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Q2 2019 Donaldson Company Inc Earnings Call

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## PRESENTATION

**Operator**

Good morning. My name is Kim, and I will be your conference operator today. At this time, I would like to welcome everyone to the Donaldson Second Quarter Fiscal Year 2019 Earnings Conference Call. (Operator Instructions)

Brad Pogalz, you may begin your conference.

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**Brad Pogalz** ***Donaldson Company, Inc. - Director of IR***

Good morning. Thank you for joining Donaldson's Second Quarter 2019 Earnings Conference Call. With me today are Tod Carpenter, Chairman, CEO and President of Donaldson; and Scott Robinson, Chief Financial Officer. This morning, Tod and Scott will provide a summary of our second quarter performance and an update on our 2019 plans.

During today's call, we will reference non-GAAP metrics, such as adjusted earnings. You can find a reconciliation of GAAP to non-GAAP metrics within the schedules attached to this morning's press release.

I want to remind everyone that any forward-looking statements made during this call are subject to risks and uncertainties, which are described in our press release and SEC filings.

I also want to remind everyone that we will be hosting an Investor Day on Tuesday, April 9. Members of our management team will be providing an in-depth review of our businesses and strategic priorities, so I invite all of you to participate via the live webcast. Details of the event can be found on our Investor Relations website, or please feel free to reach out to me with questions.

With that, I'll now turn the call to Tod Carpenter. Tod?

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**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Thanks, Brad. Good morning, everyone. We are pleased to have delivered another quarterly record for sales and EPS while adjusting to an operating environment that was increasingly mixed. Within the quarter, we saw a broad-based slowdown in December that led to softer-than-expected results. While overall trends improved in January, weather-related challenges in the U.S. moved a couple of million dollars of sales into February. Currency translation was another headwind for sales with a larger-than-expected impact of 3% in the quarter. Including the increased impact from currency and the slowdown in December, we still expect strong full year sales growth of 5% to 9% or 8% to 12% without currency. Importantly, we maintained our operating margin forecast, which is up 40 to 80 basis points from last year. Scott will provide more details later in the call, so I'll now turn to an overview of second quarter sales.

Total sales were $704 million, which is 5.9% above last year or 8.6% without currency. Both segments enjoyed similar increases, including pricing benefits of more than 1%. A 6% growth in Engine was led by On-Road, which was up 22%. Second quarter sales in the U.S. were up 32% and On-Road sales grew 80% in China. The U.S. continues to benefit from increasing production of Class 8 trucks, and China is all about share gains.

As Chinese OEs developed higher-performing equipment to compete at a global level, they need advanced technology like ours. Our program wins began ramping up about 5 quarters ago, and sales have grown meaningfully since then. China's On-Road sales are now 10% of total company On-Road, and we sold more last quarter in China than we did in all of 2017. As we deepen our relationship with local manufacturers, we are focused on understanding their needs and managing their order volatility. While we expect the process of maturing our relationships will take time, we are optimistic about our long-term prospects to drive growth in China's massive market.

Turning to Off-Road. Sales were flat after growing 37% last year. Excluding currency, sales grew 3%, and the markets were more mixed than they have been. Latin America, for example, was unable to build on last year's very strong growth as political uncertainty in that region resulted in project slowdowns. We also had softness in the U.S. due primarily to lower orders from large customers in December. On the other hand, we had strong growth in EMEA due, in part, to pre-buys for upcoming regulatory changes. Despite mixed conditions, demand for our innovative products remained intact. We had mid-single-digit increases in our first-fit sales of fuel products and innovative air products, including PowerCore. Razor to sell razor blade products make up more than 30% of Off-Road sales today, and they're growing much faster than legacy products. Our past program wins and a pipeline of opportunities give us confidence that our Off-Road business will continue to outperform the market.

Engine Aftermarket sales were up 6% last quarter or nearly 9% in local currency. We're encouraged by the durability of our Aftermarket business, which finished the 12th quarter in a row with year-over-year growth in both channels. Sales of the independent channel were up in the mid low single digits, reflecting strong equipment utilization being partially offset by oil and gas-related slowdown in the U.S. Second quarter sales in the OE channel were up in the low double digits. Leading the growth were innovative air and fuel products with a combined increase in the low teens. These products further strengthen our foundation for profitable growth into the future, helping to sustain our Aftermarket business across cycles. Finally, Aerospace and Defense sales were up 5% last quarter with ground defense driving the increase. Defense orders can be lumpy, so we want to note that there is no appreciable change in market conditions.

Second quarter sales in the Industrial segment grew 5.6% or 8.4% without currency led by Industrial Filtration Solutions, or IFS. Sales of IFS grew 13.5% last quarter, including 6.5% from BOFA and a currency headwind of 3.3%. Although market uncertainty appears to be resulting in a more cautious stance regarding capital investments, sales of new equipment were up in the mid-single digits last quarter, and that's on top of a 20% increase in the prior year. Growth was supported by sales of our innovative Downflo Evolution products, which grew 50% last quarter, and we also had strong international growth. Sales in Latin America were up significantly due, in part, to some new large projects, and we also had strong growth in China. Excluding currency translation, China sales of new dust collectors were up in the low double digits, and replacement part sales grew nearly 40%. Targeted efforts aligned to China's Blue Sky Initiative creates substantial opportunities for further expansion. Process filtration continues to do well for us. Second quarter sales were up in the low teens or high teens without currency. The business represents less than 10% of IFS today, but the customer response to our offering is positive, and we expect to continue growing at a robust pace. Second quarter sales of Gas Turbine Systems, or GTS, were down 17%, which is somewhat better than expected. As we continue to deal with market declines, our efforts to rightsize this business are paying off, and they position us well for the future. Special Application sales declined 4% last quarter driven by the disk drive market. As we have previously discussed, the recent strength in disk drive sales was a temporary situation, and our second quarter results reflect the longer-term trend in this shrinking market.

Before turning the call to Scott, I want to share a few performance highlights related to our strategic priorities. During second quarter, sales of innovative first-fit and Aftermarket Products in Engine had a combined increase in the high single digits, which is several percent higher than legacy growth rates. Industrial growth initiatives for dust collection replacement parts, process filtration and Venting Solutions drove combined growth in the high single digits or low double digits without currency. Total replacement part sales for Donaldson grew 3% faster than first-fit sales last quarter, and the local currency sales increase outside the U.S. was about 10% compared with 6% in the U.S.

At a high level, these results show the progress we are making to expand our solutions and technologies around the world, and we believe these are important indicators of future profitable growth.

I'll now turn the call to Scott for his update. Scott?

**Scott J. Robinson** ***Donaldson Company, Inc. - Senior VP & CFO***

Thanks, Tod. Good morning, everyone. We're pleased to have delivered strong local currency sales growth in both segments, and adjusted EPS of $0.47 was up 9% from last year. However, a negative impact in currency and a softer-than-expected demand in December contributed to second quarter sales and profit that were below our forecast.

Before getting into the details, I want to call out 2 items. First, please note that our net earnings for second quarter 2019 and 2018 include tax-reform related charges of $400,000 and $110 million, respectively. These amounts have been excluded from adjusted earnings in their respective periods. Second, as a reminder, we adopted 2 new accounting standards this fiscal year: revenue recognition and pension accounting. Prior periods are restated to conform with pension accounting, but that's not the case with revenue recognition.

While the adoption of this standard had a small impact on sales and profit dollars, it effectively diluted second quarter gross and operating margins. Including 10 basis points of dilution from revenue recognition, second quarter operating margin was flat with the prior year, reflecting strong expense leverage, offset by a gross margin decline. Our second quarter operating expense rate improved 100 basis points from last year driven by lower incentive compensation and leverage on increasing sales. We're pleased to have delivered a historically low expense rate while investing in our strategic priorities. Second quarter gross margin declined about 90 basis points from last year or 70 basis points when you adjust for the revenue recognition impact. Higher raw material costs added 130 basis points of pressure, which we offset with price increases. Supply chain inefficiencies, including investments to support our customers, combined with an unfavorable mix of sales, also pressured gross margins. These headwinds were particularly strong in December. Our January had a sequential improvement in gross margin, and incremental margin of 50% was not enough to recover from December.

The same was true in the segments. In Engine, the second quarter profit margin of 11.3% included a drag of about 10 basis points from revenue recognition. The decline from the prior year reflected higher raw material and supply chain costs, an unfavorable mix of sales and a lower contribution from joint ventures. The Industrial margin of 13.7% also included a 10 basis points of drag from revenue recognition. The year-over-year margin decline was driven primarily by unfavorable mix of sales and an expected purchase accounting adjustment related to the BOFA acquisition. Margin pressures in both segments were partially offset by price realization and expense leverage. We also had year-over-year favorability in the corporate and unallocated expense driven by lower variable compensation than last year.

Capital expenditures grew to $39 million last quarter, primarily due to capacity expansion projects around the world.

We spent $45 million on share repurchase and dividends in the second quarter. And year-to-date, we have repurchased about 1.6% of our outstanding shares and paid dividends of $49 million.

At the end of second quarter, our leverage ratio of 1.1x EBITDA was in line with our long-term target.

The balance sheet is in good shape, and we continue to focus on optimizing our working capital.

We made progress on receivables last quarter, and new capacity will help with inventory as we normalize the supply chain.

Turning to our full year guidance. Our revised forecast still reflects strong growth and record level of sales and profit. We are projecting full year sales growth between 5% and 9% and an EPS increase between 13% and 20%. These ranges are about 2% below the prior forecast with half the change from currency and the balance from the markets, particularly related to December's pause. The currency headwind is now expected to be 3%, up from 2%, and we still expect benefits of 1% from BOFA and 1% to 2% from pricing.

Engine sales are now projected up 6% to 10%, reflecting an additional headwind of 1% from currency translation, combined with adjustments amongst the business units. Currency and recent trends led to a more modest growth projection in Off-Road and Aftermarket, which are now expected to increase in the low single digits and high single digits, respectively. Sales of Aerospace and Defense are now forecast up in the mid-single-digits driven by the defense orders, and we still expect strong growth in the mid-teens for On-Road.

Overall, we still see growth opportunities in the Engine markets. Second half sales are modeled up in the high single digits, including a 3% currency headwind. Across the segment, we expect innovative products and the strength of our recurring revenue stream will drive continued profitable growth.

Turning to Industrial, we now expect a full year sales increase between 4% and 8% or 3 points below prior guidance. Business conditions in IFS and Special Applications account for 2/3 of the change, and currency adds 1 point of pressure. IFS sales are now expected to increase in the low double digits, which includes 6.5 points from BOFA. As demand for new equipment moderates, we still expect replacement parts and process filtration will deliver strong growth. Sales in Special Applications are now expected to decline in the low single digits, reflecting renewed pressure from the disk drive market.

Our GTS forecast is unchanged. The full year sales are expected to be down in the high single digits. Sales for large turbine projects are driving the decline, and we expect full year growth in sales of replacement parts. Our second half Industrial sales are modeled up in the mid-single-digit range, reflecting solid growth in IFS and declining sales in GTS and Special Applications. Areas where we are making strategic investments like replacement parts, process filtration and Venting Solutions are expected to deliver strong growth in fiscal '19.

We still project full year operating margin between 14.2% and 14.6%, which is up 50 to 90 basis points from last year when you exclude the 10 basis point impact from revenue recognition. The improvement is coming from expense leverage and lower incentive compensation with favorability from these factors offset by increased investments in our strategic priorities like R&D and lower gross margin. We now project gross margin will be down from last year by about 5 points (corrected by company after the call) or 30 basis points when adjusting for revenue recognition. The decline is due primarily to performance in December, and we still expect price increases to offset higher raw materials and freight costs. Our operating margin forecast for the back half of fiscal '19 reflects meaningful sequential improvement in gross margin and continued expense leverage, resulting in a back half incremental margin that builds to the high 20% range over the third and fourth quarters. Improving gross margin over the long-term is a top priority. Normalizing demand, combined with new capacity, gives us an opportunity to accelerate some initiatives.

One priority is moving production to optimal locations, which typically means lower costs as we reset our supply chain. We have new capacity in 6 locations coming online over the next 2 quarters, giving us excellent opportunity for progress. New capacity also gives us the opportunity to refocus on cost reductions within the plants. As we relieve demand-related constraints, we can direct additional resources towards our continuous improvement initiatives. And of course, pricing remains a top priority.

We are pleased with the progress in many parts of the business, including Engine. We maintain a locally competitive stance in our independent channel, giving us more pricing latitude and a quicker path to recovering cost inflation. Our pricing discussions with OE customers is also about recovering the cost increases that we absorbed, but that also takes more time. As we make progress on that front, we also continue to enjoy the far more valuable part of those relationships, winning first-fit programs with innovative products. We have decades-old relationships with many of these customers, and our team of engineers works closely with theirs. Giving that proximity, our mission is to help them solve their problems while gaining share of the first-fit and Aftermarket opportunities. These wins are a critical part of our long-term sales and profit growth formula, so our focus in the OE channel has multiple dimensions.

We remain committed to increasing our levels of profitability on increasing sales. As we address the gross margin pressure, we are closely managing discretionary expenses while maintaining investments that will drive future profitable growth. And I think we are striking the right balance.

Moving down the fiscal '19 P&L, other income is now forecast between $5 million and $9 million, down $7 million from the prior guide. Softer-than-expected joint venture performance and FX losses drove the change. The interest expense forecast dropped to $21 million from $23 million, reflecting interest rate benefits from our global cash optimization efforts. We also refined our tax forecast and now expect the full year rate to be about 30 basis points below the prior guidance. We expect fiscal 2019 capital expenditures between $130 million and $150 million, cash conversion between 60% and 75% and, our share repurchase target remains at 2%.

Overall, our forecast for the back half of 2019 includes strong top line growth in businesses where we are making strategic investments;

sequential improvement in sales, operating margin and EPS; incremental margin in the high 20% range; and disciplined capital deployment that reflects investment in the company and returning cash to shareholders.

I'll now turn the call back to Tod to provide an update on some of our strategic initiatives. Tod?

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Thanks, Scott. we're excited with the progress we are making on investments that will drive future profitable growth. One of note is our e-commerce site, shop.donaldson.com. So far this year, we have transacted more than $170 million with 2,400 customers around the world. Recent enhancements include the ability to launch targeted regional promotions, and we now also show real-time product availability. Our objective with shop.donaldson.com is to make it even easier for customers to buy from us, and we have excellent momentum.

Another important activity is developing our capabilities related to connected solutions. Our Filter Minder team in Engine has pilot activities with nearly all our OEM customers. We are also pursuing Aftermarket opportunities with large fleet owners that want to optimize their costs. Importantly, our solution in Engine is being designed around what the customers want, so we can effectively leverage our deep relationships to drive this new business model. The benefits of connected solutions in Industrial are also focused on creating value for our customers. We have connected dust collectors in the field, and we began offering a subscription service last quarter that gathers real-time data, applies analytics in the cloud and relays insights to the operator through desktop or mobile applications. We are further expanding our infrastructure to offer these solutions. One important component will be adding a connected controller to all new dust collectors, making it easy for our customers to opt into the programs we develop. We have also developed a simple cost-effective way of retrofitting existing collectors in the field. Our industrial customers want these solutions, and our broad product portfolio, combined with already deep access, puts us in an excellent position to drive profitable growth in this emerging space.

Investments in capacity expansion are another way we are supporting future growth. Over the next couple of quarters, several new resources dedicated to innovative products will come online. In addition to fueling growth in both segments, this capacity also creates an operational inflection point for us. We are now at a point where we will reoptimize our production and supply chain, and we are aggressively pursuing cost optimization to drive gross margin improvement.

We are also expanding our technological capabilities through R&D investments. As we have previously highlighted, we are on a multiyear journey to increase our annual R&D spend, and we have plans to step up our capital expenditures. I am pleased to announce that we will be investing $15 million to build a new R&D facility at our global headquarters here in Minnesota. This new facility will directly support the further strengthening of our material science capabilities. These technologies are critical to penetrating new and existing markets, especially those that place a high value on the integrity and quality of their respective products. These R&D investments have a high return for us. We can develop products that carry gross margins above the company average, and we can diversify with those technologies in a wide variety of applications.

Donaldson is a technology-led filtration company, and these investments will continue to strengthen our position as a leader in the global filtration industry.

Before closing, I want to thank our employees for their commitment to supporting our customers and executing our strategic priorities. As we move into the second half of fiscal '19, I am confident that we are going to finish the year strong while strengthening our position for future growth. I also want to make a special acknowledgment to the employees that work at our Alabama facility where tornadoes passed within 15 miles of our plant. Our thoughts are with all of you and your families as you work to recover from the devastating weather last weekend.

Now I'll turn the call back to Kim to open the line for questions. Kim?

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Your first question comes from the line of Nathan Jones from Stifel.

**Nathan Hardie Jones** ***Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst***

Maybe we could just start talking a little bit more about December. I mean, you guys said it was pretty broad-based and pretty state. Maybe you could give us some color on how much below your expectations it was, whether or not there was any particular end markets or particular geographies where it was worse? Just any more color you can give us on what happened in December.

**Scott J. Robinson** ***Donaldson Company, Inc. - Senior VP & CFO***

Yes. December was -- just started out as kind of a slow month for us, and it kind of continued. We probably missed our sales by about $20 million, so that's a big number for us to miss in a month. And it just kind of started slowly and continued that way during the month. And then in January, things improved.

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Yes. Nathan, I would add a little bit of color in the sense that it was broad-based, both in our Industrial businesses and our Engine-based businesses. We still have -- while we still have year-over-year growth, December carved such a hole for us. We actually had negative incremental margin in December, and as Scott pointed out in his script, had a 50% January incremental margin growth, and it still was not enough to get us to where we want to be and we would expect to be with an incremental margin. Then that shows the hit specifically that we took within December as we saw Industrial-based projects kind of get a new cautiousness to them and then a more broad-based Engine slowdown as well.

**Nathan Hardie Jones** ***Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst***

And so -- I mean, it sounds like you start to rebound in January. Can you talk about did January get back to where you had anticipated? Obviously, the incrementals are very, very good there. And then any commentary you can give on what you've seen in February.

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Yes. So in January, we did see a nice rebound to what we would have expected within January and got back into what we had been putting within our forecast for the balance of the year. So we're very comfortable. We'll talk about February in Q3 here in about 90 days, so I won't comment on that at this point. But within January, we did see a very noticeable rebound back to what we would consider more normalcy.

**Brad Pogalz** ***Donaldson Company, Inc. - Director of IR***

Nathan, this is Brad. I'll jump in. The -- just doing the math on the guide as well. If you think about the number Scott shared, the $20 million and then the extra percent from currency, those 2 items alone account for almost all of our full year guidance change, sales and EPS. So that gives you some context about how we're thinking about the rest of the year as well.

**Nathan Hardie Jones** ***Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst***

Yes. looked like it didn't change much for the rest of the forward outlook. If I can slip just one more in on OE price. I know that takes more time, but we've been taking a fair amount of time. So I mean, you've been dealing with the inflation for 12 months now. Can you talk about our progress you've made on the OE price side, what actions you're still looking to take and what we could expect from OE price going forward?

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Sure. First, I'd compliment the teams across the industrial-based businesses where we have worked very hard through this inflationary period, and we would suggest that we are back into a more normal type of a pricing action that the company usually sees. So we've worked successfully through that tough cycle. On the independent Aftermarket channel within Engine, we've also successfully worked through that, and I would compliment the teams worldwide that have done excellent there. So we feel very good about where we are in that space. And our OE teams have done an excellent job, really going after all of the price recovery. While we have not had 100%

success on that, we still have some progress to go. We are quite a ways down the path with very noticeable success in that cycle. Still, it does not appear as though we would be able to accomplish a 100% price get-back, if you will, but good progress being made, still more opportunity and still working very hard to accomplish that.

**Operator**

Your next question comes from Brian Drab from William Blair.

**Brian Paul Drab** ***William Blair & Company L.L.C., Research Division - Partner & Analyst***

Tom, first, just on China, great momentum there. Can you elaborate a little bit as to -- are you still primarily selling air intake filters? Is there opportunity as you gain traction there and you gain share to sell the whole suite of products for lubricant, hydraulics? And how -- just where can this business go? Where do you hope that you are in China and the truck market in a year or 2?

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Yes, Brian. This is Tod. Within China, we're having good success, as you know, on air, but we are also having success in liquid. So we are across the product families in Off-Road, which is where we've traditionally had good success. We continue to have good penetration in both of our product families. And now, we have good momentum within the On-Road sector of China. And you may note that the China Class 8 truck market is roughly 3x the size of that of the United States. And so consequently, we have won air-based projects in China with PowerCore, and that's future revenue that we would expect to continue to pick up. And we have also 1 liquid-based new revenue, new projects across that space as well. Mostly on the liquid offering are on the Off-Road sector rather than within the On-Road sector. So we're very pleased with the progress that we have, and we look for more great things out of China.

**Brian Paul Drab** ***William Blair & Company L.L.C., Research Division - Partner & Analyst***

Okay. What would you say -- can you give us any clue what your share of that market is now? You think it's still low single-digit percentage and what you think it could be? Any goals there?

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

It is low single digits at this current time. We have some internal goals. Obviously, we want to get into what we more normally would believe as comfortable across our Engine-based businesses. So clearly, it's a double digit. We believe we're on a nice track to be able to do that. If China does have some interesting volatilities to it, as they bring projects forward and then ready them for project launch and then we'll pause, so they have create -- they naturally create a more lumpiness to the beginning of programs, so we'll be sure to call that out as we see that. But we have some excellent wins that we expect future revenue over there, and we would expect to get our share in China up to what we enjoy worldwide.

**Brian Paul Drab** ***William Blair & Company L.L.C., Research Division - Partner & Analyst***

Okay, great. And then just one other question for now. I'm just curious if you can give us some insight into the gas turbine market just in a little more depth regarding the competitive landscape. I think a couple of years ago, one of your competitors placed a pretty big bet on taking some low-margin business, and this whole story is -- we don't have the transparency that we use given some of the acquisitions in the space in that. But is there anything you could help us just to understand how the competitive landscape is and how the environment is in terms of your need to make decisions to walk away from low-margin business? And just how challenging is that end market going to be over the next year or 2?

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Brian, as you know, we changed our strategy some years ago now in order to be careful about our large turbine projects. It would appear that, that strategic change was timed exceptionally, while our competitive -- our competitors really went all-in at that moment. We were adjusting. They were doubling down. And so consequently, I think because the cycle then turned difficult on all of us, we sit today at a really strong position with how we're operating the business, and our gas turbine team has done exceptionally restructuring it and sizing it for the current market. As we look forward within the marketplace, we do not see an appreciable rebound within the gas turbine within this fiscal year. We've always said that this year would be more stability. And based upon our ability to go after Aftermarket and small turbine-based projects, small turbine meaning oil and gas and those kinds of related projects, we believe that we will start to see growth -- some growth next fiscal year, but this is a year of stability.

**Scott J. Robinson** ***Donaldson Company, Inc. - Senior VP & CFO***

Brian, maybe I can just add, too. This is Scott. I think we probably told you that, that large turbine business now represents less than 10% of total GTS, so we have very limited exposure at this point. And so there is really not any risk of going down further in large turbine, and we will continue to be selective and disciplined and only take large turbine projects where the return is sufficient. And so we really rid ourselves of that exposure. And so going forward in the large turbine business, it can only be positive to Donaldson.

**Operator**

Your next question comes from Charley Bradley (sic) [Brady] from SunTrust.

**Charles Damien Brady** ***SunTrust Robinson Humphrey, Inc., Research Division - MD***

Charley Brady. Just starting on the capacity additions that you guys were doing and the moving up of production to optimize that, I'm wondering, within the guidance, is there an embedded headwind from doing these type of stuff that maybe doesn't repeat as you go into '20?

**Scott J. Robinson** ***Donaldson Company, Inc. - Senior VP & CFO***

Yes. This -- I'll start. This is Scott. So certainly when you're starting up a new line or you're moving things from one plant to another, especially if it's from continent to continent, there's a certain amount of friction or headwind you incur as a result of that. We've been doing that, and we've been moving things back and forth. And we feel like we've made great progress, and we have a lot of new capacity coming online. And the reduced cost you get from that will more than offset any friction. And, so there is friction. And obviously, as production ramps up, you get better absorption and you have better cost. But we are -- and as I said, in the next 2 quarters, we're going to have quite a bit of capacity coming online. And so a lot of the friction has been incurred, and we see improvement coming very soon.

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Charley, it's Tod. I'll just add a little bit more color. So we're at an inflection point that we're really pleased to be at right now. And so specifically, when we look at these last 2 years and the success that our company has had where we have grown over 3 years over 30%, we knew that we would have some capacity constraints because we are coming out such of a -- off such a tough time. They turned out to be much greater than we thought we had, and so we had to add the capacity expansion. We have been suboptimizing our internal supply chain for quite some time now to make sure that we take care of our customers because that's very important to us, while our overall sales teams worldwide worked the pricing-based issues that also came forward based upon inflation. We're roughly through our pricing-based actions now. We're roughly through -- we've got a couple of quarters here to get through all the capacity expansion that we need, and so the renormalization is standard work for us. It's work we are exceptional at, and now we can dig in and really attack the gross margin activity. And so I look for good things going forward over the next several quarters as we renormalize and attack efficiency across our corporation.

**Charles Damien Brady** ***SunTrust Robinson Humphrey, Inc., Research Division - MD***

That's great color. And just another one for me on the BOFA acquisition. You've had it in the mix for a little while now. Can you just talk about where you guys are in integration and maybe the opportunity there, I guess, strictly on the Aftermarket with those guys?

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

So the BOFA integration is going quite well. We won't take BOFA integration 100% into Donaldson. Remember that we still have 88% ownership share, not 100%. And so that limits some of the things that we'll do longer term, of course. But the technology-based sharing is going on, and it's going very well. The overall strategic linkage of what we're trying to accomplish for the razor and razor blade-based models is going very well, and the important thing to remember is that BOFA brought new markets to us and brought growing markets to us. And so consequently, we're very happy that there's not a lot of product overlap, but there's technology overlap. And that's the importance of how 1 plus 1 equals 3. And additionally, we're excited with the BOFA team. The leadership team that came through with BOFA has done an excellent job. They fit culturally wonderfully inside Donaldson, and we're very proud to have them within the company.

**Operator**

Your next question comes from Richard Eastman from Baird.

**Richard Charles Eastman** ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Yes. Tod, could we talk just for a minute about IFS? I maybe missed what the projected growth rate would be there for all of '19. Did you mention low double digits?

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Yes, yes. That's right.

**Richard Charles Eastman** ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Okay. So low double digits for the full year. And then -- so maybe the math then in the second half, if you account for BOFA, would be most of the growth. So is the core business in local currency? Is there any growth projected for the second half there?

**Brad Pogalz** ***Donaldson Company, Inc. - Director of IR***

Rick, if you pull -- this is Brad. If you pull out BOFA, IFS sales in the back half are still forecast up in the high singles. You'd get in the neighborhood of 7%, 8%, and that's with about 3 points of currency. So the back half growth is still reasonable.

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Yes. Remember, we lapped BOFA. And so consequently, when you look at that, what Brad talked about within the model, with low doubles is how you get there.

**Richard Charles Eastman** ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Okay, okay. And then -- so is the backlog an order intake on the core IFS business both dust collection and compressed air? Are those -- are you comfortable there that we haven't -- have we seen any falloff there at all, just relative to the PMIs and cap spending comments that you made earlier?

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Within the compressed air side, we've not really seen appreciable falloffs, so we're pleased there. That's mostly a European-based business and have not seen, really, any appreciable change. Within the Industrial air filtration or dust collection base business, we have seen, especially in December, kind of a new cautiousness within capital-based projects, for sure. However, we did base that within the guide that we are getting out today.

**Richard Charles Eastman** ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Okay. And then I just want to ask one question around -- in the guide for the full year, one of the things that we did do was reduce our other income meaningfully from $12 million to $16 million to $5 million to $9 million. I was a little bit curious because that other income number was actually about -- the JV number was actually about $8 million in '18, so we kind of forecast a step-up. We're pulling that back out to be more like flat. And it just -- it strikes me that, that reduction literally is about $0.04 on the year is kind of what you're cutting guide. So I'm curious, is that the CAT-related JV? Kind of how has that slowed down? And is there any broader implication for your business? I mean, is that a leading or lagging indicator?

**Scott J. Robinson** ***Donaldson Company, Inc. - Senior VP & CFO***

Yes. This is Scott, Rick. So you have the numbers right. The other income came down, that was due to JV income, number one. FX loss is number two. I would say that the JVs experienced somewhat consistent what the company experienced, so we wanted to bring that down in the course of what we expected. The other 2 lines there below operating income are interest and taxes, and so we brought our interest expense down 2%. We brought our tax up 30 basis points. So when you put those 3 together, it was more like a $0.01 drop, but -- so you were right. It was $0.04 in other income, then you made up 3 with the other 2 lines for a negative 1. So we just wanted to hit those more accurately forecasted based on finishing 6 months of the year.

**Richard Charles Eastman** ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Yes. But my question kind of stands, though. Is that -- is the JV -- the reduction in the JV income, obviously, is attributed to the JV profitability. That's down now on a forecasted basis. Is that primarily Off-Road effect? Is that from the CAT JV, which should be more Off-Road? Is that -- did that business slowed down that much or...

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

No. I would remind you that we also have a JV in Saudi Arabia in the power industry, which also turned more difficult. We have a JV in Indonesia with -- that really services a liquid-based component, which also turned more difficult. A lot of this is December. And then you also have the JV within CAT where we're building in the United States and Europe. So it's really more of a broad-based JV-based comment with the industries that we have the JVs for.

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**Richard Charles Eastman** ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

I see. Okay, okay. And one thing I wanted to kind of just double check as well given maybe gas turbine in this quarter was a little bit stronger than anticipated. You didn't change the full year outlook. So at the end of the day, the second quarter was probably not the bottom in terms of revenue for gas turbine?

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**Scott J. Robinson** ***Donaldson Company, Inc. - Senior VP & CFO***

Yes. So I mean, we pretty much held it consistent. So you start to be pretty small numbers when you're talking about changes within gas turbine. Like we said, the large turbine, we're walking away from a lot less than 10%. And therefore, that generally indicates that this year will be the bottom for GTS, and we expect improvement going forward.

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**Richard Charles Eastman** ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Okay, okay. Just -- and one last question, I promise here. The Off-Road business in Europe was quite strong. And was that -- could you give us some general feel for what regulatory impacts we're seeing there? And how does that play out over the next 12 months?

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**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Sure, Rick. This is Tod. So overall within the Off-Road, we have a strong emissions business over there. And consequently, you have some pre-buys as a result of some regulations that are coming onboard. And they had a pre-buy as a result of the Stage 5 regulation for the larger diesel engines, and that is -- would be the reason that drove that Off-Road bump up, if you will. Now next calendar year, as of January, the smaller base diesel engines have that same regulation change, and so we would expect looking out there to be another lumpy bump but that it would settle back down to more normalcy rates. But that's the reason for the strength.

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**Richard Charles Eastman** ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

And your content on the large or small close enough that we'll see that impact?

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**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Yes.

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**Operator**

Your next question comes from Laurence Alexander from Jefferies.

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**Nicholas Cecero** ***Jefferies LLC, Research Division - Equity Associate***

This is Nick Cecero on for Laurence. I guess if maybe can you comment a bit on specific raw materials you're seeing the most inflation in and I guess how you think it plays out in the back half of the year?

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**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Sure. This is Tod. So the 2 that are most headwinds -- most prevailing headwinds at the moment are clearly steel. If you remember, we had longer-term contracts with steel below market, and so we have been adjusting all fiscal year to that step-up of steel-based headwinds. So that would be one. We do see some moderation going forward as we finish out the balance of the fiscal year, meaning that it will likely stay roughly within the level that it's at, so it would not provide further headwinds. But then the other one is media-based pulp and paper type of activities that go across our family of products to build medias. And that was pretty significant year-over-year on the gain. So those are the 2 that are primarily driving all our raw material headwinds as we look forward.

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**Nicholas Cecero** ***Jefferies LLC, Research Division - Equity Associate***

And then in regards to supply chain cost, is there any lever you can pull in order to offset them?

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**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

So we are pulling that. As you know, we have one worldwide system now that we've talked about within our compass-based project that we implemented worldwide. We now have the ability and are doing a very good job at centralizing all the demand worldwide in order to gain some purchasing power. Our purchasing teams have been going after that for multiple quarters. They've had good success, and we look forward for them to continue that type of process. That's a new way to go at this based upon new information that we can now gather across our supply chain. And so we'll look for good work next fiscal year as well.

**Nicholas Cecero** ***Jefferies LLC, Research Division - Equity Associate***

And then just one more, if I may. You called out oil and gas slowdown in the U.S. I guess are you seeing a type of pickup as we move through the past couple of months? And do you see any pickup in the back half of the year?

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

No. We have -- within the guide that we've given, we have more of that normal seasonality that we see within the back half baked into that guide. So especially based upon when we saw the bounce that came back into January, we would say it's a little bit more business as usual. However, we do also need to point out the December pause.

**Operator**

Your next question comes from George Godfrey from CL King.

**George James Godfrey** ***CL King & Associates, Inc., Research Division - Senior VP & Senior Research Analyst***

Two questions. One is CapEx this year in the range, Tod, you've given, looks like it's just under or at 5% of revenue. You think that level of investment comes down as a percentage of revenue as we head into 2020? Or you need additional capacity and build up for the projects you highlighted earlier to keep the CapEx at a higher level than what it's been historically?

**Scott J. Robinson** ***Donaldson Company, Inc. - Senior VP & CFO***

Yes. So this is Scott. So we see that as going on for this year and next year and then coming down. So we'll have some projects that we'll be finishing this year that will go into next year. So we're going to have an elevated level next year, and then we see it coming back down.

**George James Godfrey** ***CL King & Associates, Inc., Research Division - Senior VP & Senior Research Analyst***

Got it. Okay. And then my second question is if I look at where I think net debt or leverage ratio is to going be at the end of this year, plus the free cash flow you're going to generate in Q3 and Q4, probably net leverage is below 1. So my question is how aggressive do you get with share buyback or acquisitions if the leverage ratio does fall below 1?

**Scott J. Robinson** ***Donaldson Company, Inc. - Senior VP & CFO***

Yes. So I mean, we maintain our guidance at 2% per share buyback. We're sitting at 1.6% repurchase as of the end of this quarter. The current debt-to-EBITDA ratio sits at 1.1x. Every year, we take kind of a holistic view of our forward-looking as well as our backward-looking return to shareholders. And we assess our capital deployment strategy, and we go year-by-year with that with kind of a longer-term view. So we will continue to do that and projection with our planning process and review with our board, and I'll let Tod talk about acquisitions.

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

Relative to acquisitions, you know acquisitions are part of our strategy. We're happy to have done 5 acquisitions in the last 3 years. We talked about the bolt-ons of all of those and their strategic importance to each of the business units. We continue to have it as part of the strategy. We have a nice robust process now that I would suggest has good opportunities. They're all strategic. We're very selective. We're also a disciplined buyer, and nothing has changed, really, for us in that regard. We're also very happy to have a strong balance sheet that allows us to have this as part of our strategy. So really, nothing appreciably changes for us strategically in the way that you look at our actions of acquisitions.

**George James Godfrey** ***CL King & Associates, Inc., Research Division - Senior VP & Senior Research Analyst***

Okay. And so let me just ask one or push on that point a little bit more, and I recognize you have a very strong balance sheet, methodical. When does a strong balance sheet go to an inefficient balance sheet in that the leverage you're just not taking advantage of the leverage capability that Donaldson has, I guess, what I'm trying to get at?

**Scott J. Robinson** ***Donaldson Company, Inc. - Senior VP & CFO***

Yes. And that's a fair question. I promise to consider that when we do our plan for next year. That's something we think about, and we think about the opportunities there in front of us and what we know that's coming, and we look at our return. We've had a very consistent -- we've been increasing our dividend for 20 years. We have a very consistent share buyback, and I would expect that those things will continue. I would not expect us to pile all sorts of cash up on the balance sheet. So we have to be thoughtful with the capital we deploy and deploy that in an effective way. And I think the cash flows that we generate are relatively consistent and predictable, and so we feel good about that. And that gives us a pretty solid basis from which to go forward.

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

And I also want to point out that we're very proud of the organic growth that we've had as a result of our razor to sell razor blade strategy and bringing forth technology over the last 3 years, and a strong balance sheet has allowed us to answer all of those calls for customers because the demand ramped up even faster than we had thought. So we were able to really execute that without additional borrowing, et cetera and self-fund while also continuing on our acquisition-based strategy. And we look to continue to execute on that. So overall, as we look at our company and our strategy, our strong balance sheet is not just about acquisitions. It's also about being able to execute internally on the organic side, and we're pleased to be able to have done that very quickly.

**Operator**

There are no further questions at this time. I now turn the call back to Tod Carpenter.

**Tod E. Carpenter** ***Donaldson Company, Inc. - Chairman, CEO & President***

As we conclude today's call, I want to remind everyone that we will be hosting an Investor's Day on April 9. We're looking forward to providing a deep dive into our strategic long-term priorities, so please reach out to Brad with any questions.

As always, we appreciate your time today and your interest in Donaldson Company. Thank you, and goodbye.

**Operator**

This concludes today's conference call. You may now disconnect.