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DCI - Q2 2017 Donaldson Company Inc Earnings Call

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PRESENTATION

Operator

Good morning. My name is Denise and I will be your conference operator today. At this time I'd like to welcome everyone to the Donaldson's Q2 FY17 conference call.

(Operator Instructions)

Thank you, Brad Pogalz, you may begin your conference.

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

Thank you. Good morning, everyone.

Thank you for joining Donaldson's FY17 second 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 walk through the details of our second quarter performance, the drivers of our increased guidance for FY17, and provide an update on some of our strategic initiatives.

During today's 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, this morning 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 will turn the call over to Tod Carpenter. Tod?

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

Thanks, Brad. Good morning, everyone.

We are pleased with results we delivered during the first half of the fiscal year. We now expect to generate full-year sales and profit above our original forecast. Scott will cover the guidance in more detail, but the midpoints of our new ranges implies sales will be up 3% from last year and adjusted EPS will be up about 8%.

I want to thank our Donaldson employees for their contributions so far this year. They've done an excellent job executing our strategic priorities and meeting the needs of our customers. Every day our employees around the world demonstrate the innovation, value and stability that Donaldson provides. I sincerely appreciate the commitments they have shown and their efforts are reflected in our strong performance.

In second quarter total revenue was $551 million, up 6.4% from last year in dollars and 7% in local currency. The strength in the quarter was entirely driven by the Engine segment, which was up 13% as we compared against a very soft quarter last year. Within Engine there was clear evidence that our strategy to win innovative first-fit programs and grow our replacement parts business is working. In the quarter we also saw some positive macro trends with restocking be the most notable. As an aside I feel compelled to add a bit of restraint to the recent enthusiasm regarding market conditions.

Beyond restocking, the signs of stabilization are becoming more apparent, key measures like commodity prices, rig counts and industrial production all appear to be moving in the right direction. While these trends are encouraging, there is still uncertainty relating to the timing of sustainable demand-driven growth. The mixed outlooks provided by our large customers reinforce the point that it is unlikely that we will see a meaningful turn prior to the end of our fiscal year in July. There's also lingering uncertainty related to policy changes and global economic conditions, which is underscored by the dramatic exchange rate fluctuations in recent months.

While our assessment may seem conservative, we believe a cautious stance is appropriate because it gives us flexibility to react to market changes. Turning back to the recap of Engine sales, strength in Aftermarket, Off-Road and Aerospace and Defense offset continued weakness in On-Road.

Sales in On-Road were down 28% from last year, with the US accounting for more than half of the decline as the production of class 8 trucks remains depressed. Part of the decline is also attributable to the strong comp we had one year ago, which highlights the dramatic cyclicality inherent in US truck production.

The Off-Road business reversed a multi-year decline during second quarter when it generated a 10% sales increase. Additionally, ordering patterns from our large customers continue to be stable. We did not see the typical calendar year-end demand fluctuations and sales were actually up from first quarter. These trends reinforce our perspective that Off-Road is stabilizing but it is still unclear as to whether we will see end market expansion in the near-term.

We were pleased with the aftermarket performance in the quarter, which jumped 20% from a historically low second quarter in FY16. For the fourth quarter in a row, both the OE and independent channels contributed to the year-over-year increase.

There were several areas of strength in aftermarket last quarter. The OE channel benefited from restocking while the going rig count helped the independent channel. Beyond these market driven tailwinds we are seeing benefits from executing our strategy.

First, we continue to gain traction from winning new programs to provide OE service parts. For example, liquid sales were up more than 20% last quarter as a result of these new service part programs. Additionally, PowerCore remains a stronger to be here to overall success as aftermarket sales of this product were up more than 30% last quarter.

Finally, Partmo generated sales of $4 million in the quarter which contributed about 1.5% to total aftermarket growth. As we said at the beginning of year our focus is growing replacement part sales and our first-half performance is evidence of the success we have had. Rounding out the Engine discussion, sales of aerospace and defense grew 10% last quarter as we saw strength in the commercial and defense businesses.

Within commercial, the strength has been coming from fixed-wing aircraft as we are gaining traction with our cabin air system. The Industrial segment was under pressure last quarter with total sales down 4% as currency translation and year-over-year declines in both gas turbine systems and special applications were only partially offset by growth in Industrial Filtration Solutions. Total IFS sales grew 6% last quarter or 7.5% in local currency. We were pleased with the strong replacement part sales, while First-Fit remains under pressure.

On the positive side, quoting activity is increasing in most geographies as current and potential customers respond to our offering, including our LifeTec filters and Downflo Evolution. Within the quarter, sales of Downflo Evolution, or DFE, more than doubled as we continue to expand outside the US.

The Gas Turbine business continues to face pressure from an increasingly competitive market. The 36% sales decline was led by a sharp drop in large turbine projects reflecting a combination of our strategic shift to bid these projects more selectively and customer delays. We expected a sales decline from executing our strategy, but project delays in the Middle East and other regions speak to the volatility in this business.

Finally, Special Applications' sales declined about 8% last quarter, primarily driven by membranes and disk drives. I would now turn the call over to Scott for a recap of our second quarter performance and full-year outlook. Scott?

Scott Robinson - *Donaldson Company Inc - CFO*

Thanks, Tod. Good morning, everyone.

We were pleased with the quarter as we converted a 6.4% sales increase in second quarter to sharp increase in net earnings, as we saw better absorption and expense leverage. Our Q2 EPS of $0.35 was up 25% from last year on a GAAP basis and 20.7% when compared with last year's adjusted EPS.

As a reminder, the prior GAAP metrics included about $1 million of one-time charges. These items reduced second quarter 2016 GAAP EPS by $0.01 and operating margin by about 30 basis points. Our second quarter 2017 operating margin grew to 12.6% from last year's GAAP and adjusted rates of 10.4% and 10.7%, respectively.

The improvement from last year was split fairly evenly between gross margin and operating expense. Higher fixed cost absorption drove the gross margin up to 34.1%, while the expense ratio of 21.5% reflects leverage on the sales volume that was partially offset by a headwind from incentive compensation.

Our effective tax rate in the quarter increased to 29.8% from 23.0% in 2016. The prior-year rate was artificially low due to the retroactive benefits from the PATH tax act and other discrete items. Additionally, the mix of earnings lowered the rate last year and pushed this year's rate up.

We continue to manage our balance sheet with discipline. We ended the quarter with a gross-debt-to-EBITDA leverage ratio of about 1.5 times, right in line with our long-term targets.

Compared with last year, receivables are up slightly and inventory is down more than 5%. We are pleased with how we've kept working capital in check while managing the sales increase. During the second quarter we returned $23 million to our shoulders through dividends and invested another $10.5 million to repurchase 0.2% of our outstanding shares. So far this year we've repurchased about 1% of our outstanding shares. Including CapEx of $13 million and reflective of our efforts to optimize working capital, cash conversion in the quarter was a robust 112%.

Of course location of cash continues to be hot topic, so I will remind you that nearly of all of our cash is outside the US. Another hot topic is overall tax reform, so I wanted to quickly address a question that many of you have asked. At Donaldson, the US is a net exporter. In FY16, Donaldson US exports totaled roughly $20 million, while imports into the US were less than half that amount. So we're talking about small dollars here relative to cost of goods sold driven in large part by our decades-old strategy to build a region to support region production model.

We always consider the full economic impact of production decisions so our approach will continue to be guided by the interests of our customers and shareholders. Turning to our FY17 outlook, we now plan to exceed our original forecast for full-year sales, operating profit and EPS. I want to underscore a point Tod made though. There are still a lot of unanswered questions related to the timing and magnitude of a market recovery.

While recent trends are undeniably positive we feel strongly that maintaining a cautious stance is the most prudent approach for keeping our expenses, inventory and other investments in line.

We have reflected this balance in our guidance, which includes some puts and takes within the business that yield an adjusted EPS forecast between $1.60 and $1.68. The midpoint of this range is 8% above last year and $0.06 above the midpoint of our prior guidance. We continue to expect GAAP EPS will be $0.05 above adjusted EPS as a result of the Northern Technical escrow settlement from earlier this year.

On the top line, total sales are forecasted to increase between 2% and 4% from last year compared with prior guidance of plus or minus 2%. Included within this forecast is a headwind from currency translation of about 1%.

The Engine segment is driving all of the upside in our sales forecast, with notable strength in Off-Road and Aftermarket. Although third-party estimates for heavy duty equipment production are still depressed with Ag and Mining declines in the mid- to high single-digit range and Construction flat to down slightly, we've seen our Off-Road business pick up.

We now expect full-year sales will increase in the mid-single-digit range, reflecting a first full-year sales increase in this business since mining's peak in 2012. Aftermarket sales accelerated in the second quarter and we're forecasting the trend to continue to the balance of this fiscal year.

The factors Tod mentioned like restocking and the pickup from oil and gas are compounded by benefits from our innovative product and the short cycle wins we've had in liquid business. Including the benefit of $12 million to $13 million from the Partmo acquisition we now forecast aftermarket sales will increase in the high single to low double-digit range, which is well above our forecast for flat overall market utilization.

We also fine-tuned the forecast for On-Road and Aerospace and Defense. Sales of A&D are now forecasted to be up in the low single-digit range while On-Road sales will be down from last year in the high teens.

Specific to On-Road, the downward revision reflects slightly more pressure in the US and a modest softening elsewhere in the world. Altogether, Engine sales are now forecast to increase between 5% and 7% from last year compared with the prior guidance for sales to be roughly flat.

On the other side we expect Industrial segment sales will be below our initial guidance. Total Industrial sales are forecasted to decline between 1% and 3% from last year, which includes an impact from currency translation of about 1.5% and lower projections for both GTS and Special Applications.

While there are no notable market changes contributing to this update in special applications. We sharpen our pencils for the back half of the year and now see sales being down in the mid-single-digit range. The GTS business however is facing increased pressure from the inherent lumpiness of large turbine projects. We know expect sales will decline in the mid-teens with the guidance revision driven primarily by project delays. The declines in GTS and Special Applications are being partially offset by a low single-digit increase in Industrial Filtration Solutions, consistent with our prior forecast.

Our FY17 operating margin is now expected between 13.7% and 14.3%. The midpoint of this range is up 40 basis points from our prior guidance and 80 basis points from last year's adjusted rate. Included within the full-year forecast are benefits from restructuring that we did in 2016, which total about $12 million and the headwind from compensation expense. In light of the updated sales and profit forecasts we now expect another $8 million to $10 million in incentive comp this year bringing the total year-over-year headwind to somewhere between $28 million and $30 million.

Another less precise headwind is coming in gross margin as we invest in staffing and premium freight to meet our high service-level commitments in the face of increased demand. It's a welcome problem, but these charges do affect the amount of incremental profit we deliver. As a reminder, our rate of incremental profit can fluctuate given a variety of factors, including the pace of change and the mix of business. Additionally, with fixed expenses accounting for 15% to 20% of cost of goods sold and more than two-thirds of operating expense, the incremental rate can vary widely.

We wrap our perspective on all these things in our full-year guidance, which does demonstrate our ability to generate incremental profit on a stable sales base. Further down the income statement we still expect other income between $15 million and $17 million and our full-year tax rate is now expected to be 27.1% to 29.1%. In terms of capital deployment, we lowered our full-year CapEx forecast to be between $60 million and $70 million and we still expect to repurchase between 2% and 3% of outstanding shares. We plan to generate free cash flow of $240 million to $260 million and expect cash conversion between 105% and 115%.

Now I want to offer some color on the back half of FY17. Compared with the first half, our guidance implies strong sequential improvement in sales and operating profit. We also expect to see a bigger step-up from the second to the third quarter than we do from Q3 to Q4. Please keep in mind that the comps in the second half are much tougher than the first so the year-over-year improvement will also be more modest. We have plans in place to leverage the momentum we have seen in the business, but we are also focused on the long term.

A notable example, and one that I am particularly passionate, about is our global ERP. We closed the quarterly books in the system for the second time now and I can confidently say that we are getting a deeper understanding of our business and processes every day. I'm also confident that our efforts surrounding the global ERP are part of a journey that will take years. I see a large pipeline of projects to help us increase efficiency, get smarter about ourselves and our customers and take cost out of the business in a thoughtful manner.

I am very pleased by the progress to date and look forward to continuing this journey. With that, I'll turn the call back to Tod.

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

Thanks, Scott. To summarize our sentiment, we are encouraged by overall end-market conditions, but not yet confident that sustainable market growth is right on the horizon. We are, however, confident in our strategic priorities and our ability to maintain our focus on those things that are within our control. More specifically, we continue to act with the future in mind. Our sales teams are in the field building and deepening our customer relationships while our engineers are developing new and innovative filtration techniques and products.

The combination of their efforts is perfectly aligned with our strategy: win new innovative first-fit business to drive sales of replacement parts. Over the past few years our customers have become increasingly interested in signing longer-term supply agreements with us because they see how our strategy creates value for them. We used to discuss two- or three-year contracts, but now we are talking about arrangements that can last up to 10 years, resulting in strong customer relationships. The strategy begins with the innovative first-fit wins and we continue to be pleased with the inroads we are making.

Our win rates for new programs are at or above historic levels. Importantly, a large portion of those wins are incremental business for Donaldson and we have a big pipeline of new opportunities.

In liquid for example, first-fit wins with our innovative Synteq XP media are starting to show up in revenue. This product effectively addresses challenges created by high fuel injector pressure and the increasingly use of low sulfur and biodiesel. Although the dollars are still small, our select fuel business, which leverages Synteq XP media, has increased by nearly 50% so far this year.

We're also excited about the progress with Downflo Evolution in the Industrial segment. As I mentioned earlier in the call, sales of these dust collectors more than doubled in the quarter. Customers continue to respond to DFEs value proposition and the innovative technology will drive our replacement part sales. We also see geographic growth opportunities with this product. We launched in the US in 2015 and began selling worldwide in FY16.

One year ago, international DFE sales were only about 10% of the total. So far this year they've grown to nearly 25% of the total, while sales in the US are also growing. Another area of strength is the progress we have made to grow our replacement part sales across the Company. Year-to-date replacement parts account for more than 60% of total revenue and sales of these products is up in the low double-digit range.

We're seeing growth in both segments and in geographies around the world, which reflects our robust selling and distribution model. We are also investing in our future by developing an eCommerce capability. A competitive advantage of Donaldson has been making it easy for customers to do business with us, and eCommerce is another way we are going to reinforce that advantage. We expect to launch the site for selected businesses during FY18, so there's still some work to be done, but we're making good progress.

These are just a few examples of how we are delivering against our strategic priorities. We are confident that our continued strong execution will position us to deliver on our strategic and financial commitments for the balance of this year and into the future. Now I'll turn the call back to Denise to open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Nathan Jones, Stifel.

Nathan Jones - *Stifel Nicolaus - Analyst*

Morning, Tod, Scott, Brad. I wonder if we could just start a little bit in the Engine business there. Clearly strong sales, clearly a big increase in your forecast for the year. Can you give us a little bit more color on what you think is fundamental market improvement there versus customer restocking and maybe how long you think that restock could last?

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

Sure, this is Tod. Relative to the restocking where we are in the cycle of restocking, it is really tough to say. What we have seen clearly is good execution in share gain, we've seen restocking as far as the third component end market increase, really unclear at this time. On the restocking, I want to remind you that our sales on independent channel are roughly 60% of our Aftermarket and our OEM channel is 40% and you will see a less of a restocking phenomenon in the independent channel then you will on the OEM and we are seeing it on the OEM. So we are within that particular cycle of restocking it is not sure, we are not sure.

Nathan Jones - *Stifel Nicolaus - Analyst*

Historically, could you give us some color on maybe an average length of the restocking cycle, just to give us some kind of idea of maybe how long to expect on that?

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

Again, it is just unclear. We are looking at what happened in this quarter as an acute event and really we kind of shrug that off, we take care of our customers, and we really focus on them, make sure that our delivery rates are where they need us to be in order to strengthen our long-term relationships. But as far as the longevity of the restocking, it is really tough to say.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay, fair enough.

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

Nathan, this is Brad. One point I would add on historic side to give you context, when things were going the other way a couple years ago, we were talking about the old rules of thumb on destocking were typically 1 to 2 quarters. And then it ended up being 4, 5, 5.5, 6 quarters where were saw more aggressive destocking. So I think part of what's happened in the market in the last couple of years is some of those old paradigms have changed as well, which clearly adds to the uncertainty.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay, understood. Then just a follow-up question on the mining market. I think you said you are still expecting that to be down mid-single-digits this year. I know that does drive some outsized aftermarket in that. I think people are starting to get more positive on the mining market, can you talk about what you are seeing there and what the expectations are going forward maybe out into 2018 if you have any ideas there?

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

Sure. I think what you see are articles about the actual mining operators and producers like the Rio Tinto's of the world coming out a little bit more positive on their balance sheet recovery, et cetera. And so that's getting people more positive about the mining sector, but for us it is really about vehicle utilization and overall quantities of the product that's been shipped. And so we continue to look for vehicle utilization, you look for it in highly dependent mining based economies like Australia, South Africa, et cetera, and it's still a little modest out there, and mixed. We did not change our projections on mining as a direct result of lack of clarity.

Nathan Jones - *Stifel Nicolaus - Analyst*

Have you have seen any directional change there at all?

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

No.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay. Thanks very much for the help.

Operator

Brian Drab, William Blair.

Brian Drab - *William Blair & Company - Analyst*

Good morning, thanks for taking my questions. First just on a little bit more on the restocking. I'm looking at the aftermarket forecast and looking at first half of FY17 versus second half of FY17 and in the guidance that you just gave us I think you said up high single-digits to low double-digits for the year. That would put aftermarket up about 8% in the second half of 2017 versus the first half. That seems like typical seasonality and I'm just wondering if you can comment, does that increase second half over first half in your mind and in your model contemplate just typical seasonality or is there continued restocking and is there potentially upside to that number if we see continued restocking?

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

Brian, I think you've analyzed that correctly. We will look for the normal seasonality. We built that within our guidance here and that's the way we really look at the aftermarket activity. We see -- we really don't know where we are in this restocking channel, if you will, or in the cycle, so consequently we are really a bit more business as usual on the predictability of things and that's what you are interpreting in the guidance, and I think that is spot on.

Brian Drab - *William Blair & Company - Analyst*

Okay. Thanks and then I guess related to predictability and visibility. I'm not sure if this is a great question because I know you have many data points that you look at to follow the market on competitive landscape, but does the acquisition of CLARCOR in any way take away meaningful important indicator or data points that you had previously tracked to keep an eye on the market and the competitive landscape?

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

As far as the way we view the markets, and the way that we overall forecast the market it does not. Obviously it takes away just a data point of comparative analysis of how we are doing as compared to a competitor. But as far as the macro trends and how we operate Donaldson Company and what we look for within our forecasting, it doesn't change anything.

Brian Drab - *William Blair & Company - Analyst*

All right, great, and last one for me. You mentioned the Synteq product again and that the dollars are still small, but I'm wondering if you can tell us a little bit more about which products and markets are driving the great growth in liquid filtration, and are you taking share there, and if you can tell us what percent of total sales, liquid sales account for today given it sounds like you are seeing great growth in that with without product line?

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

Sure, Brian. The overall share gain that we are experiencing is in fuel. We've been talking to about fuel and our competitive advantage with some of our innovative technologies that we've created over the last three, four, five years and you are starting to see that come forward. We've highlighted that story for quite some time and you're really now seeing that come into production. So we would look to build on that based upon the clear share gains that we have had in that segment and so it is really fuel drive.

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

Brian, this is Brad. I will give you the stats on it. Liquid is about a third of total Engine and the fuel [loo] business Tod is talking about is a little more than half of that.

Brian Drab - *William Blair & Company - Analyst*

Okay and liquid as a percent of total sales today and maybe compared to what it was a year or two ago?

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

I have to do the math, about one-third of total Engine but where it was -- --

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Brian Drab - *William Blair & Company - Analyst*

That's the only place we have liquid, is what you're saying, it's all in Engine, right?

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

Liquid in total this year is up in the low teens so versus a year ago we continue to do quite well in this business.

Brian Drab - *William Blair & Company - Analyst*

Great, okay.

Scott Robinson - *Donaldson Company Inc - CFO*

In the Industrial segment, Brian, you see us going after liquid with things like our LifeTec products and other, so you will see our liquid base strategy really starting to go over to the Industrial side as well in quarters to come.

Brian Drab - *William Blair & Company - Analyst*

Okay. All right, great, thank you.

Operator

Charlie Brady, SunTrust Robinson Humphrey.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Thanks, good morning guys. I was wondering if we could dig a little bit more on the Off-Road piece of Engine? I mean clearly you've touched on a little bit because I would like to get a little deeper in granularity into what you are seeing on that? And I think you talk about some of the restocking, but that sounds more like an aftermarket phenomenon then on the OE side. I'm just trying to understand the strength on the Off-Road business. From an OE perspective it just seems a little stronger than we would've thought it would have been coming into this quarter.

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

Charlie, this is Tod. It is actually stronger than we had predicted in our models as well, and I think the primary comp when you go year-to-year is last year we had year-end shutdowns and extended year end shutdowns as it was a pretty difficult moment and you saw across all sectors of the Off-Road really managing finished goods inventories and therefore producing less. We did not see those extended shutdowns this year, so in a way it is kind of easy comps year-over-year, but really what carries that strength is less shutdowns across all sectors, Ag, Construction and Mining.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Okay, that is helpful in understanding that. So I guess I would take from that then and I guess you alluded to it going into the second half you don't really have that same phenomenon so the rate of increase maybe it's stronger than it was otherwise going to be thought, but you are not going to get the similar type of surprising pop to the upside in the second half just because you don't have the similar phenomenon on the shut-down comp, is that correct?

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

That's correct. That's the way we view it and that analysis is what we built in guidance.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Okay and on the gas turbine business on the order delays, it sounds like that's pushed into 2018. Is it in fact order delays or are you seeing things maybe being pushed out when you say delayed, delayed to date unknown type of delays opposed to six, eight month type of time frame?

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

Two types of delays, we've seen the projects that are in hand move out of this fiscal into next fiscal year, but we've also seen quotes that were expected to be awarded move out much further as well.

Charlie Brady - *SunTrust Robinson Humphrey - Analyst*

Thank you. That's. That's helpful, thanks.

Operator

Matthew Paige, Gabelli & Company.

Matthew Paige - *Gabelli & Company - Analyst*

Good morning, everybody. Wanted to touch on some points, kind of what you brought up earlier. Have you evaluated what kind of impact you would see from the administration's tax proposals?

Scott Robinson - *Donaldson Company Inc - CFO*

Yes, we've been following that closely and I provided a little bit of additional information this quarter to discuss the fact that Donaldson is a net exporter out of the US, so we felt like we are well-positioned there. I also indicated that are most of our cash sits outside of the US so any sort of repatriation changes we would look to take advantage of. Obviously a lower corporate tax rate would help our Company so we feel like we sit in a strong position in relation to the various tax changes that have been considered and we continue to monitor that every day.

Matthew Paige - *Gabelli & Company - Analyst*

Great and then how do you view a potential boost in infrastructure spending affecting Donaldson for the products that are in your end markets?

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

We're really pleased that the administration is taking a look at boosting infrastructure spending. However, that would not affect our FY17 typically as I want to remind you that we would end in -- our fiscal year ends July 31st -- so any infrastructure spending boost by the time it would roll through the overall end markets would likely be in future fiscal years.

Matthew Paige - *Gabelli & Company - Analyst*

Got it, and then the last question for me is obviously, On-Road class 8 has been under pressure, but seems some signs of life in recent orders. Can you maybe provide some color on how your conversations with customers there have gone?

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

I think it is really just more bouncing along at the current levels and everybody trying to understand when the US-based market, which has really driven so much of the headwinds here, when that US market will start to see a turn. We are really, with all of our On-Road OEs more fixated on winning future business and winning new platforms than any kind of euphoria about end market turnaround.

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

Matthew, this is Brad. One thing I would add is this looking at ACT data I guess from our point of view the other a positive that's buried in some of these declines is that the forecasts as they've been moving through the year are coming down at less dramatic pace. I think year ago the quarterly forecast or moving down by 10% or 15% or 20% each quarter from what they thought just 90 days ago, and now that seems to have stabilized. Still declining production but at least the forecasts seem to have a better handle on it.

Matthew Paige - *Gabelli & Company - Analyst*

Great. Thanks for the time.

Operator

Richard Eastman, Robert W Baird.

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

Yes, good morning and congrats on the nice surprise, nice quarter and I'm sure you breathe a little bit of a sigh of relief here. Tod just a quick question when I look at the geographic growth rates kind of by segment, Engine and Industrial, what maybe strikes me a little bit here is EMEA and the strength in EMEA across the board. Is -- from a geographic standpoint -- was EMEA the biggest maybe surprise to you and is there a macro perspective that you could overlay onto what amounted to 10% growth rate? Local currency?

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

I don't think EMEA really surprised. If you take a look at previous calls I've been talking about the gains we've been making in our aftermarket strategy and pressing forward with our replacement parts businesses across EMEA, and they've been executing very well on those strategies for some time. To larger extent they are really just a microcosm of our comprehensive plan for the year, which is grow replacement parts to offset the headwinds we should experience in the first bit and really all segments, all regions in the Company are performing quite well there.

So the thing that I would suggest about EMEA is that throughout all of this it has held up in the core base businesses. A bit stronger than, for example, the US region cycled down much heavier, and there was less of a drop in Europe. So I think overall we're pretty proud of the execution across our European organization.

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

I understand. Then just a quick question as well, do you have any visibility when you look the aftermarket business and the nice bounce there--do you have any visibility into the sell-through in that channel versus your sell-in this quarter?

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

We don't, Rick, and that's what really creates the difficulty for us to predict where we are in any kind of acute event like a restocking.

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

Okay, and maybe last question, really good incremental EBIT leverage in the quarter and obviously we were surprised here with the restock and just the acceleration here and the upside in the revenue. As we go -- as we push forward over the next, call it, 12 months, so we capture the first half of next year--should we expect that incremental to settle down more in the 25 to 30 range, or how do you think about that because you obviously do reinvest if you feel there's some sustainability in the revenue top line. So should that be the way we're thinking about the incrementals here moving forward?

Scott Robinson - *Donaldson Company Inc - CFO*

Hi, Rick, this is Scott. We are pleased with the incremental improvement we delivered in the first half. We did have a pretty good lift in sales. We've taken our guidance up a little bit on increased sales for the last half of the year.

So we are comfortable with the current guidance, and as we've always said, we believe that we can slowly improve our profit on increasing sales, and that is something we are going to work on every day. We do have some headwinds coming this quarter, as I mentioned. We have some variable comp that we are going to have to absorb. We do have some additional margin costs associated with a suddenly increase in demand that being freight and maybe some additional cost in the plant that we have to manage. But at the end of the day we believe we can slowly increase incremental margins on improving sales.

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

Is there any issue, Scott, or any concern around any materials inflation, materials cost inflation at the cost of goods sold line?

Scott Robinson - *Donaldson Company Inc - CFO*

Yes, there's certainly some inflation coming. We monitor our commodity prices every day and they are providing a little bit of a headwind going forward. We work to mitigate that, but that is something that we are aware of.

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

Okay. Very good. Thank you and congrats again. Nice quarter.

Scott Robinson - *Donaldson Company Inc - CFO*

Thanks, Rick.

Operator

Laurence Alexander, Jefferies.

Dan Rizzo - *Jefferies & Co. - Analyst*

Good morning, this is Dan Rizzo on for Laurence. You mentioned that Ag was going to be down mid-single-digits, can you provide some color what you are seeing there? I mean are trough conditions forming at all or is it just not showing any signs of firming up, any insight?

Scott Robinson - *Donaldson Company Inc - CFO*

What was the last part, Dan?

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

I'm not sure we've got your whole question. Can you please repeat that?

Dan Rizzo - *Jefferies & Co. - Analyst*

Sure, I think you indicated that Ag was down mid-single-digits. I was just wondering if trough conditions are starting to form, if there's any signs of strength at all?

Scott Robinson - *Donaldson Company Inc - CFO*

Within Ag I think you see Deere for example, they took up their forecast and so they gave -- they signaled some positivity out there. So we do hear those kind of data points, but we did take that into account because as you look outside the US it is a little bit more of a troubled story with other large based customers. So overall there's clearly mixed signals across the ag market and there's just not clarity so we just did not feel comfortable altering where we currently stand on ag as we don't see it in our backlog and we don't really translate that obviously therefore into revenue.

Dan Rizzo - *Jefferies & Co. - Analyst*

Okay. Then the cost you removed due to last year's restructuring, or 2016 restructuring, is there any chance those costs could seep back in as things accelerate or as some of your end markets accelerate?

Scott Robinson - *Donaldson Company Inc - CFO*

Sure, we said that was $12 million of benefit coming into this year. Those were structural costs I would say that we worked to take out. If sales continued to accelerate we are certainly going to have to address our expense levels. Some of our expenses are fixed, others are variable, but in general I think if revenues are way up then our expenses are going to have to address that. We are cautious in adding infrastructure so we are very careful about adding in, but we will continue to invest in the future of the Company on sales increases.

Dan Rizzo - *Jefferies & Co. - Analyst*

Okay. Then finally, with your eCommerce efforts -- that's coming online in the next year or I think you said 2018, is using eCommerce unusual for the industry, is this something that not a lot of people have ever looked to before? I was just wondering what the dynamics look like.

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

It is not unusual, but for Donaldson it represents a new channel, just simply because we are very inconsistent in its usage. Today you could order an eCommerce part in some of our businesses in some of the regions, but you can't order a part over the Internet from Donaldson everywhere in the world. That's the thing we are out to change. They will be multiple models of eCommerce, the Engine model for Aftermarket because we are a distribution based partnership model we'll keep that intact. But there are other businesses also that will have a direct end market model because that's the way we run the business so we are building in the flexibility necessary to arm all of our businesses to really use this eCommerce channel as a positive for growth.

Dan Rizzo - *Jefferies & Co. - Analyst*

Great. Thank you very much.

Operator

There are no further questions at this time. I turn the call back over to Brad Pogalz.

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

That concludes today's call. I want to thank everyone for listening for their time and interest in Donaldson. I also want to thank our employees again. I'm very appreciative of their efforts and because of them I am confident that we can deliver our strategic and financial commitments. Have a good day. Goodbye.

Operator

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