



CATERPILLAR
PROFILE

RANK:
58
REVENUE:
\$42.6 billion

PROFITS:
\$2.7 billion
EMPLOYEES:
104,490

ANNUAL TOTAL
RETURN:
68.7%

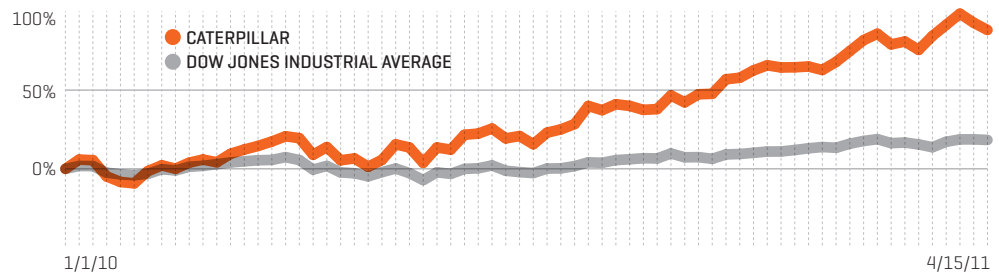
CATERPILLAR IS ABSOLUTELY CRUSHING IT

BY
GEOFF COLVIN

THANKS TO PRUDENT PLANNING, THE INDUSTRIAL EQUIPMENT GIANT CAME BLAZING OUT OF THE DOWNTURN. NOW, WITH ITS SALES AND STOCK SOARING, CAT IS EXPANDING AGGRESSIVELY TO STAY ON TOP.

Best in Class

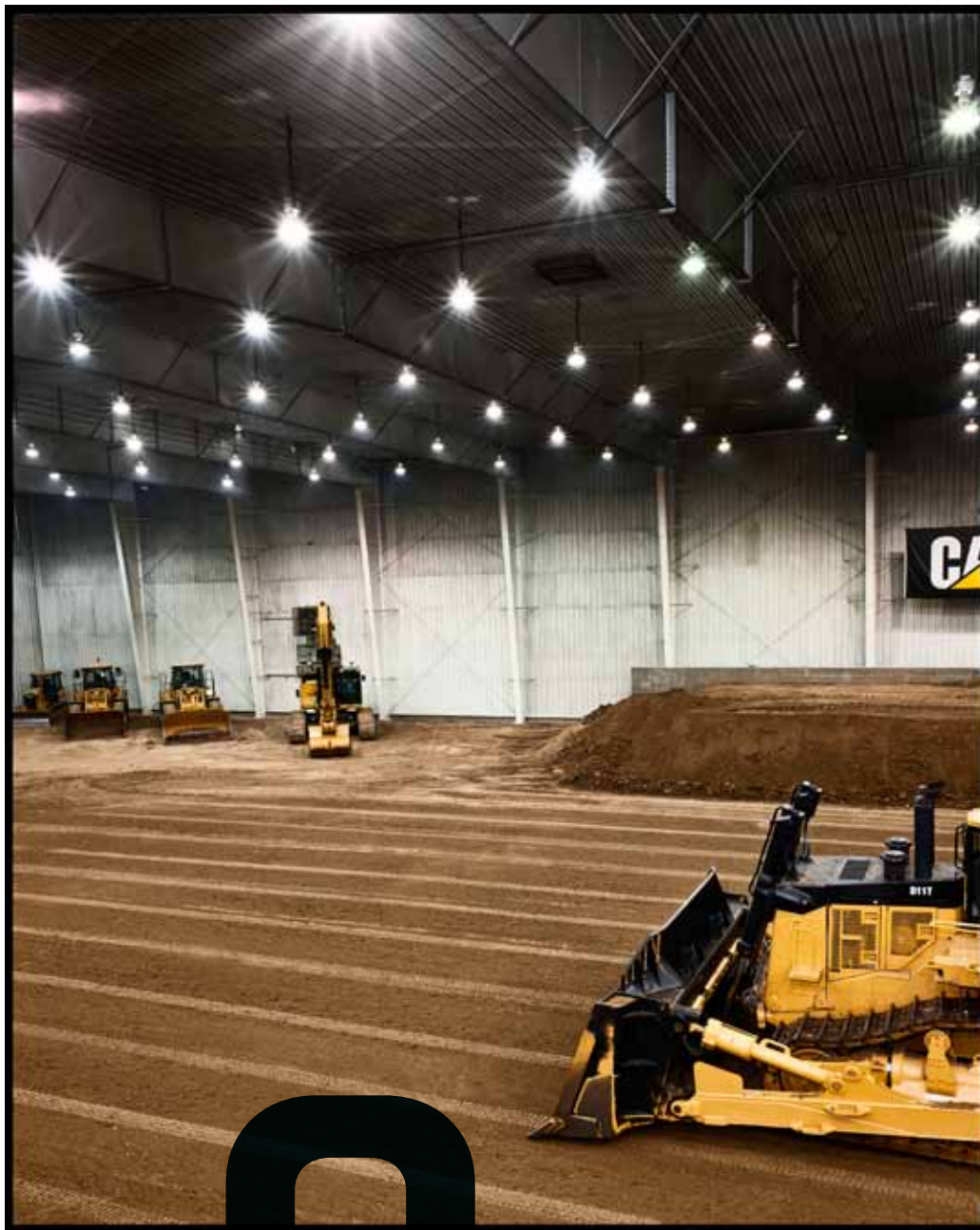
Since the beginning of 2010, investors have driven up the price of Caterpillar shares by 88%. That makes CAT by far the best-performing stock among the 30 components of the Dow index, which has risen 18% overall during the same period, despite the boost from Caterpillar's big gain.



SOURCE: BLOOMBERG

Caterpillar CEO Doug Oberhelman stands before a 777F mining truck, which carries a payload of 100 tons. Cat, already the world's top maker of monster machines, is trying to establish itself as the dominant player in developing markets.





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CATERPILLAR HAD A TERRIBLE PROBLEM in South America, and that's where the company sent Doug Oberhelman. It was the early 1980s, in the depths of the Latin American debt crisis, when the region got economically clobbered. "We sold 1,200 machines a year in Argentina in the late '70s," recalls Oberhelman, 58, who took over as CEO of Caterpillar last July. "In 1981, '82, and '83, while I was there, we sold four total." It was a miserable experience—his duties included putting PROPERTY OF CATERPILLAR decals on repossessed construction equipment—but its value has lately become evident. "It was a fabulous underpinning for business because it was how to survive in a depression," he says. "I'd forgotten a lot of those stories—until the last couple of years."



Inside the company's demonstration and learning center near Peoria, where customers can test-drive the newest Caterpillar tractor in a field-type setting

dirt-moving machines, many of them produced by unionized American workers in the Rustbelt. “Who would’ve thought, out of all those names?” marvels Oberhelman. Caterpillar is on such a tear that last year it even outran Wall Street darling Apple (not a Dow component), which was up a mere 53%.

The puzzle isn’t just a 2010 story. In April, Caterpillar announced first-quarter profits that walloped Wall Street’s expectations and pushed the stock to a new high some 30% above its previous all-time peak. Caterpillar dealers recently told Wells Fargo analyst Andrew Casey that demand is so strong that “Cat can sell anything it produces.” Profits this year look to be about 10% higher than the company’s 2008 record, by analysts’ consensus.

The puzzle’s solution is just as counterintuitive as the puzzle itself. It comes down to this: The financial crisis and recession, which caused the worst revenue plunge in the 86-year-old company’s history—worse than any year in the Great Depression—while wrenching, were the best thing that has happened to Caterpillar in a long time.

It’s not that Caterpillar was doing poorly before the downturn. It was and still is the world’s dominant maker of construction and mining equipment, as well as a leading producer of diesel and gas engines, industrial turbines (essentially jet engines that power equipment and generate electricity), and locomotives. No competitor can match the breadth of Caterpillar’s product line. Its largest rival, Japan’s Komatsu, will take in an estimated \$25 billion in revenue this year compared with Caterpillar’s \$50 billion. Other competitors include Volvo, John Deere, Doosan Infracore of South Korea, and China’s LiuGong—plus hundreds of small, local, specialized producers.

While none of those companies threatened Caterpillar’s dominance in the boom years, they were (and remain) tough competitors, and Cat, as the big, old, successful incumbent, faced the inevitable dangers of success: loss of strategic focus, weak discipline, and maybe someday being overtaken by an industry disrupter. The recession pushed Caterpillar off that road. “You really find out who you are, what your capabilities are, in tough times,” says CFO Ed Rapp, 54, a Caterpillar lifer, like most of its top leaders. “It forces you to reflect on what really differentiates you in the eyes of your customers.”

That corporate soul-searching paid off, sharpening Caterpillar’s focus and emboldening it to make major investments, including three strategically crucial acqui-

For anyone wanting to solve the apparent puzzle of Caterpillar’s recent run of success, Oberhelman’s experience managing in a devastated market is an important clue. The puzzle is worth solving for those trying to win in today’s global markets. The solution turns out to be valuable to managers in any kind of business.

The puzzle begins with this question: Why was Caterpillar the best-performing stock last year among the 30 companies in the Dow Jones industrial average? After all, the modern information-based economy favors a Dow component like Microsoft, which is burdened by few physical assets and makes a product—software—that consists of pure thought. Or pillmakers like Merck and Pfizer, which pack massive intellectual capital into tiny, high-priced packages. Yet outperforming them all, with its shares up 64% in 2010, was a company that requires huge sums of financial capital to manufacture multi-ton



“WELL BEFORE THE RECESSION, CATERPILLAR FORCED ITS MANAGERS TO MODEL DISASTER: ‘LET’S SAY SALES DROP 80%. HOW ARE YOU GOING TO REACT TO MAKE MONEY?’”

sitions in the past year that investors love. (More on those later.) A crisis tends to magnify advantages and disadvantages, rewarding or punishing years of past behavior. As it turned out, Caterpillar got rewarded in big ways.

T O UNDERSTAND WHY Caterpillar’s post-crisis success has been so dramatic, one must examine the cyclical nature of Caterpillar’s business and in particular the blitzkrieg suddenness with which the financial crisis struck. Because Cat machines are expensive investments that last for decades, it’s tempting to imagine that sales trundle slowly up and down over the years, in sync with changes in GDP. But in fact sales lurch wildly. When the economy is strong, customers always find money for new, cutting-edge earthmovers. But when corporate budgets tighten, the multidecade longevity of Caterpillar’s machines works against the company. It’s easy for a customer to put off buying a new locomotive or excavator in a downturn. And cash-strapped owners flood the market with used machines that have lots of life left in them. Here’s an example of how Caterpillar’s machine sales worldwide varied in this past cycle (for three-month periods ending in the month indicated vs. a year earlier): April 2004, up 43%; September 2009, down 52%; September 2010, up 53%. In this business a monthly sales chart can look like a photo of the Alps.

With that roller-coaster trend in mind, Caterpillar through the boom was planning carefully for a bust—much more carefully than in previous cycles. “This is something we’re very proud of,” says Oberhelman, who, just before becoming CEO, ran the company’s main businesses—machines and engines. “Jim Owens, my predecessor, worked very hard on a trough strategy.” In fact, he put Oberhelman in charge of it. They forced the managers of each business unit to model the worst trough in their history. “Let’s say you’re running mining, and sales drop 80% in two years,” says Oberhelman. “How are you going to react to make money? Well, you can imagine how popular that was in 2005. Nobody wanted to talk about it. But we forced them through the exercise.”

It didn’t hurt that Caterpillar saw the recession coming more clearly than most large companies. Top management, realizing the company’s susceptibility to GDP shifts, had once asked Cat economists to find a leading indicator. “We’ve got good news and bad news,” the economists reported, as CFO Rapp tells it. “The good news is, we found an indicator that predicts shifts in U.S. GDP with a lead time of six to nine months. The bad news is, it’s our own sales to users.” Using that metric, Cat anticipated the U.S. recession coming in the third quarter of 2007 and said so

publicly, triggering a 2.6% one-day drop in the S&P 500.

But the company never foresaw how vertiginous the sales drop would be. As late as September 2008, all still seemed well. At a mining industry trade show that month, Rapp recalls, “There was only one plea from customers: more product, more product.” Then suddenly, over Thanksgiving week, “things really drove off a cliff,” he says. “In September of 2008 we were looking for 2009 sales of \$55 billion to \$57 billion. They actually came in at \$32 billion.”

That’s why all those years of disaster planning proved so valuable. With a catastrophic sales drop looming and 2009 shaping up as a crisis year, “we didn’t have to scurry around,” Rapp recalls. “We said, ‘Pull the trough plans and do it now.’”

Each business immediately went into crisis mode. The company got most of the pain and termination costs of layoffs (35,000 from a workforce of 120,000) behind it in January 2009. At headquarters, “trough teams” worked from a 13-point list of priorities: dealer health, supplier health, cash, counterparty risk, and others. The teams met every Wednesday; Rapp met with them every Friday; and he delivered decisions from the top-executive group to the teams every Monday morning. He also set out the company’s three crisis goals: Stay profitable with strong cash flow, maintain the credit rating, and maintain the dividend.

The company achieved all three. Its new managerial tactics—intensive disaster planning when times were good; disciplined, fast execution of the plans when times turned bad; and concrete crisis objectives—worked. Caterpillar came through the recession financially strong, a novel experience. “We weren’t in this position in the past, because we always came out weak,” says Oberhelman. “We didn’t get through those cycles so well in the ‘80s and ‘90s.” Thus, Cat faced an unfamiliar but important problem: how best to use its strong balance sheet in a feebly recovering economy. In deciding, it got help from a fortunate coincidence.

A S THE CRISIS YEAR was winding down, in October 2009, Caterpillar announced that Jim Owens would retire on reaching age 65 the following year, in accordance with company policy, and would be succeeded by Oberhelman. Born near San Diego, Oberhelman had grown up in northern Illinois, where his father was a John Deere salesman. He studied finance at Millikin University, a small, Presbyterian-affiliated school in Decatur, Ill., across town from the plant where Caterpillar makes some



Below, a Caterpillar 992K wheel loader, which is 18 feet tall and weighs more than 200,000 pounds; left, the padfoot drum of a Cat soil compactor



of the world's largest trucks. Immediately after graduating in 1975, he joined the company as an analyst in the treasury department. His career took him not just to South America but also to Japan, Florida, and Canada, then back to headquarters in Peoria in 1995. He speaks quietly and calmly, in a flat Midwestern accent.

"One of the really great aspects of that transition, which we'd never done before at Cat, was that the first six months [after the announcement but before taking over] I spent only thinking about strategy," he recalls. He picked his top team, 16 people, and they "dissected the company," he says. "We put everything on the table—good, bad, and ugly." Realizing the danger of blurred strategic focus, they went deep: "We've gone into a lot of different businesses over the last 20 years. We said, 'What really is our business model, and how do we want to make money?'"

The 2009 experience had driven home the strength of the company's basic model and especially the crucial importance of Caterpillar dealers. The model's goal is simple: Ensure that customers make more money using Cat equipment than using competitors' equipment. Though Cat equipment generally costs more than anyone else's, the model requires it to be the least expensive over its lifetime,

factoring in purchase price, maintenance costs, operating costs, uptime, life expectancy, and resale value.

For customers, maintenance and uptime are critical. Kenny Rush, vice president of Sellersburg Stone in Louisville, says that's why he's such a fan of the Caterpillar 992 loader his firm uses in a quarry. "We've run that machine since 1998, and it's had 98% to 99% availability," he says. "It cost \$1.5 million. But we ran it 22,000 hours, which is about 10 years, before replacing any major components." Dealers are key to those economics. A machine that breaks down can halt an entire job, and getting back under way in two hours rather than 48 hours means big money. Large, successful dealers that carry lots of parts, maintain skilled technicians, and move fast are thus a major selling point, and Cat's dealer network is the undisputed best in the business.

A typical example is Gregory Poole Equipment, the Cat dealer in Raleigh, N.C. Its main site is a six-acre campus that stocks \$6 million of parts and includes repair and rebuilding facilities for most of Caterpillar's broad line of machines and engines. The company also maintains 20 other sites around the eastern part of the state and a fleet of 200 trucks for customer service. Total employees: 850. No Cat competitor has as large a dealership anywhere in the area. "If you need a part, we probably have it here," says CEO Greg Poole, grandson of the dealership's founder. "If we don't, you can order it as late as 7 p.m., and we'll prob-



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ably have it here by 6 a.m. the next morning.”

The dealers are a key element in a virtuous circle that keeps Cat on top, what CFO Rapp calls the Caterpillar flywheel: Big, strong dealers help Cat sell the most machines; all those machines in the field bring dealers lots of revenue from parts and service, so much that they can survive in years when they don't sell any new machines at all; and that financial stability enables dealers to grow bigger, attracting even more customers, and build a larger base of machines that need to be serviced.

“Our dealers—that has been the source of our Cat brand advantage more than most people really understand,” Oberhelman says. But the lowest-total-cost business model is under threat. “We can't pretend Komatsu isn't beating us on cost—they are,” he told employees last summer. Thus, one major initiative that came out of Oberhelman's strategy exercise was to keep dealers strong by continuing to improve machine quality, designing machines for fast, effective maintenance, and finding more ways to lower total ownership cost.

Caterpillar's strategists also realized that when you've got a lot of money to spend, you'd better spend it carefully. So they devoted months to identifying industries that are growing fast, in which customers are highly profitable, and in which Cat can capitalize on its dealer network or extend an existing business. Result: a decision to get bigger in mining, eco-friendly engines, and railroad equipment. Though Cat has been global for decades, the strategists also resolved to bulk up heavily where growth is greatest, especially in infrastructure—in other words, in China, India, and Brazil. And the strategy team made a further key decision: Invest early in this cycle, using Cat's financial strength while others might still be recovering.

With the strategy exercise complete by spring 2010, the company began to move. On June 1, a month before Oberhelman officially became CEO, Cat announced it would pay \$820 million for Electro-Motive Diesel, a major maker of locomotives, to combine with its Progress Rail Services business. In October it announced it would pay \$810 million for MWM, a German maker of industrial engines that run on gases. “Natural, synthetic, methane, coal bed, landfill, you name it, they'll burn it,” says Oberhelman. “It's a great crown jewel 20 years from now. I love that business.”

Three weeks later Cat said it was buying Wisconsin-based Bucyrus International, a 131-year-old maker of mining equipment, for \$8.6 billion. Bucyrus produces some of

the few man-made moving objects that make a Caterpillar mining truck look small. Cat's biggest truck carries 720,000 pounds of rock; Bucyrus's biggest shovel fills it in three scoops. Before the deal, Cat figured it could sell mine operators 30% of the mobile equipment they needed; with Bucyrus it can sell them 70%.

Investors often dislike big acquisitions, fearing that the buyer is overpaying. But they seem fond of these deals. On the announcement of the biggest, Bucyrus, they actually bid Cat's stock up, which is almost unheard of.

Besides acquisitions, Cat announced a multibillion-dollar series of new and bigger factories in China, India, Brazil, and the U.S. Investors liked those too, especially the investments in China.



BERHELMAN KNOWS THAT China is a giant long-term opportunity, but it's also perhaps the greatest threat to Cat's dominance in the future. Caterpillar is not China's leading construction equipment company; Liu-

Gong Machinery is, though overall it's much smaller than Cat. But Oberhelman wants to be No. 1 in China by 2015, and he could do it. The company has been in the country for 36 years, developing a dealer network, investing in joint ventures, and building plants. In addition, Cat machines and engines carry a lot of high technology, which the Chinese don't have. Of course, they'll get it eventually. Oberhelman assumes that it's only a matter of time before one of China's equipment makers emerges as a major power with a global reach. That's a big reason he's in a hurry to become the leader in China and other developing markets where that inevitable Chinese rival hasn't yet built a presence.

For now, Caterpillar is riding high. The stock's epic run—more than quintupling in just over two years—will end; charts shaped like that can't go on forever. In addition, it's impossible to know how competitors will respond in coming years to Cat's aggressive expansion. What's certain is that in this case, a year of historic crisis sparked a more impressive performance than many years of prosperity ever did. Says CFO Rapp: “I'm absolutely convinced that down the road, we'll look back on 2009 as the all-time great Caterpillar performance.”

Meanwhile, in booming China, the world's fastest-growing major economy and largest market for virtually everything Caterpillar does, company managers are being forced to do the trough exercise, just in case. **F**