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Q1 2019 Donaldson Company Inc Earnings Call

EVENT DATE/TIME: DECEMBER 04, 2018 / 3:00PM GMT

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PRESENTATION

Operator

Good morning. My name is Kim, and I will be your conference operator today. At this time, I would like to welcome everyone to the Donaldson Q1 2019 Earnings Conference Call. (Operator Instructions) Thank you.

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

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

Thanks, Kim. Good morning, everyone. Thank you for joining Donaldson's First Quarter 2019 Earnings Conference Call. With me today are Tod Carpenter, Chairman, CEO and President of Donaldson; and Scott Robinson, Chief Financial Officer. Tod and Scott will provide a summary of our first quarter performance and an update on our 2019 plans.

During today's call, we will reference non-GAAP metrics such as adjusted earnings. You can find a reconciliation of GAAP to non-GAAP metrics within the schedules attached to this morning's press release.

I want to remind everyone that any forward-looking statements made during this call are subject to risks and uncertainties, 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. Good morning, everyone. I want to start by welcoming the BOFA team and their valued customers to Donaldson Company. We are excited about the opportunities with BOFA, which is an excellent example of our strategic and selective acquisition process. BOFA complements our portfolio of solutions for industrial air filtration, and their strong OE relationships in growing markets will benefit from our technology and global footprint. With about $40 million of annualized revenue and margins above corporate average, we expect BOFA will make solid financial contributions to our company.

In terms of the quarter, we are pleased with the results. We delivered record first quarter sales of $701 million, and EPS grew almost 22% to a first quarter record of $0.56. Our margin is still being impacted by inflationary pressure. However, benefits from pricing and significant expense leverage resulted in year-over-year growth in operating margin. Scott will provide more details later in the call, so I'll turn now to an overview of our first quarter sales.

Total sales grew 8.8%, including a 2% headwind from currency. The revenue recognition accounting change and a partial month of BOFA added about 1%, and pricing gave us more than 1%. Sales of Engine were up 8.8% last quarter or about 10% without currency and revenue recognition. On-Road grew the fastest, with the first quarter sales up 38% as we continue to have a strength in the U.S. and China.

Class 8 truck production and benefits from past program wins are driving the U.S. business, and China is all about share gains. Sales there were up significantly last quarter, and On-Road in China now represents 9% of total On-Road, up from 3% a year ago. As Chinese manufacturers enhance their equipment performance, they need higher technology filters like ours. Given our low share in China, we are somewhat insulated from the volatility of their truck market, and we see tremendous long-term opportunity.

The pace of growth in Off-Road moderated to 2% last quarter due in large part to the strong comparison last year. When we look at it on a 2-year basis, the results look more consistent with recent trends. The one exception was our U.S. Off-Road business. Sales were down 9%, primarily due to hydraulics. We anticipated these products would support our first-fit growth, but analysis of customer data and end user consumption indicates a transition to OE service parts this year.

While the change negatively affects our Off-Road forecast for hydraulics, we still see a favorable demand environment, particularly related to our innovative air and fuel products. For example, first-fit sales of fuel and lube were up in the low 20% range last quarter. Innovative air products, including PowerCore, were up in the mid-teens. We expect these products to continue outperforming as we move through the cycle, helping to support a full year increase in Off-Road.

In Aftermarket, sales were up 7% last quarter. We had strong growth in both channels, signaling to us that the business is still being driven by demand. Equipment utilization remains a core driver of Aftermarket, but we are seeing geographic variability. Areas with more uncertainty like Russia, Turkey and South Africa are under pressure, while growth remained strongest in areas with more exposure to oil and gas like the U.S.

Program wins are also contributing to Aftermarket growth. First quarter sales across the portfolio, which includes PowerCore and fuel filters with Synteq XP, were up in the mid-teens. By combining our high-performance media with a growing assortment of razor-to-sell razor-blade products, we are creating a long runway for future growth.

Sales of Aerospace and Defense grew 12% last quarter, driven by first-fit and replacement parts for ground defense vehicles.

Turning to the Industrial segment. First quarter sales were up 8.8% or about 10% without headwinds from currency and benefits from BOFA. In addition to encouraging market conditions, there is notable strength in businesses where we are making targeted growth investments. One area is Industrial Filtration Solutions, or IFS. Sales were up 11% last quarter, reflecting low double-digit growth of new dust collectors and replacement parts. Quoting volume increased in all major regions, and our proactive management of the replacement cycle is driving aftermarket sales. Additionally, we are investing to grow outside the U.S.

Similar to Engine, IFS has low market share in China and demand for higher technology solutions is growing. Sales of dust collectors were up 50% last quarter, and China now represents 10% of total IFS sales, up from 7% 1 year ago. Current trends are encouraging, and programs like the Blue Sky initiative give us future opportunities for growth.

Trends are also encouraging in process filtration, which includes our LifeTec filters for food and beverage. First quarter sales were up 20%, and our investments in expanding the sales team and product offering continue to gain traction in the market.

Sales of Gas Turbine Systems, or GTS, were down 3% last quarter. Timing of large turbine projects helped moderate the decline, but this market remains under pressure. Our go-to-market strategy is unchanged. We will continue to be selective in pursuing large turbine projects while actively driving aftermarket opportunities.

Within Special Applications, the 9% sales increase was due in large part to disk drive as the market continues to be more favorable than what we expect over the long term. Venting Solutions is also performing well, with sales up in the low double digits last quarter. Our investments to further penetrate this space are giving a solid foundation for future growth.

Overall, we're pleased with first quarter results and how they highlight the power of our strategic model. Sales of first-fit and replacement parts were up in both segments. Innovative products grew faster than legacy products in their respective businesses. And our acquisition of BOFA gives us access to new markets within Industrial.

Now I'll turn the call over to Scott for his update. Scott?

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

Thanks, Tod. Good morning, everyone. We had an important anniversary last quarter. 2 years ago, we closed our consolidated books for the first time on our global ERP. Since then, we have strengthened our capabilities and deepened our understanding of our data and processes, but we're still early in this journey. To drive us further, we created a global financial shared services team earlier this year. Their mission is to optimize, standardize and globalize our processes, and I'm excited about the opportunity in front of us.

Turning to first quarter results. Sales growth of 9% drove net earnings up 21%, and we made progress on driving incremental margin. Before getting into the details, I want to call out 2 items. First, please note that last quarter's net earnings included discrete tax benefit of $900,000, which we excluded from adjusted earnings. Second, as a reminder, we adopted 2 new accounting standards this fiscal year: revenue recognition and pension accounting. Prior year periods are restated to conform with pension accounting, but that's not the case with revenue recognition. Adoption of this standard added 0.7% to first quarter sales with no impact on gross profit, effectively diluting gross margin by 20 basis points and operating margin by 10 basis points. Including dilutions from revenue recognition, operating margin grew 30 basis points to 14.1%, the highest first quarter margin in 5 years.

While inflationary pressures still exist, they were offset by benefits from pricing and expense leverage. As a rate of sales, operating expenses improved 110 basis points, driven primarily by leverage and higher sales. There's a bit of timing involved as we expect operating expenses to drift up over the year, but we are proud of the performance last quarter. We also had favorability from lower warranty costs, which was offset by acquisition-related costs and higher freight expense.

As expected, inflation is still a headwind to gross margin. The first quarter rate was down 80 basis points, or 60 basis points without dilution from revenue recognition. Pricing added about 140 basis points in the first quarter, which offset raw materials inflation. Higher supply chain costs, including investments to support our customers, combined with an unfavorable mix of sales, account for the balance of the gross margin change.

I also want to touch on segment profitability. As a rate of sales, Engine operating profit declined 90 basis points to 13.3%. Although pricing was positive in Engine, we are still working with our OE customers to recover the raw materials and demand-related costs we've absorbed. Unlike the independent channel, that process takes longer and builds over time.

Within the Industrial segment, our profit rate grew 210 basis points to 16.6%. Inflation is less of an issue for the project-based portion of Industrial, which has more real time pricing. Additionally, growth in higher-margin products like replacement parts, process filters and venting solutions enhanced segment profitability. We continue to invest in these businesses, which will help the mix of company's margin up over time.

First quarter corporate and unallocated expense was favorable to last year due to higher variable compensation and additional pension expense in the prior year quarter.

First quarter interest expense dropped by $1 million due in large part to our global cash optimization efforts. Tax reform gives us the flexibility to better match the location of our cash and debt with our operational needs. Given our large presence outside the U.S., we can more efficiently access overseas debt with favorable rates. Tax reform also helped our consolidated tax rate. Excluding the discrete benefit of $900,000, our first quarter adjusted tax rate dropped to 24.3%, reflecting a lower corporate rate in the U.S. and benefits from stock option activity.

We invested $124 million back into the business last quarter. BOFA was a large portion at $96 million, and capital expenditures increased to $28 million. A large portion of our CapEx was capacity expansion. We invested in all regions to support future demand of fast-growing products. These investments were already part of our long-term capital plan, but as previously noted, we accelerated the timing to meet our opportunity.

We also spent $105 million on share repurchase and dividend last quarter, underscoring our commitment to invest back into the company and return cash to shareholders.

The balance sheet continues to be strong. While we are comfortable with our leverage ratio of about 1.1x EBITDA, we expect to bring that down a bit by the end of the year. We also plan to reduce our working capital needs as demand normalizes and our global financial shared services team makes progress on receivables.

As I transition to our full year forecast, I want to first highlight the partial year benefits from BOFA. The acquisition adds about 1% to sales, 10 basis points to operating margin and $0.02 of EPS. With that in mind, I'll walk through the details of our outlook.

Total and segment-level sales are planned up between 7% and 11%, including a 2% headwind from currency and pricing benefits of 1% to 2%. The Engine sales forecast also includes about 1% from the revenue recognition change. Sales of Aerospace and Defense are projected to be flat with last year, and we see growth in our other Engine businesses. Sales of On-Road are forecast up in the mid-teens, due primarily to the U.S. and then supported by China. While the U.S. truck cycle is likely nearing peak, we have support from past program wins. Program wins are also driving strength in China, where our business is more dependent on customer ordering patterns than the overall truck cycle.

We updated our Off-Road forecast to reflect the impact from the hydraulics parts that Tod referenced. We now expect sales up in the mid-single digits versus prior forecast in high single digits. Although our projection is more modest, we still believe construction and mining are mid-cycle, while agriculture may even be earlier. Given that Off-Road grew more than 50% over the past 3 years, the moderating growth is predictable and not a concern.

Aftermarket sales are now projected up in the low double-digit range, benefiting from hydraulics sales. Equipment utilization is still strong, and past wins with innovative air and liquid products will contribute to another year of growth in Aftermarket.

We also have favorable trends within Industrial, and BOFA is adding about 4% to segment sales. Sales from BOFA benefit IFS, so we raised our forecast for this business to grow in the mid-teens, up from the prior forecast for high single digits. Organic growth is coming from both new equipment and replacement parts, and we project above-average growth in process filtration.

Sales of Special Applications are forecast in line with last year, reflecting declining sales of disk drives being offset by growth in Venting Solutions.

Finally, GTS sales are projected down in the high single-digit range, driven entirely by large turbine projects. These projects will represent less than 10% of GTS sales this year, but the market pressure is intense enough to offset strong sales of replacement parts.

BOFA also contributed to our increase in our full year operating margin, which is now forecast between 14.2% and 14.6%. The midpoint of this range is up 60 basis points from last year, and our incremental margin is in the low 20% range, in line with our historic average. Also, please keep in mind that our forecast includes 10 basis points of dilution from the revenue recognition accounting change.

We expect gross margin will be roughly in line with last year, including the optical drag from revenue recognition of 30 basis points. Our forecast reflects a $30 million headwind from higher raw material and freight costs, which we expect to offset with price realization.

We also expect to deliver operating expense leverage. We took a very focused approach to expense planning this year, allowing us to budget for strategic investments while delivering incremental profit on increasing sales.

Moving down the P&L. We expect other income between $12 million and $16 million; interest expense of $23 million, including an impact from BOFA; and a tax rate between 24.7% and 26.7%.

Fiscal 2019 capital expenditures will land between $130 million and $150 million. Cash conversion is forecast between 60% and 75%. And our share repurchase target is 2%. Altogether, our EPS forecast of $2.31 to $2.45 implies an increase of about 16% to 23% from last year's adjusted EPS.

Our front half-back half sales split is modeled like last year. Within Engine, first quarter was our toughest year-over-year comparison, but we will still expect to see some noise by business unit as we move through the year. We also expect noise in the Industrial segment, particularly in GTS. To help with modeling, note that we expect the second quarter sales of GTS to be the lowest of the year with a more stable volume in the back half.

In terms of operating margin, we are forecasting typical seasonality, where second half operating margin is higher than the first.

I also want to mention that we expect modest increases in operating expense over the course of the year as we ramp up investments in certain businesses.

Overall, our 2019 forecast includes strong top line growth, incremental levels of profit on increasing sales and disciplined capital deployment that reflects investment in the company and returning cash to shareholders.

After first quarter, we are solidly on track to deliver our fiscal '19 financial plans, and our targeted approach to budgeting has given us the ability to invest for future success.

Now I'll turn the call back to Tod. Tod?

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

Thanks, Scott. I want to also recognize the 2-year anniversary of our global ERP. Completing that project was an important step in our company's future, and it facilitated another anniversary.

1 year ago, we launched our e-commerce site, shop.donaldson.com, with a small number of customers around the world. We took a very deliberate approach as we migrated customers, making sure that we understood how we could serve them better by creating a great user experience. By the end of fiscal '18, we had transitioned nearly 1,500 customers and $100 million in revenue to the new platform. In the past quarter, we had $85 million in revenue with more than 2,000 customers. By the end of the quarter, there was more engine aftermarket revenue transacted through shop.donaldson.com than any other channel.

We have great momentum with the platform. We are building the team and continue to refine the user experience, and we are confident that e-commerce will further strengthen our reputation as a top-tier partner.

Investments in capacity expansion are another way of supporting our growth. Based on current and projected demand, we are adding new lines and square footage in every major region. These investments were already part of our capital plan, but successful product launches like LifeTec filters and new program wins like those in China prompt us to accelerate those plans.

China is an important opportunity for us. The increasing standards related to equipment performance and air quality are playing to our strength as a technology leader, giving us new access to China's massive market. Sales from this region account for about 7% of total Donaldson today, and we have very low share with local customers. While we expect a learning curve with these customers, including the period-to-period variability we see in their ordering pattern, the dynamics today mean we are less dependent on macro conditions for our success. Given that, we are excited about China's near- and long-term contributions to both segments.

We are also excited about our R&D investments, which are targeted towards foundational capabilities. We expect to add another 10% to R&D investment this year, which is on top of a 10% increase last year.

One aspect of our innovation relates to further expansion into markets like food and beverage. Customers in this type of industry place a high value on the integrity and quality of their product, and our product offering meets those needs. We can design technologies and leverage them across our diversified portfolio, supporting our business case for incremental investment and mixing the company's margin up over time.

Another technology-related focus is connectivity. We continue to explore the new business models in Industrial, where we believe this offering will help us expand the value of our addressable market. We have gathered tens of millions of data points from connected dust collectors across the country. At the same time, we have been piloting different business models to understand how we create value for customers and us.

We hit a milestone last month as we began offering an early adopter program. We created a subscription service that uses sensors and a controller to gather real-time data from a collector, apply analytics in the cloud and relay insights to the operator through desktop or mobile applications. While we are early in our evolution, we are excited to begin learning more in this new and evolving opportunity.

The Engine business is also benefiting from connectivity. Large manufacturers want to offer better insights to their customers, so we are increasingly bidding new programs with solutions that include sensors. Our offering is also compelling to large fleet owners looking to optimize their costs, so we are exploring those opportunities as well.

In addition to these larger projects, there are business- and region-specific initiatives happening across the company to sustain our strong growth.

I want to thank our employees for their contributions to the progress we had made on our strategic priorities and for their commitment to our customers. We are seeing the results, and I'm confident that their alignment as a global team will help us achieve our strategic and financial targets in 2019 and beyond.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Nathan Jones from Stifel.

Adam Michael Farley ***Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst***

This is Adam Farley on for Nathan. Turning to Engine, you guys had a great quarter on On-Road, another really strong comp on the back of a strong year. I was wondering if you could just provide a little more color on mix in Engine, how much of an impact that was versus price cost.

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

Adam, this is Brad. There was some mix in Engine, but as Scott mentioned, there was more pressure from pricing. While we got some traction in the quarter and pricing was positive in Engine, we still have work to do on the OE side to recover some of that cost.

Adam Michael Farley ***Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst***

Okay. All right. And then similar to the last question, in Industrial, was there any onetime discrete in mix in Industrial? Or is that just capturing real price cost?

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

No, Industrial was really as expected, so no real onetime.

Operator

Your next question comes from Brian Drab from William Blair.

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

So just quick housekeeping. The BOFA acquisition closed October 22, right, so there's no -- really no impact in the current quarter results from that. Is that correct?

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

Yes, like half a month or a few weeks.

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

Yes. Okay. And you mentioned, I think, Scott, in your comments that you are seeing ag as being in early part of the cycle, of course. I'm just wondering, should -- is your view and is what you're seeing from Deere and other customers in that end market that things should continue to improve? Or is some of this China noise creating some disruption in demand in that market for you in this fiscal year, you think?

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

Yes. So I think you have it right. I mean, we see Deere and CAT having strong growth projected, so we feel good about that. The order patterns in China are always volatile, and that's something we're learning how to deal with and getting more experience with. So I think you have it right.

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

I guess I'm wondering 2 things. I'm wondering 2 like -- one of the themes that I think we are hearing -- that I'm hearing from some other companies I cover in this market is that tariffs and impact on soybean demand and things like this are maybe affecting farmers' decisions, growers' decisions in North America. I don't know if you could comment on whether you're seeing that from your customers.

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

We don't see a difference in the way that Deere has been reacting throughout this whole external conversation. Likely, Deere is better to comment on the farmer-based customer, but what we see in our aftermarket channel is certainly kind of business as usual.

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

Okay. All right. And then you mentioned some on pricing. I'm just wondering, if you go back to the beginning, say, like the beginning of this calendar year when you're pretty aggressively going after pricing on -- related to steel and other tariffs and commodity pressures, how much price have you been able to get since you really started to go after those price increases? What is price -- where is price today relative to where it was at the beginning maybe of the calendar year for the segments?

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

Brian, this is Brad. I'll start. I would say that the pricing momentum picked up towards the fourth quarter, so think spring, summer of the calendar year. And we had a really nice bit of momentum in that quarter, but that was even only a partial quarter as it benefited from what we had done in the early part of the calendar year and then the incremental raise that happened April, May -- or that we announced April, May, excuse me. And so the trend in the last couple of quarters has been pretty consistent in the 1.5 percentage point range. Earlier in the year, I would say that we are still flat, if not upside down, on price cost overall with way more pressure in Engine than Industrial.

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

Okay. That 1.5% that you just mentioned, is that -- would that be about what you got in price in the first quarter here consolidated?

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

Again, this is Brad. It was about 140 basis points in the first quarter.

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

Right. Okay. And sorry, was that -- is that net of cost? Is that price cost net? Or is that price?

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

That's price. So quick clarification. Scott had mentioned that price offset raw materials. Granted while gross margin was down, the impacts from freight and some of what we're doing with the suboptimal supply chain to meet our customers' needs was the incremental pressure there. We did get enough price in the quarter to offset raw materials, but of course, we still have work to do to recover some on the OE side.

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

Okay. And then just the last question related to that. Gross margin -- maybe you said this already, but gross margin in fiscal '19, do you think that, that ends up being in line with '18 or above or below?

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

Yes, the guidance is essentially flat.

Operator

Your next question comes from Richard Eastman from Baird.

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

Tod, maybe could you just kind of parse out the growth forecast on the On-Road side? I'm a little bit curious. We're talking about mid-teens, and we're kind of looking at the U.S. ACT number that's kind of maybe 5%. And my thought is you referenced some new wins in the U.S. And I'm curious, if you look at the mid-teens growth for On-Road, is it kind of -- how does it slice off between the U.S.? I mean, are we kind of high singles and then the share gains in China are pumping that up further? Or...

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

Rick, this is Brad. I'll let Tod comment on share gains.

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

I don't want to get too granular, but you must have more visibility kind of on China, and I'm just curious how that looks.

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

Well, in China, we expect more growth over the course of the year, and that's been, obviously, in the U.S. The U.S. business is going to taper down in terms of growth rate over the year but still positive in total On-Road in the back half of '18, but -- or excuse me, '19, but it will be a lower rate of growth. China is stronger. The comment you're making about the ACT forecast, keep in mind that, essentially, the first half of our year, we're benefiting from very strong year-over-year growth, even as we compare against good numbers 1 year ago. So as we move into the back half, there's more pressure on that.

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

Yes. And, Rick, I'll just comment on -- the wins that we've seen and have seen and experienced in China are liquid based. And as we look forward, we expect to bring on more air wins within China, gaining share in that regard as well.

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

I see. Okay. And then just one question around the Off-Road business. Could you just maybe explain maybe a little slower to me the hydraulic business there. Basically, somebody took that into kind of in-house, the OE business. Is that what you were referencing?

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

Yes. So we account for the hydraulic business through the OE service channel, and we had thought that it would go through the OE side of that, so first-fit side. And really, just better visibility, using our ERP now allowed us to really properly identify that, that is really in the OE service channel and, therefore, replacement parts and aftermarket as externally reported. So we're very happy with the visibility. It does make a little bit of consternation within the numbers that you see, but that's what's really taking place.

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

I see. So it's actually a shift from what would've been OE to kind of Aftermarket OE. Is it -- versus OE sales, it's Aftermarket OE?

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

Right. It's one OE channel versus other OE channel. First-fit...

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

Yes. Okay. All right. And then just -- maybe just one quick question. On the core incremental in the quarter, at face value, it's about 17% EBIT. Curious if there is a core number there. Reported was 17%, but you got the noise around currency. You probably got a little bit of BOFA in there. Was there a core number that you could get to us?

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

I would say that is pretty much the core number. I don't think there's a massive amount of noise. I mean, you have a few things from BOFA. You have a little bit from revenue recognition, the pension comparison. But our historical average is 20%, we're just slightly below that. We expect to get better as we move through the latter part of the year.

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

And the delta there as we improve off of that 17% for the back half of the year, really, most of that comes out of the Engine business and to some degree, pricing catching up to the OE side of the business and the materials cost inflation. Is that going to be the biggest delta?

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

That will be a piece of it, and we're getting strong expense leverage as we grow our revenues and manage our expenses. We're really leveraging our expense base. Our margins are projected to essentially -- our gross margins are projected to be essentially flat this year. So you're getting a lot of expense leverage as we catch back up on gross margin.

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

Okay. And you referenced the second half revenue being greater than first half will help us on the leverage side and then we got some catch-up on the Engine side.

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

Right.

Operator

Your next question comes from Laurence Alexander from Jefferies.

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

This is Dan Rizzo on for Laurence. You mentioned that you're taking share in China On-Road truck and that's kind of messing things, I think. I was just wondering what the overall market looks like outside from the share you're taking. Is it softening and you're just kind of growing into it?

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

Yes. If you really take a look and you go to LMC data as they would estimate the overall China market, you know what, first thing I want to point out is we have very low share, so low single digits, so we have tremendous runway. And so, therefore, we're somewhat agnostic to the comprehensive direction of the overall China market because we do have that long runway, and we also have program wins in our pocket where revenue lies ahead of us. That said, the China, directionally, at the macro market, is softening a little bit, but we still have great opportunity.

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

Okay. And then in gas turbines, are we kind of near the trough now? I mean, it seems like things have finally kind of hit the bottom. I'm not certain that they're rebounding, but have they kind of hit, I don't know, a low level?

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

I would say it's tough to say. Sure feels like it. We've strategically as well as end market walked down. Large turbine projects are now less than 10% of our total revenue as a company. So we feel we have much less exposure. We'll continue to read the press clippings relative to our customer base, the Siemens, the GEs, et cetera, then look to them as to when the comprehensive market will fall out. So it's tough to say where the overall market is, but we believe Donaldson is certainly at the trough.

Operator

Your next question comes from George Godfrey from CL King.

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

Could you just expand on when you say you have more work to do on the pricing, is that pricing to get channel to fresh price list, customers who accept new products at higher prices, perhaps less discounting or higher price? Can you just flesh out exactly what do you mean by more work to do on pricing?

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

Specifically getting raw material cost increases and the freight increases through our OE channel. The OEs are exceptional at kicking that price recovery down the road, and we still have some of that work that lies ahead. That's what we were referring to.

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

Got it. So there -- so getting a higher price to the higher input, there's no risk of losing a first-fit or losing a platform, it's just simply getting the end customer to recognize the input costs are now higher.

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

And going through the lengthy negotiation because we have long-term contracts with them that actually call, as we said many times, for price downs, 1% to 2%, but we are also linked into the material indexes that allow us to have a conversation in times -- inflationary periods like this. However, you just don't flip the switch to get that with the OE. It is a rather protracted process.

Operator

Your next question comes from Brian Sponheimer from Gabelli.

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

Just to tie as in a bow, the shift of the hydraulics business to the Aftermarket, did you quantify that? I'm sorry if I missed it.

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

Brian, this is Brad. We took Off-Road forecast down to mid-single digits from high and Aftermarket up to low double digits from high single digits.

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

Okay. All right. So it can be inferred that way. And I would presume that, that is a margin hit to some degree. Or is there any margin implication because of that for either area?

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

No. No, no, there's not.

Operator

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

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

That concludes today's call. I want to thank everyone listening for their time and interest in Donaldson. Have a great day. Goodbye.

Operator

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