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PRESENTATION

Operator

Good morning. My name is Denise and I will be your conference operator today. At this time I would like to welcome everyone to the Donaldson Q1 FY17 conference call.

(Operator Instructions)

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

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

Thanks, Denise. Good morning, everyone. Thank you for joining Donaldson's FY17 first quarter earnings conference call.

With me today are Tod Carpenter, President and Chief Executive Officer; and Scott Robinson, Chief Financial Officer. This morning Tod and Scott will discuss our first quarter order performance and provide some insight on FY17 and an update on some of our strategic initiatives. Before we begin I want to cover a few housekeeping items.

During the call we may reference non-GAAP metrics, such as adjusted earnings per share. You can find a reconciliation of GAAP to non-GAAP metrics within the schedules attached to this morning's press release. Also for reference, we posted a schedule on our Investor Relations website showing the year-over-year sales change with and without the impact from currency translation.

I 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. We are pleased with the start to our fiscal year, with first quarter results keeping us on track to deliver full-year sales and adjusted profits in line with our prior guidance. As we look more broadly, we see mixed signals in the market.

On the positive side, there is further evidence of stability in some of our businesses. In the Engine segment demand in off-road has stabilized while trends in the aftermarket business suggest we are through the broad-based destocking we experienced in prior quarters.

On the Industrial side, there has been a slight pick-up in quoting activity, and we're seeing slightly more first-fit projects move forward. While we are encouraged by these signs of stability, we are not seeing evidence of a near-term market rebound.

For example, since the US presidential election there has been a lot of optimism about the possibility of increased infrastructure spending.

We're also excited about that possibility, but we recognize that it would be a while before any increase would take place. Until then we will remain cautiously optimistic and focus on what we are seeing in our business. Based on our analysis, which is supported by customer perspectives and third party data, we continue to view this operating environment as being "more of the same" for at least the balance of our fiscal year.

With this market perspective as a backdrop, I'll now turn to our first quarter sales performance. Total sales of $553 million were up 2.8% from last year, driven primarily by growth of replacement part sales in both segments. Within our Engine segment the total increase of 2.1% was led by aftermarket as first-fit sales remain under pressure.

Consistent with our projections, sales of On-Road products declined nearly 26% from last year with the US accounting for more than half of the decline as our sales followed the decrease in Class 8 truck production. The Off-Road business continues to level off, showing a very modest decline from last year and the prior quarter. Beyond the year-over-year performance we have been seeing relatively even demand from our off-road customers, which is an encouraging sign of stabilization. Our Engine Aftermarket business is also showing signs of stability as we recover from sharp declines in the first quarter of last year.

First quarter sales were up more than 6% reflecting similar increases in both the OE and independent channels and including about $2 million of incremental sales from our acquisition of Partmo. Aftermarket sales of PowerCore also contributed to the first quarter increase with sales up in the low double-digit range from last year. With hundreds of SKUs across multiple generations, this product continues to demonstrate that our "razor to sell razor blades" approach is an effective way to drive aftermarket retention.

In the OE channel of our Aftermarket business, we are maintaining a cautious stance given the uncertainty of how our largest customers will behave at year-end. One year ago we saw unusually large demand fluctuations as many customers tightened their balance sheets at the turn of the year.

While these fluctuations moderated in January, the volatility created quite a bit of pressure on our operations. Given that possibility we are tempering any enthusiasm about recent OE trends.

Sales in Aerospace and Defense increased 4% from last year, driven by growth in sales of replacement parts while first-fit sales continue to face headwinds from declining production of defense equipment and rotary wing aircraft.

Our Industrial segment sales increase of 4.1% was also driven by overall growth in replacement parts with our gas turbine business being a notable exception. As expected, total GTS sales increased 34%, driven almost entirely by first-fit revenue as we compare against a historically low volume quarter last year.

The market conditions one year ago prompted us to begin to take a hard look at our GTS business. We decided to make a strategic shift that included a greater focus on growing aftermarket sales combined with a more selective approach when bidding on large turbine projects. This approach can be broadly defined as bidding in a way that creates value for our customers and us versus winning a project at any cost.

We recognize the consequences of the strategic shift would likely be topline pressure, but we believe our technology and service offering give us a platform to effectively compete and win new business in the aftermarket. During first quarter we saw a mid single-digit increase in sales of these aftermarket products, adding to our confidence that we made the right decision for our Company. Going forward, we will continue to monitor the market and adapt our product offering to profitably grow sales.

In our Industrial Filtration Solutions business sales were roughly flat with last year, including an increase in the low teens from sales of replacement parts. On the first-fit side we remain encouraged by our Downflo Evolution offering, with sales nearly doubling from last year. We continue to drive growth in the US with the product launched two years ago, and we are also seeing rapid growth in APAC and emerging sales in Europe and Latin America following the recent launch in those geographies. Finally, within Special Applications strong sales of venting solutions were not enough to offset the decline in disk drives resulting in a total decline of about 1% from last year.

Across our Company we're seeing more evidence of benefits from our strategic initiatives and strong execution than tailwinds from the market, and I will share some examples of how we are maintaining our momentum in a few minutes. Before turning the call over to Scott, I want to briefly acknowledge the news that broke this morning about Parker-Hannifin's acquisition of CLARCOR. Like you, we're learning about the transaction real-time, so we have nothing specific to share at this point.

We will obviously be learning more in the coming weeks and months but, for us, we're simply focused on providing the best technology, value and service to our customers. Now I'll turn the call over to Scott so he can provide some additional context on our first quarter performance and full-year guidance. Scott?

Scott Robinson - *Donaldson Company Inc - CFO*

Thanks, Tod, and good morning, everyone. Our Company achieved an important milestone in the first quarter as we closed our consolidated books for the first time on our new global ERP. I want to thank everyone involved in reaching this milestone. We have a lot of optimization work left, but I am proud of the efforts to date.

I'll shift now to a recap of our first quarter performance. We were pleased with our performance as we converted a 2.8% sales increase into strong profit growth on both a GAAP and adjusted basis. First quarter GAAP EPS was up more than 48%, driven in part by one-time items this year and last.

In 2016 we incurred charges for restructuring and fees for the investigation into our GTS business that totaled $10 million, with $3 million in gross margin and $7 million in expense. This year the one-time impact benefitted GAAP earnings. During the quarter, we settled claims against an escrow account that was established when we acquired Northern Technical two years ago. Per the terms of the settlement, we can only disclose the financial impact, which was $6.8 million.

This benefit was recorded in the other income and expense line of our P&L so, there was no impact to operating margin, and it was excluded from adjusted EPS. Excluding the one-time items in both years, our Q1 adjusted earnings per share grew 11.8% to $0.38 from $0.34 last year. Our operating margin in the quarter grew to 13.8% from last year's adjusted rate of 12.2%, with the majority of this increase coming from gross margin improvement.

Our first quarter gross margin of 35.1% benefited from higher fixed cost absorption as compared with last year's rate, which faced pressure from under-absorption. Looking back, our Q1 rate is fairly consistent with our historic first quarter gross margins.

We also generated 20 basis points of expense leverage in the quarter. As expected, the tailwind from restructuring actions we took last year was partially offset by higher variable compensation expense.

Our balance sheet continues to be a source of strength for us. At the end of the quarter our gross debt to EBITDA leverage ratio was about 1.5 times, representing a notable decline from last year's October rate as we continue to benefit from our efforts to improve working capital.

Compared with last October, receivables are down 3% and inventory is down almost 13%. The most significant improvement in AR is coming from reductions to the balance in delinquent accounts, and inventory is moving in line with the region-level targets we set last year.

During the first quarter we returned $23 million to our shareholders through dividends and invested another $41 million to repurchase 0.8% of our outstanding shares. First quarter capital expenditures of $12 million was below our recent run rate given the timing of certain projects, and our cash conversion for the quarter was a very healthy 150%. I know that geographic location of cash is a hot topic right now so I'll add that nearly all of our cash at the end of the quarter was outside the US.

Turning to our view of FY17, I want to start by highlighting the full-year impact of the settlement I discussed earlier. We now expect OI&E income between $15 million and $17 million and a full-year tax rate between 26.4% and 28.4%. Altogether, GAAP EPS is now forecast to be higher than adjusted EPS by about $0.05.

Beyond those changes, our current perspective on the full-year performance is consistent with our prior guidance. Total and segment level sales are forecast between a 2% decline and a 2% increase from last year and we are targeting adjusted earnings per share between $1.50 and $1.66. While first quarter performance was encouraging, we are maintaining a cautious stance given the lingering uncertainty we still see in the markets.

One area of concern for us is that recent exchange rate volatility. The sales benefit of $1.6 million that we realized in the first quarter reflects quite a bit of movement within the quarter. The tailwind we were seeing during the first two months shifted to a headwind as the dollar strengthened against all major currencies towards the end of the quarter.

If today's rates hold, our first quarter favorability will reverse. Another area of concern is the lack of change in overall market conditions despite the signs of stability within our business. Consequently, our expectations for business performance and market conditions are consistent with what we said last quarter.

The engine business is facing ongoing headwinds from heavy duty equipment production with On-Road seeing the most pressure given the declining build rates for Class 8 trucks in North America. We think full-year sales in that business will be down in the high single-digit range with the aerospace and defense and off-road business are each expected to be down in the mid-single-digit range.

Specific to Off-Road, our forecast reflects production declines in all of our end markets. Both agriculture and mining equipment production will be down another 5% to 10%, and production of construction equipment is expected to be flat to down 5%.

In the Aftermarket business, we think we can grow in the low single-digit range in the market where equipment utilization is roughly flat. The increase will be driven by our innovative technology and past investments in geographic expansion, including the recent acquisition of Partmo in South America, which is expected to contribute $12 million to $13 million this year.

Our perspective on full-year sales for the business in the Industrial segment is also unchanged. The tepid first-fit conditions affecting Industrial Filtration Solutions will be more than offset by growth of replacement part sales resulting in low single-digit increase for this business.

We are also forecasting strong growth of replacement part sales within the Gas Turbine business, but it is not enough to offset pressure from lower sales to large turbine projects. Consequently, we expect total GTS sales to be down in the high-single to low-double-digit range.

I do want to point out the pressure in this business is more self-directed. Our sales forecast for large turbine projects, which will be about 30% of total GTS revenue, reflect the expected impact from strategic shift Tod discussed. Within Special Applications, we are forecasting a low-single-digit decline as lower sales of disk drive filters are only partially offset by growth in areas like venting solutions.

We are targeting a full-year operating margin between 13.3% and 13.9% reflecting year-over-year improvement in both gross margin and expense rate. At the mid-point of this range, operating margin is up 40 basis points from 2016's adjusted rate despite the net headwind from higher variable compensation that is partially offset by benefits from last year's restructuring actions. Before moving on, I want to briefly address the question many of you have asked about incremental margins.

I'll forewarn you that the answer is probably going to be less precise than you would like, but it's an important topic and we wanted to share our perspective. At a high level, we believe stable or growing sales can drive an incremental profit margin. You saw that in our first quarter results, and that expectation is reflected in our full-year guidance.

The incremental profit rate is dependent on a variety of factors, so I'll walk through some of the moving pieces starting with our structure. Fixed expenses are roughly 15% to 20% of cost of goods, and they also account for more than two-thirds of total operating expense. Although these data points could be used to model an incremental margin forecast, we would add a word of caution.

While that approach works mechanically, it does not capture the nuances within the business. The variability becomes clear when you look at our historic incremental margins. Things like the pace of the sales change, mix of business, and a variety of other factors ultimately drive our results.

In addition to the operational factors, we have plans to reinvest in our business to accelerate growth should the opportunity emerge. Our full-year guidance wraps together our perspective on all these factors, so our plan is to limit our guidance to overall operating margin versus providing a precise set of line item targets. With that, I'll quickly wrap up the FY17 guidance.

In terms of capital deployment, our forecast includes CapEx of $70 million to $80 million, and share repurchase of 2% to 3% of outstanding shares. Or cash conversion is still expected in the 90% to 100% range.

Finally, I want to remind everyone of how we expect sales and operating profit to unfold this fiscal year. Our sales forecast reflects similar first half versus second half seasonality as last year. For operating margin we would expect nearly all of the year-over-year improvement will occur in the first half given the easier comparison with last year combined with the front-loaded benefits from previously taken restructuring actions.

In summary, the cautious stance we are maintaining allows us to deliver profit growth in a relatively flat sales environment and it also gives us the flexibility to pursue growth opportunities should they emerge.

From our perspective, the pockets of uncertainty in the environment will continue to present a challenge so we will remain focused on operational efficiency and balance sheet discipline across the Company. Now I'll turn the call over to Tod for an update on our current priorities. Tod?

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

Thanks, Scott. We believe our guidance appropriately reflects the mixed market conditions we are seeing. As we discussed, we continue to see evidence of stability in certain businesses, but we're not expecting a return to broader market growth during our fiscal year. Given the current environment, we think growing profit with flat sales reflects our focus on controlling what we can.

To deliver our FY17 commitments and position us for the future, we are prioritizing a core set of actions.

For future success, we're leveraging our technology to drive first-fit program wins. Engine liquid is a significant example of this opportunity.

Our innovative Synteq XP technology addresses challenges from low sulfur and biodiesel fuels and higher fuel injection pressures creating a first-fit opportunity for this fuel filtration solutions that did not previously exist. We've had a number of significant wins over the past few years, and we continue to work a very large pipeline of opportunity.

We are also investing in businesses that have near-term growth opportunities, including replacement parts. Engine liquid is playing a key role here as well. Over the past year we have been winning new business in the OE service channels by adding new parts to our offering.

During first quarter, our liquid business grew in the low double digits compared with last year reflecting the progress we are making by expanding our business with existing customers and adding new ones. Another core priority is improving operational efficiency. Across the Company we are identifying opportunities to refine our operations and capture more cost savings where appropriate. Given the work we did last year and our current project pipeline, we believe we are well-positioned to grow our profitability with relatively flat sales.

Finally, we are making thoughtful investments in our business. For example, we are developing a global e-commerce system that will go live during our next fiscal year. This new system will allow customers around the world to order our products with ease.

We also continue to pursue inorganic growth through acquisitions. There's nothing to announce today but we remain a disciplined buyer in continue to work our pipeline.

Our FY17 plans align with our strategic priorities to grow our business through our core technologies, geographic expansion and acquisitions. We are confident that our efforts position us to deliver our commitments this year and strengthen our foundation for future growth.

I sincerely want to thank our employees across the world for their dedication to helping us achieve our priorities. With that, I'll turn the call back to Denise to open the line for questions. Denise?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Charley Brady, SunTrust Robinson.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Thanks. Good morning, guys. With respect to the GTS business, I know it's a hugely lumpy business, but I wonder if you could maybe give us some sense of how you think the rest of the year plays out in terms of how the sales might come in for the rest of the year, understanding that it's a pretty lumpy business.

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

Charlie, this is Tod. In the GTS business our first quarter is actually, on a comparative basis year-over-year, the best quarter we are going to have. It's really going to be now tougher comps as we lay out our expectations for the balance of this fiscal year every quarter going forward.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Thanks.

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

Our full guide on GTS was 10% down for the year roughly, and that still holds.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Okay. That's helpful. Thanks. And kind of a bigger picture question, on the cash you noted almost all the cash is outside the US. Given the incoming administration, what's your big picture thought on if there were some legislation or change in the tax law that would allow you to repatriate cash at a more reasonable rate? Is that something you are inclined to do? And does that help you one way or the other in terms of potential M&A transactions or anything like that?

Scott Robinson - *Donaldson Company Inc - CFO*

This is Scott. It's certainly something we think about a lot. Our cash historically has mainly been outside the US and we repatriate when we can and where it makes sense. Certainly if the incoming administration were to facilitate monies moving back to the US, we would be glad to take advantage of that.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Okay. Thanks, guys

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

Thanks, Charlie.

Operator

Ben Hearnsberger, Stephens.

Ben Hearnsberger - *Stephens Inc. - Analyst*

Thanks for taking my question. If you look at your guidance, I'm curious if you would give us the gross margin implied in your full-year guide.

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

Ben, this is Brad. We haven't broken out the specific line items. But full-year improvement is going to be driven more by expense leverage versus gross margin.

Ben Hearnsberger - *Stephens Inc. - Analyst*

Okay. And then looking at expense leverage, I think 1Q adjusted OpEx was up slightly year-over-year. Can you give us the puts and takes -- how much of a tailwind did you see from some of the restructuring actions, how much bonus accrual did we see in 1Q?

Scott Robinson - *Donaldson Company Inc - CFO*

This was in our guidance, but just to recap we had approximately $12 million of benefit coming in from the restructuring programs from last year. That was offset by $20 million of incremental variable compensation expense. Those two amounts were inherent in the guidance. Obviously our profitability in our guidance increased so we were able to offset that headwind with disciplined cost management throughout the Company.

Ben Hearnsberger - *Stephens Inc. - Analyst*

Yes. I'm sorry. So the $12 million -- that was all incremental to 1Q?

Scott Robinson - *Donaldson Company Inc - CFO*

No that was (inaudible) to the first half. That was mainly for the first half of the year and included in our full-year guidance.

Ben Hearnsberger - *Stephens Inc. - Analyst*

Sure. Can you tell us how much you experienced in 1Q out of that $12 million?

Scott Robinson - *Donaldson Company Inc - CFO*

It's not that precise. If you just take the announcements we did over the past fiscal year and assumed it was perfectly ratable by quarter, there would be more of that $12 million in first quarter than there would be in second quarter. But it's not perfectly precise.

Ben Hearnsberger - *Stephens Inc. - Analyst*

Okay. And then I had a higher level question for Tod. And I know this is real-time, but clearly you know Parker, and you know the CLARCOR filtration business. I'm just curious at a high level, how do you think about the potential change in the competitive dynamics of the market if the deal does go through?

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

We compete with Parker in the compressed air space of Industrial -- so industrial uses of compressed air. And we also compete with Parker in diesel fuel within their Parker Racor brand. CLARCOR is not in the compressed air space; however, they are in diesel fuel. Putting the two together clearly allows some synergy of a larger company but for us, from a competitive standpoint of view, it's really kind of more of the same at this point.

Ben Hearnsberger - *Stephens Inc. - Analyst*

Okay. Thanks for taking my questions.

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

Thanks, Ben.

Operator

Laurence Alexander, Jefferies.

Dan Rizzo - *Jefferies & Co. - Analyst*

Good morning. This is Dan [Rizzo] on for Laurence. The recent rebound in metal commodity prices -- it's too soon to tell if that's going drive growth later in the fiscal year? Is there any signs of anything yet?

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

No we've not seen any signs of that. We have longer contracts for our critical materials like steel. They'll go out six months. And until we lap those contracts, then we will get a little bit better visibility depending upon where steel is as we renegotiate. But all of that and what we know currently is baked into the current guidance.

Dan Rizzo - *Jefferies & Co. - Analyst*

Okay. And then you mentioned the -- you gave that example of engine liquid as an example of new product or new contract win. Is there any others that you can provide color on that's showing that there's more in terms of first-fit wins that are driving growth?

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

Sure. We have -- if you just take our air-based products, if you split the Company in air and liquid, on air we have won over 75% of what we define as a must win project in the last 12 months. And in liquid we are also over 75% of what we define as a must win project. Must win to us means it would drive $5 million worth of revenue for the Company over a 10-year period. So you can see our win rates across our product families are really quite high, and we are very proud of that.

Dan Rizzo - *Jefferies & Co. - Analyst*

Okay. Actually that was very helpful. Thank you very much.

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

Thank you.

Operator

Brian Drab, William Blair.

Brian Drab - *William Blair & Company - Analyst*

Thanks for taking my questions. First, are you starting to see -- destocking has been such a theme here for several quarters. Are you starting to see some restocking potentially in any of your end markets?

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

Tough to say, Brian. We still have uneven ordering patterns across our Aftermarket. We have some real successes to point to within our strategic initiatives of adding to our strong distribution channel as well as broadening our product portfolio. So we can point specifically to driving that within that growth that you saw within our first quarter. But we also have a little bit of easier comps because of that destocking you referred to in the first quarter last year. So we believe there is certainly the range of possible outcomes across the aftermarket channel have narrowed. And there is a little bit more stability but we're not calling it as we are on the floor. We are still just a little bit uneasy as we turn into the end of this calendar year.

Brian Drab - *William Blair & Company - Analyst*

Okay thanks. And then turning to Gas Turbine -- and actually on the smaller scale gas turbine business, which I understand a lot of that will go into oil and gas, what are you seeing in the oil and gas market? Are you seeing any signs of stability or potential growth there given that's really fallen off a cliff hasn't it for you over the last several quarters or many quarters?

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

Yes. Oil and gas is certainly pressured, especially our aftermarket channel and then what we would consider our small turbine business. So oil and gas pipeline, gas turbines -- they are certainly under pressure over the last couple of quarters. As we pare back and look deeply inside of our aftermarket business, we wouldn't point to any specific indicator to suggest oil and gas is helping us with the lift at this moment. We continue to look for that but really nothing appreciable to discuss.

Brian Drab - *William Blair & Company - Analyst*

Okay. And which lines, if any, would you highlight in this first quarter -- which business lines outperformed what you were expecting?

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

I think the quarter is pretty much what we had thought. We talked about in our guide that our strategy is to press hard in our replacement part businesses to help offset the headwinds of our first-fit. And you see that across our Company in all of our numbers. And so really we just have very good strategic execution, and I'm really proud of every region and what they are pressing for right now in that strategic focus.

Brian Drab - *William Blair & Company - Analyst*

Okay thanks. Would you mind if I ask one more? In light of this CLARCOR agreement with GE, can we just -- can you drill down into the dynamics in that market a little bit and talk about, first of all, in the Gas Turbine market my understanding is that there is some pressure from your customers to maybe move away from buying the whole system, meaning including the housing and the internal filtration components in that housing, as I understand it, is a major part of the purchase -- the overall purchase price of the filtration system. How does that affect the top line for you? Or how has it affected and how does it affect going forward the top line in the gas turbine segment? And can you also comment on just how important GE is to your gas turbine business for the large scale turbine filtration systems? Thanks.

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

So what you're referring to, is a large turbine filter house has some components in the middle that are what's called smart parts. The filters themselves -- for example, compressed air componentry, that goes in to keep those parts running effectively in front of the turbine so I can supply ambient air. It's roughly 20% to 25% of the overall cost of a filter house per se. There was a move by one customer, GE, to actually go in that direction on one platform and clearly market information indicates that is what they've done and they have reached an agreement to do so. We don't see that behavior everywhere across the market. But what that does do -- if you're going to supply those smart parts, if you will, that allows some of the sheet metal fabrication to really be extended out to any sheet metal fabricator around the world. So that 75% to 80% of the price of a larger filter house could go elsewhere.

Now you still have to make it to the project specifications and GE welding requirements and so on, which are very specialized. But that's the net effect in the relationship of those. As far as GE and the importance to our overall Gas Turbine business, well GE is the number one gas turbine manufacturer in the world. So clearly they are important as well as all of their competitors. They are currently not our largest customer within our Gas Turbine segment at this point.

Brian Drab - *William Blair & Company - Analyst*

That's all very helpful. Thank you.

Operator

Rob Mason, Robert Baird.

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

Good morning. Just a clarification question first, Scott. I want to make sure that I heard you correctly. You said that your guidance, your plan, does not really contemplate any operating margin expansion in the second half of the year. That would all be in the first half. Did I hear that correctly?

Scott Robinson - *Donaldson Company Inc - CFO*

Yes, that's essentially correct.

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

And then I'm curious -- given the FX movements that we've seen of late, what are you assuming in the minus-2 to plus-2 sales guidance for currency impact now?

Scott Robinson - *Donaldson Company Inc - CFO*

Well we had some tailwind in the first part of the year. And that flipped to a slight headwind currently as where the rates sit today. So the benefit that we achieved from currencies in the first part of the year would be erased. We still maintained our current guidance, essentially all respects for our revenues for the year.

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

Okay. And then, Tod, I've noticed your engine aftermarket business demonstrated another strong quarter in Europe, and that's a string of several solid quarters there. Could you just drill down into what's driving the engine aftermarket strength in Europe, whether that's Western Europe or is that emerging Europe where that is coming from and some of the drivers there?

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

Sure. So within Europe we're really just executing a strategy that we've been talking about for several quarters, which is strengthening our distribution channel, adding distributors to our current business as well as broadening our product offering. It's really both. We have done -- had success in both Western Europe and Eastern Europe and even up into Russia, actually. And so we are just continuing to work our strategic plan, continuing to have that unfold. And the next step that we would look to do is even expand our distribution centers across Europe to support our growing business. But really that's what's happening and they are just doing a great job.

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

And then shifting gears just to the IFS business real quick, you mentioned some slight uptick in quoting activity. What do you think -- one, is that region specific or is that a broader comment in IFS? And then two, what are you hearing from the field that will take those customers to actually pull the trigger on spending on the capital equipment side there?

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

So it is both in Europe and the United States. However, the reason why we remain a bit more cautiously optimistic about it is because we still have what we would consider to be large projects, elephant projects, rather than a consistent base of say lower six digit type of projects. When we have a lot of those type of projects going on, then we know that the overall CapEx spend across the industrial base is back. But this is a bit of a lumpier type of a move. And so that's why we have a bit more cautiousness in that. What would it take? Just really industrial production is going to really have people start to believe and spend CapEx. And then you'll get a more broad-based first-fit project buy, if you will.

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

Okay. Very helpful. Thank you.

Operator

(Operator Instructions)

George Godfrey, CLK.

George Godfrey - *C.L. King & Associates - Analyst*

Good morning and thank you for taking my question.

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

Good morning, George

George Godfrey - *C.L. King & Associates - Analyst*

Good morning. I wanted to ask about the desire today versus maybe a year or two ago for acquisitions. I heard your comment about looking at doing deals. But I'm just wondering if the appetite level, given Parker Hannifin's actions this morning, might increase your sense of urgency or the magnitude in size. Looking at the last couple of years, you've spent some money on acquisitions but nothing really all that large. I'm just wondering if that's changing today and has it changed over the last year?

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

When you take a look at our strategy within acquisitions, we have always had a looking to add overtime 1% to 2% acquisition revenue on an annual basis as part of our strategy. Five to six years ago we just weren't very good at executing on that. And so we stepped back a couple of years, and we refurbished our entire process. And out of that process, we were honest with ourselves, and said if it's part of the strategy then embrace it. If it's not, then let's stop trying to execute. Well we took action to embrace it, and you see our four acquisitions over the last couple of years as a net result of that. I would say that our process and our pipeline is still robust. It is strategic in nature and selective that we remain a disciplined buyer.

George Godfrey - *C.L. King & Associates - Analyst*

Okay. And if I could just follow up on that just one quick question. Leverage based on my estimates net debt to EBITDA 0.8 times, what would you be comfortable taking that up to? Do you have a threshold our a limit or a target range in mind?

Scott Robinson - *Donaldson Company Inc - CFO*

We are certainly comfortable with where we sit today. We were a bit higher last year. And if you recall, we said we were working to bring that down. We were comfortable with where we sat last year but we just thought we had room in the balance sheet to improve our asset efficiency. And we worked to improve that to bring that down to the current 1.5 level that we sit at today. We certainly like that position. It gives us powder should we need it. And we just look to maintain a strong balance sheet going forward.

George Godfrey - *C.L. King & Associates - Analyst*

Great. Thank you very much.

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

Thanks, George.

Operator

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

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

That concludes today's call. I would like to thank everyone for their time and their interest in Donaldson and particularly the Donaldson employees across the world for their wonderful performance and our first quarter. Thank you. Have a good holiday.

Operator

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