of several large projects and favorable currency impacts.

Sales were up in North America from a low 2017 base due to higher sales from turbines and aftermarket parts sales for reciprocating engines. New engines and aftermarket sales for industrial applications increased 17%, largely due to improving global economic conditions with Latin America the only region that was not up. Sales in EAME were also positively impacted due to favorable currency impacts.

Transportation sales were up 13%, driven primarily by higher sales in Asia Pacific and North America for rail services. Australia is seeing good growth, including from a recent acquisition. And higher rail traffic in North America is driving demand for higher rail services. Marine was up largely due to the timing of deliveries. But the end market, especially for offshore vessels, continues to be challenged.

Segment profit for Energy & Transportation was $874 million, up about $300 million from the first quarter of last year. And segment margins improved from 13.2% to 16.7%, which is almost in the middle of the Investor Day range at lower volume levels. E&T's profit improvement was mostly due to higher sales volume and favorable price realization. These were partially offset by higher short-term incentive compensation expense and some increased spend for targeted investments. Now let's move on to the outlook on Slide 9.

With a great start to the year and with the improvements we are seeing in many of our end markets, we are raising the full year profit per share outlook to a range of $9.75 to $10.75 and the adjusted profit per share outlook to $10.25 to $11.25, an increase of $2 per share, more than a 20% raise. If you move to Slide 10, I'll walk through the key elements of the revised outlook.

The increase in the profit outlook is driven by better-than-expected sales volume. We expect strong economic conditions to continue and for commodity prices to remain at levels that support capital investments. This is driving an improved sales outlook across the 3 primary segments.

We remain focused on controlling structural costs. While we continue to invest in long-term growth initiatives to expand product and to grow services, our assumptions for these cost increases has not changed since our prior outlook. And we remain committed to a flexible and competitive cost structure and keeping structural cost under control.

We've recently received lots of questions from investors about potential impacts from higher commodity prices, especially steel. The revised outlook does reflect an assumption for higher material cost. However, we have also increased our estimate for price realization, partially due to a midyear price increase. We expect this upward revision to price realization to more than offset material cost increases.

Also, as I mentioned earlier, at the end of the day, we believe higher commodity prices drive improved market conditions for many of our end markets. Lastly, on the improved profit outlook, we now expect short-term incentive compensation expense to be about $1.4 billion, nearly the same as last year.

I want to take a second to discuss the implied rest of the year outlook. As you know, we do not give quarterly guidance. The first quarter was impressive with segment margins that were above our Investor Day targets for both Construction and Resource Industries. While we expect strong operating margins for the rest of the year, which is defined as within or better than the Investor Day ranges, we do not expect to repeat first quarter operating margin at the consolidated level. And let me explain what is driving some of this change.

There were several positives in the first quarter that we would not expect to continue for the full year. The price versus material cost delta was very favorable in the first quarter and better than we expected. We expect this delta of price versus material cost to be negative for the balance of the year. However, as I stated for the full year, we expect price to more than offset material cost.

Second, Cat inventory grew in the quarter to support higher production. Our expectation is that inventory levels will come down, which would result in unfavorable changes to cost absorption. And is often the case, the first quarter got off to a slow start for project spend. We expect the targeted investments for future growth to be higher over the remaining 3 quarters.

The outlook assumes that first quarter adjusted profit per share will be the high-water mark for the year. Now let's discuss the segment sales assumptions moving to Slide 11.

For Construction Industries, we expect sales up across all regions. Strong economic conditions, strength in the oil patch and funding for pipelines and state and local infrastructure investments should continue to drive robust demand in North America. Asia Pacific should remain robust with China leading the region. We now expect industry sales for the 10-ton and above excavator to be about up 30% versus last year. EAME is benefiting from strong business confidence and stability in oil prices. And while Latin America sales are still at historically low levels, economic conditions are improving.

For Resource Industries, favorable commodity prices and positive global economic factors has helped the financial health of our customers and improved business confidence. We expect improving profitability of our mining customers to drive higher capital expenditures for replacement and mine expansions. Strong global economic conditions should support higher sales of equipment for heavy construction and quarry and aggregate machines. Lastly, we expect production levels for our customer base to be maintained, supporting consistent aftermarket parts demand.

Energy & Transportation. In oil and gas, stable oil prices should continue to drive strong demand for well servicing and gas compression application and rebuild activity in North America. However, demand for onshore drilling and new offshore drilling and production are expected to remain at lower levels.

After a multiyear downturn, we are seeing signs of improvement in power generation, driven largely by improving economic conditions. Good economic growth should also benefit industrial engines, and we have increased our full year sales forecast primarily due to higher projected demand in EAME.

Lastly, improvements in North America rail traffic and our focus on growing services is expected to drive improved sales for transportation. However, marine and new locomotive remain challenged. Let's move to Slide 12 and discuss our cash deployment strategy.

While not a significant change from previously communicated priorities, there are some differences I want to review. The refreshed cash deployment methodology reflects the fact that our cash priorities will vary from time to time depending on circumstances and where we are in the cycle.

Having said that, we think about it in the following way. Our first priority is to maintain a healthy balance sheet in support of a mid-A credit rating. Next, we intend to deploy the cash necessary to run the business, described here as operational excellence and commitments. Finally, the use of discretionary cash is shown at the bottom of the chart.

We intend to fund profitable growth while still returning capital to shareholders. Caterpillar has paid higher dividends each of the past 24 years. Sustainable dividend growth remains a very high priority for us.

As you saw in the release, we also repurchased about $500 million of common stock in the first quarter. Our strategy for share repurchases is to be in the market more consistently with an intent to offset the impact of dilution over time.

In our prior cash deployment priorities, we often viewed profitable growth funding as investments in capacity. As we've said in Investor Day, we feel we have the necessary bricks and mortar capacity that we need and expect CapEx to be about $1 billion to $1.5 billion for the foreseeable future. Given our current capacity, we have refocused profitable growth funding to be in line with the new strategy. We intend to fund initiatives that drive long-term, profitable growth heavily focused in the areas of expanded offerings and services, including M&A where it makes sense.

Now let's turn to Slide 13 for a quick summary before we get to the Q&A. So in summary, sales and revenues were up 31%. We had a record first quarter profit per share and adjusted profit per share more than doubled from a year ago. It's a quarter that all of us are definitely proud of. The strategy is working. We are focused on structural cost control while investing for profitable growth, and we are delivering significant margin improvement.

The balance sheet is strong. Cash flow is good. And we bought back $500 million of common stock. And going forward, plan to offset dilution over time.

Lastly, improving global economic conditions and our continued focus on cost discipline enabled us to raise the 2018 outlook range by $2 per share. We are proud of the high quality financial performance in the quarter. The Caterpillar team has worked hard to reduce structural cost while investing in the business. And this quarter reflects the fruit of that tremendous effort. As we look forward, I believe the company is focused in the right areas to continue to drive future profitable growth.

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

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

All right. So Kate, I think we're ready for the question-and-answer portion of the call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today is coming from Jamie Cook.

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

Crédit Suisse. I guess 2 questions. One, some follow-up on your capital allocation priorities. I understand what you outlined. But given the lack of internal investment that you need for capacity and you said you'll repurchase shares to offset creep, but you know -- and I mean, it's still -- you're still going to have plenty of cash so I don't feel like that answers all the questions. So how do you think about a more meaningful share repurchase versus just offsetting creep? And can you talk about your view on M&A and how we should think about larger M&A over the cycle. And then my second question, given the performance that we've seen, in particular within the construction business and the resource businesses in the quarter and even last year to some degree, how do we think about the margin in those business longer term given that we're already exceeding the -- your longer-term targets that you put out in September?

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

Jamie, this is Jim. Just starting with the M&A question. So all of our business leaders continually evaluate opportunities for M&A, nothing new. So at any one time, there's dozens of things we're evaluating. And so again, we're ready to make acquisitions as they make sense for us. We've talked previously about the fact that we are very focused on expanded offerings and services. And that's where both our organic and our external investment will go. That's a big priority for us. In terms of the margin question. Certainly, we have experienced strong margins in the first quarter. Our goal is to grow the business. And we talked in Investor Day about the fact that we are focused on growing absolute OPACC dollars. That's our focus. And so again, we want to have a healthy operating margin range, but we really want to invest to grow. And that's what we're intending to do.

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

But just back, sorry, on the share repurchase. I mean, given the pullback in your stock, the numbers that you guys are putting up, which are much better than even the targets were that you talked about in September, how do you think about a more meaningful share repurchase?

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

We don't have anything to announce really at this time again. As we said, we'll be in the market on a consistent basis to offset dilution over time, but we don't have any announcement today about any kind of share repurchases.

Operator

Our next question today is coming from Courtney Yakavonis.

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

Morgan Stanley. Just wanted to get a quick update on your view of commodity inflation. I think you mentioned that those continue to be a headwind. And you did raise your expectations in this guidance, but can you just give us a sense of how much you were expecting. I think you had inflation already in your current guidance. And then second question, if you can just talk about your expectations for China. I think last time you had given us an expectation for about 8% growth. I'm just curious if you can give us an updated view there.

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

All right. Do you want me to start with the commodity question or would you like to, Jim?

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

Go ahead, Amy.

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

All right. So Courtney, you're correct. We started off the year expecting material cost to be higher. We started to see some material cost increases in the back half of 2017. For the industry, steel prices, I think, were up about 40% last year. I think they were up about 15% for the industry in the first quarter. We have not seen that type of cost increase flow through to our results, but we have seen material cost increases most notably for steel continue to increase. And as we said, we now expect material cost increases to be higher for the full year than we thought they would be in the fourth quarter outlook, and that is primarily driven by steel. There are a lot of factors that are driving those steel cost increases, but what we pointed out is that we continue to expect price realization to offset those material cost increases. And in fact, from the fourth quarter outlook to this outlook, we now expect the price realization increase was actually larger than the material cost increase so that gap grew a little bit, not a significant amount, but it did grow a little bit favorable versus what we had in the fourth quarter outlook.

And on China expectations, you're correct. We started the year expecting industry demand to be up about 8%. We tend to focus on the 10-ton and above excavator as we talk about specific numbers for industry demand. China continues to be stronger than we expect. We now expect the China 10-ton and above excavator demand to be up 30% this year. At that level, that's about 88,000 excavators for the industry. That's probably about 20% to 25% above where we think normal replacement demand and the macro environment in China support. But we do at this point continue to expect China to be very strong for the rest of the year. That said, we expect normal sales patterns in China. So we expect about 60% of end-user demand to come in the first half of the year and about 40% of end-user demand to be in the back half of the year.

Operator

Our next question today is coming from Ross Gilardi.

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

Bank of America Merrill Lynch. So I just want to ask you about this midyear price increase. Are competitors matching it? And how are you presenting it? I mean, is it a cost push price increase or is it just because demand is so strong right now and you end up in a situation where you feel pressure to lower price if your input costs go down?

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

Ross, there's a lot of factors that go into pricing. Certainly, key to them is our strategic initiatives and our focus on profitable growth. We began midyear price increases several months ago, discussions around what was appropriate in the market environment that we're seeing today. And the midyear price increase, which is primarily for Construction Industries products and some Resource Industries products that are largely used in heavy construction activity is where we took that midyear price increase.

Joseph E. Creed - *Caterpillar Inc. - VP of Finance Services Division*

This is Joe. And it was a modest increase. I wouldn't view it as a surcharge that would drop if based on commodity prices or anything.

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

But what are you seeing competitively? I mean, are you seeing other OEMs do the same thing?

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

Yes. So I mean, I think we only feel appropriate to talk about our actions. We certainly read the same information that you do. But I think it's only appropriate at this time to talk about our pricing actions, not those of others.

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

Okay. Fair enough. And then just about mining aftermarket. I mean, you had just a huge year last year. Obviously, your results continue to improve quite a bit in the segment. But are you seeing any signs of slowdown in spare parts demand from mining equipment as rebuild activity has already been completed and any more granularity you could provide on kind of the new equipment environment?

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

Sure. So the short answer is no. We're not seeing any slowdown in aftermarket parts demand for mining. We continue to see robust rebuild demand. Strong utilization in the mines is driving improving aftermarket parts demand and orders. So we expect increases in aftermarket parts for the full year 2018. However, we are expecting even from a percentage basis more significant increases in new equipment for mining. So after several years of underinvesting in replacement demand and some new mining expansion, we expect new equipment sales to grow by more than aftermarket parts sales this year.

Operator

Our next question today is coming from Seth Weber.

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

It's RBC. I actually wanted to follow up on the resource margin question a little bit more. So profits were up basically double on kind of flattish revenue sequentially. And I think what I heard you say was that the first quarter had more equipment sales. That equipment sales were particularly strong in the first quarter. So I'm just trying to tie a lot of this stuff together with kind of margin trajectory for the resource business, just the big ramp that we saw in the first quarter versus the fourth quarter. And then just kind of the -- well, I guess, you kind of addressed the mix going forward, but should we still expect margin expansion from the first quarter level, I guess, is my question.

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

Yes. So a couple of things in there. The resource margin largely driven by volume increases. So Resource Industries saw a 31% volume increase driven by higher end-user demand. That was the biggest driver. They also had some favorable price realization and really kept their cost relatively flat on that significant volume increase. So that drove a lot of margin improvement. One thing that we point out at the consolidated level that's impacting Resource Industries' margins as we move throughout the year is cost absorption. So Resource Industries saw a significant increase in inventory in the quarter, which had a favorable impact to their margins and to their performance in the quarter. They now expect their inventory to be about flat for the rest of the year, which will have a negative impact in cost absorption for the remainder of the year. So Resource Industries does expect their margins to come down from the first quarter, but to remain within the Investor Day range for the full year. And at Resource Industries volume level, a few changes like cost absorption can have a meaningful impact in margin performance. But for the full year, we do expect Resource Industries to be within the Investor Day range.

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

Okay. That's helpful, Amy. And then maybe just a quick follow-up on the finco. It does sound like some of the metrics did tick up here. And I think you called out power, Cat Power Finance and some Latin American business. Is that isolated project activity or can you just give us any more color on what's going on there?

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

Yes. So Cat Financial's normal business in the quarter was quite good. Average assets were up, margins expanded. There was some weakness in their Cat Power Finance and LatAm portfolios, as you discussed. And even in the Cat Power Finance, a significant portion of that was in Latin America. So it's a reflection of some weakness in Latin America that we all are well aware of and has been there for some time, putting some pressure on that portfolio. There's also some unique just financing rules and issues in LatAm about being able to get inventory back and how you process through past dues. So overall, no, it's really mostly very specific to Latin America and the weakness we've seen in the recent past in that economy. And outside of that, it was really just 1 or 2 customer issues that were going through some financial challenges and had some restructures to their loan.

Operator

Our next question today is coming from David Raso.

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

Evercore ISI. Just a clarification, I think you mentioned first quarter EPS would be the high-water mark for the year by quarter. And I'm just trying to make sure I understand. In the last 20 years, your second quarter has always been above your first quarter, except for twice, right, when oil and gas was rolling over in 2015 and in 2011 when Bucyrus and the Japanese disaster hit the quarter, so kind of unique circumstance. And I know you just commented a bit on resource. But can you help us understand a little more the puts and takes on why such an anomaly of the first quarter being the high-water mark. The idea of the investments, might be interesting if you can maybe flesh out some numbers around that. The price/cost won't be as positive as the first quarter. But as you said, if anything, for the full year, your view even got a little better for price/cost. Now maybe a lot of it was in the first quarter already. I appreciate that. But just making sure we understand why such an anomaly that the second quarter is below the first quarter.

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

Yes. So there are 3 reasons why we see the first quarter profit per share to be the high-water mark. And you mentioned all 3 of them. I'll go through them again. Price versus material cost, very favorable in the first quarter. We expect to be favorable for the full year. But for the balance of the year, we would expect material cost increases to be greater than price realization.

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

And Amy, if I can stop you there for a second. If I'm seeing the waterfall chart right, price realization with helpful manufacturing costs were a positive $207 million? Is that the right way to read it on a consolidated operating profit, the waterfall chart?

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

So we got price realization, I think, was a $186 million in the quarter.

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

And the costs were a positive $21 million, so call it $207 million?

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

Correct.

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

So do you think the full year is still positive? It can't take out more than $207 million. So I mean, it's $50 million, $60 million a quarter drag.

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

Yes. So...

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

And that's $0.06. I'm just making sure I understand where the magnitude to create such an anomaly in your seasonal pattern of earnings.

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

Yes. So manufacturing cost, a significant piece of that favorability was cost absorption. So with the inventory growth in the quarter, which I believe was $900 million or so that drove favorable cost absorption. We do not expect that -- we expect that to actually be an unfavorable item for the balance of the year. So it is -- there is negative material cost in that manufacturing cost bucket and favorable cost absorption that will not repeat itself. In addition to that, we do talk about period cost spend, which is twofold. One is just normal seasonality of spend. So the first quarter is often a slow quarter for project spend as R&D projects pick up throughout the year. And then many of our target initiatives for e-commerce, for digital, for expanding products like the next gen hex got off to a slower start than we expected. And we expect those projects to get back on track as we proceed throughout the year.

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

And can you flesh that last part out? The other part about starting the year slowly and ramping up. That's part of the normal seasonal pattern we've seen. So that doesn't answer the anomaly question. The target investments though could be helpful. Can you give us some order of magnitude on how big these target investments ramp up as the year goes on?

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

I don't have a specific number to give you, David. I mean, what we did talk about is that we did not change our estimate for those for the full year, but we got off to a slow start in the first quarter. So we kept our fourth quarter outlook for investing in those target initiatives are the same, but underspent on those in the first quarter.

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

Okay. If there's nothing else to point out, that's helpful. I appreciate the feedback. It just seems a bit of an odd seasonal. I mean, it just seems the last 2 times we've had the first quarter be even this low a percent of the full year guide, you kind of have to go back to -- we were peaking in early '12 and we rolled over by the end of the year. Oil and gas started to roll over in '15. I'm just making sure we all don't walk away saying, hey, that was the best quarter they're going to give us, period. The only other time that's happened is we peaked in early '12 and oil and gas hit us broadly in '15. So I'm just being clear of what you're trying to communicate.

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

Yes. So very clearly, we are trying to communicate that we see strong demand across all regions and most of our end market increasing from our fourth quarter outlook. And so driving the first quarter raise is an increase in our sales volume expectation, which implies that we see continued good growth for the balance of the year.

Operator

Our next question today is coming from Ann Duignan.

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

JPMorgan. Can I just take a step back on the price/cost comment that you made. I just want to make sure I understand. Did you specifically say the price/cost will be a negative for the remainder of the year for each of the quarters? And if no, since you're pushing through a price increase in an environment where backlogs are very solid, why wouldn't you push through a price increase sufficient to offset input cost? And what does that mean for 2019 if we're behind going into 2019?

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

So a couple of things. Yes, you're correct that we said that for the balance of the year, price versus cost would be negative. We don't give quarterly guidance. And I, in fact, don't have the breakout of what that will be quarter by quarter. But for the rest of the year, that comparison will be negative. And certainly as we sit here today at the end of the first quarter, we're a long way from looking out into what 2019 will look like. And we do. And Brad said this a couple of times in his script, continue to stress that at the end of the day higher commodity prices are a good thing for our end markets. And we're seeing that translate into improvement across many -- for many of our customers. As far as the price question, we have good margins. It's a competitive marketplace. Continues to be a competitive marketplace. And as a key point of our strategic strategy is to profitably grow the business.

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

Just then as a follow-up on the backlog. Could you just talk about the mix in your backlog by segment. I know you did address resource. But are there any positive or negative kind of product mix in the backlog that we should be aware of as we look at the remainder of the year?

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

Sure. So the growth in the backlog was driven by construction energy and Energy & Transportation. Resource Industries backlog was flat sequentially from the fourth quarter of 2017 driven really by 2 things. One, we had a very strong order board in the fourth quarter. We saw some of those orders. We didn't -- so I guess I would say it that way. We saw a very strong fourth quarter. And then velocity for shipment really picked up in the first quarter. So we were able to keep up with orders and get throughput up and shipments out the door. Construction Industries backlog increase is reflective of continued strong demand in Construction Industries. And I'd say the same for Energy & Transportation. The biggest piece of that for reciprocating engine largely for North America onshore oil and gas. And I know there's always a lot of interest. The Solar backlog remains healthy and was flat, about flat sequentially from the fourth quarter to the first quarter.

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

Just quickly on construction, any change in mix of the backlog, more compact, more large, anything we should consider that would negatively or positively impact mix?

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

Yes. I would say broadly speaking that we're not seeing much significant mix impact across of the segments in our outlook. It's not an area that we're focusing on really positively or negatively. Over the entire portfolio is pretty balanced.

Operator

Our next question today is coming from Jerry Revich.

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

It's Goldman Sachs. I'm wondering if you could talk about your expectations of period costs over the course of this cycle over prior recoveries around year 2, year 3 was when we would see period costs really move higher. I'm wondering if you can counsel us on how to think about it given the difference in the approach to CapEx and post restructuring if this level of period cost performance that you put up in the quarter sustainable.

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

This is Jim. So Jerry, we are certainly committed to controlling structural costs. As we said many times, we are going to be making targeted investments. And those are in the areas of expanded offerings and services. And so in the past, when we wanted to grow, it was through either R&D for new products. We build the factories or we're going to make an acquisition. So now we're really looking at and making some investments again in services. We're expanding our digital capabilities. And so some of that will involve period cost, but again we're very committed to keeping our structural cost under control. So I don't know if I answered your question. But again, we'll make some targeted investments, but we're not just going to let costs creep up the way they have in the past.

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

And Jim, the returns profile of those investments, over what period do you expect an ROI? Is it a long term, strategic type of investment that we should be thinking about? Or is it more quick hitting, within 2 years we'll see the earnings benefit of any related period investments?

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

There isn't one answer to the question. So for some of them, they'll be longer term. And for some, they'll be relatively short. So again, as we focus on the aftermarket, generally, many of those investments should produce relatively short-term returns and some will be more long term.

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

Okay. And then structurally, how do you think about your expected level of dealer inventories in this cycle? If I have it right, I think your dealer inventories are down half a month to a month from the last cycle. Is that the level that you expect to see in this cycle? Can you just put that into context for us considering how much dealer inventories can move early in the year?

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

Yes. So Jerry, maybe I'll step back a little bit. Dealer inventory levels in terms of months of sales are at the bottom end of our current range that we think about. But keep in mind that dealer inventories are controlled by the dealers that are independently owned and operated. So ultimately, they have the decision power there. But we have moved, I would say, from a targeted range for dealer inventories in terms of months of sales from 3.5 to 4 months of sales down to about 3 to 3.5 months of sales. So as you hear us talk about that, it probably is lower than where we were in the prior cycle. Right now we're at the bottom end of that range. And in some regions, most notably in China, we're actually well below that range. And we expect at some point, I guess, over the long -- that will be sustainable. We'll have to see some dealer inventory come back into our Chinese dealers.

Operator

Our next question today is coming from Rob Wertheimer.

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

It's Melius Research. The question is just a philosophical one, I guess, for Jim on margins. How did you think about setting the margin target that you did at the Investor Day? And I assume that you think you can grow profitably and maybe even gain share at those target levels. How do you think about as you achieve as you have really exceptional results, whether you let them drift above that cyclically or not. We're at low cycle and mid cycle now and really just above or not and how you think about competitiveness and balancing what margin you take.

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

Yes. So it certainly is a balance. To answer your first question, how did we establish the margins? We looked at the margins that we achieved at similar sales levels in the recent past. And we put forward what we felt was a reasonable expectation for our teams to improve margins. As we said, again, both this morning and in Investor Day, our goal is to profitably grow. And we want to make investments to grow within a healthy range. We're not too concerned about quarterly deviations because we expect quarter-to-quarter that there'll be some movement there. But again, we're trying to grow the business over the long term in a healthy margin rate.

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

And then I assume you think you can grow share a little bit in those ranges. And would you let margins drift above that if we hit high cycle volumes at some point, which we haven't been obviously.

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

Yes. It is a balance. And obviously, one of the things we're trying to do is grow the aftermarket. And to have aftermarket, you need to have market share of new equipment. So it's always a balance. And there's no one answer to the question. But yes, we want to increase share. We do. And it's always a balance between margins and share. But again, our goal here is to grow the business.

Operator

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

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

It's Vertical Research. First, just back on dealer inventory and when you look at the $1.2 billion of build in the quarter and it sounds like that's primarily expected to go to end market demand this year. So are you looking at no net build in dealer inventory? And then if that is the case, where would you be on kind of inventory to on months of inventory as you get to the end of the year?

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

Yes. So your assumption is correct, Joe. We expect dealer inventory to end the year about where we are now at the end of the first quarter, maybe up or down a little bit. But I think broadly speaking, to end the year pretty close to where we ended the first quarter. We do expect Construction Industries dealer inventory to come down in the second quarter on a strong selling season. And at the same time, we expect Resource Industries dealer inventory to come up in the second quarter on continued kind of build-out and support of strong demand, end-user demand for Resource Industries. And then for that inventory to again come down by the end of the year. I don't have an estimate of months of sales for the end of year. And quite frankly, as we all know, ultimately, where we end dealer inventory will have a lot to do what the 2019 outlook is. And we're not giving that today. And so I think kind of estimating what months of sales will be and frankly, walk through with our outlook include exactly knowing where dealer inventory will be at the end of the year has a lot to do with where dealers are and where expectations for 2019 for the dealers comes in at.

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

Okay. And then on mining equipment. You're talking about seeing demand both on replacement as well as initiated expansions. And I guess, specific to the expansions, given the amount of equipment that was sold in 2011 and '12 and some thinking that there's enough equipment on the sidelines that they can come back into service for a while. But where are we there? Are we at a point where through cannibalization and the amount of equipment that's back in service that we're getting to more normalized levels of parked fleet and that from here we're looking at needing OE to serve that demand? Just kind of a status update on parked fleet and the drivers of that new equipment demand.

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

Sure. So the parked fleet does continue to come down, rebuilds remain robust. We expect them to be robust throughout the rest of the year. So I would say that there are still trucks that come back online in our estimation. There's a lot of complexities about bringing the parked fleet online versus expansions. Where is that parked fleet at versus where are the expansions in mines at. And there are also many things driving new equipment, demand expansion being one, but also replacing equipment which has been delayed for some time now also being a significant driver of new equipment demand. And so we do -- I think in short, we do have the parked fleet continuing to come down, rebuilds, driving aftermarket parts sales continues to be robust. And where that new equipment is, I guess, kind of in short term, it's pretty broad around the globe and pretty broad by commodity. So the recovery in mining that's occurring continues to be pretty broad-based.

Operator

Our next question today is coming from Andrew Casey.

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

Wells Fargo Securities. I just want to make sure I'm understanding some of the messaging coming out this call because during the call the stock's kind of sold off quite a bit. You're kind of pulling back expectations on share repurchase and yet it seems like you're going to be generating quite a bit of cash through the year especially given the implied inventory drawdown. What are you looking to use that cash for? I know you've identified the deployment options. Are we -- should we kind of walk away from this call looking like you're a little concerned about peak or are you looking at and evaluating an active pipeline within M&A? And if so, could you please share a ballpark average deal size you might be contemplating?

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

This is Jim. So it certainly wasn't our intent to express a concern about peak, to use your words. Really no change here in terms of us continually looking at M&A opportunities. Obviously, our cash position has improved over the last year. And that allows us the flexibility to make investments, both organically and in M&A. And again, we're not ruling anything out. So what I said about share repurchase that we didn't have an announcement to make today. And again, we're looking at staying with our strategy to grow our business as we communicated in Investor Day.

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

You're clear, Brad.

Bradley M. Halverson - *Caterpillar Inc. - CFO & Group President of Finance, Human, Global Information Services Division & Corporate Auditing*

Yes. This is Brad. So my guess is, you guys are modeling and you see potentially some strong cash flow moving forward and want to know what we're going to do with it. And I think what Jim has said, we're going to continue to invest in the business. Maybe different than the past. We're going to be in the market on a more continuous basis for stock repurchase to offset dilution. We are continuing to look to grow and do the M&A business. I think what we're saying is that, we're not going to answer that question right now that you have potentially on your mind as to what we would do with the excess cash that could happen down the road. We're not saying it wouldn't be a repurchase. We're just not answering it right now.

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

Okay. And then one last question as this gets to the cycle for a business that's enjoying some really strong demand trends. If we look at Construction Industries and exclude the China market, could you kind of give us kind of a ballpark range maybe percentage or however you want to potentially answer it. Where is construction industry unit volume relative to peak if we exclude the China market?

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

So Andy, I don't have that number off the top of my head. I think if you look, you have to look market by market. North America is doing strong. But I think one could argue we're just starting to see healthy new home construction. Infrastructure remains far below potential. LatAm is just starting to recover and is well below the sales levels that it was a few years ago. And you could say the same thing about Europe, which has been strong for some time now, but in total is far below where sales were in Europe a decade ago. And the AME portion of EAME have seen some weakness in the last few years, and they're starting to see a little bit of turnaround and improvement as well. So I think it is a different story across the different regions of Construction Industries. A region like China, we've been pretty clear. We think is quite robust and above where we think normal replacement demand. Another region like Latin America is still from a historical perspective at very low levels.

With that, I think that needs to be the last question. Kate?

Operator

Thank you. Do you have any closing comments you'd want to finish with?

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

Again, appreciate everyone calling in today, and we appreciate your questions and look forward to chatting with you next quarter. Thank you.

Operator

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