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EDITED TRANSCRIPT

CAT - Q2 2017 Caterpillar Inc Earnings Call

EVENT DATE/TIME: JULY 25, 2017 / 3:00PM GMT

OVERVIEW:

Co. reported 2Q17 sales and revenues of $11.3b and profit per share of $1.35. Expects 2017 sales and revenues to be $42-44b and profit per share to be $3.50.

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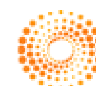

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Caterpillar 2Q 2017 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 Campbell - *Caterpillar Inc. - Director of IR*

Thank you very much, Kate. Good morning and welcome, everyone, to our second-quarter earnings call. I'm Amy Campbell, Caterpillar's Director of Investor Relations. And 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.

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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 the forward-looking information.

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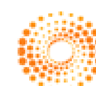

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A discussion of some of the factors that either individually or in the aggregate could make actual results differ materially from our projections can be found in our cautionary statements under Item 1A, Risk Factors, of our Form 10-K filed with the SEC in February of 2017. And it's also in our forward-looking statement language included in today's financial release.

In addition, there's a reconciliation of non-GAAP measures that can also be found in this morning's release, and it's posted at 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 second-quarter results and our revised outlook. And then we will turn it back to Kate to begin the Q&A portion of the call.

Jim?

Jim Umpleby - *Caterpillar Inc. - CEO*

Thank you, Amy. I'd like to start by congratulating our team on another impressive quarter. Our operational performance was excellent. As demand increased, we did a good job managing costs and improved profit margins.

A number of our markets remain challenged, but there were improvements in a few of our key markets this quarter. Construction in China and gas compression in North America were highlights. Mining and oil-related activities have come off recent lows, and we're seeing improving demand for construction in most regions.

Based on our solid year-to-date performance and current ordering activity, we're raising the midpoint of our 2017 sales and revenue by $3.5 billion to $43 billion, which would represent an increase of 12% over 2016. We're also raising our 2017 outlook for adjusted profit per share from $3.75 to $5.

We remain committed to our lean manufacturing journey to improve efficiencies and reduce lead times. And we continue to execute our restructuring plans to achieve a more competitive cost structure. We remain vigilant about product quality and will continue to invest in R&D to improve current and future products and solutions.

In the second half of this year, we will make targeted investments to improve competitiveness and drive long-term profitable growth. We will continue investing to expand our digital capabilities and accelerate important product development programs. We're moving forward to ensure we're helping our customers harness the power of data and technology to be as productive and efficient as possible.

Caterpillar already has the largest connected industrial fleet in the world. We have more than a half million assets connected today and intend to significantly increase our connected assets by year-end. I want to emphasize these are targeted investments in key initiatives, and we'll maintain a strong focus on controlling our structural costs moving forward.

Before I turn it over to Brad to discuss the details of the quarter and the outlook, a quick update on our strategic planning committee. We have completed our review of the business, and I look forward to sharing our strategy at Investor Day on September 12 at our demonstration facility in Tinaja Hills, Arizona.

With that, I'll turn it over to Brad to walk through the quarter.

Brad Halverson - *Caterpillar Inc. - Group President and CFO*

Thanks, Jim. As Jim stated, the second quarter continued what has been a great start to 2017. Before I walk through the analysis of the quarter and the revised outlook, let's turn to slide 4 and I will walk quickly through the headline numbers.

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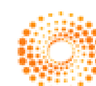

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Sales and revenues of $11.3 billion were up about 10% from the second quarter of last year. While many of our end markets are far off previous peaks, we are starting to see several markets recover, and demand for China construction and North America gas compressions remains strong. Sales were higher in all three primary product segments, led by Construction Industries, followed by Resource Industries, and then Energy & Transportation.

Profit per share was up $0.42, from $0.93 to $1.35. We continued to execute on our restructuring plan, which includes the closure and consolidation of more than 30 facilities. These actions are important to achieving the flexible cost structure required to remain profitable through the cycles.

At the same time, we are thoughtfully preserving the capacity needed to meet future growth needs. As a result of restructuring actions, we incurred $169 million in restructuring costs in the quarter, $30 million more than in the second quarter of 2016.

In the quarter we also recognized a pre-tax gain of $85 million on the sale of our investment in IronPlanet. Adjusted profit per share was up $0.40 from $1.09 in the second quarter of 2016 to $1.49. Higher sales, including a favorable mix, were the primary drivers of the profit improvement. Improved price and lower variable manufacturing costs were about offset by higher period costs due to an increase to the short-term incentive compensation accrual that resulted from the upward revision to the outlook.

Now let's turn to slide 5. Second-quarter operating profit was $1.251 billion as compared with $785 million in 2016, up $466 million. Operating profit pull-through in the quarter was nearly 50%. Positive changes to operating profit came from several areas. The largest increase to profit was the result of higher sales volume and favorable mix.

All four geographic regions and all three primary product segments saw higher sales and revenues. However, increases to sales and revenues were largely concentrated in four end markets. China construction and North America gas compression continued to experience strength, and robust overhaul and maintenance activity drove higher aftermarket parts sales for both mining and well servicing equipment.

Price improved $183 million in the quarter. The favorable change was largely due to Construction Industries, as Resource Industries and Energy & Transportation price realization were about flat. Variable manufacturing costs were favorable $44 million, largely due to the favorable impact of period cost absorbed, as inventories increased in the quarter in many of our factories to support higher production. As we ramp up production, we remain focused on lean principles and we are working diligently to bring production up quickly but also efficiently.

Material costs were about flat in the quarter. While our design and procurement teams continued to work on projects to lower material cost through redesign and re-sourcing, we expect higher steel cost to put pressure on material cost in the second half.

Total period costs were higher by $237 million. In the quarter, we accrued about $330 million more short-term incentive compensation for ME&T than the second quarter of last year. When you exclude the higher STIP accrual, period costs were lower by about $80 million, driven by restructuring and cost reduction actions over the past year that are focused on lowering the Company's embedded cost structure.

As we have weathered through the challenges of the last few years, maintaining a strong balance sheet has been a priority, and we are continuing that focus. ME&T operating cash flow for the quarter was $2 billion, and is $3.6 billion year to date, both well above prior-year comparables. ME&T debt to cap at the end of the quarter was 38.6%, well within our target range. We ended the quarter with $10.2 billion in enterprise cash. And, in June, the Board approved an increase in our quarterly cash dividend, which we expect will make 2017 the 24th year in a row of paying higher dividends to our shareholders.

Now let's move on to discuss each of the segments, and we will start with slide 6. Construction Industries sales were up 11% to $4.9 billion. Higher sales volume to Asia-Pacific and Latin America and favorable price realization contributed to the increase. Most of the sales increase on the quarter for Construction Industries was driven by what has continued to be strong end-user demand in China for construction equipment, most notably excavators. Through the first half of the year, the 10 ton and above excavator industry in China was up about 130% from last year.

Strength in China continues to be driven by government support for infrastructure and strong residential investment. Sales in China in the second quarter were better than we had expected, and we now expect demand in China to remain strong through the rest of the year.

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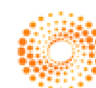

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If you look at the chart at the top of the right-hand side of slide 6, it shows China industry sales for 10 ton and above size excavators from 2006 through 2017 forecast. You can see from the chart that while demand for 10 ton and above excavators is up significantly versus the last two years, it is still far below highs achieved earlier this decade. Continued strong strength in China is dependent on underlying demand, government support, and accommodating credit conditions.

For Latin America, sales were higher due to an increase in end-user demand across several South American countries, as well as favorable dealer inventory changes. While we saw some regions improve in the quarter, Latin America, especially Brazil, remained challenged, and sales are still at very low levels.

North America sales to end users were up, and price realization improved. However, these were mostly offset by a drop in dealer inventory. North America dealers typically pull from inventory in the second quarter to support the strong selling season. However, this year the reduction in dealer inventory drawdown was greater than last year, resulting in an unfavorable impact to sales.

As you can see in the chart on the bottom right-hand side of slide, higher end-user demand in North America was primarily driven by improved residential and nonresidential construction. As the chart also shows, infrastructure spend in the US has been stagnant for some time, and sales of construction equipment for infrastructure projects was down in the quarter, as we have yet to see federal, state, and local funding for road projects translate into higher sales. The United States is in need of infrastructure investment. Passage of a federal infrastructure bill would be positive for our country and our business.

As expected, in the middle of the spring and summer selling season, the backlog for Construction Industries was down from the first quarter of 2017. However, the decrease this quarter of about $300 million was less than the first-quarter to second-quarter reductions in both 2015 and 2016, when the backlog went down by $1 billion and $900 million, respectively. Order rates are strong in the quarter, with all regions seeing an improvement from a year ago.

Now let's move to slide 7. Construction Industries segment profit was favorable by about $350 million, driven by favorable price realization and higher sales volume, including a favorable mix of product.

Period costs were about flat as higher short-term incentive compensation expense was largely offset by restructuring and cost reduction actions.

Construction Industries was an early adopter of our operating and execution model, and this focus has helped to improve their segment profitability. Segment profit margin in the quarter was 18.2%, an increase of almost 600 basis points from the second quarter of last year.

Let's move to slide 8 and Resource Industries. Continued strong demand for aftermarket parts to support overhauls and maintenance work, combined with favorable changes to dealer inventories, were the primary drivers of the $300 million increase in sales and revenues for Resource Industries, an increase of 21%.

In order to call a recovery in mining, we have said that, first, the excess machine inventory in the mines would need to be worked off. Then demand for overhauls and maintenance would drive higher aftermarket parts sales. And last, orders for new equipment would start to increase.

The cycle is starting to play out. Utilization on trucks is up 4% from last year. The parked fleet continues to come down. And for the fifth quarter in a row, parts sales have increased to support rebuild and maintenance needs as well as higher utilization of fleets in the mines. And our order rates are improving. After four years of dealers reducing their inventories, for the second sequential quarter, dealer inventory held about flat. Sales increases and favorable dealer inventory changes were broad-based across all regions.

As you saw in the sales to user numbers that were released yesterday, RI's sales to users were about flat in the quarter. However, we believe sales to users are a lagging indicator of industry trends. Order rates in the quarter were up more than double the second quarter of last year.

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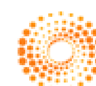

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The backlog for Resource Industries was up about $300 million from the end of the first quarter 2017. And Resource Industries was a significant part of the $3 billion increase in the backlog since the second quarter of last year. However, while Resource Industries has started to recover, sales volumes remain at historically low level.

We'll move to slide 9 and look at their operating performance. On improving sales, with a focus on operational performance, Resource Industries delivered a solid quarter. Segment profit was $97 million, up $260 million from a loss of $163 million in 2016. The improvement in profit resulted from higher sales volume, including a favorable mix of product, and lower period costs.

Resource Industries continues to implement a number of restructuring actions to lower their breakeven point. These initiatives enabled them to deliver lower period cost in the quarter, even after recognizing a large increase in short-term incentive compensation expense. Resource Industries incurred additional warranty expense of a little over $50 million in the quarter for a customer program we do not expect to repeat.

Next we'll go through Energy & Transportation on slide 10. Sales were up $200 million or 5% in the quarter to $3.9 billion. Higher sales into oil and gas combined with higher industrial aftermarket sales were the primary drivers of the sales increase. Sales into power generation were about flat, as a slight improvement in North America was mostly offset by weaknesses in other regions.

Transportation sales decreased, largely due to lower demand for marine applications. Sales into the rail industry were about flat. While the rail industry remains weak, and the number of stored locomotives remained elevated, this was mostly offset in the quarter by an increase in rail services to support higher rail traffic.

The chart on the right side of slide 10 shows the four-year history of US rig counts and West Texas Intermediate oil prices. The number of rigs in production has doubled from recent lows reached in May of 2016. US oil production has increased accordingly.

In the areas where we participate in the oil and gas market, the recent strength has largely been concentrated to well servicing and midstream gas compression applications. Demand for aftermarket parts to support overhaul and maintenance of well servicing fleet increased in the quarter, primarily to support rigs that are going back to work in the Permian Basin and other shale formations in Texas, Oklahoma, and New Mexico, where the cost of production and transportation is low enough to encourage investment despite recent oil price volatility.

Midstream gas compression is having another good year as we support the continued buildout of North America's natural gas infrastructure. In addition, recent developments in the Permian in the last 12 months have had a higher concentration of natural gas than previous wells. This discovery has contributed to a higher demand for 3500 and 3600 reciprocating engines to support the midstream gas compression growth in that region.

If we move to slide 11, we'll look at the segment profit for Energy & Transportation. Energy & Transportation profit was up $98 million, from $602 million to $700 million. This was largely attributable to higher sales volume, the favorable impact from cost absorption, and improved material cost. Period costs increased in the quarter but were about flat, after excluding higher short-term incentive compensation expense.

Before I move on to the outlook, a quick comment on Financial Products. Operating profit was down slightly due to the absence of the sale of securities at Cat Insurance Services. The portfolio remains healthy, with past-dues down 22 basis points from the second quarter of 2016, and write-offs were down $7 million. Used equipment prices continue to improve, which helps, and the team delivered a solid quarter.

We'll move to slide 12 and we'll cover the outlook. We announced this morning that we are raising the outlook for full-year sales and revenues and profit per share. In April we provided an outlook for sales and revenues of $38 billion to $41 billion.

As a result of strong operational performance in the first half, encouraging order rate, good economic indicators, and a solid backlog, we are providing new guidance for sales and revenues in the range of $42 billion to $44 billion, with a midpoint of $43 billion, up $3.5 billion from the prior outlook.

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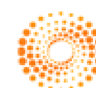

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At the midpoint of the sales and revenues range, we have raised the profit per share outlook to $3.50 per share, and raised the adjusted profit per share outlook from $3.75 to $5.

We move on to slide 13 and cover the sales outlook by segment. We now expect Construction Industries sales for the year to be up 10% to 15% versus the previous outlook of flat to up 5%. This is driven largely by higher end-user demand in both China and North America. Order rates for Construction Industries have been strong for the first half of the year across most regions, with an exception of the Middle East and Brazil, which remain challenged.

The backlog is also up significantly from the second quarter of 2016. We do not expect sales in the second half of the year -- excuse me. We do expect sales in the second half of the year to be slightly lower than the first half.

For Construction Industries, the second quarter is typically the strongest quarter of the year as construction activity and deliveries pick up to support the spring and summer construction season in the Northern Hemisphere. Fewer work days due to holidays and vacations, combined with the anticipation of colder weather, typically drives sales lower in the second half. In China, on average for the last five years, over 55% of sales were realized in the first half of the year.

For Resource Industries, we now expect sales to be up 20% to 25% for the full year versus the previous outlook of up 10% to 15%. While we expect aftermarket parts sales to remain strong through the rest of the year, as the number of parked trucks is reduced and the demand for overhauls declines, we expect the rate of growth to slow and for parts sales to be lower in the second half than the first. However, we expect this will be more than offset by an increase in new equipment sales.

Energy & Transportation sales are forecasted to be up 5% to 10% for the year versus the previous outlook of about flat. We continue to see strong rebuild activity in well servicing for engines, transmissions, pumps, and flow iron. And new equipment deliveries are expected to increase in the second half of the year. We also expect shipments to North American gas compression customers to be higher in the second half. Industrial, power generation, and transportation are all expected to be about flat to slightly up.

We move to slide 14. At the midpoint of the sales and revenue range, the new outlook for profit per share is $3.50, and the revised outlook for adjusted profit per share is $5. The increase in the profit outlook since April is largely the result of the improved forecast for sales and revenues and disciplined cost control, partially offset by an increase in short-term incentive compensation expense. As compared to 2016, at the midpoint of the range, the revised outlook reflects higher sales and revenues of about $4.5 billion, or 12%, and an increase in adjusted profit per share of $1.58.

The increase in adjusted profit per share versus 2016 is largely driven by higher sales volume of $4.5 billion and the associated margin on those sales; favorable price -- while we do not expect the same level of price favorability in the second half of the year, we still expect favorable price realization for the full year in a range of 0.5% to 1%. Favorable impact from period cost absorbed, as inventories are expected to increase to support higher production levels. These favorable items will be partially offset by higher short-term incentive compensation expense of about $1 billion.

Material costs are now expected to be about flat for the full year. While geopolitical uncertainty and commodity volatility continue to be risks to the outlook, our outlook assumes that oil prices remain bound within the recent range of volatility, markets stay resilient to geopolitical uncertainties, and China remain supportive of growth. However, changes to any of these variables, as well as others, could impact our sales and revenues outlook for the full year.

We'll turn to slide 15 and wrap up. Operational performance for the year has been strong, with second-quarter operating profit pull-through of nearly 50%. While a number of our end markets remain challenged, we see strong demand in deliveries for China construction and North America gas compression equipment. And demand for aftermarket parts has increased to support overhaul and maintenance activity for well servicing, gas compression, and mining equipment. Orders and end-user demand for North American construction equipment also improved in the quarter.

We continue to be focused on lean, product quality, and investing in the business for future growth. The balance sheet remains strong, and we delivered $2 billion in ME&T operating cash flow in the quarter. Given year-to-date performance and our confidence in the second half of the year, we are raising the outlook for both sales and revenues and profit per share.

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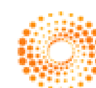

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With that, I will turn it back to Amy.

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

Thanks, Brad. And Kate, I think we're ready to move on to the Q&A portion of the call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Ross Gilardi.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Good morning, Bank of America. Amy, on page 6 of the press release, it shows that Cat just increased its global flexible workforce by 3,500 workers in the second quarter. And I think you are up about 30% year-on-year and quarter-on-quarter. And you haven't had a seasonal working cap -- workforce build like that since 2010.

So first of all, where did you hire more people by business and geography? And then second, if you are ramping flexible employment, why are you still implying the 20% decline in second-half-earnings versus first-half? I recognize all the puts and takes you just provided, but the workforce changes would perhaps suggest otherwise.

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

Yes. So, it's a great question. I think it's certainly a great change in where we've been over the last several years, is bringing back workforce. And to first question, where has it been, Ross, it's really been around the globe. Certainly China, sales were up; Brad mentioned industry up over 100% this year versus last. So that's been a significant growth in workforce. Lafayette to support the higher demand for the 3500 and 3600 engine. And beyond that, we're hiring in other factories around the globe and here in East Peoria. We're bringing people back to work in Pontiac. It's been pretty broad-based.

As far as the second half versus the first half, I think if you look at the comps for sales in the second half of the year versus the first half, they are actually up just about $1 billion. So we are implying higher production. Production is higher in the second half than it was in the first half. So we can talk through some of the puts and takes on profitability, but we do expect production to be up in second half of the year.

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Thank you.

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

Do you have a follow-up?

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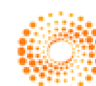

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Ross Gilardi - *BofA Merrill Lynch - Analyst*

Yes, I also just wanted to ask on your capital spending, I think Cat's spending like 50% of depreciation right now. And as we just discussed, you are starting to hire people. When you are you going to start reinvesting in the business again? And are there any areas of Caterpillar right now that are just structurally tight?

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

Yes, I think if you're talking about fixed assets, bricks and mortar and machines, we continue our restructuring plan. We think at the end of those plans we will have the capacity we need to meet our future growth needs. So I don't -- we don't foresee that we have fixed capacity challenges. Really what we're seeing right now as we bring capacity -- as we bring production back, we're coming back from pretty low levels.

Jim talked about where we're investing in the business in the second half of the year is through some targeted investments in key initiatives to advance our market competitiveness in digital; to advance some product programs that we have. So that's where we see the second-half investments back in the business [being].

Ross Gilardi - *BofA Merrill Lynch - Analyst*

Thank you.

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

And that is driving some of the second-half versus first-half profitability.

Operator

David Raso.

David Raso - *Evercore ISI - Analyst*

Hi, Evercore ISI. This year, I would say the most interesting thing has been the Construction Industries margins. I just want to get your perspective on how should we think about those margins going forward. Everybody's been thinking about what normalized earnings could be for Cat midcycle. And I'd say probably the biggest surprise this year has been those margins.

Can you help us a bit with -- you made the comment on mix. Is it geographic? Is it product? Just given the high level of margins we've seen so far this year.

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

So for Construction Industries, I think your point is a good one. They have had impressive margins, Brad pointed that out, both in the first and the second quarter of 600 basis points from a year ago.

In the second half of the year we do expect some headwinds to profitability. North America continues to be very competitive from a pricing perspective. We expect that to put pressure on Construction Industries' price realization in the second half. We still expect them to be favorable slightly, but not as favorable as we've seen in the first half of the year.

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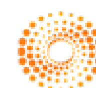

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Through the first half of 2017, we've clawed back the price that we lost in 2016. And we do expect some price pressures in the back half of the year, especially in North America.

Across all three of the primary product segments, we do expect the material cost headwinds. We delivered about $50 million of material cost improvement in the first quarter. It's about flat this quarter. We expect that to reverse to about a $50 million headwind in the back half of the year. That's across all three segments.

And construction-industries also -- and the other two primary segments -- have some key initiatives there, planning on spending and the second half of the year. That all said though, David, we would expect the segment margins for Construction Industries for the full year to be about couple hundred basis points than they were last year.

David Raso - *Evercore ISI - Analyst*

But if -- I mean, last year, they were only 10.5%. You are running at 16%, 17%, year to date? I mean, are you really implying margins that low -- I mean, you basically are implying single-digit margins in the back half of the year for CI?

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

Your numbers are a little different than ours. We add back the inter-segment sales. But yes, there is a pretty significant margin erosion that's implied in the outlook in the back half of the year for price, for higher material cost, and then to reflect these investments that we expect to make in the business.

David Raso - *Evercore ISI - Analyst*

Yes, okay. I hear. I am just trying to understand structurally if we try to look out to 2018 and 2019 -- I appreciate the detail in the answer, but just trying to think about obviously setting up a little bit the September Analyst Meeting.

When you think of the profitability of the segment now versus last cycle, for example, again, how much should we take to heart this first-half run rate margin to some degree, even with the second half being lower? I'm just trying to get perspective of how you are thinking about the segment moving forward.

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

So, as you said, we'll certainly be discussing more on all three of the segments' margins as we get to the Analyst Day in September. Construction Industries was an early adopter of our operating and execution models focused on OPACC profit generation. Couple hundred basis point improvement from last year is certainly something to be proud of. And they have -- they continue to restructure. We've got Gosselies and Aurora that still we don't expect to see those improvements until 2019. Maybe we'll see some of that flow through in 2018, so I think we certainly see growth from here for Construction Industries' margin.

David Raso - *Evercore ISI - Analyst*

All right, I appreciate it. Thank you.

Operator

Jamie Cook.

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Jamie Cook - *Credit Suisse - Analyst*

Credit Suisse. Two questions. One, on the resource side, the margins were a little lighter than I thought. But then you mentioned you had $50 million of one-time warranty expense, so it was actually more comparable to the first quarter. So given your increase in resource sales, how are we thinking about profitability and the restructuring actions layering in to 2017 and 2018?

And then my second question: how much of your forecast in fiscal year 2017 is being hindered by your inability to ramp production? One of the things that dealers talk about is a lead times extending, so if you could just comment on that as well. Thanks.

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

Yes. Thanks, Jamie. So, RI profitability, I think if you step back, we do expect sales to be slightly higher in the second half. As Brad mentioned, parts sales will come down a little bit, but that will be more than offset by shipping out of the backlog for new equipment orders.

That said, and I think if you neutralize for that higher warranty expense, we expect first-half and second-half profitability to be pretty similar on slightly higher sales in the second half. And that's driven by the steel cost pressures that we expect to see, as we talked about in the last quarter. Resource Industries has a slightly less favorable geographic mix of product sales in the second half, and then also the investment that they are making to advance market competitiveness in digital and product programs.

Jamie Cook - *Credit Suisse - Analyst*

And just -- sorry, Amy, to be clear, the profit dollars similar, that's including the warranty expense in the second quarter? When you say second-half versus first-half, I'm just -- because that's a (multiple speakers)

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

Plus or minus. Not giving exact numbers, we see the first-half and the second-half profitability to be pretty similar.

Jamie Cook - *Credit Suisse - Analyst*

Okay. And then, sorry, just lead times capacity constraints; how much of your forecast is being hurt by that?

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

I would say we don't see the forecast really being much impacted by capacity constraints; although as you mentioned, we have seen leadtimes go out. If you look at several of our products, the 3600 large engine and mining trucks -- demand for those products really shot up overnight. The large mining trucks now we expect for production to be triple what it was in 2016. Production for the 3600 has more than quadrupled from a year ago. And again, both of those products were at pretty low levels, so it does take time to get that demand back, especially through the supply chain and getting the workforce back to work.

And we also have -- as we're restructuring and seeing some really elevated levels of demand in China for excavators, and demand come back in North America for earthmoving equipment, with the restructuring of Gosselies -- while we've put those products on managed distribution, we do believe that we're getting product to the dealers to get to customer sales. However, we have seen the month of sales for dealer inventory come down, and that's a little lower right now than we would like it to be.

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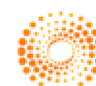

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Jamie Cook - *Credit Suisse - Analyst*

Okay, that's helpful. Thank you. I'll get back in queue.

Operator

Joel Tiss.

Joel Tiss - *BMO Capital Markets - Analyst*

Bank of Montreal. I just wondered if you could give us a little set up. I'm not asking for a forecast on China for 2018; seems like everything is a little buoyant because of the election this year. And I just wondered if you could frame how do you think about 2018 a little bit.

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

Well, I think it's early for us to be thinking about 2018. But maybe I'll give a little color to where we're at for China excavator sales. If you look at the chart that Brad had in his presentation for 10 ton and above excavators, this year we expect the industry to sell about 55,000 excavators, up from about 30,000 excavators last year, so pretty significant increase. We think -- I think it is too early to forecast 2018.

We do think that that is slightly above normal replacement demand for excavators -- 10 ton and above excavators in China, which we believe to be somewhere between 45,000 to 50,000. So we're probably this year just slightly above that normal replacement demand.

Does that answer your question, Joel?

Joel Tiss - *BMO Capital Markets - Analyst*

Yes.

Operator

Nicole DeBlase.

Nicole DeBlase - *Deutsche Bank - Analyst*

Yes, it's Deutsche Bank. So, you provided some detail around what you expect for resource and construction profitability. I know previously you had said kind of flattish margins for E&T. Is that still the case, or has that changed?

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

So for Energy & Transportation, what we would expect for margin is for first-half profitability, and second-half profitability to be pretty similar.

Nicole DeBlase - *Deutsche Bank - Analyst*

And when you say profitability, just to confirm, is that the absolute EBIT dollars, or is that the margin percentage?

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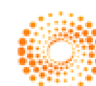

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Amy Campbell - *Caterpillar Inc. - Director of IR*

That would be the margin percent, the segment margin percent.

Nicole DeBlase - *Deutsche Bank - Analyst*

Okay, perfect. That's helpful. Thanks. And then secondly, going back to the China question, how would you characterize China inventories right now on the construction side? Is there still further restocking to come, or do you think that that process is pretty much complete?

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

No, there's -- we think that there's still dealer restocking to come. So, if you look at dealer inventories in China, we probably typically target about 2 1/2 months of sales. China's target for dealer inventory months of sales is a little lower than the rest of the world. They have less variety in the configurations they sell.

We are about -- quite a bit lower than that at the end of the second quarter, even though we did take dealer inventory up some. So we do expect to continue to be rebuilding dealer inventory levels through the back half of the year. But as I mentioned, certainly in China, the strong selling season for end-users is in the first half.

Nicole DeBlase - *Deutsche Bank - Analyst*

Understood. Thanks. I'll pass it on.

Operator

Ann Duignan.

Ann Duignan - *JPMorgan - Analyst*

JPMorgan. Could we talk a little bit more about these targeted investments and initiatives that are important to your future competitiveness? I thought that this was a pretty interesting portion of the press release. If you could give us some more examples of what exactly these investments are going to be, and what do you mean by technology updates to your products?

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

It's pretty broad-based, and I'd say it's pretty difficult to boil it down to a few bullet points, but I'll give you some highlights. One of the significant areas of focus is a bold goal for our business to connect more assets. So we believe we have the largest connected industrial fleet in the world, at 530,000 assets. And we have a bold goal to go out and connect 100,000 more by the end of the year. We don't know if we'll get there, but that is certainly where we're moving the teams toward.

And that requires the expense of buying the boxes, and the labor cost to connect those assets. And certainly that will benefit both our customers and us as we bring back that data, and learn ways and use the data and the power of data to develop solutions to lower the cost and improve the productivity for customers. So that's one area.

Another would be expanding our e-distribution channel and the different solutions we have out there for customers. That's another area we're focused on. And then we're also spending money to advance some of our product programs, pull money into this year, or push those product programs and make sure they have successful launches in the back half of the year.

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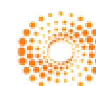

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Brad Halverson - *Caterpillar Inc. - Group President and CFO*

Ann, this is Brad Halverson. Maybe just another comment about how we use that language. We use that language because that's how we're operating internally. We've been through four years of a downturn. It's been hard on us. We've taken significant restructuring activities, and we like where our cost structure is at and where our balance sheet is at.

And so using our operating and execution model, Jim is really driving continued focus on cost reduction across the support areas. And as we increase period cost, you'll see that there will be very targeted in areas that offer the most long-term value for the Company, consistent with the pools of OPACC we see out there in the future.

And this is a little example in the second half of this year where we're going to take an opportunity to do a little bit of that where we think there is a lot of value, and keep a lid on the other costs that we have in the Company.

Ann Duignan - *JPMorgan - Analyst*

Brad or Jim, do you think it has impacted your competitiveness, the fact that you had been so focused on restructuring and cost reductions, and some of your competitors are well ahead of you in terms of IT initiatives? And I'll leave it there. Thank you.

Brad Halverson - *Caterpillar Inc. - Group President and CFO*

Yes, I'd say, Ann, actually I think not. Because this time -- I've been in a career here at Cat a long time -- typically we have reductions in areas that are easy to find, so we reduce R&D or reduce other things. In this downturn, if you look at our cost reduction, it's been highly targeted to areas that are not future value. They are areas of efficiency and consolidation and support costs.

We have really increased spending in many of the growth areas. We protected R&D, by and large, and we protected things like digital spending. So, we've taken an entirely different approach in this downturn in terms of where we took cost out and what cost we protected. So I'd say it's different than we would have historically done.

Ann Duignan - *JPMorgan - Analyst*

Okay, I appreciate the color. I'll get back in line. Thanks.

Operator

Jerry Revich.

Jerry Revich - *Goldman Sachs - Analyst*

Goldman Sachs. I'm wondering if you could say more about the contribution of the operating and execution business model in Construction Industries so far. What's been the impact on OPACC or margins, however you can frame that for us? And how far are we in that journey for construction at this point?

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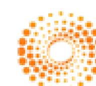

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Amy Campbell - *Caterpillar Inc. - Director of IR*

Well, I think it's been extremely impactful to Construction Industries' margins. You can go back several years and look at where their segment margin percents were, and see that they've come quite a ways on down sales. So sales in 2017, still probably -- I don't have the numbers in front of me -- but 10% to 15% off of peak levels of sales volume, and much higher levels of segment margin.

They've driven higher OPACC, just raw dollar OPACC, over that time frame. And that said, as all of the segments have worked on their operating execution and OPACC improvement initiative, Construction Industries still has projects lined up and improvements they expect to make in their OPACC.

Jerry Revich - *Goldman Sachs - Analyst*

And Amy, on that last point, are we closer to the seventh inning? Or can you just frame that within construction specifically in terms of the number of projects in front of us?

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

Yes, I think we'll give more color to that at the Analyst Day in September. But I think it's fair to say that they still have a pretty healthy-sized list of profit improvements that they are focused on driving through their business.

Jerry Revich - *Goldman Sachs - Analyst*

Okay. And Amy, as you folks build out the connected fleet, and perhaps we can get more precision on how much dealer inventories are required, how are you folks thinking about required dealer inventories in this cycle compared to the last cycle? You spoke about the development in China. But I'm wondering how are you thinking about what's the right level of inventories and months of supply globally now, and how that might be different versus the last cycle?

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

I think that we have probably always held around a target of 3 1/2 to 4 months on sales of dealer inventory. I think if we're honest, we probably typically struggle to get there, and were -- would end the year a little north of 4. I think that's about where we ended 2016.

I don't know that our target for months of sales of dealer inventory has changed that much. But as we have seen volume come back pretty quickly in a few of our end markets, we have seen that months of sales drop below our 3 1/2 target.

Jerry Revich - *Goldman Sachs - Analyst*

Thank you.

Operator

Joseph O'Dea.

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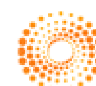

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Joseph O'Dea - *Vertical Research Partners - Analyst*

Vertical Research. The first question is just rebuild and overhaul activity in both mining and upstream oil and gas. And just to understand of what your visibility is on current levels of demand, and then what a step-down potentially looks like. And so just to get an appreciation for how significant a step-down you could see in aftermarket and mining in the back half of the year. And then do you see at more a sustainable level?

Same thing for oil and gas: do you see a big uptick in activity there? How long that persists, and then what kind of a headwind you face when that maybe comes down a little bit?

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

Yes, I'll handle each one of those separately, Joe. So for mining, we do see part sales come down in the second half of the year. I wouldn't say that it's that significant. And I don't have a forecast for 2018 to give you, of where we think part sales will be over time. We do expect some decline in part sales second half and first half; but it's not a double-digit number, but is coming down.

For oil and gas are really where we're seeing, as we talked about, the aftermarket parts demand is primarily in well servicing. And it has primarily been, as Brad talked about, in the Permian Basin and in other shale formations in that region: other parts of Texas, New Mexico, Oklahoma, where the cost of oil production is still encouraging investment. We haven't seen demand to date come down in those regions. We haven't seen a lot of increase in demand in other shale formations outside of that area.

So without providing an outlook for 2018 or guiding to where I think we could go from here, certainly the oil price drives that. A significant step down would probably put some pressure on where we are seeing some strength today. But if we were to start to see oil prices get back up over $50 and start to see some of the pipeline buildout that we need to help transportation in a few of the other shale formations, we could start to see those pick up. So I think it's really too early to call where we go, much out past the end of 2017.

Joseph O'Dea - *Vertical Research Partners - Analyst*

I appreciate it. And then on resources specifically and the OE order side of things, I think you've commented on needing to see stabilization in commodity prices to encourage continued spend or growth in spend on replacement.

We have seen some stabilization in some key commodities at levels that are well above where they were a year ago. So I guess, just in terms of -- are current commodity prices supportive enough? And how long do you think we need to see a pattern of stabilization before that encourages a little bit more spend?

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

I do think -- what I would say is, if you look at the order rate in the second quarter -- Brad mentioned that it was more than double from second quarter of last year. So I think, without having the buying decisions of all of the miners in front of me, it's probably fair to conclude that at current commodity prices is driving demand for investment.

I think what's probably more important, and we've stressed this throughout the entire downside of mining, is that mine production continues to really increase; or in some commodities, state about flat. So it's really an issue of making sure they have healthy operating equipment in the mines. And when do they need to start to invest capital to keep their equipment running and functioning?

So I think commodity prices right now are supportive. They need to stay supportive. If we were to see change materially, that could change the story. But where they are right now, we are seeing healthy demand for mining equipment.

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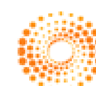

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Joseph O'Dea - *Vertical Research Partners - Analyst*

Okay. Thanks very much.

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

But I will stress, but off of very low levels. For the last year, very low levels -- but it's still at pretty low levels historically.

Operator

Seth Weber.

Seth Weber - *RBC Capital Markets - Analyst*

It's RBC. Just following up on that last question, Amy, and your answer: given the improving environment in Resource Industries, the commodities environment, et cetera, what do you think you need to see to get positive pricing in Resource Industries here going forward? Pricing was still negative; is there something that's happening that's just causing pricing to continue to be tough?

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

Well, I think it's exactly my last comment, which is industry volumes still are at extremely low levels, so manufacturers have a lot of capacity and are trying to fill up their factories, and earn and win every deal to do that. These are certainly very attractive, both from the original sale and the aftermarket parts stream, deals to win. So I think we really won't start to see price appreciation in Resource Industries until we start to see constraints in capacity amongst us and our competitors.

Seth Weber - *RBC Capital Markets - Analyst*

Okay. And if I could just ask a follow-up. In response to an earlier question, I heard some mention about supply chain. Can you talk about whether you are seeing any kind of pockets of pressure on the supply chain, or how you are feeling about the supply chain here in this increasing demand environment? Thank you.

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

As I mentioned, we are, for a few products, bringing production up quickly off of very low levels. It's difficult to get both -- get the factories back to work and get the workforce in and trained. So that is taking a little time. On top of that, we've had higher demand for aftermarket parts, which also puts demand into the supply chain.

I think we just think it takes time. We hope to be worked through most of those issues by the end of the year. And it is largely workforce and supply chain that's driving that -- I'd say setting the pace for how quickly we can bring production up.

Seth Weber - *RBC Capital Markets - Analyst*

And that's mostly on construction on the supply chain bottleneck?

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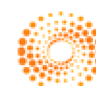

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Amy Campbell - *Caterpillar Inc. - Director of IR*

I would say that we have, depending on the product, we have supply chain issues we're working across the product line.

Seth Weber - *RBC Capital Markets - Analyst*

Okay. Thanks, I appreciate the answers. Thanks, everybody.

Operator

Andrew Casey.

Andrew Casey - *Wells Fargo Securities - Analyst*

Wells Fargo Securities. A question on the Construction Industries; 200 basis point margin increase for the year. Back to David's question, it really does imply a pretty sharp drop-off in the second half. And it's still a little bit confusing to me, based on the commentary you gave about inter-segment sale impacting that.

Because if I look at the first half, you had $54 million or thereabouts in inter-segment sales. And that's kind of small in the scope of the $9 billion first-half sales reported. Is there an acceleration in the second half inter-segment, or is -- how should we look at that?

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

No, it's not -- I think from David's question, if I look at the margins that I referenced, he said single digits. I'm not quite to single-digit numbers, so I was just clarifying his math. I think we were both probably in about the same place.

I think that question stands, though. We do see softer segment margin percent and the back half of the year for Construction Industries. Sales are down a little bit; that drives some of it, which is not unusual from a historical perspective for Construction Industries sales to be down in the back half of the year.

They do expect some price pressure, especially in North America. They expect some material cost pressures for steel, and then some higher period costs then to support these investments.

Joe Creed - *Caterpillar Inc. - VP, Finance Services*

This is Joe Creed. I think we're focused on expanding margins in the segments. And we have to be careful not to look at quarter-to-quarter margins in each of the segments, because they can fluctuate from time to time inside the quarter. But on an annual basis, we're committed to the improvement.

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

And so, a couple hundred basis point improvement for the year certainly, I think, is something to denote, and impressive.

Andrew Casey - *Wells Fargo Securities - Analyst*

Okay. All right, thank you very much.

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Operator

Steven Fisher.

Steven Fisher - *UBS - Analyst*

It's UBS. Just to continue that discussion there, you mentioned a number of times the competitive price pressure you expect in the second half in construction, and you just clarified it's North America. Just curious, why will the competitive price pressure be more intense in the second half relative to the first half? Why wasn't that price pressure there in the first half?

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

I'd say the price pressure has been there, but we expect it to continue. And we expect -- I'd say our competitors, as we continue to see the strong dollar work against us from a competitive standpoint, to put additional price pressure in the back half of the year, Steve.

Steven Fisher - *UBS - Analyst*

Okay. And this may be a longer question than the last minute of the call. But what you think is the most likely path to noticeably higher construction equipment sales in North America?

In the past, you've talked about 3% GDP growth driving fleet expansion. Is it really just needing stimulus, at this point, to get the infrastructure piece going? Or is it waiting for a replacement cycle? Or is it an expansion of the rental channel? What's going to get that North America to break out?

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

I think it's a question that will be discussed at the Analyst Day in September. But I think if you go back to the chart on Construction Industries sales that's in the presentation pack, I think what you'll see is we have seen healthy growth in nonresidential and residential spend. Although we still think, from a residential perspective, we're not keeping up with population growth in the US.

But what has, I'd say, disappointed for the last several years has been a lack of growth in infrastructure investment, which is really I think the area that looks prime to need some more investment and some more growth.

Steven Fisher - *UBS - Analyst*

Okay, thank you.

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

All right. Thanks, Steve. And with that, I think that was our last question.

Kate?

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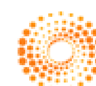

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Operator

Thank you. Ladies and gentlemen, this does conclude today's conference call. You may disconnect your phone lines and have a wonderful day.

Will there be any closing remarks?

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

No, I don't think we have any closing remarks, Kate.

Operator

Thank you, ladies and gentlemen. Have a wonderful day, and thank you for your participation.

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