THOMSON REUTERS

EDITED TRANSCRIPT

Q1 2020 Donaldson Company Inc Earnings Call

EVENT DATE/TIME: DECEMBER 03, 2019 / 3:00PM GMT

©2019 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

CORPORATE PARTICIPANTS

Brad Pogalz *Donaldson Company, Inc. - Director of IR*
Scott J. Robinson *Donaldson Company, Inc. - Senior VP & CFO*
Tod E. Carpenter *Donaldson Company, Inc. - Chairman, CEO & President*

CONFERENCE CALL PARTICIPANTS

Adam Michael Farley *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*
Brian Paul Drab *William Blair & Company L.L.C., Research Division - Partner & Analyst*
Daniel Dalton Rizzo *Jefferies LLC, Research Division - Equity Analyst*
Richard Charles Eastman *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Donaldson's Q1 FY '20 Earnings Conference Call. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Mr. Brad Pogalz, Director of Investor Relations. Please go ahead, sir.

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

Thanks, Julianne. Good morning, everyone. Thank you for joining Donaldson's First Quarter 2020 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 first quarter performance and an overview of what we are planning for the balance of the year.

During today's call, we may reference non-GAAP metrics. Please note that there is 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. I want to highlight two important points in our quarter. First quarter market conditions were consistent with what we expected, and we are pleased with our improvement in gross margin. As we look ahead, our perspective on fiscal '20 sales, operating margin and EPS is aligned with our prior guidance. We are planning for an uneven demand environment this year, and we saw that in first quarter.

During 2020, we expect softer sales of new equipment, a stable base of recurring revenue and strong increases in our strategic growth areas. We also expect operating margin will be up from last year, driven by gross margin. Scott will provide more details later. So I'll now turn to an overview of first quarter sales.

Total sales of $673 million were down 4% from last year. Currency was a headwind of 140 basis points, which we offset with the benefits from both BOFA and price realization. Sales in the Engine segment declined 4.5%, driven primarily by our first-fit businesses.

On-Road sales were down 11% in the quarter, with China accounting for nearly half of the decline. We are now lapping some of our earliest fuel wins in the region, and demand has yet to stabilize. As we expand our business with Chinese manufacturers, we expect On-Road sales will grow over time. Until then, we are focused on building and deepening these new relationships, winning programs and launching PowerCore in China.

In the U.S., we are seeing early signs of the peaking truck market. After growing more than 30% in each of the last 2 years, On-Road sales in the U.S. were about flat with last year. Slowing production of Class 8 trucks is widely expected, and that's reflected in our full year forecast as well.

©2019 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

First quarter sales in Off-Road were down 10%. Exhaust and emissions accounted for more than half the decline due in large part to timing. We benefited throughout 2019 from pre-buys in Europe related to an upcoming regulatory change, so we expect the business will be down this year before ramping up again in 2021. Slowing market conditions are also affecting Off-Road. We estimate the construction cycle is at or near its peak.

For ag and mining, the recoveries are muted as manufacturers navigate geopolitical and trade-related uncertainties. As our first-fit markets predictably cycle, we remain focused on winning new programs with innovative technology. We have a robust pipeline with more than $0.5 billion of future opportunities and our razor-to-sell razor-blade solutions are outperforming legacy technology quarter after quarter.

We see similar dynamics in our aftermarket business. Total aftermarket sales were down 3.6% in first quarter, while technology-based razor-blade products were up in the mid-single digits. We saw most of that benefit in the OE channel of aftermarket, which was down in the low single digits as innovative products could not fully offset the impact from slowing market conditions.

Backlog and order levels have been fairly stable in recent months, so we believe the OE channel performance is more about demand pull-through than destocking at this point. The independent channel, which is about 60% of total aftermarket, was also down in the low single digits. We are seeing weakness in the U.S. due in part to oil and gas, while sales into Europe are strong. The independent channel tends to move more with demand so it's a useful proxy for equipment utilization.

Our aerospace and defense business had another strong quarter. Sales were up 11% with helicopter and ground defense programs driving the growth.

Turning to our Industrial segment. First quarter sales were down 3%. Sales in Gas Turbine Systems, or GTS, declined 19%, due in large part to small turbines. Our backlog supports increasing sales over the next couple of quarters, so we expect that first quarter will be the lowest level for GTS this year. In Special Applications, sales were down 4% last quarter due to the secular pressure in the disk drive market.

Sales of Industrial Filtration Solutions, or IFS, were about flat with last year, but that includes a mix of results across several areas. I want to first point out that BOFA added about $10 million to IFS in the quarter with incremental sales of more than $8 million as we hit the 1-year anniversary of the acquisition. The largest portion of IFS is our dust collection business, which we call Industrial Air Filtration, or IAF. These products account for about 60% of the total IFS, and sales were down in the high single digits last quarter.

As expected, the market for new equipment remains soft. Quoting activity is stable, but customers still appear cautious as they deal with macroeconomic uncertainty. First quarter sales of IAF replacement parts were about flat with last year as share gains helped offset slowing industrial production. China is one example of where we are gaining share. We are capitalizing on the momentum created by the Blue Sky initiative and sales of IAF replacement parts in that region were up in the high teens last quarter. IAF replacement parts represent a large portion of our Advance and Accelerate portfolio, and we expect sales will continue to ramp up this year as we make incremental investments to support that team.

Process filtration is also all about share gains, and we are targeting the food and beverage market, where the margins are above our company average. First quarter sales were up in the low teens and that's on top of a 20% increase last year. We are expanding the LifeTec brand, investing in new capacity and developing a strong sales team to build on the momentum we have in process filtration.

There are a lot of positive things happening across the company, and they are not isolated to our Advance and Accelerate portfolio. The Critical Core businesses are winning new programs for future revenue. Mature businesses are generating profit and cash flows that can be reinvested, and our fix and reposition teams are pursuing margin enhancement opportunities. We are confident that we have outlined the right mission for each piece of our portfolio, and we expect that will drive value creation well beyond this fiscal year.

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

©2019 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

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

Thanks, Tod. Good morning, everyone. We generated first quarter sales of $673 million, and EPS was $0.51 per share. First quarter operating margin declined 90 basis points to 13.2%, and our EBITDA margin of 16.7% was down 40 basis points. The delta between the two rates reflects incremental depreciation related to our significant capacity investments.

While operating margin is still our primary metric, EBITDA offers a helpful reference point as we progress through two years of elevated capital expenditures. As a rate of sales, operating expenses were up 130 basis points from last year. The increase was driven by loss of leverage on lower sales and investments in our strategic growth opportunities. For example, R&D was up 5% in the quarter, and we are adding more headcount and tools to the Industrial segment to build our connected solutions and thus collection businesses.

We offset a portion of these investments with gross margin, which grew 40 basis points in the first quarter. Importantly, gross margin was up in both segments. The increase was driven by benefits from pricing, along with lower raw material and supply chain costs, which was partially offset by a lack of volume, leverage on lower sales.

While we are pleased with the gross margin increase, we also recognize there's more work to do to create a sustainable level of improvement. Our top initiatives include leveraging new capacity to lower the cost of manufacturing and optimize the supply chain, cost takeouts within our mature manufacturing plants and strengthening our part level profitability, including continued refinement of pricing strategies. We expect to complete many of these projects over the coming quarters, and we will continue to pursue new opportunities that will further enhance our gross margin.

Turning to our other financial metrics. Our leverage ratio at the end of the quarter was slightly above 1x net debt-to-EBITDA, which is a comfortable spot for us. Cash conversion was 75% in the quarter, up from about 50% last year. We're making progress on reducing days sales outstanding and we have ramped up our focus on inventory and payables.

I want to take a quick moment to thank all the people involved in driving these improvements, which are enabled by our global ERP. Fiscal '20 marks the beginning of our fourth year of being on the system, and our team is focused on standardizing, optimizing and globalizing our processes. So a big thanks to all those people. I sincerely appreciate their passion, and I am confident they will continue finding ways to make us more efficient organization.

I'll now turn to a review of our fiscal '20 forecast. As Tod mentioned earlier, there are no changes to the guidance ranges we provided last quarter. I also want to remind everyone that we intentionally kept the guidance ranges wide this year to account for the greater level of uncertainty in the operating environment. One quarter in, we still feel the same way. Between currency and commodity price fluctuations, the political environment and trade-related concerns, we feel it's prudent to maintain that approach.

Starting at the top, full year sales are forecast between a 2% decline and a 4% increase from last year. This range includes a headwind from currency of 1% to 2%, partially offset by pricing benefits of 1%. Engine sales are projected down 4% to up 2%, with On-Road and Off-Road each declining in the mid-teens. On-Road sales will likely be pressured by a slowdown in Class 8 truck production. Off-Road will have the exhaust and emissions headwind, and we also expect markets will remain soft. Aftermarket sales are projected to increase in the low to mid-single digits, reflecting share gains and continued strength in sales of innovative products.

PowerCore is a great example of how we plan to keep growing. Aftermarket PowerCore sales were up in the mid-single digits last quarter, achieving a new quarterly sales record. When we talk about growing aftermarket with share gains, greater retention rates from proprietary products are a key part of that strategy. Rounding out Engine, sales of Aerospace and Defense are planned up in the mid-single digits, reflecting growth in commercial aerospace and ground defense.

Sales in the Industrial segment are planned up between 2% and 8%. We expect a low single-digit decline in special applications, with secular headlines from disk drive being partially offset by growth in venting. GTS sales are forecast up in the low single digits, reflecting higher sales of replacement parts. In IFS, sales are planned up in the mid- to high single digits, including the incremental benefit from BOFA.

©2019 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

We received some questions about IFS after the last call so let me add a little more color. First, we aren't banking on very favorable market conditions. When we break down IFS, about half the total business unit is related to new equipment. That's made up of things like new dust collectors and OE systems for compressors. We're planning on these businesses to be down a bit this year, reflective of the environment. The other half of IFS is dominated by our Advance and Accelerate portfolio, including dust collection replacement parts and process filtration. We expect healthy growth rates in these businesses will more than offset a softer demand environment for new equipment.

I'll also attempt to get another -- and talk to another question you might have. We do expect sequential momentum in IFS over the course of the year. We expect benefits from the investments we've been making will layer in over the next several quarters. Consequently, our second half growth in IFS should be much better than we expect in the first half of 2020.

I'll talk more about calendarization in a few moments, but first, I'll go through the rest of our fiscal '20 guidance metrics. Operating margin is forecast between 13.9% and 14.5%. That represents an increase from last year of 30 to 90 basis points, which we expect to be driven entirely by gross margin. There are a lot of moving pieces affecting our gross margin as we stand up new capacity while working to transfer production from one facility to another.

We expect to complete many of these projects as we move through the year, setting us up to deliver our full year gross margin target. We are projecting the expense rate will be flat to slightly up from last year, with higher incentive compensation of about $10 million being the largest notable item.

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%. We expect capital expenditures to remain elevated at $110 million to $130 million. However, the pace of spend will likely drift down over the course of the year as products are completed.

We also expect to repurchase 2% of the shares again this year, which is consistent with our recent trends. Altogether, we're planning cash conversion of 80% to 95% and GAAP EPS between $2.21 and $2.37.

Before turning the call back to Tod, let me further elaborate on the calendarization of 2020 sales and margin. Consistent with what we outlined last quarter, we expect better year-over-year performance in the second half than in the first. One reason for the cadence is that second half has an easier comparison. When we reflect on the second half of 2019, FX headwinds were more severe, and engine was under pressure from OE destocking. We don't expect to repeat that this year, which results in better performance. The only notable exception is On-Road where the widely anticipated Class 8 production slowdown will be more of a headwind later in our fiscal year.

For 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 tough comp to deal with, and we plan to realize benefits from our margin improvement initiatives later this fiscal year. While we would happily accept a little less uncertainty, I am proud of the way our global team is responding to the uneven environment. I should point out that part of why our business is uneven is because of the choices we are making. As markets become less favorable, we are building efficiencies in certain businesses while continuing to press for growth in others. Our teams are doing a solid job of balancing these opportunities, and I am confident that we are making the right decisions to position us for 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'm proud of the work our team is doing to navigate the environment and deliver on our commitments. I'm also proud of the spirit of innovation I see everywhere at Donaldson, so let me take a moment to share a few examples.

We've announced some new developments with connected solutions in the past couple of months, so I'll start there. Within the Engine segment, we continue to leverage the Filter Minder brand. We bought this Iowa-based company a few years ago because of their capabilities related to sensors and indicators. Today, it's our center of excellence for our Engine segment's connected solutions business.

©2019 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

Our newest product is a wireless monitoring system for truck air filters, which we believe has great potential for fleets. It can be easily retrofitted on to existing systems, giving our customers better visibility into filtration performance and allowing them to optimize service intervals. This technology has clear value to fleets, and we also see great opportunities with the OE customers.

One of our R&D priorities relates to the move from what we call "best effort" filtration to "intelligent" filtration. In short, we believe we can create more value by designing filters that are rightsized to the customers' application. Given our deep expertise with filter media, development and design, we believe we are uniquely positioned to meet that need. With our breadth of offering and depth of knowledge, we also feel uniquely positioned to meet the needs of our industrial customers.

One year ago, we announced an early adopter program for dust collection monitoring, and we followed that with a commercial launch this past September. Our new offering, which we call iCue is a subscription-based service that allows customers to receive real-time information about the performance of their dust collectors. Once again, we made it easy to install, and it can be used on any type of dust collector. By connecting these collectors, we help our customers save energy costs and reduce unplanned downtime, and we create greater ability to retain our replacement part sales.

While it's still very early, we believe our connected solutions will deepen our customer relationships and create access to new growth opportunities. Another way we are deepening relationships is with e-commerce. We processed nearly $110 million worth of orders for more than 2,000 customers in the first quarter, and we have been constantly enhancing the site. We recently opened the platform to guest orders for many of our Industrial segment products, which will make it easier for us to sell to the hundreds of thousands of potential dust collector customers. We also improved the experience for our customers with the new personalization capabilities.

We view shop.donaldson.com as a valuable new channel to reach a wide range of existing and potential customers. Donaldson is a technology-led filtration company, and it's exciting for me to watch us leverage our expertise and press into these new and dynamic opportunities. I'm confident that we are making the right strategic choices today that will position us to deliver long-term profitable growth.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Brian Drab from William Blair.

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

So Scott kind of proactively was addressing this, but I was wondering if we could just have a little more detail around the Industrial segment. I'm just looking at the numbers and seeing the guidance for the Industrial segment overall to grow 5% for the year after being down, what looks like 6% organically in the first quarter. And then you have the benefit of the BOFA acquisition, that contribution of acquisition revenue won't be there for the balance of the year. So can you just talk a little bit more about how -- I mean, it looks like you need to grow 6% plus high single digits sort of for the rest of the year in Industrial and how do you do that?

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

Yes. So I'll start, and maybe Tod can jump in. So yes, the guidance is today, as you noted, with the current for IFS being mid-single to high single, GTS is low single and then special apps is down low singles. And if you look at the implied, as you noted, that comes up a little. The comps get a little bit easier in the second half. And GTS was down a little bit in the first quarter, and we expect that to be the weakest quarter of the year, so when you roll those out, we still see that 2% to 8% guidance range.

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

Yes. Brian, this is Tod. Maybe a little bit more color as well. It's clear that what's happening also, we entered the year talking about the risk relative to industrial-based equipment sales in our Industrial Air Filtration business. I commented on that in the script. And consequently, we do recognize that as a risk looking forward. However, we want to emphasize that we do not see a taper off of quoting

©2019 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

activity at this point. We do see a cautiousness and an elongation of quote to order cycles within this first quarter. But we don't expect it to step down at this point. And that's important to note as we look to the balance of the guide.

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

Okay. So you don't view this guidance as particularly aggressive, right? And you wouldn't -- would you say which way you'd lean toward low end or high end of that guidance? Or just kind of here's the range and it's wide, given the uncertainty?

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

Right. We went into the year and we talked about leaving the ranges why due to the uncertainties that we see. They still remain wide. We also went into the year talking about if we went to the low end, the risk would be equipment-based revenue. Those all still hold true for what we said 90 days ago.

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

Okay. And then you gave some numbers around China, but can you just give us what the percentage of total revenue was in China in the first quarter? And then I think you may have given some of this, but the decline or growth in both Industrial and the Engine segments in China in the quarter?

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

Brian, this is Brad. I'll take that. China in total is right about 6% of total Donaldson revenue. Engine in the quarter was down in the high singles. Industrial was down in the 20% range. There are a couple of caveats with Industrial that I want to call out: the first is GTS, that's a pretty small business, and that had a pretty notable decline due to turbines in -- large turbines in the first quarter; and then on top of it, remember, half of our disk drive business comes out of China. So disk drive in total is something like mid-teens as a percent of China, and that business is just under secular pressure. So the decline for Industrial is a little bit misleading at the down 20% range. But while we're on the topic, I guess, I also want to point out that there are a couple of things that were encouraging to us there are that our Engine aftermarket business and our Industrial Air Filtration businesses, both had pretty strong growth in the quarter in China. So we are gaining share on the replacement parts side. It's just about the market, and as Tod and Scott have alluded to, that's more of a volatile market than the rest of the world.

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

Okay, Brad. How does that break down in China between Engine and Industrial?

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

[Industrial] (corrected by company after the call) is a little more than half. And again, keep that disk drive right in mind.

Operator

Your next question comes from Richard Eastman from Baird.

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

Just a quick question around the IFS business. When we talk about the strength and the process side there, do our wins in process give you visibility at this kind of growth rate through the balance of the year as they kind of phase in and ship? And then also within process and particularly food and beverage, is that business -- are those wins skewed towards Europe?

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

Rick, this is Tod. So if you take a look at the way our backlog flows through the food and beverage, our process-based filtration businesses, it's really very similar to all the other more repeatable or replacement parts businesses in Donaldson, a bit of a shorter type of a time frame, so say, 90 days or so. It's not like some of our equipment-based businesses that give you 6 and 7 months visibility. So that would be the answer relative to our time sense. We do see good order momentum within that particular business. We're really right where we thought we would be in our growth rates within the plan. And yes, it is slanted more toward Europe with roughly about 60% of it being in Europe.

©2019 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

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

I see, okay. And then just -- maybe just one last question around the Engine aftermarket. Given how that business performed here in this quarter, I guess, you referenced the fact that the marketplace now from your perspective is really being driven by demand and utilization rates. Are you pretty comfortable here that the big step downs, destocking step-downs are pretty much washed out of the numbers? And as we move forward here, are we really looking at demand proxy here?

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

Yes, Rick. If we take a look at first quarter performance range in aftermarket and we look all across the world, all areas of the world are continuing to move in a positive direction. We're up year-over-year. Our aftermarket headwinds are a U.S.-based story. And when we further break that down, it really goes to the U.S. It points directly more toward an oil and gas type of a story. And so therefore, we're pretty comfortable that it's more utilization within that particular segment, and so it's a U.S.-based headwind story.

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

Okay. And similarly, in aftermarket, again, being U.S.-based, but is Latin America, is that growth rate -- is that share gain like in a channel? Or -- I wouldn't think the markets are quite that strong. The business probably isn't that big, but are there some channel gains in Latin American aftermarket?

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

There are some channel gains. There's clear market gains within that particular segment, if you talk to Brazil, for example, and other countries. We do have a slight phenomenon there, however, to where we're shifting some of the manufacturing from the United States to our Latin America-based facilities and then shipping directly to customers. So there's a slight transfer tailwind, if you will. But yes, we also have clear share gains.

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. A&D seems to be -- and it continues to do very well. I was just wondering what the visibility on that? And when you might think that could be reaching peak as well? I mean, is it just -- how far out can you see?

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

So on the defense side of things, where it's largely a ground-based vehicle, we have a good lead time in defense. It's one of the longest in the company. I would, however, caution that it gets lumpy within the ground-based vehicles when we get drop-in retrofit orders from allies, if you will, that also use our ground-based vehicles, our being the United States government's ground-based vehicles. So we have long visibility there. We are picking up share within the Aerospace segment, primarily the replacement parts for our helicopter-based business. That's a little bit shorter visibility, more like the typical replacement parts business. But just generally, the larger share of our Aerospace and Defense business, when you put all that OE and ground-based vehicle business together, we do have quite a significant time visibility on.

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

All right. And then you said R&D is up 5% in the quarter. I mean, given what the different dynamics of everything you guys are doing, is there a point where you think R&D is going to peak anytime soon? Or is it going to continue to be elevated, I guess, for the foreseeable future?

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

We're continuing to invest in our opportunities where we see opportunities to support our strategy of further diversification in the company and strengthening our technical sciences for filtration. This is the third year in a row whereby we have increased our R&D by roughly 10%. And so we'll continue to do so in support of our strategy. We are on a longer-term path to increase our R&D spend from 2% to 3% to 3% to 4%. However, I do not feel encumbered to race it to 3%. I do feel that it's important to make sure that it's funded properly to support our strategic chosen initiatives and I think we've done a very good job there.

©2019 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

Operator

Your last question comes from Nathan Jones from Stifel.

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

This is Adam Farley on for Nathan. So turning to gross margins and capacity additions, maybe just a little more color on what has been brought online so far and maybe how should we expect those additions and gross margin expansion to sequence going forward?

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

So this is Tod. I'll start and then maybe Scott can give a little bit more color. What has been brought online so far is some of the expansions within Europe, some of the expansions also down in Latin America and in the U.S., the major expansion that we have still lies ahead of us. And so as we talk about our year and as it unfolds, when we refer to our gross margin expansion, while we have some good work that's already hitting the gross margin opportunity, we've always talked about the project base work being more of a second half story versus a first half story. And so much of that is capacity expansion, where we'll be really realizing that internal supply chain balancing, really lies ahead of us. So we'll look for that gross margin expansion as it goes through the year to really ramp up.

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

Okay. And then with demand looking potentially weaker than expected, are there any additional cost levers that you could pull in the event that demand takes another step down?

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

Sure. So this is Tod again. So when we look at our overall corporation, I think when you look at our history and how we react to the overall cycles that we experienced within our company, we have a strong history of performing overall adjustments for the transactional base across the corporation. And we'll continue to do that. We have been doing that even in last year, in the second quarter in the -- from the second quarter, third quarter, fourth quarter, and we have done a bit of that also in the first quarter of this fiscal year, and we'll just continue to do that. For us, that's standard work in normalizing the overall interim supply base in support of our customers. And so we'll continue to look to do that.

Operator

Our next question comes from Richard Eastman from Baird.

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

Could I just ask -- could we just tease through maybe for a second the gross margin impact, the 40 bps? And Scott, maybe this is for you, I guess, but if we could just tease through that for a second because I think the commentary kind of blew buy me a little quickly, but I think you said the raws were down year-over-year. So you'll get maybe 20 basis points of the 40 out of price and then raws were down. Maybe you could just tease through that a little bit, if you don't mind?

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

Yes. There's a lot, obviously, in the soup when it comes to the margin improvement. And our whole operating improvement for the year is based on our planned gross margin improvements. As you mentioned, we had benefits from pricing and lower supply chain costs. Those were offset because our volume was a bit down. And we continue to work the projects, and as Tod mentioned, all the capacity expansion. And we're -- I would say we're bringing on new projects pretty evenly throughout the remainder of the year, and we kind of expect a slow and steady improvement throughout the year. So I think you had it right when you talked about benefits and pricing, lower supply chain costs, offset partially in the first quarter by lower volumes. And then from there for the rest of the year, we're expecting 30 to 90 basis points of operating margin improvement, and that's all driven by gross margin. And so we feel comfortable that we're going to kind of have a slow and steady march up for the next 3 quarters.

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

Yes. And that -- so if we did 40 bps here in the first quarter with down sales, if we hold that maybe based on price and lower raws, then the 40 basis points grows in the back half with these project contributions and better volume for that matter?

©2019 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

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

Yes. And the cost take-outs we're planning.

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

Okay. Excellent. Sorry?

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

I'll just add one point on that. The raws are going to be more of a favorability in the first half of the year than the last half. If you recall 1 year ago, prices were higher, some of the key imports like steel and media, than they were towards the back half. So just keep that in mind, that's not a bank and steady amount of favorability.

Operator

We have no further questions. I would like to hand the call back over to Mr. 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 day. Goodbye.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Briefs are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT BRIEFS REFLECTS THOMSON REUTERS'S SUBJECTIVE CONDENSED PARAPHRASE OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT BRIEF. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2019 Thomson Reuters. All Rights Reserved.

©2019 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.