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Deere & Co. (DE)

Q2 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to Deere & Company's Second Quarter Earnings Conference Call. Your lines have been placed on listen-only until the question-and-answer session of today's conference.

I would now like to turn the call over to Mr. Brent Norwood, Director of Investor Relations. Thank you. You may begin.

Brent Norwood

Director-Investor Relations, Deere & Co.

Hello. Also on the call today are Josh Jepsen, Chief Financial Officer; Dave Gilmore, Senior Vice President Ag & Turf Sales and Marketing; Kanlaya Barr, Director of Corporate Economics; and Rachel Bach, Manager of Investor Communications.

Today, we'll take a closer look at Deere's second quarter earnings then spend some time talking about our markets and our current outlook for fiscal year 2023. After that, we'll respond to your questions. Please note that slides are available to complement the call this morning. They can be accessed on our website at johndeere.com/earnings.

First, a reminder: This call is being broadcast live on the Internet and recorded for future transmission and use by Deere & Company. Any other use, recording or transmission of any portion of this copyrighted broadcast without the express written consent of Deere is strictly prohibited. Participants on the call, including the Q&A session, agree that their likeness and remarks in all media may be stored and used as part of the earnings call.

This call includes forward-looking statements concerning the company's plans and projections for the future that are subject to uncertainties, risks, changes and circumstances and other factors that are difficult to predict. Additional information concerning factors that could cause actual results to differ materially is contained in the company's most recent Form 8-K, risk factors in the annual form 10-K as updated by reports filed with the Securities and Exchange Commission.

This call also may include financial measures that are not in conformance with accounting principles generally accepted in the United States of America, GAAP. Additional information concerning these measures, including reconciliations to comparable GAAP measures, is included in the release and posted on our website at johndeere.com/earnings under Quarterly Earnings & Events.

I will now turn the call over to Rachel Bach.

Unverified Participant

Good morning; and thanks, everyone, for joining us today. John Deere completed the second quarter with strong performance. Financial results for the quarter included 24% margin for Equipment Operations. Across our businesses, outperformance was driven by strong demand, favorable pricing, and operational execution enabled by supply chain improvements. Ag fundamentals remain healthy, providing a strong second half of fiscal year 2023 and support an order backlog that extend throughout the fiscal year. Likewise, the Construction & Forestry

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division continues to benefit from healthy demand with order books virtually full for the remainder of the fiscal year.

Slide 3 begins with the results for the second quarter. Net sales and revenues were up 30% to $17.387 billion while net sales for the Equipment Operations were up 34% to $16.079 billion. Net income attributable to Deere & Company was $2.86 billion or $9.65 per diluted share.

Taking a closer look at the individual segments, we begin with the Production & Precision Ag business on slide 4. Net sales of $7.822 billion were up 53% compared to the second quarter last year and in fact more than our own forecast, primarily due to increased shipment volumes and price realization. Price realization was positive by about 20 points. We expect price realization to normalize as inflation continues to subside. Currency translation was negative by approximately 3 points. Operating profit was $2.17 billion, resulting in a 27.7% operating margin. The year-over-year increase was primarily due to favorable price realization and improved shipment volumes. These were partially offset by increased R&D and SA&G spending, higher production costs and unfavorable foreign currency exchange. Prior year results were negatively impacted by an impairment of $46 million related to events in Russia and Ukraine.

Moving to Small Ag & Turf on slide 5. Net sales were up 16%, totaling $4.145 billion in the second quarter as a result of price realization and higher shipment volumes, partially offset by negative currency translation. Price realization was positive by just over 12 points while currency was negative by roughly 2 points. Operating profit was improved year-over-year at $849 million, resulting in a 20.5% operating margin. The increased profit was primarily due to price realization and to a lesser extent higher shipment volumes and mix, which were partially offset by higher production costs, R&D and SA&G, and negative currency translation.

Slide 6 covers our industry outlook for ag and turf markets globally. We expect industry sales of Large Ag equipment in US and Canada to be up approximately 10%, reflecting another year of strong demand. We've seen continued industry themes since last quarter with strong ag fundamentals, a historically high fleet age, and low field inventory from prior year supply constraints. We expect elevated demand to continue for the back half of the year, as evidenced by an order bank that extends into fiscal year 2024.

For Small Ag & Turf, we estimate industry sales in the US and Canada to be down around 5% as strength for midsized equipment is offset by weakness in more consumer-oriented products. Demand for compact tractors has declined year-over-year, resulting in inventory levels rising to pre-COVID levels. Meanwhile, hay and forage segment remains strong, driving demand for products like our 100 to 180 horsepower tractors, windrowers and round balers.

Moving on to Europe. The industry is forecasted to be flat to up 5%. Commodity prices have softened from near all-time highs in recent months, but farm input prices are coming down as well. As a result, arable cash flow is normalizing from recent peaks, but still above average and continuing to drive demand for the rest of the year.

In South America, we expect industry sales of tractors and combines to be flat, holding strong relative to historical levels. Ag fundamentals remain solid in Brazil, but markets are tempered by delays in government-sponsored financing programs for small ag producers. Meanwhile, Argentina continues to grapple with the historic drought, which has significantly pressured yields for the year. Industry sales in Asia are forecasted to be down moderately.

Now, digging into the segment forecast beginning on slide 7. For Production & Precision Ag, net sales continue to be forecasted up around 20% for the full year. The forecast assumes about 15 points of positive price realization for the full year and minimal currency impact. As noted last quarter, we expect price realization to moderate in the

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latter half of the fiscal year relative to our reported first six months. For the segment's operating margin, our full year forecast is now between 25% and 26%.

Slide 8 shows our forecast for the Small Ag & Turf segment. We now expect net sales to be up around 5% in fiscal year 2023. This guidance includes about 9 points of positive price realization and just over 0.5 point of currency headwind. The segment's operating margin is now projected to be between 15.5% and 16.5%.

With that, we'll turn to Construction & Forestry on slide 9. Net sales for the quarter were $4.112 billion, up 23% primarily due to price realization and improved shipment volumes. Price realization was positive by nearly 13 points while currency translation was negative by approximately 1.5 points. Operating profit increased year-over-year to $838 million, resulting in a 20.4% operating margin due to price realization and higher shipment volumes and mix, partially offset by higher production costs and increased SA&G and R&D expenses. When comparing to last year, keep in mind the prior period results included a non-repeating net benefit of $279 million, mostly driven by a gain on the previously held equity investment in the Deere-Hitachi joint venture.

Slide 10 shows our 2023 Construction & Forestry industry outlook. Industry sales of earth-moving and compact construction equipment in North America are both projected to remain flat to up 5%. End markets for earth-moving and compact equipment remain relatively stable. While the commercial real estate and office segments weaken, the oil and gas sector is levelling and housing starts appear to have bottomed. Headwinds from year-over-year declines in residential and commercial have been more than offset by strong US infrastructure spending and rental inventory restocking. Importantly, dealer inventory remains below historical averages.

In Forestry, we estimate the global industry will be flat as the US and Canada markets continue to soften while Europe continues to grow. Global roadbuilding markets are forecasted to be flat. North America remains the strongest market, compensating for sluggish fundamentals in Europe as well as parts of Asia.

Moving on to the C&F segment outlook on slide 11. Deere's Construction & Forestry 2023 net sales are now forecasted to be up around 15%. Our net sales guidance for the year considers about 10 points of positive price realization. Operating margin is now expected to be in the range of 18% to 19%.

Next we'll shift to our Financial Services operations on slide 12. Worldwide Financial Services net income attributable to Deere & Company in the second quarter was $28 million. The decrease was due to less favorable financing spreads and a higher provision for credit losses, partially offset by income earned on a higher average portfolio. Additionally during the quarter, there was $135 million after-tax correction of the accounting treatment and timing of expense recognition for financing incentives offered to John Deere dealers. The accounting correction is unrelated to the current market conditions or the credit quality of the Financial Services portfolio, which remains strong.

For fiscal year 2023, our outlook is now $630 million, reflecting the less favorable financing spreads, the correction of the accounting treatment for financing incentives, a higher provision for credit losses, increased SA&G expenses, and lower gains on operating lease dispositions, partially offset by the benefits from a higher average portfolio balance.

Turning to slide 13. Credit quality remains well above historical averages with minimal allowances, past dues and write-offs as a percentage of the portfolio. Provisions for credit losses excluding the portfolio in Russia is forecast to be at 17 basis points for fiscal 2023 and remains below long-term averages. Meanwhile, write-offs, past dues and non-performing loans all remain stable, reflecting strong credit quality within our portfolio.

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And lastly on slide 14, we've outlined our guidance for net income, our effective tax rate and operating cash flow. For fiscal year 2023, we are again raising our outlook for net income to be between $9.25 billion and $9.5 billion, reflecting the strong results for the second quarter and continued optimism for the remainder of the year. Next, our guidance incorporates an effective tax rate between 23% and 25%. Lastly, our cash flow from Equipment Operations is now projected to be in the range of $10 billion to $10.5 billion.

That concludes our formal comments. We will now shift to discussion of a few specific topics relative to this quarter before we open the line for Q&A.

Let's start with Deere's performance this quarter, Brent. We saw Production & Precision Ag net revenue up 53% year-over-year and operating margins expand 7 points; Small Ag & Turf up 16% on revenue with 6 points of additional operating margin; and C&F was 23% top line growth accompanied by 4% operating margin expansion excluding the non-recurring items.

What were the prior-year drivers of the strong quarter?

Brent Norwood

Director-Investor Relations, Deere & Co.

Thanks, Rachel. I would start by saying the performance came in ahead of our own internal expectations due to two primary drivers. From a top line perspective, our factories had their best quarter of execution since the beginning of COVID. Supply chain improvements enabled our factories to hit their line rates and deliver machines at a faster pace. As a result, we were able to pull ahead some of the year's production in to the second quarter, which will take some pressure off the back half. So we'd expect revenue to be down sequentially by a bit over 10% in the third quarter. With factories running more smoothly, we experienced fewer production inefficiencies. In fact, the second quarter saw the lowest level of production cost inflation since 1Q 2021. Fewer factory disruptions due to labor and supply chain challenges enabled us to achieve better overhead efficiency and incur lower premium freight costs. Furthermore, production costs benefited from better raw material compares relative to last year.

Unverified Participant

That's helpful perspective on the benefits of the improving supply chain in our factories. As we pull production forward, how does that shape the back half of the year? Will the supply chain allow for increased production in the second half?

Brent Norwood

Director-Investor Relations, Deere & Co.

Supply chain improvements have enabled our suppliers to deliver towards their volume commitments and improve their on-time deliveries. That said, there are still enough constraints in the supply base that will limit higher levels of production later in the year. Our safety stocks for critical components are still low, and our margin of error is relatively thin. Given the existing constraints, we expect to execute to schedule, but don't foresee adding a lot more production to the back half of the year. Furthermore, we are also laser-focused on managing field inventory as we think about exiting fiscal year 2023. The real benefit of the pull-ahead is the return to more seasonal production schedules that are closer to our customers' seasonal use of our products.

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Unverified Participant

Great. Thanks, Brent. My next question is for Kanlaya. There are a lot of variables impacting farmer fundamentals this season. Farm net income will be at a second all-time high, albeit down from last year's record. Commodity prices remain volatile while input prices are coming down. Meanwhile, stocks to use remains tight, and two of the four largest export markets for corn remain severely constrained. How are these factors impacting farmers right now?

Kanlaya Barr

Director-Corporate Economics, Deere & Co.

Well, thanks for the question, Rachel. There are many factors at play here and there's still a lot of uncertainties, especially as we are in the midst of the growing season. And in the end, it all comes down to profitability. On the revenue side, although commodity prices are volatile, grain stocks continue to be tight, bumper crops in Russia, Australia and Brazil are not enough to offset the combined effects of this year's severe losses in Argentina and Ukraine. [indiscernible] (00:16:02) yield, stocks to use will remain below the 10-year average, the USDA forecast corn and soybean prices to be the third highest in the past decade, and wheat the second highest. Furthermore, crop insurance reference price will provide a safety net for farmers as well.

Now, looking on at the cost side, input costs have come down quite a bit. Not all farmers will be able to realize those savings this year, but that could be a tailwind for the next crop. And in the end, we are looking at a lower cost per bushel this year. Now, putting all of this together, we are coming off a really great year last year, income is going to moderate, but we are still looking at farmers margin that are going to be above the 10-year average.

Unverified Participant

And how about elevated interest rates globally? How are farmers contending with this increase in cost over last year?

Kanlaya Barr

Director-Corporate Economics, Deere & Co.

Interest rate expense is only about 6% to 7% of total ag production expenses, but a little over half of that is tied to mortgages, which are mostly fixed at lower rates. The portion that ties to operating loans that tends to be more variable is about 3%. And that number is even smaller for row crop producers. Their interest rate expense is less than 1% of their overall operating expenses. So this is nothing, but the impact of higher interest rate is much smaller than the tailwinds from lower input costs and fuel costs. With that said, rising interest rates also has an impact on real estate. While the housing market has been significantly affected by the elevated interest rate, the farmland market has been relatively immune and farmland values continue to hold up through Q2 of this year.

David C. Gilmore

Senior Vice President-Sales & Marketing, Regions 3 & 4-Agriculture & Turf Division, Deere & Co.

And Rachel, just to add some context from some comments that came from the Federal Reserve Bank of Kansas City earlier this spring, when you put interest rates in perspective relative to history, roughly $0.12 of every dollar of a Midwest US farm earnings is going to interest costs today versus the long-term average of $0.15. As a result, customers are managing this expense very well. Also as the Fed reported, the marginal increase in interest costs

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on operating loans is a financial equivalent of an additional 2.5 bushels of yield for corn. That's why a major component of our smart industrial strategy is focused on helping our customers better manage volatile periods by delivering products and solutions that minimize costs and increase yields. Our goal is to deliver products and solutions that offset and improve the variable cost structure of our farmers.

Unverified Participant

Thanks, Dave. That really helps paint the picture. Kanlaya, what other tailwinds or headwinds should we think about over the next few years?

Kanlaya Barr

Director-Corporate Economics, Deere & Co.

Oh, that's great question, Rachel. The volatility and uncertainties will continue to be with us for quite some time. However, we expect the tailwind from growing population and increased income to continue. In addition, biofuels will play an increasingly important part in the sustainability journey by providing diesel alternatives to the transportation segment including heavy-duty or off-highway vehicles, long haul aviation and maritime. And finally think about technological improvement in farm equipment, which will continue to drive productivities, reduce costs, and provide more economic headroom. So, overall, still a large number of positive tailwinds to consider.

Joshua Jepsen

Senior Vice President & Chief Financial Officer, Deere & Co.

One other obvious thing to add here is while we can't control the macro volatility, we can focus proactively on monitoring and staying ahead of shifts in trends to ensure we're helping farmers be more effective and efficient in and out of the field regardless of the end market environment.

Unverified Participant

Thanks, Josh and Kanlaya. Let's dig in a little deeper on the global issues you mentioned and focus specifically on the Brazilian market. Dave, Brazil has been one of the strongest markets in the industry over the last three years. What's been driving that?

David C. Gilmore

Senior Vice President-Sales & Marketing, Regions 3 & 4-Agriculture & Turf Division, Deere & Co.

Well, as you correctly said, Rachel, Brazil certainly has been a great market for us, both in terms of growth and profitability. It's one of few geographies in the world adding production area each year. It's also a market that's rapidly adding efficiencies, migrating to higher horsepower, and just beginning to adopt precision ag technology which plays to our strengths. The last few years have seen records, both in terms of agricultural yields, but also farmer profitability. The combination of record ag production, favorable currency and growing exports has generated excellent profitability for our customers and in turn has driven significant demand for our equipment over the last few years.

Joshua Jepsen

Senior Vice President & Chief Financial Officer, Deere & Co.

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Yeah. This is Josh. One thing I'd add to Dave's comments. At the onset of our smart industrial strategy, we set a goal to achieve North American like margins or better in Latin America. And so far, we've achieved that, making the region very important to the overall financial profile of the company.

Unverified Participant

I guess, that leads right into my follow-up question. Dave, how are current market conditions trending and can you give us an update post the Agrishow show earlier this month?

David C. Gilmore

Senior Vice President-Sales & Marketing, Regions 3 & 4-Agriculture & Turf Division, Deere & Co.

Absolutely, Rachel. I was just down in Brazil for Agrishow, which is the largest customer farm show in Latin America. The event produced record attendance and sales, highlighting customer optimism going forward. That said, sales for small ag equipment have been running behind pace this year, leading to increased field inventory. The government-sponsored financing plan typically gets announced at Agrishow, but it's been postponed for the time being, which has caused some delay in purchases, especially for small and medium producers who are most reliant on the government-sponsored financing for equipment purchases.

Large producers, on the other hand, tend to be less reliant on government-sponsored financing, instead utilizing cash, private credit lines or John Deere Financial. The delayed harvest plan had limited impact for Large Ag customers. More pressing for large producers right now is exporting the record crop that they grew this year in a timely manner given the lack of storage for Brazilian grains. However, demand for large equipment remains stable, though we are monitoring retail activity closely for the back half of the year. I would note that we do expect to see higher in-season inventory this year, further reflecting a return to normalcy for the market.

Unverified Participant

Appreciate the additional insight into a pivotal market everyone is watching very closely right now. I'd like to transition briefly to John Deere Financial and discuss two topics. First, it's been an eventful quarter for many of our nation's regional banks. Josh, can you give us an update on how John Deere Financial is fairing in this environment?

Joshua Jepsen

Senior Vice President & Chief Financial Officer, Deere & Co.

Of course, Rachel. We're closely monitoring all the challenges in the banking sector as the market has contended with rising rates over the last year. Fortunately, John Deere Financial remains in excellent condition. There's been no change in our ability to fund the portfolio, and the credit quality has been outstanding. As we discussed previously, our forecast this year implies past dues, non-performing loans and write-offs are stable and remain below long-term averages. For our lease portfolio, return rates are near zero, and recovery rates are as strong as they have ever been. Our customers have had three very strong years financially including 2023, so we feel like we are very well-positioned here.

Unverified Participant

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That's good to hear. And the second question on John Deere Financial. We saw net income affected by $135 million after-tax correction of accounting treatment. Can you explain what that was related to and what impact that might have, if any, on future profitability?

Joshua Jepsen

Senior Vice President & Chief Financial Officer, Deere & Co.

Sure thing. It relates to the accounting treatment of dealer loyalty incentive program. Effectively, we've made an accounting correction on the timing of expense recognition moving from when incentives are redeemed to when they're earned, much in line with our methods for our Equipment Operations incentives. Due to the coincidental timing of broader market concerns, I just want to make it abundantly clear that this is a one-time non-cash accounting correction, it is unrelated to the credit quality or performance of JDF's portfolio.

Unverified Participant

Perfect. Thanks for the clarification, Josh. The next question is related to inventory. The recent AEM data shows a year-over-year increase in Large Ag inventory for products like combines and four-wheel-drive tractors. Dave, can you explain what's going on with the new field inventory at the moment?

David C. Gilmore

Senior Vice President-Sales & Marketing, Regions 3 & 4-Agriculture & Turf Division, Deere & Co.

The Large Ag inventory build seen recently is due to the return to normal seasonality in our production schedules. Keep in mind that year-over-year comparisons aren't as relevant because of the challenges we faced in the first half of 2022 from the labor disruption to supply chain obstacles. These challenges caused us to run at low and unhealthy levels during all of 2022, making the year-over-year increase appear somewhat inflated. Compared to historic averages, however, we are still well below seasonally adjusted target levels with inventory to sales ratios for 220-plus and four-wheel-drive tractors in the teens as of the end of April. Pre-COVID, both products would have been at least 10 points higher in the second quarter on an inventory to sales ratio basis.

Meanwhile, our combine inventory to sales ratio currently sits at 23% as we were able to pull some of our production ahead into the second quarter. At this time, we expect the second quarter to be the highest production for combines this year. Combine inventory seasonally peaks during the quarter of highest production with historic average IS ratios greater than where we are currently.

There are a lot of benefits to returning to normal seasonality, one of which is it contributes to a healthier pace of used trades for our dealers and customers. These were delayed last year due to heavy fourth quarter deliveries. Last year, customers were reluctant to allow a dealer to remarket their used trade before the new machine arrived. Being on a more seasonal pace facilitates better used trade planning prior to the harvest season. So we've seen used inventories increase seasonally keeping up with elevated production of new equipment, which is good for both dealers and customers. The most important takeaway is that by the end of the year, Large Ag inventory to sales will be lower than both historic and target levels.

Unverified Participant

Thanks, Dave. And one final question. Brent, how would you characterize the market environment for farm equipment as we progress through the back half of the year and into 2024?

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Brent Norwood

Director-Investor Relations, Deere & Co.

It's a great question, Rachel. First, I think it's best to start with some context on how we got to this point. The current replacement cycle began in 2021 after a six-year period of historic underinvestment in ag equipment. And since 2021, the entire industry has been severely constrained by labor and the supply base, which kept production volumes relatively modest when compared to prior replacement periods. Inventory for new and used equipment remains below target levels and the fleet has continued to age out for tractors even if it's down a bit for combines.

While it's been difficult working through all the challenges in the post-COVID era, these constraints created an unintended benefit of dampening the amplitude of the equipment cycle for the time being. To quantify that, we are producing roughly 20% to 25% less than the average production volumes of prior replacement periods.

As we look ahead to the rest of 2023, we see robust demand with our order books providing excellent visibility through the end of the year. Furthermore, we expect the ending inventories in 2023 to be below target levels, making for a very good starting position entering 2024. With regards to next year, we'll begin to gain more visibility soon with our early order programs and order books continuing through the summer and fall seasons. As evidence of continued healthy demand levels, we opened Phase 1 of our sprayer early order program in May and are already sold out of our Phase 1 allocation. Furthermore, our sprayer early order program included pricing in line with historic averages, pointing to a reversion to normalcy for the industry. Overall, the environment continues to be healthy and supportive of a business cycle with a dampened amplitude.

Unverified Participant

Thanks for the commentary and insight, Brent. And before we open the line for other questions, Josh, any final thoughts?

Joshua Jepsen

Senior Vice President & Chief Financial Officer, Deere & Co.

Sure. We've had a very strong first half of 2023. This is a testament to the extraordinary efforts of the entire John Deere team. Everyone from our employees to dealers and suppliers have remained committed to providing customers with the best experience possible.

As we move into the second half of the year, we're encouraged by strong visibility through the remainder of the year. Additionally, while we're seeing improvement in the supply chain, which is helping us to deliver product and solution for our customers, the situation remains fragile. Overall, fleet dynamics such as inventory and fleet age and on balance positive fundamentals put us in a good position to continue to deliver customer value in 2023 and beyond. Although it's too early to have a firm view on 2024, the fundamentals give us confidence as we move into our early order program selling season.

Importantly, we will continue to invest for the long term to unlock value for customers. And as we do this, we remain dedicated to drive further structural profitability for Deere as evidenced across all our segments the last couple of years. This will include new ways to add value and create more resilient, sustainable businesses for our customers and Deere.

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Unverified Participant

Thanks, Josh. Now let's open the line for questions from our investors. Brent?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Jamie Cook with Credit Suisse, you may go ahead.

Jamie Cook

Analyst, Credit Suisse Securities (USA) LLC

Hi. Good morning and congrats on a nice quarter. I guess, first with regards to Precision and Production Ag, your sales guide hasn't changed with North America large ag industry better and pricing up a bit. I understand there's a pull-forward. Again, higher production than you thought. But to what degree, if supply chain improves, do you want to beat your forecast? Or to some degree, do you want to match the cycle, which bodes well for 2024?

And then, I just guess, my second question on the margin performance of the company. Obviously, it's been fantastic. How much of this do you think is sort of structural versus your margins are overearning just relating to the pricing with inflation and supply chain and freight benefits starting to come in? Thank you.

Brent Norwood

Director-Investor Relations, Deere & Co.

Hey, good morning, Jamie. Thanks for the question. I'll start first on production levels. If you look at all segments, roughly, we'll see kind of similar revenue first half to second half. But for all of the segments, second quarter would be the quarter of highest production for PPA, C&F and SAT. So, as a result, you're going to see a sequential decline anywhere from 10% to 15% in revenue as we go into the third quarter. And I think quarters three and four will be sort of roughly equal in production levels, and that's true broadly speaking for most of our segments.

And the reason and the rationale behind that is really to make sure that we are managing end of year inventory levels really, really well. We're here at the midpoint of the year and we want to make sure that as we exit 2023, we set us up for a really good start into 2024. So that's a little bit of color on sort of the production schedules.

And then again, the other thing I would note there, Jamie, is this is a really healthy return to more seasonal patterns in production and to make sure that our schedules match our customers' sort of seasonal use of our products. So we were really pleased to be able to execute well in the second quarter.

Now, with respect to structural profitability, I think there's a couple of things at play. First, I would say Deere has been on this journey of structural profitability improvement really for the last four years. The centerpiece of that has been our investment in technology, right. And over the years, we've been able to add new solutions, new technologies to our equipment, and all of those have come at margin-accretive levels. So we are benefiting from that today in a very structural way irrespective of where volumes are. That will continue to drive structural improvement for us.

I think in addition to that, with the launch of the smart industrial strategy in 2020, you saw us drive portfolio improvements. We consolidated all of our tech spend under our CTO organization. And there's still a lot to come,

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right. We're not done there yet. I think in the areas of lifecycle solutions, precision upgrades, solutions as a service, you're going to see continued effort on our part to improve further our structural profitability.

That said, based on the volumes that we're at today, we are achieving margins and a return on assets commensurate with what we think we should be achieving given the structural profitability of the company at the moment.

Joshua Jepsen
Senior Vice President & Chief Financial Officer, Deere & Co.

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Yeah, Jamie. It's Josh. Maybe one thing I'd add. As Brent mentioned, I think given where we're at in the replacement cycle, we feel like we're performing in line with where we should be. I think importantly we are seeing significant structural improvements in our businesses across the board. And maybe to highlight one example would be what we've seen in C&F. So we have strategically and maybe a bit methodically over the last few years been executing on a strategy that is delivering the performance you see today. So that is adding with the acquisition of Wirtgen exposure to roadbuilding. It is dissolving our joint venture on excavators to control and own our destiny there in a critical machine form that we have.

On top of that, we have managed the portfolio in terms of exiting certain markets while extending our product portfolio in large production class equipment and on the small end on compact construction, and we've done things like extending distribution on compact construction, which probably doesn't get a lot of fanfare, but extending distribution into our ag channel, which has been tremendously helpful for that business. And that's driven the performance to where we are today.

I think as we look forward, Construction & Forestry will benefit from technology and the ability to bring precision technology to our customers to make them more profitable and more productive. I think we'll see that across other businesses. So, that's an example of one business. I think those similar things will carry through to other businesses as well. So, on top of that, we will continue to manage costs as we have before, thinking about inflationary pressures, how do we root those out and continue to move forward to drive structural profitability for the company. Thank you.

A

Thank you.

Operator: Thank you. Our next caller is Tim Thein with Citigroup. You may go ahead.

Tim W. Thein
Analyst, Citigroup Global Markets, Inc.

Q

Yeah. Thanks. Just to come back on Large Ag. In terms of the back half and especially the fourth quarter, have your own expectations regarding channel inventory changed from last quarter? It's hard to exactly parse out in terms of, again, this pull-forward. But I guess, your exit rate in terms of where you expect to exit the year from a channel inventory perspective, again, just relative to last time we spoke?

Brent Norwood
Director-Investor Relations, Deere & Co.

A

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Yeah. With respect to ending inventory, our forecast for the end of the year actually hasn't changed since our last guidance in the first quarter. I think the only thing that's changed is, again, because of the pull-ahead in production in the second quarter, we've seen channel inventories come up a little bit faster than expected. That's a real benefit to our dealers. It's giving them more time to deliver machines to our customers, more time to facilitate used trade-ins. So those are all really positive. And what I'd say is, is the pull-ahead in the second quarter hasn't changed at all our view on end of year.

And maybe I'll turn things over to Dave Gilmore who is our Head of Sales and Marketing, and he has some further commentary on that.

David C. Gilmore
Senior Vice President-Sales & Marketing, Regions 3 & 4-Agriculture & Turf Division, Deere & Co.

A

Yeah. Thanks, Brent. You said it. The Large Ag inventory build seen recently is really due to a return to normal seasonality. And one thing that should be noted relative to the field inventory that's in place right now, a high percentage of that new inventory that's in the field today and reports is retail sold to a customer and is simply pending delivery of that equipment to the retail customer. So we're returning to normal seasonality and that's a very good thing for the industry and it doesn't change our expectation to meet historically low target levels of inventory at the end of the year.

Brent Norwood
Director-Investor Relations, Deere & Co.

A

Thanks, Tim.

Operator: Thank you. And our next caller is Steven Fisher with UBS.

Steven Fisher
Analyst, UBS Securities LLC

Q

Great. Thanks. Just to maybe follow up on that inventory question again. I appreciate that it sounds like it's just a return to normal seasonality and a bit of a pull-forward. So, Brent, I think out of the commentary that you're laser-focused on inventories. So, I guess, what are the things that you're going to be looking for over the next few months to tell you whether you should still be building channel inventory on Large Ag or just producing in line with retail? And then, do your kind of sprayer early orders imply higher, lower or flat production?

Brent Norwood
Director-Investor Relations, Deere & Co.

A

Yeah. Hey Steve. In terms of the inventory management, the way that our order fulfillment process works, we'll get great visibility into next year as we progress through the summer and fall months. And then as we begin to dimensionalize a view on 2024, we'll have an idea of sort of where ending production rates need to be. I think as of right now, the idea is to maintain discipline until some of those data points come in. The EOP results that we saw for Phase 1 of our sprayer program was really encouraging.

It's hard to do a year-over-year compare. Last year, we only ran one phase. This year, we are running two, and the first phase had a ceiling and it was allocated. We fully met that in a relatively short period of time so we were pleased with the velocity of that order book. But I would say it's difficult to extrapolate one phase for one product broadly to the rest of the portfolio. What I would say is, as we think about 2024, we do see a return to normalcy for certain dynamics, particularly the supply and demand dynamics of farm equipment should be a little bit more in balance in 2024 than what it's been over the last three years. Quite frankly, that's a healthy dynamic that we want

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to see return to the market in 2024. And our view on sort of ending production rates and inventories may change a little bit as we further discern data from our order books and EOPs. But we'll wait for that information to come in before we further refine any view of next year.

Joshua Jepsen
Senior Vice President & Chief Financial Officer, Deere & Co.

A

Yeah. Steve, it's Josh. Maybe to give you a couple examples of where we've been monitoring and taking actions. If you look at small tractors in North America, compact utility tractors, where you've seen the industry come off from a retail perspective. Obviously, more exposed there to interest rates and the macro environment. We've seen inventory rise and we will cut production and have cut and will produce below retail in the back half of the year to try to manage that inventory. Similar to the comments Dave made in Brazil on small tractors, 5000, 6000 Series tractors in Brazil where you've seen some slowness in the retail environment because of the lack of financing, we are dialing that back as well. So I think in a number of places, we will continue to monitor and execute accordingly to manage field inventories. Thanks, Steve.

Steven Fisher
Analyst, UBS Securities LLC

Q

Thank you so much.

Operator: Thank you. Our next caller is Matt Elkott with TD Cowen. You may go ahead, sir.

Matt Elkott
Analyst, Cowen & Co. LLC

Q

Good morning. Thank you. Would love to hear your thoughts, any thoughts you might have on the emerging El Niño event because the last one had some overlap with the equipment down-cycle of the mid to late teens. I know there were very important reasons for that down-cycle like coming off the ethanol expansion as well as trade tariffs. But could El Niño and warmer temperatures pose a challenge in the next few years? On the flip side, as precision technology continues to advance, can adoption actually benefit from external challenges like weather as farmers try to offset with higher yields and productivity? Thank you.

Joshua Jepsen
Senior Vice President & Chief Financial Officer, Deere & Co.

A

Yeah, Matt. Thanks. Good question. I'll start maybe on the latter part as it relates to precision technologies. I mean, certainly as we see more volatility and more uncertainty in our customers' operation, the ability to get jobs done more quickly and more precisely is hugely beneficial. And we've seen this over the last few years. 2019, a great example, where we had a really wet spring and customers leveraging technologies like ExactEmerge high-speed planting, getting their crop planted in a matter of days and hours versus traditional weeks. So we think that is really important. We think it's a driver to be able to react to more uncertainty from a weather perspective and be able to deliver not just the same outcomes, but better outcomes as it relates to cost, time and then ultimately on the yield side.

Kanlaya Barr
Director-Corporate Economics, Deere & Co.

A

Look, regarding the El Niño side, we're still looking at the weather pattern and there it might be pointing toward more the ending of La Niña and toward the El Niño. Historically, again, this is still a long way to go here. We still have to see if that really happens and how that's going to turn out in the summer. But historically, we'll probably

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see more moisture in North America and some of the dryness in places like Australia or Northern South America. So we still are monitoring that. And in North America, if we really see that El Niño, we might see some upside on the yield trend as well. But again, this is still we have months to come to see how that would play out.

Brent Norwood
Director-Investor Relations, Deere & Co.
A

Thanks, Matt.

Matt Elkott
Analyst, Cowen & Co. LLC
Q

Great. Thank you very much.

Operator: Thank you. Our next caller is John Joyner with BMO Capital Markets. You may go ahead, sir.

John Joyner
Analyst, BMO Capital Markets Corp.
Q

Okay. Thank you for taking my question. Somehow seasonal normalization is now a negative these days. So, with regard to farmer sentiment, Rachel, you correctly highlighted that even though crop prices have moderated and so has the cost side of the equation. But with such a myopic focus on grain prices, do you get a sense of average farmer profitability today versus, say, six months ago, a year ago and whether there is any hesitation creeping in at all around purchasing new equipment?

Brent Norwood
Director-Investor Relations, Deere & Co.
A

Hey John. With regards to sentiment versus farmer fundamentals, it's interesting. And we see all of the farm sentiment indicators and the barometers out there, and they haven't always matched precisely what we're seeing with the actual fundamentals of the industry. And that's been a phenomenon where those two have maybe become detached over the last two to three years. So, sometimes it's difficult to use those barometers as a great read for what's really happening with respect to customers' purchase decisions.

That said, customers are going to be very profitable this year. And even as we look ahead into next year and start plugging in some of the kind of early WASDE figures, customers are still going to be making good money, and I think you'll still see profitability at levels that are capable of stimulating replacement demand even beyond kind of where we're at today.

I don't know if Kanlaya Barr, if you have any further comments on that as well?

Kanlaya Barr
Director-Corporate Economics, Deere & Co.
A

No, no, I agree with that, Brent. I mean, if you look at, yes, price is coming down, but it's still at the top 3 of the last 10 years. And then we still have good guide on the cost side. Cost is coming down as well. So I would think that, yeah, we still have pretty good favorable margin for farmers coming into this new crop year.

Joshua Jepsen
Senior Vice President & Chief Financial Officer, Deere & Co.
A

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I think the other benefit, we're continuing to see strong used values, which are helpful when we think about trade differentials. That's a really important component to that investment decision. And then that is still very supportive. We're still, on Large Ag overall, relatively low levels of inventory. So, thanks, John.

Operator: Thank you. Our next caller is Rob Wertheimer with Melius Research. Sir, you may go ahead.

Rob Wertheimer
Analyst, Melius Research LLC

Q

Thanks. My question is going to be on Small Ag & Turf. And I wonder if you would give a little bit of a state of the market and what you have done as, Josh, you did in Construction. This is the market where you guys are obviously strong, but not as strong as in Production and Precision. The margins were quite good this quarter and I'm just curious about what you've done, the sustainability, whether price can hold up in that market, given somewhat high inventories and less strong fundamentals. Thanks.

Brent Norwood
Director-Investor Relations, Deere & Co.

A

Hey Rob. Regarding Small Ag & Turf and some of the structural profitability improvements made to that business, I think it's a segment that's probably flown under the radar screen. One of the things we've learned over the last couple of quarters, it's also a segment that's not always well understood by investors. It's a very diverse portfolio of products that we offer in the Small Ag & Turf segment. About a third of that business goes to really the consumer-oriented products, things like our riding lawn equipment as well as compact utility tractors. But the other two-thirds are sold into the farm economy, and I think that's where you've probably seen some of the most structural improvements over the last four years. We've made a lot of the portfolio decisions that we've made over the last four years have been in the Small Ag & Turf business. So we've been very, very discerning in sort of the markets that we play in and the product offerings that we offer to those markets.

And then I'd also highlight that the majority of our midsized tractors that come out of Mannheim, Germany, those are being recorded in our Small Ag & Turf division, and Europe has been a really important driver there. And we've talked a little bit about this on some of the prior calls. Our strategy in Europe has been much more focused over the last three years. We've really focused on the high horsepower segment, kind of the 150-plus segment, and have a focus that is much more on precision technology. So I think there is more differentiated products flowing through our Small Ag & Turf division than maybe investors appreciate. That's what's driven a lot of the improvements over the last couple of years.

Dave, anything else you'd add to that comment?

David C. Gilmore
Senior Vice President-Sales & Marketing, Regions 3 & 4-Agriculture & Turf Division, Deere & Co.

A

Yeah. From a US and Canada perspective, when you referenced the products that we would include in "Small Ag & Turf," a majority of those products are going to customers perhaps in dairy and livestock operations, which again in the US and Canada, those customers are generating profits and expected to continue that profit generation into 2024. So, that's been a good market for us as our company and our dealers focus on those customers generating income from a dairy and livestock operation.

Joshua Jepsen
Senior Vice President & Chief Financial Officer, Deere & Co.

A

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Hey Rob, it's Josh. One or two things I'd add to that. On top of everything that Brent and Dave said, I think this is an area where we have been very focused on the cost structure and the cost structure of these products and driving that down, we've been very disciplined on price across the globe, which has been beneficial. And then, not unlike the other parts of our business, there's emerging opportunities as it relates to technology and the ability to leverage technology that's been developed in Production & Precision Ag into things like dairy and livestock, like hay and forage that we believe will drive continued value. You think about connectivity and driving connectivity and what that means from a customer support and the ability to better take care of customers, a good example where we see opportunity to not only better serve customers, but also create value for the company. Thanks, Rob.

Rob Wertheimer
Analyst, Melius Research LLC

Q

Yeah. Thank you.

Operator: Thank you. Nicole DeBlase with Deutsche Bank, you may go ahead.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah, thanks. Good morning, guys.

Joshua Jepsen
Senior Vice President & Chief Financial Officer, Deere & Co.

A

Good morning, Nicole.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

My question is around pricing. So when you guys say that pricing is starting to kind of return to normal, what would you define normal as, particularly within Production & Precision Ag? And then second part of the question is just what are you seeing from a competitive perspective with respect to price? Thank you.

Brent Norwood
Director-Investor Relations, Deere & Co.

A

Regarding price, maybe there's a couple of different dynamics at play here. Maybe I'll just start kind of with the rest of the year and you can see this in our guide. We would expect price realization to moderate as we progress through 2023. And that really reflects some of the midyear pricing actions that we took in 2022. We'll anniversary and we'll lap those here in the third quarter, and you'll see pricing moderate. That's effectively implied in our guide given that in Production & Precision Ag, for example, we achieved 22% in the first quarter, 20% in the second quarter. Our full year guide is 15%. So that implies that 3Q and 4Q will see price realization down significantly. Now, on the flip side there, production costs are also moderating, so we think the delta between the two remains relatively static first half to back half of the year.

Now, as it relates to 2024 pricing, we've said all along our goal was to get back to more normalized levels of price realization. If you look back over sort of the pre-COVID era, that would be anywhere from sort of 2% to 3% for the entire Equipment Operations. Production & Precision Ag has typically been on the higher end of that range, and some of the other divisions on the lower side. Right now, we're one of the first manufacturers to have early order programs extending into 2024. So we do have prices out for those products. We talked about the sprayer early

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order program, which was filled relatively quickly. The pricing on those sprayers was depending on the configuration somewhere in the 2% to 4% range. So right in a range that we would view as normal, which again we think is healthy for the industry.

And then importantly, as we have a conversation about price, we also have to have a conversation about production cost. And based on where we stand today, we continue to see further moderation in production costs, and line of sight into 2024 appears as though that will stabilize a bit for us then. Thanks, Nicole.

Nicole DeBlase
Analyst, Deutsche Bank Securities, Inc.

Q

Thanks.

Operator: Thank you. Our next caller is Tami Zakaria with JPMorgan.

Tami Zakaria
Analyst, JPMorgan Securities LLC

Q

Hi. Good morning. Thanks so much. So, following up on the last answer that you gave, just to make sure, the first phase of the early order program, that's all allocated now. Which quarter does it extend to for 2024? And also, last year you said you didn't do it in two phases, so this year it's different versus last year?

Brent Norwood
Director-Investor Relations, Deere & Co.

A

Yeah. That's right. So typically and historically, we have run two, maybe even three phases for early order programs. Last year, the supply and demand dynamics for sprayers and planters were so out of balance that we only had to run one phase. Again, as we return to more seasonal patterns and more balance in the supply and demand dynamics for farm equipment, we're going to try to mimic what we've done in historic early order programs. So, this year, we're going to run two. Typically we source about 90% of model year 2024 planters and sprayers through the early order program. So these programs are really important for us as we think about production for next year.

And, Dave, do you want to talk about the second part of that question there just regarding the shift in phases?

David C. Gilmore
Senior Vice President-Sales & Marketing, Regions 3 & 4-Agriculture & Turf Division, Deere & Co.

A

In phases, yeah. And I might also add in addition to ordering products from our factories, the whole goods this year as well we have a precision upgrade portion of our early order program that allows a customer that's purchased a piece of equipment earlier to upgrade to the most recent John Deere technology that allows them to unlock agronomic, economic and environmental value. So that's another change and improvement to the early order program that Brent referenced. And ultimately, what we're intending to do with those EOPs is get an early indicator of production schedule so that we can build those and get them in the hands of customers prior to their use season. So we'll be taking orders now that will be delivered throughout 2024.

Joshua Jepsen
Senior Vice President & Chief Financial Officer, Deere & Co.

A

Yeah. This is Josh. Maybe one follow-up to Nicole's question on price. We talk about normalizing price, and that's purely inflationary price, so the historically 2% to 3%. And what we have seen, though, on top of that is another

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3% to 4% of price that comes through additional features, which effectively is you can think about more technology. And we don't see that trend changing much at all and, if anything, potentially accelerating as we drive more features and more opportunity to create more value for customers and drive very quick ROI for those investments as they reduce cost and improve yield. So just an add to Nicole's question on price. Thanks. We'll go ahead and jump to the next question.

Operator: Thank you. The next caller is Kristen Owen with Oppenheimer. You may go ahead.

Kristen Owen
Analyst, Oppenheimer & Co., Inc.
Q

Great. Thank you for taking the question. I wanted to ask about Construction & Forestry. You did mention that the order books there were virtually full for the year. Can you just help us understand the mix there? And then, I believe you said inventories were still quite tight. I just wanted to clarify, was that an industry statement or a Deere statement? And I'll leave it there. Thank you.

Brent Norwood
Director-Investor Relations, Deere & Co.
A

Yeah. Thanks, Kristen, for the question. Regarding C&F, you're correct. As we look at order books, we are almost full for the year. We're certainly full in the US and Canada. The one market that we still have more work to do would be Brazil. That's a market that has really weakened over the first half of the year and we're monitoring really closely in the back half of the year. And we have seen inventories rise a little bit as retails have suffered here in the last quarter. I think it's a combination of a little bit of political uncertainty earlier in the year, higher interest rates have put a little bit of a downward pressure on that market for us. So that's really the one callout I would have for sort of the rest of 2023.

Now, as it relates to inventory, our comments on the call have all been Deere specific inventory. Similar to Large Ag, we've seen a little bit of an increase here in season, but that's all commensurate with our production levels that we had in the second quarter, and our ending inventory forecast right now still shows us running really, really lean at the end of the year. So we're going to continue to manage that really tightly as we exit 2023 and create our starting point into 2024. Yeah, Kristen.

Joshua Jepsen
Senior Vice President & Chief Financial Officer, Deere & Co.
A

Kristen, it's Josh. Maybe one thing to add to that. From an order perspective, on North America, we're taking orders into the first quarter of 2024, so we're continuing to see strength there. Contractors for the first time in their careers are turning down jobs because of lack of labor. So I think the desire for more technology, the ability to do jobs in an easier, more simple manner is desirable. So we see a lot of opportunity there to continue. Thank you.

Brent Norwood
Director-Investor Relations, Deere & Co.
A

Hey, Michelle, I think we have time for one last caller.

Operator: Thank you. Our last caller is Stanley Elliott with Stifel. You may go ahead, sir.

Stanley S. Elliott
Analyst, Stifel, Nicolaus & Co., Inc.
Q

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Hey good morning, everyone. Thank you for fitting me in. Quick question. Can you guys talk about kind of the share repurchase expectations in the back half of the year? You're tracking two times ahead of last year and free cash flow has accelerated. Thanks.

Joshua Jepsen

Senior Vice President & Chief Financial Officer, Deere & Co.

A

Thanks, Stanley. It's Josh. Appreciate the question. I think we're seeing here the benefit of our business model and executing the strategy in terms of really strong cash generation. And clearly, with our full year guide, we see that continuing. So we did about $1.3 billion here this quarter. We don't provide a forecast there, but I think fair to assume we would continue at a similar pace through the year.

Brent Norwood

Director-Investor Relations, Deere & Co.

Thanks, Stanley. That concludes today's call. We appreciate everyone's time and thanks for joining us today.

Operator: Thank you. This concludes today's conference call. You may go ahead and disconnect at this time.

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