

Inside Caterpillar: Last Quarter's Progress.

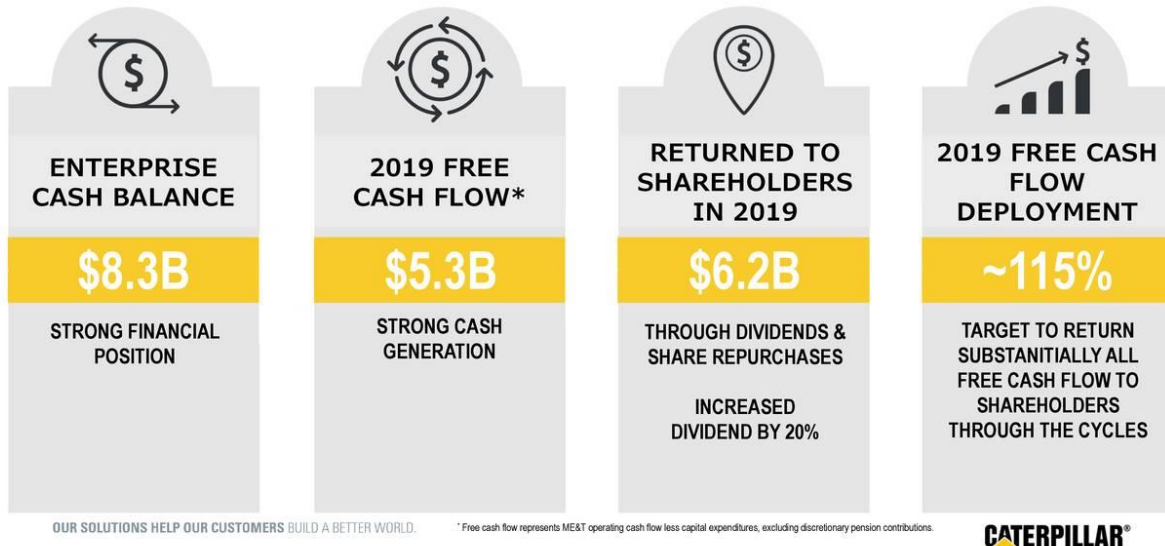
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Caterpillar's fourth quarter revenues dropped 8% from a year ago, with all 3 business segments (construction, resources, and energy and transportation) experiencing weaker sales. Overall for 2019, Caterpillar's revenue was 2% lower than 2018—so its customers really slammed the brakes in the last quarter of the year. Cat's sales are made in 2 stages: first, to its dealer businesses, then to the end user actually using the equipment. 2019's lower revenue resulted from both weaker end user demand as well as a reduction in dealer inventories.

Caterpillar thinks most of the demand weakness grew out of general economic uncertainty. Construction activity in North America has been a strong spot for the company over the last couple years, but that has started to weaken, and should continue into 2020. The strongest business category recently, Resource Industries, slowed down more than expected last quarter. Quoting activity from miners remained high, though, and commodity prices are at a high enough level to justify equipment investment, so Caterpillar believes that customers are just waiting a little longer to make those investment decisions in today's economic environment. Because of this and other signals from end markets, management called this weakness in sales a "pause" instead of a prolonged downward change in fundamentals and therefore will remain at current levels in its investments in new products in services.

Besides investing in new products and services, Caterpillar's third focus towards gaining profitability is what it calls "operational excellence". This includes the usual cost reduction and supply chain efficiency methods but also the goal of reducing lead times for its equipment manufacturing. Reducing lead times lets Caterpillar send new product to dealers faster, and makes dealers feel more secure about not holding as much inventory. Over the past year, dealer inventory has lowered significantly, and Cat has actually been working with the dealers to lower that inventory. Cat believes that its cyclical nature is sharpened by movements in dealer inventory, so if it can manage that inventory better by reducing lead times, it can dampen the company's overall cyclical nature.

Cash Flow and Capital Structure



We'll finish with the above graphic summarizing Caterpillar's cash activity in 2019: a 20% dividend increase, a 9% reduction in share count since the beginning of 2018, and more than 100% of its free cash flow returned to investors. Management was pretty emphatic during this quarter's earnings call that the dividend increases and share buybacks will continue in 2020, a nice gift while we wait out this "pause" in its cycle.

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