Caterpillar Inc. (CAT) CEO Discusses Q2 2013 Results - Earnings Call Transcript

Executives

Mike DeWalt – Corporate Controller

Douglas R. Oberhelman – Chairman and Chief Executive Officer

Brad Halverson – Group President and Chief Financial Officer

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Robert Wertheimer – Vertical Research Partners

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Ross P. Gilardi – Bank of America Merrill Lynch

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Caterpillar Inc. (CAT) Q2 2013 Earnings Conference Call July 24, 2013 11:00 AM ET

Operator

Good morning, ladies and gentlemen, and welcome to the Caterpillar Earnings Call. At this time, all lines have been placed on a listen-only mode, and we will open the floor for your questions and comments following the presentation. It is now my pleasure to turn the floor over to your host Mr. Mike DeWalt. Sir, the floor is yours.

Mike DeWalt

Thanks, Kate, and good morning, everyone, and welcome to our second quarter earnings call. I'm Mike DeWalt, Caterpillar's Corporate Controller. On the call today I'm pleased to have with me our Chairman and CEO, Dough Oberhelman; and Group President and CFO, Brad Halverson.

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Now, this morning, undoubtedly we'll 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. Our discussion of some of the factors that either individually or in the aggregate, could make actual results differ materially from our projections, that can be found in our cautionary statements under Item 1-A, Risk Factors, of our Form 10-K filed with the SEC in February of this year, and also in the forward-looking statements language in today's release.

Now, in addition, a reconciliation of non-GAAP measures can be found in our financial release, and again that's been posted on our website at Caterpillar.com.

Now, before we start the Q&A today, I'm going to be covering three main topics. The first will be a summary of our second quarter results and revised outlook. And then I'm going to take a few minutes and talk a little bit about our business segments and then I'm going to finish up with cash flow and the stock repurchase that we talked about this morning.

So I'll start with second quarter, which I'm going to discuss in two ways. First, I'm going to cover at a high level our second quarter results versus the second quarter of 2012. And then I'm going to discuss the specific headwinds that we faced in second quarter and how we are thinking about them going forward, and our expectations for the second half of 2013. First, compared to the second quarter of 2012, our results this morning were quite a bit lower. But to put the year-over-year comparison in context, the second quarter a year ago was certainly a tough comparison. The headline from last year's second quarter started with Caterpillar reports best quarter in history.

Sales this quarter were – sales and revenues were $14.6 billion and that's a 16% decline from the second quarter of 2012. And this morning, we reported profit at a $1.45 per share and that was down $1.09 from the second quarter of last year. Now the sales and revenues declined versus last year and dollars was about $2.8 billion and about half of that was the result of dealer inventory changes and the other half from lower end-user demand. Now in last year's second quarter, dealers bought more machines from Caterpillar than they delivered to customers. And their machine inventories rose again last year about $300 million.

In the second quarter of this year 2013 it was the reverse. Dealers bought less from us than they sold to the customers, and their inventory of new machines as a result declined about $1 billion. So in combination, the impacts and the changes of dealer machine inventories was negative by about $1.3 billion for the quarter-over-quarter. The remaining sales decline was the result of lower end-user demand for machines and to a lesser extent, power systems. The decline in profit was largely a result of that drop in sales.

And on page 6 of this morning's financial release, we have a waterfall chart that would step you through the quarter-to-quarter changes in operating profit. It shows a decline in total from last year to this year of about $1.59 billion and lower volume, which includes product mix more than accounted for the total decline in operating profit.

So the overwhelming story on a quarter-to-quarter profit decline was volume. And I think the waterfall chart covers the other pluses and minuses reasonably well. So I'm going to change gears a little here and talk about the headwinds in the second quarter and how we are thinking about them relative to the second half of the year and we'll start-off with dealer inventory.

As I mentioned before dealers took out about $1 billion of inventories in the second quarter. And that was a sales headwind for us as our sales were about $1 billion below end-user demand. In terms of what that means for the second half of the year, well we expect that to continue. We think dealers are going to take inventory down another $1.5 billion to $2 billion or so between now and year-end.

The continued dealer inventory decline, in fact is the main reason that we lowered our sales and profit outlook for 2013 this morning. We're expecting sales and revenues in a range of $56 billion to $58 billion, and profit of about $6.50 a share to middle of that sales and revenues range. That's a drop of about $2 billion on the top line and $0.50 a share at the bottom line. So, dealer inventory reductions where headwind in the quarter and the main reason we lowered the outlook.

Now our inventory was also a headwind in the quarter. In addition to what the dealers took out, we cut inventory by $1.2 billion in the quarter. That was negative to profit from a cost absorption standpoint. And just to help you get a handle on the profit impact, we use a rule of thumb of 13% to 15% of the inventory change.

The year-end expectation for our inventory is that it will end the year about where it ended the second quarter. That means we do not expect the profit headwind that we had in the second quarter from inventory absorption to continue in the second half of the year. In addition, we also had a substantial currency headwind in the second quarter. And in this context, I'm not really talking about year-over-year, I'm not talking, I'm not comparing the second quarter year-ago. I'm talking about actual translation and hedging losses with a lot of $134 million that happened in the quarter and were reported in the other income and expense line of our P&L, which is a couple of lines below operating profit on the P&L.

Now as we put our outlook together, we don't forecast future currency movements. We do our outlook based on exchange rates as they are. As a result, our outlook does not expect currency translation and hedging losses in the second half of the year like the $134 million in the second quarter.

Now the flip side of that is we did have a positive item in the quarter. We had $135 million gain on our settlement related to the Siwei acquisition and that's also something that we don't expect to repeat. So as we're thinking about the second half of the year, kind of relative to the second quarter, the average sales for each of the two quarters on a quarterly basis in the second half, it's about the same as the second quarter, but we don't think we'll have the negative cost absorption impact like the second quarter had. We don't think we'll have the $134 million at least in our outlook of currency losses, and the Siwei $134 million gain, we don't expect to continue.

The other difference that you need to take into consideration is that we're taking additional actions to reduce costs in the second half of the year. Now, we started taking action in the second quarter, and began implementing cost reduction measures and we're going to do more of that in the second half of the year.

Okay. that's enough for now on the quarter and the outlook. I'd like to change gears just a little bit and talk about segments. I'm going to start by saying that our largest segment this year by sales has been Power Systems. Our most profitable segment this year has been Power Systems. The highest margin rate of any segment this year has been Power Systems.

Now I know that most of you are on the phone here today already know that, but there are many casual observers of Caterpillar that if you ask them that question, what is that mining, which is in our Resource Industries segment. The point of this discussion is that we serve a number of different cyclical industries, but thankfully, they don't all follow the same path at the same time. The diversity within and in fact, between our segments have to mitigate year-to-year swings in sales, both down and up for the company.

The Power Systems segment again; our largest and most profitable segment over the past five years has also been relatively speaking the most stable of our two large equipment segments. and that's because it spent a number of different industries itself electric power, oil and gas, rail, marine and industrial engines. And actually, even within those industries, there is diversity, in oil and gas for example. Our sales of engines for drilling and fracking are weaker and gas compression continues to do pretty well.

Moving on, our Construction Industries segment sells an extensive range of construction equipment around the world to support infrastructure development, commercial and residential construction. The worldwide construction industry is showing signs of recent improvement that remains relatively depressed from a historical standpoint. Construction in the United States well starting to turn up, it's still far below the 2006-2007 peak, and the construction equipment and industry in Europe is as you'd expect well below the prior peak, and construction equipment sales in China in 2013, we expect to be about half of they were in 2011.

The point is, there is a lot of room to grow, just to get back to where we've been before. When economic and construction activities begin to improve in the world, particularly in the U.S. and hopefully, eventually in Europe, it should be a positive for our business. Our Financial Products segment is also important to our business and it's doing very well. It provides financing to end-users that purchase our equipment and it also provides financing for some Caterpillar dealers. Financial Products revenues and profit have proven to be much more stable through the business cycle than our product related businesses, and they're currently performing well. Revenues this quarter were up 5% from the second quarter a year ago, and profit was up.

Now the segment that's currently getting significant attention is Resource Industries, which is primarily mining. Now I'm going to give you one down of what's happening in mining. But before I do that, I'd like to point you to today's financial release. And on page 16 in particular, question number five in the Q&A in the back of the release, we've tried to provide a pre-comprehensive discussion of the mining industry and how it impacts our sales. Now the high points of that discussion start with the production of mine commodities and the underlying health of that mining industry relies on commodity demand and production, and based on the data that we've seen, it looks like mining production in 2013 is going to be a little higher than it was in 2012.

And recently a couple of the big public mining companies have reported they're producing at record levels. Now commodity production underpins the need for mining CapEx. And despite 2013 increases in commodity production, it's clear that mining companies are currently cutting their CapEx after significant increases in 2011 and 2012. While we don't specifically accumulate CapEx estimates ourselves for the industry, we do the follow the market surveys. Based on those surveys, it appears total mining CapEx in 2013 is likely to be down 5% to 10% from 2012. And those some surveys are also indicating further CapEx decline near 20% for 2014.

Now the mining industry CapEx includes spending on exploration and developing, buildings and structures and things like processing plants and equipment. At Caterpillar, we're mostly impacted by spending on equipment, while we don't have a consistent CapEx yield at that level of detail for the industry worldwide; we have reviewed data at the level of details from the Australian Bureau of Statistics, and it tells us that over the past few years, the largest and fastest growing category of CapEx in Australia was four buildings and structures, and while this is the largest category, the most significant declines in 2012 have been for exploration and development and equipment and based on our own experience with large capital projects that makes sense to us. It's difficult to stop construction on large-scale facilities once they get substantially started. That means in the short-term, we believe that more of the decline in mining CapEx is for equipment, things like Caterpillar machines.

It now leads us to end-user demand for our products. That's how much CAT dealers are actually delivering to end-users of mining companies. Year-to-date deliveries to end-users and our expectations of what dealers will deliver for the full year are declines of about 20%. While dealer inventories are down – while dealer deliveries, I'm sorry, are down, for the type of equipment that we make we believe we are doing a little better than the equipment industry overall. And that brings us to resource industry sales. So we started with CapEx, we've moved onto end-user demand from our dealers and now to our sales.

And to relate the decline in mining equipment demand placed on our dealers or sales need to consider several other factors besides mining CapEx. Our resource industry segment includes things that are not directly related to mining CapEx like aftermarket part sales as well as equipment sales to the forestry, paving and quarry, and aggregate industries. Although, resource industry sales of aftermarket parts are down a little in the second quarter of 2013 compared with the year ago, the decline is much less than the decline for equipment and in the context of the total decline in sales, the resource industries is just not a significant factor.

And the collective sales of equipment for forestry, paving and quarry and aggregates, are also down, but again, the vast majority of the decline in resource industry sales for the quarter, the second quarter of 2013 is mining equipment.

Now, in addition to those factors to understand our sales, we also need to consider dealer inventory changes. Dealer inventory increased in the second quarter last year and it declined substantially in the second quarter of 2013. That means that last year we were selling more products to dealers than they were delivering to the end-user and mining companies.

And in the second quarter of this year, we sold far less equipment than dealers were selling to mining customers. In fact, our sales of traditional CAT Mining equipment such as mining trucks, large track excavators and wheel loaders would have had to vend more than 50% higher in the second quarter to match what dealers were delivering to end-users.

In the second half of 2013, we expect that dealers will continue to substantially reduce their inventories. And that means we expect to continue to undersell mining demand for the remainder of 2013.

Given the substantial decline in sales in 2013, the uncertainty around when cyclical recovery will resume, we've taken substantial action to adjust our production levels and to reduce costs. We expect to take further action in the second half of the year. Now, our intention is to reduce costs and drive operational improvements and do it in a way that doesn't significantly reduce our ability to ramp up when production improves.

I know many of you would like to get a better understanding of what we think will happen after 2013. Now, we're going to discuss that here for a couple of minutes, but we want to start by saying, we are not providing sales outlook for 2014 either for resource industries or for CAT in total. It's certainly too early to do that. And the activities over the past five years in the mining equipment industry certainly reinforced that. It has experienced significant demand shifts, goes up and down in the mining industry overall has had difficulty in forecasting those shifts in advance and frankly, that's impacted our forecasts.

We understand that as a part of being in this industry. And this year is a good example as mining companies have been cautious and dealers have reduced our inventories. What we will discuss here this morning is what the industry surveys, not our forecasts, but what the industry surveys about next year suggest and what that could mean and the impact of dealer inventory reductions wind down.

Now, earlier I mentioned that, we've seen surveys that suggesting another 20% decline in the mining CapEx in 2014 from 2013. Again, that's not our estimate, and we're not providing an outlook. But if you take that CapEx survey at face value, it suggests another down here in 2014. To put mining CapEx in the context of our sales though, you have to consider the impact of dealer inventories.

Even if dealer deliveries of new mining equipment were to be down 20% next year from 2013, if we see an end to the dealer inventory reductions over the next few quarters. We believe our sales of new mining equipment to dealers would be positive. In other words, we believe the significance of the end of dealer inventory reductions would have a more significant positive impact on year-over-year sales than our 20% decline in end-user demand.

Just to clarify this, we're not suggesting an increase in inventories next year. Just the absence of the big declines in 2013 that pulled our sales well below what dealers are delivering to mining customers.

Now, in addition to that, if the world economy continues to improve, we would expect commodity productions to also increase and that coupled with the relatively large number of new machines placed in service over the past several years, that should be a positive for mining aftermarket part sales. Again, this is not a forecast for 2014, this time, too early to do that. The preference of this discussion was just to illustrate for you the significance that dealer inventory changes are having on our mining business today and what the implications are for when the decline comes to an end.

Now, looking further ahead, our long-term view of mining remains positive. Commodity demand is driven by economic growth, population increase and the rising standards of living, and we believe that will all continue to improve over the long-term. In addition, declining ore grades imply that in the future more material will need to be moved per ton of commodity output, and that's another positive, at least, from our perspective for long-term equipment needs.

Finally, much has been written and said about the impact of China on commodity demand in the mining industry. Our long-term view of China is also positive. We expect continued urbanization and improvement in standard of living for the people of China. We believe that means more electricity production will be generated and increased production and consumptions in general.

Now, increasing electricity production in particular is a positive for coal. Coal makes up a large portion of the electricity generated in China and they continue to add coal fire capacity. Now that said, we do not expect the significant economic growth rates that China experienced over the past 10 years will continue indefinitely. But we do believe that China will continue to grow at a much faster pace than the rest of the world. And it's also important to remember that over the past 10 years, the size of the Chinese economy has more than doubled, and that means that economic growth rates of 7% to 7.5% had a greater impact today than a 10% growth rate would have had 10 years ago. It's a big economy that relative to the world in total is growing faster.

So in summary on mining, we don't expect much change in the environment in the short-term and the remainder of 2013 will be tough for our mining business. As dealer inventory reductions come to an end, our mining equipment sales could rise from 2013 levels, even if mining CapEx declines. And our long-term of mining remains positive. the world needs mine commodities. As the world grows, we believe commodity demand will continue to increase.

One last quick topic, and then we'll go on to the Q&A, and that topic is cash flow and cash deployment. While it was certainly a tough quarter for sales and profit, our Machinery and Power Systems operating cash flow was better than it's been in a long time. We generated $3 billion worth of the operating cash flow in the quarter, and that's a substantial increase from $1.3 billion in last year's second quarter, and we've put that to work for stockholders.

In the second quarter, we have repurchased $1 billion of CAT stock and we announced a 15% increase in the quarterly dividend. And in this morning's financial release, we announced that with the strength of our cash flow, balance sheet and cash on hand, we expect to repurchase an additional $1 billion of CAT stock in the third quarter. Repurchasing stock in the downturn has been a key part of our cash deployment strategy and we are executing on it.

So with that, we are ready to open up the floor for Q&A.

Question-and-Answer Session

Operator

Thank you. (Operator Instructions) Our first question today is coming from Robert Wertheimer. Please announce your affiliation, then pose your question.

Robert Wertheimer – Vertical Research Partners

Hey, it's Vertical Research Partners, thank you. Good morning, everybody.

Douglas R. Oberhelman

Good morning, Rob.

Robert Wertheimer – Vertical Research Partners

Let's see – let me just start with our systems, since you did highlight that division, I mean, you had one of the strongest margins you've ever had. And wanted to just check in on whether you are seeking or actually just whether that was a mix related, I know power gen – backup power gen has been awful whether it's structure improve in the margin or division and then whether you are seeing any change in electric power?

Douglas R. Oberhelman

Yeah. If you look actually Rob, the dealer statistics that we put out yesterday morning, you can see that's a little bit better than it was a year ago. I think a lot of that has to do with – it was a kind of even turned down a year ago. So I think a little bit on powers – on electric power in particular, the comps will probably just continue to get little easier.

I think for power systems overall, they had a pretty down good quarter. Sales volumes down a little bit, but some of the pieces were up. I think more of their profit improvement had to do with a little price realization and they've done a pretty good job on cutting costs. As opposed to power system, as opposed to construction and resource industries, they didn't have near the decline in inventory that those other two segments did, so the absorption impact was relative to the company in total lots more for them.

Robert Wertheimer – Vertical Research Partners

I'm not sure, if this is one you are willing to or able to answer, but is it possible to look through the turmoil that's gone on in resources over the past six months, and think about what's your margin would be in a more stable environment at these volume levels?

Mike DeWalt

Well, you are right, I'm not going to throw out a number. But I think in my opinion, we had a one positive item the Siwei settlement would be in their numbers, if you would have to take out, that would actually make a little bit lower. But we are in the middle of pretty heavy inventory decreases and that in total, the amounts that they are really underselling real demand and the absorption impact probably more than offset that.

In sense, we are moving from, let's just say, higher volumes over the last year to lower volumes this year. Cutting cost is not a process, and that's going to continue into the second quarter. So if for example, volume, end-user demand kind of hung in at this level. Our sales would probably go up a little bit, because we would stop cutting inventory. We wouldn't have the Siwei adjustments in there, but costs would likely be lower as we've – as where part rates grew kind of the cost cutting activities that we've been doing.

So I guess my part is that would probably be a little higher than it is now, but I don't know that I would want to throw out a number.

Robert Wertheimer – Vertical Research Partners

I guess that was my two. Thank you, Mike.

Operator

Thank you. Our next question today is coming from Ann Duignan. Please announce your affiliation and then pose your question.

Ann Duignan – JPMorgan

Hi, good morning, JPMorgan.

Douglas R. Oberhelman

Good morning, Ann.

Ann Duignan – JPMorgan

Good morning. I'll start out with the decremental margin question. Doug, you've been pretty vocal about driving for 25% pull-through. Can you talk about the decrementals this quarter whether they were disappointing or not to you and are we going to get back to 25% by year-end?

Brad Halverson

Hi, Ann, this is Brad Halverson, and it's a good question. If you look at the second quarter, I think there is a couple of things if you look to the right up to consider in terms of results. On it's close to 70% of our drop in sales, are mining which is negative for mix. But even putting that to a side, if you just look at the period cost absorbed kind of impact, you get to a decremental margin slightly under 30% and we've talked about 25% to 30% kind of a decremental margin in terms of our target.

So for the quarter, you will get slightly under 30%. If you look full-year at our outlook, even with all the headwinds you'll get to a decremental pull-through of 24%. And this was something that we spend a lot of time on, internally. We have targets that we've committed to. And if you look across our segments Resource, Construction, Power, Financial Products each of them, as we talked about before, have made a commitment as to what they'll make at certain volume levels, which ties to our external commitment and they are executing on that. So when we get through the end of the year, we'll be at 650 right around 24% which is, with the mining headwind I think a good number.

Ann Duignan – JPMorgan

Fair point. Thanks for the clarification. It's normally in the press release, but it wasn't conspicuous either today. My follow-up would be on pricing and you also mentioned in the press release some negative pricing, I think it was in resources in Australia. Can you talk about pricing overall and where you are seeing the most price, obviously probably in mining, but why would we be giving up pricing at this point in the cycle?

Mike DeWalt

Yeah, again this is Mike. Just a couple of comments, I think when we talk price realization here it's versus the second quarter a year ago and again, I don't want to harp too much on this, but we had an absolutely fabulous quarter a year ago. Price realization in the second quarter last year, kind of everything came up heads and we had just about $500 million reported for last year, which was pretty close to a third of the whole year.

So, I think to start the discussion off, it was – in total and in particular for price, a pretty tough comparison. we did have slightly negative price realization well less than 1% for Resource Industries and for Construction Industries. For Construction Industries, it was mostly in Latin America, and we have a few big deals going on down there that had a little tighter pricing. And I think for mining in general, it's a tough market out there right now, I mean volume is down quite a bit, and it I think by and large, we're pretty close to holding our own again with a slight reduction in the quarter compared with a really big quarter a year ago.

I don't' think there's any big fundamental shifts. You didn't ask this question, but I'm going to answer it anyway. As a part of this updated outlook, before we were kind of talking about 1% of this year, we're not far off that, and I think we're looking at just a little under 1% for the full-year for the total company this year. So it was a little tighter I think in the second quarter, but pricing didn't overall go down. it was helped a little bit by better number at Power Systems.

Ann Duignan – JPMorgan

Okay, wonderful. (Inaudible) so I will turn it over. Thanks, guys.

Douglas R. Oberhelman

Thanks.

Brad Halverson

Okay.

Operator

Thank you. Our next question today is coming from Ross Gilardi. Please announce your affiliation, then pose your question.

Ross P. Gilardi – Bank of America Merrill Lynch

Hi, Bank of America, thank you. Mike, in talking about mining, there is an awful lot of focus dealer destocking and the business as the big source of paying, but this is a major order business. So I mean, isn't the real fundamental issue that the miners are just canceling orders and as long as that remains the case, you are not going to see much of a pickup in production and margins unless until you see a pickup in orders?

Mike DeWalt

Yeah, Ross, that's actually a great point. And one of the things I think that has been impacting orders, remember we don't take orders directly from the mining companies, we take orders from the dealers, the dealers take orders from mining companies. So if you look at the destocking inventory, I think that's certainly having some impact on the dealer order rates to us. So we definitely would like to see order rates pick up, but I think certainly until we get through the inventory reduction, there will probably a drag at least on orders placed on us.

But to your point, I'll just kind of go back to it. I talked about the surveys that suggest mining CapEx down another 20, for that to be the case, I mean, orders have to pickup. I mean, if dealers don't order anything or, I'm sorry, customers don't order from dealers and dealers from us don't order anything or don't order more, then 20% is just not, I don't think it's in the cards. That would look like an optimistic number. So I think for mining CapEx next year to be down 20%, they have to order more, dealers would have to order more from us than they are today. Maybe I am not trying to make that overly complex, but to say that even at 20% decline in mining CapEx considering the dealers ought to be out of inventory here pretty soon, would have to mean more orders placed on us, and that's a better way to say it.

Ross P. Gilardi – Bank of America Merrill Lynch

Okay. Thanks, Mike, and then you mentioned in the discussion of resources in the press release that that acquisitions and divestitures negatively impacted operating profit by $33 million in resources and I believe that's with $135 million gain from Siwei in there. So is that $33 million a year-on-year swing in earnings or should we assume that BUCY is loss making at this point?

Mike DeWalt

No, no, no.

Douglas R. Oberhelman

I think what you need to do is go back in our second quarter release from a year ago, one of our Q&As in the back of that release had quite a bit of detail on Bucyrus and included in there we had pre-tax gains on the sale of the Bucyrus distribution, we had some big ones. So basically the gains from last year on the sale of Bucyrus distribution to some of the big dealers more than offset the $135 million this year.

Ross P. Gilardi – Bank of America Merrill Lynch

I got you. Just related to that though, have you had an impairment test for Bucyrus yet and if not, is there a next test coming up to do that annually?

Douglas R. Oberhelman

Yeah, we do that annually. I want to be careful on how I answer this. If you do an impairment test, it looks forward to what you think you're going to generate in that business over a longer period in time and we certainly wouldn't be using a cyclical low straight line going forward. In our mining business, I think there is reasonable headroom, I certainly don't want to predict what a test would be, but I think the chances of an impairment there are probably not, it certainly not like, but…

Ross P. Gilardi – Bank of America Merrill Lynch

Okay. Thanks very much.

Operator

Thank you. Our next question today is coming from Ashish Gupta. Please announce your affiliation, then pose your question.

Ashish R. Gupta – Credit Agricole Securities, Inc.

Hi, good morning, it's CLSA. I believe in the past that Doug mentioned that China is not overexcavated. Now I'm wondering kind of what the pickup in sales we've seen recently. I'm wondering how to think about the machine population over time, now they are moving to more to maintenance from infrastructure. I'm just wondering how you guys view the long-term machine population in China, relative to some of the more developed economies?

Mike DeWalt

Yeah. I mean this is the case where there is a short-term story, there is a long-term story. I think clearly, if you look at long-term, I mean I know the market doesn't like to look out this far, but if you look out at a point where China is developed, say today to the level of Japan or South Korea or Europe maybe, the excavator population, the construction equipment population in terms of equipment relative to the economy currently is a lot lower than those developed countries. So as the standard living wise is there at the level of development, builds out over time, the population of equipment in China will certainly need to grow. I guess the big question you have is, will that take three years, five years, 10 years, 20 years, 50 years. And I think that depends a lot on the scale of China's growth.

From our perspective, I think it's going to grow. I mean our view is it, it's probably I guess the second biggest economy in the world today and it is growing at a faster pace than the rest of the world and it's important, it's going to grow and this level of development is going to grow. And I think as a result of that construction equipment industry, there it's going to need to grow.

But it is true when we see that in our part sales in China. As the population is increased and the equipment gets used, it has driven part sales up in China over the past few years and as that population continues to develop that's a trend that will probably continue.

Douglas R. Oberhelman

Yeah, Doug Oberhelman here, I'll just comment a bit on China as we see it in particularly as I see it. I'm not one in the camp of a China implosion that that China will implode and drag the world down into a massive black hole. I think what we will see in China is very healthy with a much slower rate of growth and I would call it 5 to 8, they say 7 to 7.5, so be it, but that means the maturing of that market for construction equipment and all kinds of things. And as that economy is double to the last decade, we've seen our fuel population of machines grow and grow and grow, allow parts and services opportunity for our dealers. And our business model plays well with that.

And that's exactly what we're trying to do. We've also been working hard on market share in China and that is up and we're quite happy with that. And as that year-over-year sales are up that is for all of our business in China are fairly substantially.

So, we're going to see China go in fits and starts. Obviously and I have said this before to many that, I hope we don't see another double-digit burn. The after effects of that and the residue is painful for everyone, 5% to 7% 8% growth rate is just fine. We've sized our business for that. We'll do very well with that particularly trying to get to a leadership position in market share, and that's really the way we see China overall. Mining certainly, is an opportunity there. we're working on that, and much of that is underground as you know. we now have an underground offering to work with. So a long-term, China and mining are appealing to our short-term. we go through cycles and we're certainly in that downturn at the moment.

Ashish R. Gupta – Credit Agricole Securities, Inc.

Thanks for that, Doug. Just one quick follow-up, when you guys look at your global fleet of machines with GPS data, can you help provide us with some sort of indication of what you're seeing globally by region?

Douglas R. Oberhelman

Ashish, I'd like to give you the answer to that, but of all the myriad of data that I made sure I was up to speak on, before I came in here today, I didn't look at that. So I don't…

Brad Halverson

We can't do it regionally anyway, but overall machine operation is service meter units on the fuel population that we have monitored today are relatively steady and have that. And I think as we look back a few months. So overall, that's a worldwide number including the U.S., China and everywhere else in the world. So it's hard to say that regionally.

Ashish R. Gupta – Credit Agricole Securities, Inc.

Great, thanks very much.

Operator

Thank you. Our next question today is coming from Andrew Kaplowitz. Please announce your affiliation, then pose your question.

Andrew Kaplowitz – Barclays Capital, Inc.

It's Barclays. Good morning guys.

Douglas R. Oberhelman

Hey, Andrew.

Brad Halverson

Hey, Andrew.

Andrew Kaplowitz – Barclays Capital, Inc.

Hey, so if you look at your press release, one of the things that you said is, you believe it's unlikely that dealers will continue to reduce machinery, machine inventory in 2014. So maybe, Mike if you can talk about your conviction level on that statement, this is first down cycle of that you've had with your PDCs, with your product distribution centers. so I guess what I'm wondering is, is there anyway to look at the overall inventory in the channel between the PDCs and the dealers to get a read on whether you think inventory is low enough that you can sort of make that statement, because it's hard for us, because the PDCs are relatively new development.

Douglas R. Oberhelman

Yeah, yeah. That's actually a very good question, Andy. If you just look at dealer inventories, they're really today, really on the lower side of the historic range, actually, really on the lower side. If you include PDC inventories right now, the sum of the two is probably right kind of maybe, more in the middle of our reasonable range. and we're looking for continued dealer inventory reduction through the rest of this year. I mean we're looking at somewhere between $1.5 and $2 billion coming out in the second half.

So further from here, I mean mining inventory probably be at about half the level, but it's started the year and construction down some. Now your question about conviction level, as in all things, it depends upon what the economy does that our sales forecast for next year ends up being and we don't have that. But if you look at just where months of supply are or the severity of what's happening, and particularly in construction it's trajectory of the way the sales chart looks. I think there is a pretty reasonable conviction that dealer inventory is certainly not going to have the kind of declines that it had this year. and probably, I guess at this point, I think it would be, we will have a pretty reasonable conviction that it's not going to go down certainly at least much next year. But again, I'm going to qualify that, because it depends a lot upon what happens to sale, as into some degree, when it happens next year.

Mike DeWalt

Now, just a couple of other comments; dealers are using PDC quite a bit more this year. The usage rate, the percent of dealer machines that are coming out of PDC is actually quite a bit higher in the second quarter than it was last year. So it looks like dealers are using PDC inventory and that's a good thing. However, delivery times for product to dealers compared with a year ago are much less and I don't think that's probably a surprise, so that's happened. So I think there is a pretty reasonable conviction on dealer inventory that's going to slow or stop.

Andrew Kaplowitz – Barclays Capital, Inc.

Mike, it's fair to say then that at the end of this year, when the dealer inventory comes out as you expect that the addition of PDC plus the dealer inventories would then be at the low-end of your historical range versus dealer inventories in the past?

Mike DeWalt

Well, that will dependent upon what our forecast for the first quarter sales is, because when we look at it, months of supply is kind of related to the forward-looking sales estimate for the quarter. So since we don't have that out there right now, it's a little bit tough for me to just say that. But I think our expectation is it would certainly be in the range, yeah.

Andrew Kaplowitz – Barclays Capital, Inc.

Okay. And then if I could ask a follow-up on Resource Industries' margins. I mean, I know people are already hitting you on that. I guess, the issue that we have is the decremental margin in that particular business looks exceedingly low, and you've talked about really accelerating cost takeout in 2Q. Is it possible to quantify how much cost takeout you really started in 2Q in terms of expense, so maybe we can sort of pass-through why the decrementals were so low. I know you are going to tell me that mix is negative also.

Mike DeWalt

Well, mix is certainly negative for the total company, because more of the decline was mining. But we introduced this concept of profit curves inside the company, demands of the business, and each of our three segments have a positive curve. In other words, if sales goes up, there is an expectation of a certain amount of profit, when sales goes down, there is an expectation that only that much will come out. And so there is basically, think of it as an incremental and decremental margin rate for each segment.

And the take-out rate for mining is a little higher than the 25% that we look at for the total company, and that's probably not as fast. So we are trying to take actions on costs that will allow us to get as close as possible for that, sort of curve decremental margin rate.

So they've been, I'm not going to quantify for you, but they've been doing – rolling lay-offs, rolling temporary lay-offs for salaried management, employees. We've taken R&D down a little bit. And the things that we're going to do in the second half of the year, we certainly haven't announced to our own employees yet. And so the specifics on that are probably going to start coming out, I would guess over the course of the next month or so. So it's probably better to talk about the specific items after that, but definitely we're planning to take some more action here in the second half of the year.

Now, one thing that and this is through the first half of the year and this will ease in the second half of the year, it's particularly earning decremental and that just period cost absorption. I mean, we added a lot of inventory in the first half of last year and in the second half. I'm not talking dealer inventory, I'm talking our inventory. And this year's first half, we've taken inventory out. We took about $0.5 billion out in the first quarter. We took $1.7 billion up this quarter, and that does primarily impacted construction and resource industries.

And the more vertically integrated you are, the larger the impact is on your business and that's been a particular negative for Resource Industries in terms of incremental. There was a positive last year and negative this year. It's not really an operational item. When you think about it, it's not operating efficiency. So as the inventory declines start to slowdown, that should be a little better in the second half.

Andrew Kaplowitz – Barclays Capital, Inc.

And for that segment the decrementals to inventory reduction would actually be higher than 13% to 15% as you said for the whole company?

Douglas R. Oberhelman

Yeah. We've not given out a number overall, but if you think about it the absorption thing is basically down to fixed costs that essentially get absorbed in and released from inventory, when you build and sell inventory. If your entire business was just buying and selling material, you wouldn't have a lot of value added to absorb. Then the businesses where you are a lot more vertically integrated, you would have more and I think Resource Industries is probably a little more vertically integrated than Construction, for example.

Andrew Kaplowitz – Barclays Capital, Inc.

Thank you.

Operator

Thank you. Our next question today is coming from Jamie Cook. Please announce your affiliation, then pose your question.

Jamie L. Cook – Credit Suisse Securities LLC

Hi, good morning, Credit Suisse. I guess just two quick follow-up questions. Under your new forecast, I think, your forecast implied that mining OE would be taken down about $7 billion, what are your assumptions under your new forecast, because I'm just trying to back into what mining OE will be as a percentage of total sales as we exit 2013, because I actually think that would be most helpful as we all have different macro assumptions or assumptions on mining. But if we can get a sense of what mining OE would be, I think that would be much easier for us. and as I calculate it could be as low as 10% or as high as 15% and I'm just wondering how off I am? And then I guess my second question, Mike, last quarter, I think you said, your core mining business would be down 50 [but you see] 15 and then aftermarket flat, just can you talk to what your new assumptions are? Thanks.

Mike DeWalt

Yeah, again, if you look at the last outlook and this outlook, the main driver of the decline is dealer inventory. So I mean that's the biggest driver and that is machines. So it's a combination of Resource Industries and Construction. What we're looking at in the back half of the year is probably more slanted to Resource Industries. So I think proportionately of the decline in the outlook, more of it would have been Resource Industries certainly than Construction. And actually, Power Systems is sort of flat to slightly up in the outlook.

Jamie L. Cook – Credit Suisse Securities LLC

Okay, but you didn't answer the question on…

Mike DeWalt

No, we don't disclose new equipment separately from aftermarket in our results. So I can't really give you mining equipment number separate in Resource Industries. We still don't disclose it that way. I am not trying to (inaudible). What I am trying to tell you is it, whatever your current estimate is probably the majority of the decline in the outlook, and when I say majority, I mean, more than half in this context, would be Resource Industries for equipment. They have more of the defined and dealer inventory in the second half.

Jamie L. Cook – Credit Suisse Securities LLC

And then any change in your assumption, so do you see this turning what you saw at aftermarket, can you just talk to those relative to last forecast?

Mike DeWalt

Yeah, I think directionally, both of those numbers are kind of the same, but remember when we were talking about the 50%, that's not end-user demand that's what we're selling to dealer's.

Jamie L. Cook – Credit Suisse Securities LLC

Yes.

Mike DeWalt

And that has been impacted, of course, by the dealer inventories, so that means that our sales of the traditional product is down. The Bucyrus product is down a little bit, but I think that's sort of proportion that you used with Bucyrus sales holding up much better than the traditional CAT product, is absolutely true, and a lot of that is because the dealer inventory impact is much more pronounced for trucks and dozers and wheel loaders, then it certainly is the Bucyrus product.

Jamie L. Cook – Credit Suisse Securities LLC

And then the mining aftermarket?

Mike DeWalt

Yeah, it's holding up pretty steady. We had a really strong first half last year. Coal mining was still doing okay and then it's kind of started to tail off a bit in the second half of last year, but our expectations for aftermarket this year haven't really changed.

Jamie L. Cook – Credit Suisse Securities LLC

Okay, thanks. I'll get back in queue.

Mike DeWalt

(Inaudible) that you would be concerned about.

Operator

Thank you. Our next question today is coming from David Raso. Please announce your affiliation, then pose your question.

David M. Raso – International Strategy & Investment Group LLC

ISI, I'm just trying to gain some comfort with the second half implied margins. if you pull out the settlement gain in 2Q, the margins for the year so far about 8% and 9%. the second half of the year is implying more at 11.5% to 12% operating margins. So when I think about how to bridge that gap, basically to find about 300 bps of margin improvement. you are looking for sales growth of about 7% sequentially first half to second half. and I can get a decent amount of margin improvement with a pretty healthy incremental margin on that sequential build increase, but can you help us a bit with the mix to better understand the incremental margins, the overhead absorption benefit. Where do you see the 7% sequential increase, which businesses maybe geography, just help us a bit, we're trying to get a feel for how much could the incremental margins be, the overhead absorption benefit, what could it be on that sequential improvement?

Mike DeWalt

Yeah. I think when you say incremental margins; you are talking about kind of from the first half to second half.

David M. Raso – International Strategy & Investment Group LLC

Yeah, I'm talking sequentially.

Mike DeWalt

Yeah, yeah. I think there are three big things that are driving that. one is just the absence of negative inventory absorptions. and if you start with the premise that the second half of our year, if you look at the implied guidance at the midpoint on sales and revenues, it has sales in the second half of the year averaging about what they did in the second quarter, but up a bit from the first half average. so volume will be some hope, and we would certainly expect our reasonable incremental margins on volume. I mean I'm not talking massive, but our kind of target range is around 25%, and so incremental margin on volumes, second half versus first half a little better. I think the second thing is absorption that was a pretty big deal in the first half, and in particular, in the second quarter, we have $1.2 billion inventory declines.

so that had a pretty sizable effect. And I think the third thing is, to get to a point where inventory is not going to go down further, our production needs to go up. And that's certainly the case, particularly for construction. And so that are to be positive for this efficiency in general. And then we have cost reduction activity, we've said we're going to do it. We haven't really – particularly because we haven't announced it internally, any specifics, but we're going to take additional actions in the second half of the year to lower cost, so volume from efficiency as production goes up, absence of the large negative cost absorption impacts and some additional cost reduction.

David M. Raso – International Strategy & Investment Group LLC

But where is it coming, you mentioned construction, but if you had to handicap, the 7% increase in revenues sequentially first half, second half, is the increase mostly in Construction, is it Power or even suggesting Resource Industries sequentially better. I'm just trying to get a feel to better gauge those incremental profitability?

Mike DeWalt

Yeah. I think you would, normally, if you think about our fourth quarter, our Power Systems business usually has a stronger second half than they do first half. so I don't know anything this year that would cause that to be different and where we're ramping up production is mostly in Construction.

David M. Raso – International Strategy & Investment Group LLC

Okay. And lastly not to even suggesting and tell me 2014 sales guidance, but just going from what you've articulated in this press release and this discussion. You feel inventory won't be lowered further next year as a base case, right? So that's $3.5 billion of Cat sales growth next year, if retail is flat, I mean that's a caveat there. But when I think about your commentary and your thoughts around Construction and Power, can we walk away from this call saying base case, Cat is thinking revenue growth at a bare minimum is up next year?

Mike DeWalt

I would love to answer that question directly. But and I said about five times in my script, we're not doing an outlook. I think the message that we're trying to get people to think about is just the scale of the impact that dealer inventory reduction has had in this year. And the likelihood that, there is a lot of water to go under the bridge, and so I'm hesitating a little bit on making too much in the way of predictions about next year. Well, I think given the scale of what's happened this year, it's certainly not likely that that's going to happen again in terms of dealer inventory reduction. So…

Douglas R. Oberhelman

David, Doug here. I've kind of been waiting to make this point and this inventory swing up and down has been painful on us and our dealers. That is the fundamental reason we established our enterprise system, structure organization and emphasis a few months ago, working on lead times, lead manufacturing, and really getting after a condensed supply chain. And that's my number one initiative between now and the end of '15, and I think I said in the last call, we expect to see some of that in 2015. There is lots of mine, lots of fruit to be picked on this one. And if there is ever a reason or a good way to get after it, it's this inventory swing that we've seen up and down. I just want to make sure you all understand how important that is if we get that organized. We have come a long way, but we still have the ways to go with that, and we'll start to see that manifest itself late next year and certainly into 2015 a little bit.

David M. Raso – International Strategy & Investment Group LLC

Okay. Thank you very much.

Mike DeWalt

With that, I'm afraid we're at the end of our hour here today. Thank you very much for joining in and we'll talk to you this time again next quarter.

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.

If you have any additional questions about our online transcripts, please contact us at: transcripts@seekingalpha.com. Thank you!

Executives

Mike DeWalt – Corporate Controller

Douglas R. Oberhelman – Chairman and Chief Executive Officer

Brad Halverson – Group President and Chief Financial Officer

Analysts

Robert Wertheimer – Vertical Research Partners

Ann Duignan – JPMorgan

Ross P. Gilardi – Bank of America Merrill Lynch

Ashish R. Gupta – Credit Agricole Securities, Inc.

Andrew Kaplowitz – Barclays Capital, Inc.

Jamie L. Cook – Credit Suisse Securities LLC

David M. Raso – International Strategy & Investment Group LLC

Caterpillar Inc. (CAT) Q2 2013 Earnings Conference Call July 24, 2013 11:00 AM ET

Operator

Good morning, ladies and gentlemen, and welcome to the Caterpillar Earnings Call. At this time, all lines have been placed on a listen-only mode, and we will open the floor for your questions and comments following the presentation. It is now my pleasure to turn the floor over to your host Mr. Mike DeWalt. Sir, the floor is yours.

Mike DeWalt

Thanks, Kate, and good morning, everyone, and welcome to our second quarter earnings call. I'm Mike DeWalt, Caterpillar's Corporate Controller. On the call today I'm pleased to have with me our Chairman and CEO, Dough Oberhelman; and Group President and CFO, Brad Halverson.

This call is copyrighted by Caterpillar Inc., and any use, recording, or transmission of any portion of this call without our written consent is strictly prohibited. If you would like a copy of today's call transcript, we'll be posting it in the Investor Section of our Caterpillar.com website, and it'll be in the section labeled Results Webcast.

Now, this morning, undoubtedly we'll 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. Our discussion of some of the factors that either individually or in the aggregate, could make actual results differ materially from our projections, that can be found in our cautionary statements under Item 1-A, Risk Factors, of our Form 10-K filed with the SEC in February of this year, and also in the forward-looking statements language in today's release.

Now, in addition, a reconciliation of non-GAAP measures can be found in our financial release, and again that's been posted on our website at Caterpillar.com.

Now, before we start the Q&A today, I'm going to be covering three main topics. The first will be a summary of our second quarter results and revised outlook. And then I'm going to take a few minutes and talk a little bit about our business segments and then I'm going to finish up with cash flow and the stock repurchase that we talked about this morning.

So I'll start with second quarter, which I'm going to discuss in two ways. First, I'm going to cover at a high level our second quarter results versus the second quarter of 2012. And then I'm going to discuss the specific headwinds that we faced in second quarter and how we are thinking about them going forward, and our expectations for the second half of 2013. First, compared to the second quarter of 2012, our results this morning were quite a bit lower. But to put the year-over-year comparison in context, the second quarter a year ago was certainly a tough comparison. The headline from last year's second quarter started with Caterpillar reports best quarter in history.

Sales this quarter were – sales and revenues were $14.6 billion and that's a 16% decline from the second quarter of 2012. And this morning, we reported profit at a $1.45 per share and that was down $1.09 from the second quarter of last year. Now the sales and revenues declined versus last year and dollars was about $2.8 billion and about half of that was the result of dealer inventory changes and the other half from lower end-user demand. Now in last year's second quarter, dealers bought more machines from Caterpillar than they delivered to customers. And their machine inventories rose again last year about $300 million.

In the second quarter of this year 2013 it was the reverse. Dealers bought less from us than they sold to the customers, and their inventory of new machines as a result declined about $1 billion. So in combination, the impacts and the changes of dealer machine inventories was negative by about $1.3 billion for the quarter-over-quarter. The remaining sales decline was the result of lower end-user demand for machines and to a lesser extent, power systems. The decline in profit was largely a result of that drop in sales.

And on page 6 of this morning's financial release, we have a waterfall chart that would step you through the quarter-to-quarter changes in operating profit. It shows a decline in total from last year to this year of about $1.59 billion and lower volume, which includes product mix more than accounted for the total decline in operating profit.

So the overwhelming story on a quarter-to-quarter profit decline was volume. And I think the waterfall chart covers the other pluses and minuses reasonably well. So I'm going to change gears a little here and talk about the headwinds in the second quarter and how we are thinking about them relative to the second half of the year and we'll start-off with dealer inventory.

As I mentioned before dealers took out about $1 billion of inventories in the second quarter. And that was a sales headwind for us as our sales were about $1 billion below end-user demand. In terms of what that means for the second half of the year, well we expect that to continue. We think dealers are going to take inventory down another $1.5 billion to $2 billion or so between now and year-end.

The continued dealer inventory decline, in fact is the main reason that we lowered our sales and profit outlook for 2013 this morning. We're expecting sales and revenues in a range of $56 billion to $58 billion, and profit of about $6.50 a share to middle of that sales and revenues range. That's a drop of about $2 billion on the top line and $0.50 a share at the bottom line. So, dealer inventory reductions where headwind in the quarter and the main reason we lowered the outlook.

Now our inventory was also a headwind in the quarter. In addition to what the dealers took out, we cut inventory by $1.2 billion in the quarter. That was negative to profit from a cost absorption standpoint. And just to help you get a handle on the profit impact, we use a rule of thumb of 13% to 15% of the inventory change.

The year-end expectation for our inventory is that it will end the year about where it ended the second quarter. That means we do not expect the profit headwind that we had in the second quarter from inventory absorption to continue in the second half of the year. In addition, we also had a substantial currency headwind in the second quarter. And in this context, I'm not really talking about year-over-year, I'm not talking, I'm not comparing the second quarter year-ago. I'm talking about actual translation and hedging losses with a lot of $134 million that happened in the quarter and were reported in the other income and expense line of our P&L, which is a couple of lines below operating profit on the P&L.

Now as we put our outlook together, we don't forecast future currency movements. We do our outlook based on exchange rates as they are. As a result, our outlook does not expect currency translation and hedging losses in the second half of the year like the $134 million in the second quarter.

Now the flip side of that is we did have a positive item in the quarter. We had $135 million gain on our settlement related to the Siwei acquisition and that's also something that we don't expect to repeat. So as we're thinking about the second half of the year, kind of relative to the second quarter, the average sales for each of the two quarters on a quarterly basis in the second half, it's about the same as the second quarter, but we don't think we'll have the negative cost absorption impact like the second quarter had. We don't think we'll have the $134 million at least in our outlook of currency losses, and the Siwei $134 million gain, we don't expect to continue.

The other difference that you need to take into consideration is that we're taking additional actions to reduce costs in the second half of the year. Now, we started taking action in the second quarter, and began implementing cost reduction measures and we're going to do more of that in the second half of the year.

Okay. that's enough for now on the quarter and the outlook. I'd like to change gears just a little bit and talk about segments. I'm going to start by saying that our largest segment this year by sales has been Power Systems. Our most profitable segment this year has been Power Systems. The highest margin rate of any segment this year has been Power Systems.

Now I know that most of you are on the phone here today already know that, but there are many casual observers of Caterpillar that if you ask them that question, what is that mining, which is in our Resource Industries segment. The point of this discussion is that we serve a number of different cyclical industries, but thankfully, they don't all follow the same path at the same time. The diversity within and in fact, between our segments have to mitigate year-to-year swings in sales, both down and up for the company.

The Power Systems segment again; our largest and most profitable segment over the past five years has also been relatively speaking the most stable of our two large equipment segments. and that's because it spent a number of different industries itself electric power, oil and gas, rail, marine and industrial engines. And actually, even within those industries, there is diversity, in oil and gas for example. Our sales of engines for drilling and fracking are weaker and gas compression continues to do pretty well.

Moving on, our Construction Industries segment sells an extensive range of construction equipment around the world to support infrastructure development, commercial and residential construction. The worldwide construction industry is showing signs of recent improvement that remains relatively depressed from a historical standpoint. Construction in the United States well starting to turn up, it's still far below the 2006-2007 peak, and the construction equipment and industry in Europe is as you'd expect well below the prior peak, and construction equipment sales in China in 2013, we expect to be about half of they were in 2011.

The point is, there is a lot of room to grow, just to get back to where we've been before. When economic and construction activities begin to improve in the world, particularly in the U.S. and hopefully, eventually in Europe, it should be a positive for our business. Our Financial Products segment is also important to our business and it's doing very well. It provides financing to end-users that purchase our equipment and it also provides financing for some Caterpillar dealers. Financial Products revenues and profit have proven to be much more stable through the business cycle than our product related businesses, and they're currently performing well. Revenues this quarter were up 5% from the second quarter a year ago, and profit was up.

Now the segment that's currently getting significant attention is Resource Industries, which is primarily mining. Now I'm going to give you one down of what's happening in mining. But before I do that, I'd like to point you to today's financial release. And on page 16 in particular, question number five in the Q&A in the back of the release, we've tried to provide a pre-comprehensive discussion of the mining industry and how it impacts our sales. Now the high points of that discussion start with the production of mine commodities and the underlying health of that mining industry relies on commodity demand and production, and based on the data that we've seen, it looks like mining production in 2013 is going to be a little higher than it was in 2012.

And recently a couple of the big public mining companies have reported they're producing at record levels. Now commodity production underpins the need for mining CapEx. And despite 2013 increases in commodity production, it's clear that mining companies are currently cutting their CapEx after significant increases in 2011 and 2012. While we don't specifically accumulate CapEx estimates ourselves for the industry, we do the follow the market surveys. Based on those surveys, it appears total mining CapEx in 2013 is likely to be down 5% to 10% from 2012. And those some surveys are also indicating further CapEx decline near 20% for 2014.

Now the mining industry CapEx includes spending on exploration and developing, buildings and structures and things like processing plants and equipment. At Caterpillar, we're mostly impacted by spending on equipment, while we don't have a consistent CapEx yield at that level of detail for the industry worldwide; we have reviewed data at the level of details from the Australian Bureau of Statistics, and it tells us that over the past few years, the largest and fastest growing category of CapEx in Australia was four buildings and structures, and while this is the largest category, the most significant declines in 2012 have been for exploration and development and equipment and based on our own experience with large capital projects that makes sense to us. It's difficult to stop construction on large-scale facilities once they get substantially started. That means in the short-term, we believe that more of the decline in mining CapEx is for equipment, things like Caterpillar machines.

It now leads us to end-user demand for our products. That's how much CAT dealers are actually delivering to end-users of mining companies. Year-to-date deliveries to end-users and our expectations of what dealers will deliver for the full year are declines of about 20%. While dealer inventories are down – while dealer deliveries, I'm sorry, are down, for the type of equipment that we make we believe we are doing a little better than the equipment industry overall. And that brings us to resource industry sales. So we started with CapEx, we've moved onto end-user demand from our dealers and now to our sales.

And to relate the decline in mining equipment demand placed on our dealers or sales need to consider several other factors besides mining CapEx. Our resource industry segment includes things that are not directly related to mining CapEx like aftermarket part sales as well as equipment sales to the forestry, paving and quarry, and aggregate industries. Although, resource industry sales of aftermarket parts are down a little in the second quarter of 2013 compared with the year ago, the decline is much less than the decline for equipment and in the context of the total decline in sales, the resource industries is just not a significant factor.

And the collective sales of equipment for forestry, paving and quarry and aggregates, are also down, but again, the vast majority of the decline in resource industry sales for the quarter, the second quarter of 2013 is mining equipment.

Now, in addition to those factors to understand our sales, we also need to consider dealer inventory changes. Dealer inventory increased in the second quarter last year and it declined substantially in the second quarter of 2013. That means that last year we were selling more products to dealers than they were delivering to the end-user and mining companies.

And in the second quarter of this year, we sold far less equipment than dealers were selling to mining customers. In fact, our sales of traditional CAT Mining equipment such as mining trucks, large track excavators and wheel loaders would have had to vend more than 50% higher in the second quarter to match what dealers were delivering to end-users.

In the second half of 2013, we expect that dealers will continue to substantially reduce their inventories. And that means we expect to continue to undersell mining demand for the remainder of 2013.

Given the substantial decline in sales in 2013, the uncertainty around when cyclical recovery will resume, we've taken substantial action to adjust our production levels and to reduce costs. We expect to take further action in the second half of the year. Now, our intention is to reduce costs and drive operational improvements and do it in a way that doesn't significantly reduce our ability to ramp up when production improves.

I know many of you would like to get a better understanding of what we think will happen after 2013. Now, we're going to discuss that here for a couple of minutes, but we want to start by saying, we are not providing sales outlook for 2014 either for resource industries or for CAT in total. It's certainly too early to do that. And the activities over the past five years in the mining equipment industry certainly reinforced that. It has experienced significant demand shifts, goes up and down in the mining industry overall has had difficulty in forecasting those shifts in advance and frankly, that's impacted our forecasts.

We understand that as a part of being in this industry. And this year is a good example as mining companies have been cautious and dealers have reduced our inventories. What we will discuss here this morning is what the industry surveys, not our forecasts, but what the industry surveys about next year suggest and what that could mean and the impact of dealer inventory reductions wind down.

Now, earlier I mentioned that, we've seen surveys that suggesting another 20% decline in the mining CapEx in 2014 from 2013. Again, that's not our estimate, and we're not providing an outlook. But if you take that CapEx survey at face value, it suggests another down here in 2014. To put mining CapEx in the context of our sales though, you have to consider the impact of dealer inventories.

Even if dealer deliveries of new mining equipment were to be down 20% next year from 2013, if we see an end to the dealer inventory reductions over the next few quarters. We believe our sales of new mining equipment to dealers would be positive. In other words, we believe the significance of the end of dealer inventory reductions would have a more significant positive impact on year-over-year sales than our 20% decline in end-user demand.

Just to clarify this, we're not suggesting an increase in inventories next year. Just the absence of the big declines in 2013 that pulled our sales well below what dealers are delivering to mining customers.

Now, in addition to that, if the world economy continues to improve, we would expect commodity productions to also increase and that coupled with the relatively large number of new machines placed in service over the past several years, that should be a positive for mining aftermarket part sales. Again, this is not a forecast for 2014, this time, too early to do that. The preference of this discussion was just to illustrate for you the significance that dealer inventory changes are having on our mining business today and what the implications are for when the decline comes to an end.

Now, looking further ahead, our long-term view of mining remains positive. Commodity demand is driven by economic growth, population increase and the rising standards of living, and we believe that will all continue to improve over the long-term. In addition, declining ore grades imply that in the future more material will need to be moved per ton of commodity output, and that's another positive, at least, from our perspective for long-term equipment needs.

Finally, much has been written and said about the impact of China on commodity demand in the mining industry. Our long-term view of China is also positive. We expect continued urbanization and improvement in standard of living for the people of China. We believe that means more electricity production will be generated and increased production and consumptions in general.

Now, increasing electricity production in particular is a positive for coal. Coal makes up a large portion of the electricity generated in China and they continue to add coal fire capacity. Now that said, we do not expect the significant economic growth rates that China experienced over the past 10 years will continue indefinitely. But we do believe that China will continue to grow at a much faster pace than the rest of the world. And it's also important to remember that over the past 10 years, the size of the Chinese economy has more than doubled, and that means that economic growth rates of 7% to 7.5% had a greater impact today than a 10% growth rate would have had 10 years ago. It's a big economy that relative to the world in total is growing faster.

So in summary on mining, we don't expect much change in the environment in the short-term and the remainder of 2013 will be tough for our mining business. As dealer inventory reductions come to an end, our mining equipment sales could rise from 2013 levels, even if mining CapEx declines. And our long-term of mining remains positive. the world needs mine commodities. As the world grows, we believe commodity demand will continue to increase.

One last quick topic, and then we'll go on to the Q&A, and that topic is cash flow and cash deployment. While it was certainly a tough quarter for sales and profit, our Machinery and Power Systems operating cash flow was better than it's been in a long time. We generated $3 billion worth of the operating cash flow in the quarter, and that's a substantial increase from $1.3 billion in last year's second quarter, and we've put that to work for stockholders.

In the second quarter, we have repurchased $1 billion of CAT stock and we announced a 15% increase in the quarterly dividend. And in this morning's financial release, we announced that with the strength of our cash flow, balance sheet and cash on hand, we expect to repurchase an additional $1 billion of CAT stock in the third quarter. Repurchasing stock in the downturn has been a key part of our cash deployment strategy and we are executing on it.

So with that, we are ready to open up the floor for Q&A.

Question-and-Answer Session

Operator

Thank you. (Operator Instructions) Our first question today is coming from Robert Wertheimer. Please announce your affiliation, then pose your question.

Robert Wertheimer – Vertical Research Partners

Hey, it's Vertical Research Partners, thank you. Good morning, everybody.

Douglas R. Oberhelman

Good morning, Rob.

Robert Wertheimer – Vertical Research Partners

Let's see – let me just start with our systems, since you did highlight that division, I mean, you had one of the strongest margins you've ever had. And wanted to just check in on whether you are seeking or actually just whether that was a mix related, I know power gen – backup power gen has been awful whether it's structure improve in the margin or division and then whether you are seeing any change in electric power?

Douglas R. Oberhelman

Yeah. If you look actually Rob, the dealer statistics that we put out yesterday morning, you can see that's a little bit better than it was a year ago. I think a lot of that has to do with – it was a kind of even turned down a year ago. So I think a little bit on powers – on electric power in particular, the comps will probably just continue to get little easier.

I think for power systems overall, they had a pretty down good quarter. Sales volumes down a little bit, but some of the pieces were up. I think more of their profit improvement had to do with a little price realization and they've done a pretty good job on cutting costs. As opposed to power system, as opposed to construction and resource industries, they didn't have near the decline in inventory that those other two segments did, so the absorption impact was relative to the company in total lots more for them.

Robert Wertheimer – Vertical Research Partners

I'm not sure, if this is one you are willing to or able to answer, but is it possible to look through the turmoil that's gone on in resources over the past six months, and think about what's your margin would be in a more stable environment at these volume levels?

Mike DeWalt

Well, you are right, I'm not going to throw out a number. But I think in my opinion, we had a one positive item the Siwei settlement would be in their numbers, if you would have to take out, that would actually make a little bit lower. But we are in the middle of pretty heavy inventory decreases and that in total, the amounts that they are really underselling real demand and the absorption impact probably more than offset that.

In sense, we are moving from, let's just say, higher volumes over the last year to lower volumes this year. Cutting cost is not a process, and that's going to continue into the second quarter. So if for example, volume, end-user demand kind of hung in at this level. Our sales would probably go up a little bit, because we would stop cutting inventory. We wouldn't have the Siwei adjustments in there, but costs would likely be lower as we've – as where part rates grew kind of the cost cutting activities that we've been doing.

So I guess my part is that would probably be a little higher than it is now, but I don't know that I would want to throw out a number.

Robert Wertheimer – Vertical Research Partners

I guess that was my two. Thank you, Mike.

Operator

Thank you. Our next question today is coming from Ann Duignan. Please announce your affiliation and then pose your question.

Ann Duignan – JPMorgan

Hi, good morning, JPMorgan.

Douglas R. Oberhelman

Good morning, Ann.

Ann Duignan – JPMorgan

Good morning. I'll start out with the decremental margin question. Doug, you've been pretty vocal about driving for 25% pull-through. Can you talk about the decrementals this quarter whether they were disappointing or not to you and are we going to get back to 25% by year-end?

Brad Halverson

Hi, Ann, this is Brad Halverson, and it's a good question. If you look at the second quarter, I think there is a couple of things if you look to the right up to consider in terms of results. On it's close to 70% of our drop in sales, are mining which is negative for mix. But even putting that to a side, if you just look at the period cost absorbed kind of impact, you get to a decremental margin slightly under 30% and we've talked about 25% to 30% kind of a decremental margin in terms of our target.

So for the quarter, you will get slightly under 30%. If you look full-year at our outlook, even with all the headwinds you'll get to a decremental pull-through of 24%. And this was something that we spend a lot of time on, internally. We have targets that we've committed to. And if you look across our segments Resource, Construction, Power, Financial

Products each of them, as we talked about before, have made a commitment as to what they'll make at certain volume levels, which ties to our external commitment and they are executing on that. So when we get through the end of the year, we'll be at 650 right around 24% which is, with the mining headwind I think a good number.

Ann Duignan – JPMorgan

Fair point. Thanks for the clarification. It's normally in the press release, but it wasn't conspicuous either today. My follow-up would be on pricing and you also mentioned in the press release some negative pricing, I think it was in resources in Australia. Can you talk about pricing overall and where you are seeing the most price, obviously probably in mining, but why would we be giving up pricing at this point in the cycle?

Mike DeWalt

Yeah, again this is Mike. Just a couple of comments, I think when we talk price realization here it's versus the second quarter a year ago and again, I don't want to harp too much on this, but we had an absolutely fabulous quarter a year ago. Price realization in the second quarter last year, kind of everything came up heads and we had just about $500 million reported for last year, which was pretty close to a third of the whole year.

So, I think to start the discussion off, it was – in total and in particular for price, a pretty tough comparison. we did have slightly negative price realization well less than 1% for Resource Industries and for Construction Industries. For Construction Industries, it was mostly in Latin America, and we have a few big deals going on down there that had a little tighter pricing. And I think for mining in general, it's a tough market out there right now, I mean volume is down quite a bit, and it I think by and large, we're pretty close to holding our own again with a slight reduction in the quarter compared with a really big quarter a year ago.

I don't' think there's any big fundamental shifts. You didn't ask this question, but I'm going to answer it anyway. As a part of this updated outlook, before we were kind of talking about 1% of this year, we're not far off that, and I think we're looking at just a little under 1% for the full-year for the total company this year. So it was a little tighter I think in the second quarter, but pricing didn't overall go down. it was helped a little bit by better number at Power Systems.

Ann Duignan – JPMorgan

Okay, wonderful. (Inaudible) so I will turn it over. Thanks, guys.

Douglas R. Oberhelman

Thanks.

Brad Halverson

Okay.

Operator

Thank you. Our next question today is coming from Ross Gilardi. Please announce your affiliation, then pose your question.

Ross P. Gilardi – Bank of America Merrill Lynch

Hi, Bank of America, thank you. Mike, in talking about mining, there is an awful lot of focus dealer destocking and the business as the big source of paying, but this is a major order business. So I mean, isn't the real fundamental issue that the miners are just canceling orders and as long as that remains the case, you are not going to see much of a pickup in production and margins unless until you see a pickup in orders?

Mike DeWalt

Yeah, Ross, that's actually a great point. And one of the things I think that has been impacting orders, remember we don't take orders directly from the mining companies, we take orders from the dealers, the dealers take orders from mining companies. So if you look at the destocking inventory, I think that's certainly having some impact on the dealer order rates to us. So we definitely would like to see order rates pick up, but I think certainly until we get through the inventory reduction, there will probably a drag at least on orders placed on us.

But to your point, I'll just kind of go back to it. I talked about the surveys that suggest mining CapEx down another 20, for that to be the case, I mean, orders have to pickup. I mean, if dealers don't order anything or, I'm sorry, customers don't order from dealers and dealers from us don't order anything or don't order more, then 20% is just not, I don't think it's in the cards. That would look like an optimistic number. So I think for mining CapEx next year to be down 20%, they have to order more, dealers would have to order more from us than they are today. Maybe I am not trying to make that overly complex, but to say that even at 20% decline in mining CapEx considering the dealers ought to be out of inventory here pretty soon, would have to mean more orders placed on us, and that's a better way to say it.

Ross P. Gilardi – Bank of America Merrill Lynch

Okay. Thanks, Mike, and then you mentioned in the discussion of resources in the press release that that acquisitions and divestitures negatively impacted operating profit by $33 million in resources and I believe that's with $135 million gain from Siwei in there. So is that $33 million a year-on-year swing in earnings or should we assume that BUCY is loss making at this point?

Mike DeWalt

No, no, no.

Douglas R. Oberhelman

I think what you need to do is go back in our second quarter release from a year ago, one of our Q&As in the back of that release had quite a bit of detail on Bucyrus and included in there we had pre-tax gains on the sale of the Bucyrus distribution, we had some big ones. So basically the gains from last year on the sale of Bucyrus distribution to some of the big dealers more than offset the $135 million this year.

Ross P. Gilardi – Bank of America Merrill Lynch

I got you. Just related to that though, have you had an impairment test for Bucyrus yet and if not, is there a next test coming up to do that annually?

Douglas R. Oberhelman

Yeah, we do that annually. I want to be careful on how I answer this. If you do an impairment test, it looks forward to what you think you're going to generate in that business over a longer period in time and we certainly wouldn't be using a cyclical low straight line going forward. In our mining business, I think there is reasonable headroom, I certainly don't want to predict what a test would be, but I think the chances of an impairment there are probably not, it certainly not like, but…

Ross P. Gilardi – Bank of America Merrill Lynch

Okay. Thanks very much.

Operator

Thank you. Our next question today is coming from Ashish Gupta. Please announce your affiliation, then pose your question.

Ashish R. Gupta – Credit Agricole Securities, Inc.

Hi, good morning, it's CLSA. I believe in the past that Doug mentioned that China is not overexcavated. Now I'm wondering kind of what the pickup in sales we've seen recently. I'm wondering how to think about the machine population over time, now they are moving to more to maintenance from infrastructure. I'm just wondering how you guys view the long-term machine population in China, relative to some of the more developed economies?

Mike DeWalt

Yeah. I mean this is the case where there is a short-term story, there is a long-term story. I think clearly, if you look at long-term, I mean I know the market doesn't like to look out this far, but if you look out at a point where China is developed, say today to the level of Japan or South Korea or Europe maybe, the excavator population, the construction equipment population in terms of equipment relative to the economy currently is a lot lower than those developed countries. So as the standard living wise is there at the level of development, builds out over time, the population of equipment in China will certainly need to grow. I guess the big question you have is, will that take three years, five years, 10 years, 20 years, 50 years. And I think that depends a lot on the scale of China's growth.

From our perspective, I think it's going to grow. I mean our view is it, it's probably I guess the second biggest economy in the world today and it is growing at a faster pace than the rest of the world and it's important, it's going to grow and this level of development is going to grow. And I think as a result of that construction equipment industry, there it's going to need to grow.

But it is true when we see that in our part sales in China. As the population is increased and the equipment gets used, it has driven part sales up in China over the past few years and as that population continues to develop that's a trend that will probably continue.

Douglas R. Oberhelman

Yeah, Doug Oberhelman here, I'll just comment a bit on China as we see it in particularly as I see it. I'm not one in the camp of a China implosion that that China will implode and drag the world down into a massive black hole. I think what we will see in China is very healthy with a much slower rate of growth and I would call it 5 to 8, they say 7 to 7.5, so be it, but that means the maturing of that market for construction equipment and all kinds of things. And as that economy is double to the last decade, we've seen our fuel population of machines grow and grow and grow, allow parts and services opportunity for our dealers. And our business model plays well with that.

And that's exactly what we're trying to do. We've also been working hard on market share in China and that is up and we're quite happy with that. And as that year-over-year sales are up that is for all of our business in China are fairly substantially.

So, we're going to see China go in fits and starts. Obviously and I have said this before to many that, I hope we don't see another double-digit burn. The after effects of that and the residue is painful for everyone, 5% to 7% 8% growth rate is just fine. We've sized our business for that. We'll do very well with that particularly trying to get to a leadership position in market share, and that's really the way we see China overall. Mining certainly, is an opportunity there. we're working on that, and much of that is underground as you know. we now have an underground offering to work with. So a long-term, China and mining are appealing to our short-term. we go through cycles and we're certainly in that downturn at the moment.

Ashish R. Gupta – Credit Agricole Securities, Inc.

Thanks for that, Doug. Just one quick follow-up, when you guys look at your global fleet of machines with GPS data, can you help provide us with some sort of indication of what you're seeing globally by region?

Douglas R. Oberhelman

Ashish, I'd like to give you the answer to that, but of all the myriad of data that I made sure I was up to speak on, before I came in here today, I didn't look at that. So I don't…

Brad Halverson

We can't do it regionally anyway, but overall machine operation is service meter units on the fuel population that we have monitored today are relatively steady and have that. And I think as we look back a few months. So overall, that's a worldwide number including the U.S., China and everywhere else in the world. So it's hard to say that regionally.

Ashish R. Gupta – Credit Agricole Securities, Inc.

Great, thanks very much.

Operator

Thank you. Our next question today is coming from Andrew Kaplowitz. Please announce your affiliation, then pose your question.

Andrew Kaplowitz – Barclays Capital, Inc.

It's Barclays. Good morning guys.

Douglas R. Oberhelman

Hey, Andrew.

Brad Halverson

Hey, Andrew.

Andrew Kaplowitz – Barclays Capital, Inc.

Hey, so if you look at your press release, one of the things that you said is, you believe it's unlikely that dealers will continue to reduce machinery, machine inventory in 2014. So maybe, Mike if you can talk about your conviction level on that statement, this is first down cycle of that you've had with your PDCs, with your product distribution centers. so I guess what I'm wondering is, is there anyway to look at the overall inventory in the channel between the PDCs and the dealers to get a read on whether you think inventory is low enough that you can sort of make that statement, because it's hard for us, because the PDCs are relatively new development.

Douglas R. Oberhelman

Yeah, yeah. That's actually a very good question, Andy. If you just look at dealer inventories, they're really today, really on the lower side of the historic range, actually, really on the lower side. If you include PDC inventories right now, the sum of the two is probably right kind of maybe, more in the middle of our reasonable range. and we're looking for continued dealer inventory reduction through the rest of this year. I mean we're looking at somewhere between $1.5 and $2 billion coming out in the second half.

So further from here, I mean mining inventory probably be at about half the level, but it's started the year and construction down some. Now your question about conviction level, as in all things, it depends upon what the economy does that our sales forecast for next year ends up being and we don't have that. But if you look at just where months of supply are or the severity of what's happening, and particularly in construction it's trajectory of the way the sales chart looks. I think there is a pretty reasonable conviction that dealer inventory is certainly not going to have the kind of declines that it had this year. and probably, I guess at this point, I think it would be, we will have a pretty reasonable conviction that it's not going to go down certainly at least much next year. But again, I'm going to qualify that, because it depends a lot upon what happens to sale, as into some degree, when it happens next year.

Mike DeWalt

Now, just a couple of other comments; dealers are using PDC quite a bit more this year. The usage rate, the percent of dealer machines that are coming out of PDC is actually quite a bit higher in the second quarter than it was last year. So it looks like dealers are using PDC inventory and that's a good thing. However, delivery times for product to dealers compared with a year ago are much less and I don't think that's probably a surprise, so that's happened. So I think there is a pretty reasonable conviction on dealer inventory that's going to slow or stop.

Andrew Kaplowitz – Barclays Capital, Inc.

Mike, it's fair to say then that at the end of this year, when the dealer inventory comes out as you expect that the addition of PDC plus the dealer inventories would then be at the low-end of your historical range versus dealer inventories in the past?

Mike DeWalt

Well, that will dependent upon what our forecast for the first quarter sales is, because when we look at it, months of supply is kind of related to the forward-looking sales estimate for the quarter. So since we don't have that out there right now, it's a little bit tough for me to just say that. But I think our expectation is it would certainly be in the range, yeah.

Andrew Kaplowitz – Barclays Capital, Inc.

Okay. And then if I could ask a follow-up on Resource Industries' margins. I mean, I know people are already hitting you on that. I guess, the issue that we have is the decremental margin in that particular business looks exceedingly low, and you've talked about really accelerating cost takeout in 2Q. Is it possible to quantify how much cost takeout you really started in 2Q in terms of expense, so maybe we can sort of pass-through why the decrementals were so low. I know you are going to tell me that mix is negative also.

Mike DeWalt

Well, mix is certainly negative for the total company, because more of the decline was mining. But we introduced this concept of profit curves inside the company, demands of the business, and each of our three segments have a positive curve. In other words, if sales goes up, there is an expectation of a certain amount of profit, when sales goes down, there is an expectation that only that much will come out. And so there is basically, think of it as an incremental and decremental margin rate for each segment.

And the take-out rate for mining is a little higher than the 25% that we look at for the total company, and that's probably not as fast. So we are trying to take actions on costs that will allow us to get as close as possible for that, sort of curve decremental margin rate.

So they've been, I'm not going to quantify for you, but they've been doing – rolling lay-offs, rolling temporary lay-offs for salaried management, employees. We've taken R&D down a little bit. And the things that we're going to do in the second half of the year, we certainly haven't announced to our own employees yet. And so the specifics on that are probably going to start coming out, I would guess over the course of the next month or so. So it's probably better to talk about the specific items after that, but definitely we're planning to take some more action here in the second half of the year.

Now, one thing that and this is through the first half of the year and this will ease in the second half of the year, it's particularly earning decremental and that just period cost absorption. I mean, we added a lot of inventory in the first half of last year and in the second half. I'm not talking dealer inventory, I'm talking our inventory. And this year's first half, we've taken inventory out. We took about $0.5 billion out in the first quarter. We took $1.7 billion up this quarter, and that does primarily impacted construction and resource industries.

And the more vertically integrated you are, the larger the impact is on your business and that's been a particular negative for Resource Industries in terms of incremental. There was a positive last year and negative this year. It's not really an operational item. When you think about it, it's not operating efficiency. So as the inventory declines start to slowdown, that should be a little better in the second half.

Andrew Kaplowitz – Barclays Capital, Inc.

And for that segment the decrementals to inventory reduction would actually be higher than 13% to 15% as you said for the whole company?

Douglas R. Oberhelman

Yeah. We've not given out a number overall, but if you think about it the absorption thing is basically down to fixed costs that essentially get absorbed in and released from inventory, when you build and sell inventory. If your entire business was just buying and selling material, you wouldn't have a lot of value added to absorb. Then the businesses where you are a lot more vertically integrated, you would have more and I think Resource Industries is probably a little more vertically integrated than Construction, for example.

Andrew Kaplowitz – Barclays Capital, Inc.

Thank you.

Operator

Thank you. Our next question today is coming from Jamie Cook. Please announce your affiliation, then pose your question.

Jamie L. Cook – Credit Suisse Securities LLC

Hi, good morning, Credit Suisse. I guess just two quick follow-up questions. Under your new forecast, I think, your forecast implied that mining OE would be taken down about $7 billion, what are your assumptions under your new forecast, because I'm just trying to back into what mining OE will be as a percentage of total sales as we exit 2013, because I actually think that would be most helpful as we all have different macro assumptions or assumptions on mining. But if we can get a sense of what mining OE would be, I think that would be much easier for us. and as I calculate it could be as low as 10% or as high as 15% and I'm just wondering how off I am? And then I guess my second question, Mike, last quarter, I think you said, your core mining business would be down 50 [but you see] 15 and then aftermarket flat, just can you talk to what your new assumptions are? Thanks.

Mike DeWalt

Yeah, again, if you look at the last outlook and this outlook, the main driver of the decline is dealer inventory. So I mean that's the biggest driver and that is machines. So it's a combination of Resource Industries and Construction. What we're looking at in the back half of the year is probably more slanted to Resource Industries. So I think proportionately of the decline in the outlook, more of it would have been Resource Industries certainly than Construction. And actually, Power Systems is sort of flat to slightly up in the outlook.

Jamie L. Cook – Credit Suisse Securities LLC

Okay, but you didn't answer the question on…

Mike DeWalt

No, we don't disclose new equipment separately from aftermarket in our results. So I can't really give you mining equipment number separate in Resource Industries. We still don't disclose it that way. I am not trying to (inaudible). What I am trying to tell you is it, whatever your current estimate is probably the majority of the decline in the outlook, and when I say majority, I mean, more than half in this context, would be Resource Industries for equipment. They have more of the defined and dealer inventory in the second half.

Jamie L. Cook – Credit Suisse Securities LLC

And then any change in your assumption, so do you see this turning what you saw at aftermarket, can you just talk to those relative to last forecast?

Mike DeWalt

Yeah, I think directionally, both of those numbers are kind of the same, but remember when we were talking about the 50%, that's not end-user demand that's what we're selling to dealer's.

Jamie L. Cook – Credit Suisse Securities LLC

Yes.

Mike DeWalt

And that has been impacted, of course, by the dealer inventories, so that means that our sales of the traditional product is down. The Bucyrus product is down a little bit, but I think that's sort of proportion that you used with Bucyrus sales holding up much better than the traditional CAT product, is absolutely true, and a lot of that is because the dealer inventory impact is much more pronounced for trucks and dozers and wheel loaders, then it certainly is the Bucyrus product.

Jamie L. Cook – Credit Suisse Securities LLC

And then the mining aftermarket?

Mike DeWalt

Yeah, it's holding up pretty steady. We had a really strong first half last year. Coal mining was still doing okay and then it's kind of started to tail off a bit in the second half of last year, but our expectations for aftermarket this year haven't really changed.

Jamie L. Cook – Credit Suisse Securities LLC

Okay, thanks. I'll get back in queue.

Mike DeWalt

(Inaudible) that you would be concerned about.

Operator

Thank you. Our next question today is coming from David Raso. Please announce your affiliation, then pose your question.

David M. Raso – International Strategy & Investment Group LLC

ISI, I'm just trying to gain some comfort with the second half implied margins. if you pull out the settlement gain in 2Q, the margins for the year so far about 8% and 9%. the second half of the year is implying more at 11.5% to 12% operating margins. So when I think about how to bridge that gap, basically to find about 300 bps of margin improvement. you are looking for sales growth of about 7% sequentially first half to second half. and I can get a decent amount of margin improvement with a pretty healthy incremental margin on that sequential build increase, but can you help us a bit with the mix to better understand the incremental margins, the overhead absorption benefit. Where do you see the 7% sequential increase, which businesses maybe geography, just help us a bit, we're trying to get a feel for how much could the incremental margins be, the overhead absorption benefit, what could it be on that sequential improvement?

Mike DeWalt

Yeah. I think when you say incremental margins; you are talking about kind of from the first half to second half.

David M. Raso – International Strategy & Investment Group LLC

Yeah, I'm talking sequentially.

Mike DeWalt

Yeah, yeah. I think there are three big things that are driving that. one is just the absence of negative inventory absorptions. and if you start with the premise that the second half of our year, if you look at the implied guidance at the midpoint on sales and revenues, it has sales in the second half of the year averaging about what they did in the second quarter, but up a bit from the first half average. so volume will be some hope, and we would certainly expect our reasonable incremental margins on volume. I mean I'm not talking massive, but our kind of target range is around 25%, and so incremental margin on volumes, second half versus first half a little better. I think the second thing is absorption that was a pretty big deal in the first half, and in particular, in the second quarter, we have $1.2 billion inventory declines.

so that had a pretty sizable effect. And I think the third thing is, to get to a point where inventory is not going to go down further, our production needs to go up. And that's certainly the case, particularly for construction. And so that are to be positive for this efficiency in general. And then we have cost reduction activity, we've said we're going to do it. We haven't really – particularly because we haven't announced it internally, any specifics, but we're going to take additional actions in the second half of the year to lower cost, so volume from efficiency as production goes up, absence of the large negative cost absorption impacts and some additional cost reduction.

David M. Raso – International Strategy & Investment Group LLC

But where is it coming, you mentioned construction, but if you had to handicap, the 7% increase in revenues sequentially first half, second half, is the increase mostly in Construction, is it Power or even suggesting Resource Industries sequentially better. I'm just trying to get a feel to better gauge those incremental profitability?

Mike DeWalt

Yeah. I think you would, normally, if you think about our fourth quarter, our Power Systems business usually has a stronger second half than they do first half. so I don't know anything this year that would cause that to be different and where we're ramping up production is mostly in Construction.

David M. Raso – International Strategy & Investment Group LLC

Okay. And lastly not to even suggesting and tell me 2014 sales guidance, but just going from what you've articulated in this press release and this discussion. You feel inventory won't be lowered further next year as a base case, right? So that's $3.5 billion of Cat sales growth next year, if retail is flat, I mean that's a caveat there. But when I think about your commentary and your thoughts around Construction and Power, can we walk away from this call saying base case, Cat is thinking revenue growth at a bare minimum is up next year?

Mike DeWalt

I would love to answer that question directly. But and I said about five times in my script, we're not doing an outlook. I think the message that we're trying to get people to think about is just the scale of the impact that dealer inventory reduction has had in this year. And the likelihood that, there is a lot of water to go under the bridge, and so I'm hesitating a little bit on making too much in the way of predictions about next year. Well, I think given the scale of what's happened this year, it's certainly not likely that that's going to happen again in terms of dealer inventory reduction. So…

Douglas R. Oberhelman

David, Doug here. I've kind of been waiting to make this point and this inventory swing up and down has been painful on us and our dealers. That is the fundamental reason we established our enterprise system, structure organization and emphasis a few months ago, working on lead times, lead manufacturing, and really getting after a condensed supply chain. And that's my number one initiative between now and the end of '15, and I think I said in the last call, we expect to see some of that in 2015. There is lots of mine, lots of fruit to be picked on this one. And if there is ever a reason or a good way to get after it, it's this inventory swing that we've seen up and down. I just want to make sure you all understand how important that is if we get that organized. We have come a long way, but we still have the ways to go with that, and we'll start to see that manifest itself late next year and certainly into 2015 a little bit.

David M. Raso – International Strategy & Investment Group LLC

Okay. Thank you very much.

Mike DeWalt

With that, I'm afraid we're at the end of our hour here today. Thank you very much for joining in and we'll talk to you this time again next quarter.

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.