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# EDITED TRANSCRIPT

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## CORPORATE PARTICIPANTS

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

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

**Scott Robinson** *Donaldson Company, Inc. - CFO*

## CONFERENCE CALL PARTICIPANTS

**Ben Hearnberger** *Stephens Inc. - Analyst*

**Eli Lustgarten** *Longbow Research - Analyst*

**Brian Drab** *William Blair & Company - Analyst*

**Charley Brady** *SunTrust Robinson Humphrey - Analyst*

**Nathan Jones** *Stifel Nicolaus - Analyst*

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

**Larry Pfeffer** *Avondale Partners - Analyst*

**Jim Giannakouros** *Oppenheimer & Co. - Analyst*

## PRESENTATION

### Operator

Good morning. My name is Sharon and I will be your conference operator today. At this time I'd like to welcome everyone to the Donaldson's fourth-quarter FY16 conference call.

(Operator Instructions)

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

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

Thanks, Sharon. Good morning, everyone. Thank you for joining Donaldson's fourth-quarter earnings conference call. With me today is Tod Carpenter, President and Chief Executive Officer, and Scott Robinson, Chief Financial Officer. This morning Todd and Scott will discuss our recent performance, review our outlook for FY17 and provide an update on some of our strategic initiatives.

Before we begin, I want to cover a few housekeeping items. During the call we may reference non-GAAP metrics, such as adjusted earnings per share. You can find a reconciliation of GAAP to non-GAAP metrics within the schedules attached to this morning's press release or within a supplemental schedule posted on the Events and Presentations page of our Investor Relations website. Also on the website is a schedule 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. Todd?

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### Tod Carpenter - Donaldson Company, Inc. - President and CEO

Thanks, Brad. Good morning, everyone. I want to start by thanking our employees around the world for their contributions over the past year. It has been a challenging year that was filled with difficult decisions, but our employees have remained resilient and focused. Our Company has been



successful for more than 100 years because of dedication to our customers and I sincerely appreciate the work our employees do every day to maintain that culture.

Throughout the year, we further strengthened our Company's foundation. We prioritized operational efficiency and proactively removed costs from the organization. Additionally, we continued to push forward with our strategic growth initiatives. I'll talk about a few notable successes later in the call, but first I'll provide a brief update on our sales performance and overall market conditions.

We are pleased with our fourth-quarter sales performance. In total, sales declined 3% to \$594 million, which includes a negative impact from currency translation of 1%. Excluding that impact, total sales declined 2% from last year, reflecting a decline of 5% in industrial and flat sales in engine. The equilibrium we are finding between our forecast and demand is a sharp contrast from what we experienced during the past year and a half. We continue to be encouraged by some of the trends in the business, such as the return to a more normal seasonality, which we saw in the back half of 2016.

In terms of market conditions, the macro trends affecting our engine business are fairly consistent with what we discussed last quarter. On-Road was down 12% in the quarter, driven by a 24% decline in North America as build rates of heavy duty trucks continued to deteriorate. On the other hand, the Off-Road business has remained relatively predictable. Once again, we saw a sequential increase from third quarter to fourth quarter and the pace of decline versus the prior year continues to moderate.

Although none of our customers are officially calling bottom, we continue to be encouraged by signs of aggregate stability in this market. We are also encouraged by Engine Aftermarket results in the quarter, with another quarter of sequential improvement and year-over-year increases in both channels. The OE channel was up in the mid-single-digit range but results were a bit mixed by end-market.

Off-Road was less volatile while in On-Road customers appeared to be destocking a bit. Overall, we still believe the impact from destocking is becoming less significant. However, there is still enough variability in week-to-week ordering to suggest that both Off- and On-Road customers have yet to find a stable bottom.

In the independent channel, sales increased in low-single-digit range. Compared with the prior quarter, we saw another sequential improvement indicating a return to the typical seasonality we would expect in a more stable environment.

Turning to the Industrial segment, sales in local currency declined 5% from last year, led by a 19% decline in Gas Turbine Systems. Our Industrial segment businesses were on forecast last quarter, but given the magnitude of the sales decline in GTS, I want to give a little more color on those results. The 19% sales decline in fourth quarter compares with a 22% increase last year, as we saw the characteristic lumpiness of revenue from large turbine projects. Our project-related sales still includes those projects won before we made a strategic shift to be more selective in our bidding. We will begin seeing the impact of that shift in FY17, but we also expect to benefit from efforts to grow our GTS replacement part business.

Stepping back, I want to share a few highlights about our full-year results. Total sales were down more than 6% for the year, or \$150 million. Currency translation accounted for half of the decline and the first-fit portions of our engine and industrial businesses made up the majority of the balance.

When we look a little deeper into the business, there are some positive indications that our strategy is working. In local currency, our replacement parts sales were essentially flat with last year despite headwinds from things like OE destocking, the oil and gas slowdown, and geopolitical uncertainty around the world. Replacement part sales represent more than 55% of our business, so we are very pleased that we held our revenue in such a volatile environment.

We also saw further evidence that our focus on innovative products is working. For example, PowerCore sales in Engine increased almost 4% last year, reflecting an aftermarket increase of almost 8%. Also in Engine, lube and fuel products, which are a critical component to our long term growth formula, saw a several percentage point increase from last year. Within Industrial, sales of DownFlo evolution equipment more than doubled versus the prior year as we began selling around the world.



Additionally, sales of our Integrated Venting Solutions delivered an increase in the high teens last year, as we use this innovative product to expand our addressable market to automotive, consumer electronics and medical electronics. Including replacement part sales, the businesses I referenced represent nearly three-quarters of our total revenue, signaling to us that we have a very strong foundation to build upon this year.

As we transition to fiscal 2017, our perspective on the overall market conditions is still somewhat guarded. We expect that global production of heavy duty equipment will decline across all of our end-markets. Within Off-Road, we estimate that production of agriculture and mining equipment will continue their multi-year slowdowns with declines of another 5% to 10% each. We also expect the year-over-year decline in production of construction equipment, albeit a bit more modest, flat to down 5% range.

There are a wide range of factors pressuring these off-road markets, but they aren't new. For example, depressed commodity prices, the impact from the oil and gas slowdown and a decline in overall infrastructure spending has been affecting production for some time now. We have definitely seen a moderating pace of decline, but it is clear to us that there is still some uncertainty. The transportation market is also expected to be down in our fiscal year. Leading industry forecasters are calling for continued declines of Class A truck production in North America, while the heavy-duty on-road markets in Europe and Asia Pacific appear to be more stable.

Turning to equipment utilization, which is a key driver of our aftermarket business, we are estimating the markets will be somewhat flat this fiscal year. More specifically, we expect modest increases in utilization of transportation and construction equipment that will likely be offset by continued declines in both ag and mining.

With that context, I'll turn the call over to Scott for an update on recent performance and our FY17 guidance. Scott?

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**Scott Robinson** - Donaldson Company, Inc. - CFO

Thanks, Tod. Good morning, everyone. I also want to start by thanking our employees. We finished our global ERP implementation in August, and our team did an incredible job. The decision to embark on this four-year project was a courageous one. Throughout the implementation, we upheld our "customer-first" approach and we delivered on our commitments.

As we transition to the optimization phase, we still have hard work in front of us. We expect to realize pockets of benefits across the organization from things like better inventory management, pricing sophistication, and enhanced global processes, but that will take time. Of course, these are just a few examples of the power created by a global system, so we are excited to begin the next phase. Many thanks to everyone involved. I am very proud of our global team.

I am also proud of our efforts to manage the business responsibly during a very challenging environment. A top priority for the Company has been and will be enhancing operational efficiency. Throughout the year, we maintained a very tight control on expenses, due in part to proactive restructuring across the Company. During the fourth quarter, we implemented additional restructuring actions, including a change to our footprint in China. Given current market headwinds in that region, we consolidated our headquarters locations and closed our office in Hong Kong. We are still optimistic about the long-term growth prospects in China, but the uncertainty today prompted us to take action.

Turning to our financial metrics, we delivered fourth-quarter EPS of \$0.44, or \$0.46 when you take out restructuring charges. Compared with last year, we saw an increase on both a GAAP and a non-GAAP basis, but we fell short of our forecast due primarily to higher-than-expected loss on foreign exchange. For context, certain gains or losses on foreign exchange are included within the other income and expense line of our P&L. This line includes a variety of other items such as income from joint ventures, royalties and interest income. The impact from foreign exchange swung from a net gain in 2015 to a loss in 2016. The swing from a gain to a loss had been happening throughout the year, but the impact in the fourth quarter was greater than expected, given some variability within our basket of currencies.

On a full-year basis, the loss in other income and expense was compounded by lower income from joint ventures, reflective of the same end-market pressure facing other parts of our business. Our operating margin results in the fourth quarter partially offset the impact I just discussed. On a non-GAAP basis, which excludes restructuring and other one-time charges, we delivered a 15.8% adjusted operating margin. That compares with



14% last year, reflecting year-over-year improvement in both gross margin and expense rate. Gross margin benefited from several things, including lower raw material cost, improved fixed-cost absorption and the overall mix of sales.

On the expense side, savings from restructuring, combined with overall expense discipline, drove our results. As most of you know, we've been talking about expense discipline and our focus on operational efficiency all year, so I want to pause briefly on my discussion in the quarter to talk about the full-year impact of those efforts. As Todd referenced, total sales declined by \$150 million from last year, placing significant pressure on the bottom line. In response to this pressure, we reduced expenses by about \$40 million, or 8.5% when you adjust for one-time charges. Our discipline led to full-year operating margin growth on both a GAAP and non-GAAP basis in a year where sales declined 6%.

Turning back to the quarter, we continued to make progress on strengthening our balance sheet. Our primary focus has been working capital, with our sights set on reducing inventory and receivables. Both metrics are down when compared with the beginning of the year, but the most substantial improvement occurred after we set region-level targets following the first quarter. Compared with that point, inventory is down more than 18%, and we reduced our days' sales outstanding by 1.5 days.

As we saw our gross-debt-to-EBITDA ratio fall more in line with our long-term target of about 1.5 times, we resumed our share repurchase activity. In the quarter, we invested \$16 million to repurchase 470,000 shares. For the year, we returned \$84 million to our shareholders by repurchasing 1.9% of outstanding shares.

We also paid dividends of \$91 million to our shareholders last year and we are very proud to have recently been added to the S&P Dividend Aristocrats Index. After paying a dividend every quarter for more than 60 years, the recent inclusion in the index marked our 20th year of consecutive annual dividend increases.

Our focus on operational efficiency, maintaining a strong balance sheet, and returning excess cash to shareholders are foundational to our near- and long-term success. I'll talk about how we build on this foundation as I now turn to our FY17 guidance.

As we said last quarter, we took a cautious stance when developing our plans for this year. Given the market conditions Todd referenced, we believe this approach is the most responsible. Our plans reflect continued expense and balance sheet discipline while also giving us the flexibility to pursue sales should an opportunity emerge. In total, full-year sales are expected to be within plus or minus 2% from FY16. At the mid-point, sales are roughly flat with last year, despite a continued headwind from end-markets. Both segments are also in the plus-2%-to-minus-2% range, with modest growth in certain businesses being offset by declines in others.

In the Engine segment, we expect Aftermarket sales growth in the low single digit percentage range as we leverage past investments and our innovative technology. Continued production declines of heavy duty equipment will drive our other engine businesses. We expect the most pressure in On-Road, resulting in high single digit percent decline from last year. In both Off-Road and aerospace and defense, we are forecasting a decline in the mid-single-digit range.

Within the Industrial segment, we expect Industrial Filtration Solutions' sales will increase from last year in the low-single-digit range, reflecting a tepid first-fit environment that is more than offset by strong growth of replacement parts. In Gas Turbines, we also see strong growth of replacement parts. However, our decision to be more selective on large turbine project mixes out to a full year sales decline for GTS in the high-single- or low-double-digit range. Finally, sales of Special Applications are expected to decline from 2016 in the low-single-digit range as pressure from disk drives is only partially offset by growth in areas like venting solutions.

Within our total sales guidance, we have included the incremental benefit from the Partmo acquisition which is roughly \$12 million to \$13 million in FY17. Additionally, based on current exchange rates and a basket of currencies, our full-year guidance does not contemplate an impact from currency translation of total sales. Of course, we would revise that perspective if we see any material shift in currency during the year.

We are forecasting full year operating margin between 13.3% and 13.9%. At the midpoint of the range, operating margin is expected to improve 40 basis points from 2016's adjusted operating margin of 13.2%, reflecting some stability in gross margin and expense leverage. Included within

our forecast is a year-over-year headwind related to compensation expense of \$20 million, which is in line with the estimate we provided last quarter.

One offset to this headwind is a benefit from previously taken restructuring actions. In FY17, we expect to realize \$12 million of savings with the incremental benefit skewed heavily towards the first half of the year. Additionally, we expect the leverage against flat sales as we benefit from our recent and ongoing efforts to enhance operational efficiency.

Moving down the P&L, we expect income in our OI&E line between \$8 million and \$10 million, compared with \$4 million in 2016. We typically don't guide to this metric and we don't intend to give line-item specifics, but we wanted to provide some perspective given the foreign exchange variability I discussed earlier. We are forecasting a slight year-over-year increase in our interest expense and our tax rate is expected to be between 26.7% and 28.7% as we return to a more normal historic average.

In terms of capital deployment, we remain focused on our core priorities, invest in the business, pay dividends, and to the extent our balance sheet allows, repurchase shares. We are forecasting capital expenditures between \$70 million and \$80 million and we expect to repurchase between 2% and 3% of our outstanding shares. Our forecast results in another strong year of cash conversion. After achieving 113% last year, we expect this year's cash conversion in the 90% to 100% range. Altogether, we expect FY17 earnings per share between \$1.50 and \$1.66. As of today, we are not forecasting any impact from adjusting items, so GAAP and adjusted EPS are expected to be one and the same.

Before turning the call to Tod, I want to provide a little color on the forecasted cadence of sales and operating profit in 2017. Our sales forecast reflects a similar seasonality as what we saw in 2016, meaning that sales will be weighted towards the back half of the year. Compared with last year, operating margin is expected to show more improvement in the first half of FY17 than the back half, driven by a couple of factors.

As I said earlier, the incremental benefits from last year's restructuring are weighted towards the first half. Additionally the first half of 2017 has an easier comparison, given the gross margin pressure from sales volatility that we experienced earlier in the year.

Now I'll turn the call over to Tod for an update on some of our strategic efforts. Tod?

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

Thanks, Scott. I'm very proud of the operational discipline our employees have shown over the past year. In 2017, we will retain this discipline while making further progress on the critical components of our strategic plan, which include: grow the core business in technologies; expand geographically; and expand through acquisitions. Over the past 12 months, we have made progress in all of these areas.

Earlier in the call, I highlighted the 2016 results for a few of the growing businesses within our portfolio, PowerCore, engine liquid, DSE, and Integrated Venting Solutions. During FY16, this innovative lineup of products was also helping us plant seeds for future growth. In both Engine Air and Liquid, we saw very solid program win rates, with Air in the 75% range and Liquid higher than that. In both businesses, a significant portion of the wins were incremental business to Donaldson and one with innovative technology. As we weather the near-term pressure from end-markets, our program wins position us well for future growth.

In terms of geographic expansion, we have begun production of both air and liquid products at our new facility in Poland. This plant is particularly beneficial to our liquid business as we pursue additional growth across the world. Beyond capacity, increasing our local production in Europe further insulates us against future exchange-rate volatility.

In addition to Poland, we now have liquid manufacturing in South America through the Partmo acquisition. This acquisition will help bolster our Aftermarket business in this critical market with a brand that is very well known in that region. We are excited to begin the integration.

Earlier in FY16, we acquired Engineering Products Company, or EPC. This technology-related company broadens our offering of sensors and indicators that measure filter life, which is becoming increasingly important to our customers.

Finally, I also want to thank the employees around the world for the time and energy they put into our global ERP implementation. This system creates a greater level of transparency into our business than ever before and I look forward to our Company benefiting from that transparency in the future.

In the coming year, we are focused on a core set of actions. Specifically, we will continue developing our technology to drive new, first-fit program wins. We will invest in pockets of our business that have near-term growth opportunities, including replacement parts. We will focus on enhancing operational efficiency to protect our bottom line without sacrificing the future. We will be disciplined in our investments, maintaining a strong balance sheet and redeploy cash to our shareholders.

Our FY17 plans have tactics in place for every one of these items, which gives me confidence we can deliver our financial and strategic objectives in the New Year. With that, I'll turn the call back to Sharon to open the line for questions. Sharon?

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions)

Your first question comes from Ben Hearnberger from Stephens.

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### Ben Hearnberger - Stephens Inc. - Analyst

Thanks for taking my question. Tod, I'm wondering, clearly China has been difficult. Can you update us on your strategy there going forward?

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### Tod Carpenter - Donaldson Company, Inc. - President and CEO

Sure. China has been difficult due to their end markets and their clear GDP pressures. We have restructured China to align our Company with the realities of that market; however, we still believe in China and it's a very important market for our long-term strategy. We continue to invest in China to make sure that we press forward with our innovative products, both on the industrial and the engine side and we continue to have wins in China, so long term we still stay the course with China because we believe in that and it's important for us.

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### Ben Hearnberger - Stephens Inc. - Analyst

Okay. On the ERP implementation, it was a cost headwind in 2016. What is the tailwind now that it's rolled off?

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### Scott Robinson - Donaldson Company, Inc. - CFO

We addressed that last quarter, but as the project rolls off, it will be about flat with regard to next year as baked into the plan.

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### Ben Hearnberger - Stephens Inc. - Analyst

That's on an operating basis. How much from a capital expense standpoint was it in 2016, I guess, that we're not going to see again in 2017?



**Scott Robinson** - *Donaldson Company, Inc. - CFO*

Well, the total project was about \$90 million that we spent and that was over a period of four years. That ended at the end of this fiscal year. We have about \$60 million to \$70 million of total CapEx planned for next year.

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**Ben Hearnberger** - *Stephens Inc. - Analyst*

Okay, and then a question on GTS. It sounds like the expectation is that replacement grows in 2017. I guess, can you parse out the guide a little bit further between replacement and then project declines year over year in 2017?

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

Ben, this is Brad. We expect replacement parts will probably be up in the high-singles area and then it will mix out with projects being down there. That's the balance. Replacement parts, for context, are in the plus or minus 40% of total GTS sales.

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**Ben Hearnberger** - *Stephens Inc. - Analyst*

Got it. Okay, thank you, gentlemen.

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

I think Scott said CapEx of \$60 million to \$70. Next year's CapEx guidance in total is \$70 million to \$80 million. I want to correct that before we move on.

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**Operator**

Your next question comes from Eli Lustgarten from Longbow Securities.

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**Eli Lustgarten** - *Longbow Research - Analyst*

Can I -- just one clarification. Can you give us what the adjusted operating margins for engine and industrial were for the quarter if we ex out the charges? Can you give us a little feel of -- I realize the first half was much weaker last year, so as much as you compare but can you give us feel for what we should expect year over year in the operating margin segment adjusted for those sectors?

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

Sure. We're going to look that up, Eli. Could we move to the next question and Brad will get the table specifically for you and break down engine and industrial. Can we come back to that?

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**Eli Lustgarten** - *Longbow Research - Analyst*

Sure, not a problem. In discussing relatively flat sales as you went through the various segments, can you give us some feel, maybe a little more color on what's going on with the declines that you expect, particularly in mining and ag? Is that all first-half phenomena or is that down for the entire year? Because it looks like this ag market looks like it's going to be in shambles for a while. The 5%, 10% (inaudible). Can you give us an idea, is it more heavily weighted to the first half than the second half? The same thing, too, when you get to the construction on-road. We are talking a 30% decline in production that you're going to feel the brunt of because of the fiscal year than anything else.





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

That's exactly right, Eli. On the On-Road, it would likely be more first-half weighted than second half just simply because we're in the midst of a large decline already and if you take a look at FY17 -- or sorry, calendar 2017, from ACT and our customers, it's a more modest decline which hits our second half, so that's the 5% to 10% range within the transportation side, but in the first half of the year we're still going through that as much as 30% decline that everyone is talking about in the industry. On-Road is pretty straightforward. Within the ag and mining, it's a little bit more spread equally through the year, if you will. It's more of a drip down should there be that continued pullback as we see no real impetus for those markets to pick up steam.

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**Eli Lustgarten** - Longbow Research - Analyst

Can you give us a little insight about what's going on in pricing across the board? This is a tough market and with raw materials stopping, starting to be a benefit for most companies, are you seeing that? Do you have enough offsets internally for the price increases that are coming in raw materials or do you have to raise prices or give us some feel for what's going on there?

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

Eli, pricing really has always mattered, as you know, within our model. We have pressure from the OEs with long-term contracts that pull pressure down. We take opportunities regionally within the aftermarkets that present themselves. Pricing has always mattered but no one is acting irrationally out there and so it's a bit more of business as usual and we'll continue to take those regional opportunities that present themselves as possible.

Relative to materials, we have longer-term contracts on our largest percentage of the materials, which happens to be steel and urethanes and with those longer-term contracts we actually experienced a more positive materials tailwind, if you will, because of those longer-term contracts. It's the reason why looking forward, it's a more modest tailwind to us simply because we've been experiencing that and ahead of that overall market tailwind, if you will.

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**Eli Lustgarten** - Longbow Research - Analyst

So you still have contracts going through most of 2017 to give you the favorable things. How long do the contracts go out for before we have to--

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

No, to this calendar year and then we look forward after that.

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**Eli Lustgarten** - Longbow Research - Analyst

All right. Thank you very much.

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

Eli, this is Brad. I want to address the question you asked about segment EBIT. The Engine segment had about 40 Bps of impact from restructuring charges, and Industrial was about 70 Bps, so removing those engine would be 14.4%, and 17.1% for Industrial. That's, for the reference of others, that's on the segment detail tab within our release schedules. There's segment level.

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**Eli Lustgarten** - Longbow Research - Analyst

Great. Thank you very much.

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

Thanks, Eli.

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**Operator**

Your next question comes from Brian Drab from William Blair.

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**Brian Drab** - William Blair & Company - Analyst

Good morning. Thanks for taking my questions. First question is on acquisitions. Can you talk about the pipeline? As we sit here today, you've got over \$200 million in cash, generating over \$200 million in free cash. The end markets that you're playing in are pretty beat up and I'm wondering within this fragmented filtration market, are you seeing a lot of opportunities? Because by my account, I guess we've only spent \$20 million to \$30 million on acquisitions over the last 12 to 18 months.

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

Brian, we continue to work our new and improved process for acquisitions, our robust process, that has yielded four acquisitions over the last two years. We have a robust pipeline as a result of that process. We continue to work that diligently. I would describe our pipeline as robust, strategic, but also selective and we will remain a disciplined buyer. I would also characterize and say even though it's a bit of a tough environment out there, we do not see any kind of irrational behavior within the acquisition markets at this time.

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**Brian Drab** - William Blair & Company - Analyst

Okay, thanks. On the restructuring, I want to make sure I understood. It's \$12 million incremental and \$12 million incremental savings for FY17. Is that what I heard? Then you said it's weighted more towards the first half of the year. Does that mean that -- is it a \$12 million run rate by the end of the year or is it actually \$12 million that we would load into the model for 2017?

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

It's \$12 million for the FY17 and the benefits when you compare to last year will impact first and second quarters more than third and fourth quarters.

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**Brian Drab** - William Blair & Company - Analyst

Are the restructuring activities taking place throughout 2017, or is this \$12 million related to activities that were completed in 2016?

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

It's related to activities that were completed this fiscal year, so FY16.

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**Brian Drab** - *William Blair & Company - Analyst*

Okay, I understand. Maybe just comment on the liquid side of the business. I'd be interested if you could tell us what percent of sales were liquid in the quarter, maybe an update on some of the wins in that segment?

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

I'll have Brad get the percent for you. This is Tod. The wins that we've had as we look across the overall year, we have had a very successful year on winning Liquid and Air. Our Liquid win rate is about 70% to 75%. Air is about 60% to 65%. In Fuel specifically, it's 90%. When you then translate that longer term, those are clear wins that are going to plant proprietary future growth, help our OE businesses, but then also circle back and help bolster our aftermarket strategies as well. We're very proud of the success worldwide because we've been winning in emerging markets. We've been winning in developed economies. Its been very broad.

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

Brian, Liquid -- the lube fuel business in total for Donaldson last year was just about \$0.25 billion.

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**Brian Drab** - *William Blair & Company - Analyst*

Okay, thanks very much.

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**Operator**

Your next question comes from Charley Brady from SunTrust Robinson Humphrey.

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**Charley Brady** - *SunTrust Robinson Humphrey - Analyst*

Thanks. Good morning, guys.

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

Good morning, Charley.

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**Charley Brady** - *SunTrust Robinson Humphrey - Analyst*

On industrial filtrations and your outlook for 2017, can you just parse out what your expectation is on the parts aftermarket growth versus the OE, presumably decline in OE in 2017 for that business?

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

Charley, this is Tod. We've not parceled that out specifically before and we don't give that level of guidance. We do say that our IFS business total will be up low-single digits. I would suggest to you that the headwind on the OE side will be offset by our expected replacement parts growth.

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**Charley Brady** - *SunTrust Robinson Humphrey - Analyst*

Okay, fair enough. I wonder if you can just -- on the other expense in the fourth quarter, when you called out it's comprised primarily of the JV income being lower in the FX switch from headwind to a tailwind. Could you parse out of that \$2.7 million kind of how much of that came down in the FX, how much was from the JV piece of it?

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**Scott Robinson** - *Donaldson Company, Inc. - CFO*

Well, yes, I think you had it right. The Q4 expense was \$2.7 million versus income of \$3.8 million last year. That contains several items, income from the joint venture, royalties, interest income as well as FX. For the year, the largest piece of that change was driven by the FX. The second largest piece of that was driven by reduced joint venture income, driven by the market pressures that the Company has faced in the rest of its business.

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**Charley Brady** - *SunTrust Robinson Humphrey - Analyst*

I guess what I'm trying to get to is was it majority driven by one versus the other as far as FX or the JV income? Was it mostly the FX swing?

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**Scott Robinson** - *Donaldson Company, Inc. - CFO*

Yes. That was the biggest piece, the FX.

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**Charley Brady** - *SunTrust Robinson Humphrey - Analyst*

In your commentary, your press release, you talked about aerospace/defense decline in commercial helicopters, but I wonder if you can just look at the other piece of that business outside of that. Are you expecting any particular piece of that to be up? I think you called out for that -- I that you said the whole segment or that business segment would be down in 2017 so I'm just trying to understand, are there pluses in that piece of the business in 2017?

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

Right. There are not pluses. When you take a look and parcel that back, defense, which is a much lower portion, after a multiple year step down, defense is again expected to decline slightly, but the story in why we have aerospace and defense down mid-single digits is really coming from the aerospace sector and particularly the Rotocraft. That links back to the oil and gas markets where there are less Rotocraft being purchased, which used to ferry people out to offshore oil platforms, et cetera, and that's the headwind within that particular market. It's definitely a more challenged market across the board.

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**Charley Brady** - *SunTrust Robinson Humphrey - Analyst*

Got it. Thanks.

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**Operator**

Your next question comes from Nathan Jones from Stifel.

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**Nathan Jones** - *Stifel Nicolaus - Analyst*

Good morning, Todd, Scott, Brad.



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

Hi, Nathan.

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**Nathan Jones** - Stifel Nicolaus - Analyst

I wonder if I could take a follow-up to Eli's question, but from a little bit different angle, talking about increased steel costs and other increased raw material costs. Do you expect or have you seen any kind of improvement in utilization for mining equipment as those prices increase, and how would you expect that to progress if we see higher raw material costs or more stable raw material costs, as a demand driver rather than a cost driver?

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

Right now, it's definitely commodity based, as of course the mining companies can get more for the raw materials they will continue to improve vehicle utilization. But the consumption does have a role in the long run. They aren't just going to continue to stock all of that. As we saw with an abundant coal supply for example, in China that really put pressure all the way down through Australia and Indonesia in this downward cycle. It needs a little bit more of a pick-up of a global GDP, if you will, to get the comprehensive mining sector really moving forward. It's a bit more structural than just simply if commodity prices rise, things will all of a sudden turn for us. We see it more incremental going forward as that whole market recovers.

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**Nathan Jones** - Stifel Nicolaus - Analyst

Fair enough.

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

I think you'll see that in Caterpillar's guidance, for example, as well, where they're calling for a more modest calendar year of 2017, for example.

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**Nathan Jones** - Stifel Nicolaus - Analyst

Okay, and then one on the GTS. You've made this strategic decision to steer away from low price OE projects and it sounds like your forecasting the impact of that on the original equipment project side to get you in 2017. How does that play out over the coming few years on the aftermarket side of that business as whether it's at your decision or is somebody else's decision, this equates to a loss of share on the project side. What I'm wondering is how that impacts the aftermarket as we go forward over the next several years.

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

We don't believe it does, because we have a strong brand in the number-one market, which is the Middle East. We also now with our Northern Technical acquisition have a strong presence in the Middle East and so therefore we're much closer to our end-user customers than we have been before. This gives us a stronger position to really continue to capture, have a higher capture rate in the aftermarket. We also expanded our product family within the aftermarket within that Northern Technical acquisition and so we're now -- we actually have a much broader market opportunity within GTS to address within aftermarket. We're very comfortable in this typical a little bit more pressured cycle with projects from a -- clearly GTS is pressured from pricing on the project side, but also the quantity of projects out there is less and so we need to be very selective. This market goes through these types of cycles. You have to be prudent and responsible while in that and that's what we are doing with this particular strategy.

**Nathan Jones** - *Stifel Nicolaus - Analyst*

Okay, that's helpful. One on the guidance. Can you talk about what the major sources of variability are in the guidance? What would get you to the bottom end and what would get you to the top end?

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

Sure. The answer for the low and the high is really the same. It's a GDP story, so to the extent that a geography has GDP headwinds, such as Western Europe or the US, and that significantly changes the overall behavior of industrial base production or vehicle utilizations, we would feel that in our aftermarket first, which would then step down again into the OEs. That's the headwind side. The tailwind side would be if we do start to see a little bit more positive across the GDPs worldwide, clearly we would leverage that quite nicely to be able to hit the high end of the guidance.

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**Nathan Jones** - *Stifel Nicolaus - Analyst*

Okay, that's helpful. Thanks for taking my questions.

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

Sure.

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**Operator**

Your next question comes from Richard Eastman from Robert W. Baird.

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

Yes, good morning.

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

Good morning.

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

A couple quick questions, but let me focus on the engine aftermarket business. In the quarter we saw less-than-typical seasonal improvement from Q3 to Q4, considerably less, and I just have a question kind of surrounding that. Why would that be the case here if we return to seasonality, that typical seasonality in the middle? Was the weakness -- why was the weakness in Asia, pronounced in Asia, on the aftermarket engine side?

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

What we had last year, of course, is a lot of headwind in the fourth quarter. We had a bit more of a pick-up in this year's fourth quarter. If you look at -- I mentioned in my prepared comments that we have a bit more erratic ordering patterns. Our aftermarket sales time fence, if you will, is much more compressed than it ever has been. We're talking maybe just a couple weeks of visibility in some of these areas in some of the geographies. I believe we did see the seasonality, but we did not see people take back all of the stock that they're used to normally carrying and so there was a little bit of a balance. Notice that I said there's some of the geographies that have been destocking just a little bit and so they've compressed on

the destock but also compressed their ordering patterns. They kind of offset each other to really mute a little bit of what we would have hoped would be mid-single-digit growth to become low--single-digit growth.

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

I see. Was that more pronounced in Asia, just given the status of the end market there or that you saw more destocking there in Asia aftermarket?

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

More destocking for sure across Asia, across our distribution channels, yes.

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

Then just a question real quickly on the Gas Turbine side of the business. Does Donaldson, are they -- are you guys suspect or have any content on GE's new H-class turbine where their backlogs have been getting -- have grown considerably? Do you have any OE content there?

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

When a gas turbine is sold, no matter what the technology, in F&H or whatever technology from GE, Siemens or Mitsubishi, they are all projects. What you have to have is the technology that really reaches across, if you will, that product family of gas turbines for that particular customer to be qualified. Are we qualified with the H engine? Absolutely. With Donaldson technology, we are, but you still win those on a project. You don't win, for example, like you do in an engine where you can win all of the 10-liter engines. In this, you still got one particular project where that H engine is going to be implemented worldwide. But we are qualified. We do sell to the H engine and we'll continue to do so, however in that selective fashion as we mentioned in our strategy.

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

I see, okay. One last question. On the adjusted op margin guidance for 2017, I think the 13.3% to 13.9%, the low end and upper end, you're talking about maybe 10 to 70 basis point improvement over FY16 and again, at the midpoint we have zero growth. The commentary earlier suggested that the increase at the midpoint here of, call it, 40 basis points on zero growth is a function of the operational efficiencies that you targeted and mix here with your aftermarket business growing. Is that how we -- (multiple speakers)

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**Scott Robinson** - *Donaldson Company, Inc. - CFO*

I'm saying a more stable volume situation.

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

Does that guidance include the \$20 million comp step up?

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**Scott Robinson** - *Donaldson Company, Inc. - CFO*

Yes, it does.



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

Okay, so we'll offset that with the restructure savings plus some additional operating efficiencies, plus we should have a more favorable mix with aftermarket growth and OE declining.

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**Scott Robinson** - *Donaldson Company, Inc. - CFO*

All those things are considered. That is correct.

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

Okay, I got you. All right, thank you.

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**Scott Robinson** - *Donaldson Company, Inc. - CFO*

Thanks.

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**Operator**

Your next question comes from Laurence Alexander from Jefferies.

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**Unidentified Participant** - *Analyst*

(Technical difficulty) on for Laurence. You mentioned and we talked about improved fixed cost absorption on the gross margin. Could you just elaborate on what's driving that and is there any particular product lines or anything?

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**Scott Robinson** - *Donaldson Company, Inc. - CFO*

I think that it's general cost containment, cost improvement across the board. I wouldn't think there's any one particular specific area. We had some restructuring to improve our cost structure, continued cost discipline, and that spreads across pretty much all the product lines.

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**Unidentified Participant** - *Analyst*

You mentioned briefly about the specialty product business, some of what's going on there. Can you give more granularity? I think you said disk drive pressure -- or disk drive growth is offsetting weakness in venting solutions. Did I hear that right or can you just give us some elaboration on that segment?

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

You actually have that reversed. Disk drive headwind, which will likely be high-single digits, is being offset by the other pieces of special applications with things which we expect to grow, like integrated venting solutions.

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**Unidentified Participant** - - *Analyst*

Okay. All right, thanks. Finally, you mentioned the M&A pipeline, how you have the new and improved product process and you aren't seeing rationality, but are you looking more towards technology improvements or improving product offerings or footprint? Is there a specific way you're going about it in terms of M&A?

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

There's not a specific piece of that strategy that you mentioned that we would target. The way we do this is each business unit has a particular organic growth strategy. Within that strategy, if we see a way to accelerate that organic growth plan through an acquisition, as you saw us do with our recent Partmo acquisition, we knew eventually we had to manufacture product in Latin America, down in South America, because we had already expanded our distribution, expanded our product line and now we had to get closer to the customer to give them a quicker response. That's just a normal strategic step for us and so we acquired. It could be a channel, it could be a product expansion, it could be all of those, but it starts with that organic strategy that we have within a business segment.

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**Unidentified Participant** - - *Analyst*

Thank you, guys, for the clarification.

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**Operator**

Your next question comes from Larry Pfeffer from Avondale Partners.

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

Good morning, Larry.

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**Larry Pfeffer** - *Avondale Partners - Analyst*

Tod, just trying to get a little more color on this. You used the word encouraged quite a few times in your script. Is that more just on stability in end markets and then the projects you are winning, or are you actually seeing improving end-market fundamentals out there?

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

I use the word encouraged because it's been a tough slog for the last 18 months and it's been a walk down that has been tough to get through. I think as I look forward, the range of possible outcomes has certainly narrowed significantly for our Company, and so the encouragement is that while I'm not ready to call bottom, I am encouraged by the fact that we're a little bit more predictable than we have been at any time in the last 18 months.

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**Larry Pfeffer** - *Avondale Partners - Analyst*

Okay, that's helpful. Looking -- touched on the special apps segment in the last question. Obviously, IVS looks like it's doing well and you have the secular pressure on the disk drive side. Is there a time frame you're looking at for when that business can get you back to posting overall growth?

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

The disk drive business specifically?

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**Larry Pfeffer** - *Avondale Partners - Analyst*

The Special Apps segment, I guess.

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

We're not calling out a time frame as to when we would see Special Apps be able to offset the headwinds we expect looking forward in the disk drive. It's just that, as you called out, it's a natural secular decline that we'll see, so we've not laid that line in the sand, if you will.

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**Larry Pfeffer** - *Avondale Partners - Analyst*

Okay, understood. Thanks, guys.

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

Thank you.

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**Operator**

Your next question comes from Jim Giannakouros from Oppenheimer.

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

Hi, Jim.

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

Good morning, Jim.

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**Operator**

Your line is open.

(Operator Instructions)

Your next question comes from Eli Lustgarten from Longbow Securities.

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**Eli Lustgarten** - *Longbow Research - Analyst*

Hi, thank you for giving me a quick follow-up. Two specific ones. One in the segment details, you have your corporate and allocated and I know everything that goes in there, but do you have any feel for what corporate and allocated would do in 2017 versus 2016? Should that be relatively stable, similar numbers, up, down a little bit?



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

Eli, we haven't specifically guided to that but the FX loss that we've talked about and some of the variability from the OI&E line does flow through corporate and unallocated, so that gives you a sense that, that's where some of the improvement will come from, or show up.

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**Eli Lustgarten** - Longbow Research - Analyst

Okay.

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

What Scott talked about in his OI&E guide.

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**Eli Lustgarten** - Longbow Research - Analyst

The second piece is, you've basically forecasted plus or minus 2% across the Company. When you looked at the quarterly detail, you tried to give us some of that. Your second half is strong as first half. Is this plus or minus 2% the guidance for every quarter or is there bigger swings in one part of the year that would offset the second half of the year?

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

Eli, this is Brad again. When we look at the plus or minus, it's flat on the year and as we said in the remarks, the seasonality is about the same as well, so it was a little bit back-half weighted this year and I think using that triangulation, that will get you in the ballpark. But there isn't a notable story in quarter A versus quarter B.

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**Eli Lustgarten** - Longbow Research - Analyst

Basically they're similar. You get similar plus or minuses throughout the whole year, is what you're betting on at this point?

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

Yes.

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**Eli Lustgarten** - Longbow Research - Analyst

Okay, thank you.

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**Operator**

(Operator Instructions)

Your next question comes from Jim Giannakouros from Oppenheimer.

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**Jim Giannakouros** - *Oppenheimer & Co. - Analyst*

Hey, guys. Sorry about that.

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

Good morning, Jim.

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**Jim Giannakouros** - *Oppenheimer & Co. - Analyst*

Actually wanted to tack on to Rick's couple of questions. First, on GTS, curious as who to you competition for GE's new class of turbines is looking. Appreciating that a major competitor of yours has an increased focus there, so curious if you could speak to what your competitive advantages are and/or trends from a share perspective. Just in general, how things are progressing and I guess the differences in the landscape that affords you an advantage in winning those projects that you alluded to. Thanks.

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

The overall atmosphere of winning any kind of project in H and F or whatever the turbine may be, GE is always a disciplined buyer and the value proposition that Donaldson Company brings forward is we, essentially, 20 years ago started this particular market. We are number one in the gas turbine market and it's because of a technology that we have which in this particular market we call Spider-Web. If you think about it, we have nano fibers, which are roughly about 0.1 the diameter of a human hair that we put within on our medias, which then filter out the particulate ambient air better than anyone else in the marketplace, which then allows you to have a cleaner turbine and produce more energy out the back side.

That's our value proposition as well as our strong customer projects execution, which we have a long, strong track record and that's how we win. We'll build a gas turbine project anywhere in the world. It's not uncommon for these complicated projects to have one line item purchase order to be worth millions of dollars, have 50 to 60 semi-trucks that are manufactured in four different countries and they all come together on a site. It takes special coordination and a special team to be able to do that and Donaldson has that.

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**Jim Giannakouros** - *Oppenheimer & Co. - Analyst*

That's helpful, thank you. Going back to the margin guide, I suspect that organic growth is the biggest swing factor and if -- curious if you're trending towards the lower end how much you could actually flex expenses down to offset and if you could cite specifics as to where exactly? As a follow on, is further restructuring actions, are they being considered in 2017 or are you pretty confident that it's substantially behind you and now you're just in a block-and-tackle mode from an expense side? Thanks.

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

This is Tod. I'll start with the restructuring answer and then toss it over to Scott to finish off. Within restructuring, we currently do not have any additional restructuring plans in the Company. However, we continue to look at aligning our Company overall with end markets, with the end-market demand. Should there be a demand shift, surely we would look deeply among ourselves and adjust accordingly. To be honest with you at Donaldson that's standard work. That's what we do every day and we'll continue to act in that fashion.

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**Operator**

(Operator Instructions)



We do not have any questions at this time. I will turn the call over to the presenters.

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

Thanks, everyone. That concludes today's call and I want to thank all of you there for your time and your interest in Donaldson Company. Goodbye.

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**Operator**

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

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