RJ INsight

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INDUSTRIAL PRODUCTS & SERVICES

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Infrastructure & Construction

Impressions from the Caterpillar Day

Event

On Tuesday, we attended a Caterpillar investor day at the company's corporate headquarters in Peoria, Illinois.

Action

We continue to recommend the purchase of OUTPERFORM-rated Toromont shares over MARKET PERFORM-rated Finning shares because of the former's stronger balance sheet, better track record, and more attractive valuation.

Analysis

Although CAT's overall tone about the long-term prospects for the company was generally very positive, a fair amount of uncertainty about the current global economic outlook still repeatedly factored into the discussions. In fact, management offered two three year targets—or 'scenarios'—for CAT. The first envisioned a V-like recovery in demand for many of its products with revenue and EPS recovering to the range of $60 bln and $8.00 to $10.00, respectively. The second involved more of a "Great Recession" outlook in which demand remained subdued to 2012 and CAT's EPS leveled off at ~$2.50 following additional right-sizing initiatives. Only time will tell which of these two very different outlooks will ultimately transpire over the next three years (although the stock market seems to be increasingly betting on the former). Either way, we take some comfort knowing that CAT remains optimistic, but also realistic, and is thus making sound contingency plans for a world that gets stuck in a funk—plans that we assume are being shared with its dealer network. At the same time, putting all macro uncertainties aside, we were reminded once again of the value that is inherent in the business of selling and serving CAT equipment in protected markets. Indeed, as we have expressed many times over the years, we view the underlying fundamentals and investment merits of both Finning and Toromont as very compelling. The CAT dealer business, although certainly cyclical, operates with limited capital requirements, boasts the industry's broadest product offering, and provides lucrative recurring revenue streams, growth potential, and market share muscle. That said, with nothing coming out of the investor day to directly or immediately alter our prevailing investment theses on either stock, we continue to favour Toromont for the aforementioned reasons. We still view Finning as a core holding for long-term investors but are reluctant to 'chase' the stock at its current level. Potential catalysts that would cause us to reconsider our present stance in favour of a more bullish rating include a demonstrated margin improvement, reduced inventories, backlog recovery, and/or a more attractive valuation.

SECTOR SUMMARY

COMPANY / TICKER	CUR	PRICE	RETURN	RATING / TARGET
Finning International				**MARKET PERFORM 3 =**
FTT-TSX	C	$18.33	-2%	$17.50 =
Toromont Industries				**OUTPERFORM 2 =**
TIH-TSX	C	$22.43	26%	$27.75 =

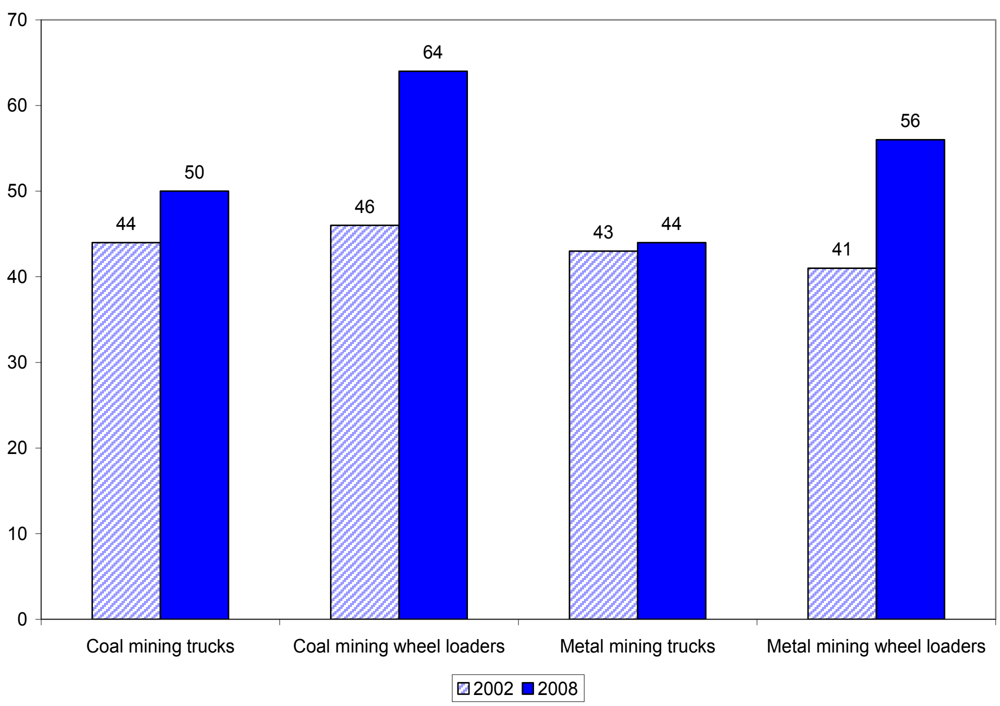
Target return includes dividend/distribution
Sources: Raymond James Ltd., Thomson One

Key Observations for the Dealer Network from the CAT Day

Our primary interest at the CAT investor day was to listen for any comments that had direct or tangential implications for the two public CAT dealers that we follow, namely Finning and Toromont. Aside from the economic uncertainty that featured prominently in management presentations, we made the following observations from this perspective:

- **Confidence is slowly returning to the mining sector—**CAT said that although order activity has yet to materially improve, there is a palatable increase in confidence and higher inquiry activity from the company's global mining customers. It certainly helps that most commodity prices have been trading sustainably above key investment threshold levels for several months now. It is also advantageous that the worldwide mining fleet is still relatively aged and in looming need of replacement (see Exhibit 1). These factors bode well for Finning's prospects in Canada, South America, and the UK (re: coal mining). They are also positive (albeit less material) for Toromont's mining opportunities in Eastern and Northern Canada.

Exhibit 1: Percent of Global Units More than 10 Years Old



Source: Caterpillar, Inc.

- **Infrastructure stimulus spending is still a big opportunity for CAT and its Dealers**—According to the Association of Equipment Dealers, roughly 5-10% of total stimulus spending that is dedicated to infrastructure development is estimated to go directly to equipment purchases, which—considering the billions of dollars that have been committed—represents a sizeable opportunity for CAT and its dealers around the world. CAT indicated that so far China is the only region where the stimulus spending has materialized into actual machine order activity. However, for most of the rest of the world (including Canada, Europe, and South America), similar order activity is expected to transpire next year. As expounded in many of our past reports on the infrastructure cycle, we continue to view this as a meaningful source of new machine demand for Finning and Toromont in 2010.

- **CAT elaborated on a new *Lane Strategy* that will reduce equipment complexity without compromising the product's high quality reputation**—Essentially, CAT will begin offering its products in four different *lanes*, each segmented according to varying degrees of availability and customization. Lane 4, for example, will be dedicated to the highly specialized, intensely engineered customized product that will be available in months. Lane 1, by contrast, will be dedicated to the pre-packaged, highly standardized and very popular product configurations that will be available in a matter of days. As we see it, there are two important dealer implications to this. The first is that, according to CAT's plans, this strategy will lower average inventory requirements of the dealer network (and shift more of the inventory burden to the OEM). The second implication is that by segmenting its product in this way, CAT appears to be finally targeting one of its nagging problems in underperforming markets such as the UK—namely, that their machines are viewed as being over-engineered and, as a result, too costly for the customer (for details see our Dec-12-08 report on Finning (UK) The Good, the Bad, and the Ugly, share price: 13.65). This does not go as far as the development of a dedicated and branded CAT *Lite* product that we have mused about in past reports. But it does strike us as a promising (albeit nascent) development for the company and Finning in particular.

- **CAT continues to emphasize a strong dealer network as a key to its long-term success—**At Tuesday's event, CAT management disclosed some interesting numbers on its current dealer network. For example, it said that the average size of a CAT dealer in North America is $526 mln compared to only $165 mln for the average non-CAT dealer (both Finning and Toromont dwarf these numbers). It also said that the average CAT dealer derives a much higher portion of its revenues from parts and services activity than does a non CAT dealer. The implication is that size and scale can lead to market dominance as well as a sound and stable distribution chain—with both Finning and Toromont providing proof of this. Another interesting statistic that CAT disclosed along these lines was that the average CAT dealer remains family-owned and has held its franchise for over 40 years. While CAT was making the point that continuity also matters, we viewed this statement as a testament of the generational/ownership issues that the company will eventually have to confront in its dealer network. This is something that, in our experience, CAT never openly discusses. But we can put two and two together. Specifically, if CAT deems dealer size and continuity as being important, but also faces an aging base of franchisees, then consolidation of the dealer network seems inevitable, at least to us. Again, it is not something that CAT widely advertises, but the fact is that CAT dealer consolidation has been slowly but steadily taking place around the world for many years (see Exhibit 2). We believe this trend will continue over the long run, to the benefit of larger dealers like Finning and Toromont. That said, according to CAT, the number of its dealers that it has on its acquisition 'watch list' around the world right now is only 8 (which is down from 12 last year). Thus, to the extent that distressed dealers often make for the most likely targets, the field of imminent acquisition opportunities in the CAT dealer world appear surprisingly thin at present.

Exhibit 2: Examples of CAT Dealer Consolidation (since 1997)

Date	Consolidating CAT Dealer	Existing Territories	Targeted CAT Dealer	Target Territory
2007	Compagnia Generale Trattori	Northern Italy	Maia Due S.P.A.	Southern Italy
2005	Cleveland Bros.	Pennsylvania & W. Virginia	Beckwith Machinery	Pennsylvania
2004	Pon Holdings	Netherlands	Various CAT dealers	Sweden, Norway, Denmark, NL
2004	Milton	Northeast U.S.	Syracuse Supply	Upstate NY
2003	Ohio Machinery Co.	Eastern Ohio	Holt Caterpillar	Western Ohio
2003	Macrosa	Brazil	Bahema	Brazil
2003	Finning International	Western Canada; UK & Chile	Matreq Ferreyros	Bolivia
2002	Finning International	Western Canada; U.K., & Chile	Macrosa General Machinery	Argentina Uruguay
2002	Wagner Equipment	Colorado	Rust Tractor	New Mexico & West Texas
2002	Holt Caterpillar	South & Central Texas	Darr Equipment Co.	Central Texas
2001	Sotreq	Brazil	Lion	Brazil
2001	Toromont Industries	Ontario & Newfoundland	Powell Equip. Ltd.	Manitoba & Nunavut
1999	Barloworld Equipment	South Africa	Greenfield	Siberia
1997	Finning International	Western Canada & Chile	Leverton	United Kingdom
1997	Toromont Industries	Ontario	Nfld. Tractor & Equip.	Newfoundland

Source: Raymond James Ltd., Company Documents

- **CAT remains committed to leading R&D—**Despite some cutbacks that have been made in the name of austerity, CAT still plans on spending ~$1.4 bln on R&D in 2009. This will mark the second biggest R&D commitment in the company's history. These formidable efforts—assuming they continue to bear fruit as they have in the past—directly benefit CAT's dealers, including Finning and Toromont. In particular, they lead to new product development that secures the CAT product's dominant position in its markets and opens new markets up for its dealers. One good example is the electric drive mining truck, which will enter the market next year and make CAT and its dealers the only 'one stop shop' for complete AC product support as well as a full family of both mechanical drive and electric drive trucks. The D7E electric drive dozer is another (related) example. This product will boast as much as 30% lower fuel consumption, 50% less noise, and a 10% reduction in total ownership costs. Other promising new products that CAT is developing and which its dealers will sell and service include the vocational on-highway trucks (a partnership with Navistar (NAV-NYSE)) as well as GPS-based systems for machine control guidance and site management systems (CAT, in fact, alluded to an opportunity for its dealers to acquire Trimble distribution rights in their respective territories as part of the company's strategy to develop GPS-based solutions for its customers).

- **CAT remains fundamentally bullish on its engines business—**Although engines is an often overlooked part of the CAT story, it has been a material contributor to growth and a recent outperformer of the machine business (in terms of both revenues and margins). CAT clearly remains committed to this wide and diverse product line with a compelling strategy to capitalize on growth opportunities in the marine, power generation, industrial, and oil and gas markets. To varying degrees, both Finning and Toromont are aligned with these opportunities. On the oil and gas side in particular—a market where CAT expressed exceptional bullishness—these two dealers are very exposed. Despite languishing North American gas prices, CAT singled out gas compression as a market with a 'very bright' long-term outlook and one to which the company will remain committed. This has positive longer-term implications for both Toromont and Finning (more the former). On the oil side, which relates only to Finning, both the near-term and long-term horizon looks more promising with crude hovering around $70 a barrel.

- **Excess inventory and over capacity still present near term industry challenges—**Despite the generally optimistic tone from CAT management and the presentation of a very clear and compelling growth strategy for the company over the long run, it remains obvious to us that some significant near-term challenges remain. Most notably, following an intoxicating boom that quickly went bust, the global equipment industry is still plagued with insufficient demand and excess supply. One good example of this is the enormous increase in total industry machine production from 2002-2008. Specifically, over this short period of time global output doubled from 450,000 units to 900,000 units, according to CAT (and even this wasn't enough to keep up with demand). Obviously, once the music suddenly stopped, the market was flooded with excess inventory. This is a problem that we believe will hang over the market (any infrastructure stimulus aside) for at least another year. Indeed, it is telling to note, we believe, that CAT's current global capacity utilization is only 30%! At this level, the earnings leverage latent in CAT and (less so) its dealers should be sizeable. However, we think it will still take some time to transpire. The implications of this on pricing, margins, and backlog for both Finning and Toromont remains our primary concern at this point in time.

Risks

Equipment Distributors (FTT and TIH)—For many of these suppliers, business is dependent on continued market acceptance of the products in their portfolio. As such, any inability to maintain quality of products at competitive prices may materially erode the company's market share and materially impact operations and future prospects. Long-term maintenance and repair service contracts are common with large equipment purchases and typically establish a fixed price over the contract term. An inability to fulfill these contracts successfully and at agreed-upon margins may also have an adverse impact on the company's overall operations. Other risks arise from the reliance on agreements with several equipment manufacturers (e.g., Caterpillar in the case of Finning and Toromont), distributors and/or suppliers.

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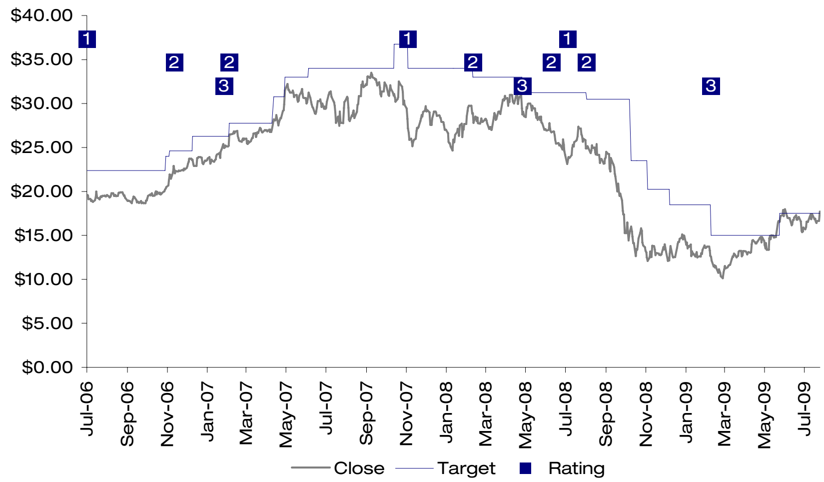
COMPANY	SYMBOL	EXCHANGE	DISCLOSURES
Finning International	FTT	TSX	2
Toromont Industries	TIH	TSX	6

FINNING INTERNATIONAL | FTT-TSX

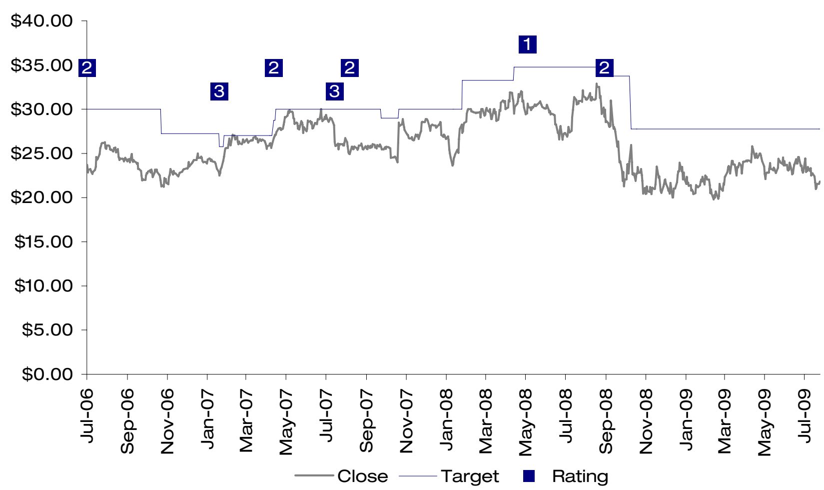


1-STRONG BUY 2-OUTPERFORM 3-MARKET PERFORM
4-UNDERPERFORM 0-UNDER REVIEW

RATING & TARGET CHANGES

Date	Price	Rating	Target
Nov-15-05	$19.05	2	$21.25
Jan-27-06	$19.88	2	$21.88
Feb-16-06	$19.07	2	$21.50
May-11-06	$20.01	2	$23.25
Jun-14-06	$18.05	1	$22.38
Nov-09-06	$20.24	1	$24.00
Nov-15-06	$21.23	1	$24.63
Nov-22-06	$22.89	2	$24.63
Dec-20-06	$23.56	2	$26.25
Feb-06-07	$25.38	3	$26.25
Feb-14-07	$25.21	2	$27.75
Apr-23-07	$27.00	2	$30.75
May-10-07	$29.90	2	$33.00
Jun-15-07	$30.55	2	$34.00
Oct-24-07	$30.90	2	$36.75
Nov-14-07	$28.25	1	$34.00
Feb-21-08	$29.75	2	$33.00
May-07-08	$29.47	3	$31.25
Jun-20-08	$26.86	2	$31.25
Jul-15-08	$23.13	1	$31.25
Aug-13-08	$24.89	2	$30.50
Oct-20-08	$15.20	2	$23.50
Nov-14-08	$12.50	2	$20.25
Dec-18-08	$12.15	2	$18.50
Feb-19-09	$12.67	3	$15.00
Jun-04-09	$16.65	3	$17.50

TOROMONT INDUSTRIES | TIH-TSX



1-STRONG BUY 2-OUTPERFORM 3-MARKET PERFORM
4-UNDERPERFORM 0-UNDER REVIEW

RATING & TARGET CHANGES

Date	Price	Rating	Target
Nov-02-05	$23.27	2	$27.00
Jan-27-06	$25.30	3	$27.00
Feb-08-06	$24.00	3	$25.75
Apr-12-06	$25.00	2	$28.25
Apr-27-06	$26.60	2	$28.75
Jun-26-06	$23.26	2	$30.00
Nov-02-06	$21.96	2	$27.25
Jan-30-07	$22.93	3	$25.75
Feb-06-07	$24.15	3	$27.00
Apr-23-07	$25.92	2	$28.75
Apr-26-07	$27.10	2	$30.00
Jul-25-07	$28.19	3	$30.00
Aug-17-07	$24.96	2	$30.00
Oct-04-07	$32.10	2	$29.00
Oct-31-07	$26.20	2	$30.00
Feb-05-08	$28.26	2	$33.25
Apr-24-08	$29.50	2	$34.75
May-15-08	$29.52	1	$34.75
Sep-09-08	$30.17	2	$33.75
Oct-20-08	$24.08	2	$27.75