Caterpillar

SELL: US$133.38 (-19.18%)

Slowing to a crawl

17 October 2020

NUS INVESTMENT SOCIETY

Company Overview

Figure 1. Caterpillar Revenue Distribution by Business Segment

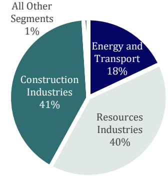
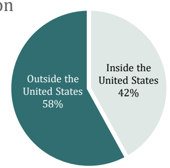


Figure 2. CAT Revenue Distribution by Region



Caterpillar is the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines, industrial gas turbines and diesel-electric locomotives. Caterpillar leads the industry with their cutting-edge technology and decades of product expertise. The company operates through three primary segments – Construction Industries, Resource Industries and Energy & Transportation – and provides financing and related services through its Financial Products segment.

(US$m)	2019A	2020E	2021E	2022E
Revenue	53,800	41,417	45,279	49,584
Net Income	6,093	2,989	3,943	4,967
NI Gr Rate (%)	*(4.0)*	*(52.0)*	*34.8*	*25.9*
Profit Margin (%)	*26.9*	*10.5*	*12.3*	*13.6*
ROA (%)	*7.76*	*5.08*	*8.22*	*8.63*
ROE (%)	*42.6*	*22.2*	*31.0*	*34.7*
EV/EBITDA	11.5	19.6	15.9	13.7
EPS	1.26	5.35	7.54	9.37
D/E	4.4	4.2	3.9	3.3

12M Industry Outlook

Figure 3. Breakdown of Heavy Machineries Buyers by Region (m)

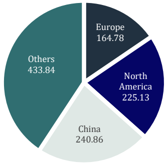
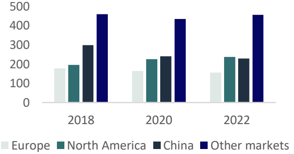


Figure 4. Growth of heavy machinery by region



1. **Demand recovery remains muted:** Growth in end-user demand for machinery is expected to be small with mining and construction firms reducing CAPEX spending. While the long term rebound in demand is expected to grow at a 4.2% CAGR from 2020 to 2027, the buildup of dealership inventory in 2019 amidst sluggish demand from uncertainties due to COVID-19 would result in a drag in OEM demand in the next 1- 2 years.
2. **Weak rebound of North American energy:** The current low demand environment as a result of the Covid-19 pandemic has translated to depressed oil prices and is foreseen to remain low. We expect O&G activity to remain subdued through the remainder of 2020 particularly onshore North America, due to their relatively higher breakeven shale prices required.
3. **Middle to long term downside risk:** The mid to long term outlook for heavy machinery is mixed with increasing diversification of Oil Majors away from oil and gas and into renewables. There has been sluggish demand in new home builds in the US in 2019 and we expect it to continue until 2023 given the weaker employment rates and economic outlook.

Investment Thesis

Figure 5. Segment Revenue (US$m)

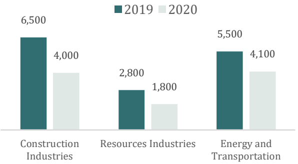
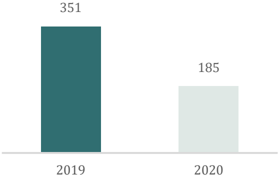


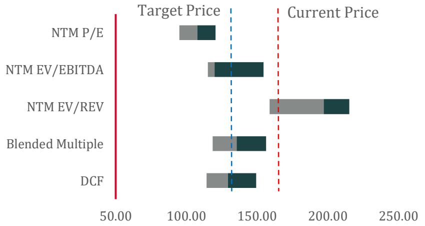
Figure 6. Weir O&G Revenue (US$m)



1. **Excessive optimism in autonomous mining system –** Despite miners' ageing haulage equipment, retrofitting demand to Caterpillar's autonomous systems may remain soft. With ores and coking coal prices remaining weak as compared to prices in 2019, CAPEX of leading miners are expected to fall by US$6.5b from initial 2020 guidance, delaying equipment retrofitting.
2. **Weir acquisition may drag profit margins –** Weir's oil and gas division has experienced continued eroding margins and depressed sales volume in both their OE and AM. With differing product offerings, short-term cost synergies may not be realised and Caterpillar's profit margins may experience a drag in the short to middle term.
3. **Mismatched expectations in US construction –** Despite the optimism, the recovery in the US construction sector is expected to be muted due to the decreasing demand in private non-residential sector and the delay and cancellation of multiple construction projects. This in turn, delays the recovery of CAT in the 1 to 2-year timeframe.

Valuations

Figure 7. Football Field Analysis



Target Price	
Blended Target Price	$133.38
Blended Downside	-19.18%

Relative Valuation: Blended NTM P/E, NTM EV/EBITDA, and NTM EV/Revenue, with all three methodologies weighted equally. This results in a blended RV price of $140.32.

DCF: A DCF valuation was used with a WACC of 7.37%, and blended valuation over a 5-year forecast using a Gordon growth method with a terminal growth rate of 2% in line with that of the US economy, and an Exit EBITDA multiple of 7.68x.

Blended Downside: We selected the median RV to account for Caterpillar's market leadership while being exposed to macroeconomic headwinds, excess dealership inventories and weak pricing power. This was blended with our DCF valuation in a 50-50 weightage, achieving a target price of $133.38, representing a downside of –19.18%.

Sources: Company Filings, Statista, McKinsey, Bain & Co, NUS Investment Society Estimates and Research

Prepared by: Industrials Coverage Team – Ng Wai Ching, Tan Kai Qian Makarios, Bryan Cheah Jun Xiong