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Remake Your Portfolio With Caterpillar

David Fried, Buyback Letter 05.14.07, 4:00 PM ET

Remanufacturing is the ultimate recycling--actually, similar to recycling, but much more extensive. It involves taking a product apart; cleaning, fixing or replacing worn parts; upgrading the technology where possible; putting it back together; and then testing to make sure it meets original manufacturer specifications and will perform as new.

It is the practice of taking end-of-life goods and re-engineering them back to as-new--or better--condition, with a warranty to match. Call it cradle-to-cradle, as opposed to the cradle-to-grave life cycle of most manufactured goods.

A few companies with an eye on the future are employing remanufacturing--big guys General Electric and Xerox, and smaller companies such as carpet maker Interface and oil and gas services company Hanover Compressor. But none do it as extensively and consistently as Caterpillar.

We bought Caterpillar, the world's largest remanufacturer, in February for the Buyback Letter Stock-Pickers Portfolio. CAT, as you probably know, manufactures construction and mining equipment, diesel and natural gas engines, and industrial gas turbines.

Caterpillar launched its remanufacturing business in the 1970s and today processes more than 2 million units annually and recycles more than 100 million pounds of remanufactured products each year. Caterpillar started the business by remanufacturing engines and other parts for its own machinery, and now it offers remanufacturing services for a variety of products and components to serve Caterpillar and many outside clients.

Remanufactured products can cost, on average, half of what new ones do, and the business can be very profitable for companies that do it well, like Caterpillar. In fact, Caterpillar brass were so impressed with the "reman" operation's profit margins that they spun it into its own separate division in 2005. The reman unit tallied more than $1 billion in sales in 2005, and Caterpillar expects it to grow 15% annually. Bottom line, it's one of Caterpillar's fastest-growing divisions, and Chairman and CEO Jim Owens says he expects the remanufacturing business to continue to be one of the largest growth opportunities for Caterpillar in the future.

Caterpillar is heavily into reman research, including hosting a research and development unit devoted to it. But equally important to the company is taking future reman into consideration during the front-end of the manufacturing process.

Caterpillar insists its product designers purposefully consider how easily something can be remanufactured. They even have a box for reman on their product development checklist. Their reman engineers work with the new engineers, for example, to suggest that by putting another 10,000th of an inch of metal onto a part, the company could get more lives out of it. The thicker part might cost $1 more to produce, but if they get two to four more lives out of it because it was designed to be remanufactured, it will be well worth it. It is this thinking that runs counter to traditional manufacturing wisdom, in which it may be considered dumb to spend more to extend a product's life.

For Caterpillar and others who do remanufacturing, that strategy gives them a competitive advantage. Think about it: Generally, 70% of the cost to build something new is in the materials and 30% of it in the labor. Remanufacturing flips that ratio and sets to work on the larger component--squeezing productivity out of physical materials.

After new parts have been used for one or more life cycles, remanufacturers start the manufacturing process over with materials that are essentially free--with all the energy costs already factored in. The logic of this becomes even more compelling as metals, minerals and oil flirt with record prices these days.

Remanufacturing is also simply the right thing to do from an environmental perspective. Overwhelmingly fewer resources are consumed to remanufacture a component than to build a completely new one. In fact, remanufacturing is more environmentally friendly than recycling because it dramatically lowers the volume flow of resources. Fewer parts are thrown away, reducing landfill pollution.

Caterpillar has been solidly extending its reman reach for several years. In 2004, it announced it would open its facilities to remanufacture parts other than those made by Caterpillar, and it included the defense industry in that broad sweep. (The largest remanufacturer in the U.S. is the Defense Department, with the Pentagon's yearly expenditure for reman at about $15 billion.) Also in 2004, Caterpillar bought two remanufacturing companies that serve the auto industry and reopened a British plant that had been converted to remanufacture military tanks, railroad engines and truck transmission systems.

Last September, Caterpillar was aggressively pursuing the Chinese market, which it estimates could become as big as $10 billion a year, and became the first foreign company licensed to assist the Chinese government in the development of a remanufacturing industry. Caterpillar also opened a plant in Shanghai that will function as its Asian remanufacturing center to recycle and refurbish old motors and hydraulic pumps to be sold at a deep discount.

Caterpillar is looking very good to us. The company reported better than expected quarterly earnings and raised its outlook, saying "exceptional growth" outside North America was offsetting weakness in the U.S. While net profit fell to $816 million, or $1.23 a share, from $840 million, or $1.20 a share, last year, the latest results topped the average analyst profit expectation of $1.08 a share. Sales and revenue rose 7% to $10.02 billion. U.S. sales tumbled $450 million, or about 13%, due partly to a "steep drop in housing construction" and a decline in nonresidential building activity. Looking forward, Caterpillar raised its sales outlook to a range of between $42 billion and $44 billion, up from $41.5 billion in 2006, and its earlier estimate of $41.5 billion to $43.6 billion. It also raised its profit target to a range of $5.30 to $5.80 per share, up from $5.17 a share in 2006, and its earlier estimated range of $5.20 to $5.70.

Also, take note that there have been no insider sales at Caterpillar for the trailing six months, a fairly extraordinary thing given the size of the company. We also are bullish on Caterpillar because of its $7.5 billion stock buyback over the next five years. It is the fourth program of stock buybacks since 1995, and during that 12-year period, Caterpillar has returned $8.5 billion to stockholders through repurchasing. In the last 12 months, Caterpillar has reduced shares outstanding by 3.7%.

David Fried is editor of the Buyback Letter. Please click here for more of Fried's analysis and recommendations of companies repurchasing their own shares.