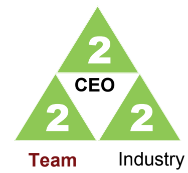
Management CV

Research Note:
Caterpillar Inc. (CAT)
May 13, 2014

CAT: Can Do Management



Douglas Oberhelman (61) has been Chairman & CEO of Caterpillar since 2010 but with the Company for 39 years. Results were weak in 2013 primarily due to weakness in the mining sector though CEO Oberhelman's focus on working capital efficiency has resulted in record operating cash flow of $9 billion as inventory fell significantly. In response to the revenue decline, management initiated restructuring moves to reduce costs ($200 million of restructuring expenses in 2013 and $400-$500 million this year). Management expects ongoing cost reductions of $200 million for 2014 and $400-$500 million after 2015, a considerable savings in our view. Oberhelman just announced an update to his strategic plan that we think focuses on the right areas. Major initiatives include: improvements to its already strong dealer network, continued cost discipline with a more flexible cost structure, product development and continued development in China, the largest market in the world for construction equipment. Longer term goals include growing EPS by at least 15% per year and a TSR in the top quintile of the S&P 500. We like the fact that management quickly transitioned from a growth strategy to cost containment last year in the face of a challenging environment and like their financial discipline. We rank both the Team and CEO "2" as they have extensive industry experience and have a pay plan with the right incentives.

EXECUTIVE TEAM SKILLS FIT We like the tenure of CAT's officers though we think the team is somewhat top heavy with finance backgrounds. CEO Oberhelman started with CAT in 1975 and was promoted to CEO in July 2010 and Chairman 4 months later. During his tenure, he served in a number of finance and strategic planning roles in North and South America, as well as Japan. He was appointed CFO in 1995 and served 3 years before becoming a VP at the Engine Products Division. He rose to Group President in 2002 and was in charge of Asia Pacific, Financial Products, IR, and global purchasing, among other areas. We think Oberhelman has done a good job of focusing on what he can control (costs and operating efficiencies via Lean manufacturing techniques) rather than on what he can't, namely predicting the economic cycle. We also think his "Across the Table" initiative, which will formally be rolled out at the end of the year, has great potential. It aims to drive more consistent performance among dealers and management thinks it can drive $9-$18B in incremental revenues by 2018. Bradley Halverson (53), a CPA, is new to the CFO role since the beginning of 2013. He has been with CAT since 1988, starting as an accountant. In 1993 he moved to Caterpillar Overseas as a business and strategy consultant and was promoted to Comptroller of Europe before moving back to the US. He then served 4 years at the Engine Division, 2 years as a VP in the Financial Services division, Corporate Controller from 2004-2010 and VP, Finance & Accounting before being appointed CFO. We like his extensive company experience and think he has maintained a strong balance sheet. Though early in the process, we like his cost discipline so far. Ed Rapp (55) has been Group President, Construction since 2013, and has been with CAT since 1979. He spent 3 years as CFO until being replaced by CFO Halverson last year, this after 3 years as Group President of Caterpillar, Inc. Based in Singapore, he has served in a number of senior roles throughout the world including department manager in the Building Construction Products Division and Regional Manager of Europe. We think a key executive to keep an eye on is Dave Bozeman, SVP of the new Enterprise Systems Group. Bozeman joined in 2008 from Harley Davidson. He is in charge of CAT's Lean initiative, which has become a key focus area and could yield results by 2018 of $2-$4 billion in Operating Profit After Capital Charge (OPACC).

COMPENSATION & ALIGNMENT ANALYSIS We like the large amounts of at risk-pay for officers, though we think the compensation plan is overly complex. The team's total cash pay was $18.2 million, which was just 0.3% of EBIT and well below their peer average of 2.2%. CEO Oberhelman received total compensation of $15 million for 2013, down 33% from 2012. This consisted of $1.6 million in salary, a $2.2 million cash bonus, $8 million in option awards and $3.2 million in pension and other pay. The rest of the team was paid between $4.5 million (Group President Steve Wunning) and $9.9 million (Group President Gerard Vittecoq) *(continued on next page)*

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with over 50% in equity, which we like. The annual cash bonus is based on OPACC, which was changed in 2012 from the previous metric, Return on Assets. OPACC is calculated as operating profit excluding short-term incentive pay less a capital charge (17% in 2013). OPACC is based on Machinery & Power Systems and excludes the results of the Financial Products segment. For the CEO the entire bonus is based on Corporate OPACC but for Group Presidents this weighting varies from 20%-80% with the remainder based on various metrics, including group OPACC and 4 other measures. Bonus targets are 175% of salary for the CEO (up from 150% in 2012) and 100% for Group Presidents. The bonus is subject to a minimum Profit per Share ($3.50 in 2013) amount before it can be funded. We think the plan could be just as effective with less complex metrics and would prefer to see metrics that can be less easily manipulated. There are several long term incentive pay (LTIP) plans. A Long-Term Cash Performance Plan pays cash based annually on 3-year performance of ROA and TSR vs. a peer group, both equally weighted. Payments can vary from 0%-200% of target with targets of 170% of salary for the CEO and 110% for Group Presidents. Equity awards are in the form of options, though specific targets were not provided other than the Board targets the median LTIP of peers minus the cash LTIP. There is also a Chairman's Restricted Stock Program which makes awards to officers at the Board's discretion, though no employee can receive more than 15k shares per year and in 2012 it did not make up more than 11% of total equity awards for any officer. We do not like discretionary awards or the fact that specific targets were not provided for equity-based awards, which totaled nearly $25 million for the senior team in 2012.

EQUITY OWNERSHIP ANALYSIS Officers and Directors have good beneficial ownership stakes, for a company of CAT's size, at 5.4 million shares (0.85% of the Company). CEO Oberhelman has direct ownership of 207k shares worth $21 million and another 650k vested options. We also think that the rest of the senior team has good beneficial ownership stakes. Insiders sold 336k shares over the last 6 months vs issuance of 434k shares and we also note 251k in open market sales worth $23 million over the last 18 months. The amount of sales is not overly concerning given a large amount of equity based compensation but we would be more negative if sales increased much above these levels and feel insider selling warrants a close watch going forward. Holding requirements for officers are 50% of the shares awarded over the last 5 years. We like these type of holding requirements, but according to the Board the amounts equate to about 3x salary, which is lower than we like to see. We also note that a shareholder proposal for 2013 would have required leaders to hold 75% of their after-tax shares awarded until retirement age, but the measure was defeated after the Board recommended a "No" vote. Outstanding options were 60% in-the-money at a weighted average strike price of $65.03, providing good alignment with shareholders.

CAPITAL ALLOCATION PRACTICES We like management's clear, consistent and shareholder friendly capital allocation strategy. It seeks to return as much earnings to shareholders as possible within clearly stated limits. Despite the difficult macro environment, the Board has raised the dividend by a 12.5% CAGR over the last decade to $2.40/share (2.3% yield). In January, management completed a $7.5 billion repurchase program and the Board approved a new $10 billion repurchase plan. At the same time it entered into an agreement with Citibank to buy $1.7 billion of its shares in Q1'14. Management states it will continue to repurchase shares aggressively as long as the debt-to capital ratio remains in the low 30% range. ROE fell considerably in 2013 to a still respectable 19.7%; though this was down from 37% in 2012 and 41% in 2011. After the challenging July 2011 $8.8 billion acquisition of Bucyrus, M&A activity has been fairly limited, with just 1 in 2013, a Swedish Marine propulsion firm for $166 million. Management states it has an annual placeholder of $1 billion for M&A but has nothing large on the horizon and expects deals to be relatively small with Power Systems mentioned as a growth area. Management expects the Bucyrus deal to bring over $500 million in annual synergies by 2015.

OTHER FIDUCIARY ISSUES Only 2 non-independent Directors can serve on the Board and currently 11 (of 12) Directors are considered independent. *End*