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PRESENTATION

Operator

Good morning. My name is Krista, and I will be your conference operator today. At this time, I would like to welcome everyone to the Donaldson First Quarter Fiscal Year 2018 Conference Call. (Operator Instructions) Also, please note that anybody that was dialing the (833) 231-8250, we are very sorry today if you could not get into the call. We are having some technical difficulties, and we are working to find a solution. Again, I apologize. And I would now like to turn the call over to your host, Mr. Brad Pogalz. Please go ahead.

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

Good morning. Thank you for joining Donaldson's First Quarter 2018 Earnings Conference Call. Here with me is Tod Carpenter, chairman, president and CEO of Donaldson; and Scott Robinson, chief financial officer. This morning, we'll provide an overview of our overall performance, details on our guidance increase and an update on some of our strategic priorities.

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. - Chairman, CEO & President***

Thanks, Brad, and good morning, everyone. With a strong start to the fiscal year, we are now projecting a much higher level of sales and profit than originally forecast. Sales are now expected to increase between 10% and 14%, and EPS will be up 12% to 20% from last year's adjusted EPS. We're pleased with the continued momentum in the Engine business, which is the primary driver of our increased guidance. We're also seeing improving conditions within the Industrial segment. While still early, we are encouraged by the trend. Scott will give some additional color on our guidance, but first, I'll provide some revenue highlights from the quarter.

Sales increased to $645 million, or 17% above last year. Engine sales jumped 25% to $442 million, which is up a couple percent from the prior quarter. A sequential increase from fourth quarter to first quarter is uncommon, which speaks to the upwardly volatile nature of this recovery. In Engine, sales of first-fit and Aftermarket products were up meaningfully from last year. The largest increase was in Off-Road, which was up 37%. The strength continues to be broad-based with sales up in every major region and across all our end markets. While growth has been strong, we see even more runway as we are still well below peak volumes in this business.

In addition to market-driven strength, Off-Road is benefiting from innovative first-fit fuel solutions. Sales of these products, which leverage our proprietary Synteq XP media and are nearly all incremental to Donaldson, nearly doubled in first quarter. While the revenue is still small, we expect strong growth to continue as the program wins over the past several years go into production.

Our On-Road business is also performing well. First quarter sales grew 26%, with 2/3 of the increase coming from the U.S. as heavy-duty truck production ramps up. As is typical, Aftermarket has led this recovery and sales have been strong for quite a while. Since bottoming in early fiscal '16, sales have been up every quarter for the past seven, and first quarter of this year was a record level. Sales grew 25% to $309 million, which includes a benefit of nearly $9 million from the Hy-Pro and Partmo acquisitions.

We had Aftermarket strength in all major regions, and both the OE and independent channels were up in the 20% range. Within the OE channel, growth still appears to be demand-driven versus restocking, and both channels are benefiting from increased levels of equipment utilization. The mining and energy markets are also driving growth in our independent channel. These applications have higher dollar content, require more frequent changeouts, and are coming off a deeper bottom.

Based on these factors, customers exposed to these markets are experiencing above-average growth. These macro factors are complementing the strategic work we have done over the past several years to drive our Aftermarket revenue. One example is our liquid business. Sales of fuel and lube products, which make up about 20% of Engine sales, were up more than 20% in the quarter, and that's on top of growth in the low teens last year. Hydraulic filter sales, which account for slightly less than 20% of total engine, were up 30%. We have focused on what we call short-cycle wins over the past several years, which is where we work with OEs to provide their service parts. As end markets improve, we are seeing benefits from those wins.

Aftermarket sales of PowerCore were also up in the mid-20% range last quarter. We continue to retain the vast majority of PowerCore Aftermarket given our broad number of SKUs, global distribution and high service levels. Rounding out the Engine segment, sales of Aerospace and Defense were down slightly in the quarter. The decline was primarily driven by sales of replacement parts as we annualized strong growth last year.

Turning to the Industrial segment, total sales increased about 2%, or flat with last year when you exclude FX benefit. Sales of Industrial Filtration Solutions, or IFS, grew more than 6% last quarter driven by both first-fit systems and replacement parts. We are encouraged by the sales trend of first-fit systems, which make up about half of total IFS. Quoting activity for these products has remained stable, but the average size of a quoted project increased in certain regions as potential customers explored greater levels of investment. Our suite of new IFS products, including Downflo Evolution for dust collection and LifeTec filters for process filtration are also contributing to the strong growth in this business.

Special Applications revenue grew 4% last quarter with roughly half the increase coming from disk drive filters. The disk drive business, which is more than half the total Special Application last quarter, continues to benefit from our strategic efforts to increase content per drive and grow market share. Additionally, the pace of decline in the hard drive market has moderated, leading to stronger-than-expected sales. We view the favorable market conditions as temporary, and we continue to explore new ways to leverage this technology into adjacent markets.

As expected, our Gas Turbine business continues to face pressure in the large turbine market. Total GTS sales were down 19% in first quarter, with sales to large turbines accounting for all the decline. We saw a partial offset from strong sales of replacement parts, which represented nearly 60% of GTS in the quarter. We are pursuing the aftermarket sale on every type of turbine, which we believe is a powerful opportunity given the competitive dynamics in the first-fit GTS market.

Overall, there was strength across our company last quarter. Aggregate sales of both first-fit and replacement parts were up in the double digits, and our innovative products are outpacing growth in their respective businesses. These trends give us confidence that our strategic efforts are working and our investments this year are geared towards furthering our success. I'll discuss a few examples later in the call. But first, Scott will review our key financial metrics and revised guidance. Scott?

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

Thanks, Tod. Good morning, everyone. We are very pleased with our first quarter performance. Continued strength in the markets and disciplined expense management led to strong increases in both sales and operating profit. These increases translated to a first quarter EPS of $0.46, which was up 7% on a GAAP basis and 21% from last year's adjusted EPS. I want to remind everyone that our adjusted EPS last year excluded the onetime gain from the Northern Technical escrow settlement, which is worth about $0.05 per share.

Now I'll touch on a few highlights from the quarter. First quarter sales increased 16.6%, or a little more than 13% when you exclude the benefits from currency translation and acquisitions. Our first quarter operating margin grew 30 basis points to 14.1% from 13.8% last year, reflecting a decline in gross margin that was more than offset by expense leverage. Gross margin was 34.8% compared with 35.1% last year. Reflected in this year's rate are headwinds from mix, raw materials and the cost of chasing higher-than-expected demand.

The mix pressure was largely driven by the resurgence in our first-fit businesses, particularly engine OE. As expected, pricing for both steel and media was unfavorable versus last year. These represent the largest 2 inputs into our cost of goods, so they are contributing to the year-over-year pressure in gross margin.

Finally, costs related to chasing higher-than-expected demand continued to negatively impact gross margin. We are focused on operational efficiency and expect this pressure to abate over the course of the year. Our operating expense as a rate of sales dropped 60 basis points to 20.7%. The year-over-year favorability includes a negative impact of about 50 basis points from the timing change of our annual stock option grant. We also had higher incentive compensation expense in the quarter.

While we had some spend towards our strategic investments, including an incremental $2 million in R&D, we expect the pace of spend on these initiatives will be greater in the coming quarters. All these expense pressures were more than offset by sales leverage. We had a $9 million swing in our other income and expense line as expense this year is up about $1 million compared with income last year of $8 million. The prior year included the gain from the Northern Technical settlement of $7 million, which is the primary driver of the year-over-year change.

Our first quarter tax rate increased to 28.1%, reflecting a negative impact from the mix of earnings that was partially offset by a benefit from the accounting change for stock option expensing. First quarter capital expenditures were $20 million, which included investments in capacity expansion and our new e-commerce platform.

Both receivables and inventory increased in the last year, primarily driven by the strong top line performance. Specific to inventory, we are also making incremental investments to maintain future service levels. We feel the approach is appropriate and creates a competitive advantage as demand spikes.

Finally, we returned $66 million to shareholders last quarter through dividends and share repurchase. Of that amount, $43 million was used to buy back 0.7% of our outstanding shares.

Turning now to our fiscal 2018 outlook. We expect to deliver a higher level of sales, operating profit and earnings than prior guidance. We are forecasting full year sales increase between 10% and 14%, including a 3% benefit from currency and 1% from acquisitions. At the midpoint, we added about $150 million to our FY '18 projection. Favorable FX rates makes up more than 1/3 of the increase with the balance coming from improving market conditions, primarily in Engine. Engine segment sales are now expected to increase between 13% and 17%, up 7% from prior guidance and driven by increases in all four business units. First-fit sales are benefiting from higher levels of equipment production across all our key geographies and end markets: construction, Ag, mining and transportation.

In terms of industry equipment production, we estimate the strongest overall growth will come from Latin America as all end markets gain momentum. The strength in Asia Pacific and Europe will be more specific to Off-Road equipment production, while the U.S. will be led by heavy truck production.

Based on our market projections, we now expect sales in both our Off-Road and On-Road first-fit businesses to increase in the mid-teens from last year, which is above our forecast for their respective markets. We also see additional momentum within Aftermarket. So we now expect the full year sales increase in the mid-teens. The forecast includes a benefit of about 2% from Hy-Pro and Partmo, which is consistent with our previous estimate. Our Aerospace and Defense guidance also came up. We now expect a full year increase in the low single digits, reflecting modestly stronger-than-expected sales in both commercial and defense businesses.

Turning to the Industrial segment, sales are forecast up between 4% and 8% with currency driving about 2/3 of the increase. Our IFS sales are expected to be up in the high single to low double-digit range, reflecting improved market conditions for first-fit systems and strong sales of replacement parts. We continue to forecast a GTS sales decline in the high single-digit range, reflecting a sharp decline in large turbine sales, offset by growth of replacement parts. Finally, Special Applications sales are expected to grow in the low single-digit range, with the improvement coming as declines in the disk drive market have temporarily moderated.

Turning to operating margin. We raised our guidance 10 basis points to a full year rate between 14.1% and 14.5%. The midpoint of the range is now up 40 basis points from last year, reflecting strong incremental margin that is partially offset by a handful of items.

Let me start with those things that are consistent with what we outlined last quarter. First, we expect to spend an incremental $10 million to $15 million on strategic investments in the technology development, capacity expansion and e-commerce. Second, we expect headwinds from steel and media costs will continue. We offset this pressure with pricing where we can, but we do expect a net headwind for the year. New to this quarter is our projection for incentive compensation. Based on our revised outlook, we now see a year-over-year headwind of a few million dollars from incentive compensation, a reversal from the modest tailwind we originally projected.

I also want to point out that incremental margin is muted by the portion of our sales increase attributable to currency translation. Our region to support region production model provides a natural hedge by generally matching cost with revenue. Given that dynamic, we do not expect the incremental margin on the 3% benefit our top line will get this year from FX. Overall, we are pleased with our ability to support our customers' needs, effectively manage expense and invest back into our company.

Turning to other financial measures. Full year interest expense will be about $21 million. Other income is forecast between $3 million and $7 million. And our tax rate will be 27.4% to 29.4%. This year's capital expenditures are forecast between $80 million and $100 million and cash conversion will be 75% to 90%. Finally, we plan to repurchase about 2% of our outstanding shares. All together, we expect earnings between $1.90 and $2.04 per share compared with our prior guidance of $1.79 to $1.93. The midpoint of our new range implies an increase from last year's GAAP and adjusted EPS of 13.2% and 16.6%, respectively.

To help with modeling, let me share a few points on our FY '18 cadence for sales and profits. Sales are weighted towards the back half, and the first half increase will be greater than the second as comps get tougher over the course of the year. In terms of operating margin, we expect year-over-year improvement every quarter. Additionally, the pace of spend on our strategic investments was lower in the first quarter, so we expect a ramp-up over the course of the year. Finally, please keep in mind that the option expense in the first quarter will be a year-over-year tailwind in the second quarter.

Overall, we expect strong performance to continue throughout the year. We are focused on meeting our customers' needs, getting our costs more in line with the unexpectedly strong demand and investing for the future.

I'll now turn the call back to Tod for a brief update on several of these investments. Tod?

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

Thanks, Scott. We are on pace to deliver record revenue and EPS this year, and we're excited about the investments we are making for future growth. As we outlined last quarter, there are three primary categories for the incremental investments in our agenda: first, capacity expansion; second, customer engagement through e-commerce; and third, technology investment.

Capacity expansion this year includes both distribution and production. Our most notable distribution expansion is in Europe where the size of our largest facility will nearly be doubled. Production expansion is happening around the world and is largely driven by the need to support growth of our innovative PowerCore and liquid products. We expect the level of investment for these particular projects to peak in the next couple of quarters, but we are always evaluating capacity needs and we'll continue to add as appropriate.

Our e-commerce project is also underway. We began piloting with selected customers earlier this month, and we are targeting a full rollout by fiscal year-end. This new channel presents an exciting opportunity for us. We believe we can drive growth and operational efficiency by making it even easier to do business with Donaldson. Our site will offer enhanced functionality, speed and convenience for our network of dealers and distributors, and potential customers will find a new and efficient way to engage with us.

We also increased our level of spend directed towards R&D this year, which accounts for about half of the $10 million to $15 million of strategic investments. A portion of this investment will be directed to further expanding our materials science capabilities. We are focused on products that command above-average gross margins and give us an opportunity to expand into new and adjacent markets.

We are also investing in connectivity solutions. Customers in both segments are increasingly interested in using connected equipment to drive more value for their customers or ensure the quality of their products. We are expanding the team and have already approached important customers with some of this innovative technology.

These technology investments are the first steps in our multiyear journey to increase our R&D spend by about 1% of sales. Each of these investments is targeted towards further strengthening our position as a leader in the global filtration market. I want to add that we are still a return-driven company so we are taking a focused approach to our investment agenda.

We are committed to delivering incremental sales of profit on increasing sales. I am confident that this year's forecast supports that commitment. With our strong top line forecast and operational discipline, we are creating the capacity to make these investments while also growing our operating profit.

Before closing, I want to thank our employees for doing an excellent job balancing the needs of our customers with the goal of positioning our company for the future. I sincerely appreciate their commitment to delivering on our financial and strategic targets this year.

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

QUESTIONS AND ANSWERS

Operator

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

Charles Damien Brady *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Just looking at the margin on Engine, kind of on a year-over-year basis. What's the expectation going forward? Do you continue to expect to see that number, that margin increase, because you've got some higher expenses going into that? Or does that just kind of all run through corporate? I guess, I'm trying to get a sense of -- I would have thought of the incremental margin as you went through the year, and particularly on industrial products too, more so that you get better margin pickup on that. What's driving that?

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

Yes. This is Scott. So we would expect the Engine margin to increase. We're having volume, and we're able to leverage that. We do have some headwinds that we're experiencing. Raw material costs are increasing, and we have to work to offset that through pricing. But we can't immediately offset it all, and we are working to do that. And we have some additional costs that we incur when demand spikes to satisfy customer deliveries. And so when you pull all that together, along with the mix of sales that we're experiencing, it will increase, although I understand at a rate a little bit less than you would expect, but it will increase.

Charles Damien Brady *SunTrust Robinson Humphrey, Inc., Research Division - MD*

I guess, just specifically on Industrial Products in the quarter, that pretax margin was down year-on-year on higher sales. I guess, I'm really trying to understand the driver of that in Q1.

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

Yes, the biggest piece of that is the Northern Technical settlement that we incurred last year. So we had a gain of $7 million in the first quarter of last year. And that's in that number that -- when you look at last year's number. So you have to back that out when comparing to this year's number.

Operator

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

Brian Paul Drab ***William Blair & Company L.L.C., Research Division - Partner & Analyst***

Scott, first, thanks for those comments on the cadence for the year. I was wondering if you could maybe give us a little more detail or color on the second quarter. And given the -- I think you made the comment that the start to the year, the kind of the seasonality that you saw from the fourth quarter to the first quarter was atypical. What should we expect about the first quarter to second quarter? Because usually, of course, you have the seasonally softest quarter on the Engine side in the second quarter.

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

Yes. So there was a jump and we've been experiencing increasing revenue. So I guess, that's not unreasonable to see. We expect stronger sales in the second half of the year than in the first half, so that's relatively consistent with our historical trends. So you'll see a little bit of an increase in the second half versus the first half. We do project revenues to continue to grow, albeit at a rate slightly lower as we move forward, especially in second half as comps get a little more challenging, based on the strong second half growth that we experienced last year.

Brian Paul Drab ***William Blair & Company L.L.C., Research Division - Partner & Analyst***

Okay. But for second quarter, would we be correct to model the typical seasonal decline in Engine -- sequential decline? Because typically, you've done like 25% of your revenue in Engine in the first quarter and then 23% in the second quarter, roughly speaking. Is that the kind of seasonality we should expect?

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

Yes, I think that's reasonable.

Brian Paul Drab ***William Blair & Company L.L.C., Research Division - Partner & Analyst***

Okay, all right. And then Tod, just a question for you. One of the last things that you mentioned there was the connectivity solutions rollout. Could you give us any better sense for what the latest is there in terms of what types of products and solutions we could expect from you guys?

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

Sure. If you look at the Engine business and contrast to what we're doing on the Industrial business, they're really 2 different stories. On the Engine business, I'll take that first. Connectivity is really an enabler to continuing to win at the OEs because all of our OEs -- OE-based customers within their platforms are looking to connect their devices for their end users. So ours is an enabler to continue to play. And you note that a few years ago we did the acquisition of Filter Minder in Iowa to help us accelerate that, and that's working very nicely. So that's how we view the Engine piece of the business. On the Industrial side though, since we sell more direct to end user base products, particularly, for example, in Torit, that will be more providing the end user the experience to run their machine more efficiently, for example. And that's how we're using connected devices within that type of an application. So two different purposes within the two segments.

Brian Paul Drab ***William Blair & Company L.L.C., Research Division - Partner & Analyst***

Okay. And then I guess, just one last question, a timely question. I don't know if you have any comments on what you're seeing in the proposed tax legislation and what that overall effect would be on your business.

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

Yes. So our tax team is anxiously awaiting any final laws that are adopted. I would say overall, we feel we're well positioned for the things that are being talked about. Most of our -- almost all of our cash is outside the U.S., so any sort of repatriation, that would be a positive for us. And a reduction in corporate tax rates would certainly also be a positive for what we see. So we feel like we're well positioned, and we -- I know the guys are studying every day. And we're just kind of waiting for what the final resolution will be.

Operator

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

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

So we saw the market reads during the quarter supporting your initial outlook in Engine specifically. But I think that you had a bit more line of sight to OEs' intentions or plans for build rates. Can you walk us through what you were seeing three months ago and what ensued or what changed specifically over the last three months to increase your outlook going forward?

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

Sure. If you step back from our business, Jim, and you really look at the way this recovery has happened, we have always maintained that we would see it in our Aftermarket businesses first. And so what's driving the growth over the previous multiple quarters was really the success we've been having on our strategic initiatives with Aftermarket as well as then the vehicle utilization across all of the end markets really driving that. Now what has -- what started to happen at the beginning of -- or near the end of last fiscal year was you started to see the vehicle production rates to kick in, and now you're starting to see that more substantially. You take a look, for example, across our Engine base business and you look at how we performed geographically, and you would see a very broad-based business all across the world pick-up, but with a little bit of favorability where there's a larger OE presence. So for example, Western Europe, Japan and the U.S., those businesses are going to be a higher percentage of gain or growth than those that are aftermarket, and that's the difference.

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

Okay, that's helpful. And in IFS, you mentioned in your prepared remarks project activity picking up or I guess, order rates or I guess, your pipeline of opportunities is kind of as expected, but customers reevaluating the size or scope of the projects. Can you put any finer points on that? Any end markets that you'd call out there?

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

Yes. So if you step back and look at it, it's still a fairly elongated quote-to-order cycle, but we're starting to see more quotes. So the quote activity has picked up. And therefore, when you look at the quantity of projects and the size of projects that are happening, and it's primarily U.S.-driven, when you look at that, that brings up the overall average of projects. Now the conversion rate still is slow, but we are very pleased with the roughly 6% growth that we've had in our IFS business within the quarter. And therefore, we have increased that outlook for IFS, which will drive the positivity within industrial.

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

Got it. And one last one. On the incrementals, I mean, if you -- modeling the midpoint, I think we're still kind of at that 20%. And you highlighted that you have variable costs that are weighing that down. You also have the raws, higher raws. I mean, can you put any numbers to that as far as which one is impacting more? Or can you size those two weights on your incrementals and when we should be thinking about those variable costs specifically that you do take on, as you mentioned, as demand spikes? When does that normalize? When does that kind of roll off, if it does?

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

Sure, so maybe two different angles to the question. The first one is overall, if you go back to FY '16, our adjusted operating margin was 13.2% and the midpoint of our current forecast is 14.3%. So that represents a 110 basis point improvement over that time, so we feel pretty good about that. In terms of the specific things that we're experiencing now, as you remember, last quarter we talked about the strategic investments. That was $10 million to $15 million, and that's approximately 40 to 60 basis points. So that would be the biggest impact that we would see this year. The second largest impact would be raw materials, and then the third would be incentive comp. So those are the three main drivers of that. And we still get -- we increased to 10 basis points with this recent update to guidance, and that represents a 40 basis point improvement over last year. So we're committed to growing our levels of profitability on increasing sales, and that's what we're focused on every day here.

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

Right, I understand that. I just -- you initiated guidance at about a 20% incremental margin. You're still there. So I just figured something moved on you in the quarter, and I assumed the $10 million to $15 million not being locked in there, that it would be the raws or the variable costs. And to the extent that you can -- which one moved on you, that would be helpful, just to understand the puts and takes there.

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

Yes, I think you have it right. It's raw material cost and the incentive comp.

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

But I think in -- yes, in terms of movement, incentive comps versus three months ago -- this is Brad. Incentive comp, as Scott mentioned -- but I'd also underscore a comment he made about leverage on the sales coming from currency. Guidance up about [$150 million], and about 1/3 of that is coming from the spot, where we don't really get an incremental, Jim.

Operator

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

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

I'm going to follow up on some of Jim's questions there. If we're looking at the raw material impact on incremental margins, you talked about not being able to recoup raw material price increases straight away. Can you maybe talk us a little bit through how long you expect that could take, whether or not you expect to be able to recapture at all the difference between the channels? I imagine the independent channel is probably the easiest on -- new OE is probably the most difficult. But just if you could give us just a little more color on how much, when, how kind of you go about recapturing those increased raw material prices.

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

Sure. This is Tod. So I think you have it framed up correctly. So when you look at the OE portion of the business, we do have indexed pricing, if you will, with our largest customers based upon material indexes. And so that work is in flight where possible, where the contracts allow. We do have latitude, as you suggested, within independent Aftermarket, which is roughly about 60% of our Aftermarket-based business, or on the Engine side, about 40% of our Engine business. And where geographically possible, that work is also in flight. And then on the Industrial side, the Industrial side is really more of a project-based business, particularly in our IFS-based businesses. And so that really as the quoting activity, rolls forward that we -- so much (inaudible) a lot of background noise so -- for someone. So as that business continues to roll forward, we continue to look at the opportunities on a project-by-project basis to price appropriately.

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

Sorry about that background noise. I'm in the airport. Any ideas on maybe when we can expect that to start positively impacting the incremental margins or the overall margins?

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

Likely later this fiscal year. This work is really a lot of blocking and tackling. This is really drawn out, particularly as you deal with the OE portion of our business. And then contractually, if we take pricing actions, we are, before they can become effective in many of the Aftermarket areas, about a quarter away before that starts to hit. So it's really quite elongated as an overall pricing cycle.

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

Okay, that helps. And then on incentive comp, are you now accruing at maximum levels for fiscal 2018? If things get better, and God forbid you have to raise guidance again, you're hitting better numbers there, is there a potential for a further ramp in incentive comp? Or have you got to the max levels at this point?

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

Yes, this is Scott. So we're not at max levels at this point. So if we had to raise guidance again, that would be an additional expense associated with higher levels of expected profitability and sales.

Operator

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

Laurence Alexander ***Jefferies LLC, Research Division - VP and Equity Research Analyst***

Two quick questions. As you look at the way order trends have evolved, can you tease out a little bit how it affects your thinking about the longer-term prospects for your business, in terms of either -- how much capacity do you think you need to have in 2018, 2019? But also can you tease out what you're -- in a little bit more detail, what you're seeing in particular in terms of the opportunity set in China, either as you upgrade the technology you're selling there or the way demand, order trends are changing?

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

Let me split -- let me take the first portion of that, and then I'll circle back and talk a little bit about China. Relative to capacity across the company, we do have projects in flight specifically addressing our Engine-based business. Our capacity in the two sides of the company is very different. Our Industrial-based growth is a bit more modest. So plants that support that segment are -- have utilization runway ahead of them. On the Engine side, we have capacity expansion taking place to support all of this growth. And we continue to take a look at our overall model and have -- we take a look at it on a five-year basis and have plans for further capacity expansion over the course of the next five years as we look at the overall potential Engine growth going forward. That is all inclusive of product manufacturing as well as distribution. And as I pointed out within Europe, we're nearly doubling our largest distribution facility. If I then roll over to China and take a look at our opportunities in China, we have very low share in China, low single digits share primarily within our Engine business as well as -- what would drive us there would be our IFS-based business in China. And so consequently, what we're doing is we're taking our technology and now winning at the national base China companies. We always have had a nice base in China of the multinational customers, but now we're winning at the national base just simply because what they have is overcapacity of vehicle production opportunities. And so they are looking to export, which means they have to meet Western-based standards, which give Donaldson technology an opportunity for sales within those national Chinese corporations, and we are winning on that basis. So we look, as time goes forward, to support the growth to meet future investment all across Asia, to build more manufacturing plants as we continue to properly execute or -- excellently execute on that strategy in Asia.

Laurence Alexander ***Jefferies LLC, Research Division - VP and Equity Research Analyst***

And I guess, just on the capacity question, I guess, sort of what I was getting at is given how strong volumes were in this quarter, are you -- you have sketched out in the last couple few quarters, you plan to add capacity. Do you think you need to accelerate those plans or do a second round of capacity expansions above what you had initially planned in order -- if -- have the order trends changed enough to warrant that?

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

It's possible. We have currently a project in flight to expand our air manufacturing -- air filtration capacity. And we have also a very large project in flight to expand liquid-based capacity right now. And we are currently looking at when we will need the next manufacturing plant. And what looked like was potentially more than a year away, now is going to be measured in quarters.

Operator

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

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

Tod, I was wondering if you had any metrics on the Gas Turbine business, whether it be book-to-bill or anything else you can share about project activity going forward.

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

When you look at the large turbine projects, what we really have is a smaller number of projects that we're even quoting, Brian. I think you see that within the GE, for example, press releases. They are the largest turbine manufacturer in the world. You see that within Siemens. So everybody is calling that large turbine project outlook down and we're no different. So we really see that stretching out for some period of time. However, we do suggest that we have, based upon our strategic change of well over a year ago where we saw this difficult moment in large turbine projects coming, therefore, we changed our strategy to be more selective. We have fought through a lot of that downturn. And therefore, as a company, we would suggest that this fiscal year that we're living now is likely the bottom for our GTS business looking forward.

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

Okay. If I'm taking that a step further, if you see GE and Siemens as guiding that business down, what gives you the confidence that, that is, in fact, the bottom?

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

Well, because what -- our exposure to large turbine projects, which is really driving their negative outlook, has really been greatly reduced as an overall percentage of the business. It's very low now. And so what's driving our sales there are really the Aftermarket business as well as any -- what we would call smart, small turbine-based projects, which are oil and gas related, moving oil or gas up and down pipelines or that type of activity, not power grid-based projects. So our exposure, we've worked through over the -- more than last year. We've worked through minimizing that as a company. Therefore, we have the confidence.

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

And what would be the signs, first, from an Aftermarket side and then I guess from a project side, that, that would potentially turn that business around?

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

Well, it's going to be really the larger portion of what we'll see. When you see a big, huge uptick, if you will, it's going to be driven again by the large turbine projects. And so when you see global GDP start to pop, where you have energy-based demands worldwide come on board and pressuring grids around the world, well, then large projects are going to pick up, and that would then allow a spike. But until then, we really stay focused on that short-cycle portion of that particular business, as we did within the overall company strategy when other businesses were in a difficult moment.

Operator

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

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

Tod, could you maybe just -- I want to circle back for a minute or two to the Engine and Aftermarket business. I mean, just a really nice, as you alluded to, kind of seasonal uptick. And when you referenced it in your comments, you kind of suggested the first-fit business is still running well below quarterly revenue run rate. But you look at the Aftermarket business and it's well above anything you've been able to deliver in past history here, and then also maybe five points better seasonally from the fourth quarter to the first quarter, can you just kind of sift through that a little bit? Is the liquid Aftermarket sales driving some of that increase, that abnormally high increase in the growth rate in Aftermarkets? Or is there a geography there where you feel like you've really gained some traction?

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

It's actually both. So if I just deal with the liquid portion of it, Rick, it -- you look at the wins that we've had across our liquid-based initiative, it's really about overall expanding our product portfolio, which we continue to do as a strategic portion of that liquid-based growth initiative, and we're doing that quite well. So we're really trying to bring all products available to all regions. And then second step is really strengthening the distribution in a particular geography. The third step is acquisition where possible. And if you look at the acquisition piece, for example, we made the acquisition in Colombia. And so you would see all three pieces of that portion of the strategy being enacted in Latin America. And therefore, our Latin America sales are up year-over-year quite nicely and well into the double digits. So you have a little bit of a geography base upon the acquisition piece, but you really have, more broadly, every region is up just simply because we're -- I think we're executing quite well and the end markets have recovered a bit.

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

This is Brad. I want to add air to the list though. PowerCore did really well in the quarter again. PowerCore has been up every quarter for literally years, really strong growth rate. So it's not just a liquid or geographic story. I mean, it really is broad-based within Aftermarket based on what we've been doing for a long time to win those programs.

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

Yes, yes, okay, okay. And -- okay, just kind of final thoughts on the Aftermarket. Is the liquid component there -- I'm just trying to circle back to the liquid component into the Aftermarket. Have you gotten better traction on the Aftermarket side with liquid than you have on the first-fit side? I know we've talked about some wins in first-fit. Have those started to kick in as well in liquid specifically?

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

Yes. So yes, we've been really in Aftermarket, in liquid much longer than on the OE side. And so consequently, we had momentum within the Aftermarket to support liquid. And so that's been the addition throughout the customer base where we've always enjoyed a strong air position. Now we're really gaining momentum on the liquid position as well.

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

Yes, okay. And then just two quick questions on the Industrial side. You give a pretty clean picture on the gas turbine side. But for the second quarter of gas turbine sales, do they match the first quarter? I mean, how -- I'm just trying to look for a little bit of cadence here with gas turbine sales? Or would they be expected to be down meaningfully from first quarter to second quarter?

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

Rick, this is Brad. Gas turbine sales will actually -- we're projecting them to be up in second quarter, given the very, very low level from one year ago. So when you're looking at quarterly year-over-year changes, second quarter is the anomaly in our FY '18 forecast. Third and fourth quarter are both expected to be down again.

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

Okay. So up in the second quarter year-over-year, sequentially, still somewhat down from the $26 million? I mean, just to get that...

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

Sequentially, you get...

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

You usually have a pretty good beat on that, yes?

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

Sequentially, it will be up. We expect it to be up from first quarter.

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

Okay, okay. Yes, okay. And then just kind of a quick question. Now that you've broken out Latin America, I'm a little bit curious. And I'm sure this is a small number, but it's a big percentage change. In Specialty Apps, Latin America was up like 28%. But I'm curious, that's unlikely to be disk drive business. What is that? What are you guys selling into Latin America on the Special Apps side?

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

First of all, it's very, very small. It's less than 1% of the company. And then second, it really starts with our LifeTec filters, so -- that we've talked about for -- ever since we've had some sales down there, integrated venting, and our -- what we call stretched membrane based business. All three of those have sales within what we call Special Applications in Latin America.

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

Yes, okay. But no dark horse to come on strong there with the material side of business or anything like that?

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

No. (inaudible) yes, I want to emphasize, it's a large percentage, but a very small number.

Operator

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

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

Tod, I just want to talk about the $10 million to $15 million in incremental spend for capacity expansion. If I look at that as a percentage of CapEx and apply that same percentage at the midpoint and everything went right, that's about 14% greater looking at the revenue projection for this year. Would that translate into your thinking about -- around $350 million in -- from a revenue basis on the ability to expand your capacity? Not making any predictions on revenue, but just trying to get an idea of how much more run rate you can do with that expansion.

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

So it's very different between an air expansion and a liquid expansion. So mix plays a significant role in any number we would try to throw out there and then also obviously, the level of expansion. So within air, we have multiple expansions throughout the world and adding multiple air lines. So it's not as if you have one manufacturing plant today in Donaldson that you can point to and say we're duplicating that. So consequently, what we look to be adding is roughly between $100 million and $200 million of air capability. But then when you rotate over to the liquid expansion that we are currently doing, that is going to be a bit of a slower ramp-up based upon the learning curve of where some of that expansion will take place. So that again, a typical plant can do between $100 million to $150 million. We have one that could do more than that. So roughly, if you smash all that together, somewhere between $200 million to $300 million is likely within that capacity expansion.

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

Got it. And then my follow-up, I realize the semi market is not an area you play in, you like dirty environments, a lot of earth-moving components. But I'm just curious anecdotally if any of your customers have made any comments about Tesla's introduction of an electric semi.

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

No, no, no conversations along those lines.

Operator

And we have no further questions in the queue at this time. Tod Carpenter, I'll turn the call over to you.

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

That concludes today's call. And I just want to thank all of you for taking your time and for your interest in our company. Have a great day. Goodbye.

Operator

This does conclude today's conference call. Thank you for your participation and you may now disconnect.