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PRESENTATION

Operator

Good morning. My name is Denise, and I'll be your conference operator today. At this time, I'd like to welcome everyone to the Donaldson's Fiscal 2019 Q4 Earnings Conference Call. (Operator Instructions) Thank you. Brad Pogalz, Director of Investor Relations, you may begin your conference.

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

Thanks, Denise. Good morning. Thank you for joining Donaldson's Fourth Quarter and Full Year 2019 Earnings Conference Call. With me today are Tod Carpenter, Chairman, CEO and President of Donaldson; and Scott Robinson, Chief Financial Officer. This morning, Tod and Scott will provide a summary of our fourth quarter performance and an overview of what we are planning for the new fiscal year.

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

I want to remind everyone that any forward-looking statements made during this call are subject to risks and uncertainties, which are described in our press release and SEC filings.

With that, I'll now turn the call over to Tod Carpenter. Tod?

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

Thanks, Brad. Good morning, everyone. We set several new records in fiscal 2019. Sales reached an all-time high of $2.85 billion; adjusted earnings per share were $2.21, or 10.5% above last year's record; and we invested $0.25 billion in our future, with $150 million of capital expenditures and $100 million for the acquisition of BOFA. On top of investing for the future, we returned nearly $230 million to shareholders through dividends and share repurchase.

By these measures, 2019 was a solid year for Donaldson company. I want to thank our employees for their contributions and continued commitment to our stated purpose of advancing filtration for a cleaner world.

We have a strong plan for 2020, which Scott and I will talk about later. But first, I'll share some thoughts on fourth quarter sales.

Total sales of $727 million were in line with our forecast and slightly up from last year. Pricing added 1%, while gains from BOFA and revenue recognition accounting offset a currency headwind of 2%. Results in the quarter highlighted the uneven demand environment. Engine sales were down 1% and slightly ahead of projections, while Industrial sales were slightly below projections with a 3% increase.

In Engine, the forecast favorability came from Aerospace and Defense. Sales were up 4% last quarter, with first-fit orders driving the growth. As expected, On-Road growth moderated to 2% last quarter, which follows nearly 2 years of significant growth in the U.S. and China. While heavy-duty truck production in the U.S. is likely at peak, our fourth quarter sales grew at a robust rate of 26%.

In China, sales were down as we lapped a 600% increase last year. As we have previously discussed, our new programs in China are with

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local manufacturers that have more order volatility than their Western counterparts, so we expect demand fluctuations will be a natural part of our growing -- of growing our share in China.

Off-Road sales were down 10% last quarter, a little better than forecast and reflective of an uneven demand environment. Sales in Europe were the strongest, with continued benefits from pre-buys related to upcoming regulatory changes.

In other parts of the world, including the U.S., large customers appear to be destocking as backlog and orders hovered at 2 year lows. Also within Off-Road, fourth quarter sales of razor-to-sell razor-blade products were flat with last year, which is significantly stronger than performance of legacy technology. Innovative products have been and will remain a core part of how we mitigate the natural cyclicality of our engine markets.

Aftermarket is another mitigating factor. Fourth quarter sales were about flat with last year or up 2.5% in constant currency. We continue to see evidence of destocking at large OE customers, and lower demand in the construction, agriculture and oil and gas markets were added pressures. The macro headwinds facing Aftermarket were offset by a low single-digit sales increase for innovative products, which make up about 1/4 of total Aftermarket. They consistently grow faster than legacy products, making them an important stabilizer for the company.

Turning to the Industrial segment. Fourth quarter sales grew 3.3%, or 5.5% in constant currency. Sales within Industrial Filtration Solutions, or IFS, were up 6% last quarter. This translates to an increase of 3% when you exclude the benefit from BOFA and headwind from currency.

Sales last quarter of new dust collectors were below expectations, driving the miss for the segment. Quoting activity is stable, but customers seem reluctant to invest in new systems given macro uncertainty.

We are, however, still generating growth with dust collection replacement parts. China was the strongest region last year, where sales were up more than 30%. Although the business there is still small, it's growing rapidly. And things like China's blue sky initiative create new demand for our products.

Also within IFS, fourth quarter process filtration sales were up about 10%, and that's on top of a 30% increase last year. We're generating new agreements with manufacturers in the food and beverage industry and our expanded sales force is gaining traction with customers around the world. Based on this momentum, we see another year of strong growth in 2020.

As expected, fourth quarter sales in Gas Turbine Systems, or GTS, were up 7% from last year. The increase was driven by large turbine projects, due in part to an easy comparison in the prior year.

I want to pause here and recognize the GTS team. They've done an excellent job rightsizing this business over the past few years. Their proactive approach and focus on driving profitable growth turned GTS into a more stable business with greater margin potential.

We are also pleased with how we are managing our disk drive business. Secular pressures in that market drove the 9% decline in Special Applications last quarter, but high standards with Disk Drive customers spurs advancements in our technical capabilities that can be leveraged elsewhere in the company. Sharing innovation across our company is complemented by a strategic approach to managing our portfolio.

I want to highlight a few of our successes from last year. First, our combined Advance and Accelerate portfolio grew twice as fast as the company. Second, replacement parts were also above the company average at more than 60% of total sales. Replacement parts are critical to mitigating the cyclicality of the markets we serve. Third, innovative products remain a growth driver for both new equipment and replacement parts. Sales of these products in Engine were up about 10% in 2019 and dust flow collectors were up more than 30%.

Our diverse portfolio is a core strength, and we will leverage that in 2020. We plan to make further investments in our growth businesses, supported by efficiency gains in other parts of the company.

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In addition to those gains, we are actively looking for other opportunities to reduce cost and optimize our structure which is standard work for us. This is what we will control in 2020. We are also paying close attention to the markets, which have changed in the 5 months since our Investors Day. At that time, we estimated market growth between 1% and 3%, supported by stable levels of investment, commodity prices and currency exchange rates. Based on today's estimates, global equipment production will likely be down in the low to mid-single-digit range. Industrial production has come down to the low end of our prior estimate and currency is anything but stable. It's hard to say how much of the change is driven by cautiousness versus real demand erosion, but we do expect the environment will be more challenging than prior year.

With these factors in mind, we are projecting a modest sales increase in 2020, which also means that our 2021 sales will likely be closer to the low end of the range we provided at Investors Day.

I'll now turn the call to Scott for more details on what's included in our 2020 plan. Scott?

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

Thanks, Todd. Good morning, everyone. In 2019, we focused on supporting our customers, enhancing our global processes and strengthening our foundation for future growth. This year, our focus is navigating an uneven demand environment and driving gross margin improvement. I'll share some thoughts about 2020 after a quick recap of 2019.

Overall, we're pleased to have delivered fourth quarter sales and EPS that were both in line with forecast. In constant currency, sales were up 2.3% last quarter and GAAP EPS was $0.45 versus $0.78 last year. The year-over-year change was largely in -- due to tax reform. We had a $0.20 benefit in 2018 compared with a $0.16 charge in 2019. A portion of the charge relates to final regulations for the Tax Act and we also had some strategic restructuring of our legal entities. With the flexibility enabled by tax reform, we've simplified our structure to more easily match global cash with operating needs. Please note that the restructuring charge resulted in nonoperating expense this year compared with income last year.

Excluding nonrecurring items, fourth quarter adjusted EPS grew 5% to $0.61. An audit settlement led to a better-than-expected tax rate, which is offset by a lower-than-expected margin.

Operating margin was down 50 basis points last quarter or 40 basis points without the revenue recognition change.

Lower incentive compensation contributed to a favorable expense rate, which partially offset the gross margin decline.

At a high level, we didn't make as much progress on gross margin as we'd expected. Pricing offset higher costs in the quarter, which we feel good about, but we still have work to do on key initiatives, including line transfers, cost take-outs within our manufacturing process and strengthening our part level profitability. Market level mix pressure was also one thing that held gross margin back. In some cases, our best performance came from lower-margin products like the emission pre-buy in Off-Road or large turbine projects in GTS.

Uneven demand was another headwind. In fact, every quarter in 2019 had a period where demand changed suddenly and dramatically. In some cases, demand stabilized afterwards. In other cases, we had a modest rebound, which was what happened in July. While good news in July wasn't enough to offset the margin shortfall in the quarter, we were encouraged by the trend as July was one of our strongest gross margin performances last year.

Moving off the income statement. Our balance sheet showed improvement in working capital last quarter. The leverage ratio is right in our target range and fourth quarter cash conversion was more than 100% on an adjusted basis.

For the full year, investments in the business and cash returned to shareholders totaled $475 million. Excluding the tax charges, we generated a strong ROIC of more than 18%. We are proud of this performance and we plan to build on this success.

Turning now to our outlook. Our fiscal '20 sales are forecast between a 2% decline and a 4% increase. We expect a benefit of 1% from

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pricing and currency headwinds of 1% to 2%.

Engine sales are projected between a 4% decline and a 2% increase. First-fit is under the most pressure, with sales in both On-Road and Off-Road projected down in the mid-teens. The On-Road decline is primarily driven by the U.S., where lower heavy-duty truck production is widely anticipated. We're also planning that On-Road will be down in China. We're still optimistic about the long term, but the process of maturing our relationships with these customers, combined with their order volatility, makes for a dynamic environment. In Off-Road, strong comparisons from pre-buys in 2019 and expected softness in key end markets are driving the decline.

We expect Aftermarket to provide stability in 2020 with a full year increase in the low to mid-single-digits. That's above our estimates for equipment utilization, driven by share gains from innovative products.

Share -- sales of Aerospace and Defense are planned up in the mid single digits, reflecting growth in commercial aerospace and ground defense.

Industrial sales are projected up between 2% and 8%, which is strong growth for our mixed portfolio.

We expect a low single-digit decline in Special Applications, driven by the secular Disk Drive trend, while growth in venting solution provides a partial offset.

For GTS, we are forecasting a low single-digit increase this year, while sales in replacement parts should more than offset further contraction of large turbine projects, which represent less than 10% of GTS sales.

Sales of IFS are planned up in the mid- to high single digits, including a small partial-year benefit from BOFA. Share gains with dust collection replacement parts should easily offset market-related headwinds for new equipment. And we also expect another strong year with process filtration.

We continue to expand our LifeTec offering and our larger-than-ever our sales team is building a relationship with new food and beverage customers.

For 2020 operating margin, we expect a full year rate between 13.9% and 14.5%, which is up 30 to 90 basis points from last year. The improvement comes from gross margin, and the key activities relate to what I mentioned before: resetting the supply chain, aggressively pursuing cost reductions and enhancing part level profitability.

We expect higher expenses will offset a portion of the gross margin improvement. Resetting the annual incentive plan is the biggest headwind which adds about $10 million of expense, and we'll continue to invest in R&D and their growth businesses.

We are planning to minimize the profit impact of these investments through cost reductions in other areas.

Beyond what's in plan, we will continue to identify and harvest additional savings around the company.

For our other operating metrics, we planned interest expense of $18 million to $20 million, other income of $4 million to $8 million and a tax rate between 25% and 27%.

Just a quick comment on taxes. This year's rate is up from last year as we don't expect as much benefit from stock options or audit settlements.

We expect capital expenditures to remain elevated at $110 million to $130 million, driven primarily by in-flight capacity projects. We also expect to repurchase 2% of shares again this year. Altogether, we're planning cash conversion of 80% to 95% and GAAP EPS between $2.21 and $2.37.

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Overall, we expect typical seasonality in 2020, which means that the second half should generate higher sales, margin and EPS in the first half. That said, there are some nuances, so we want to help with modeling, but I have one request. Please keep in mind that our practice is to limit the detailed guidance for the full year, so my comments will stay at a high level.

For sales in FY '20, tougher comps, combined with the pace of ramp-up for certain initiatives, translates to a first half forecast that's down from 2019.

With operating margin, the full year growth of 30 to 90 basis points will be driven by performance in the second half. The first half has a few things going against it: tougher comps, margin improvement initiatives that build over the year and the headwind from incentive compensation fixed right away in the first quarter.

One more point about modeling. About half of $10 million headwind from compensation expense will go into the corporate and unallocated line, with the balance split between the segments. As I said earlier, our mission this year is to navigate an uneven demand environment and drive gross margin improvement.

Our 2020 plans reflect deliberate choices related to growth and investments. For example, the Advance and Accelerate business are receiving the most investment and being tasked with the highest growth. Conversely, areas like our first-fit Engine businesses are creating investment capacity, with expense savings and enhanced profitability in a challenged environment.

Looking further ahead to fiscal '21, market conditions are the only reason we see ourselves towards the low end of the targets we provided at Investor Day. We see great opportunities in front of us, and there are several things that make me confident in our future: we have the right strategy, we have a disciplined approach to managing the portfolio and we have a powerful and committed base of employees that are acting as a one Donaldson team. I want to thank our employees for the work they did last year and the role they'll play in our long-term success.

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

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

Thanks, Scott. I think it's clear, but just to reiterate, our focus this year is navigating uneven demand and improving gross margin. Our global team is aligned around this mission and each area has plans in place to achieve this result. That's our tactical plan. But we will also drive our strategic plans. We are a returns-focused company that is committed to long-term profitable growth, so I'll share a few examples of our progress.

As always, Donaldson's story begins with innovation. We plan to spend $65 million on R&D this year. That's up 7% from 2019 and another year of developing breakthrough technology. Material science capabilities are the biggest opportunity for us and the new research facility is under construction. These technologies can be applied in many areas like process filtration. The customers in the food and beverage industry care deeply about the integrity of their products, which creates an opportunity for us to further leverage our advanced LifeTec filters.

Sales in process filtration are planned up again this year and we see a long runway ahead.

We also leverage new technology in Venting Solutions. These high-tech projects protect sensitive devices and parts, and this business is the one place at Donaldson where we are targeting the automotive industry. To that point, we recently launched a vent that protects battery packs, which is critically important in electric vehicles. We see a big opportunity in this new space and we are excited about the role of venting in our future.

Connected solutions is another unique offering for us. With remote sensing, we can provide end users with real time, actionable information about their dust collector performance. Based on our research, this level of support is highly valuable, further solidifying our brand as an innovative and customer-focused partner.

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We are also innovating the way we sell and we are doing that through e-commerce which we launched nearly 2 years ago. Since launch, we've invoiced more than $480 million in sales through hundreds of thousands of transactions. There have been millions of sessions from customers around the world and those figures should grow again this year.

For the Engine business, e-commerce gives us an opportunity to better serve existing aftermarket customers. They appreciate the efficiency and we appreciate the speed and cost savings from processing the orders.

The same is true with our Industrial customers with one added benefit. We turned on the ability to receive guest orders earlier this year, and that can drive incremental revenue from customers we couldn't efficiently serve in the past. Cultivating innovation is a core principle at Donaldson, and we see it everywhere in the company.

With our excellent employees, clear strategic focus and disciplined approach to investing I am more confident than ever in our ability to create long-term value for all our stakeholders.

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

QUESTIONS AND ANSWERS

Operator

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

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

I'd like to just start off in IFS and that part of the guidance. You guys have got mid- to high-single-digit growth in IFS in 2020, which on the surface, looks pretty strong in this kind of macro environment. It looks like 1 to 2 points from BOFA, probably offset by 1 to 2 points of currency headwinds. So you're still looking at organic growth within that range. I would've thought Industrial CapEx, new Industrial CapEx is probably down in 2020. Industrial production is probably a flattish. So maybe you can just bridge that gap for us, how you get to -- what's pretty strong growth there in an environment that's not that strong?

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

Sure. This is Tod. So Nathan, I think you have your numbers built in that model accurate, BOFA will add $9 million to $10 million of that growth. And then when we really consider the comprehensive portfolio of what's in IFS, we -- while there is that CapEx portion of our dust collection business or our brand we call Torit, that likely will face some headwinds. Also, in that IFS business, in our Advance and Accelerate portion of the portfolio, is our dust collection aftermarket business which we've been growing, frankly, at high single digits for a number of years. And we have good opportunities in taking share in China based upon the Blue Sky Initiatives there. We have good momentum in Europe. We have multiple growth opportunities across the Americas. And then also don't forget that IFS carries our process filtration business, which we've been growing at double digits for multiple years and we look for another year of strong growth. So if you roll that all together and IFS has some really strong opportunities for us in fiscal '20.

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

Okay. That's very helpful. Second question here, maybe just on the cash conversion. You guys are spending pretty heavily last year, this year or this coming year on the strategic initiatives. Can you maybe give us an update on how long we should expect this kind of level of CapEx? When we should return to a more normalized level? What that is? And what the long-term free cash flow conversion targets are?

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

Yes. So -- Nathan, this is Scott. So it's still consistent with what we said at Investor Day. So this year, we ended right on our target of $150 million of CapEx. We said at Investor Day and in the past that we were expecting higher levels of investment last year and this year. So for this year, we have continued elevated levels of $110 million to $130 million. And the purpose for that is to finish the projects that we have in flight. So we've been adding significant amounts of capacity and we need to finish these projects and grab the returns to help with the margin improvement. So we feel good about where we're at. We're right on line with the projects and we have to complete those. Longer term, this spending will come down. We expect a more average or normal range will be 3% of revenues. We said our cash

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conversion is 80% to 95% this year, and that's with CapEx of $110 million to $130 million. So we expect, over time, that will improve as we come back to a more normalized CapEx spending of 3% of sales. So we're still at elevated spending with slightly lower cash conversion and that will improve as we bring down the CapEx spending.

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

And you would anticipate 100% plus, long term, in terms of conversion?

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

Yes. I mean 90% to 110%, depending on the revenue growth and what other things we're doing, but that's a reasonable range.

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

Okay. And then just on gross margins. You guys called out gross margins as the big driver of 30 to 90 basis points of margin expansion. And clearly, you'd be growing margins here outside of any kind of volume leverage. Can you maybe talk about the biggest initiatives that you guys have got, that are going on to drive that gross margin improvement? What you're looking at in terms of price cost tailwinds? I assume that will be in fiscal 2020. And just any information you can give us on what's driving that margin improvement?

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

Yes. So as I said, we were disappointed in our margin improvement for this year. We did not accomplish everything that we wanted to, and that's why our margins ended up a bit short. But the projects are in-flight, and that's what that CapEx relates to. So number one is complete the projects we have in flight and drive the returns that we expected out of those. As we complete those projects, we will begin to normalize our supply chain and improve our inbound freight and focus a lot more on gaining efficiency, the cost takeout and allow our teams to spend more time on raw materials. We have to work on our product-level pricing to improve products with low-margin parts. And our -- we had a 1% increase for pricing this year. That will drive any costs associated with raw material increases to more of a neutral position.

In terms of media, we are expecting slight increases in media costs this year, and that's one of the reasons that we have to continue to increase our prices to offset the raw material impacts. That's kind of an overall summary on all the things that are going at the margin and why we believe we have great opportunities to improve our gross margins going forward and we are going to drive those projects to completion.

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

And maybe just to add a little bit of color here -- this is Tod, Nathan, is that overall, the organization is really focused on it. Every region has specific targets. Every business is focused. They understand this is the number one problem in the corporation across the entire leadership. This is really from an operational standpoint of view, our focal area.

Operator

Your next question comes from Brian Drab with William Blair.

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

At the Analyst Meeting, you talked about the $100 million target for cost cutting and clearly, discussion of cost cutting so far today in this call too. I'm just wondering, do you have maybe a little more urgency around the $100 million or maybe pull some of that forward, accelerate that schedule somewhat? And in the -- I guess it's about 5 months only since the Analyst Day, but where are we on that $100 million program at this point?

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

Sure, Brian. This is Tod. So we still feel strongly that $100 million is the proper target. We embrace that challenge. We have specific plans across our operations teams. Now the lead time of some of those projects, we had urgency even at Investor Day relative to the $100 million. And so the opportunity to accelerate that from what we had thought is just really not there. These projects are multiple-quarter projects that we have in flight that we're really pressing hard on in order to bring forward. But it's still the target that we covet, it's still being executed on, but I do not see opportunity to really accelerate that.

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

Okay. Okay. And then given the -- so not a huge change, but change in trajectory in the top line versus what we discussed at the Analyst Day over the next few years. Is there any change in your plans for capacity expansion or reducing capacity potentially, given that change in trajectory?

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

Yes, Brian. Tod again. So this is what we talked about at Investor Day as well. And we have a multiple year, 5-year plan within our operations team. And what we did in order to expand the capacity is we pull forward, by year, sometimes as much as 3 years, many of those 2 years ahead, within that 5-year plan when we expanded capacity. So we're really just executing what were our plans to begin with. And so consequently, we really feel good about where we are. And frankly, that allows us to now really work hard at normalizing our internal supply chain for our customer base. And that's what our focus is today. We're comfortable with where we are in capacity and we'll just continue to execute that plan.

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

Okay. And then just one last one, kind of along the same lines. Just wondering, as these end markets are challenged at the moment, or at least many of them are, is there any way that you can accelerate getting some of these new end markets up and running, specialty chemical, electronics, medical, pharmaceutical, some of these things that you talked about at the Analyst Day, to offset some of the pressure?

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

So we're clearly pressing hard in the process filtration. But also with the markets that we talked about, and we highlighted this at Investor Day as well, the sales cycle on those, in order that we have validation, are often multiple year type of activities. We have process filtration well in flight. People are pressing hard. But we're as much as 2 to 3 years into that cycle already, which is the reason why we're seeing some momentum and doing quite a nice job. The others are still going to take some time. And if you remember on that whole medical opportunity, we still need to advance our material science opportunities and we'll continue to do so.

The other one we didn't talk so detailed about in our Investor Day is our venting products. And so venting is a good opportunity, and we're pressing hard on that, which is the reason why in my prepared remarks, I really highlighted a lot of opportunities in automotive, in supporting electric-based vehicle within venting. So that's a good opportunity that we'll be pressing harder in order to grow as quickly as possible.

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

Got it. And just quickly, Tod, can you make any comment on August versus what you guided in terms of overall demand?

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

Everything we've experienced in August is baked into the guidance that we gave for the full year.

Operator

Your next question comes from Richard Eastman with Baird.

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

If we could just circle back for a minute on the gross margin. Can I just ask, from a -- you gave some decent guide on the op margin improvement, 30 to 90 basis points. You did mention OpEx will be up some here, mainly incentive comp. But is the target -- what would be the target for the gross margin improvement? What would be that range? Would it be 100 basis points to -- maybe you could just lay that out? And I'm curious how much mix should be beneficial for you this year.

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

Yes, I mean this is Scott. Rick, we factored, certainly, mix into the guidance and we are working to grow our Advance and Accelerate and grow higher-margin products, right, which you can mix the company up by investing in higher-margin products. And that's something we're always going to be working to do with our Advance and Accelerate category. So that helps with mix, and that's one of the ways

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we're driving our gross margins up. So we've's said we're going to be up quite a bit in op margin, and that's mainly driven by gross margin, for the most part, which is a little bit of a headwind from our operating expenses. So all the improvement is really coming solely from gross margin, and it's all the things that we talked about with Nathan's questions and in my script. And we have to finish those projects to improve our margins. But gross margins are the key for this year. And the operating margin improvement is going to be driven solely by gross margin improvements. And part of that comes from mix and part of that comes from all the other things I referred to with regard to improving our margins.

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

Okay. So might we expect 100 to 125 margin improvement basis points?

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

Well it's 60 -- 60 basis points of operating improvement is the midpoint for margin, and that all comes from gross margin. It's a little bit of a headwind from the expenses. So all the operating margin comes through gross margin improvements.

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

Yes, Rick. Rick, this is Brad. I would pull on that. That's the thing to keep in mind. If you just pick something within the range, and for the exercise, it's 60 basis points, assume that the incremental incentive compensation, the math on $10 million, gets you into the neighborhood of 30 basis points. So we've got to offset that right away. So that's kind of where you get to it. You start talking way into 100 plus basis points, and that's just above where we'd expect to end the year. But we certainly expect strong improvement.

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

Yes. And then one would expect, again, given how this year lays out relative to the comps, relative to the deceleration we're seeing in some of the engine markets, to be sure, one might think that, again, I -- maybe the first half revenue was down, we still may see first half gross margin. The financial metrics still across the P&L are probably still down in the first half. And then the improvement for the full year that you're laying out is really going to be second half-driven when the sales growth kind of materializes against the easier comps. Is that how the P&L should shake out first half, second half?

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

Yes, I think that's a fair characterization, Rick, especially when you start to look at our gross margin improvement projects that are in-flight, they're more back half-related based upon we have to finish up those projects in order to drive what we would expect to take place. So yes, clearly it -- that correction, if you will, ramps up as we progress through the year.

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

And this is Brad, I'll add to that. Scott touched on this, but keep in mind, the incentive comp headwinds starts August 1, first day of the fiscal year.

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

Okay. And then just as a quick just follow-up here maybe. On the industrial side of the business, it's good to see gas turbine forecast maybe being up low single digits. We should probably presume then the equipment side of that business is kind of based out -- it's probably a little north of 0. But the -- but that -- but the big risk there around the equipment side seems to be washed out of the numbers. Now we're kind of talking about replacement parts. Is that accurate there that the risk of gas turbine kind of bottoming here is finally -- maybe finally in the rearview mirror?

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

Rick, Tod. Yes, that's absolutely right. Your characterization is fair. We look at our large turbine projects as being somewhere between 0 and 5%., so it will be mid-single digits at best this year. So yes, it's washed out. We've been highlighting that in the last couple of quarters, saying that it's less of overall risk to the corporation. And that really aligns well with our longer-term strategy, whereby growth in the business will come from aftermarket or share gain within aftermarket. But then also keep in mind that we have a small turbine projects based there, things such as oil and gas pipeline, offshore, oil rigs, things like that. And that we -- is essentially the bulk of our project-based business, we call it small turbine, as opposed to making projects for the power grids.

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

Okay. Because overall, the -- your sales guide for the full -- for fiscal '20, for the full year, it looks like you've kind of stress-test this pretty well this early in the fiscal year with the guide. And maybe the risk to the low end, the minus 2% revenue, is kind of concentrated down in the Industrial sales and maybe macro risk. Can I summarize it that way?

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

I'd say the risk would be, yes, more macro geopolitical, what's going to take place, the risks and uncertainties that we're all experiencing in our daily lives now. And yes, I think that's fair to characterize and wrap up as a risk.

Operator

Your next question comes from Laurence Alexander with Jefferies.

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

I guess 2 quick ones. Can you give an update on how your thinking has evolved around M&A opportunities, both valuations that you're seeing and areas that might be more likely over the next year or so if the current environment continues?

And on the Chinese side, could you speak a little bit about what you're seeing in the aftermarket there, and what you now see as a timeline before the Aftermarket really kicks in as a growth driver for your China business?

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

Laurence, this is Tod. Let me take the M&A portion first. So M&A continues to be part of our long-term strategy. Nothing has appreciably changed from a market standpoint of view. We still work it as part of our normal base processes. We suggest that we still have a robust pipeline. It's very strategic. We remain a disciplined buyer. So our behavior is all -- remain intact. And we have seen no appreciable change in the overall M&A markets at this point.

Longer term, for China, relative to the aftermarket, we have some momentum, particularly on the Industrial side within China because of the Blue Sky initiative in our IFS-based businesses. And so we are starting to see the aftermarket portion of that already come through. And that is one of the reasons why we would suggest our IFS has a good growth opportunity, and that is baked into our fiscal '20 guide that you have received today. So we think that China has some momentum already that we are seeing in the aftermarket, and we're really quite happy with that.

Operator

And there are no further questions at this time, I'll turn the call back over to Tod Carpenter for closing remarks.

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

That concludes today's call. I want to thank everyone listening for your time and interest in Donaldson company. Have a great rest of the week. Goodbye.

Operator

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

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