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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Donaldson's Fiscal 2020 Third Quarter Earnings Call. (Operator Instructions)

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

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

Thanks, Julianne. Good morning, everyone. Thank you all for joining Donaldson's Third 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 third quarter performance, including an overview of how we are navigating the complexities created by the coronavirus pandemic.

I want to remind everyone that we issued a business update press release on April 28, which included some details that we will reference on this morning's call. During today's call, we will also reference non-GAAP metrics. We included a reconciliation of GAAP to non-GAAP metrics within the schedules attached to this morning's press release. Finally, please keep in mind 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 hope that all of you and your families are staying safe as we deal with these unprecedented times. One thing the pandemic has brought to light is the hard work of everyday heroes, so I want to express our profound appreciation for the frontline workers that keep the world moving forward, and that includes thousands of Donaldson employees. I'm always impressed by our employees, but I'm particularly proud of their performance during the pandemic. Every day, they show up with a relentless customer-first attitude, which is more important than ever as we support critical markets like agriculture, transportation and food and beverage. To my Donaldson colleagues around the world, thank you for everything you do.

Since the outbreak began, our decision-making has been guided by 3 priorities: supporting the health and safety of our employees, delivering on our customer commitments and doing our part in reducing the transmission of the virus. Providing a safe work environment is always a top priority, but we intensified our efforts. We have significantly limited business travel, implemented a thorough cleaning regimen in factories and office spaces, instituted remote work policies for all that are able and introduced COVID-related paid leave while promoting existing employee assistance programs. Our crises response team reviews these protocols regularly, and we adjust when appropriate. Social distancing practices and enhanced cleaning schedules will be in place for the foreseeable future, and we are reopening our offices in various locations around the world. The pace of bringing our employees back to the office will be dictated by guidance from health experts, along with our own assessments of workplace readiness. We are taking a cautious approach, and we will remain flexible as we execute these plans.

I also want to provide an update on the status of our operations. Overall, we're in a good position and have not experienced meaningful

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disruption. Our success can be attributed to a handful of factors, starting with our footprint. We have a region-to-support-region production strategy, and that allows us to be nimble and flex appropriately based on local conditions. That has been incredibly valuable as the pandemic affected different parts of the world, in different ways, at different times. Additionally, our diverse portfolio of businesses is heavily biased towards replacement parts and essential or critical markets giving us the opportunity to continue production during government-mandated shutdowns. These structural benefits have been brought to life by our excellent team. There has been an unprecedented level of collaboration and coordination amongst us, our suppliers and our customers, and our teams are acting quickly and decisively to mitigate risks and deliver on our commitments.

Of course, things are still uneven, so I want to provide a rundown of our operational situation today. The Asia Pacific region is in recovery mode, with China furthest along. Conditions in India are still tighter than other countries, but that has been loosening, and we are on a good path. Europe is in various stages of reopening, and our supply chain risk has gone down over the past month. The temporary shutdowns due to government mandates have been lifted, and we are stabilizing rapidly. The Americas are further behind on the recovery curve with varying degrees of lockdowns continuing in South America, while large customers in North America only recently began reopening their factories. The global situation has been improving in recent weeks. All our critical suppliers are online, and our production employees are at work and engaged. Based on these factors, I am confident we can continue supporting our customers around the world.

I'm going to turn now to a brief overview of our third quarter sales, which were slightly better than we expected based on a strong finish in April. Total sales for the quarter were down 11.7% from the prior year, or 9.7% without the currency headwind. Engine segment sales were down 14%, reflecting a sharp decline in our first-fit businesses. While it is impossible to precisely estimate the impact of COVID-19 on our results, our first-fit businesses were clearly under pressure as many large customers stopped producing equipment during the quarter. In our On-Road, sales were down 47% as customer shutdowns were compounded by an already weak truck market in the U.S. and China. As a reminder, our first-fit On-Road business is only about 5% of total revenue, so our aggregate exposure to the truck market is limited. In the U.S., which is the largest portion of our On-Road business, third-party data indicates that our sales fared better than total Class 8 truck production. Based on our track record of program wins, we are well positioned to have a strong performance when this market recovers.

Third quarter sales of Off-Road Products were down 25%, with more than half the decline coming from Exhaust and Emissions. We are comparing against a large increase in Europe last year related to pre-buys for an upcoming regulatory change, so we expected pressure this fiscal year. As a side note, we continue to work on the transaction related to the sale of our Exhaust and Emissions business to Nelson Global Products. We will provide more details as we have them, but for now I want to reiterate our commitment to the strong relationships we have with our employees, customers and suppliers. Excluding Exhaust and Emissions, third quarter sales of our filtration-related Off-Road Products were down in the mid-teens. On a relative basis, products for the agriculture market performed better than the construction and mining markets. And overall global demand for new equipment remains under pressure.

Engine Aftermarket performed much better than our first-fit businesses in the quarter and results were mixed by channel and region. The total Aftermarket decline of 8% was primarily due to a low double-digit decline in sales through the independent channel. The pandemic is contributing to lower equipment utilization, and that impact was compounded in the U.S. by the collapse of the oil and gas market. Economic and geopolitical uncertainty in Latin America added to the pressure, but share gains in Eastern Europe and China were notable offsets as we build our presence in these markets.

Sales through the OE channel of Aftermarket were down only slightly in the quarter and up in local currency. We believe a portion of the demand was from large OE customers buying inventory ahead of need, so we expect additional volatility in future periods.

Rounding out the Engine segment, sales of Aerospace and Defense were about flat with last year. As expected, the commercial fixed-wing market is under pressure, but we were able to largely offset the impact with growth in filters for ground defense vehicles and helicopters.

Turning to the Industrial segment. Sales were down 6% in third quarter, driven by a 12% decline in Industrial Filtration Solutions, or IFS. Our dust collection business, which makes up 60% of IFS was hit hard by the pandemic. Our quoting activity and replacement demand

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were under pressure as economic uncertainty went up and global industrial production dropped. We remain confident in our value proposition and expect that quoting will go back up as the economy reopens, but it is too soon to say how long that will take. But we are not just waiting for the recovery. Our Industrial Air Filtration team has done an excellent job engaging our customers with things like virtual trainings, reinforcing our brand as a strategic and supportive partner.

The pandemic has also given us an opportunity to demonstrate our value proposition in process filtration. Sales in Europe and the U.S., our 2 largest markets, were both up year-over-year, and in local currency, sales for all process filtration were up in the low single digits. We continue to expand our share in the food and beverage market, and this business remains a strong contributor to our future growth and profit margin expansion.

Third quarter sales in Gas Turbine Systems, or GTS, were up 6%, driven by strong sales for Retrofit projects. Like the large turbine projects, Retrofit sales can be lumpy. We had a solid performance last quarter, and we remain very proud of the improved profitability in GTS.

Special Applications sales were up 5% in third quarter, driven by strong growth in disk drive and Venting Solutions. Our disk drive business continues to benefit from share gains and increased expansion of nearline storage for the cloud, and growth in Venting is related to value-added solutions for batteries and powertrains in passenger cars. Given the state of the auto industry, the Venting performance was particularly impressive. We are leveraging our technology and pressing into a new market to meet an expanding need. There are powerful examples across the company of how innovation is driving results, and the pandemic has not changed our long-term priorities. I'll talk more about that later.

Before turning the call to Scott, I want to provide a few comments on trends in May. Total sales for the month are expected to be down about 24% from last year. Many of our large OE customers reopened facilities in the month but we did not see much of a rebound, which may relate to the inventory building that occurred during our third quarter.

On a regional basis, sales trends are consistent with what we saw in third quarter. Asia Pacific is performing the best, while sales in the Americas are the weakest. Sales in China were up in the month, which is the best performance we've seen in a while, but there is also quite a bit of uncertainty related to the durability of the increase, so we are more cautious than optimistic at this point. The situation in both North and South America remains challenging and it is hard to find bright spots in those geographies today.

In terms of product sales, replacement parts are predictably doing better than new equipment. Businesses like Engine Aftermarket and process filtration offer a bit of relative stability, while new equipment production for engine-related products and capital investment for dust collection systems were still under pressure. While we would not typically go into detail on the current quarter trends, we felt it was important to give a little more context given the extraordinary pace of change.

As we contemplate the final 2 months of this fiscal year and our plans for fiscal '21, we will remain focused on executing those things under our control, including promoting the safety and well-being of our employees, maintaining tight control on discretionary expenses, making targeted investments to support near- and long-term growth priorities and protecting the strength of our financial position.

I'll now turn the call to Scott for an update on our other key metrics. Scott?

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

Good morning, everyone. I want to echo Tod's sentiments. Donaldson has great employees. The way we work has changed rapidly during the pandemic, and our teams have stayed connected, remained productive and delivered results. I want to thank our employees around the world for everything they're doing to keep us moving forward. As predicted, third quarter was a volatile period. The demand environment deteriorated for month-to-month and things became more uncertain as COVID-19 spread broadly. Unfortunately, the situation is still unclear. Economic conditions are varied by region and markets, resulting in uneven and unpredictable demand. Given that, we feel it's prudent to continue to withhold fiscal '20 and '21 guidance for our key financial metrics.

I will, however, talk about some general expectations during my remarks. So I'll turn now to a recap of third quarter performance. All

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things considered, we are in good position today. Despite a sales decline of 12%, our third quarter EBITDA margin was flat with the prior year. Additionally, our decremental margin was about 19%, which is significantly better than our historic average in the mid- to high 20% range. The favorability was due in part to product mix and lower incentive compensation, so let me take you through some of the puts and takes. Third quarter operating margin was 13.4% compared with 14% in the prior year. Lost leverage on lower sales was the primary driver of the decline, and that impact was compounded by higher depreciation related to our capacity expansion projects. Based on the nature of these investments, the third quarter depreciation impact was skewed towards gross margin in the Engine segment. Overall, our teams are doing an excellent job mitigating the pressure created by lower sales.

In terms of gross margin, plant managers are quickly adjusting labor to account for changes in demand, and our procurement and supply chain teams continue to drive optimization initiatives that will have long-term benefits. These efforts, combined with favorable mix of sales and lower raw material costs, narrowed the third quarter gross margin decrease to 60 basis points. Additionally, we had strong operating expense performance in the third quarter. On a dollar basis, operating expenses were at the lowest level in 3 years, which comes after 3 years of incremental investments related to our Advance and Accelerate portfolio and R&D capabilities. I want to add that we are not pausing investments in these initiatives, which are critical to our long-term growth plans. As a rate of sales, third quarter operating expenses were up only slightly from the prior year. We had favorability from incentive compensation, which was down nearly $6 million, and discretionary expenses were significantly reduced in relation to COVID-19. Despite the near-term pressures from the pandemic, we are pushing forward on our margin initiatives. New capacity that brings a lower cost to manufacture 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.

The list is the same as what we have been sharing for more than a year. These are our top priorities and regardless of the macro backdrop, we feel confident in our ability to continue making progress. We also feel confident in our financial position. At the end of the third quarter, our leverage ratio was 1.0x net debt to EBITDA, which is where we were at the end of the second quarter and right in line with our long-term target.

Working capital was down from the prior year, driven by reductions to receivables and inventory, and our cash conversion in the quarter was 98%. We continue to work with our suppliers and customers to manage credit and supply chain risk, and we are also working with our valued banking partners to further bolster our liquidity position. Out of an abundance of caution, we drew an additional $100 million from our revolving credit facility during third quarter. Then later in May, we entered into an additional 364-day credit agreement that gives us access to another $100 million. At the same time, our pace of capital expenditures is decelerating. Third quarter CapEx declined by more than 40%, and the spend trajectory is consistent with what we communicated previously. Importantly, the projects were already in various stages of completion as COVID-19 spread, so we could finish these projects without putting our financial position at risk. Although the demand environment today is materially different than it was a year ago, we still feel confident these projects will improve our cost structure, strengthen our customer service at local level and position us to grow in strategically important markets and geographies.

Let me share a few examples of what we're working on. We are setting up our first PowerCore line in China to support new program wins and -- with local manufacturers. We doubled the production capacity for process filtration, position us for larger presence in the food and beverage industry and new capacity in the Americas and Europe allows us to optimize the point of manufacture for engine-related projects. We still have a little work to do, but our teams are working hard to get them online soon.

Returning cash to shareholders is another important part of our capital deployment priorities. We are committed to the quarterly dividend, which has been paid every year for more than 60 years and increased annually for 24 years in a row. As I've said to many of you, that's an awesome track record, and I don't want to be the person that messes it up. Of course, we regularly review our dividend policy and based on forward-looking scenarios, we feel comfortable with our ability to continue this impressive run. Share repurchase has always been the more variable component of our capital deployment. We have been regularly repurchasing our shares for decades, and we know that's a valuable activity to many of our shareholders. We take a thoughtful and measured approach in the execution of our share repurchase plans. Our minimum objective in any given year is the offset dilution related to stock-based compensation, which is about 1% of shares. The level of repurchase beyond that amount is governed by our balance sheet and other opportunities to deploy capital.

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We repurchased 1.6% of outstanding shares so far this year. Based on the uncertainty created by the pandemic, we do not expect additional share repurchase in fourth quarter. As the situation with the pandemic evolves, we will continue to prioritize a strong financial position and remain focused on executing our strategic priorities. That has been our approach for a very long time, and we believe it will serve us well for a long time to come.

Again, I would like to sincerely thank my colleagues around the world for their strong performance, and I wish all of you health and safety during these times.

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

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

Thanks, Scott. Donaldson Company turns 105 this year. We have experience with every type of economic environment, and we have always emerged to become an even stronger company. Our playbook is simple and consistent. We leverage our deep technical expertise to build a portfolio of filtration capabilities that we deploy into a diverse set of markets. We are a returns-focused company. We think long term while maintaining a clear focus on those things we control in the near term. The pandemic has no impact on this playbook or our strategic priorities, which always starts with technology.

Along those lines, I'm very excited to share that our new material research center is nearing completion. This R&D facility has a $15 million investment in building our material science capabilities. We leverage some of this know-how in our process filtration business today, but the new facility is going to give us a significantly stronger platform. We plan to further penetrate the food and beverage market, followed by future expansion in specialty chemicals, electronics and eventually, life sciences. These markets are less cyclical, highly technical and therefore, highly profitable, making them an attractive complement to our strong Engine business.

Technology remains a core part of our Engine strategy as well. We want to win new business with products that drive Aftermarket retention. While the pandemic has created uncertainty, we are still working with large OE customers on new programs, and their demand for proprietary products is going up as they look to grow their parts business. Through our technology, Donaldson becomes a core part of the customer's growth strategy, giving us a wide competitive moat. The value of these products to our company has been demonstrated year-after-year, so we continue to make investments.

We recently introduced a new generation PowerCore filter called PowerCore Edge. It has the smallest footprint of any generation yet, and our world-class media makes it an excellent solution for Off-Road applications that face heavy dust environments. PowerCore Edge will be another powerful tool for driving long-term share gains in our core markets. Additionally, we are building our first PowerCore line in China. As large Chinese manufacturers move up the technology curve, a couple of things happen that create opportunity for us. First, a higher performing piece of equipment requires more advanced filtration. With our strong global brand, decades-long presence in the country and significant experience supporting world-class OEMs, we are a natural partner for the Chinese manufacturers. Second, when end users buy a more expensive piece of equipment, they are more likely to maintain it properly. That makes PowerCore particularly interesting. As the replacement cycle is created in China, retaining the parts business is now valuable to those manufacturers.

Advancing our R&D capabilities and growing our portfolio of innovative products are what we would consider standard work at Donaldson. As I mentioned, we think long term, and we are committed to creating value for all our stakeholders. I am confident we can deliver on that commitment because we have dedicated, talented and incredibly smart teams in every part of our company. Once again, I want to thank our employees for all they do. I'm proud to be on the team with them.

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

QUESTIONS AND ANSWERS

Operator

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

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

I guess I'll start with the short-term questions. Your guys -- third quarter here spend a pretty wide range of business conditions covering February, March and April. You said you expect May to be down 24%. Could you compare that to what April was down? I think out in the market at the moment, we're hearing customers going back to work, but not really doing that much in terms of buying in May, more kind of figuring out what they're going to make, what they need in order to do that and with some expectation that maybe June gets a little bit better. So can you comment on whether or not you think April and May are kind of the bottom of this cycle for you?

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

Sure, Nathan. This is Tod. When we look at April, we had some project-based businesses that had some pull forwards in the very end of the month. And so we had a nice pickup, frankly, better than we had expected, but they were slated to go in our May time frame. And so when we look at April and May, actually, they were about the same when we combine the 2 together, is the way we would forecast that. So we did not see a pickup or really further deterioration in May. Now whether that's bottom? Tough to call. I -- we really don't know that. We did see a number of OEs come back to work in the month of May, but we also believe that this will be fits and starts ahead of us, just because of the fact that OEs will be trying to find what their overall first-fit production rates are and their demand pull-through will be. So we look -- again, we look at April and May to be roughly about equal. And we're a bit more cautious about June and July based upon the first-fit-based businesses that we see.

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

Okay. You guys have finished a lot of these capacity additions. Those were supposed to be accretive to your gross margin level. So I'm sure that probably helps with the decrementals as we go through this. Can you comment on what kind of decrementals you're expecting to post here in the fiscal fourth quarter?

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

Well, we -- and Nathan, this is Scott. So yes, we are proud of the accomplishments that we've had with all of our expansion projects and those help us to normalize the supply chain as we've talked about, to reduce our cost, to improve our freight situation. And so as you stated, we would agree that, that helped our margin in the fourth quarter to be less down...

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

Third quarter.

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

Sorry, in the third quarter. In the fourth quarter, we would expect that help to continue. The big question is what will the volumes be that will drive the absorption. And that's kind of a tough call right now, but we expect to continue the tailwind from the initiatives that we've undertaken.

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

Nathan, this is Tod, maybe just a little bit more color. So the discretionary expenses are being fantastically controlled by decision-makers all across our company everywhere in the world. And some of those things, such as travel and entertainment were down 80% on normal run rates. We're not going to be able to withhold that over the months ahead. Eventually, we have to lighten that back up and let people really press back into the marketplaces. And so there's some puts and takes there such as the comp activities that Scott talked about also that give us a little bit more favorable tailwind in the third quarter than we would expect looking forward. A little bit tough to predict the overall decremental margins. Clearly, we're running better than we would have expected on the models as we went into February. And the commitment that we have to all of you is that we will continue to be very diligent in controlling what we can in our operational expenses.

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

Just one quick one on the potential OEM aftermarket channel inventory stocking. This might be a bit of a hard question to answer, but do you have any information on maybe what that added to revenue or? How many points of growth that added to revenue that we might have to pay back here at some point? And I would think that maybe that inventory destocking doesn't come for a little while. If those OEMs are still worried about their own supply chain, they might run that inventory a little higher for a little longer.

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

Yes. I think that's a fair comment. The way that we would see it is we're not sure when it will come. Clearly, the OEs are holding on the inventory. We already saw some destocking in the independent channel. Clearly, the OEs are holding on likely a little bit longer until they find what their pull-through rates will be. Really difficult for us to predict at this point in time.

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

Nathan, this is Brad. And maybe to put a fine point on some of the details that Tod mentioned in his remarks, the independent channel of our Aftermarket business, sales through that channel typically are in the neighborhood of 60% of Aftermarket. And in the last quarter, it was about 55% as that channel slowed more substantially than the OE channel. Now, we never know precisely whether or not an order is restock or destock, so we can't really talk to that specifically. But we do look at the trends between independent and OE to see if there's any sort of alignment or lack of alignment. And clearly, this last quarter, there was a lot of lack of alignment, about a 10-point spread year-over-year between the 2. So that gives you a little bit of a sense of magnitude of what we saw on the OE channel. But to the points Tod made, I mean, it's really tough to see where that would come back to.

Operator

Your next question comes from Brian Drab from William Blair.

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

So if I -- again, as Nathan did, I'm going to think about some near-term questions and just sorting through the impacts of the pandemic. But if I used the assumption that April and May were roughly similarly tough, is it fair to assume that at this point, based on what you saw as you exited May, what you're hearing from the customers that June and July, probably are tougher than the environment that you had in February and March? And thus, the fourth quarter is down sequentially on the top line for sure? Can you give any...

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

Yes. Really hard to predict, Brian -- Yes, so let me just give you a little bit of color. Really hard to say on that, Brian, just simply because, clearly, we see order incoming patterns, and we try to match that up with all the plant shutdown notices. We do have some customers that came back in May, then shut down -- then the plant shutdowns in June. And so that's the fits and starts that I referred to earlier. And so therefore, because of that situation, and then on again, off again, it's really difficult to predict where we are on this first-fit cycle of things. It -- there's no consistent line to be drawn at this point.

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

So there's no way, Tod, that you can say, well, I saw things better at the end of May versus the beginning?

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

No. I -- okay -- we actually did that analysis. I was very curious about it. And after parceling through every morsel of it, I gave up on it because, yes, I couldn't really say that with strong conviction that I can give you a line on that.

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

Okay. And then just asking that -- maybe it's a question about decrementals, but just asking another way. But let's just say, given all the levers that you pulled, if revenue -- just as a scenario, if revenue were to be similar in the fourth quarter compared with the third, would gross margin be about the same or up or down from what you reported in the third?

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

Yes, I'll start. So we had a good mix in this last quarter. So I think if you made some assumptions, which obviously you have to do in this kind of situation. But if our mix held, I think we can maintain those margins. We have a lot of different businesses in there. There's a lot of puts and takes going on, so it's hard to say. But I think if we presumed a relatively consistent mix and reasonable sales, I think our margins could hold.

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

Yes. And I would agree with Scott. I think obviously our biggest variable, if you will, is how much of the first-fit business will come back within the fourth quarter, which is headwinds overall to margin-based mix and then our Special Applications business also, if -- should that experience some headwinds, as we would expect, that will also be some headwinds to the overall gross margin performance in the corporation. And so those are 2 of the significant mix components that we continue to keep a strong eye on in order to best understand where we are.

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

Okay. And just the same question on operating margin. Would -- given a flat revenue scenario?

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

Yes. The biggest impact would be, we had some incentive comp adjustments this quarter. So that was a $6 million expense reduction, and that's really catch-up from the first 3 quarters. So you have to annualize that. It wouldn't be as large in the fourth quarter. We would continue to manage our expenses aggressively and work to keep our discretionary expenses at low levels in light of the sales situation. So I would expect that to continue. We are at our lowest level in 3 years in terms of OpEx, so we're pretty proud of that performance. I think that shows that we're managing expenses tightly, especially in light of the fact that we continue to invest in the initiatives that we've talked about in the past. So I think save the incentive comp adjustment I would expect our operating expenses to continue to be managed that way in the fourth quarter.

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

Yes. And I just want to add a little bit of color here, Brian. I think it's important to understand that we are controlling what we can control. But throughout all of this, we're taking a long-term view. And we are not going to jeopardize the strategic health of this corporation, and that is the way we're managing.

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

Got it. No, understood, Tod. And Scott, just to be clear, you're -- on the -- you're talking about bonus accrual as -- is it -- is that -- was it tailwind in this quarter to margins, that isn't as big a tailwind in the fourth quarter? Did I understand that correctly?

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

Yes. That is correct. Both bonus and long-term incentives.

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

Okay. And then just lastly, these Aerospace and Defense orders that are -- this has been a good market for you. Does that continue or some of these larger projects maybe that you're doing there fall off?

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

So headwinds on -- clearly, headwinds on fixed-wing-based aircraft, being it made up on ground-based defense vehicles and helicopters. We would expect that performance to continue about where it is at the moment. Our teams have done an excellent job around the world, really filling in that gap and that headwind that fixed-wing aircraft is presenting.

Operator

Your next question comes from Laurence Alexander from Jefferies.

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

So just a couple of things. First, on the bonus accruals, can you help us think through what normalization would look like? Is that a headwind in 2021 or 2022? And...

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

Yes.

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

Can you help us with -- yes, can you peel back a little bit how you're thinking about planning assumptions for 2021, but also the longer-term growth, like what's really changed?

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

Well, those expenses, assuming everything else equal, and through a -- the third quarter benefit was $6 million, we'll get a fourth quarter benefit as well. So that will be a headwind for next year.

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

And Laurence, the long -- this is Tod. So the long-term playbook, nothing has changed for us. In fact, we would argue the investments we made into our corporation over the past 2 years with capacity expansion to allow for supply chain normalization, internal supply chain to feed (inaudible).

Editor

This transcript is incomplete due to a portion of the audio being unavailable. The following represents the missing audio portion and has been provided by the Company.

[Thanks, Julianne.

As we end today's call, I want to make one more comment. The tragic event that recently took place in our Twin Cities community and the violence that followed are greatly disturbing. I offer my deepest condolences to the family and friends of George Floyd and wish healing to those affected by the subsequent events that unfolded following the tragedy.]

I want to stress that Donaldson is committed to sustainable change; and we stand united with our communities and nation to stop the senseless cycle of discrimination

[That concludes today's call. I want to thank everyone listening for your time and interest in Donaldson Company, and I hope that you, your families and friends are safe.

Goodbye.]

Editor

End of of missing audio portion.

Operator

This concludes today's conference call. Thank you for your participation. You may now disconnect.

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