

## International Stock Market Weekly

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**Industrial machinery**

The construction industry has undergone tectonic changes over the past century and in the next decade will go through a complete transformation to a degree that will create tremendous opportunities for investors. That transformation is already underway and is being carried out by an ever-growing number of innovative robotics and AI startups as well as the traditional big players in the construction industry. The construction industry incumbents who understand the risk of extinction are either developing robotics and AI technologies and applications in house and/or acquiring, partnering with, or taking stakes in robotic and AI startups. On the startup front, we are seeing an increasing number of potential disruptors emerging as well.

While there are several listed companies developing interesting construction robotics businesses, including John Deere, Kubota, Hyundai, and AGCo (via its subsidiaries) we find Caterpillar to be the most promising player in the space due to its deep domain knowledge of the industry, acquisitions of key companies with disruptive technologies and capabilities, and its strong market position in the construction equipment business.

## Stock pick for the fourth week of December

### Caterpillar (NYSE: CAT)

Caterpillar offers investors a winning combination of market leadership, technology innovation, and a healthy dividend

#### Building a foundation for future growth

Our top pick for the first week of January is Caterpillar (NYSE: CAT).

Caterpillar is an American manufacturer of construction and mining equipment, diesel and natural gas engines, industrial gas turbines, and diesel-electric locomotives and is a component of the DJIA. The company operates through four segments: Construction Industries, Resource Industries, Energy and Transportation, Financial Products, and other operating segments, which includes activities such as product management and development, filter and fluid manufacturing, undercarriage, rims and tiers, ground engaging tools, fluid transfer products, and connecting and sealing components.

#### Rationale

2020 manufacturing activities crushed expectations and 2021 is also looking very promising. Caterpillar's sales and earnings are cyclical due to the nature of its businesses. In 2020, that posed a problem due to the challenges that the US economy faced but as seen in the latest earnings, the company surprised with stronger-than-expected results, evidence that it is on the road to recovery. Accordingly, we like Caterpillar because the stock has started its upswing phase and along with this, the number of analysts upgrading their forecasts have already started to rise with the latest results.

We believe that by examining the details of Caterpillar's retail sales, it is clear that the company is now at the beginning of a turnaround. The bulk of Caterpillar's sales come from its retail sales via its independent dealers. Those dealers' retail sales are now climbing, and this will translate into more orders for Caterpillar. Looking at the company's retail sales, we can see that they appear to have already bottomed and will strengthen in 2021 in a manner not unlike in 2017.

Caterpillar has a first-mover advantage in developing autonomous heavy equipment and already has systems deployed around the world, with the most famous site being Rio Tinto's (NYSE: RIO) massive mines in Australia where its autonomous machines run around the clock. The company's autonomous technology strategy is now paying off, giving it a jump ahead of competitors like Hitachi (OTC: HTCMTF), Komatsu (OTC: KMTUF), Sandvik (OTC: SDVKY), and Volvo (OTC: VOLAF) and John Deere (NYSE: DE)—all of which are selling autonomous construction equipment but do not come close in terms of the number of sites where they operate. Autonomy is rapidly becoming a core component of the global mining industry that is worth nearly USD700bn. Caterpillar is leading the autonomy revolution with both vehicles and software. The company is not only selling its own autonomous trucks, which cost between USD3.5-5mn each, but also offers retrofits to Caterpillar vehicles and competitor's vehicles as well. Interoperability is core in the company's robotization strategy with its offerings as it recognizes there are other companies offering similar retrofit solutions. According to estimates from Zion Market

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Research, the global mining automation market will grow from USD3.65bn in 2018 to USD6.18bn in 2025, and Caterpillar should capture the lion's share of this pie.

### **Constructing a foundation in robotics**

Caterpillar is well aware of the groundswell taking place around in construction with automation and indeed it is one of the stronger players to take advantage of its deep industry domain knowledge, ample cash hoard, and brand recognition to become a major player in the robotization of construction.

While there have been moves by other companies to develop construction robotics such as Doosan Infracore (042670) with its Concept-X, the majority of the companies in the construction equipment business are simply too stodgy and conservative to engage aggressively in what they likely deem as risky moonshot projects but what are in fact the next big growth businesses in the sector. Caterpillar's activities are a clear indicator that the company is fully committed to leading this future growth business.

Indeed, some of Caterpillar's more interesting digs in construction robotics include the acquisition of San Francisco-based delivery robot maker Marble. According to Caterpillar, the acquisition was part of its roadmap to build its internal team to focus on the next generation of autonomous controls for their large equipment. The company's stated goal is to become the leader in autonomous equipment for the construction, quarry, industrial, and waste industries. Marble was founded in 2015 and prior to the acquisition, Marble had secured USD10mn in investment to develop intelligent, courier vehicles for "last mile" delivery applications. However, a red ocean of competitors, regulations by various government agencies regarding operating autonomous vehicles on sidewalks, and a lack of mass adoption outside of college campuses has dampened the emergence of the market as a viable application for these technologies.

Caterpillar offers bolt-on autonomous technology that works with existing machines so that it can minimize the impact from slowed sales from the pandemic and customers can upgrade their fleets whilst mitigating the overall costs. Demand for machines that do not require human operators on board has skyrocketed due to the pandemic and this will translate into machines that are fully autonomous going forward, in our view. Indeed, sales of the company's autonomous technology for mining grew at a double-digit pace in 2020 vs. 2019 according to data shared with the press.

Caterpillar's autonomous technology endeavors did not begin in the depths of the pandemic. Rather it has been developing these technologies since 2017 when the company was recovering from its longest downturn as a way to boost revenue from the highly profitable sales of services. It is, however, still the early part of the autonomous story and could be some time before the businesses make meaningful contribution to the company's revenue which amounted to USD54bn in 2019.

While rivals such as Komatsu are also engaged in the development of autonomous equipment,

Caterpillar has a considerable lead in the business and should, especially when we use its latest robotics company acquisitions and investments as a proxy, emerge as the leader in this market.

**Moonshot opportunities**

Caterpillar is a company with big ambitions and has the resources to realize them. The term ‘moonshot’ is frequently bandied about with abandon these days, but Caterpillar, with its experience and capabilities in delivering autonomous mining systems is working with NASA on unmanned digging and drilling machines to mine materials to 3D print materials on the moon when NASA returns to the lunar surface in 2024. Not only is this evidence of the company’s technical prowess but it is also part of its goal to grow its very lucrative autonomy and digital businesses as part of its strategic efforts to create new profit streams.

**Fig 1. Caterpillar autonomous equipment demo**



Source: Caterpillar/handout/Reuters, Hyundai Motor Securities

**Fig 2. Autonomous system for blasthole drills**



Source: Caterpillar, Mining, Hyundai Motor Securities

**Fig 3. NASA plans to use AVs on the moon**



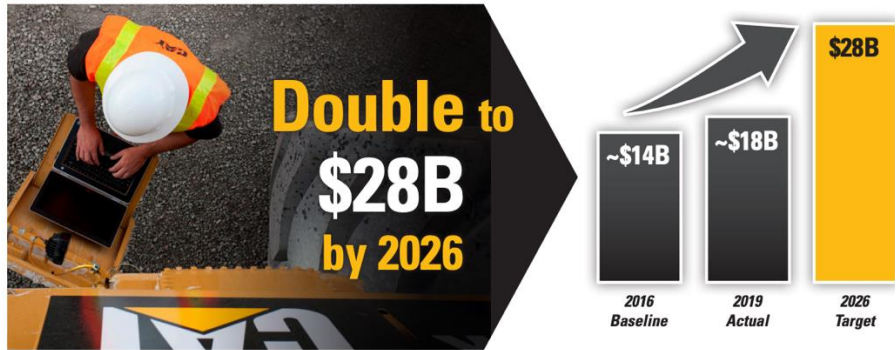
Source: NASA, Hyundai Motor Securities

**Fig 4. Caterpillar AVs used by Rio Tinto mine**



Source: Rio Tinto, Hyundai Motor Securities

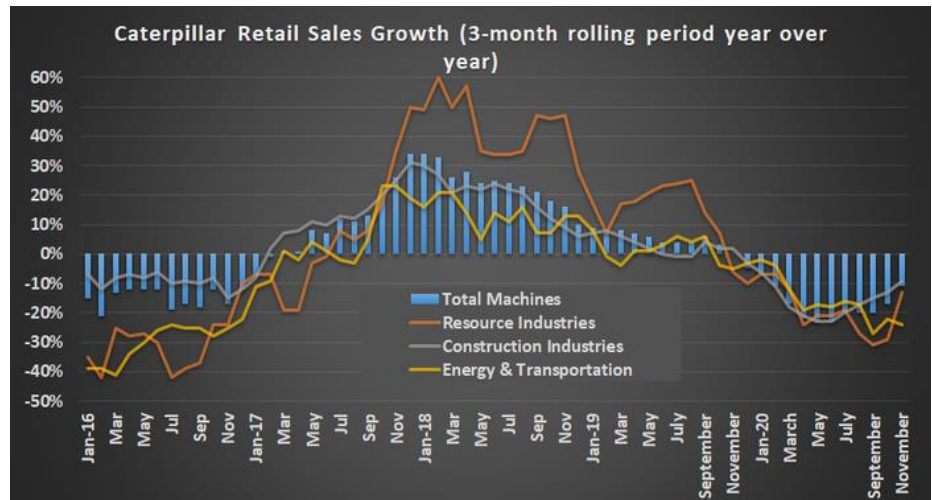
**Fig 5. ME&T services revenue to double by 2026**



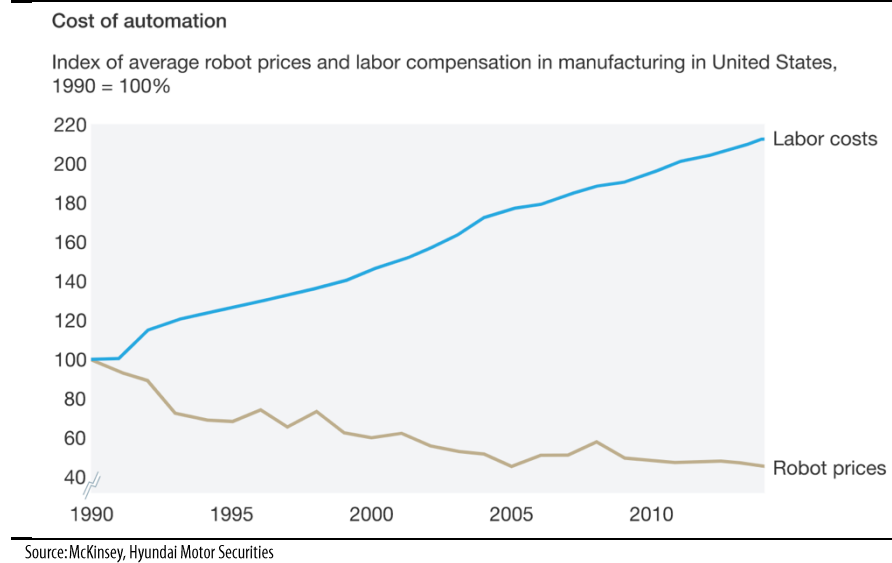
Note: ME&T Services Revenues include, but are not limited to, aftermarket parts and other service-related revenues and exclude most Financial Products' revenues, discontinued products and captive dealer services.

Source: Caterpillar, Hyundai Motor Securities

**Fig 6. Caterpillar YoY retail sales growth**



Source: Caterpillar, Hyundai Motor Securities

**Fig 7. Robot prices falling compared to labor costs**

### Solid foundation of dividend payouts

Manufacturing activity finished 2020 strong and 2021 should bring even more gains, which is great news for companies like Caterpillar. In December, the PMI was a big beat of 60.7, trouncing economists' consensus of 56.8. Anything above 50 is a sign that manufacturing is expanding. For reference, the PMI plummeted to 41.5 due to lockdowns from the pandemic. In addition to the opportunity that Caterpillar provides growth investors with its aggressive foray into lucrative technology and services businesses, the start of the cyclical recovery phase, and the bottoming of its sales and FCF will be a huge positive for investors seeking attractive dividends.

Historically, the company has been very generous in returning almost all of its FCF to investors via attractive dividend payouts. With the company's current performance, it will easily be able to cover its dividend payouts for income-seeking investors. At the stock's current price, the yield stands at 2.24% and we do not see any issues which would threaten its ability to pay this. We recommend Caterpillar to growth investors as well as dividend investors as the dividend is easily covered by the company's FCF while management intends to reduce the cyclical nature of the company's earnings by expanding revenues from services, which are steadier than equipment sales as customers still use equipment even when they delay buying new equipment. The company's FCF bottom of the cycle will rise over time. Overall sales amounted to nearly USD54bn in 2019 and USD18bn were from services and management has a plan for sales from services of USD28bn in 2026, which we think is easily achievable with the expansion of new technology businesses such as autonomous products and related services. Caterpillar is a great stock for investors looking for exposure to the upside of the coming construction robotics disruption and all of the new business opportunities that will emerge with it along with the added bonus of a steady dividend.

While there are some who believe Caterpillar's valuations are on the higher side when looking at EV relative to EBITDA, we however are in the camp that sees the company's growth potential driven by its push into robotics and other technology businesses. Accordingly, we see the company as evolving from a simple manufacturer of heavy industrial equipment to a provider of state-of-the-art autonomous cyberphysical platforms for construction business. Having said that, some of the challenges for the company include those facing its resources and energy and transportation segments. Coal mining is a key market for the resources segment and coal production is falling in the company's key US market. This will only accelerate with the incoming Democratic control of the Executive and Legislative branches. Second, the energy and transportation segment, which handles locomotive sales may face challenges as railroads focus on ways to streamline their asset base. Oil rig counts are also a good indicator of oil and gas spending, but a substantial improvement remains to be seen. While we recommend monitoring capital spending in the oil and gas and mining industries, the increase in infrastructure spending, sharpened focus on services, and emphasis on autonomous product development make Caterpillar a winning investment for investors looking for a safe bet with considerable growth potential.

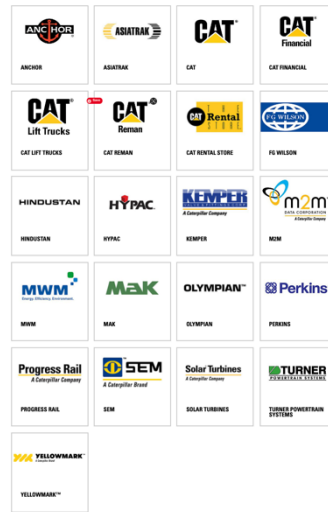
**Fig 8. Caterpillar dividend history**

EX-DIVIDEND DATE	RECORD DATE	PAYABLE DATE	AMOUNT PER
01/17/2020	01/21/2020	02/20/2020	\$1.03
04/17/2020	04/20/2020	05/20/2020	\$1.03
07/17/2020	07/20/2020	08/20/2020	\$1.03
10/23/2020	10/26/2020	11/20/2020	\$1.03

\*\*\*Dividends are adjusted for the 2005 2-for-1 stock split and the 1997 2-for-1 stock split. A complete stock split history for Caterpillar is available [here](#).

Source: Caterpillar, Hyundai Motor Securities

**Fig 9. Caterpillar family of brands**



Source: Caterpillar, Hyundai Motor Securities

**Fig 10. Building a strong presence in additive manufacturing for construction**



Source: Caterpillar, Hyundai Motor Securities

**Fig 11. Fastbrick Hadrian X bricklayer robot**



Source: Smallcaps.com.au, Fastbrick, Hyundai Motor Securities

**Fig 12. Marble Robotics delivery robot**



Source: Caterpillar/Marble, Hyundai Motor Securities



**Fig 13. Clearpath Robotics Moose UGV**



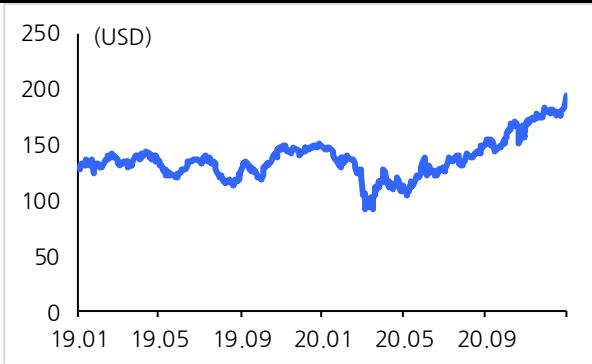
Source: Clearpath Robotics, Hyundai Motor Securities

**Fig 14. Sarcos Robotics exoskeleton**



Source: Sarcos Robotics, Hyundai Motor Securities

**Fig 15. Caterpillar Stock Price**



Source: Bloomberg., Hyundai Motor Securities

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**Stock ratings distribution (January 1-December 31, 2019)**

Rating	Count	% of rating category
BUY	135	85.99
MARKETPERFORM	22	14.01
SELL	0	0.0

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