THOMSON REUTERS

FINAL TRANSCRIPT

Q4 2017 Donaldson Company Inc Earnings Call

EVENT DATE/TIME: 09/07/2017 10:00 AM GMT

CORPORATE PARTICIPANTS

Brad Pogalz *Donaldson Company, Inc. - Director of IR*
Scott J. Robinson *Donaldson Company, Inc. - CFO and VP*
Tod E. Carpenter *Donaldson Company, Inc. - CEO, President & Director*

CONFERENCE CALL PARTICIPANTS

Brian C. Sponheimer *G. Research, LLC - Research Analyst*
Daniel Dalton Rizzo *Jefferies LLC, Research Division - Equity Analyst*
George James Godfrey *CL King & Associates, Inc., Research Division - Senior VP & Senior Research Analyst*
James Giannakouros *Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst*
Kyle Dicke
Nathan Hardie Jones *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*
Peng Yao Wu *SunTrust Robinson Humphrey, Inc., Research Division - Associate*
Richard Charles Eastman *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

PRESENTATION

Operator

Good morning. My name is Jody, and I will be your conference operator today. At this time, I would like to welcome everyone to the Donaldson's Q4 Fiscal Year 2017 Conference Call. (Operator Instructions) Thank you. Brad Pogalz, you may begin your conference.

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

Good morning. Thank you for joining Donaldson's Fourth Quarter and Full Year 2017 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 provide a recap of our fiscal 2017 performance and discuss our fiscal 2018 strategic priorities and financial targets.

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'll turn the call over to Tod Carpenter. Tod?

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

Thanks, Brad. Good morning, everyone. We are proud of our fiscal 2017 performance, which reflects benefits from our strategic priorities combined with improving conditions and engine-related markets. Total sales increased 7% to $2.37 billion, which brings us back to where we were 2 years ago.

We grew operating margins at 13.9%, which is 70 basis points up from last year's adjusted rate and a full percentage point above adjusted rate in 2015.

I want to thank our employees for their contributions last year. They did an excellent job executing our strategy while meeting our customers' needs, and they showed characteristic resilience as we dealt with the mixed environments between Engine and Industrial.

As we look forward, we expect Engine markets to stay in recovery mode, while key Industrial markets will likely remain uncertain. Our fiscal '18 plan is comprised of a robust strategic agenda, which includes a continued focus on driving growth and enhancing operational efficiency. We also plan to make investments in capacity expansion, customer engagement and technology development.

The midpoints of our fiscal '18 sales and EPS guidance both reflect record performance for our company, as we plan to deliver 10% EPS growth on a 6% sales increase. Before Scott and I cover our plans for fiscal '18, I want to share some of our sales highlights from 2017.

Our full-year sales were nearly 1% above our previous guidance as we saw fourth quarter favorability in both segments. In total, Q4 sales grew 11% to $660 million, with the Engine segment driving the increase. Engine sales were up 18% in the quarter, as both first-fit and Aftermarket showed strength. Aftermarket sales were up 19% from last year, which included a combined benefit of about 5% from the Partmo and Hy-Pro acquisitions. Strategically important product categories also contributed to our growth last quarter.

For example, sales of replacement fuel and lube filters were up more than 20%, as we continue to benefit from short-cycle program wins. On the other side, Aftermarket sales of PowerCore increased in the high teens. Additionally, fourth quarter marked the sixth quarter in a row for year-over-year increases in both the OE and independent channels of Engine Aftermarket. Ordering patterns within the OE channel suggest that volume is demand-driven versus restocking and it is broad-based. The independent channel strength is also broad-based, and there are clear benefits from the recovery in the mining and oil and gas markets.

Our Off-Road first-fit business is also seeing benefits from the recovery in these markets. Fourth quarter sales grew 28% to $71 million, which is the highest revenue we have seen in nearly 3 years as production continues to come off historically low levels. Sales of first-fit fuel within Off-Road are also encouraging. Although these products are still a small part of total Off-Road, sales were up more than 30% last quarter. We expect momentum to build as past program wins launch into production.

On-Road sales grew 4% in fourth quarter, as increasing production of Class 8 trucks drove growth of more than 30% in the U.S. While the production trend is encouraging, the percentage increase is inflated due to a very easy comparison.

Rounding out the Engine segment, Aerospace and Defense sales were about flat with last year as growth in commercial aerospace was offset by declining Defense sales.

Turning to the Industrial segment. We delivered a modest year-over-year increase last quarter. Our Industrial Filtration Solution business continues to face a mixed environment. Total IFS was up 5% in the quarter, driven entirely by a mid-20% growth rate for sales of replacement parts. On the other hand, market demand for new systems remains at a low level. We saw modest growth in sales of Special Applications, with strength in Venting Solutions being partially offset by a low single-digit decline in disk drives.

Sales to Gas Turbine Systems were down 15% last quarter, which is better than expected, as fewer projects slipped from the quarter into fiscal '18. Market conditions for GTS are still challenging. Overall demand for new turbines remains low, so pricing is aggressive. Given these dynamics, we are confident in our decision to be selective in how we compete for large turbine projects.

Stepping back from the quarter, I want to also provide some full-year sales highlights. We came into the quarter with a handful of strategic priorities, including growing sales of replacement parts to offset anticipated weakness in first-fit and further penetrating the markets with innovative products to drive growth this year and into the future. As we look back on the year, we are encouraged by what we accomplished, as strong execution of our strategy compounded with the unexpected benefits from improving market conditions.

For example, replacement part sales were up in the mid-teens from last year, and these products accounted for more than 60% of total sales. Importantly, both segments had comparable growth rates. In the industrial segment, we are proactively managing the replacement cycle and providing high service levels to tens of thousands of customers. In the Engine segment, Aftermarket achieved a record level of sales last year. Two notable drivers are innovative products, which have a higher retention rate, and our geographic diversification

(technical difficulty)

Or nearly 50% when you include Partmo.

With regard to innovative products, we continue to plant seeds for future growth. We remain pleased with program win rates in both air and liquid, and benefits from past wins were evident in our fiscal '17 results. For example, total PowerCore increased in the low double digits, sales of Downflo Evolution dust collection systems grew nearly 70% and sales of premium fuel products grew in the mid-30% range. All of these offerings have strong value propositions to their respective customers, and they all drive Aftermarket retention with innovative technology and design.

In addition to these "razor to sell razor blade products," innovative products within Integrated Venting Solutions are also performing well. Full-year sales grew in the high single-digit range, and that's on top of growth in the high teens last year. IVS is slightly less than 15% of our Special Applications sales, but it continues to grow quickly, and we are optimistic about its long-term prospects. These are important examples of how our diversified portfolio and technology offering contributed to our success in 2017, and our 2018 agenda will build on this foundation.

I'll now turn the call over to Scott for additional comments on 2017 and the details of our 2018 outlook. Scott?

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

Thanks, Tod. Good morning, everyone. We are pleased to have delivered fourth quarter sales above forecast and earnings per share in line with our guidance. Sales jumped 11% to $660 million, and GAAP EPS was $0.51 in the quarter. Our Q4 operating margin of 14.3% was down from last year's GAAP and adjusted rates of 15.2% and 15.8%, respectively. For reference, the prior year adjusted rate excludes $3.5 million of restructuring charges.

Fourth quarter gross margin declined to 34.8% from last year's adjusted rate of 35.4%. We saw headwinds from inflation, mix and incremental freight charges. Better fixed cost absorption offset some of those pressures. Our fourth quarter expense rate increased to 20.5% from last year's adjusted rate of 19.6%, driven primarily by higher incentive compensation. Once again, leverage on the sales increase provided some relief. The tax rate was 25.6% in the fourth quarter, down from 28% last year as we had a favorable mix of earnings between tax jurisdictions.

I also want to share some perspective on our full-year results. We delivered sales of $2.37 billion, which is $150 million above the prior year and the midpoint of our initial FY '17 guidance. Despite pressure from incentive compensation and incremental costs from higher-than-expected demand, we delivered an adjusted operating margin growth of 70 basis points. As Tod mentioned, the 13.9% margin in 2017 is a full percentage point above the adjusted rate in 2015 on comparable sales.

Our 2-year operating margin improvement reflects our ability to capture margin as sales stabilized in a more predictable range, which is what began in the back half of 2016. Over the past 6 quarters, several key markets moved through stabilization and into recovery. As we added costs over the course of 2017 to meet demand, our incremental profit settled into a level that is more consistent with historic performance.

In terms of other key metrics, last year's capital expenditures were $64 million. Notable investments include capacity expansion for key product lines and our e-commerce platform. We completed 2 strategic acquisitions last year, Partmo and Hy-Pro, for a total investment of $32 million. Fiscal 2017 free cash flow grew 15% to $247 million, and our cash conversion was 106%. While working capital went up with demand, our leverage ratio stayed in line with our target at about 1.5x gross debt to EBITDA.

Before moving on, I want to point out a change on our balance sheet. During the fourth quarter, we amended our revolving credit facility and increased its size to give us more flexibility in capital structure. The updated agreement is now classified as long-term debt on the balance sheet. We are pleased with the terms under which the amendment was completed, which are reflective of our long history of taking a disciplined approach to managing our business. This new agreement supports our current and future needs, and we are appreciative of the strong partnerships we have with these lenders.

Turning back to our results. We returned nearly $233 million to shareholders through dividends and share repurchase last year. Total dividends paid were $92 million. And we repurchased 2.5% of our outstanding shares, which is slightly above our historic average. As we transition to fiscal 2018, we will maintain our discipline with regard to both operations and capital deployment. We're also maintaining a cautious stance with expense planning, which fits, given the mix environment between our 2 segments and our desire to increase the level of strategic investments. Capacity for making these strategic investments is also coming from leveraging our sales, which are expected to increase between 4% and 8% this year. Currency translation, combined with the benefits from last year's acquisitions, will add about 2% to our growth. The majority of the sales increase is coming from the Engine segment, which is expected to be up 6% to 10% in FY '18.

Our analysis of external forecasts indicates that both production and utilization of heavy-duty equipment will be up in the low to mid-single-digit range this year. For our businesses, we expect that the benefits from our strategic initiatives will drive growth that outpaces what we see in the markets. Both Off-Road and On-Road are planned to be up in the mid- to high single-digit range. Aftermarket sales are projected to be up in the low double-digit range, which includes a benefit of about 2% from Hy-Pro and Partmo.

Aerospace and Defense sales are forecasted down to low single-digit range, driven by a decline in Defense that is partially offset by strength in commercial aerospace.

Our Industrial segment continues to face a variety of market conditions. We are planning full year sales to be flat to up 4%, with the strongest growth coming from Industrial Filtration Solutions. We expect IFS will increase in the mid-single-digit range, reflecting strong sales of replacement parts and lukewarm demand for first-fit systems. Sales of Special Applications will be roughly flat with the prior year. The disk drive business is expected to follow the market's secular decline, and another year of strong growth in sales of venting products is helping to offset the pressure. Finally, our Gas Turbine business is planned down in the high single-digit range. We expect that declining sales of turbine projects will be partially offset by growth of GTS replacement parts. For reference, Aftermarket is expected to make up about 60% of GTS sales in FY '18, but large turbines less than 20%. Sales into small turbines make up the balance.

Our FY '18 operating margin is planned between 14% and 14.4%, with the midpoint up 30 basis points from 2017. Lower incentive compensation contributes some favorability, but we also expect strong incremental gains from leverage. We will be investing a portion of these gains into strategic investments related to capacity expansion, customer engagement and diversification through technology development. In total, we are forecasting to spend between $10 million and $15 million on these initiatives next year, which Tod will discuss in greater detail. We are also anticipating margin pressure from inflation in fiscal '18, largely driven by steel and, to a lesser extent, media. As always, we will leverage our continuous

(technical difficulty)

to mitigate some of the pressure. As a reminder, raw materials represent 60% to 65% of total cost of goods sold, with steel and media being the 2 largest inputs.

In fiscal '18, we expect interest expense of about $21 million, other income between $5 million and $9 million and a full-year tax rate between 27.4% and 29.4%. We expect our tax rate to go up this year, given the mix of earnings, but the adoption of the accounting change related to stock option expensing is partly offsetting this impact. We are planning capital expenditures between $80 million and $100 million in FY '18, which is up from last year as we support our capacity and technology needs. We expect to deliver full-year cash conversion between 75% and 90%, which we feel is appropriate given our opportunities to grow the business this year and invest for future growth. We plan to repurchase approximately 2% of our outstanding shares in FY '18, which is consistent with what we would expect over the long term.

Our goal in any given year is to at least offset dilution of about 1%, and repurchase beyond that level will be dictated by our balance sheet and strategic agenda. Altogether, we plan to deliver full year earnings per share between $1.79 and $1.93. The midpoint of the range implies a 7% increase in GAAP earnings and a 10% growth from last year's adjusted EPS. Our plan does not contemplate any adjusting items in FY '18, so GAAP and adjusted EPS are expected to be one and the same.

To help with modeling, I want to quickly touch on our forecasted cadence of sales and profit this year. We are expecting sales will be weighted towards the back half, but not quite to the extent we saw in FY '17. We also expect that the sales increase in the first half will be greater than the second half based on an easier comparison.

In terms of operating margin, the first half of last year is a tougher comparison. One year ago we were capturing a lot of incremental margin, as sales are increasing much faster than our cost. And the first half of this year will include cost related to our strategic investments. Given those dynamics, we expect that our operating margin improvement will come in the back half of the fiscal year.

And one bit of housekeeping on the profit cadence in the first half. For fiscal '18, we changed the timing related to our annual stock option grant. We will now incur that expense, which is around $3 million, in the first quarter versus second quarter. In fiscal 2018, we see an opportunity to drive strong profit growth, increase the level of strategic investments in the business and return cash to our shareholders.

I will now turn the call back to Tod to provide some color on our initiatives. Tod?

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

Thanks, Scott. Our fiscal '18 agenda includes plans for driving growth and enhancing operational efficiency. We are also planning to make several strategic investments this year, including projects focused on capacity expansion, customer engagement and further diversification through technology development.

Let me share some color on these investments. We will increase our manufacturing capacity for our innovative air and liquid technologies. Customer demand remains strong, and we expect these businesses have a long runway for growth. The plan includes a mix of adding new lines and new square footage based on current and projected demand.

We are also expanding our distribution capacity. Work is under way in some locations, such as our European distribution center, and we will continue those efforts into fiscal '18. We see a cost benefit to having this capacity, and we also see an opportunity to further deepen our customer engagement. Additional distribution capacity allows us to maintain our high service levels while accommodating the customers' desire to receive products from fewer locations and/or consolidate their orders.

Another investment related to customer engagement is e-commerce. We began building the site last year and will launch globally later this fiscal year. By making it easier for our current and potential customers to engage with Donaldson, we expect that this channel will be an efficient way for us to meet demand.

Finally, we'll be making technology investments to further diversify our product offering. Over the next several years, we will plan to increase our R&D spend to somewhere between 3% and 4% of sales, which is up from our prior target of 2% to 3%. We spent about 2.3% last year, and we plan to increase that by 20 to 30 basis points this year.

Developing connectivity solutions is one of our initiatives. Our customers in both segments are becoming increasingly interested in this technology, which could help them better manage things like service intervals or product integrity. We're in the early stages of development, but we are preparing to meet the customer demand as it emerges. We are also investing in new filtration technologies to expand further into adjacent markets.

All of the strategic investments I discussed are critical to our long-term success, as they support our technology leadership and global presence. We also believe that our fiscal '18 plan strikes the right balance between making these investments and delivering incremental profit on our sales increase.

Again, I want to thank our employees. They've done an excellent job executing our strategy throughout this recent downturn, and I am confident that we will continue to build momentum and deliver on our financial and strategic commitments in 2018.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Charley Brady of SunTrust Robinson.

Peng Yao Wu ***SunTrust Robinson Humphrey, Inc., Research Division - Associate***

This is actually Patrick Wu standing in for Charlie. It looked like the APAC Aftermarket business did fairly well in the quarter, I think up over 30%, even though it's off of slightly negative comps. Can you talk a little bit about what you're doing there and how should we sort of look at fiscal '18 sort of to be? And can you also remind us how big a size the APAC Aftermarket business is?

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

Sure. This is Tod. Within APAC, it's really driven by the success we're having in China. We entered China and started having success with the multinational companies, the John Deere, Caterpillar, et cetera. And now we're having success with the Chinese nationals such as the LiuGong, Lonking and the Sanys, et cetera, of the world. As we look to expand and grow in China, we have a lot of opportunity there, because our share is in the very low single digits. So some of the percentage gain is just simply because it's a low base. That said, our strategy and our execution is really working well in China. Coupled with a bit of end-market improvement in China has really driven our success in APAC for the quarter.

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

Patrick, this is Brad. I'll just give you that stat that you're interested. Total APAC Aftermarket is in the mid-teens as a percent of total. But to Tod's point, China is a few percentage points of total Aftermarket revenue. So there is a lot of runway there.

Peng Yao Wu ***SunTrust Robinson Humphrey, Inc., Research Division - Associate***

And when you say mid-teens as a percent of total, that's percent of total Aftermarket, right?

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

Correct.

Peng Yao Wu ***SunTrust Robinson Humphrey, Inc., Research Division - Associate***

Got it. And then you've mentioned that you -- that the team is sort of rethinking and exploring ways in terms of how to bid for certain projects and gas turbines. It's down 15% this quarter, off of close to down 20% comps. And obviously, you're expecting another down year in '18. I guess, can you provide a little bit more color on -- it sounds like it's mostly on the large turbine side. You guys added some color on percentages from Aftermarket and large and small turbines. Can you guys talk a little bit -- can you give a little more color on that market and if you guys can see it pass toward an inflection point sometime in maybe the latter half of the fiscal year?

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

Sure. We projected gas turbine to be down this year, but we believe also that fiscal '18 is likely going to be the bottom point for that particular market. We do have quite long visibility, more visibility in the gas turbine market than any other business that we have. We see the long-term larger turbine projects, if you will. And therefore, we can say pretty confidently that the overall long turbine project is going to continue to remain depressed throughout the balance of this fiscal year. As we turn into fiscal '09 (sic) ['19] though, we do expect an uptick to that. It really reflects the proper alignment with our strategy -- our strategic choice over the last year, where we became far more selective in our gas turbine -- large turbine project and that we're really pretty happy with where we sit. But again, we expect it to take the upturn more in later fiscal years, but not fiscal '18.

Peng Yao Wu ***SunTrust Robinson Humphrey, Inc., Research Division - Associate***

Just as a very quick follow-up to that. And when you say you're more selective on the large projects, are you speaking more along the lines of looking at just going after higher-margin business? If a project isn't fitting into the profile, it's -- that sort of dynamic has changed, where you are okay with walking away from some projects?

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

Absolutely. That's exactly what we're doing. We're walking away from those that we feel are low margin and not paying for our technology.

Operator

Your next question comes from the line of Jim Giannakouros of Oppenheimer.

James Giannakouros ***Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst***

Just taking a step back and looking at your revenue margin profile. When I look 4, 5, 6 years ago when you had higher revenue level, certainly in engine, a little bit of a choppier comparison, just given the volatility in gas turbines over the last 5 years. But just overall, back in like FY '12, '13, '14, 15% was in the -- margins -- overall margins was part of the conversation or was potentially contemplated. But we enter 2000 -- your fiscal '18. You've done a number of -- you had your restructuring efforts several years ago. You're entering an up-cycle in

Off-Road and On-Road at a higher Engine Products segment to overall revenue level. I'm just trying to figure out what the major puts and takes are as to why that margin of 15%-plus is not even contemplated currently? What's structurally different now versus then?

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

Yes, this is Scott, I'll start. I have here in front of me FY '13 to the current. And FY '13 and '14 were in the low 14% range. Our high revenues peaked out at $2.493 million (sic) [$2.493 billion]. Next year, we'll be right at about $2.5 billion. So we've gotten the sales forecasted to a level approximately equal to our prior record. And in our -- as our revenue started to turn down, we hit the [12] of operating margin. So we've harvested 100 basis points of improvement in the last 2 years. And we plan, at the midpoint of our guidance, another 30 basis points next year as we grow revenues and invest in the business. So we are committed to increasing our levels of profitability on increasing sales, but we also want to invest back in the business. So we're into the low 14s. And as sales grow, that will grow, but we also want to invest back in the company.

James Giannakouros ***Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst***

Got it. I guess, where I'm struggling is just maybe on a per segment basis. When you look at Engine Products back in FY '13, you were knocking up against 15%. And that was at a lower revenue level versus what, I think, you're guiding to for next year, right? You're going to be 1 point -- over 1.6 easily if you hit your mid- to high single-digit kind of growth rate next year versus the 1.5 that you did years ago. If you can, I guess, isolate the puts and takes on the differences between now and then on a per segment basis, that might be helpful, understanding that Engine Products might be a little simpler story. A lot of noise obviously in GTS, in industrial.

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

This is Tod, I'll start. If you take a macro step back, look at our overall Engine business, we have added a number of different capacity expansions between 2013 and now. Additionally, we have some capacity expansion in flight. For example, the [Pullen] project that we've talked about a number of times, we have additional capacity expansion to support our liquid initiatives going on this year, which will add additional footprint in multiple locations in order to meet the customer needs. And then as you just step back at the performance from last year, we enjoyed really quite a nice bump in our Engine business. We're still catching up with some of that and making sure that our priority is always to take care of our customers. So there is a bit of a higher spend in support of some of that business at this point, simply because we're having to really air ship some shipments, for example, to meet our customers' demand. So there's a little bit of operational efficiency that we'll be focused on this year to gather it. Long term is as we look across our company, that 10 to 20 basis point improvement of operating margin is -- on an annual basis, is still within conversation here. We're just in a little bit of a point where we got -- we have the need for capacity expansion investment in our company and we had a nice pickup of business.

Operator

Your next question comes from the line of Nathan Jones from Stifel.

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

I wonder if we could just start on the uncertainty you're talking about in Industrial markets. And I think particularly, you're talking about IFS and first-fit there. Some of the macro indicators globally look pretty good. Some of the leading indicators look pretty good. Do you feel like we're on the cusp of a recovery in that market? What do you think needs to happen to drive that? Just where you think we are in that cycle.

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

This is Tod. We're seeing utilization numbers nicely. And so you see that in our Aftermarket segment, for example, that we talked about in our prepared remarks. But we're still very guarded on the first-fit CapEx project space. Our quote-to-order cycle is still elongated, and we do not see a more regular cadence of projects coming through really in any region at this point in time. So we're -- if you just step back and look at it, what we're experiencing growth across our industrial segment is really on the replacement parts. So that's the first step to CapEx expansion. But it's -- we have not seen that yet. So we remain pretty guarded on that outlook, and that's what we put within the guidance.

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

If that changed and things improved there, how long would you see that in advance of that starting to come? I mean, how -- you said your quote-to-order is still elongated. What's kind of the time frame that you're looking at there in terms of what that quote-to-order length is? What is it normally when you start seeing a first-fit recovery cycle?

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

Sure. The CapEx projects typically, we're given about a 90-day period on average to deliver, say, an average-sized project within the Industrial segment. So we'll get about a quarter's look at that before -- when it does start to pick up. And we've not seen evidence of that type of a cadence at this point.

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

Okay, that's helpful. And then on the investments, it sounds like some of these are going to run through CapEx, some of these are going to run through the P&L. Can you give us just some order of magnitude on what the impact is to margins or EPS from the increased investments that are running through the P&L in '18?

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

Yes, the total investments that would impact the P&L is about $10 million to $15 million, and that's 40 to 60 basis points of operating margin if you just isolate those exact numbers. There is some CapEx associated with some of the projects as you recommended, but the $10 million to $15 million is the P&L impact.

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

And that's incremental over '17, yes?

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

Yes.

Operator

Your next question comes from the line of Laurence Alexander from Jefferies.

Daniel Dalton Rizzo ***Jefferies LLC, Research Division - Equity Analyst***

This is Dan Rizzo on for Laurence. If we think about the Chinese environmental regulatory crackdown, is that providing increased demand for filtration systems? And could that provide a tailwind for you guys over the next couple of years, or is it already?

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

It's not. It's really -- what's happening in China is their desire to export. And so therefore, the need to meet Western-based standards, since they have a lot of capacity in country. So what's giving us opportunity is they have to meet U.S. or European standards. And therefore, they know we already meet that and given us opening not specific to the Chinese government slate, if you will.

Daniel Dalton Rizzo ***Jefferies LLC, Research Division - Equity Analyst***

Okay. And then just a little more color on, sorry if I missed this, but on order trends for mining vehicles, what do you expect going forward?

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

So -- sure. For mining vehicles, we see mid-single-digit increase on the production to high single digit is what we have baked in within the guidance.

Operator

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

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

Could I just ask -- again, in the fourth quarter here with the revenue number that we were able to generate, which is quite impressive, I'm just curious where was the -- where did the margin kind of slip out to give us the midpoint EPS number? Because the operating expense looked high to me. Was that somewhat discretionary on the comp side? Or did something surprise you within the midsection of the P&L to deliver the kind of the midpoint of profit guide?

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

Hi, Rick, this is Scott. There was several impact -- factors impacting the Q4 operating margin, as I tried to kind of lay out in my script. We had increased demand, which we were happy to see. And we had some cost incurred associated with fulfilling that in terms of freight and overtime. We had a slight uptick in commodity prices, a slight uptick in freight, also an uptick in incentive compensation based on the higher sales. So you put those main factors together, and that's what drove what you're seeing in the fourth quarter.

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

Yes, okay. Okay. And then as we roll into '18 with your guide, do you expect to see -- does your gross margin improve with leverage, your gross margin and mix? Should that be up 20 or 30 bps or something like that, similar to what we're seeing at the guided up profit line?

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

Right. So we have a 30 basis point improvement in operating margin, and that comes from both. Gross margin and OpEx are contributing to that. So you get a little bit of an uptick in both sides of that equation.

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

Yes, okay. Okay. And then just a question maybe -- and I think you might have touched on this a minute ago. But when you looked at your high single-digit growth rate expectation for -- you kind of combined On-Road, Off-Road kind of first-fit. Could you just kind of segment those two? Is the -- is your expectation around the On-Road business to be up kind of mid-single digits, with Off-Road up maybe closer to double digits build rate?

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

Globally, when you step back and look at Off-Road and On-Road, they're about the same, both mid-single digits to high single digits. But they're very different stories geographically. So the On-Road sector will be really driven by the U.S., which is going to be up in the double digits, really pulled down by the other geographies, therefore in aggregate, being mid- to high single digits. And the Off-Road is very broad-based. It's mid-single digits to high single digits in all geographies. So they're very different stories. They just happen to end up at the same point of mid- to high single-digit growth.

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

Yes, I understand, okay. But pretty healthy environment, just generally speaking, in the Off-Road market globally?

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

Correct.

Operator

Your next question comes from the line of Kyle Dicke of William Blair.

Kyle Dicke

Just a couple of quick ones from me. But first, I know you've commented a few times on the commodity inflation as a headwind to gross margin in the quarter. But were you able to offset any of that with pricing?

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

Yes. So we -- as we said, we have some commodity inflation. We work to offset that by two ways. One is, we have continuous cost improvements, and our plants do a very good job at this of continuing to identify cost-saving initiatives and bring our costs down to provide margin. And also, we work -- on the pricing side, certain of our contracts will have a basket concept in them that allows us to adjust pricing should certain commodity costs move outside a certain range. And so we work via that approach as well as just general pricing mechanisms that we might in place -- put in place such as an improve -- or an increase in Aftermarket parts or whatever it may be.

Kyle Dicke

Okay. But -- so that kind of that spread between the price and the cost was negative in the quarter?

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

That is correct.

Kyle Dicke

Okay. And then I'm not sure if -- I apologize if you've provided this previously. But how do the margin profiles of the Partmo and Hy-Pro businesses compare to kind of the company overall average?

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

We haven't provided that specific detail in terms of a forecast going forward. But they're consistent, I would say, with the general line of the business that they participate in within our company. And we have improvement initiatives identified for both those businesses. And I would say at this point, the acquisitions are performing quite well.

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

I do want to add, though, we're in the early innings of integration there. So in time, we have plans. Because we remain a disciplined buyer through acquisitions, we can see the opportunity to get to company averages. But we are -- we've owned both of them less than a year. So we're in the early innings of integration.

Kyle Dicke

Right. Okay. And then lastly, could you just provide an update on the acquisition pipeline and what you're seeing there?

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

Sure. The acquisition pipeline still remains robust, but we remain a selective buyer. We're very strategically focused on what we have within the pipeline. We're pleased with the process as evidence of the fact that over the last couple of years, we had 5 acquisitions, really aligning with our long-term strategy. So nothing really gets changed from prior quarter.

Operator

Your next question comes from the line of Brian Sponheimer of Gabelli.

Brian C. Sponheimer ***G. Research, LLC - Research Analyst***

Most of my questions have been answered. But just to stay on the acquisition front, have you seen any change in business multiples that have come largely as a result of the Hy-Pro acquisition?

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

No, we've not seen that, Brian. It's really business as usual. Filtration multiples are higher and -- than typical other industrial averages, and we have not seen any difference within the marketplace.

Operator

Your next question comes from the line of George Godfrey of C.L. King.

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

I just wanted to ask about the increase in investments, specifically the R&D and the CapEx. You talked about developing new products here. Based on your assumptions today, as you roll out and bring these new products to market, do you think the -- our margin uplifting, that there'd be more profitable higher returns on invested capital? Or do you think they're neutral with where you are now? And I guess, to follow on, is it getting harder and harder to raise the margin on return profile as you roll out new products? Understanding that you don't go where commodities are, you want to have a specialized products. But I'm just trying to get a sense of looking out 1 or 2 or 3 years what your expectations are on returns on capital and profitability on new products incrementally.

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

Sure. We're a technology-led filtration company. It's an important part of our strategy. As we look to invest in additional R&D, we look for them to be margin-enhancing overall for the company, so definitely above company averages.

Operator

I turn the call back over to Tod Carpenter.

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

That concludes today's call. I want to thank everyone for their time and interest in our company. Goodbye.

Operator

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