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Donaldson Company Inc at Robert W Baird Global Industrial Conference

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PRESENTATION

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

Quick overview. But Donaldson is -- has a well-deserved reputation as a best-in-class filtration company, within the $50 billion plus global filtration marketplace. From our perspective, technology and innovation, OE relationships and the strength of Donaldson's core operations team, all serve as competitive differentiators for Donaldson within this filtration market space. Over the years, management has consistently emphasized diversification within its end markets and geography. But this diversification both in end markets and geography basically is a solid base to provide long-term growth and that has been their perspective.

So with that, I will introduce Tod Carpenter, President and CEO of Donaldson. He will give you an overview and then we'll break for questions. Again, please send up any questions via the iPad here or just raise your hand. So with, that, Tod?

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

Great. Thanks, Rick. Okay, so first before we dive in, take care some of the administrivia. This presentation includes forward-looking statements which reflect the company's current views with respect to future events and financial performance, but involve uncertainties that could significantly impact results.

So with that done, I'd like to introduce Donaldson. Thank you for being here today. Thank you for your interest in our company. Donaldson is a filtration company. We are a technology-led filtration company and we are diversified by the businesses in our portfolio and the geographies in which we play.

The value proposition that we bring to our customers are really four fold. You can take Donaldson filtration-leading technology and just have a better filter, so therefore, higher efficiency. You can also have the same performance as your previous filter, however, reduce the overall size of that. You can also have a longer filter life. So essentially, just take that efficiency and extend the change intervals or particularly true on our industrial side of our company, have reduced operating maintenance costs. If you think about the smaller size package, I give you one example. Over-the-road trucks, the hood of that truck as they look for better fuel economy, is becoming more and more aerodynamic and the air filter is now under the hood rather than on the side of the front portion of that truck. You'll see trucks with two stainless steel air cleaners, if you will, in the front of them. That is now gone and under the hood. So space is a premium under the hood and where our value proposition is, we can give you the same filtration efficiency at 60% less size and allow it to go under the hood, allowing that customer, for example, in the on-road market to really realize their value proposition of fuel economy. All of these type of technology advantages allow us to have a better aftermarket retention.

We have two reporting segments within our engine business segment. We filter the air that goes in. We filter the liquids around the engine as well as, if you look at excavators for example, will have hydraulics. And within our industrial segment, we have a very diversified portfolio. In the top left is what we call dust collection or our Torit brand. We will filter weld fumes, pharmaceutical dust, wood chips, any type of an industrial-based application that creates that industrial dust is how we apply our filtration systems there. In the top right is our gas turbine business unit. It is filtering ambient air that goes in front of gas-turbine power plants around the world to help protect the engine, to really allow it to perform better and have more power externally. And then in the lower portion is the smallest filter that we have in our portfolio. It's about half the size of your little finger nail and it's in the disk drive business.

Our growth comes from expanding our core products and technologies. We are number one in the world in air filtration in our end markets. And we look to serve those same customers now with our liquid-based technologies. For example, we also look to expand in geographies where we are underrepresented. The northern portion of Latin America is a great example where we have experienced high single-digit or low double-digit growth for the last several years. And the third leg is to execute acquisitions. And we have completed four acquisitions, all bolt-on acquisitions within the last two years.

Our sales growth model is, we use Donaldson proprietary technology to drive first-fit solutions for our customers, which allow a better aftermarket retention. We then reinvest back into our company as it create -- or to keep that leadership position as well as lead in first-fit solutions. So, think of this as razors to sell razor blade and we do this in air as well as liquid.

That proprietary first-fit is very important. On the x-axis is time, y-axis is share. And if we sell a first-fit application and win a program with legacy-based or more commodity-based products, our ability to retain that aftermarket typically follows this red curve. You can it has entrance competitive, people enter the marketplace, our ability to hold on falls off rather quickly. However, when we are able to use proprietary technology, such as one of our flagship products would be PowerCore, our ability to retain that aftermarket follows this blue curve. You can see we are able to hold on to aftermarket for a much longer period of time and at higher rates.

In fiscal 2017, we expect continued end market challenges all across primarily our engine-based business. Our construction, agricultural, mining, on-road now, particularly in the US is facing some headwind. We also see a little slower, more moderate global GDP and, therefore, limited capital investments, really giving headwinds to the industrial side of our company.

So what are we doing about it? We're sticking to our strategic plan and we're continuing to invest in the company. Specifically, within our guidance, we look to continue to win our first-fit programs. So win those proprietary first-fit razors. We expect growth and advancement of our strategic plans within the replacement parts. That should offset that first-fit headwinds that we see. We look to leverage our technology specifically within liquid and some of the other smaller business areas that we have. We continue to invest in the company expanding in our distribution channels as well as putting, for example, a new ecommerce system in. We now have a new manufacturing plant available in Poland where we are building air and liquid for the first time and we also prioritize returning cash to the shareholders.

Over the past 25 years, our company has grown sales of 7% while earnings have grown 11%. We believe we have a strong value proposition to you, our shareholders, based upon our long-term performance.

So with that as a quick introduction to our company, I would open the floor to questions. So Rick?

QUESTIONS AND ANSWERS

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

You know what there is a question here. Why don't we just kind of start kind of with capital deployment and particularly on the M&A side. Maybe just question kinds of deal with maybe where you interest level lies size, vertical, on the buy side, and if there's any selling out of your portfolio businesses that might be considered? So, trying to paraphrase here, but --

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

Sure, so, relative to M&A, M&A has always been part of our growth strategy. We look to add 1% to 2% annual growth over time through acquisitions. About two years ago, we took a good hard look at ourselves and we'd only done one acquisition over the past four, maybe five years. And we said look, either it's in or it's out. We decided it was in. We refurbished our entire process on how we look at acquisitions. We have organic strategies of growth in the company for every business now across the portfolio. And where we see an opportunity to accelerate that organic growth strategy, we will acquire. We've done that four times in the last two years, each of them for a different strategic purpose; one of them, product expansion; one of them geographic expansion; and so forth, one of them a technology expansion in our engine business. So where we see opportunity, we will grow.

We have a more robust process. We have a robust pipeline. I would say though it is more strategic in nature. It is specific. So, that's the way that we really look at acquisitions. We also look to further diversify our portfolio and our company through adding additional technologies where we see weakness across our technology stream that we can then bring some Donaldson know-how to it and press forward into markets, further diversifying our corporation. That's the second piece of that acquisition portion of our strategy, if you will.

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

Okay. A couple things, I just want to maybe start a little bit with an outlook. I thought it was interesting coming out of your July fourth quarter end, right, so that's kind of speaking to guidance kind of into 2017, but I was a little bit curious, I mean you talked about stabilization in the aftermarket side of the business. In fact, we actually saw growth there. Then you know we -- you thought that the off-road markets had kind of bottomed. Maybe just kind of just maybe rephrase or just kind of give us that guide you know now at this point into the year? I mean how do you look at your aftermarket and your OE business, on road, off road?

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

Sure, so if you take a look at what we guided, our fiscal year is August 1st to July 31st. We came out with a plus or minus 2% guides for the full year looking forward, so net zero if you will. The way we look at that is we face headwinds within the first-fit side of our end markets and we continue to press heavier into our aftermarket strategies and be able to look to be able to offset the headwinds in the first-fit and then come out net zero.

On the first-fit side, we still see headwinds in construction, for example, where we see low single-digit decline. That's what we would expect in the first-fit. In agricultural and in mining, we would say high single-digit declines on those two particular areas. Then in the on-road sector, we've been through quite a decline already and looking forward we would say high single digits to low double digits, particularly led by the US-based market as the European on-road market still continues to hang in there. So, net-net it's zero, but it's first-fit headwind offset by advancing our strategies within the replacement part cycles and pressing forward into geographies as well as distribution expansion and product availability expansion in that portion of our company.

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

Okay and when we -- you know when we travel the, what, three months ago or, you made a couple comments that I thought were really interesting and one was basically you said, you know as we plan for 2017, this year internally, I think the phrase you used, you know we looked at the metrics of the last three or four years and just let's assume standard rules do not apply. So I understand for 2017 where we are. But you know when you look forward over the next two to three years, I mean how do you see your long-term growth when markets kind of stabilize and maybe normalize? This is really maybe a thought on global GDP, but I'm just kind of curious if that statement was more of a short-term statement or if you said look guys, let's sharpen the pencils here?

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

What we look for really within the model is we have got to win that first-fit portion of the business in order to be able to continue to plant seeds for future growth. So even though we face a lot of headwinds across the end markets and they've been prolonged for two, three, four years across those, our win rates, on a very important part of our model, have been on air where we talk about a must-win program. A must-win program for us on air and liquid is any program that will give us $5 million worth of revenue over a 10-year period. Our win rates on air are 75% and 75% of that has been won with proprietary first-fit solutions. On liquids, our win rates are north of 75% and 40% of that has been won with proprietary and those -- that 40% is all fuel. It's not the lubrication of the engine. That's not a technology play for us.

But when you look at that type of a win rate, even in this particular headwind cycle that bodes well and gives me tremendous confidence that we're going to come out of this cycle much stronger than we have in the past. Additionally looking forward, if you go back to 2012 when Caterpillar, a very important customer for us, was a $66 billion company. Today, they've guided their $39 billion and you go across the who's who, the Caterpillar, the John Deere, the AGCO, the C&A, so entire customer base across that end market base for us, the decline from peak to trough on an annual basis will be anywhere from 8% to 13%. Donaldson Company is down 3% and half of that is FX. So, we believe that shows the diversity, the strength of the diversity of the overall model that we have as a company. But it also suggests to you that we have been winning market share even in a declining market, again given the confidence that we're going to come out much stronger than we went into this cycle.

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

Maybe you could just expand on, again a lot of investment in here and I kind of pumped you up a little bit at the beginning about innovation technology leaders, but maybe just talk through a couple of those, the approach to new products that Donaldson takes? You know it's media, leveraging that media, but some of the specific products and maybe just expand a little bit on the share gains with the wins, especially on the industrial side?

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

So the way that we approach particular R&D is we spend 2% to 3% of revenue on R&D. Now given the headwinds we've experienced, we're likely on the upper range of that, so 3% or maybe even a little bit larger than that because even through these headwinds, we did not pull back on technology. We are a technology-led filtration company. We're very serious about that. We want to continue to invent cool things.

So consequently, when we look across our markets, we try to reinvent ourselves every three to five years and replace ourselves. And you see that with PowerCore, which is generation one. We've now started -- we've actually come out with generation two and we're also already selling generation three. So each of those progressions has now taken it down a 60% size reduction to the previous technology, then another 10% or 15%, then another 10% or 15%, really giving that value proposition of smallness, if you will, across the customer base. So that's the approach that we look to do is, is really to invent -- reinvent ourselves every three to five years.

Some of the really cool things that we have going on, if you look at fuel, fuel is a very important part of our growth story going forward. Biodiesel fuel, low sulfur fuels have really changed the industry. We love them because they're very dirty. As a filter company, you know you kind of like that. They also have microbiology's that grow in there. What happens is that fuel filter will essentially become almost like a paraffin wax as it's taking those particulates and those challenges out and therefore, it's a really important challenge and a technology need. Donaldson answered the call with inventing Synteq XP, a brand-new media for that particular market. It helps take out all of that particulate. It's important cause you're trying to really protect that fuel injector. The fuel injector over the last ten years has gone from 10,000 psi to 40,000 psi and even the smallest piece of particulate then opens up that fuel injector hole, which is about the diameter of a human hair, six of them. Its purpose is to atomize the fuel to make the engine efficient. A piece of particulate opens it up. Then the fuel doesn't get atomized and really takes away the engine performance. So the whole fuel technology need for filtration is very important in our growth story. I'm very proud of the fact that with our Synteq XP on these must-win programs, we are undefeated. We've not lost one in the last 12 months.

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

That's a good -- I think it's interesting to flag the fact that you guys you know with your new proprietary media, with your lead into the OE market, you guys win market share two to three years before there's any volume to be shown, right. So, I mean you can look at your performance over the last three or four years and look at share gains from a win perspective and the benefit from those wins should show up once those products go into production. I mean it's a little different business model than you see almost anywhere else.

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

It is a different business model in a sense that once we win a program, while we're very proud we win it, we also don't get any revenue for a couple years until that platform, through our customer is actually being delivered to the field. And then once that is out there, of course, they're starting to populate more vehicles out to the field and then you'll start to get that aftermarket turn and you really accelerate that. Many of those programs will see zero revenue for two to three years and they won't hit peak production where they're really populating out that first-fit side for as much as four to five years. But then you really start to see that momentum. It's the reason why I talk about that first-fit win and Donaldson Company focusing on winning on that first-fit is so vital for the long-term focus of our company. If you lose that program, you're usually out of that program for as much as 10 to 15 years. And we're enjoying 75% win rates, which really are at a high for our company.

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

So maybe talk -- do you have a question? I mean, good for you -- go ahead?

Unidentified Audience Member

What's your mix now between legacy and innovative products? And where do you see that being in five years (inaudible)?

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

Yes, so the question is, what's the mix between legacy program -- legacy products versus proprietary products and where we see that being in five years? So, our proprietary product offering, actually across the Donaldson portfolio, is still very low because our strategy to go to razor to razor blade is really quite young. It's only about 8 to 10 years old. So, we're really getting some good momentum now. I would suggest that our proprietary product offering across the portfolio is in the range of 20%, plus or minus a couple. But longer term, while we've not set a target of what that will be five years out, I can tell you if you're a customer of ours, five years or ten years ago, we would offer a proprietary offering to you to solve your problem maybe about 20% of the time. Today, we're offering it 80% of the time. So, we're fundamentally changing the game and really going hard to embrace our overall proprietary first-fit model.

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

Then maybe just the last question, maybe I'll direct this one at Scott, put you in the middle seat. But one of the things that's interesting when I talk about Donaldson and you know when we do our work is this concept of earnings power or just you know how much leverage is in the model. Cause we've been investing, we've been getting the wins and you know just a quick stab, not to lose anybody, but in five years from 2012 to our estimate on 2017, your sales have declined by about $272 million and in the tough environment, your EBIT's declined by $61 million. So what that equates to is a decremental of about 22%. That's really good, right, so in the industrial space. So you guys have managed the tough environment really well. But as you move forward and we start to see some growth, we see proprietary products, what's a realistic incremental EBIT margin to assume going forward? If OE's come back, there's lower margins. There's a lot going on there.

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

So maybe this year's a good example, right. We -- last year, we had some restructuring. There's a benefit coming into this year from that of $12 million. We didn't pay much of a bonus last year. So we restored that this year at 100%. That's a headwind of $20 million. So right there, you have a net headwind of $8 million coming into this year. Revenues are essentially flat. Yet, we have our operating margin at the midpoint of our guidance, going up 40 basis points. So we've been able to leverage the company through cost improvement actions, through investments, to generate slightly improving operating performance on a flat-year revenue. So, that's work we do every day. You know we try to improve our operational performance and try to improve our profit margins. We're committed to managing our expense infrastructure relative to the revenues we can generate. If revenues go down, as you've seen in the past, we will be adjusting our expense infrastructure. We think when revenues grow, that will be a healthy situation for our profit picture. We'll let some of that flow to the bottom line, but we'll also be continuing to invest into the company to grow and strengthen the company.

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

Is 20% to 25% incremental more reasonable than a 40%? We're not a deep discount low capacity business right?

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

Well we haven't -- you know it's something we work to improve and as revenues go up, you know I'm sure our operating margins will improve.

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

Okay, super. All right. Well thank you very much.

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

Thanks, everyone.

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

Thank you.

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

There is a break out session downstairs, so please join it if I used all the time for questions. That's downstairs in the Walton Room.