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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Donaldson Fiscal 2020 Second Quarter Earnings Conference Call. (Operator Instructions)

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

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

Thanks, Megan. Good morning. Thank you for joining Donaldson's Second Quarter 2020 Earnings Conference Call. With me today are Tod Carpenter, Chairman, CEO and President of Donaldson; and Scott Robinson, our Chief Financial Officer. This morning, Tod and Scott will provide a summary of our second quarter performance and an overview of what we're 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. We delivered strong profit performance in second quarter. Our initiatives to increase gross margin are building momentum and we are controlling expenses in a softer-than-expected demand environment. We are managing those things under our control, and I want to thank our employees for their discipline and focus. Strengthening our portfolio of filtration businesses is under our control. To that end, I want to comment on last week's announcement.

As we discussed on February 24, Nelson Global Products made a binding offer to purchase our Exhaust and Emissions business. We got into Exhaust and Emissions in the 1920s when we began selling mufflers for tractors. Exhausted and emissions is our second oldest business, and it is our only business that could be characterized as non-filtration. We have great employees and customers, but Exhaust and Emissions does not leverage our core technologies or material science expertise, nor is there a replacement parts model that aligns with our razor-to-sell-razor blade strategy. Through that lens, Donaldson is not the best owner of Exhaust and Emissions, so working with Nelson makes sense. Pending consultation with our employee works councils in Europe, along with other customary and regulatory approvals, we would expect to close the transaction in the coming months.

Turning to second quarter results. Total sales were down 6% with benefits from pricing offsetting a headwind from currency translation. At a high level expected declines in our first-fit and new equipment businesses were compounded by a broad-based slowdown. Customers were cautious during our second quarter and then conditions worsened in February with the coronavirus outbreak. I'll touch more on that in a few minutes.

Turning back to second quarter. Engine segment sales were down 7%. About 2/3 of the decline came from our On-Road and Off-Road first-fit businesses. Second quarter On-Road sales were down 21%. Half the decline came from the U.S. as Class 8 truck production

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predictably slowed. However, third-party data indicates that we continue to outperform the overall market. On-Road sales in China were also down last quarter. We had difficult comparisons from the prior year, and the revenue remains choppy as we ramp up programs with local manufacturers, many of whom are new customers to Donaldson. In Off-Road, second quarter sales were down nearly 15%. Consistent with our expectations, about 1/4 of the decline was from Exhaust and Emissions as we compare against last year's pre-buys. Soft market conditions also pressured Off-Road. Second quarter sales to many of our largest customers in construction, mining and agriculture were down from last year. Based on persistent uncertainty, we expect these trends will continue.

Similarly, lower equipment utilization contributed to the 4% decline in Aftermarket sales. Both the independent and OEM channels were down in the mid-single digits with variability by region and market. For example, oil and gas is still a headwind in the U.S., while Eastern Europe is recovering after a soft business in the prior year. Importantly, our innovative products with strong aftermarket retention continued to outperform their legacy counterparts. These products are about 1/4 of total Aftermarket, and second quarter sales were up in the mid-single digits including PowerCore. The continued success with PowerCore validates our strategy: develop innovative products that solve complex problems and drive aftermarket retention. Second quarter sales in aerospace and defense were up almost 1%. Sales to helicopters were up from the prior year and our replacement parts business continues to perform well.

Second quarter sales in the Industrial segment were down 3.5%, driven by Industrial Filtration Solutions and gas turbine systems. The 5.9% decline for Industrial Filtration Solutions, or IFS, has several moving pieces. Sales related to dust collection, which make up about 60% of IFS were down in the high single digits. About 1/4 of the decline is attributable to a tough comp from last year and the rest appears to be market driven.

Customers are focused on their immediate needs versus investments for future growth, resulting in lower sales of new equipment. Sales of dust collector replacement parts were also down in the quarter. Lower utilization is extending the replacement cycle and customers are holding off on purchases. These near-term trends do not change our long-term view, so we will continue to invest for share gains with specific go-to-market strategies in all our major regions. We see evidence of share gains with innovative products happening already. Second quarter sales of new Downflo equipment for dust collectors were up in the mid-teens and the razor blade replacement part sales were up more than 30%. We believe the strong value proposition and high aftermarket retention of Downflo products will continue to drive profitable share gains in dust collection.

Process filtration is another example of gaining share and growing margin. Sales were up in the low double digits last quarter. We are winning new accounts with large strategic customers, extending our relationship with existing accounts and expanding globally. We continue to believe process filtration will be a powerful sales and margin driver well into the future.

Sales in Gas Turbine Systems, or GTS, were down about 12% in second quarter. Demand for new turbine projects remains low and delays in planned maintenance contributed to a decline in sales of replacement parts. We do, however, expect demand for replacement parts will recover as the maintenance happens.

I know I've done it before on these calls, but I feel compelled to once again recognize our GTS team. Year-to-date sales are down about $8 million, while profit dollars are up meaningfully from last year. The GTS team is doing an incredible job growing profit in a difficult business cycle, and they are making great progress on repositioning this business for long-term success.

Wrapping up Industrial, sales of Special Applications grew 11% last quarter. Our disk drive business was unexpectedly strong due to demand for near-line storage. We're not anticipating growth in our overall disk drive business will continue, but we will continue to pursue share gains in this highly technical market.

We are also gaining share with Venting Solutions, where sales were up in the low double digits last quarter. We continue to expand our offering for the automotive market, including powertrain and battery vents. These technical products align well with the growing demand for electric passenger cars, creating an exciting growth opportunity for us.

Overall, our model is working as we would expect. New equipment appears to be gaining share in a down market, replacement parts are outperforming first-fit by a wide margin and sales of innovative and proprietary products are growing.

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Overall cautiousness was the prevailing theme during our second quarter and that has been amplified by the coronavirus.

Before turning the call to Scott, I want to share some thoughts on the outbreak. Our top priority is the health and safety of our employees.

We have implemented several countermeasures to mitigate risks to them, including travel restrictions, work-from-home flexibility, extended facility closures in China, incremental cleaning schedules and the availability of specific items, like hand sanitizer and face masks, where appropriate. I'm very happy that as of today, none of our employees have reported being infected with coronavirus. We will continue to promote health and safety in all Donaldson facilities around the world. Specific to China, our operations in Wuxi are stabilizing after an extended closing period following the Chinese New Year. Since reopening on February 10, we have been ramping up production as our staff returned to work and nearly all our suppliers are back online.

Orders are down from our forecast, which is to be expected, but they have started to ramp back up as customers resume operations. As a reminder, China is 6% to 7% of total revenue, including about 1/4 of our global disk drive production. Outside of China, we have not yet experienced significant disruption, but the cautious stance is clearly visible. We are executing on contingency plans, while closely monitoring the situation in places like Italy, South Korea and Japan.

Overall, I'm very proud of the level of global collaboration our teams have demonstrated in response to the outbreak. It is truly impressive. The hard part for us and all companies is assessing the near and medium-term impact from coronavirus. We have factored some incremental uncertainty into our fiscal '20 forecast, which I'll let Scott cover more in his remarks. Scott?

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

Good morning, everyone. I want to echo Tod's sentiment. Our teams are doing an excellent job navigating the challenges created by the coronavirus. As the outbreak in China was becoming more serious, we were beginning the second quarter financial close. That's a stressful time in any quarter and our teams rallied together to support the process. I am really impressed by what they accomplished. The coronavirus outbreak is one more item on a long list of things that are making our customers cautious. Based on the general slowdown across markets, we revised our full year forecast. I'll talk more about that later. But first, let me provide a quick overview of our second quarter key financial metrics. We converted a 6% sales decline into EPS growth of 9%. We feel good about our profit leverage and nonoperating items pushed the EPS to a second quarter record of $0.50. Operating margin grew 70 basis points to 12.8%, including a 50 basis point headwind from incremental depreciation related to capacity expansion. That's our strongest second quarter operating margin since 2012. Profit margins were also strong in both segments, with Engine and Industrial up 90 and 160 basis points, respectively.

Consolidated gross margin grew substantially to 33.7% from 32% last year. Of the 170 basis point improvement, we estimate about 1 point came from our optimization initiatives. New capacity is coming online, we are steadily adjusting the supply chain, our procurement teams are driving cost reductions and our commercial teams continue to manage pricing. Solid progress on these initiatives was complemented by a favorable mix of sales and lower raw material costs. As we said coming into the year, increasing gross margin is our top operational priority, and we are pleased with the progress.

Operating expenses as a rate of sales increased to 21% from 19.9% last year, driven primarily by a loss of leverage on lower sales in the quarter. We continue to spend wisely by managing discretionary expenses while funneling dollars towards R&D and our advanced and accelerated portfolio. Second quarter nonoperating income was about $2 million better than last year and our forecast, driven by lower loss on foreign exchange. Our consolidated tax rate of $22.2 million was also better than expected, reflecting benefits from stock option activity and a favorable mix of earnings. We made dividend payments of $27 million in the second quarter and did not repurchase any shares. We take a long view of share repurchase and consider many things, including our leverage ratio, the business outlook and our liquidity needs, which means that the amount of repurchase in any quarter can vary. We are still committed to 2% this year and have purchased half of that amount in the first quarter.

Our balance sheet remains in good shape. At the end of the quarter, we had a 1x net debt to EBITDA, and our working capital was down from the prior year, which is what we would expect in a slower sales environment as we make progress converting receivables and

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optimizing our payables.

Our balance sheet is a competitive advantage, especially as markets turn down. Based on where we are today, we feel confident that we can continue pursuing our long-term strategic priorities. As we think about the second half of fiscal '20, we have one goal, think and act long-term by controlling what we can.

With that, I'll walk through our guidance, starting with the economic environment. Regarding coronavirus, the situation is changing too rapidly to give a precise estimation of the near- or long-term impact. February sales in China were soft, but the rest of the world is more consistent with trends in the second quarter. Given the overhang of uncertainty from a variety of factors, including coronavirus, we made a downward revision to our forecast and kept our guidance ranges wide. We now expect full year sales to decline between 3% and 7%, including a headwind of 1% to 2% from currency, that should be partially offset by pricing. About 80% of the change in our sales forecast relates to lower projections in the second half of fiscal '20. We now expect the back half to be down in the mid-single digits from last year. Within the back half, we anticipate the sequential increase from second to third quarter will be much smaller than our historic average over a long period.

In the Engine segment, full year sales are expected to decline between 5% and 9%. We did not change our Aerospace and Defense forecast, which is up in the mid-single digits. For On-Road and Off-Road, we now expect full year declines in the high teens as the equipment production slows further. We also estimate a lower level of equipment utilization, so sales of aftermarket are now forecast down in the low to mid-single digits. Importantly, we continue to expect share gains as our innovative products outperform legacy technology.

Our Industrial segment sales are now projected between a 3% decline and a 1% increase. We continue to expect Special Applications will be down in the low single digits as increasing market level uncertainty unwinds the strength we had in second quarter. GTS is now projected to be about flat with last year, driven by a lower rate of growth in sales of replacement parts. Sales in IFS are now projected down in the low single digits, reflecting continued strength in process filtration that is offset by a softer market conditions for dust collection. We still expect to perform better than the market, but it's likely that new equipment and replacement parts will remain under pressure from a cautious customer stance. Based on lower sales in both segments, our full year operating margin is now forecast between 13.5% and 13.9%. We continue to expect a notable year-over-year increase in gross margin, reflecting benefits from the initiatives we outlined earlier.

Additionally, we plan to keep tight control of operating expenses, and we expect our incentive compensation headwind will be less than $5 million, down from $10 million in our prior forecast. The implied decremental margin in our current versus prior guidance is in the low 20% range, which we view as strong, given the unexpected sales decline. We also made a handful of other adjustments to our forecast. Full year interest expense is now projected to be about $18 million, other income is projected between $7 million and $11 million with the change driven primarily by the second quarter favorability, and our effective tax rate is forecast between 24.3% and 25.3%. We still expect capital expenditures of $110 million to $130 million, share repurchase of 2% and cash conversion of 80% to 95%. Altogether, we now expect full year GAAP EPS between $2.05 and $2.19.

Please keep in mind that our forecast is not adjusted for the potential E&E transaction. Pending completion of the necessary steps in closing the transaction, we will provide a more comprehensive view of how the divestiture impacts our financial metrics and outlook. Until we close, we are unable to provide detail beyond what's been shared. As we look to next year, current market conditions and the impact from the coronavirus make our fiscal '21 projections more uncertain. Based on where we are today, we expect our sales and operating margin in fiscal '21 will be below the ranges provided at our Investor Day last April. While the forecast is under review, the themes for Investor Day remain intact. We plan to direct investment to our Advanced and Accelerate portfolio, which will drive share gains and increase our margin profile. We will extend into new markets by developing new technologies and leveraging our existing portfolio, and we have a disciplined approach to capital deployment. We focus on generating strong returns and returning cash to shareholders.

With a stable base of recurring revenue, which makes up more than 60% of total sales, we believe we are well positioned to execute on the initiatives, while effectively managing through a more uncertain economic cycle.

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

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

Thanks, Scott. While markets are uncertain, we remain focused on supporting our customers and driving our strategic priorities through innovation. While we feel confident in our efforts, external acknowledgment is also positive.

Our Filter Minder team recently enjoyed some recognition from a well-regarded industry publication, which included our wireless monitoring system on their list of top 20 products for 2020. Products were judged on innovation, the ability to address important industry issues and the potential to improve a fleet's bottom line. We are pleased to be on this year's list, and we're excited about the commercial launch of our monitoring solution. Customers can easily retrofit our device on to existing systems, giving them better visibility into their filtration performance and the ability to optimize service intervals. We are also expanding the launch of our Industrial segment's connected solution, iCue. We began selling iCue in the U.S. late last year, and we plan to expand to other parts of the world in the coming months. Like our Filter Minder offering, iCue can be set up easily and provides real-time information to users about the performance of their dust collection equipment. We also continue to innovate with our existing portfolio of products. A long-running example is PowerCore. We launched the product 20 years ago and made our 40 million filter last year. We have continued to evolve PowerCore, making it better for our customers and more efficient for us to produce.

Based on a study we conducted last year, which compared PowerCore against the small number of competitive offerings, our performance advantage continues to hold up. With consistent use of PowerCore, we estimate that fleets with 500 trucks can save as much as $100,000 per year in fuel costs. By helping the engine work more efficiently, PowerCore can reduce fuel consumption, creating a strong economic and environmental value proposition. Our IFS products also provide benefits beyond just the economics. Manufacturing customers have historically focused on total cost of ownership and our products performed well against that measure. Recently, we are seeing increased engagement as our technology helps customers address higher levels of safety and environmental regulations. Places like China, where they are launching the Blue Sky initiative, and Mexico where new pollution controls are being implemented in certain cities, allow us to expand our business in underpenetrated markets.

Our company's purpose statement is "advancing filtration for a cleaner world," and these opportunities are exactly how we do that. I'm excited about the role Donaldson will play in driving towards solutions that have strong economic, social and environmental value propositions. With our deep understanding of filtration and media design and development, I believe we are uniquely positioned to meet that growing need. As I close our prepared remarks, I want to once again recognize our team's efforts related to the coronavirus outbreak. The situation is changing rapidly, and they're working to stay on top of it. I am truly impressed by the level of global coordination, and I am inspired by the amount of support and teamwork. We often talk inside the company about acting as one Donaldson, and I am witnessing the power of that mindset firsthand, further adding to my conviction that Donaldson company will continue to be a global leader in the filtration industry.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Brian Drab with William Blair.

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

Just first on the Exhaust and Emissions business, can you make any comment on what the operating profit is within that business or even where it is relative to the corporate average?

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

Yes, this is Tod, Brian. Overall, what we've said in the release that in 2019, the revenue was roughly $120 million. We would also tell you that the profitability is below company average.

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

Okay. And then it sounds like the GTS business, obviously, is doing really well in terms of profitability. Was there anything in particular that happened in the quarter that drove that -- is that level of profitability sustainable? And was that the main factor that drove the outperformance and profitability for the industrial segment?

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

Nothing unusual that we didn't expect, to be truthful. It's really just excellent execution. That team put together a strategic plan 3 years ago. Frankly, they just planned their work and work their plan, and they're just doing a great job.

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

So sustainable level there? And was that profitability in that business, the main reason that you beat my expectations -- I think you beat your expectations for the quarter and profitability in Industrial. Is there anything else going on in Industrial? Or is that the main driver?

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

No, I think the main driver, overall of the company, is really that we've been working on our gross margins all year, and we have had really strong execution to the gross margin improvement plans on a broad-based level all across the company all -- in all regions. And so we're very proud of that, and you can see that reflected and leverage all the way to the bottom line.

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

Okay. And then on pricing, you guys mentioned that price is going to allow you to offset some of these headwinds. Commodity prices have I think, generally, been coming down in steel and filtration media. I would imagine, there's polymer and oil derivatives. What are you expecting for price as contribution to revenue growth for the full year? And maybe you can see what you're expecting in the second half of the year? And how are you getting that price?

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

Brian, this is Brad. The realized savings on a like-for-like was down in the low single digits in the second quarter. So certainly it creates some favorability. It's interesting, though, because it really is still a mix of price by raw material. So filtration media for us actually ticked up slightly as a cost in the quarter, whereas steel, as you point out, is down, more aligned with what you're seeing in the indices. In terms of the back half, we think the favorability will start to narrow because we had some favorability towards the back end of last year as we made progress on some of these initiatives. But I'd echo Tod's comment on execution on our procurement side, they're doing a lot of work to be smart about how we're buying as well, and that's helping us also.

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

So in terms of price increases as a contribution to revenue growth, are we talking about -- like, you're getting 50 basis points of price or 100 basis points? Or is there any comment there that could be a little more specific.

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

In terms of pricing or pricing of raw materials?

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

I'd -- well, okay. Well, maybe I misheard, but just so let's just be clear. I thought that in Scott's comments that he said that pricing would offset some of the headwinds that you're seeing there. And I'm assuming we're talking some about selling price. He only was talking about pricing...

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

You're correct, Brian. This is Scott. You're correct. I did mention pricing, which meant prices to our customers. So we expect to have a continued small pricing benefit, which will help to offset some of the negative currency impacts that we're expecting. So you had that correct.

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Operator

Your next question is from Laurence Alexander with Jefferies.

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

This is Dan Rizzo on for Laurence. When you talk about the gross margin improvements and the increased profitability, is that more from mix improvements of new products? Or is that productivity gains?

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

Our gross margin improvement is driven by several factors. Number one, and most important is the initiatives that we are specifically undertaking to really try and drive the gross margins up, which was always our plan for this year. So the improvement this quarter of 170 basis points, we estimated that 100 basis points were driven solely by our improvement initiatives. We do get a benefit of mix, and we also had a benefit of raw material pricing, offset slightly by deleveraging due to reduced volumes. So there are several factors driving that. The biggest of which is the initiatives we're undertaking.

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

Okay. And then a couple of more questions. The first, do you have any exposure to 737 Max within the Aerospace and Defense, in the A&D segment?

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

No.

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

Okay. And finally, just given the changed dynamics and the kind of volatile landscape, how is that affecting, I guess, M&A or the pipeline of potential new acquisitions?

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

Yes. There's really no change in the M&A activities. The way that we view the M&A activities, we would suggest to you that we still have a full pipeline, strategic. And remind you that we remain a selective buyer, a disciplined buyer, if you will, relative to the metrics that we view from a valuation principle. So no real behavioral changes at this point quarter-over-quarter.

Operator

Your next question is from Nathan Jones of Stifel.

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

This is Adam Farley on for Nathan. Going back to the gross margin line and the capacity you guys added, so where is the business in terms of capacity constraints today? Are there still any pockets in the business experiencing capacity issues? Or is declining demand kind of easing that across the business?

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

Yes, this is Tod, Adam. So capacity, we're comfortable with where we are relative to capacity. The expansions that we have done in the past year really are paying off. We talked about our supply chain normalization internally to the corporation that's helping with our gross margins, and that's part of that strong execution that you saw within the quarter. We still have some of that normalization ahead of us in the balance of the fiscal year, but we're very comfortable where we are on the capacity side of things and utilizations across the company.

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

Okay. And then turning over to Engine aftermarket down in the quarter. Can you provide more color on what end markets were weakest? How aftermarket progressed through the quarter? And then the OE channel versus aftermarket, are you seeing destocking? I know last quarter, you said it was real demand. Any color there would be great.

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

Sure. So the decline, if you take a look statistically is led by the U.S. It's our biggest piece of the aftermarket business. It does have a nuance in it when you compare it to Latin America. We have had some strategic shift of that supply chain normalization. If you just look and normalize that then Latin America would be roughly about flat and U.S. would be down about 5% rather than the reported 6.8%. So that's a small nuance. But at a macro level, overall aftermarket, it's really a story of utilization now down across led, as I said, by the U.S. but across all regions. And so it starts with transportation, a lot less goods being moved and then it moves into oil and gas. The oil and gas piece being more of a U.S.-based story, therefore, helping the U.S. to lead the downward cycle. And so OE versus independent channel is off both about equal, is how to really look at that. So when you factor in everything that we're seeing, we would suggest to you that we are not seeing some kind of a step down and acute destocking across the industry. We would tell you that it's more of just a normalized slowdown, and you can see that in reduced pull-through to the overall aftermarket business.

Operator

I now turn the call back 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. And to our 14,000 employees, I want to thank you for all you do. Your safety is our priority. So please continue to do an excellent job navigating in this dynamic situation. Thank you, and goodbye.

Operator

Ladies and gentlemen, this concludes today's conference call. You may now disconnect.

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