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Q4 2018 Donaldson Company Inc Earnings Call

EVENT DATE/TIME: SEPTEMBER 06, 2018 / 2:00PM 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's Q4 Fiscal 2018 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 Fourth Quarter and Full Year 2018 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 fiscal 2018 performance and an overview of our plans for 2019.

During today's call, we will 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. I want to remind everyone that any forward-looking statements made during this call are subject to risks and uncertainties, the most important of which are described in our press release and SEC filings. Now I'll turn the call over to Tod Carpenter. Tod?

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

Thanks, Brad. Good morning, everyone. We had a strong finish to a strong year and we are pleased with our performance. Fourth quarter sales were up 10% and adjusted EPS was up almost 14%. We grew fourth quarter operating margin 40 basis points from last year, reflecting our actions to improve gross margin and drive expense leverage.

For the year, our company achieved record sales of more than $2.7 billion and record adjusted earnings of $2 per share. We also held our operating margin flat with the prior year, despite significant demand-related pressures and incremental investments related to our strategic priorities.

I want to thank our employees for their commitment to executing these priorities while supporting our customers. I'm confident their efforts further strengthened our reputation as a top-tier supplier while positioning us for future success.

We have excellent momentum across our company as we head into 2019, which we expect will be another year of record sales and profit. Scott and I will provide more details later in the call, so I will now turn to a recap of our sales performance.

Fourth quarter sales grew 10% to $725 million, reflecting growth in both segments. Engine continues to lead the company, with sales increasing 14% to $492 million. The performance drivers are unchanged. Supportive market conditions are compounding the benefits from a significant amount of past program wins.

Within On-Road, continued strength in the U.S. and China drove sales up 36% to a new quarterly record. The U.S. market continues to benefit from higher production of Class 8 trucks, and China is all about share gains. Sales in China were up sixfold last quarter, and this region grew to 10% of total On-Road sales in fiscal 2018, up from 3% in 2017. As local manufacturers shift their production towards higher-performance equipment, our company is well positioned to capture a greater share of China's massive market.

Strength in our Off-Road business, which grew 18% last quarter, remains broad based. We are experiencing growth in all major regions and markets, and benefits from program wins are also contributing to Off-Road growth. For example, sales of fuel filters, including those with our Synteq XP media, were up in the mid-20% range last quarter. Given that we continue to enjoy strong program win rates, we see a long runway for these products.

Sales of Aftermarket Products were up 11% last quarter, reflecting comparable growth in both the OE and independent channels. Markets with greater exposure to oil and gas continue to drive our independent channel, and past program wins are supporting the OE aftermarket channel. Combined sales of innovative air and fuel products grew in the high teens, including PowerCore up in the mid-20% range. Aftermarket sales of PowerCore have grown every quarter this decade, and growth is still outpacing the legacy technology after more than 15 years in production. We are seeing similar trends as we ramp up other products with a similar value proposition, further validating our razor to sell razor blade strategy.

Lastly in Engine, our fourth quarter sales of Aerospace and Defense were up 14%. Higher sales of aerospace replacement parts were partially offset by declining defense replacement parts as we had a strong comparison last year, reflecting the somewhat lumpy nature of these orders.

Sales in our industrial segment were mixed last quarter, with a total increase of 2%, experiencing a headwind from Gas Turbine Systems or GTS. As expected, sales of GTS were down 37%. Strong sales of replacement parts only partially offset the forecasted decline in large turbine projects. We expect the large turbine market to remain under pressure, which further supports the strategic choice we made more than 2 years ago. By selectively pursuing large turbine projects while increasing our focus on replacement parts, we significantly improved the profitability of GTS on a rate and dollar basis.

Outside of GTS, market conditions continued to improve. Sales of Industrial Filtration Solutions, or IFS, grew nearly 9% last quarter. New equipment sales were up in the mid-single digits, while replacement parts grew in the low double digits. Although our process filtration business is less than 10% of IFS today, it's growing rapidly. Sales were up in the high 20% range last quarter, and they continue to accelerate as we invest in this business. Products like our LifeTec filters for the food and beverage industry are an important part of our growth strategy, and we are very encouraged by the customer response.

Fourth quarter sales of Special Applications were up 14%, reflecting growth across this business, including disk drive and venting solutions. Within disk drive, market strength from cloud storage and near line capacity temporarily offset the secular pressure on hard disk drives.

Across the company, fourth quarter performance built on the theme we have been experiencing all year. Favorable market conditions compound the benefits from consistently strong execution of our strategy. Since our business troughed in fiscal 2016, we have added more than $0.5 billion in sales. The Engine segment reached an all-time high in fiscal '18 of $1.85 billion, driven by growth in all business units. We also had strong results in the Industrial segment, with total sales topping $885 million. If you set aside GTS, where we have strategically reduced sales, the remainder of the industrial segment also set a record in fiscal 2018.

We are proud of our 2018 performance, and we expect to deliver another year of solid results in 2019. We are forecasting local currency sales growth between 8% and 12%, and EPS is projected up in the mid-teens to low 20% range. We also expect to deliver incremental margin in the low 20% range, which lines up with our historic average despite continued pressure from inflation.

I'll now turn the call over to Scott for an overview of our key performance metrics. Scott?

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

Thanks, Tod. Good morning, everyone. As Tod said, we had a strong finish to the year. Fourth quarter sales were up 10%, operating margin increased 40 basis points and adjusted EPS grew 14%, which excluded a $0.20 benefit related to tax reform. Fourth quarter operating margin was 14.7%, reflecting expense leverage and modest gross margin improvement. Price increases initiated earlier this calendar year began to take hold, which fully offset pressure from raw materials inflation and other demand-related costs.

On the operating expense line, sales leverage easily offset higher freight costs. Operating profit in the quarter was also up for both segments, with Engine growing 80 basis points to 15.3% and industrial growing 200 basis points to 17.2%. Rate improvements, including price realization benefits, combined with leverage on higher sales, were strong contributors. Segment favorability was partially offset by higher corporate and unallocated expenses, with the pension settlement costs being the largest single driver.

Our fourth quarter tax expense included a $26 million benefit related to tax reform. Excluding the benefit, our tax rate was 26.2% compared with 25.6% last year. Pressure from foreign withholding tax and other reform-related matters, combined with an unfavorable mix of earnings more than offset tailwinds from a lower U.S. corporate tax rate, stock option activity and audit settlements.

We invested $23 million of CapEx last quarter and $96 million for the year to support initiatives like new capacity and e-commerce. We also returned $217 million of cash to shareholders last year through share repurchase and dividends.

Our balance sheet is in good shape as we head into 2019. We ended the year with a net leverage ratio of 0.7x, which includes last year's $35 million discretionary contribution to our U.S. pension plans. As working capital needs have gone up with sales, the flexibility offered by tax reform remains a valuable benefit. We continue to optimize global cash to better align the balance sheet with our long-term growth opportunities.

Reflecting on the full year, we are proud of what we accomplished. We grew our sales by 15% and kept operating expense growth to 12%, despite higher compensation expense and investments related to our strategic initiatives. This strong leverage allowed us to absorb gross margin pressure from a variety of factors, including higher supply chain costs and investments, raw materials inflation and an unfavorable mix of sales. We remain committed to delivering incremental levels of profit on increasing sales which is a core component of our fiscal 2019 plan.

Before going through the outlook, I want to touch on 2 new accounting standards that we are adopting this year. The first relates to pension accounting, which requires us to move certain costs and income out of operating margins. We will restate prior periods as we report our 2019 results, creating a like-for-like presentation. For reference, this change reduces the fiscal 2018 operating margin by about 10 basis points.

The other new standard is related to revenue recognition. One component of this standard is net versus gross accounting, and it affects the Engine segment. Post-adoption, we will record additional sales without a corresponding change to gross profit, effectively reducing margin. In this case, prior years will not be restated, creating the optical change in 2019 year-over-year performance by inflating the sales growth while diluting the gross margin and operating margin. I want to stress that the change related to net versus gross accounting and pension accounting have no impact on net income. I will highlight some specific items as I cover the 2019 guidance.

Our full year sales forecast includes about $25 million of additional sales from the revenue recognition change. In total, we are projecting fiscal '19 sales will be up between 6% and 10% from last year, or 8% to 12% when you exclude the negative impact from currency translation. Also please note that the currency headwind of 2% will have a similar effect on both the Engine and Industrial segments. Our total year-over-year increase is primarily driven by volume growth, and we are also expecting benefits of 1% to 2% from price realization. Sales for the Engine segment are planned up 7% to 11%, which includes $25 million from revenue recognition spread across our OE and Aftermarket businesses.

In terms of the operating environment, we are projecting higher levels of equipment production and utilization in each of our major end markets and geographies. Additionally, benefits from program wins will drive another year of strong growth in On-Road, Off-Road and Aftermarket. We expect increases in the mid-teens for On-Road and the high single digits for Off-Road, and that's on top of very strong growth for both businesses in 2018.

We know there are a lot of questions about the equipment production cycle, so I want to share a little perspective. While Class 8 production is likely nearing peak in the U.S., we see continued strength through our fiscal year. Additionally, international markets remain stable and new program wins add to the durability of On-Road for us. Within Off-Road, 2019 is expected to be the third year in a row of strong growth, and the forecast is still below the 2012 peak. Based on analysis of third-party and OEM expectations, we think we are likely mid- versus late cycle. Specific to Donaldson, the significant number of program wins over the past several years gives us confidence that we can continue to outgrow the market. Given the momentum in first-fit production from new programs and consistently high levels of equipment utilization, we are forecasting Aftermarket growth in the high single digits. Rounding out Engine, we expect sales of Aerospace and Defense will be roughly flat, reflecting similar performance for both Commercial Aerospace and Defense.

Turning to the industrial segment, we are projecting a sales increase between 3% and 7%. We are planning GTS sales down in the high single digits this year. While we expect solid growth from the replacement parts, we also forecast another sharp decline in sales through large turbine projects. Sales for these projects are expected to be less than 10% of GTS in 2019.

As our exposure to large turbine projects has gone down, we remain pleased by the profitability gains related to our go-to-market strategy. IFS sales are expected to be up in the high single digits. Favorable conditions in the manufacturing environment will drive sales of new equipment and replacement parts. And we also expect to deliver a strong increase 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.

We are forecasting a solid increase in operating margin, with a full year rate between 14.1% and 14.5%, or 30 to 70 basis points above our 2018 rate when you adjust for the pension accounting change. Also note that the revenue recognition accounting change dilutes this year's operating margin by about 10 basis points when compared with 2018.

In terms of gross margin, higher costs for raw materials and freight are expected to negatively impact gross margin by about $30 million. Additionally, the drag -- the revenue recognition standard creates an optical drag of about 30 basis points. Despite these pressures, benefits from price realization and other cost reduction efforts will keep gross margin roughly in line with last year.

We do, however, expect to deliver more expense leverage, and that's following last year's strong performance, which is the lowest expense rate in 15 years. Our targeted approach to planning created capacity for increased R&D spend and other investments in 2019 while also driving profit to the bottom line.

The midpoints of our sales and operating margin ranges imply incremental margin around 21%, which is a solid improvement from last year and in line with our historic average. We believe this level is appropriate, given the opportunities to invest in our strategic initiatives and our customers, combined with the inflationary pressures we continue to face.

Moving down the P&L, we expect other income between $12 million and $16 million, interest expense of $22 million, and a tax rate between 24.7% and 26.7%. The tax rate includes a full year benefit from U.S. rate reduction, which was partially offset by a loss of certain credits due to tax reform. We are budgeting capital expenditures of $130 million to $150 million, up from last year as we continue to add new capacity in support of our innovative, fast-growing products. We are also planning to repurchase 2% of our outstanding shares in 2019, consistent with our average over the past few years. Altogether, our EPS is forecast between $2.29 and $2.43, implying an increase of about 14% to 21% from last year's adjusted EPS.

In terms of cadence, sales will have a similar front half-back half split as last year. We plan a moderating growth rate in Engine over the course of the year, and we expect some variability in Industrial due primarily to GTS. For reference, we expect first half GTS sales down in the teens and a more modest decline in the second half of 2019. In terms of operating margin, we are forecasting comparable levels of year-over-year improvement between first and second half of 2019.

Our plans for 2019 reflect strong top line growth, incremental levels of profit on increasing sales and disciplined capital deployment that reflects investment of the company and returning cash to shareholders. We entered 2019 with solid momentum, and I'm confident that achieving our strategic and financial targets will create value for all of our stakeholders.

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

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

Thanks, Scott. We had strong performance last year, and those areas tied to our strategic growth priorities like engine, air, fuel and hydraulics, along with industrial dust collection, process filtration and venting solutions. Supportive market conditions amplified benefits from our investments, allowing us to deliver record sales and adjusted earnings per share.

Although there is global uncertainty related to trade and we still expect inflationary pressure on raw materials and freight, our plan reflects new sales and profit records in 2019. Additionally, we are planning to grow our incremental margin, while maintaining investments in strategic opportunities. We will continue to pursue near- and long-term growth opportunities in certain businesses. Liquid filtration in engine and dust collection and process filtration and industrial are prime examples, and we will also continue to develop connected solutions for both segments. Large OEM customers in the Engine segment are valuing connected filters as a tool to improve their product offering, while the IoT space in Industrial is more about how we support the end user. We have many dust collectors already giving us data from the field, and our deep knowledge of filtration performance will help us build a strong offering that creates additional value for our customers.

Growing our R&D spend is another top priority for us. We increased the spend by roughly 10% in 2018, and we expect a similar increase this year. We are pursuing several initiatives to expand further into markets where customers place a high value on technology. Products that meet these needs typically command gross margins above our company average, which supports our business case for these incremental R&D investments.

We are also enhancing the way customers engage with us by leveraging our e-commerce site, shop.donaldson.com. Over the past 9 months, we moved through pilot phase and have made excellent progress transitioning existing customers to the new platform. By year-end, we recorded $100 million in revenue from nearly 1,500 customers in more than 100 countries. Our agenda for 2019 includes enhancements to functionality and performance as we make it even easier for customers to do business with us.

Our global capacity investments are also motivated by providing an excellent customer experience. Roughly 2/3 of our fiscal '19 capital expenditures will support existing products and tooling and start-up from new program wins. Innovative products like PowerCore and our high-tech fuel filters are driving the biggest capacity needs as we consider current and projected demand.

Given the strong market conditions, some of our planned investments are being accelerated into 2019 to better position us for the long term. An additional benefit of new capacity is helping to reset our supply chain. Given the higher-than-expected demand last year, we made the choice to invest in our customers and maintain our reputation as a top-tier supplier. In certain situations, we temporarily sub-optimized our supply chain to meet the demand. While we view that choice as the appropriate long-term decision, it came with a near-term cost that we plan to normalize over time with new capacity.

Our employees showed incredible commitment last year as they worked to support our customers while pressing forward on our strategic priorities. I again want to thank them for their contributions, and I am confident our alignment as a global team will result in a great 2019 as we pursue a robust agenda that drives towards our mission of leading the world in filtration solutions.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from George Godfrey from CL King.

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

Just 2. The first one is, it was nice to see the price increase push through. And I'm just curious if you can segment how much of the price increase is strictly input higher-cost related versus pricing that's being raised for value related on Donaldson products. And then, secondly, the CapEx' pretty significant increase this year versus last, can you just give some more detail on where the incremental spending is going?

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

Sure, the -- this is Scott. The price increase, we've been focused on addressing our increase in raw material costs. And that's what our price increases has been primarily focused on. So in the fourth quarter, you saw an improvement in our gross margin of 10 basis points, so we were happy with that. But it's really been focused on addressing the increased commodity costs.

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

And relative to CapEx, George, this is Tod, our capacity expansion across both our air and liquid-based products, including PowerCore and our proprietary liquid filtration solutions are really driving much of that CapEx increase year-over-year in order to meet our customer demands. And we talked a little bit about how we will have a protracted time frame in order to normalize our supply chain and make it efficient for our customer base, and that's really what's happening here.

Operator

Your next question comes from Charley Brady from SunTrust.

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

This is actually Patrick Wu standing in for Charley. Just wanted to -- you speak a little bit about the, obviously, capacity expansion. Just wanted to get a sense of where you guys are at now first versus where you would like to be, I guess, by fiscal '19. And how are the utilization rates looking for you and the facilities that you have already?

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

Sure, Patrick. This is Tod. On air capacity, we're at utilization rate of about 80% to 90% company-wide, and on liquid, we're above 90%. We have a new manufacturing footprint coming online for liquid this month, so that will be ramping up over the current fiscal year and we will be bringing on additional capacity on air throughout this current fiscal year and actually into 2020. We have a 5-year CapEx plan across our operations. And what we are doing is accelerating some of that into 2019 and 2020, and that's across all regions in the world.

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

Okay. That's good color. And I just want to have a question on your other income expectations for fiscal '19. It seems like it's stepped up from fiscal '18, although I guess when you look back historically, it's not very different from, I guess, your other years. But I just wanted to get a sense of where the increase -- I guess, what is going to drive that increase, at least, versus fiscal '18?

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

Yes, you're right in that the guidance this year of $12 million to $16 million is certainly above last year. The biggest driver of that has to do with the new literature on pension accounting. the literature requires us to shift the income we generate on our pension investment out of operating income and into other income and expense. So that's going to be a drag on operating income and an increase in other income for next year. So that's the biggest piece.

Operator

Your next question comes from Nathan Jones from Stifel.

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

Just to follow-up on that other income question. Because you have $5 million in 2018, and the press release does talk about $3 million that would have been in there in 2018 out of the pension change, which would still leave $5 million to $9 million of additional other income. Is there anything else in there of note? Or is the '19 estimate on the pension stuff higher than what it would have been for '18?

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

Well, the biggest piece is clearly the income generated from our pension investments. And then, we do have slightly lower FX losses planned for next year. So those 2 pieces make up the difference.

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

Okay. That's helpful. Then I'd like to talk about something more interesting, the incremental growth investments. You stepped up growth investments in 2018. It sounds like you're going to step up R&D spending and maybe some other growth investments in 2019. Can you give us an idea of how much that's dragging on income on a year-over-year basis? And then maybe if you could just talk a little bit about some of the benefits you're seeing from the investments that you've made previously, and what kind of things we're investing in, in 2019 and beyond to drive growth.

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

Sure, this is Tod. I'll start maybe and talk about the things that we're investing in, and then Brad can get a little bit into the model-based numbers. So the things we're investing in within the R&D segment are what we highlighted in our comments, things like Venting Solutions, our food and beverage initiative is going quite well, and then core-based products such as liquid. We have wonderful wins in our Synteq XP-based products in liquid, and so we'd continue to invest in that as well as PowerCore and additional air-based investments. And lastly, I do want to highlight connectivity. So connectivity in both segments of our company are getting a nice investment. And connectivity is important, particularly as we go direct to that end user and the industrial-based space, where we have tens of dust collectors across this country right now, feeding millions of pieces of data to us. And with our filtration expertise, we believe that we can turn that into a revenue-generating opportunity going forward. And so we have a good investment in that as well. And so maybe I'll let Brad then talk a little more specifics about the numbers.

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

Sure, Nathan. This is Brad. All else equal, R&D, you can think about that as going up another $5 million to $6 million. But part of our expense planning for this year was to make sure we create capacity to absorb that. So last year, as we took a step up with a significant number of new projects in '18, essentially at the same time, we don't expect that this year. R&D will go up, but we're funding that with other initiatives. And all the things Tod mentioned are also choices that we're making to invest in, and it's -- we're not doing that as incremental to our overall expense.

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

Okay. And then if we think a little bit longer term, I guess, both on the R&D or growth investment side and also on the CapEx side because you're seeing that step up again, should we begin to see that plateau? Where should CapEx be longer term? Just how you're thinking about -- do we continue to ramp up these growth investments? Should we continue to see the R&D increase, or should it flatten out from here and where CapEx goes longer term?

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

Yes, I'll start with CapEx. So we had $130 million to $150 million. As Tod mentioned, we have a plan to increase capacity. We would expect to be at that level for the next couple of years, and then it would come down. And we -- as Tod said, we've accelerated some of our capacity expansion into the near future, and that's driving up our CapEx in the shorter term, and then we'd expect it to come down. In terms of R&D, we have a longer-term goal of increasing our R&D spend to be a higher percent of revenue. So we're going to continue to focus on running the company as efficiently as possible and making targeted investments in R&D. We're committed to generating increasing levels of profitability and increasing sales. And we want to increase our R&D spend to generate new technologies and continue to find products with higher than average gross margins. So we'll continue to invest in R&D as well as we go forward.

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. If we think about the R&D spend, as you increase that, I mean, when do you start to see like new products kind of get commercialized? What's the, I guess, the time frame in terms of from when you come up with something to versus when it kind of flows through to like meaningful sales and earnings?

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

So it's elongated, Dan. So what you have is, on food and beverage activities, we highlighted them in the call today that we are seeing revenue generation on that investment immediately. We are also seeing revenue generation on some of the liquid-based initiatives that we have with Synteq XP, et cetera, and we think about the wins there. But beyond that, we also have some that will be potentially years down the road before we see some revenue in line with that. So it's really a balance-based portfolio spend in order to drive additional revenues over time. I would remind you that we are a technology-led filtration company, and so technology investments are going to continue to be our focal point, and that's the R&D focus for us.

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

And then you mentioned taking share in China, I think particularly in On-Road. I was just wondering if you're -- are you taking share in a cooling environment? Obviously, you're outperforming. But I was wondering if the environment, overall, is kind of flattish to just coming down a bit.

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

In China, specifically to our share, we are low single digits. So we have a lot of runway in China and we're able to take share now because we went into China initially on the backs of the multinational-based companies. And now we're winning with Chinese national-based companies both in On and Off-Road. that's what's really driving our share gain currently. So we have a nice runway ahead of us, but we are starting to experience some notable success in that region.

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

Okay. And then finally, I mean, it doesn't appear so, but has there been any direct impacts from tariffs? Or are there any signs of customers reducing inventory to see how things play out? Has there been any change in customer behavior at all?

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

No, there has been not been any direct effects that we can attribute to tariffs about purchasing from a customer-to-customer base behavior. Obviously, everyone in the world is wondering about the geopolitical uncertainties. Steel is currently more of a commodity-based or a raw materials headwind for us as a result of tariffs, but customers are not changing a behavior as a result.

Operator

Your next question comes from Brian Drab from William Blair.

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

On the industrial guidance for 2019, it's really solid. I'd like to just focus on the Industrial Filtration subsegment for a second. And if I look at your guidance for total industrial up 3% to 7% with a 2-point FX headwind, organic's 5% to 9%, and you've got this gas turbine and special apps, those subsegments weighing somewhat on that growth rate. Am I correct in interpreting your organic growth expectation for Industrial Filtration for that subsegment is somewhere in, I don't know, the 6% to 10% range for next year?

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

Yes. So if you just break down the major segments, so our IFS segment, we would put up in high single digits. Gas turbine would be down in the high single digits. And Special Applications would be roughly flat, whereby you have things like venting offsetting the secular decline that you expect to continue to experience in disk drives.

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

That's -- so I guess the question is that, that high single digit for Industrial Filtration, what -- that's really great growth. What gives you the visibility there through fiscal '19 that you'd achieve that?

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

It's a project-based business, and CapEx spending has increased throughout the balance of the previous fiscal year. We expect that to continue. And additionally, we have some very nice growth across -- a broad-based growth across our dust collection aftermarket organization. We expect that to continue. And then, that is also the segment where our process filtration investments are really starting to pay dividends. And we experienced over 20% growth in process filtration last fiscal year. We expect good growth to continue throughout fiscal 2019.

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

Brian -- this is Brad, Brian, one quick thing. On your question about FX, you can certainly consider that IFS is under pressure in that neighborhood as a function of FX as well. So if that was part of your first question, I want to make sure we touch on that.

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

Okay. Yes, I was just saying you gave the guidance of 3% to 7% for the total segment, and 5% to 9% would be the organic, right? That's what I was pointing out and clarifying, okay. And then you've put out the press release yesterday on the e-commerce site. Do you think that, that is -- I mean, I guess obviously some of that -- some of those sales cannibalize sales that would have happened otherwise. Do you think that, that is incremental to your growth rate in fiscal '19, just rolling out that site?

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

No, it's not. So remember, there's 2 types of usage across e-commerce, and the primary number that you're seeing today is Engine-based related. And so we go through distribution and we're having our customers come through the e-commerce site, and so it's more of an efficiency play on that side of the company. And we're very pleased with the fact that so many of our distribution partners across the world have adopted that site and come online in order to be able to have a successful implementation. Later, as we look forward and continue to expand it, particularly over on the industrial side of the company, that is where we will see more of an end user base experience, and that's when it will start to be incremental. We've taken into account how we believe that will play out, and we bake that into our guidance currently.

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

Okay. And then 2 more quick ones. So the revenue guidance for the total company for fiscal '19, what have you incorporated into that in terms of price? How many points of growth are you -- do you think you're getting just from price alone?

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

Yes. We have prices in there of 1% to 2%.

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

Got it. Okay. And then kind of zooming out in a larger question, if I'm doing the math correctly, for fiscal '19, the incremental operating margin at the midpoints would be around 19%. It's been in that kind of high-teens range. I think going back, if I would have asked Bill Cook this question 10 years ago or 8 years ago, the incremental margin always seemed to be a little bit higher than that, like something in the 20s or even above that in some periods. But is this kind of high-teens incremental margin something that is what we'll see through the growth investment phase that you're in right now? Or is this -- I'm getting the sense like we're probably, and should be always kind of in the growth investment phase. And does that result in this kind of being the norm for incremental margin, something in kind of the high teens?

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

Brian, if you go back and rebuild our model over the last decade, you'll see that in growth periods versus trough periods, that we do fluctuate. It's not -- it's never been a constant low 20% range within our incremental margin. We just experienced the same thing over the last 6 years. And currently, the 2019 guidance actually comes up into the low have, which puts us back to the average, over time, that we had experienced. And so we're very proud of the fact that we've been able to get our incremental margins back from low double digits back into the low 20s and really take advantage of leveraging the growth that we have.

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

Brian, this is Brad. Let me add one thing, and we can talk more offline if it will be helpful, but I want to make sure we're starting from the same spot. We have incremental margins planned for this year in the low 20% range, and that's factoring in the pension adjustments on the fiscal '18 operating profit. So keep in mind that, that reduces the '18 operating profit by about 10 basis points. So there's the change there. And what that low 20% range isn't factoring in is the drag that comes from revenue recognition. So from our point of view, we think this is a pretty strong operating margin and incremental margin for the year.

Operator

(Operator Instructions) Your next question comes from Richard Eastman from Baird.

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

If we could, could we just spend a minute or 2 on the gross margin here on a forward-looking basis? So for '19, I think you've referenced it being flat. And could you just maybe walk through maybe the puts and takes there a little bit? I think there was a reference to price adding 1 to 2 percentage points to revenue. I wasn't sure, is the net price captured this year, or meaning, for fiscal '19, expected to be about 0? Is that what the reference was there? So in other words, rolls up high 1% to 2% kind of on a blended basis? Or maybe we just walk through the puts and takes there on the gross margin line.

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

Yes, I think you got it right, but let me just confirm. So we just talked about pricing adding 1% to 2% to revenues next year. We estimate $30 million of kind of expense headwind from increasing commodity costs. Our guidance implies that gross margins will essentially be flat. So the pricing actions that we contemplate for next year will offset our contemplated increases in costs, and gross margin will result in flat. We generate a good improvement in operating income because they're really leveraging our operating expenses.

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

And then, I'm sorry, the mix here with OE strength would offset some of the volume benefits at the gross margin line. Is that the other conservative way to look at this?

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

Rick, this is Brad. Mix is a little bit more benign for the year because we certainly have the strength in Aftermarket. But then on top of that, some of the industrial businesses, there's very nice growth there. So at a company level, it mixes out into more of a plus or minus. One thing I want to add on gross margin, and again, with the accounting changes, the -- what we're calling an optical drag on gross margin is about 30 basis points from revenue recognition. And that's a year-over-year, so don't think about it as a headwind per se as much as just when you compare against the prior year. If we were under the old standard, gross margin, all else equal, would be 30 basis points higher, at flat.

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

Okay. Okay, that's reasonable. And if I might, can I just return back on the Engine side of the business? Again, I mean, another just significant quarter here of share gains in China on the On-Road side, but also the Off-Road strength was there as well. Just kind of curious, how far do we have to run on that? I mean, you had mentioned that perhaps China was 10 -- is at 10% of Engine sales? Was that the reference there?

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

Rick, it's Brad. It's 10% of off-road sales. So China Off-Road -- or excuse me, China On-Road represents 10% of total On-Road.

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

And Rick, our share is still very low in China. And as you know, it's a very massive market. And so we have tremendous opportunity in China, still, that lies ahead of us. And we're really pleased with the fact that we're winning not only at multinational companies, but also now in national companies. And we're winning in the Off-Road segment, but also in the On-Road segment as they continue to value technology.

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

Okay, okay. And then just a last question, I'm sorry. On the industrial side of the business, with IFS, is the mix there now running about half Aftermarket and half capital equipment? And then can I just ask what that mix is? But then also, what did the book-to-bill look like on the capital equipment side? Were you pleased with that in the quarter? Does that give you good visibility on your full year outlook there of kind of high single digits for all of IFS?

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

Rick, this is Tod, I'll start. So book-to-bill and order intake do give us confidence within our forecast within 2019. And we saw our -- we saw CapEx spending, our project-based spending across the manufacturing sectors picked up as we progressed through last fiscal year. We expect that to continue through this fiscal year. And so we're therefore baking that within the guide, and I think Brad has that split for you.

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

Yes, Rick, so to answer your question about the split, it's typically -- or it's about 50-50. It's tilted towards the new equipment this year. And I would say that that's just testimonial to the market improvement there, and seeing some traction where folks are investing more in their facilities now. So that part of the business was -- had a really strong year.

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

Yes. And the method I find kind of interesting is when I look at the op profit on the industrial side of the business, obviously you've done a great job protecting profitability in gas turbine without -- with the big decline we've seen in large turbine stuff. But I'm curious, the 200 basis points in op margin within industrial year-over-year, would you attribute that to volume, to Aftermarket sales? Or is there anything in the mix here that's significantly more profitable, for instance, the special apps? How should we think about that operating margin improvement there given the mix?

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

Sure, it's favorable mix for sure in that Special Applications held in very nicely throughout the year. But it's also a tip of the cap of the excellent execution work across our GTS business in executing that strategy. That's a very tough business model for our GTS team worldwide to execute. And they had an excellent year executing a strategy that really helped us drive profitability across our industrial-based businesses.

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

And with the large turbine stuff being less than 10% forecast for '19, presumably, that business when you look out to '20, should start to see some modest growth off of '19's base?

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

Tough to say when large turbine projects are going to come back. I mean, when you look at, for example, GE's release recently, I mean, they sold single-digit gas turbines in a quarter here. So when will that pick up? Well, it's pretty low bottom. It's down considerably. I'm just not sure when we could expect that the tick up. We thought it would have moderated as we look into 2019. Clearly, it has not. So we'll wait to get a little bit more data before calling bottom on that.

Operator

There are no further questions at this time. I now 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 Company. Have a good rest of the week. Goodbye.

Operator

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