

## **Caterpillar, Inc. (CAT) – Short (67% upside): The Ultimate Value Trap (Would you rather be lucky or smart?)**

Mkt Cap: \$56.35B

EV: \$92B

**Price Target: \$28/shr**

### **Recommendation:**

Caterpillar (CAT) is an under-loved name that has lagged the S&P by 23% YTD, has a 2.5% dividend yield and to many appears to be at a cyclical trough. CAT has grown earnings from a low of \$1.43 per share in 2009 to an impressive \$8.48 last year, and looks to benefit from a positive North American construction cycle alongside bottoming mining capex while being an \$85 stock with a management 2015 EPS forecast of \$15/shr...

CAT is a short. We stress that this is not a play on the upcoming quarter; in fact we expect management to manufacture a strong print.

CAT will generate neither growth nor cashflow without ever-greater leverage pumping more product into both Caterpillar & dealer inventory, and continuing to adjust their own residual values at CAT Financial lower. Despite accounting EPS soaring the past few years, we urge investors to ask themselves where the cashflow generation really is and what they are overlooking in CAT's financing arrangements. Upon closer examination of the financials, poor management incentives, \$9B of failed acquisitions in the past two years alone, as well as negative earnings risk that is still not fully understood by current holders of the stock we highlight why CAT is a compelling short. Highlighted below are key catalysts which we believe will send CAT to its fair value of \$28/shr by 2014.

CAT:

- Generates no free cashflow, unless via borrowing
- Uses questionable revenue recognition to its own foreign subsidiaries using borrowed money for sales that do not end up at a dealer or end user
- Will NOT be able to materially raise its dividend moving forward
- Uses imprudent and aggressive economic forecasting as an excuse to stuff the channel and level load production to attempt to meet guidance
- Is in the middle-innings of a multi-year capitulation of mining capex
- Has completed \$9B in failed (including one fraudulent), value-destroying acquisitions since 2010 to try and meet long-term earnings forecasts – and still can't meet those forecasts.
- Very rarely mentions their own large financial subsidiary, which we believe will magnify its earnings downturn and impair cashflow moving forward
- Has compensation targets mis-aligned and far beneath management's guidance and stated goals

### **Questions For Management:**

- Why does management's own incentive plan include a profit threshold of \$2.50 while their own 'severe economic downturn' EPS forecast for CAT is \$3.50?  
[Link - 2012 Proxy.](#)
- Why are CAT foreign subsidiaries allowed to purchase goods from CAT parent using borrowed money and then allow CAT to recognize a sale that never actually went to an end user? [Link - SEC Correspondence.](#)
- Why isn't management held accountable for CAT Financial, a \$36B balance sheet entity whose results determine if CAT's original margins were correct to begin with?
- If your company has such great earnings prospects through 2015, why hasn't stock been aggressively repurchased recently? And why has management allowed 7.3% of unchecked share creep (\$4B of curr. mkt value) since 2009?
- If CAT machines have such high residual values and solid transaction prices, why isn't an effort made to shrink its balance sheet during cyclical booms?
- Why are such aggressive economic forecasts allowed at an organization of your resources? And why are these flimsy forecasts later blamed for causing earnings misses and channel stuffing?
- Why has your deferred revenue grown so much (and this doesn't relate to BUCY), allowing for an earnings piggy bank funded by borrowed money from foreign subsidiaries?
- Are CAT's foreign subsidiary's own orders from CAT parent within CAT's reported backlog?
- Why does CAT's compensation committee use such easy targets? Why does the compensation committee turn a \$90B balance sheet into only \$33B of 'accountable assets'?

### Our earnings vs. consensus (decidedly below):

		2013	2014	2015
Estimates	Revenue	\$ 57,350	\$ 56,154	\$ 56,723
	EPS	\$ 5.88	\$ 5.03	\$ 5.06
Consensus	Revenue	\$ 58,599	\$ 62,621	\$ 66,931
	EPS	\$ 6.81	\$ 7.92	\$ 9.15
Difference	Revenue	-2.1%	-10.3%	-15.3%
	EPS	-13.7%	-36.5%	-44.6%

Where is the value? Our view on CAT's true earnings power and lack of ROC – definitive divergence between free cashflow & accounting EPS:

#### **CAT Accounting vs. FCF EPS**

	2005	2006	2007	2008	2009	2010	2011	2012	1Q'13
Acct.	\$ 4.04	\$ 5.17	\$ 5.37	\$ 5.66	\$ 1.43	\$ 4.15	\$ 7.40	\$ 8.48	\$ 1.31
FCF	\$ 0.95	\$ 3.49	\$ 4.96	\$ 1.04	\$ 5.04	\$ 2.32	\$ 5.72	\$ 0.97	\$ 0.51
Diff	-76.5%	-32.6%	-7.6%	-81.6%	252.8%	-44.1%	-22.7%	-88.5%	-61.3%

\*FCF defined as: NI + D&A - Chg. WC - Capex

<-- where is the cash ?

### **Thesis:**

Caterpillar has benefitted from the now-fading 2009 Chinese stimulus package and global QE pushing rates near zero – both points which management has abused to build inventory and finance easy dealer floorplan financing – stuffing the channel for the past 4 years. We can't stress enough: there is no growth and there is no cashflow to be found here. Period.

We see many similarities between CAT's current behavior and Lucent's near-demise in the late-1990s – at both points each firm's core market was undergoing the ragged edge of a parabolic rise in demand. In the end a string of failed acquisitions as well as borrowing to finance ever-greater inventory *and* customer purchases was Lucent's undoing – sending a stock price that had risen to \$84 a few years earlier down to \$0.55 by Oct, 2002. We believe that just like Lucent, Caterpillar's margins aren't real – and all this requires is following the cashflow to recognize.

- Earnings d/g ignored by the market
- Revenue recognition shenanigans finally scrutinized properly
- Poor management incentives ignored by the market
- Caterpillar Financial residual risk & leverage ignored by the market
- The moral hazard of owning your own finco – borrow to fund inventory & A/R as well as set your own residual values
- Excessive inventory build ignored by the market
- Complex and questionable accounting that has been ignored by the street, particularly cross-company arrangements between Caterpillar and Caterpillar Financial
- Mining capex cycle showing no signs of turning around – likely in a secular decline through 2015
- Caterpillar Financial borrowing costs rising (even without rising rates in general) due to write-downs and a heavy rolling debt burden
- Caterpillar cashflow impaired by a reduction in deferred revenues funded by CAT Financial's overseas borrowing
- Longs more closely examining management incentives; containing payout thresholds that are below even that of management's recent economic crisis EPS scenario
- Realization that CAT Financial has been financing level-loading production and easily obtainable guidance goals as CAT level-loads production and uses low interest rates to both finance itself and its dealer's purchases of inventory and used equipment.
- Residual values turning south as miners begin to cancel equipment purchase agreements, leaving dealers forced to put the equipment back to CAT or liquidate into the market.

Below we take you through our thoughts on the above compartmentalized into the following 1) Revenue recognition/recent aggressive accounting issues, 2) Lucent – remember your history!, 3) What is Cat Financial, 4) Management (lack of ) Credibility, 5) Poor management incentives, 6) \$9B in value-destroying acquisitions, 7) our take on (much weaker) earnings and 8) Our highlights on mining capex only beginning to crater and 9) Valuation.

### **Revenue Recognition: The Smoking Gun**

We believe CAT is now resorting to borrowing to fill in gaps in revenue/earnings through both questionable revenue recognition, continued inventory build and aggressive financing terms to customers.

We believe that CAT is stuffing the channel and resorting to recognizing revenue between itself and wholly-owned foreign subsidiaries with no end user at the end of the transaction – this also serves as a way to fund CAT's operations without repatriating any foreign cash. CAT's questionable accounting is enabled by low interest rates driving higher leverage and their internal ability to set their own residual values . We believe these questionable practices will only be scrutinized more heavily going forward, especially given CAT's growing deferred revenue account (grown from \$1.2B in '09 to \$3B in 1Q'13 – BUCY was acq. w/\$467MM of deferred revenues and is at best similar in size to acquisition) and their ability to not only fund inventory build via foreign subsidiary sales to the US parent, but also borrow to fund foreign subsidiaries' purchases of CAT equipment not delivered to an end user or intermediary and recognized as revenue. Again, we wonder how much of CAT's current reported backlog of \$20.4B are foreign subsidiaries placing "orders" with the parent for delivery – manufacturing revenue/earnings with borrowed money.

### **SEC Correspondence, 5/2013:**

An SEC staff question recently asked CAT about its arrangements with its own foreign subsidiaries – their answer (if you read between the lines) confirmed a lot of our suspicions about the moral hazard of CAT's finco: CAT is using sales to its own foreign subsidiaries to pump up earnings/revenues, stuffing the channel while recognizing sales that do not end up in the hands of an end user or customer.

Or we can take you through those same staff comments below, from correspondence between CAT and the SEC, 5/30/2013:

“

U.S. Securities and Exchange Commission  
May 30, 2013

#### **COMMENT:**

3. We note in your response to prior comment 3 that your intercompany agreements provide for short term advance payments for certain purchases of U.S. manufactured products destined for sale outside of the United States. Please describe to us in greater detail the terms of the intercompany agreements that allow for these advance payments, including the following:

- Tell us the usual period over which the advances are outstanding, including how the transactions get initiated and cash paid, and how long after are the U.S. manufactured products typically shipped
- Clarify for us whether these are transactions between your U.S. and non-U.S. subsidiaries, or transactions undertaken by non-U.S. subsidiaries on behalf of customers located outside the U.S. and whether the profits being taxed are intercompany profits or profits on the sale to the final customer.
- Tell us the frequency with which you have entered into these transactions in the past three years.
- In describing the arrangements, please provide us an example of a typical transaction.

#### **CATERPILLAR RESPONSE:**

**A non-U.S. subsidiary that distributes our products to independent dealers outside the United States routinely enters into advance purchase agreements with manufacturers globally including Caterpillar Inc. ("Cat Inc."), a U.S. company. Under the agreement, the non-U.S. subsidiary makes**

**payments in advance for equipment manufactured by Cat Inc.** which is destined for export and sale to non-U.S. independent dealers. This agreement recognizes Cat Inc. as a primary source of the non-U.S. subsidiary's products, and that manufacture of many of these products in the United States requires long lead-times. The agreement provides the non-U.S. subsidiary a discount for goods purchased with advance payments in accordance with arm's length principles.

Under the terms of the current one-year agreement, the advance is made on a monthly basis in an amount equal to the average daily purchases for the preceding six months multiplied by 85, less any outstanding balance from the prior month. The advance payment calculation is based on 85 days to reflect the average time from receipt of an order from an independent dealer to delivery.

The profit on the intercompany sale to the non-U.S. subsidiary is subject to U.S. taxation at the time of shipment. In addition, profit on the sale by the non-U.S. subsidiary to the independent dealer is taxed in the United States under Subpart F contributing to our "previously taxed income" referred to in response to Comment 2.

**Advance purchase transactions from the non-U.S. subsidiary have occurred regularly throughout the past three years.** An example of such a transaction is set forth below:

Advance purchase transactions from the non-U.S. subsidiary have occurred regularly throughout the past three years. An example of such a transaction is set forth below:

	Day 1	Day 30	Day 50	Day 70
	Advance Payment	Product Shipment #1	Product Shipment #2	Product Shipment #3
		Invoice, net of purchase price discount	Invoice, net of purchase price discount	Invoice, net of purchase price discount
	\$5,000	\$2,000	\$1,000	\$2,000
Balance	\$5,000	\$3,000	\$2,000	\$0
		* * * * *		

" - Link - [SEC Correspondence](#).

### **Do You Remember Lucent? History Rhymes:**

For those who don't remember Lucent Technologies was a spinoff of AT&T in 1996 and soon became a growth investor darling rising to a market cap of \$202B in 2000 from an initial IPO valuation of \$26.2B – by 2002 it had fallen to \$2.65B. At the time the internet infrastructure boom was supposed to last forever (similar to today's mining capex boom), and as the bubble continued common sense was abandoned and investors backed in a narrative that justified a higher future stock price – no matter the current trading levels.

During Lucent's mea culpa, in which revenues were amended and restated downwards for the 2001 fiscal year by \$680MM, Lucent's new (and former CEO) said "Don't try to run the business faster than it's able to run." This was exactly what Lucent management had done during the prior four years – espousing an infinite trajectory of 14-17% revenue growth for the telecom equipment market, and a 17-22% growth rate for Lucent itself. But as Lucent and its competitors Cisco, Juniper and other telecom equipment makers created excess capacity in the face of waning demand then pricing & financing terms became more favorable to customers – this was where management took short-cuts and 'temporary' measures that nearly lead to Lucent's demise.

By year end 2000 Lucent had \$6.7B in customer credit on its books – a result of very quickly and heavily relying upon vendor financing and generous terms to avoid cancellations or deferrals at all costs. Alongside vendor financing was an ever-growing inventory to level-load production – despite sales +12% in 2000, Lucent grew revenues 34% that same year. These arrangements included multi-year deferred principal repayment and used its own borrowing to create phantom revenue from credits that had no realistic hope of repayment. This constant pulling forward of demand also created an ever-greater future deficit in customer equipment needs that would eventually have to be reckoned with as even with great pricing/terms/credit there would eventually be few buyers left. It was an unrealistic strategy that tried to bridge one bubble to the next – a free lunch. Ultimately the cycle turned and an imprudent management was left with the unwinding of their earnings management scheme, which was as swift and punishing as the ascent was breathtaking and irrefutable. \*

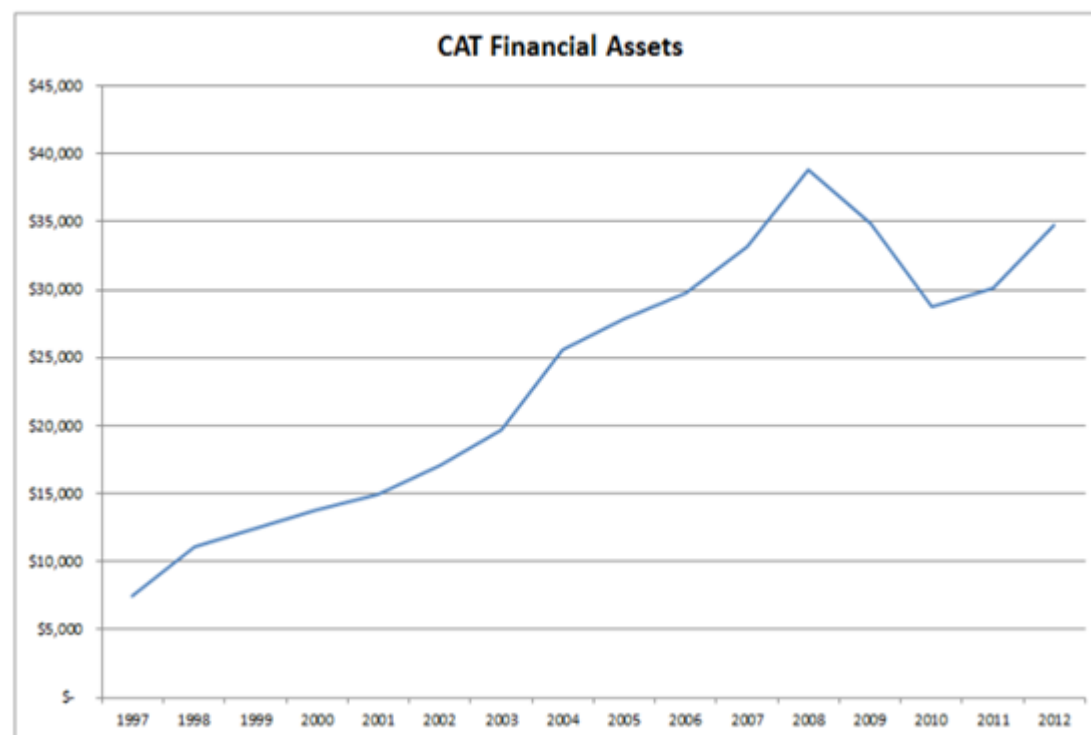
We believe CAT's own attempts to prevent deferrals and turn what is a generational mining capex boom into a permanently higher base of business activity will have similar negative results – and we see evidence throughout their behavior on revenue recognition and inventory build that supports this analogy.

\* Fortune, [“Lessons from the Lucent Debacle - Think twice about what you promise Wall Street”](#) – 2/5/2011.

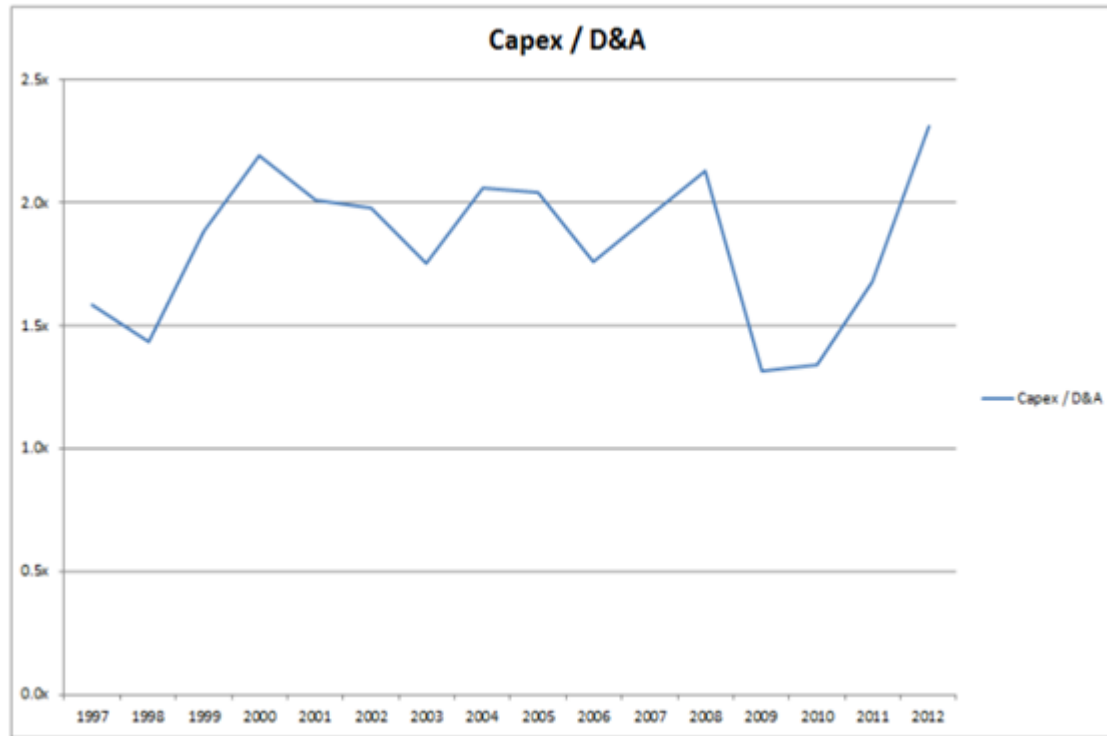
### **CAT Financial: The Enemy Within**

CAT Financial is the driver of the CAT retained earnings/borrowed money machine, below we show balance sheet growth, capex/D&A (never < 1.0x, CAT is perpetually investing in its own product) and net income margin (generally never mentioned as CAT Financial is treated like a distant forgotten division during CAT earnings calls) as well as overall portfolio yield, which has fallen steadily since peaking in 2007. We of course don't know what's inside CAT Financial, nor their residual value assumptions in selling themselves their own product due to CAT Financial's funding consisting of entirely unsecured debt.

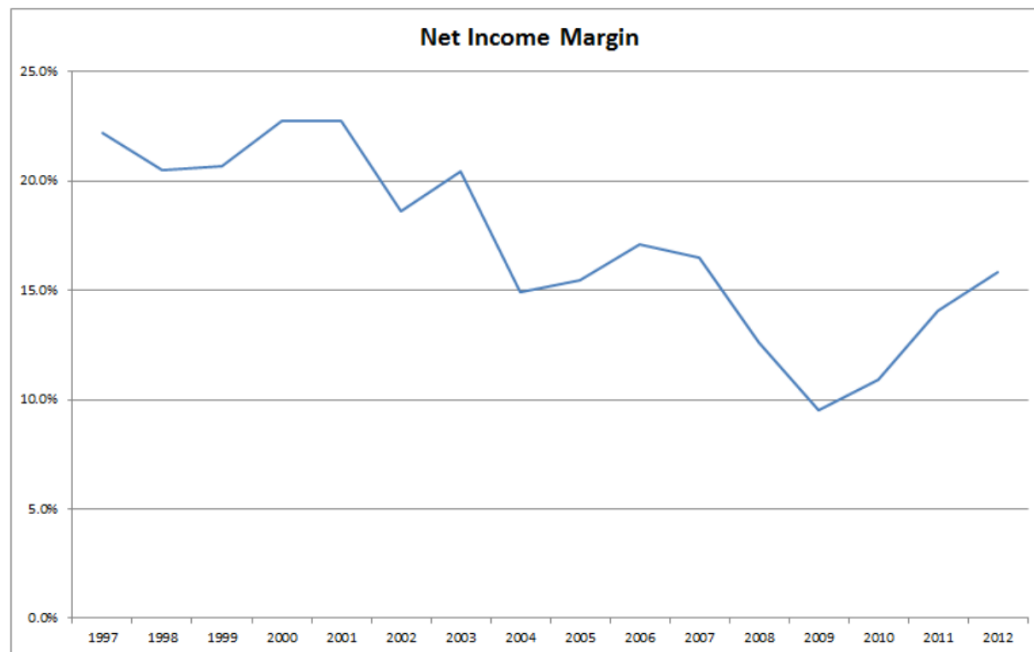
**Constantly inflating the bubble...**



...while constantly investing in our own products...



...while net income margin has steadily fallen...

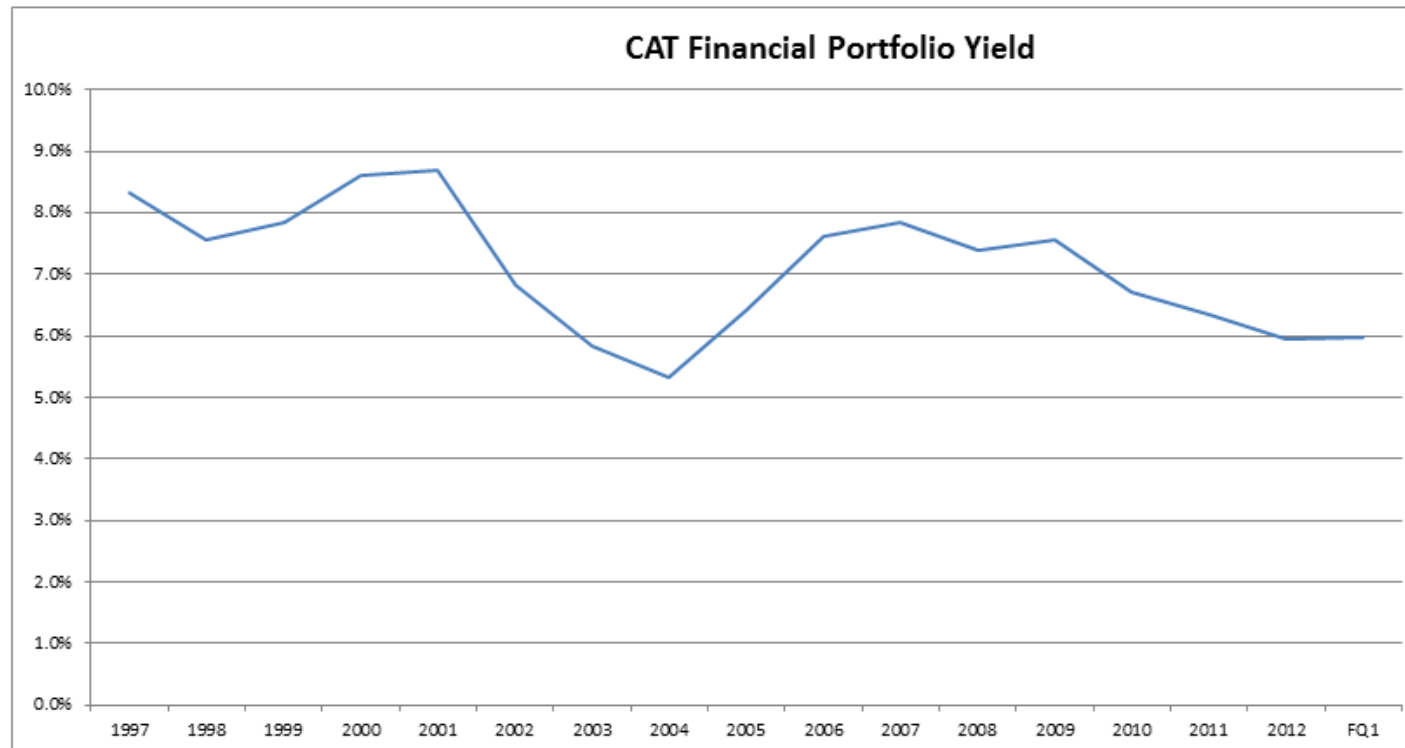


## CAT Financial source historicals:

### CAT Financial

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
D&A	179	239	260	305	431	543	648	597	636	654	702	755	742	715	710	718
Assets	7,426	11,135	12,494	13,805	14,994	17,105	19,759	25,648	27,844	29,778	33,135	38,863	34,915	28,752	30,112	34,742
Provision	39	70	60	62	97	109	101	105	92	68	97	192	225	205	176	161
Revenue	425	544	619	699	932	1,038	1,253	1,924	2,354	2,763	2,998	3,058	2,714	2,552	2,684	2,733
Net Income	94	112	128	159	212	193	256	287	364	473	494	385	259	278	378	432
Capex	282	343	490	669	865	1,075	1,136	1,228	1,297	1,152	1,366	1,608	976	959	1,190	1,660
D&A % Assets	2.4%	2.1%	2.1%	2.2%	2.9%	3.2%	3.3%	2.3%	2.3%	2.2%	2.1%	1.9%	2.1%	2.5%	2.4%	2.1%
Revenue % Assets	5.7%	4.9%	5.0%	5.1%	6.2%	6.1%	6.3%	7.5%	8.5%	9.3%	9.0%	7.9%	7.8%	8.9%	8.9%	7.9%
Net Income % Assets	1.3%	1.0%	1.0%	1.2%	1.4%	1.1%	1.3%	1.1%	1.3%	1.6%	1.5%	1.0%	0.7%	1.0%	1.3%	1.2%
Capex / D&A	1.6x	1.4x	1.9x	2.2x	2.0x	2.0x	1.8x	2.1x	2.0x	1.8x	1.9x	2.1x	1.3x	1.3x	1.7x	2.3x
Provision % Assets	0.5%	0.6%	0.5%	0.4%	0.6%	0.6%	0.5%	0.4%	0.3%	0.2%	0.3%	0.5%	0.6%	0.7%	0.6%	0.5%
Net Income Margin	22.2%	20.5%	20.7%	22.7%	22.7%	18.6%	20.4%	14.9%	15.5%	17.1%	16.5%	12.6%	9.5%	10.9%	14.1%	15.8%
CAT EPS	\$ 2.22	\$ 2.09	\$ 2.63	\$ 3.02	\$ 2.32	\$ 2.30	\$ 3.13	\$ 5.75	\$ 4.04	\$ 5.17	\$ 5.37	\$ 5.66	\$ 1.43	\$ 4.15	\$ 7.40	\$ 8.48

## CAT Financial Portfolio yield:



We believe further scrutiny of Caterpillar Financial could cause a liquidity squeeze as investors take a closer look at a balance sheet built to consume large amounts of short-term money to fund more inventory/aggressive revenue recognition – we believe this heavy near term maturity schedule would only prove to serve our thesis right if CAT were forced to de-leverage the balance sheet. The following is from CAT Financial's (hopefully now sporting a higher

readership) [latest 10-Q](#). Note the heavy debt maturity roll CAT financial carries year to year, right now in excess of \$7.6B on a \$30.3B borrowing base (Lehman may have shown us why this is a bad idea).

## **BORROWINGS**

Borrowings consist primarily of medium-term notes, commercial paper, bank borrowings and variable denomination floating rate demand notes, the combination of which is used to manage interest rate risk and funding requirements.

Total borrowings outstanding as of March 31, 2013 were \$30.25 billion, an increase of \$313 million over December 31, 2012, due to increasing portfolio balances and to provide for increased liquidity. Outstanding borrowings were as follows:

<b>(Millions of dollars)</b>	<b>March 31, 2013</b>	<b>December 31, 2012</b>
Medium-term notes, net of unamortized discount	\$ 24,093	\$ 23,475
Commercial paper, net of unamortized discount	3,246	3,654
Bank borrowings – long-term	1,632	1,602
Bank borrowings – short-term	464	418
Variable denomination floating rate demand notes	605	579
Notes payable to Caterpillar	209	208
<b>Total outstanding borrowings</b>	<b>\$ 30,249</b>	<b>\$ 29,936</b>

## **Medium-term notes**

We issue medium-term unsecured notes through securities dealers or underwriters in the U.S., Canada, Europe, Australia, Japan, Hong Kong, Argentina and Mexico to both retail and institutional investors. These notes are offered in several currencies and with a variety of maturities. These notes are senior unsecured obligations of the Company.

Medium-term notes outstanding as of March 31, 2013, mature as follows:

<b>(Millions of dollars)</b>	
2013	\$ 4,422
2014	5,950
2015	5,012
2016	2,513
2017	2,631
Thereafter	3,565
<b>Total</b>	<b>\$24,093</b>

If you don't understand the finco, we urge you to take the time to look at just what the mechanics are above – you'd be surprised to notice that this isn't a boring industrial 'utility' like management would rather you believe.



## CAT Management: Saying Whatever is Convenient

Caterpillar management is all things to whomever will listen. We believe CAT management and IR changes guidance (which is inconsistent and always thin) to whatever the latest 'recasting' tells them to – once a growth stock focused on mining capex and China, now? A boring value stock with a 'solid yield' that has a good base of revenues in developed market infrastructure. The Street plays along with this as well. Below is just a brief timeline of corporate events since the Bucyrus acquisition announcement in November, 2010:

- 4-6/2009: Caterpillar management introduces \$8-10 EPS goal for 2012. Link – [April, 2009 earnings call](#) and [June's 2012 guidance release](#).
- 10/2010: BUCY bought for \$8.6B - multiple at the time 10.5x FY1 EV/EBITDA. CAT establishes an 'operating profit run-rate of \$400MM annual synergies' by 2013 (this would not be revisited or quantified in 2012/2013 as US underground coal and global mining capex experience declines). CEO: "Its one of our top imperatives to win in China across our core business and now in mining" Link – [Bucyrus acquisition presentation](#) and [transcript](#).
- 4Q/2011: CAT mgmt. decides to aggressively build inventory globally (Investor Relations has confirmed this on numerous occasions). "We had gotten it ramped up at the beginning of 2012.... in the end of 2011 we made a decision to add a lot of inventory in lane 1 for construction in China beyond what the dealers were doing... It had everything to do with us being prepared for a selling season that didn't happen." – Mike DeWalt, CAT Investor Relations, JPM Industrials Conference 6/5/2013.- [Link – JPM Industrials Conference 2013 Replay](#).
- 3/2011: Analyst Day Guidance issued of \$8-10 '12 EPS (fails to hit) / \$15-20 '15 EPS (later guides down) – these are inclusive of current and planned acquisitions. [Link – ConExpo CAT Analyst Day Presentation](#).
- 1/2012: Guidance of \$9.25 '12 EPS established (fails to hit), Chinese GDP growth of 8.5% estimated (fails to hit: Actual 2012: 7.9%). [Link - Press Release / 2012 Guidance](#).
- 3/2012: CEO in an interview with Xinhua predicts he 'expected the Chinese economy to expand by 9-11 percent this year, despite that the government early this month lowered its 2012 growth target to 7.5 percent.'
  - o In same interview says rather cryptically: "I think slowing the economy is healthy for China and for the world. It would mean a longer and more sustainable economic period for everyone. I'm a proponent of it. It's good for Caterpillar" [Link – Xinhua interview](#).
- 4/2012: CAT raises guidance to \$9.50 '12 EPS (fails to hit). [Link – 1Q'12 Press Release](#).
- 6/2012-12/2012: CAT closes transaction acquiring Siwei for \$800MM; CAT writes off entirety of Siwei in December due to lack of due diligence and accounting irregularities – announces the 4,300-employee subsidiary is now loss-making. A CAT board member attributes the lack of accountability to being 'distracted at the time by a larger transaction and paid relatively little attention to the Siwei acquisition' and that "It came as a surprise to us." CEO later tells Forbes "The buck stops at my desk. I am accountable for that acquisition" – in reality no one on the street seems to notice and the issue just goes away without any further scrutiny from either long-term shareholders or sell-side analysts. Of course only months before writing off the entire acquisition CAT's Resource Industries chief (Steve Wunning) had this to say about the deal: "Siwei is an outstanding company with excellent people and great products in an industry that will continue to grow as the world population increases and mass urbanization drives a greater need for commodities" - [Link – Reuters release](#) / [Forbes interview with CEO Oberhelman](#) / [CAT's announcement of transaction completion](#).
- 9/2012: CAT presentation at industry trade show MinExpo presents revised 2015 EPS goal of \$12-18/shr (from \$15-20 in March '11) and 'downside scenario' EPS of \$3.50. [Link – CAT Presentation](#).

- 12/2012: CAT reports '12 EPS of \$8.48, barely hitting their 2012 LT goal of \$8-10 and despite establishing \$9-9.25 guidance in October.
- 1/2013: Guidance of \$7.00-9.00 '13 EPS (later guides down), Chinese GDP growth of 8.5% again estimated (Chinese government sets goal of 7.5% in 3/2013). [Link – Press Release / Guidance](#).
- 3/2013: CEO says in CNBC interview: "China—even with a little bit weaker [economic] number in the first quarter—the stories there are still pretty good" – China reports 1Q'13 GDP of 7.7%, decidedly below CAT's target. [Link – CNBC Interview](#).
- 4/2013: CAT lowers guidance for '13 EPS to "about \$7" and announces a share repurchase plan of \$1B (since 2009 45.6MM add'l shares have been issued as compensation - ~7.3% growth and \$4B at current mkt price; mgmt. has repurchased zero shares since 2008 up to this point) – says 'original mining equipment sales expected down 50%, Bucyrus down 15%'. [Link – Press Release / Guidance](#).
- 7/2013: Chinese GDP growth of 7.5% for 2Q'13 reported (1Q'13: 7.7%), economists expect 7.7% for 2013 – Chinese government now expects 7.0%. [Link – Chinese 2Q'13 GDP / Chinese Finance Minister Lou Jiwei's recent comments in Washington on Chinese GDP growth being ~7% for 2013 and China would tolerate < 6.5% in the future](#).

The real story is that management has a built in excuse via their obscure and aggressive GDP forecasting, which allows excessive inventory build and level-loading of production to meet optimistic goals with supposedly 'good' intentions and unrealistic January guidance.

From the 9/2012 MinExpo presentation, where Ann Duignan (JP Morgan) asked CEO Oberhelman if they were reducing 2015 guidance (which they in fact just did):

"Anne asked me right off the bat, "you're lowering your guidance." I'm not lowering our goal and intention. If it turns out that worldwide GDP growth is more like we thought it would be, and it comes around in 13, 14, 15, we're going to go right back to \$15-20...but losing 2011 and losing 2012 with a reasonable level of growth has just delayed when that is going to happen." [Link – Transcript of MinExpo Presentation Q&A](#)

Does this make sense? CAT says it operates at the whim of the global economy, but then why be so imprudent and establish aggressive economic forecasts and use them as an excuse to stuff the channel? Aside from this, acquisitions were supposed to boost CAT to their LT goals, but now with Siwei a waste of \$800MM and Bucyrus experiencing declining earnings those same acquisitions just melt into the entire organization never to be heard from during inopportune periods.

#### **Management Compensation: Return on Capital Three Card Monte**

Why is the CEO not paid on the results/risk inherent to CAT Financial? Who is responsible for \$65B of CAT's \$90B balance sheet (according to the [2012 proxy](#), no one)? Why does the street not realize CAT made \$9B of acquisitions since 2010 and has produced ZERO value out of them? Caterpillar is less a growth company and more engaged with earnings management/manipulation funded by zero interest rates and the ability to set their own residual values and stuff their own channel ([and they still can't hit their numbers!](#)).

- Mgmt. incentives are NOT aligned with shareholder interest, particularly when it comes to how much residual risk CAT has taken onto its \$90B balance sheet via Cat Financial (and its dubious profitability levels – read the CAT Financial [latest Q](#)). How do we know this? In 1Q'12 mgmt. changed their compensation definition to something called OPACC (operating profit after capital charge), which carried a headline-grabbing hurdle rate of 18% at the time (since lowered) – the catch is that this is a nonsense incentive plan that guarantees full payouts for all involved. The 2012 proxy set management's target operating profit at ~\$9.4B (which is the disclosed \$3.808B goal + an extrapolated capital charge of \$5.6B)\*, which means that CAT's \$86.2B average balance sheet (at a 17% capital charge) was compressed to \$32.9B in "accountable assets" – what happened to the other \$53.3B? Why is the CEO not paid or accountable for CAT Financial results under this plan?

- This balance sheet magic is in addition to the “aggressive” short-term compensation payout trigger of \$3.50/shr for 2012, up from \$2.50 in 2011 – not really a high bar for a company that issued guidance in Jan 2012 of \$7-9/shr and in 2010 introduced an \$8-10 EPS goal for 2012. Proxy filing here (pg. 34 for ST comp, pg 35 for OPACC definition – [2012 proxy](#)).

In short, apparently CAT mgmt isn't much of a believer in their earnings power (I guess \$2.50 EPS is challenging, but then what exactly did CAT mean when they introduced a cyclical trough EPS of \$3.50 at MinExpo in Sept. 2012? Is it even worse than that?). You can view the (heavy on pretty graphics) presentation [here](#) (pgs. 17-18). Of course from said same presentation are goals of \$12-15 EPS and \$100B revenue for 2015 - probably safe to say its not happening as we're about to run into the mid-\$5 EPS range for 2014.

\*To do the math yourself: CAT had \$8.694B '12 M&PS (Machinery & Power Systems) EBIT which then resulted in an OPACC achievement of \$3.1B, the difference (\$5.593B) is the capital charge, which then can get us to the M&PS EBIT '12 target of \$9.4B (\$3.8B OPACC tgt + \$5.6B capital charge). Then take \$5.6B/0.17 (the capital charge) to turn an \$86B balance sheet into \$32.9B – like magic. [Read the latest proxy!](#)

**Acquisitions** (wasting our record profits) – would you rather have an 11% reduction in share count, \$10 per share or a \$700MM fraud and a seriously challenged coal equipment maker? Before you answer, note that CAT took option 2. So lets go over the highlights:

#### **BUCY Acquisition (closed 2Q'11):**

- Paid \$8.6B – was 10+ EV/EBITDA mult on FY1 numbers at the time (11/2010 deal, 2011 EBITDA cons was \$840MM at the time). This business has likely seen zero EBITDA growth (not factoring in EBITDA loss from having to divest local BUCY dealers to CAT's existing dealer network).
- Then sold distribution businesses at 6-7x EV/EBITDA fwd mult (such as \$465MM Finning deal) – which leaves CAT with no service revenue and only parts in the supposedly “good” legacy revenue stream generated by their OEM install base.
- To calibrate where we could say BUCY's business is, JOY did \$1B EBITDA in 2011, and is now expected to generated \$1B in 2013/2014 (likely to be revised down further, however) – which means zero growth has occurred for BUCY's business lines within CAT (at best).
- So what did we get out of this? Remaining \$7B+ in debt for a declining revenue base in a business with secular challenges (US thermal coal production) into the future. In the interim we'll just have to wait 8-10 years before we can say this acquisition has paid for itself in EBITDA. **In the meantime there are significant issues with both BUCY/JOY's ability to magically recognize revenues out of their significant deferred revenue liabilities, which in CAT's case also means that low financing costs make it easy to extend dealer floorplan at near zero rates if one wants to meet guidance and send deferred revenue into A/R (CAT sells to dealers, CAT F then owns this as an earning asset in A/R & LT investments).** We can see this as CAT's deferred revenue liability has increased from \$1.2B in 2009 to now \$2.9B as of 3Q'13 (while Bucyrus was acquired with only \$467MM in customer advances - [1Q'11 10-Q](#)).

#### **Siwei (closed 2Q'12):**

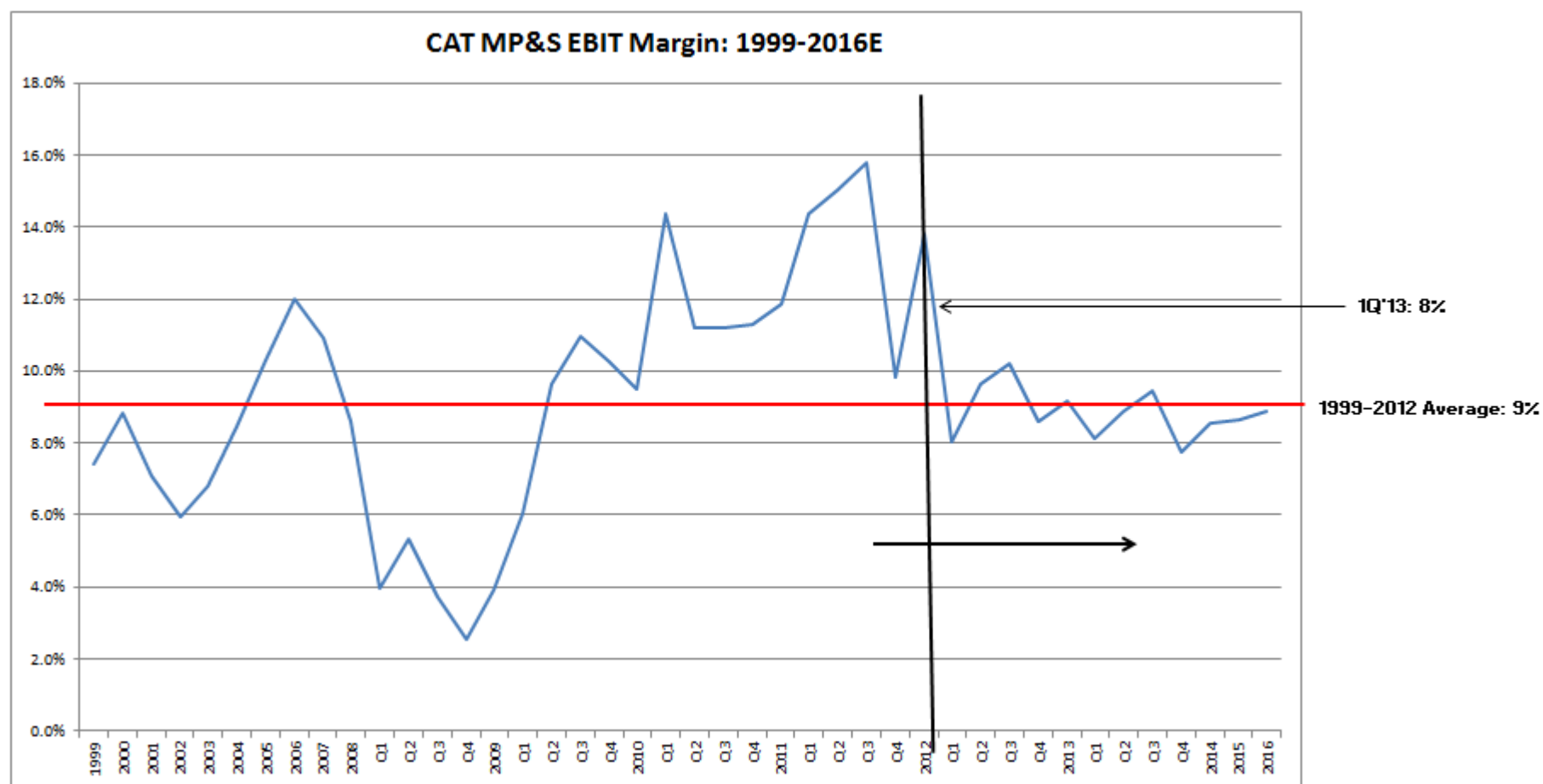
- This is a magic trick – first we buy a company in June for \$700MM, then we accuse the sellers of defrauding us and write down the entire amount in that same year's December quarter.
- June commentary from Steve Wunning: "Siwei is an outstanding company with excellent people and great products in an industry that will continue to grow as the world population increases and mass urbanization drives a greater need for commodities," said Steve Wunning, Caterpillar group president with responsibility for Resource Industries said in June, 2012

- By the way – Siwei built \$100MM in inventory in 3Q'12 alone. So what exactly were 4,300 employees doing differently in December that they didn't (or did) do in June of that year? Btw – Siwei is now an operating-loss generating division at CAT, [in case anyone missed it](#).
- Lets put this in perspective: Siwei's destruction of value equates to nearly the entirety of CAT's (largely insignificant) share repurchase announcement in their 1Q'13 press release (4/22/2013).

### Our Take on Earnings:

We believe CAT is going to “earn” in the mid-\$5 EPS range for 2014, and could tread water thereafter. The street is anchored to prior expectations and the specious logic that “we must have reached bottom” by now. Despite the fact that consensus is \$7.92 for 2014 / \$6.81 2013 we still see (significant) downside to both estimates, mainly due to mean reversion of mining capex.

Our assumptions *don't even test CAT's prior trough EBIT margins!*



In case this chart doesn't illustrate the painfully obvious, here is the bottom line for the table below, where we outline our earnings/revenue estimates:

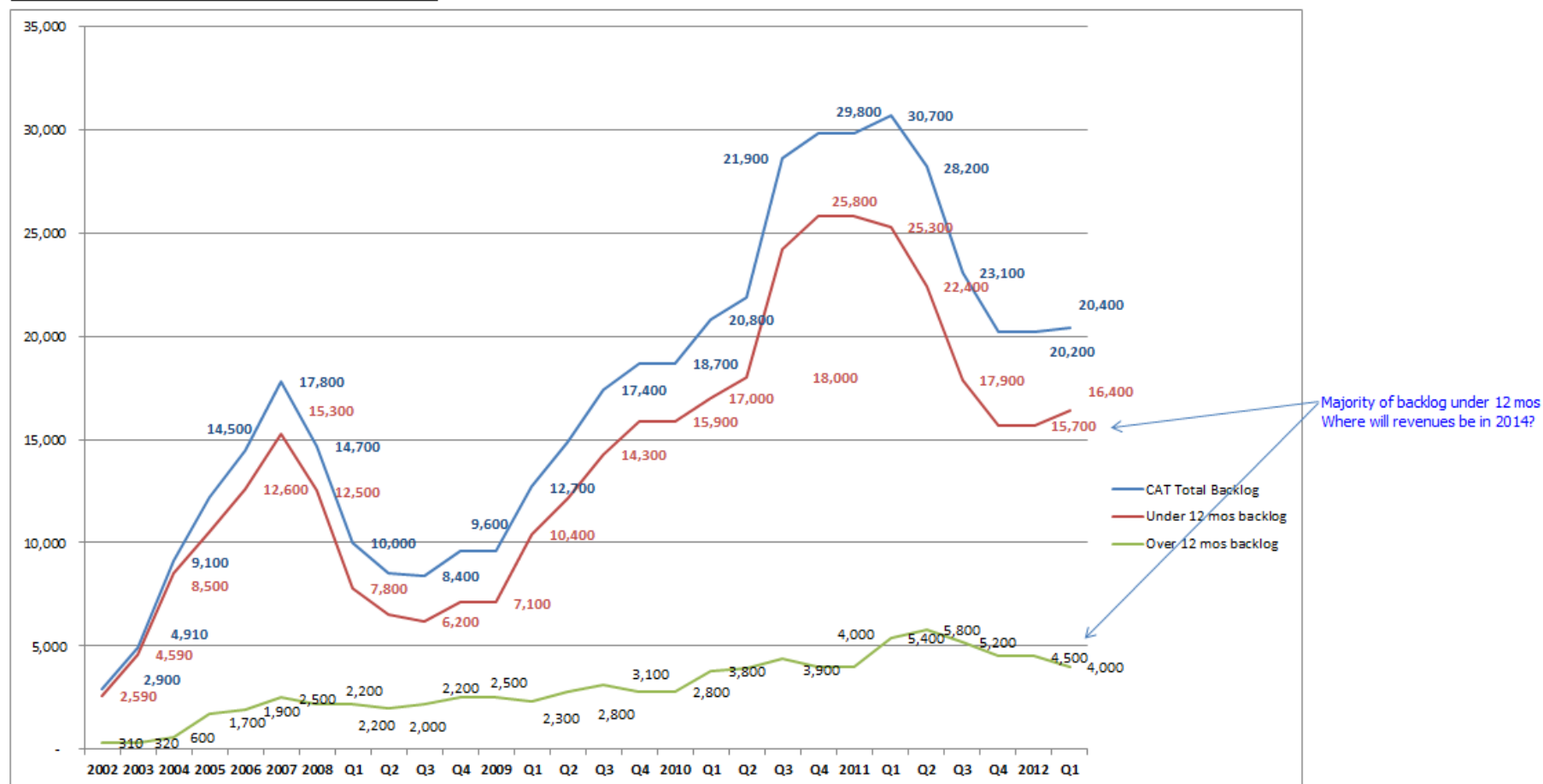
- 2013 EPS: \$5.88 vs. \$6.82 consensus
- 2014 EPS: \$5.03 vs. \$7.92 consensus
- 2015 EPS: \$5.06 vs. \$9.15 consensus

And below our earnings assumptions vs. consensus (not really that aggressive actually), in about as open and transparent a way as we can provide them. You may notice below that we have CAT forecasted to return to 2006-2008 levels of profitability, which we think is fair and even there involves yet more downside (this is our BASE assumption, not bear):

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
<b>Revenue</b>											
Construction Industries					13,572	19,667	19,334	18,326	19,609	20,393	21,209
Resource Industries					8,667	15,629	21,158	16,405	14,846	14,252	14,252
Power Systems					15,537	20,114	21,122	18,765	17,849	18,227	18,614
Other / Eliminations					2,156	2,021	1,454	1,028	1,049	1,050	1,051
<b>M&amp;PS Total</b>	\$ 38,870	\$ 41,963	\$ 48,045	\$ 29,541	\$ 39,932	\$ 57,431	\$ 63,068	\$ 54,524	\$ 53,354	\$ 53,923	\$ 55,126
CAT Financial	2,648	2,996	3,280	2,856	2,721	2,746	2,807	2,826	2,800	2,800	2,800
<b>Total Revenue</b>	\$ 41,518	\$ 44,959	\$ 51,325	\$ 32,397	\$ 42,653	\$ 60,177	\$ 65,875	\$ 57,350	\$ 56,154	\$ 56,723	\$ 57,926
<b>EBIT</b>											
Construction Industries					783	2,056	1,789	1,744	1,881	2,065	2,256
Resource Industries					1,789	3,334	4,898	2,042	1,538	1,344	1,328
Power Systems					2,288	3,053	3,434	2,398	2,045	2,145	2,248
All Other					720	837	1,014	626	630	631	631
Corporate/Elimination	(406)	(353)	(253)	(261)	(2,004)	(2,710)	(2,723)	(2,095)	(1,829)	(1,858)	(1,930)
<b>M&amp;PS Total</b>	\$ 4,251	\$ 4,231	\$ 3,869	\$ 894	\$ 3,576	\$ 6,570	\$ 8,412	\$ 4,716	\$ 4,266	\$ 4,326	\$ 4,533
CAT Financial	670	690	579	381	387	583	741	807	595	565	537
<b>Total EBIT</b>	\$ 4,921	\$ 4,921	\$ 4,448	\$ 1,275	\$ 3,963	\$ 7,153	\$ 9,153	\$ 5,523	\$ 4,861	\$ 4,892	\$ 5,070
Interest Expense	274	288	274	389	343	396	467	489	498	498	498
Minority Interest	-	-	-	(68)	58	53	41	8	40	40	41
Other	286	372	436	553	51	(56)	(436)	19	(11)	(11)	(11)
<b>Pre-Tax Income</b>	4,647	4,633	4,174	256	3,562	6,648	8,209	5,044	4,312	4,342	4,519
Taxes	1,405	1,485	953	(270)	968	1,720	2,528	1,102	942	949	987
<b>Net Income</b>	3,537	3,541	3,557	895	2,700	4,928	5,681	3,942	3,370	3,394	3,532
<b>EPS - diluted</b>	\$ 5.17	\$ 5.37	\$ 5.66	\$ 1.43	\$ 4.15	\$ 7.40	\$ 8.48	\$ 5.88	\$ 5.03	\$ 5.06	\$ 5.27
Shrs o/s - basic	658.7	638.2	610.5	615.2	631.5	645.0	652.6	656.2	656.2	656.2	656.2
Shrs o/s - diluted	683.8	659.5	627.9	626.0	650.4	666.1	669.6	670.6	670.1	670.1	670.1
Consensus								\$ 58,599	\$ 62,621	\$ 66,931	\$ 102,245
Revenues								\$ 6.81	\$ 7.92	\$ 9.15	
EPS											
Revenues - vs. consensus								-2.1%	-10.3%	-15.3%	-43.3%
EPS - vs. consensus								-13.7%	-36.5%	-44.6%	
<b>Revenue YoY</b>											
Construction Industries						44.9%	-1.7%	-5.2%	7.0%	4.0%	4.0%
Resource Industries						80.3%	35.4%	-22.5%	-9.5%	-4.0%	0.0%
Power Systems						29.5%	5.0%	-11.2%	-4.9%	2.1%	2.1%
Other / Eliminations						-6.3%	-28.1%	-29.3%	2.1%	0.1%	0.1%
M&PS YoY						43.8%	9.8%	-13.5%	-2.1%	1.1%	2.2%
CAT Financial % YoY						0.9%	2.2%	0.7%	-0.9%	0.0%	0.0%
<b>EBIT Margin</b>											
Construction Industries					5.8%	10.5%	9.3%	9.5%	9.6%	10.1%	10.6%
Resource Industries					20.6%	21.3%	23.1%	12.4%	10.4%	9.4%	9.3%
Power Systems					14.7%	15.2%	16.3%	12.8%	11.5%	11.8%	12.1%
All Other					33.4%	41.4%	69.7%	60.9%	60.1%	60.1%	60.0%
Corporate/Elimination					-35.9%	-29.2%	-24.5%	-30.8%	-30.0%	-30.0%	-29.9%
<b>MP&amp;S Total</b>	10.9%	10.1%	8.1%	3.0%	9.0%	11.4%	13.3%	8.6%	8.0%	8.0%	8.2%

So you're skeptical of our numbers and still think we've troughed? Think again – we gain confidence in our position as orders fail to materialize. Recent sell-side surveys by research firms **ISI, Credit Suisse, Barclays, Goldman Sachs have all found** that recent channel checks are *even worse than bad expectations were expecting*. Below is a time series of CAT's backlog, which ticked up (mysteriously) \$200MM in Q1'13 – while we'd prefer you keep your eye on the >12 months backlog, which continues to deteriorate from a peak of \$5.8B in Q1'12 to now \$4B and heading south further (don't take our word for it, check on CAT lead times for pretty much any construction or mining equipment, and you'll get it immediately)

**CAT Reported Backlog (2002-2012) - UTM/OTM & Total**



Think orders are coming in CAT's 2-3Q'13 reports? Not likely if the commentary below is accurate:

Credit Suisse's (Jamie Cook) latest CAT Dealer Survey (7/15/2013): On RoW sales rates we get "Previously, there had been some hope of an improvement in 2H'13 whereas now dealers are hoping for a flat market on easy comparisons." while "mining is very weak."

And watch out for pricing, as Longbow's (Eli Lustgarten) recent dealer survey (7/19/2013) mentions that "In this quarter, contacts relayed that competition for market share between CAT, DE and to a lesser extent Komatsu continues to be based primarily on overall pricing and availability of financing options. DE has made attempts to undercut CAT's prices, and all three companies are adding increasingly aggressive financing options such as variations to rent to own deals amongst others."

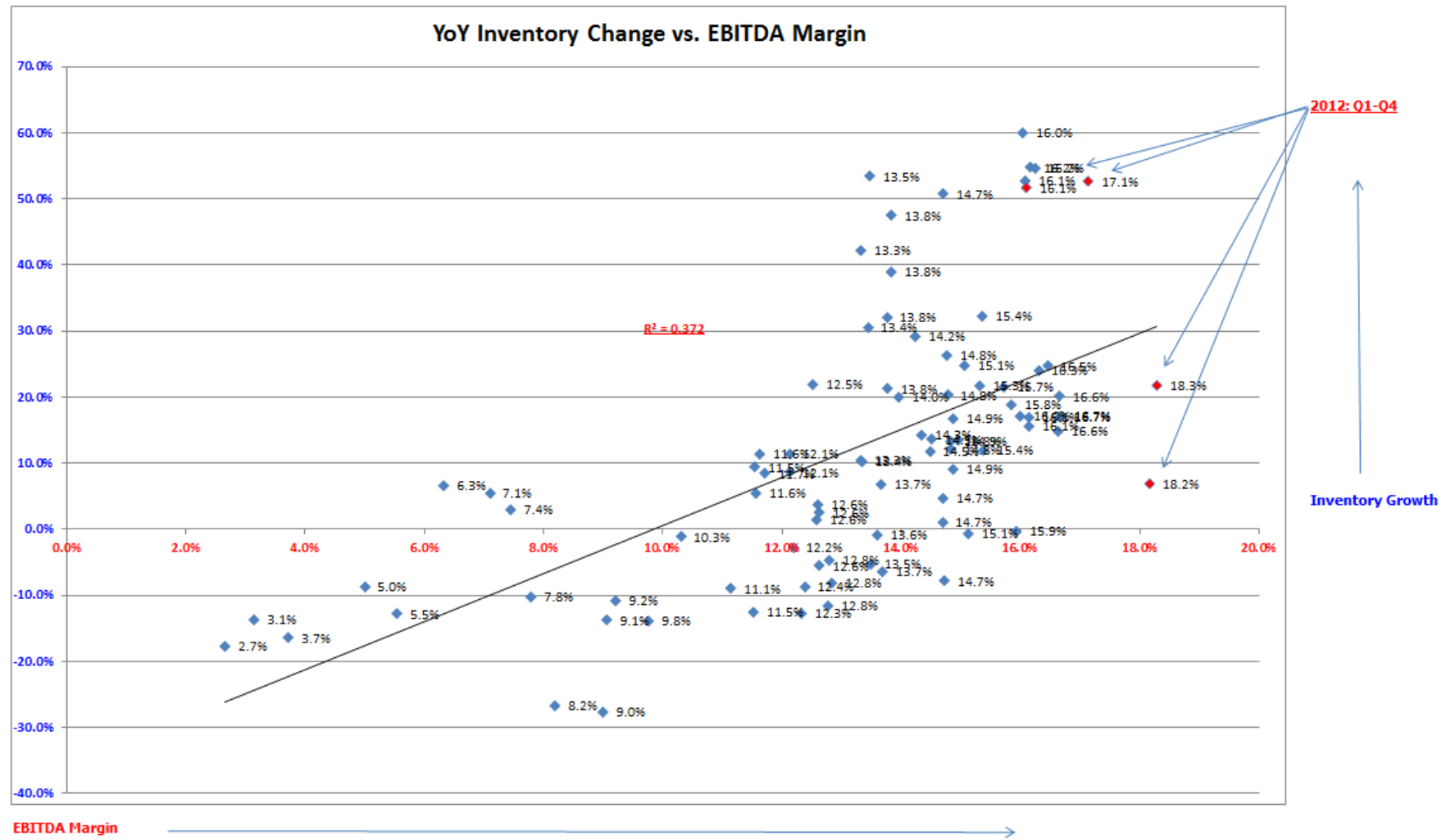
And from that very same Longbow report comes this ominous quote, as we haven't seen a price war for heavy machinery for awhile: "The first two quarters were kind of flat with last year on volumes but profitability is hurting us. The competition is aggressive with prices and there is not enough need for iron. It's more DE but Komatsu has been aggressive lately. They are buying share and throwing money at it with things rent it for a year and we will buy it back at the same price. It's a smart move by DE and CAT is trying to fight back" - CAT Dealer, South

Doesn't sound like much hope for 2014 if we're at zero lead times and not seeing orders by August – sounds like big iron globally is about to enter a price war as they face the prisoner's dilemma of cutting price to level production or attempting to hold margins by reducing production. Our bet is that global machinery is over-capacitized and a price war is more likely as a last-ditch effort to fill production slots into 2014. Why do this if you make big iron? Because you need these units for cost absorption – plain and simple. Hence the positive feedback loop of a growing backlog allowing for level-loading production AND increasing price – eventually your success (and that of your competitors) becomes your own undoing as cyclical companies have shown time and again that over-investment causes boom/bust cycles (too many competitors, too commoditized a product – we're moving dirt around, not making iPads). Add on top of this prior positive feedback loop stuffing the channel through 2012 and pumping production even higher with inventory financed at ever-lower borrowing costs (hey, it meets guidance right).

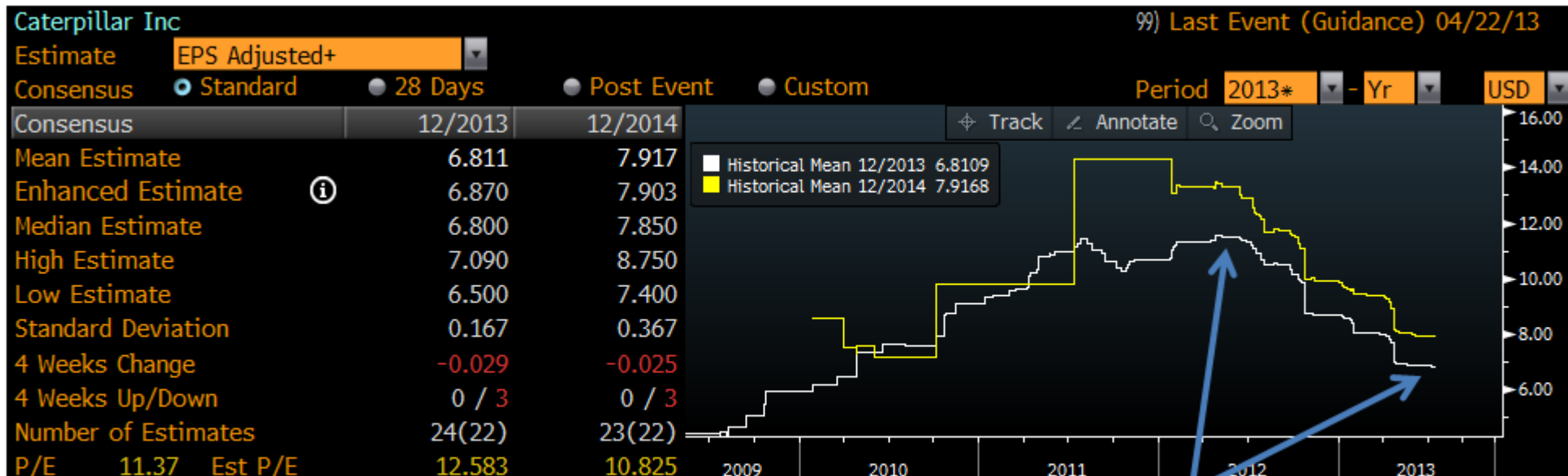
And now lets look at how far expectations have fallen in just the past year. We were supposed to earn \$11.75 in 2013 and \$14.00 EPS in 2014 right? Guess \$7 is ok because it's the "bottom" – but don't worry you get a \$2.40 dividend in exchange for risking a share price south of \$30.



And CAT has historically been challenged to maintain margins in flat/negative revenue growth environments:





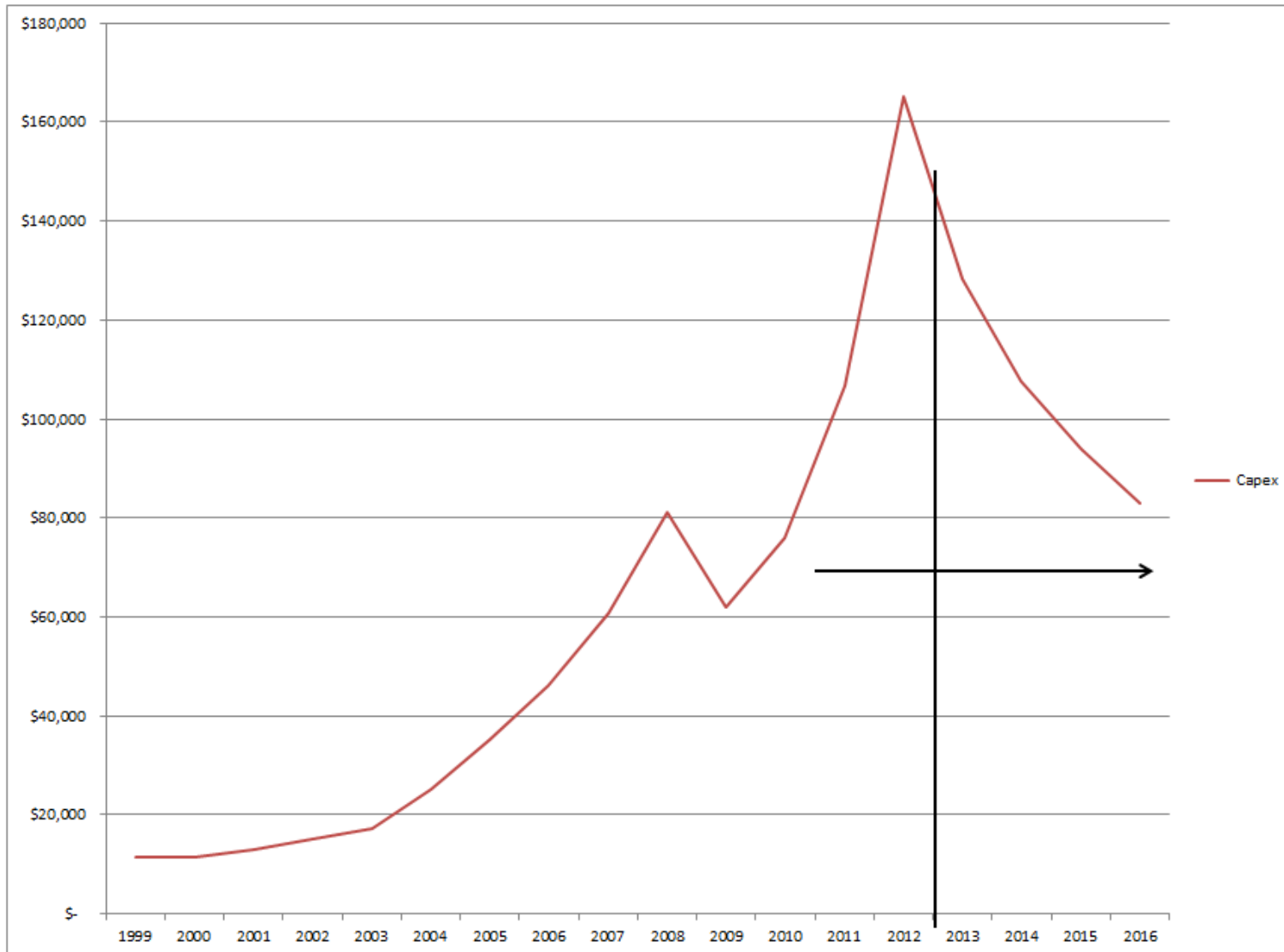


Look out below! Why are CAT shares at the same levels as mid-2012 and 2011 given we *still* have further negative revisions to both 2013/2014? And remember, CAT mgmt was saying as late as Sept. 2012 that 2015 targets were \$12-15 EPS and \$100B revenues, which absent a \$40B acq. look unachievable

## Mining Capex: Yes it Really *Is* Getting Worse

And lets check where mining capex consensus estimates last clocked in (and where we've come from since 1999):

**Mining Capex (representative group of mining majors), 1999-2016E**



Comp group selected (all amounts in USD): AA, ANR, AAL LN, ANTO LN, AGO AU, ABX CN, BHP, CNQ CN, CLF, CNX, FMG AU, G CN, ILU AU, KAZ LN, K CN, KIO SJ, MIN AU, MNOD LI, NWR LN, NHY NO, BTU, RASP RM, RIO LN, CHMF RN, SLW CN, SCCO, SU CN, TCK/B CN, TRQ, 486 HK, VALE, VED LN, WHC AU, XTA LN, ACI, NEM, IMN CN, FM CN, FXPO LN, ENRC LN

\*Source: historical and Bloomberg consensus estimates ( where 2015/2016 estimates did not exist the prior year number was used).

We won't beat the mining capex argument to death because its already going to beat earnings to death as the 2004-2012 commodity surge enters a period of decided moderation. Meanwhile global capex providers such as Komatsu, Atlas-Copco, Sany Heavy Industries, Deere, Cummins, Sandvik, Mitsubishi Heavy, Kawasaki Heavy, Samsung Heavy, Job Global, etc., have all scaled up for a much larger market and now have withering backlogs and near zero lead times with which to beat each other over the head on price. Think contribution margins for the entire production complex as a whole can be isolated? Think again. The lines that make mining dump trucks also produce parts and machinery for every other end user (such as North American construction) – less overhead absorption and lower sales in one division will wreak havoc on CAT's entire profitability profile going forward – which makes us so confident in our mid-\$5 EPS 2014 estimate.

Of course maybe not take our word for it, take recently-retired CEO Marius Kloppers of BHP or maybe Australia's resource minister Martin Ferguson (on 8/2012, a month ahead of CAT's '15 \$12-15 EPS unveiling) saying "You've got to understand, the resources boom is over... [] anyone with half a brain knows that."

Of course lets then take a look at BHP's iron ore production – chugging higher (albeit at a decaying rate with no signs of BHP throttling capex anywhere but down following its cancellation of the massive Olympic Dam project in Western Australia) and leaving even less potential ROC for capex to chase in 2014+

BHP's [just-released FY'13 \(June\) results](#) give us a window into just how the commodity miners are using their new equipment to push the cost curve to its limit – just because capex is falling doesn't mean production will fall as longer lead-time projects come online and push even more tons into the market.

Below is BHP's iron ore production:

**BHP Iron ore output: Continuing higher despite lower prices**

FYE - June	2005	2006	2007	2008	2009	2010	2011	2012	2013	YTD
'000 tons	96,745	97,072	99,420	112,260	114,415	124,962	134,406	159,478	169,856	82,596
YoY		0.3%	2.4%	12.9%	1.9%	9.2%	7.6%	18.7%	6.5%	4.8%

Note: Q4 (June) '13 iron ore production was +10%.

## Valuation:

We believe CAT is worth a fair value \$28/shr given its cashflow risk profile and current earnings correction (which we believe will last through 2015 at the least). Our target is based upon a 0.5x S&P 500-relative multiple and is predicated upon a severe de-rating of this highly leveraged firm in the face of continuing declines in mining capex as well as emerging market construction & power systems, both reliant upon commodity wealth.

We show both a cyclical trough valuation mult of 0.5x FY2/FY3 vs. S&P 500 (we believe when the cycle turns it will be hard for investors to understand the earnings/cash degradation and the sell-down will enter a tailspin) vs. a dividend discount model using a 12% discount and 3.5% growth rate (we feel both are appropriate, and the 3.5% number optimistic given CAT is likely to grow at about a global GDP level at best).

	2014	2015
SP500 P/E	13.7x	12.5x
CAT rel	0.50x	0.50x
CAT Px Tgt:	\$ 34.37	\$ 31.61
FV P/E	6.8x	6.2x
FV EV/EBITDA	7.4x	7.1x

DDM	\$ 28.24	<--- perpetuity \$2.40 / (12% - 3.5%)
Current CAT Dividend	\$ 2.40	
Avg. Growth Rate (1999-2012)	7.1%	
Assumed Growth Rate (2013+)	3.5%	
Discount Rate	12.0%	

We believe investors who may be skeptical of our belief this Dow component may fall to such lows should look at our cashflow analysis, where we believe CAT will have to unwind its factoring arrangements with CAT Financial (currently measuring ~\$3B) as well as run down half of its deferred revenue (which has grown to \$2.9B – details of which are subject of a recent [SEC staff inquiry](#)).

Caterpillar M&PS FCF	2013	2014	2015	
M&PS Net Income	3,741	3,221	3,252	
<b>Adjustments:</b>				
+ D&A	1,972	2,070	2,112	<--- includes CAT Financial, where capex > D&A since 2008
+ Other	-	(200)	(200)	
- Capex	1,340	1,340	1,005	
- Chg w/c	718	(1,174)	(850)	<--- assumes \$1.5B of deferred revenue runs off 2014-2015
<b>Unlevered FCF</b>	3,654	4,925	5,009	
+ Chg Debt (M&PS)	(1,113)	(762)	(507)	
- CAT Financial Injections		1,500	1,500	<--- assumes CAT unwinds factoring arrangements to inject cash
<b>FCFE</b>	2,541	2,663	3,002	

### **In Closing:**

If you currently own the stock we ask you to consider our presentation and ask yourself if you're satisfied reconciling the following:

- Inconsistent management guidance/public comments vs. own compensation metrics
- Lack of accountability & oversight – if Siwei can happen, why couldn't a similar sleight of hand be played on the board on revenue recognition/inventory build?
- Do you feel safe owning CAT when their free cashflow generation makes the stock much more expensive than it appears?
- Is your dividend safe? Can CAT pay out, let alone grow, its dividend without borrowing more money?
- Do you understand the risks of owning a highly cyclical business with its own management piggy bank in CAT Financial? Do you believe that low interest rates and the ability to set your own residual values have no bearing on margin performance or ability of management to manipulate earnings?
- *Do you understand how this company really makes EPS vs. actually taking in cash?*

We believe our work speaks for itself, and that most longs are in the name for many reasons not encompassing our risk factors above – we urge you to consider our analysis if you currently own or are thinking of buying CAT stock.