THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

DCI - Q2 2016 Donaldson Company Inc Earnings Call

EVENT DATE/TIME: MARCH 01, 2016 / 3:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Brad Pogalz *Donaldson Company Inc - Director of IR*

Tod Carpenter *Donaldson Company Inc - President and CEO*

Scott Robinson *Donaldson Company Inc - CFO*

CONFERENCE CALL PARTICIPANTS

Kevin Maczka *BB&T Capital Markets - Analyst*

Eli Lustgarten *Longbow Research - Analyst*

Brian Drab *William Blair & Company - Analyst*

Matthew Paige *Gabelli & Company - Analyst*

Charlie Brady *SunTrust Robinson Humphrey - Analyst*

Richard Eastman *Robert W. Baird & Company, Inc. - Analyst*

Larry Pfeffer *Avondale Partners - Analyst*

PRESENTATION

Operator

Good morning. My name is Suzanne and I will be your conference operator today. At this time I would like to welcome everyone to Donaldson's second-quarter FY16 conference call.

(Operator Instructions)

Mr. Brad Pogalz, Director of Investor Relations, you may begin your conference.

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

Thanks, Suzanne. Good morning, everyone. Welcome to Donaldson's second-quarter 2016 earnings conference call.

With me is Tod Carpenter, Donaldson's President and Chief Executive Officer; and Scott Robinson, Chief Financial Officer. This morning, Tod and Scott will discuss second-quarter performance, review the outlook for FY16, and provide an update on some of Donaldson's strategic initiatives.

Before turning the call to Tod, I have two housekeeping items to cover. I want to first remind all of you that we chose to revise our previously-issued quarterly financial statements for FY15 in our most recent 10-K. The revision appropriately recognizes the gas turbine systems revenue in each period last year. Additional details related to this revision can be found in note O of the 10-K.

I also want to remind everyone that any forward-looking statements made during this call are subject to risks and uncertainties, the most important of which are described in our press release and SEC filings. Now I'll turn the call over to Tod Carpenter. Tod?

Tod Carpenter - *Donaldson Company Inc - President and CEO*

Thanks, Brad. Good morning, everyone. I want to begin by welcoming Scott Robinson to Donaldson. He joined as our new CFO in December, so today is his first earnings call with us. I'm very excited to have him on the team. Adding his skills and experience strengthen us as we continue to navigate the challenges presented by uneven demand across the globe. Welcome, Scott.

Turning to our performance, uneven demand persisted through second quarter. The recent market volatility and global economic uncertainty was punctuated by the dour outlooks provided by some of our largest customers over the past several weeks.

Given market conditions, we continue to proactively seek opportunities to enhance operational efficiencies and take cost out of the business. Our goal is to protect bottom-line performance where we can but we also recognize the importance of striking a balance between cost savings and investments in the future. I'll share more on that later in the call.

Turning to our second-quarter top-line results, total sales declined about 12% to $517 million, which was below our expectations for the quarter. Our GTS business was the single largest contributor to this variance.

In Q2, we experienced a 40% sales decline from last year, but we did expect sales to decline as we compared against a 65% increase in the second quarter last year. The shortfall in sales was primarily driven by a higher rate of customer delivery deferrals as their sites were not yet ready to accept our equipment.

Given the challenges facing GTS over the past couple of quarters, we are taking a hard look at how we approach of this business. To be clear, this does not include the possibility of exiting this business.

In the near-term, macro headwinds like the oil & gas slowdown and economic uncertainty in the Middle East create an environment that is prone to project delays and deferrals, and is increasingly price-sensitive. Longer term, the outlook for this market looks very positive. Natural gas plants have many advantages over other means of generating power, including renewables. Third-party forecasts suggest that natural gas-fired plants will play an increasingly important role in meeting global power demand.

Turning inward, our technology-led approach to filtration aligns well with the needs of the large turbine manufacturers. These OEs have very high standards for performance and we have a strong brand and a trusted product that benefits from our portfolio of technology.

Our priorities within the business will not shift much. We will continue developing innovative products while growing our aftermarket business. The strategic change is that we'll be more selective in taking on large turbine projects. These projects drive the lumpiness of this business and they typically include a significant amount of cost in the design phase, which turns into lost leverage if a project faces consistent delays.

Overall, we believe GTS is a very good business. By being more selective in large turbine projects and growing aftermarket sales, we are confident that we can gain more stability and enhance profitability.

I'll now step back and provide a few highlights about some of our other businesses. Note that I will reference local currency results when speaking to the year-over-year percentage change.

Driven largely by GTS performance, the industrial segment experienced a local currency sales decline of 10.6% in the quarter. Also contributing to that decline, industrial filtration solutions sales were down about 2% compared with last year.

We saw comparable declines in both of the first-fit and aftermarket side of dust collection, with some of the softness coming from customers who are more exposed to the oil and gas industry. Overall the environment continues to reflect steady quoting activity with slow-to-develop orders.

Turning to the engine segment, external conditions were relatively consistent with what we have been experiencing for the past several quarters. The 5.7% sales decline reflects strength in on-road that partially offset weakness in the other businesses.

We are very pleased with the continued success in on-road. Sales increased nearly 6% in the quarter, which is on top of more than 11% growth last year and includes a high-single-digit increase in North America.

We are also pleased to have found a bit of equilibrium last quarter between our forecast and demand in off-road. The sales decline of about 13% was slightly better than our expectations, but we are not necessarily interpreting this as bottom. External benchmarks, including sales guidance provided by some of our largest customers, suggest that end-market pressures will continue, though we will continue to monitor this business closely to ensure our production and costs are aligned with demand.

Our aftermarket performance continues to reflect a combination of OE inventory management efforts and reduced demand from the field. Aftermarket sales declined about 5% in the quarter with the independent channels slightly outperforming the OE channel.

Sales through the OE channel which represent about 40% of total aftermarket, remain volatile as our largest customers continue to focus on inventory management. We saw particularly large fluctuations in ordering patterns towards the end of the calendar year as many of our customers were closing their fiscal years. However, these fluctuations moderated in January.

Sales of aftermarket products through the independent channel were weakest in the Americas and the drivers were very consistent with last quarter. In the US, the oil and gas slowdown continues to be one of the largest headwinds. In some of the most dramatic cases we are seeing year-over-year sales declines of 50% or greater to customers whose sales are heavily weighted toward that industry.

For context, most of our exposure is in fracking, where third-party estimates suggest more than half of the rigs are shut down. These rigs typically have 15 to 25 pieces of equipment with filtration needs, and those filters are changed frequently. While it's difficult to precisely quantify our total exposure to oil and gas given the crossing of specific parts between the end markets, we are clearly seeing the impact of the industry slowdown on our business.

In Latin America, we continue to see a cautious stance based on the economic uncertainty in that region, but we are also comparing against increases in the low 20% range last year. Ultimately, the regional turmoil has not affected our view that this market will be successful over time.

Turning to aerospace and defense, the year-over-year decline of 12% is largely attributable to a decline in defense which benefited last year from a large order of replacement parts. Now Scott will provide some additional detail on both the quarter and our guidance. Scott?

Scott Robinson - *Donaldson Company Inc - CFO*

Thanks, Tod. I'm really glad to be here this morning and I look forward to interacting with many of you over time. After having spent most of my career in Minnesota, I was familiar with Donaldson before joining the Company. This Company has built a reputation for consistently delivering strong performance over a very, very long period of time, and I'm proud to join this management team as we work to continue that trend.

Since joining in December, I have been building my understanding of the business while developing my set of priorities for the future. While I can't commit to being able to answer all of your questions today, I will plan to cover some of these priorities during my remarks. With that, I'll turn now to our second-quarter performance.

Foreign currency translation was once again a significant component of the year-over-year sales decline. Total sales were reduced by 4.5%, and the FX impact was about $2 million more than we forecast.

Given the volatility within our basket of currencies, I want to provide a little more context. The euro, yen and Chinese yuan represent Donaldson's largest currency exposure outside the US dollar. But the dramatic movements happening in currencies where we are less exposed are having an outsized impact on results.

For example, in the second quarter, the value of the Brazilian real declined by almost 40% and the South African rand was down nearly 25%. We transacted about 2% of our sales in these currencies, but the volatility accounted for almost 20% of the total FX impact. I'll talk more later about how this affects the full year.

Dropping to the bottom line, second-quarter GAAP EPS was $0.28, which includes an impact of about $0.01 from charges related to the restructuring and the GPS investigation that concluded in November. Excluding these items, adjusted earnings per share were $0.29 in the second quarter and that compares with adjusted EPS of $0.36 in Q2 last year. Earnings were below our expectation, largely driven by the impact from lower-than-expected sales.

Our operating margin was 10.4% in the second quarter, which included an impact of about 30 basis points in restructuring charges and investigation-related costs. In 2015, our reported operating margin was 11.2%, which also included one-time charges.

For ease of comparison I'll reference adjusted rates during my remarks, which exclude one-time items. For reference, we provide a reconciliation of non-GAAP items within the schedules attached to this morning's release.

The second quarter adjusted operating margin of 10.7% was 130 basis points below last year's rate of 12%, reflecting gross margin pressure that was partially offset by expense control. Adjusted gross margin was 33.2% compared with 34.6% last year.

The under-absorption from a decline in sales volume contributed more than a full percentage point of rate deterioration and the net transactional impact from FX added 70 basis points of pressure. We were able to offset some of these impacts through Continuous Improvement initiatives across the Company.

We are pleased with our expense performance in the quarter. The adjusted expense rate was 22.5%, which was 20 basis points below last year. In dollar terms, this leverage reflects a 12.7% decline in expenses from 2015. We continue to benefit from restructuring actions we've taken and we are closely managing all of our expenses.

In addition to these efforts, our second-quarter expenses also include a reduction in variable compensation expense. A partial offset of this favorability was a year-over-year increase in ERP expense, which reflected go-live efforts in multiple regions of the world.

As a side note on the ERP, successfully implementing this global system is one of my key priorities, and it is critical to Donaldson's long-term success. During the past several months we have gone live in new locations around the world, including China and the Czech Republic. Although the vast majority of our revenue is being transacted through the new system, we still have critical go-live events in front of us.

We are very focused on supporting those locations that have yet to convert, while also developing and enhancing best practices and controls in those sites already on the new system. These efforts position us to move quickly from the implementation to optimization phase after the roll-out is completed later this summer and we are looking forward to turning that corner.

Turning back to the P&L, there were a couple of items that had an offsetting effect on one another in Q2. On one side, we had a better-than-expected consolidated tax rate of 23%, which I will discuss in my guidance update. Offsetting the tax favorability was a higher-than-expected loss on foreign exchange, which contributed to the majority of the year-over-year decline in the "other income" line of our P&L. The gain or loss from FX can vary based on the timing of settlements, though it's not unusual to see volatility in a single period.

Turning to our cash metrics, we generated $30 million of free cash flow in the second quarter, which translated to a cash conversion of about 80%. Improving these metrics is another critical priority of mine. We amplified our efforts to reduce working capital during the quarter, and those efforts resulted in a sequential decline in both receivables and inventory.

The decline in our receivables is a function of target-setting and managed accountability across the globe. By increasing the focus on collections, we expect to see some benefits by the end of this fiscal year.

We also set Company-wide inventory reduction targets. During the quarter we made meaningful progress towards these targets in Asia-Pacific and the Americas and we've started gaining momentum in Europe.

Further strengthening and maintaining a strong balance sheet are critical, especially during the pronounced volatility we have seen in both end markets and financial markets. With a disciplined approach and enhanced focus, I'm confident we can achieve our goals.

As we transition to the second half of the year, we've adjusted the midpoints and narrowed the ranges for total sales and EPS guidance. Full-year sales are now expected to be $2.2 billion to $2.25 billion, or between 5% and 7% below FY15. At the midpoint, this indicates that sales will be lower than our prior guidance by $25 million, with a revised GTS outlook and an increased FX impact accounting for the majority of this change.

We now expect sales of GTS will decline between 20% and 25% from last year, reflecting customer delays across the world, with notable softness in the Middle East and Asia-Pacific. At this point, these delayed projects have not been canceled, but they are moving from this fiscal year to the next. However, given the volatility in this market, combined with a more selective approach to business, I would caution against simply increasing next year's estimates by the deferred amount.

We also estimate the full-year pressure from currency translation is now in the $90 million to $100 million range, representing an increase of $10 million to $15 million from our expectation last quarter. Beyond the revised GTS forecast and FX impact, our sales expectations for the balance of the year are relatively in line with our prior guidance. Our outlook on the end markets is also relatively unchanged, which is to say that we remain bearish about the environment.

At a high level, the continued decline in commodity prices, declining US industrial production and the guidance provided by some of our largest customers, suggest that any snap-back in the near term is very unlikely. It is worth pointing out that we have been experiencing pressure from many of these factors for several quarters now, so these are not new issues.

More specific to our engine business, we expect local currency sale decline between 1% and 3%. The midpoint of that range is consistent with the midpoint of our prior guidance. In terms of off-road markets, we still see revenue declines in ag equipment of 10% to 20%, a 5% to 10% decline in mining and in construction, the flat to down 5% range.

The slowdown in North American class A truck builds will be a headwind to our on-road business, but that has been expected for some time. Our on-road exposures into the medium-duty market and other parts of the world that have shown more stability, including Europe, are offsetting factors.

Sales of aftermarket parts are being influenced by declining utilization of off-road equipment, including oil and gas pressure, which is offset to a small degree by a more stable outlook in transportation. Together, sales to off-road end markets, including construction, agriculture and mining, represent an estimated 75% of our total aftermarket sales. Given utilization in all three is expected to decline, we continue to expect total aftermarket sales will be down this year.

Beyond the GTS revision I already discussed, not much has changed in our industrial segment. We now expect a local currency sales decline between 1% and 3% with low single-digit declines expected in both industrial filtration solutions and special applications.

Our sales guidance also includes an incremental contribution of less than 1% from the acquisitions we closed over the past several quarters, but it does not yet reflect the pending acquisition of the Industrias Partmo acquisition. We have received regulatory approval from the government of Colombia but we are still working with the sellers to complete the remaining closing conditions. We now expect the transaction to close by the end of this fiscal year.

Our operating margin guidance range is tighter but the midpoint of 13.3% is consistent with the prior guidance and about 40 basis points above last year. This improvement reflects continued expense controls and the benefits from our restructuring actions.

Savings from our restructuring actions, which we began about one year ago, are partially offset by other factors in gross margin. The two most notable are the increased sourcing costs overseas, which reduces gross margin by about $12 million, and the impact of lower-than-expected sales.

It's difficult to precisely quantify the margin impact of lost sales but we estimate our decremental gross margins could be in the low 40% range, or 5 to 10 points of deterioration. The variability is largely being driven by the uneven demand across the world. As demand stabilizes, we expect to regain leverage.

Given our first-half adjusted operating margin was 11.4%, we clearly need solid performance in the second half, but a sequential increase is typical of past years as we gain leverage on the seasonal sales pickup. While we are not projecting second-half sales to increase from last year, our forecast reflects a sequential improvement of nearly 11% which we expect to leverage.

We are also projecting a more favorable consolidated tax rate for the full year, with a change of about 50 basis points between the new range of 25.5% to 27.5% and the prior guidance. Projected rate reflects year-to-date performance, the projected mix of global earnings and the future benefit from the past tax act that was approved this past December.

We did not repurchase any shares in the second quarter, driven by our desire to bring our second-quarter leverage ratio of 1.9 times gross debt to EBITDA more in line with our long-term target of about 1.5 times. Our first-quarter repurchase of 1.5% of shares outstanding, combined with our tempered outlook, result in expected full-year repurchase at or below the bottom end of the prior guidance range of 2% to 4%.

I do, however, want to confirm that nothing has changed about the commitment to share repurchases that Donaldson has demonstrated over the past couple of decades. Share repurchase has always been the more variable component of the Company's capital deployment strategy, so we will continue to use our balance sheet metrics as a determining factor when projecting repurchase capacity in any given year.

Altogether, we are now expecting adjusted EPS between $1.51 and $1.61. Our profit projection, combined with the actions we're taking to reduce working capital, lead to a projected free cash flow between $175 million and $225 million, which translates to a cash conversion between 90% and 110%. Now I'll turn the call back to Tod for his closing remarks. Tod?

Tod Carpenter - *Donaldson Company Inc - President and CEO*

Thanks, Scott. As I said last quarter, our Company culture is one where we put our customers first, we execute to our strategy and we look to control what we can control. Given the persistent uncertainty in the end markets and the global economy, our number-one priority right now continues to be operational efficiency which includes cost reduction.

I am proud of the expense discipline we've demonstrated in second quarter, and we have taken actions to further reduce our expenses, including instituting hiring freezes in certain businesses across the world and further reducing planned discretionary expenses for the second half of FY16. To further enhance our operational efficiency, we are conducting a location-by-location review to identify opportunities to flex plant expenses down.

In addition to the actions we are already taking, we are looking across the Company for opportunities to take more costs out, including additional restructuring. While I have no specific plans to announce today, we are prepared to react accordingly if we identify savings opportunities at the business or geographic level. All of the actions we have been taking strike a balance between protecting operating margin without sacrificing future growth, and we will continue to be thoughtful in our approach.

Now I'd like to turn from how we are managing today's environment to our progress for securing future market share and growth. The most critical part of our long-term success will be planting seeds for future growth, which heavily relies on securing first-fit wins with our innovative technology.

We continue to be very encouraged by our success in winning new programs. During the past 12 months, we have won more than 270 new engine air programs and we are winning between 75% and 80% of our self-identified must-win programs. Importantly, more than three-quarters of the must-win programs we have been awarded were won with Donaldson proprietary technology.

PowerCore continues to be the primary example of how we benefit from planting these first-fit seeds. In second quarter, total PowerCore sales were about $42 million, with engine air representing nearly 90% of those sales.

Although PowerCore is subject to similar market dynamics as those I mentioned earlier, including lower levels of equipment production and OE destocking, both first-fit and aftermarket sales had a stronger year-over-year performance than their respective business segments. In fact, aftermarket sales increased about 2%, roughly 10 percentage points better than total aftermarket performance in the quarter.

We also continue seeing a very favorable reception to our first-fit liquid offering, which leverages our high-performing Synteq XP Media. Nearly all of the 40-plus wins we have secured in the past 12 months are incremental to Donaldson, leading to a combined program value that we estimate at more than $300 million over the respective lives of these programs.

Beyond what we have already won, we are actively competing for new wins. The estimated value of this pipeline is more than $1 billion each for both engine air and engine liquid, so we see a significant amount of runway to continue populating equipment with more and better Donaldson products.

A similar story is unfolding in dust collection with Downflo Evolution, or DFE. Our current and prospective customers easily recognize the benefit of a smaller footprint, enhanced performance and reduced maintenance. Following a successful launch in the US last year, we have seen great success as we begin selling DFE worldwide during this fiscal year.

Year-to-date, first-fit sales are five times greater than they were last year and nearly 10% of those sales were generated outside the US. We are also beginning to book sales of replacement parts which is a critical component of the long-term value DFE creates for Donaldson.

These are just a few examples of how we are continuing to press forward with new innovative products to plant seeds for future growth. The continued success of more mature businesses like PowerCore, combined with the brisk start to DFE, gives us confidence that our strategy works.

I am confident that we will exit this tough patch in strong shape just as we have with every other tough cycle over our 100-year history. With that, I'll turn the call back to Suzanne to open the line for questions. Suzanne?

QUESTIONS AND ANSWERS

Operator

(Operator instructions)

Your first question comes from the line of Kevin Maczka of BB&T Capital Markets.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Good morning.

Tod Carpenter - *Donaldson Company Inc - President and CEO*

Good morning.

Kevin Maczka - *BB&T Capital Markets - Analyst*

I'm wondering if we can start on revisiting your comments on the EBIT margin guidance, and the big second-half that is embedded there. We've got, I think, $30 million of incremental restructuring cost take-outs. You have got your normal continuous improvements. You're contemplating now further discretionary spends and hopefully there will be volume leverage.

Can we revisit all these puts and takes? Because again, it seems like an awfully big step-up to assume maybe 300 bps or more sequential in the second half versus the first.

Scott Robinson - *Donaldson Company Inc - CFO*

Sure, this is Scott. I'll start, and then I'll probably get some help for my colleagues here. There's several things impacting our guidance going forward.

The first one I would say is, we do expect increased volume in the second half of the year as compared to the first half of the year. So, we expect an improvement of 11% over the first half and we certainly leverage that volume into increased profitability.

We do have the benefits of our prior cost savings initiatives that you mentioned. And we've done our best to bake those all into the guidance going forward.

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

I'll jump in, Kevin. This is Brad. The other thing, when you think about our expenses for the back half, the second quarter expense dollars is a fair run rate for the back half of the year versus our forecast. So, of course, to Scott's point, we get leverage on the sales increase.

And then to some extent the gross margin improvement comes from leveraging against the sales where, if you remember last year at this time, sales were dropping off faster than we were able to catch with cost. So we expect to increase on top of that where it was depressed in the back half.

Kevin Maczka - *BB&T Capital Markets - Analyst*

How much of the $30 million has already been realized in the first half of the year that would be in the second half run rate versus new savings that are yet to come?

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

It's probably more of an even split. If we look at the restructuring, it started about one year ago, third quarter last year. So we're starting to lap some of the good news but it wasn't much in FY15.

And then with the first-quarter announcement of additional restructuring, I would say that the second and third quarter of this fiscal year are going to be the peak benefits, in the double-digits of millions. And then it will start to tail off a little bit into fourth quarter as we lap the savings.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Got it. And if I could just ask one more. Your gas turbine comments were helpful, but your comment about being more selective going forward, what kind of top-line implications does that have? How should we interpret that? Does that mean you plan to walk away from some business you previously would have accepted that maybe has become problematic? Or how should be view that comment?

Tod Carpenter - *Donaldson Company Inc - President and CEO*

This is Tod. The way to look at this fiscal year is those comments really have no effect to what our guidance is. That's all baked in. We have those projects clearly on our books and we will continue to execute those. Where that comment really plays is as we give future guidance for next year, as we become more selective with the projects.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Right. But you've got, it sounds like, price sensitivity as an issue here. Maybe you have some customers that are getting more aggressive on that front, I'm not sure. But then being more selective and walking away, in future years, that would imply that you're not going to have the same top-line outlook that you otherwise would have.

Tod Carpenter - *Donaldson Company Inc - President and CEO*

No, it's a growing market across the world because gas turbine, the longer-term outlook, is very positive. We definitely, in this particular environment, have a price sensitivity, there's no question. But as we look longer term, and draw that line, if you will, over a period of years, we have moderated definitely our growth rates. But we look to improve our mix, and therefore the profitability, and really make sure that we can focus hard on the aftermarket aspect of that rather than just always take one-off first-fit projects.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Okay, makes sense, got it. Thank you.

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

Thank you.

Operator

Your next question comes from the line of Eli Lustgarten of Longbow Securities.

Eli Lustgarten - *Longbow Research - Analyst*

Thank you. Good morning, everyone, and welcome Scott.

Scott Robinson - *Donaldson Company Inc - CFO*

Thank you.

Eli Lustgarten - *Longbow Research - Analyst*

Can we talk a little bit -- during Tod 's initial commentary and the tone of the presentation, you talked about a dour outlook from several customers in the last several weeks. Can you give us some flavor, it doesn't matter who the exact customer is there, but some idea.

Are we talking about was it in construction? No pick-up in the second half or down from the 5%, does ag take a step down? Can you give us some color of what that means versus expectations? Because that was a very noticeable change.

Tod Carpenter - *Donaldson Company Inc - President and CEO*

We've baked in -- and you heard that within Scott's remarks relative to our expectations across those markets, Eli, like ag, construction, mining. Specifically we talked about ag being down 10% to 20% year over year, construction down roughly 5% and mining taking another step down. It really reflects the fact that mining is stepping down after people across the world have really called bottom, at least three times prior. And you see that across our customer base. The Caterpillar recent announcement suggests now they will be down 10%, Deere 10%, and it really goes across all of those off-road segments, is really what we're referring to there.

Eli Lustgarten - *Longbow Research - Analyst*

Is it a definite change from your expectation at the beginning of the year? We're not sure that those declines are enough at this particular point, particularly in the ag. Deere's walking the numbers down is what appears to be happening. But is there a noticeable change as we turn the year or is it pretty much on the margin at this point?

Tod Carpenter - *Donaldson Company Inc - President and CEO*

The numbers I just quoted, Eli, are the same numbers we gave in the first-quarter call. So there's not a huge noticeable change in the way that we are looking across our business. But we do want to call out the fact that our customers are, as you say, walking it down a bit and we're cognizant of it.

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

Eli, this is Brad. I would add to that, though, that the customer outlooks and remarks are reflective of the environment we've been living, up to the point they made those remarks. So there's an element here of -- these are business environments that we have been experiencing for some time. I don't want to unintentionally signal that there's a big change in stance by the comment that Tod made about dour outlooks, as much as it's reflective of what we've been living.

Eli Lustgarten - *Longbow Research - Analyst*

Can we talk a little bit about what's happening in pricing across the industry? Or how much is pricing down in the various sectors? And where are you in inventory liquidation versus what you think your customers are in inventory liquidation?

The surprise revision in GDP in the fourth quarter, is that inventories weren't cut as much as people wanted them to be and it's going to affect the first half. So, can you give some idea of what's going on in pricing and what's going on in inventory, both for the Company and the customers?

Tod Carpenter - *Donaldson Company Inc - President and CEO*

Sure, this is Tod. Pricing overall at a macro level for the Corporation, has really not changed, Eli. As you know, we have long-standing contracts for our OEs that require price downs on an annual basis. On the aftermarket we control opportunities within pricing and we take those opportunities wherever we can.

Certainly, in areas like Brazil and South Africa, we are currently taking pricing actions and raising pricing in order to offset the economic headwinds that we have, being an importer into those countries. We certainly are doing that, but overall, macro-level across our engine business, it's really net zero still.

Some of the other businesses I didn't mention, GTS, we are seeing a more aggressive stance by our OEs on project awards. That's general about the atmosphere.

From an inventory standpoint, we saw an inventory destocking event, I would say, clearly, in December, across our off-road channels. But it did moderate in January and I think that's where we stand at the moment.

Eli Lustgarten - *Longbow Research - Analyst*

And one final question. You talked about the new wins that you had, and the billion dollars that still -- a lot of runway, but those are over the life of the contract. How many years -- is that typically over a ten-year period or a longer period? Can you give us some idea of how many years when you win wins, does this really provide increment a revenue?

Tod Carpenter - *Donaldson Company Inc - President and CEO*

It's 10 years, Eli. Yes. And many of those programs will go longer but we just metric ourselves to 10 years and we cut it off there. The numbers that I referenced will be over 10 years.

If you want to calendarize that, typically a project starts, you can see revenue two to three years out. It will peak in years three and going out to the end of its life but that's where the aftermarket really kicks in, as we continue to populate those first-fit vehicles out there, it kicks in pretty strongly around year four or greater.

Eli Lustgarten - *Longbow Research - Analyst*

Thank you very much.

Tod Carpenter - *Donaldson Company Inc - President and CEO*

Thanks, Eli.

Operator

Your next question comes from the line of Brian Drab from William Blair.

Brian Drab - *William Blair & Company - Analyst*

Good morning. Could we talk about the restructuring? I want to make sure that I have these numbers right. We have two phases of restructuring, one from last year that was of $35 million total -- and please stop me if I get off track here -- with $35 million total, and with $30 million incremental coming in FY16.

And then we have the second phase, which began and was the actions, I think, were largely completed in the first quarter of 2016. That's going to result in a $25 million in annual savings with about $18 million, or three-fourths I believe you said, of that being realized in 2016. Is that all correct?

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

Brian, this is Brad. Yes, you have got the numbers right.

Brian Drab - *William Blair & Company - Analyst*

Okay. So if I think about it, first of all, in terms of year-over-year incremental savings in a quarter, this year, you've got from last year's program, $7.5 million or so per quarter. The next phase of saving, $6 million per quarter, so like $13 million or $14 million per quarter in savings. And that's correct?

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

You're in the ballpark on average. I would say the nuances -- you take the $30 million -- and remember that's ratable over the first three quarters, and then we start to annualize the benefits from last year. So that shrinks a little bit. And then to the point you made, the first round was essentially done at the end of the first quarter. So that's through the three quarters of this fiscal year. But you're in the ballpark.

Brian Drab - *William Blair & Company - Analyst*

Okay, thanks. The second phase, that was completed essentially at the end of the first quarter, so the incremental $6 million per quarter, did we get that $6 million per quarter in the second quarter?

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

Yes, a lot of it was related to headcount reduction, so I think that we were definitely in that ballpark. To be perfectly fair, there were certain actions that may be completed in week two or week three of November, or things like that. But by and large, we were done by the end of the first month of the quarter.

Brian Drab - *William Blair & Company - Analyst*

Okay. I'm just wondering then, as I look at the SG&A line, in the first-quarter 2016 it was $112.5 million -- these are adjusted numbers -- $112.5 million. Then it stepped up to the second quarter, $115.5 million. I'm trying to reconcile that step-up in SG&A sequentially with the incremental $6 million in cost savings.

And then also, a sub-question to this one is, Brad, you mentioned this SG&A level is a reasonable expectation in terms of absolute dollars for the balance of the year. First of all, why wasn't that lower in the second quarter? What number are you talking about when you say that it's a reasonable expectation for the balance of the year?

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

I was talking about second quarter. I'd have to check your adjusting math just to make sure we're talking about apples to apples, because of course there were a lot of charges in both this year and the last fiscal year.

But one point on second quarter is that we typically do our option expense in second quarter, and that's true every year. So if you're looking at run rate from first to second quarter, that jumps up by a few million dollars this year.

Brian Drab - *William Blair & Company - Analyst*

Yes, okay. I didn't know was option-related. I wanted to see if there any other moving parts. So that's a few million in options?

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

That's correct.

Brian Drab - *William Blair & Company - Analyst*

Okay. And I wanted to clarify, too, on the FX, with the dollar weakening a little bit since we heard from you in the last call in November, do I understand correct that the incremental FX headwind incorporated in the guidance is really driven by non-euro-dollar rates and that's offsetting maybe even a slight tailwind related to the euro-dollar?

Scott Robinson - *Donaldson Company Inc - CFO*

Yes, that is correct.

Brian Drab - *William Blair & Company - Analyst*

Okay.

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

And the yen as well.

Brian Drab - *William Blair & Company - Analyst*

Sorry?

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

The yen as well. Slight tailwind.

Brian Drab - *William Blair & Company - Analyst*

Got it, thanks.

Scott Robinson - *Donaldson Company Inc - CFO*

Thank you.

Operator

Your next question comes from the line of Matthew Paige of Gabelli & Company.

Matthew Paige - *Gabelli & Company - Analyst*

Good morning, guys, thanks or taking my call. Could you provide any additional color regarding the slowdown that you're seeing in heavy duty on-road orders?

Tod Carpenter - *Donaldson Company Inc - President and CEO*

This is Tod, Matthew. At this point, in the on-road sector, we have not seen a marked slowdown. You see an increase year-over-year through the first half for us. We're up 6%. We have, however, baked into our guidance an expected downturn in the second half within on-road.

Matthew Paige - *Gabelli & Company - Analyst*

Okay. We're now about a third of the way through third quarter. Could you speak to any the trends that you're seeing now compared to where they were exiting the second quarter?

Tod Carpenter - *Donaldson Company Inc - President and CEO*

We're only one month through our third-quarter. Our fiscal, remember, is July. So February would be the first month and we don't have any comment on that at this point.

Matthew Paige - *Gabelli & Company - Analyst*

Okay. I appreciate your time and good luck in the quarter.

Tod Carpenter - *Donaldson Company Inc - President and CEO*

Thank you.

Operator

Your next question comes from the line of Charlie Brady of SunTrust.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Good morning, guys. I want to talk about -- make sure I heard you correct. You're expecting an 11% sequential increase in revenue, Q3 over Q2?

Scott Robinson - *Donaldson Company Inc - CFO*

That is correct.

Tod Carpenter - *Donaldson Company Inc - President and CEO*

Second half versus first half.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Sorry, second half versus first half, okay. Could you get more granular on what your expectation would be between the two segments? I'm trying to understand -- it seems your full-year guidance versus your second-half guidance -- how that's really breaking out.

Because the aftermarket continues to slip and the -- particularly on the engine side it sounds as though that market continues to weaken and gas turbine now is a bit softer. Is industrial filtration getting a little bit better, or leveling off sooner than you thought it was?

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

This is Brad. Gas turbines, we are actually forecasting to be up in the second half and that's contributing to the sequential increase. With regard to the engine businesses, recall last year, we were lapping a pretty sharp decline that began in the third quarter and continued into the fourth quarter. So to some extent, this is a year-over-year compare.

The industrial filtration, since you brought that up specifically, I would add that we said low single-digit declines, which is -- and we made the comment in the remarks that we're generally in line, in the industrial businesses, with prior guidance. The biggest change there was GTS-related.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Okay, all right. Sorry, were you going to say something else?

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

No.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Can you talk about commercial aerospace as that mix of defense? What up-ticks are you seeing in that part of that business?

Tod Carpenter - *Donaldson Company Inc - President and CEO*

This is Tod. More of a flat business is what we projected throughout the balance of the year. The reason that you have down in the first half is, we had ground-based vehicle in the defense side, had a spares order that was rather large last year. That is not in our first half this year and that's the reason why you get that down-tick. As we look forward, we have the business flat for the year.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Okay, thank you.

Operator

Your next question comes from the line of Richard Eastman from Robert W. Baird.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

Good morning. A couple things I wanted to try to clarify. In the guidance on the engine mobile side of the business -- actually, on the industrial side of the business -- your guidance is core growth of minus 3% to minus 1%. You have got IFS low single-digits, you got special apps down low single-digits and you got gas turbine down 20% to 25%. How does that actually weight out to that number? Or are you basically looking at -- is your guidance against the reported sales number?

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

The down 1% to down 3% is local currency. So there is a mixed within. GTS last year was just under $190 million, special apps is something south of that, $160 million, $170 million. Our IFS business is clearly the biggest one.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

That's in reported dollars then?

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

Oh, I'm sorry, I misunderstood. Yes, the comments are in dollars, not in local currency. I apologize, Rick, sorry.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

Okay. And the same holds true. When you made your gas turbine comment about the second half is up over the first half but the second half can't possibly be up year over year. Correct in gas turbine?

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

Correct.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

Correct. Your reference was to the 11% sequential improvement in the second half over the first half. But gas turbine will be solidly down year over year in the second half.

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

Yes. This is Brad. Yes.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

Okay. Tod, when you look at the overall business -- and I think everyone on the call understands that you're planning horizons are pretty short with the nature of your business -- but what is your sense when you look at the segments in the business, or even just engine mobile versus industrial, which of these businesses do you feel bottoms first? What are you looking at as maybe an early indicator that we can start to see some growth in our business when we look out 6 to 12 months from where we're at today?

Tod Carpenter - *Donaldson Company Inc - President and CEO*

Rick, the way I look at this is, the early indicator will come that we've bottomed in our aftermarket businesses. You'll start to see platform utilization across our markets improve. Our aftermarket business will stabilize and then start to pick up.

That in turn will then give confidence to the OEs to start to increase production. So, I really look for the aftermarket segments across Donaldson Company to be the first early indicator that we've turned the corner.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

I see, okay. And then, one last question. Geographically in the quarter -- disregarding FX and the surprise there on the op profit side -- any of the geographies surprise you in the fiscal second-quarter year over year on the negative side? Or positive side?

Tod Carpenter - *Donaldson Company Inc - President and CEO*

I would say the surprise for us would probably be South Africa. The pullback in South Africa was pretty strong and the behavioral characteristics changed within that geography to the negative rather rapidly. Beyond that, I would say not really.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

And South Africa is exposed more on the engine mobile side?

Tod Carpenter - *Donaldson Company Inc - President and CEO*

That's correct. Specifically into the mining sectors.

Richard Eastman - *Robert W. Baird & Company, Inc. - Analyst*

I see, okay. Thank you.

Tod Carpenter - *Donaldson Company Inc - President and CEO*

Thanks, Rick.

Operator

And your next question comes from the line of Brian Drab of William Blair.

Brian Drab - *William Blair & Company - Analyst*

Okay, sorry. First, let me ask one -- Rick was just asking about gas turbine seeing solidly down year over year. I don't know if we're just rebuilding the model here now but the midpoint of your guidance suggests, I think, about $88 million in gas turbine in the second half of the year. And you did $92 million in the second half of last year.

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

You are in the ballpark on this year. I would say that last year, don't forget that we had the revision so the last year comparison reflects the movement of some gas turbine revenue from second quarter of FY15, largely into third quarter but also a little bit into fourth quarter of FY15.

Brian Drab - *William Blair & Company - Analyst*

(multiple speakers) -- you raised your back half guidance

THOMSON REUTERS

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

Yes, as a baseline, correct. So when we said down 20% to 25% that reflects the restated LY.

Brian Drab - *William Blair & Company - Analyst*

Okay. That just didn't feel like solidly down, right, if you're down $4 million. At the midpoint of your guidance, 22.5% down year over year, that translates to down just a few million for second-half over second half. Okay. I'll look at those adjustments.

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

We are down. You'll have to move $8.4 million into the second half but you'll have to decide what solidly means.

Brian Drab - *William Blair & Company - Analyst*

Okay, I've got to review the moving parts, I guess. And then on that second phase of restructuring that you implemented in the first quarter of this year, have you told us what the breakdown between what's coming out of COGS and was coming out of SG&A is?

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

What was the first part?

Brian Drab - *William Blair & Company - Analyst*

How do you break down the cost savings, this $25 million annual cost savings that you're driving with the actions in the first quarter? How do you break that down between cost savings within cost of goods sold and within SG&A?

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

We haven't precisely provided that, Brian.

Brian Drab - *William Blair & Company - Analyst*

Even roughly, you can't give us a sense?

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

Well, it's in our guidance. The run rate of what I gave you for the back half of this fiscal year -- if you look at the year-over-year improvement in the back half, about half of it's coming from gross margin and about half of it's from OpEx.

Brian Drab - *William Blair & Company - Analyst*

Okay, thanks, Brad.

THOMSON REUTERS

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

Sure.

Operator

(Operator instructions)

Your next question comes from Larry Pfeffer at Avondale Partners.

Larry Pfeffer - *Avondale Partners - Analyst*

Good morning, gentlemen.

Tod Carpenter - *Donaldson Company Inc - President and CEO*

Good morning.

Larry Pfeffer - *Avondale Partners - Analyst*

Just looking at the sequential trends again into the second half of the fiscal year, on a local currency basis, are you looking at aftermarket engine being up year over year in the fourth quarter?

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

Sorry, what was that?

Larry Pfeffer - *Avondale Partners - Analyst*

Yes. Looking at the implied guidance for aftermarket engine and getting into the fourth quarter, would you expect local currency to be up year over year?

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

Yes. I think it'd be in the ballpark. Again, we haven't provided precise segment-level guidance but obviously we're comparing against a pretty sharp drop last year both in FX and dollars.

Larry Pfeffer - *Avondale Partners - Analyst*

Right. And so, if you were to look at it by end market right now, looking at the comparables in on-road and with the different segments in off-road, how do those pieces trend as we move from the second quarter into the back half? Are you seeing less negative rates in off-road aftermarket at this point, and that's what's giving you more confidence that you're going to get that improvement?

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

Yes. Off-road and aftermarket will see more sequential improvement. But I do want to point out that last -- this is Brad again -- I want to point out that the seasonality that we saw last year between first half and back half, the year was split almost 50-50 across the total business which is very, very unusual for our normal seasonality. In fact, you'd have to go back to the recession before you find another split like that. So, to some extent, the aftermarket and the OE forecast that we had in guidance are reflecting a normal seasonality. And then obviously the compare is a bit noisy as well.

Larry Pfeffer - *Avondale Partners - Analyst*

Got you. very helpful, Brad. Changing gears a little bit, the acquisition front -- I know we haven't touched on at all on this call -- how the pipeline looks at this point and what you're guys' strategic plans are into the back half of fiscal year and into 2017.

Tod Carpenter - *Donaldson Company Inc - President and CEO*

This is Tod. Industrias Partmo, as we had commented, is in flight and we have announced that. We look to close that in the fourth quarter of this fiscal year.

Beyond that, we continue to focus on acquisitions with the pipeline. I would characterize our pipeline as robust, strategic, however selective and making sure that we will continue to remain disciplined in our approach.

The metrics that we use for that discipline are an acquisition adding to the Company would be accretive in year 2. And we have a target of 15% ROI by year 5. There's no change in our behavior on the acquisition front.

Larry Pfeffer - *Avondale Partners - Analyst*

Okay. Thank you very much, gentlemen.

Tod Carpenter - *Donaldson Company Inc - President and CEO*

Thank you.

Operator

There are no more questions in the queue at this time. I turn the call back to the presenters.

Tod Carpenter - *Donaldson Company Inc - President and CEO*

That concludes today's call. I want to thank everyone for their time and interest in Donaldson Company. I also want to thank our employees for what they do every day to support our customers. Thank you and goodbye.

Operator

And this concludes today's conference call. You may now disconnect.
