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PRESENTATION

Operator

Good morning my name is Blair, and I'll be your conference operator today. At this time I would like to welcome everyone to Donaldson's third quarter FY16 conference call.

(Operator Instructions)

Brad Pogalz Director of Investor Relations, please go ahead.

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

Good morning, everyone. Welcome to Donaldson's third quarter 2016 earnings conference call. I'm joined today by Tod Carpenter, Donaldson's President and Chief Executive Officer; and Scott Robinson, Chief Financial Officer. This morning, Tod and Scott will discuss third-quarter performance, review our outlook, and provide an update on some of our strategic initiatives.

Before turning the call to Tod, I want to remind all of you that we provide supplemental schedules on our Investor Relations website that show the year-over-year sales change with and without the impact from currency translation. And the impact of certain adjusting items on gross profit and operating expense. 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 & CEO*

Thanks, Brad. Good morning everyone. The net effect from several moving pieces last quarter resulted in top and bottom line performance that matched our forecast. Scott and I will elaborate on the largest of these drivers, and later in the call I will provide an update on some of our strategic and operational initiatives, including a little more context on the most recent round of restructuring.

Turning now to the top line, total sales for the quarter were $571 million, reflecting a strong sequential increase of 10% from last quarter, and a decline of roughly 1% from last year. In local currency, our third-quarter sales were slightly above last year.

At a high level, our high engine segment ended a little short of forecast, while industrial was a little ahead. In aggregate, our business is showing more signs of stability that we have seen in well over a year and while we are not ready to call "bottom", given this protracted period of volatility, we were pleased with our overall performance in the quarter.

As I walk through segment performance, I want to focus first on those areas that showed some variability with our forecast in order to highlight business trends that are not as obvious in the reported year-over-year changes. Currency translation was one of the moving pieces that affected both segments in the quarter. After unexpectedly high pressure from FX in second quarter, the Q3 negative impact of $5.5 million was roughly $5 million less than expected.

Digging into the segments, we saw changing market conditions in a few of our businesses. Note that I will be primarily referencing local currency results when speaking to the year-over-year percent change.

Starting with engine, the 2% decline was primarily driven by our first fit businesses, while sales in both on and off road each declined about 20% from last year, their individual performance versus forecast was quite different. In On-Road, we saw as steeper-than-expected decline as growth outside the US and continued strength of the medium duty productions was not enough to offset the slowdown of class [8] truck production.

In the US, On-Road sales were down more than 35%, whereas sales through the first ever you were up nearly 5%, reflecting the shift in this highly cyclical business. As we have said all year, the question has been when, and to what extent, pressure from declining US heavy-duty truck production would effect this fiscal year versus the next.

External data suggest the recent step down in our results is likely to continue as we move through the balance of the fiscal year. Specifically, when we have mapped monthly third-party data to our fiscal calendar, year-over-year production rates of class 8 trucks experienced a sharper decline in our third quarter than prior quarter and external data is now forecasting a further decline during our fourth quarter.

On the other side, sales favorability versus our forecast in Off-Road partially offset this pressure. We have not yet seen a meaningful change in end-market conditions, but sequential deterioration has moderated over the past few quarters. Overall, the equilibrium between our forecast and customer demand is encouraging given the volatility in this business over the past several years.

Within our industrial segment, stronger-than-expected sales of GTS replacement filters were largely offset by weakness in disc drives, which represent about half of Special Applications' sales. Our disc drive businesses in a well-documented secular decline as solid-state memory replaces traditional hard disc drive, but the pace of the decline accelerated in the past quarter, and resulted in a shortfall versus our forecast. As I said earlier, the net effect from these puts and takes was that we ended the quarter a little short of forecast in engine and a little ahead in industrial.

Beyond these business drivers, I want to highlight sales performance of replacement parts. Growing aftermarket is a critical part of our strategy, and we were pleased to have picked up some nice momentum last quarter. On average, sales of replacement parts account for about 55% of total revenue with Engine and about 70% and Industrial around 35%.

In third quarter, more than 60% of our revenue came from replacement parts, reflecting an above average mix in both segments and an aggregate increase over last year in the high single-digit range. In Engine Aftermarket, was saw strong sequential performance and an increase of 5.6% from last year, reflecting year-over-year improvement in both distribution channels. Sales through the OE channel, which represent roughly 40% of Aftermarket, increased in the high single-digit range from last year. Recent performance suggests a possible end to the destocking events we have been discussing for more than a year but erratic ordering patterns on a week-to-week basis and our customers' ongoing working capital initiatives keep us cautious.

Aftermarket sales through our independent channel also increased from last year, albeit at a more modest rate. We believe this year-over-year improvement is more a function of last year's volatility than it is an indicator of improving market conditions.

For example, sales of aftermarket products are typically weighted towards the back half of the fiscal year, but the saw a 50-50 split last year. This year, third-quarter results reflected a more normal seasonality. While this performance gives us some encouragement, our customers are maintaining a very cautious stance in light of the uncertainty in the markets.

In our Gas Turbine business, aftermarket sales increased dramatically, driven in part by a softer comparison from third quarter last year, however, our proactive approach to managing the replacement cycle with current and potential customers also contributed a meaningful portion of this increase. Finally, sales of replacement parts in our Industrial Filtration Solutions business grew about 15% from last year. Here again, the sales team is proactively managing the replacement cycle, which helps bolster results during the period where expenditures on new first-fit equipment remain somewhat stagnant.

Now I'll turn the call over to Scott for a walk-through of our other operational metrics and guidance. Scott?

Scott Robinson - *Donaldson Company Inc. - CFO*

Thanks Tod. Good morning, everyone. As I close out my first six months at Donaldson, I'm very proud to join have joined this team and company. During my short time here I have had the chance to engage with our teams here in Minnesota and throughout the world. Across the company, our employees are focused on delivering results while being resilient during these uncertain times. Both attributes will be critical as we finish this year and move into FY17.

Turning now to our third-quarter performance. The theme of "moving pieces" existed throughout the P&L. I'll start by elaborating on top line impact from currency translation.

As Todd said, the impact of FX translation was about $5 million less than expected. This favorability versus our forecast was primarily driven by appreciation of the euro, but we also saw some recovery in other currencies. For example the Brazilian real strengthened by about 10% after a dramatic weakening earlier this year, and the Japanese yen continue to gain versus the dollar. I'll discuss the net effect on full-year guidance in a few minutes.

Moving down the P&L, the recent round of restructuring resulted in a charge during the third quarter of $4.1 million of roughly $3.3 million in operating expense, and the balance in gross margin. We also had restructuring charges last year of $5.2 million.

For ease of comparison, I will exclude these charges from my discussion of operating profit. For reference, our press release includes a reconciliation of GAAP to non-GAAP measures.

Our third-quarter adjusted operating margin was about 120 basis points better than last year and more than 3 full percentage points better than the prior quarter. This sequential improvement was split fairly evenly between gross margin and expense rate, as absorption on increased volume, restructuring benefits, and other cost controls allowed us to leverage a 10% sequential sales increase.

Compared with last year, adjusted gross margin improved by about 20 basis points, to 34.6%. The improvement was driven largely by overall business performance and mix, but lower-margin GTS products offset a portion of these benefits. We were very pleased with our expense performance in the quarter, which continues to reflect our discipline and the benefits from restructuring that was implemented over the last 12 months.

Excluding restructuring charges, third-quarter expenses were a little more than $118 million, which translated to a year-over-year decline of about 90 basis points. Within that amount is a charge of about $2.2 million related to the reversal of a subsidy benefit we had been recording in China.

For context, we entered into a six-year agreement that began in January 2014 which provided us subsidy based on achieving certain criteria, including a target average growth rate. Sales during the first two years of the subsidy agreement were below this target. Our third-quarter performance, combined with initial projections from our planning process, suggest this calendar year will also be below the target. With this level of performance, the growth we would need to achieve during the second half of the agreement appears unrealistic given that we felt it was appropriate to reverse the accrual at this time.

This charge was offset by a lower-than-expected tax rate of 24%, which included a benefit of 4.2 percentage points from the favorable settlement of tax audits. Altogether, we delivered GAAP EPS of $0.41 in the quarter, which includes an impact of $0.02 from restructuring charges. Excluding that, adjusted EPS was in line with our expectations of $0.43.

Turning to our balance sheet and cash flow metrics, I am pleased with the progress we're making to appropriately manage the balance sheet. Earlier this year, each region was assigned an inventory and receivables target that was based on improvement versus first quarter. Compared with this benchmark, global inventory is down almost 6% as we continue gaining momentum across the world.

At a reported level our AR position is essentially flat to Q1 but aged receivables and the number of days sales outstanding are down as we improve collections. The increasing strength of our balance sheet resulted in a cash conversion of almost 140% last quarter, well ahead of our recent run rate and also pulling our year-to-date rate over 100%.

Turning to the full-year guidance, our expectations for top and bottom line performance is consistent with the midpoints of our prior guidance, but there are a few adjustments I'd like to call out.

Starting with the top line, we expect to deliver about $2.225 billion of revenue, which is roughly 6% below FY15. As of today, we expect a negative impact from currency translation of about $80 million but keep in mind that FX rates have been very volatile. Recall that we began the year estimating an impact of $85 million and then increased that by $5 million to $10 million last quarter, only to reduce it again today.

The expected tailwind from translation is being offset by net pressure within the business. Excluding currency, sales in both segments are forecast to decline about 3% from last year, which is at the lower bound of the prior guidance range.

In engine, On-Road declines are expected to continue through at least the balance of the fiscal year. The recent trends in Off-Road are encouraging as is a return to a more normal seasonality in the aftermarket. But these are not enough to offset lower production of class 8 trucks.

The small change to our aerospace and defense guidance reflects a slowdown of helicopter production due to the repurposing of military equipment for commercial use. With this slowdown we no longer expect growing sales of commercial aerospace products.

Within the industrial segment, the guidance change is entirely due to the accelerated decline in disc drives, which was partially offset by GTS. As Tod mentioned, third-quarter sales of GTS replacement parts were very strong and we expect that to continue. Consequently, full-year GTS sales are now projected to be down 20% versus a decline of 20% to 25% before.

Our full-year adjusted operating margin is forecast between 12.9% and 13.3%. The midpoint of this range is down about 20 basis points from the midpoint of our prior guidance. We do expect some benefit from recent restructuring, but the China subsidy reversal and a mix impact from our changes to our sales forecast resulted in a net operating margin decline.

In terms of other metrics, we increased our forecast for the full-year interest to about $21 million, reflecting a slower level debt pay down than originally anticipated. Favorability from this quarter's tax elements more than offset this impact and we now expect a full-year effective tax rate between 25% and 26%.

These factors, combined with the repurchasing up to 2% of the outstanding shares results in adjusted EPS of $1.53 to $1.59. The midpoint of this range is consistent with prior guidance but we now see GAAP EPS been $0.09 lower than adjusted, when you factor in year-to-date restructuring charges and investigation related costs.

Outside the P&L, we increased our estimates of free cash flow and cash conversion due in part to our efforts to reduce working capital. Including full-year capital expenditures of about $80 million, we estimate free cash flow will be $200 million to $230 million, which translates to cash conversion between 100% and 115%.

Given all the moving pieces across the business, we thought it may be helpful to also provide some perspective on FY17. Keep in mind that we are still working through the planning process. So my comments and my answers to any questions will stay at a very high level. Of course, we will provide more detailed guidance when we release fourth-quarter results in a few months.

In terms of market conditions, there are no early indications within our business, third-party data, or customer forecasts that suggest a meaningful improvement is on the horizon. We are going to plan cautiously. We'd be prepared to meet additional sales demand should there be an opportunity, but we feel that a cautious approach makes the most sense in this environment.

In terms of profit metrics, there are a few items worth highlighting. First, in FY17 we expect to realize about $12 million of incremental restructuring benefits from the actions taken in FY16. Second, variable compensation expense will increase as we reset the planned targets for the new fiscal year. We have yet to finalize the numbers, but the year-over-year headwind could be in the $17 million to $20 million range.

Third, we expect completion of our ERP implementation this summer to benefit our expense run rate by a few million dollars. However, depreciation related to the system, and investments in optimization will likely offset the majority of any year-over-year benefit.

Finally, we expect the tax rate to be at a more normalized level. This year's discrete items and the favorable mix of earnings between tax jurisdictions contributed to a rate below what we would expect over the long term.

Beyond the specific metrics, the priorities of expense controls, capital deployment, and maintaining a very strong balance sheet will remain unchanged. I am proud of the momentum we have gained in reducing our working capital needs and that will continue to be a focus of mine in the coming year.

Now, I'll turn the call back to Tod. Now we will take your questions.

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

Tod for closing remarks.

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Thanks Scott. Within our business, we are seeing pockets of strength and stability but continued uncertainty in certain markets make us hesitant to call "bottom." Given the uncertainty, we took action during the quarter to further reduce our cost base through restructuring.

Across the globe, Donaldson leaders identified opportunities to cut about $8 million of expenses out of their respective businesses. We believe these actions better position us for the future by protecting operating margin, while maintaining the structure to support growth. In terms of driving growth, developing, launching, and expanding our innovative product offerings remains at the core of our long-term strategy.

PowerCore is the most mature example of our strategy in action. Year-to-date sales of PowerCore in the Engine segment were just over $120 million which represents about 20% of total sales of engine air products. Despite being subject to the end market volatility, sales of PowerCore are up almost 3% for the year as we continue to benefit from increasing replacement on the first fit and higher retention rates in the aftermarket.

We expect similar dynamics will play out with our liquid offering, as challenges related to high fuel injector pressures and bio diesel fuels demand more advanced filtration. Our Syntec XP media addresses these challenges and it has contributed to our ability to win first-fit programs. Over the past 12 months, we have won more than 50 new engine liquid programs that will generate hundreds of millions of dollars in revenue over their respective ten year lives. Beyond these wins, we see a large pipeline to continue gaining share of the first-fit market, which will contribute to aftermarket growth in the replacement cycle.

I also want to touch on a couple of examples within the Industrial segment where our technology is contributing to growth. In our dust collection business, Downflow Evolution, or DFE, delivers similar customer advantages as PowerCore. The technology enables comparable performance with a smaller footprint and the innovative design will lead to increased aftermarket retention.

We launched DFE in the US about 18 months ago and our year-to-date sales are triple what they were at this time last year. To build on the success in US, we made DFE a global product.

We began selling the product in Asia-Pacific at the beginning of this year and third-quarter sales in that region were more than double the sales during the first half of the year. We have also generated sales in Latin America, as we continue to expand the availability. Although the product is still early in its life cycle, the positive response to the first-fit offering makes us optimistic about our aftermarket opportunities once we enter the replacement cycle.

Another area where we are leveraging our technology is within our Integrated Venting Solutions business, or IVS. Although IVS is a small portion of our Special Applications business today, it has been growing very nicely. So far this year, we have generated growth in mid-teens, compared with 2015, making IVS one of our strongest year-over-year performers.

As we look to offset the impact from the declining disc drive market IVS opens new markets for us such as automotive, consumer electronic, and medical devices. For example our automotive vents can be used to protect the electronics, powertrain, and lighting systems on any vehicle, including passenger cars. We are excited about the prospects with IVS so we are continuing to look for new ways to apply this technology.

Across our company, we are controlling those things under our control. Given the uncertainty in the market, we are taking action to improve operational efficiency while at the same time pursuing opportunities to further leverage our technology. I am confident that our actions position us well for future growth.

With that, I'll turn the call back over to Blair to open the line for questions. Blair?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Laurence Alexander, Jefferies.

Laurence Alexander - *Jefferies LLC - Analyst*

Good morning, a couple of questions. First, can you help give us a sense of how you think your trends this year are doing compared to your end markets? That is, to what degree are the results that we're seeing benefiting from market share gains?

Secondly, the comment about the normalized taxes for next year -- do you think a 200 or 300 basis point year-over-year increase is too much? Or is that roughly the range that you're thinking of? And lastly, if you could just speak a little bit to how you think about operating leverage to a volume recovery if it does start to show up in the back half of next year?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Laurence, I'll start. This is Tod. With regards to market share gains, we believe that, particularly in our aftermarket organization, we have been winning market share. And therefore we are outperforming the end markets. And we see our strategic initiatives there, such as strengthening our distribution channels by adding more distribution partners globally, by broadening the base of our product portfolio, and offering that more globally as working throughout both the engine and the industrial portions of our Company.

So we believe that we are outperforming the overall end markets -- both in Industrial and Engine, particularly in the replacement cycles. When we win the OE side of business of course, that takes some time to come through when those programs are launched. And that could be as much as 2 to 3 years before we see any of that revenue. So while we continue to win, we're very pleased with our win rate on the first-fit cycle that really has not shown overall within our business.

Maybe I'll turn the tax comment question over to Scott

Scott Robinson - *Donaldson Company Inc. - CFO*

Sure. So we had an unusually low tax rate this quarter, due to the settlement of some tax audits. So we would not expect that sort of tax rate to continue in the future. So I think you said 2 to 3 basis points in increase, and we would consider that to be a reasonable proxy for the future.

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

And then as far as operating leverage, as we look forward within our model, typically we look within an operating margin to get somewhere in the neighborhood of 10 to 30 basis points of operating leverage as we see our company grow. Now to what degree that normalcy will return will clearly depend upon the end markets. But that's the way that we view it to be able to leverage in the out margin

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

Laurence, this is Brad. One thing I'd add to that, just doing the shorthand for decremental margins year-to-date, clearly the restructuring benefits are coming in and obviously we're able to leverage some of the sales. So I think to the extent that sales normalize, there's opportunity on gross margin as we see volume from that.

Or even just a more stable environment - the volatility last year was very difficult to manage, simply from a cost of production standpoint. So obviously, if we get a more stable level at any level that would help us too.

Laurence Alexander - *Jefferies LLC - Analyst*

Thank you.

Operator

Charlie Brady, SunTrust Robinson Humphrey.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Thank you, good morning guys. Could you talk for a minute about the operating margin outlook? First, given you brought up 2017, and I don't know if you can give guidance here, but would you expect further margin improvement in 2017 over 2016, given where you see the markets today?

Scott Robinson - *Donaldson Company Inc. - CFO*

We just are in our preliminary planning process, so we're not prepared to give FY17 guidance yet. But we will focus on that during our planning session and we will be back to you with fourth-quarter guidance on our projected margin.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

All right. Can you talk a little bit about pricing and the impact that's having one way or the other on the margin? As I look to the aftermarket mix in this quarter, which was a bit stronger than we had modeled, and your guidance for margins looking into Q4 for the remainder of the year, I would think that with more mix shift toward better aftermarket that the margins would be moving the other direction rather than coming in from where you thought they were going to be a quarter ago?

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

Charlie, this is Brad. I can take part of that. You're right in that we get some help from aftermarket, but disc drives have an above average margin and we haven't specifically disclosed what margins are in any sub segment level.

So we won't go into those details. But disc drives are above average. But also, keeping our GTS guidance with aftermarket growing nicely, that's part of what we increased.

But we still had a big fourth-quarter plan for GTS as functional projects, and that is a more below-average margin. So there is a net mix effect from those things as well.

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Charlie, this is Tod, I'll take the pricing action. Clearly what we've done globally, is where we had a particular country that was a net importer, for example, we took pricing actions to help offset some of those FX pressures where the end markets would allow us. But that's just the normal course of business for us, and each region stands on its own to be able to compete in that region.

So from our perspective, we do not have pricing leverage across the comprehensive Donaldson model. We do have an opportunity within aftermarket, and we take it when we can. But then, of course, we have the offsetting pressure of the OE first-fit, where we have price downs on an overall contractual basis across all of our OEM markets. Net-net it's usually a zero sum gain on pricing overall as you look at our company.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Okay just one more and I'll get back in the queue here. On the aerospace defense, you called out commercial aerospace helicopters. Is that the only area of near-term softness or new softness you've seen? Or is it in other areas of commercial aerospace as well?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Charlie, it's helicopters. So what's happening is some of the Blackhawk helicopters are being released into more the commercial space if you will. And that's driving down demand for new helicopters, if you will. And so while we see that military conversion into the commercial side, we are going to see overall offsetting softness and that's why we called it out.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Great, thank you

Operator

Eli Lustgarten, Longbow Securities.

Eli Lustgarten - *Longbow Research - Analyst*

Good morning, everyone. Couple questions on the guidance. Your Gas Turbine was up surprisingly more this quarter than I'd expected, because of the aftermarket filters. The implication of your guidance is that fourth-quarter Gas Turbine sales will be - unless I made a mistake in mathematics, which is possible right now - would be somewhat lower than the third quarter and well below last year? I mean that's even though you talk about some step-up with shipments?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Yes. It's right in line. So the aftermarket is part of it. And obviously we still have some project pressure that we're working through. I think as we're thinking about, and my comment on mix specifically, GTS in the second half of the year will be a little under double what it was in the first half.

Eli Lustgarten - *Longbow Research - Analyst*

Yes, I understand. But, based on the guidance --

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

We had a good quarter.

Eli Lustgarten - *Longbow Research - Analyst*

There's that. But both Gas Turbine and Special Application fourth quarter numbers should be similar to third quarter numbers, is that a fair statement?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Yes. It's in line. Yes.

Eli Lustgarten - *Longbow Research - Analyst*

And you still expect the step-up in IFS? The normalcies will step up in shipments to take place even though it might trail last year's quarter slightly?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

We have a forecasted step-up, yes.

Eli Lustgarten - *Longbow Research - Analyst*

And when you look at the engine business, we had this big decline in transportation that was probably very similar to fourth quarter. But when we get to the fourth quarter and Off-Road we now anniversary the big declines that started last year. Is it fair to say that we should see relatively similar numbers in, again, in Off-Road through the third quarter? Actually through last year, because we are now anniversarying the stepdown, and we should be relatively flattish or closer to it?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Eli, I will start. Yes, but the concern that we have is really the potential for an acute happening. Primarily our worry is in the ag sector. The ag sector in the service model is a little bit uneven, more uneven than it has been showing over the last six months. So while generally I would agree with your statement, I think we also have concern over how that end market is going to behave in Q4 and beyond.

Eli Lustgarten - *Longbow Research - Analyst*

Is that the biggest risk -- in between being in this middle to upper part of your guide to the lower end of the guide -- is turning out to be ag at this point? Is that probably the -- that and maybe a little bit of On-Road falling off?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Just generally. I'd also say, though, that globally, construction's mixed. So, if you just take a look at it, On-Road is clearly a US story falling pretty hard. Off-road, it is ag and the uncertainties across the service channel in ag.

And construction is a bit mixed. Mining is bouncing along very low levels. That is generally is how we would see it.

Eli Lustgarten - *Longbow Research - Analyst*

All right, thank you very much.

Operator

Brian Drab, William Blair and Company.

Brian Drab - *William Blair & Company - Analyst*

Good morning, thanks for taking my questions

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Good morning, Brian.

Brian Drab - *William Blair & Company - Analyst*

I'm going to try and ask about 2017 as well. I just want to make sure I heard you correctly. In terms of the market conditions, you said you're not expecting improvement? Is that what you said? No improvement is going to be embedded in your forecast?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Dramatic end-market changes is what we have said. Correct.

Brian Drab - *William Blair & Company - Analyst*

We just had a quarter here where the net result was about flat on the top line. Is it reasonable to infer that no improvement would mean you're feeling like maybe we've leveled off here in aggregate and your business is about flat? Or does no improvement mean continued decline in some of these end markets?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Brian, I think we are going to be smarter in about three months when we actually try to help you through that guidance. And I think it's appropriate for us to work through that process and finalize our planning before commenting.

Brian Drab - *William Blair & Company - Analyst*

I got it, okay. I want to make sure there's some numbers there with respect to OpEx. It seemed like some of those was a headwind? $12 million incremental savings and then the variable comp was up 17% to 20% and the ERP was washed. Did I hear that correctly?

Scott Robinson - *Donaldson Company Inc. - CFO*

That is correct. We will work through the planning process - we will work to offset that but those are some numbers that we felt important to note right now.

Brian Drab - *William Blair & Company - Analyst*

Okay. I'm just a little curious regarding the variable comp. In a year when you had to make some tough decisions across the business, in terms of personnel and net income is going to be down high single digits probably this year -- can you just comment a little bit further on what drives what seems like a pretty significant increase in variable comp?

Scott Robinson - *Donaldson Company Inc. - CFO*

It's really more of a function of this year. So as we have had to take our numbers down, throughout the year, that's resulted in us falling behind plan. Therefore the bonus amounts have been reduced, and we will restore those in the plan to 100% level next year as we planned for FY17.

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

Brian this is Brad, I'll jump in. Recall that at the beginning of this fiscal year we talked about a $20 million headwind for FY16 for exactly the same effect. So, in any given year it's less of a headwind, assuming that things are about as expected. But, clearly in the last couple years, we've seen the pressure and that's created the headwind in the subsequent fiscal year.

Brian Drab - *William Blair & Company - Analyst*

So in summary, the variable comp is negligible almost this year? And 17% to 20% is a normal level?

Scott Robinson - *Donaldson Company Inc. - CFO*

It was not a headwind this year, that is correct. It ended up not being a headwind.

Brian Drab - *William Blair & Company - Analyst*

Right, okay, and then I just want to make sure I understand -- on the OpEx line you didn't adjust in your 13.8% out margin for the China expense and so I would add back $2.2 million to your op income to get a more realistic kind of run rate of what op income margin is?

Scott Robinson - *Donaldson Company Inc. - CFO*

The $2.2 million is included in the Op expenses.

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Analytically, Brian, to your point the operational run rate would be 2.2 less than that.

Brian Drab - *William Blair & Company - Analyst*

So it would be more like a 14.2% operating margin than 13.8% I guess, okay. Lastly, can you just comment on the gas turbine market, and you modified your strategy there a little bit, avoiding some of these lower margin projects? Has anything changed in the competitive landscape? Can you comment on what, if any, structural changes have taken place in that market?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Brian, nothing has changed in the end market. We still view the end market as a very good long-term market for us, and we're very pleased to be in the gas turbine business. We just felt as though -- with the pricing pressures across that end market that we had to be more selective and really disciplined about our projects, and that is the strategy that we've implemented.

We are also pursuing aftermarket -- as you can see by the success that we've had in the third quarter -- with more field sales personnel, as well as essentially just making sure that we're having good market coverage for the aftermarket sales availability. In other words, knocking on everyone's door. Those strategies have helped us in this quarter, as I said long-term we like the gas turbine business. Nothing has changed in our long-term view.

Brian Drab - *William Blair & Company - Analyst*

Okay, thank you for taking my question.

Operator

Brian Sponheimer, Gabelli.

Brian Sponheimer - *GAMCO Investors, Inc./Gabelli & Co. - Analyst*

Hey, good morning.

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Morning, Brian.

Brian Sponheimer - *GAMCO Investors, Inc./Gabelli & Co. - Analyst*

I want to go back a little bit on Eli's question on end market? Because it sounds like ag is concerning you, and global construction is weak, and mining is bouncing on the bottom. That doesn't to me feel like it's consistent with you guys thinking that Off-Road is finding a floor? So maybe talk to that, and if I'm getting something wrong?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Brian, this is Tod. I think what we're saying is that the range of possible outcomes has narrowed. Certainly we would agree, and in fact in my statements, it reflects that we're not calling bottom. But we would also say that mining, for example, you talk, you listen to our customer base -- people are on a cursory basis using the word stability for the first time in roughly two years.

So mining may be approaching that type of a behavior. But then in aggregate in the Off-Road, we are clearly not saying bottom, but we do think that it's a more narrow range of outcomes.

Brian Sponheimer - *GAMCO Investors, Inc./Gabelli & Co. - Analyst*

Okay. And if I'm thinking about On-Road, clearly the first-fit class A market is having its own issues with production cuts and excess inventory? Give me some color, please, as to what you're seeing from an aftermarket perspective on utilization in the field?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

We're not seeing any appreciable behavioral change. In fact, aftermarket is performing well. It's really all about truck utilization, over-the-road miles, that seems to be doing fine, and overall our aftermarket replacement parts reflects that.

Brian Sponheimer - *GAMCO Investors, Inc./Gabelli & Co. - Analyst*

All right -- thank you very much and good luck for fourth quarter.

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Thank you, Brian

Operator

Rob Mason, Robert W. Baird

Rob Mason - *Robert W. Baird & Co. - Analyst*

Yes, good morning. Tod, I was wondering if you could just speak to your broader geographies, and how those performed in the quarter relative to the aftermarket-related businesses? It looks like EMEA was the strongest geography in the quarter in aggregate, but in terms of utilization rates within the bigger geographies?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Sure. EMEA was the strongest performer. And in fact, if you take out - we put South Africa in EMEA - if you take out South Africa, which was weak, then Europe really shines in the high single digits in year-over-year growth. The US also grew and Asia-Pacific grew, so when you look across all of our end markets, with the exception of South Africa, our aftermarket business grew globally in the third quarter.

Rob Mason - *Robert W. Baird & Co. - Analyst*

Specifically targeting the IFS business, where I think you said the aftermarket business there was up 15%? How did the first-fit systems business do in there, in that segment? Are you seeing any signs of capital spend for those systems loosening?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

We haven't seen any change in behavior from previous quarters. So what that means is quoting activity is stable, but they're are also very slow to turn into first-fit orders. There's been no behavioral change from previous quarters.

Rob Mason - *Robert W. Baird & Co. - Analyst*

Okay. Just last question -- to circle back to the gas turbine business -- in your prior comments about being a little more selective on the type of projects you take on there. That business will probably come in - it looks around $150 million for this year in revenue. If you were to overlay the strategy that you're going to take going forward in terms of selectivity, is there any way to give us a sense, at least order of magnitude as how that business would have looked this year under that new strategy?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

So under the new strategy, when you take a look at this year - because the large turbine projects that we talk about have a very long project cycle, if you remember we rolled that strategy out only three months ago. We get as much as nine to twelve months of visibility on those large turbine projects that I talked about with that new strategy. So overall, there's not much change to this fiscal year as a result of the strategy. What it does signal is more of a careful approach going forward while we work through this particular market dynamic.

Rob Mason - *Robert W. Baird & Co. - Analyst*

Right. Correct. So if we had started this strategy a year and a half ago, are we talking a couple of points variance between how this year, the $150 million maybe being a couple points lower or is it more significant than that?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Right. I think at this point what we're going to do is continue to work through our planning relative to FY17. And then we will come out and give you a better look at how that lays out for the fiscal year in about three months, when we're all together talking again.

Rob Mason - *Robert W. Baird & Co. - Analyst*

Okay. Okay, very good. Thank you.

Operator

Nick Pendergrast, BB&T

Nick Pendergrast - *BB&T Capital Markets - Analyst*

Hi, good morning. I just had a quick question on your cost savings. I just want to be clear, the $8 million that you called out - that's new on top of the previous cost actions, is that correct?

Scott Robinson - *Donaldson Company Inc. - CFO*

That is correct

Nick Pendergrast - *BB&T Capital Markets - Analyst*

And does any of that fall within this fiscal year? It looks like you bumped up the incremental in 2017, isn't that fallen in FY16?

Scott Robinson - *Donaldson Company Inc. - CFO*

Yes, it has bottomed out because we implemented in third quarter so you have a fourth-quarter benefit.

Nick Pendergrast - *BB&T Capital Markets - Analyst*

Okay. The other question I have is on your buybacks? You haven't done any buybacks for the last two quarters? I think you're more interested in reducing your debt, that looks pretty manageable at this level -- do you think buybacks will start back up?

Scott Robinson - *Donaldson Company Inc. - CFO*

Yes, as you would expect we look at all uses for our cash, including investing in the business, M&A, dividends and buybacks. And we have a long history of share repurchase, especially to set off any dilution from the impacts of stock-based compensation. I'm sure in the future we will continue to manage as we have in the past.

Nick Pendergrast - *BB&T Capital Markets - Analyst*

Okay, thank you very much

Operator

Larry Pfeffer, Avondale Partners.

Larry Pfeffer - *Avondale Partners - Analyst*

Good morning, guys.

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Good morning Larry

Larry Pfeffer - *Avondale Partners - Analyst*

So looking through near-term - I promise not to ask you about 2017 - but I will ask about what you've seen in May? Any color you can give on the aftermarket? What you saw on the engine piece in May?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

I apologize, we don't talk about forward quarters, so sorry for that, Larry.

Larry Pfeffer - *Avondale Partners - Analyst*

Okay, within the last quarter just looking at the individual pieces within the engine aftermarket - I know we talked a lot about OE on the call here today -but within mining, ag, truck, construction, what relative to that 5.6 X currency, where would those four end markets fall within aftermarket?

Scott Robinson - *Donaldson Company Inc. - CFO*

Honestly, Larry we don't have a break out of that level. The parts can cross end market so when we give you the general mix, we don't have specific trends by business by quarter. I think to Tod's earlier point, on when we were talking about on road utilization - there are aspects there that were encouraging on the OE channel.

Obviously last year we were hitting the first part of the destocking event that carried through the back half of the last year. So that creates some relative ease in the year-over-year comp. But in terms of end-market specific, there was nothing really that I could point to.

Larry Pfeffer - *Avondale Partners - Analyst*

Okay. And then I appreciate the color you gave on the year-to-date trends in PowerCore, but could you give us the year-over-year comp for PowerCore aftermarket in Q3?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Sure. Brad is looking that up. And while he's does that we will move onto the next question?

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

I've got it here, Larry. So for the year so far PowerCore was, as Tod mentioned, the $120 million for the quarter was up in the low single-digit range right around 3% for engine. I think we said that. Aftermarket was in the mid-single-digit increase and first fit was in the mid-single-digit decline.

Larry Pfeffer - *Avondale Partners - Analyst*

Okay. Thank you, best of luck in the quarter

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Thank you.

Operator

Jim Giannakouros, Oppenheimer.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Hi, good morning everyone.

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Good morning, Jim.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Tacking on to the last couple questions that were asked -- first on restructuring I was curious if you're still looking at options? Or you pretty much have done, or identified what you're comfortable with? Should we be looking at potential upside in the next quarter or two on what you can do on the restructuring side specifically?

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

Jim, this is Tod. First I'd really like to say that I'm really very proud of the global organization for the expense control that they have shown, and their resilience throughout this fiscal year. While we don't have anything to announce today, I also want to make the point that we always look at our business within an ongoing process, if you will, to make sure that we align expenses with overriding business conditions -- for Donaldson Company it's just standard work.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Understood. Okay. And on the aftermarket, Engine aftermarket specifically -- I know by end market it was tough to get granular that way, but maybe by channel? If you could speak specifically to what you're seeing on the independent channel? Understanding that channel runs leaner, do you suspect that your current flow of product is currently matched with demand? And if you have any comments at all on share shifts, whether it be trends or opportunities? Thank you.

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

So our independent channel, was up overall in the quarter mid-single digits, low to mid-single digits, and then our OE channel was up low double digits.

Scott Robinson - *Donaldson Company Inc. - CFO*

High single, sorry.

Tod Carpenter - *Donaldson Company Inc. - President & CEO*

High single, sorry. Overall when you take the two components, it's clear to us that our strategies are working. They're working in Europe, they're working in the United States, they're working over in Asia where we feel that we are winning share with our strategy. And that's indicative, in this tough environment, of this aftermarket performance.

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

Brian -- Jim, this is Brad. The one thing I'd jump in on too, is independent you're exactly right. Independent typically is going to match demand more closely than OED, so given the more apparent relative stability in that number, I'd say it's closer to demand. Just because there isn't a lot of destocking opportunities, compared with the OE channel.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

That's helpful, thank you.

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

Yes.

Operator

I will now turn the call over to the presenters for closing remarks.

Tod Carpenter - *Donaldson Company Inc. - President & 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

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