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# EDITED TRANSCRIPT

Q2 2021 Donaldson Company Inc Earnings Call

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## PRESENTATION

**Operator**

Ladies and gentlemen, thank you for standing by, and welcome to the Donaldson Q2 FY '21 Earnings Call. (Operator Instructions)

I will now hand the conference over to your speaker today, Mr. Charley Brady, Director of Investor Relations. Thank you. Please go ahead, sir.

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**Charley Brady *Donaldson Company, Inc. - Director, Investor Relations***

Thanks. Good morning, and thank you for joining Donaldson's Second Quarter 2021 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 second quarter performance along with an update on key considerations for fiscal 2021.

During today's call, we will reference non-GAAP metrics. A reconciliation of GAAP to non-GAAP metrics is provided 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 now turn the call over to Tod Carpenter. Tod?

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

Thanks, Charley. Good morning, everyone. Looking at second quarter results, we are pleased with our performance. Second quarter sales were up 3% versus a year ago and up 7% sequentially from the first quarter. Our second quarter results demonstrate the strength of our business model with replacement part sales providing valuable stability as we grew market share in key markets and geographies. During this quarter, we also built momentum in first-fit sales in our Engine segment, and we're seeing increases in incoming orders across our Industrial segment.

We are pleased to see the uptick in second quarter sales and incoming orders within our first-fit equipment businesses. While this creates mix pressures in the short term, it also sets the stage for replacement parts in our razor to sell razor blade strategy and provides continued confidence that the worst of the pandemic-related economic impacts are behind us.

We played the long game during the pandemic, maintaining our disciplined focus on the future and avoiding the temptation to make potentially shortsighted decisions on our cost structure. During the second quarter, we took planful actions with a longer view towards optimizing our organization and our cost structure, primarily in Europe.

We incurred $14.8 million in restructuring expense and expect annualized savings of approximately $8 million once the restructuring activities are completed over the next 12 months. Excluding the impact from our restructuring actions, gross margin was up 30 basis points from the prior year as lower raw material costs, including benefits from our procurement initiatives more than offset the increasing pressure from an unavoidable mix of sales.



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With continuing momentum, we expect full year sales to be up 5% to 8% over 2020, including favorability from FX of about 3%. We're also projecting adjusted operating margin to increase 60 to 100 basis points, driven largely by gross margin strength.

Finally, our company remains in a strong financial position. We had solid cash conversion during second quarter, and our balance sheet is in good shape with our net debt to EBITDA ratio sitting at 0.7x. Our balance sheet gives us ample capacity to pursue our strategic initiative to move into the life sciences market via acquisitions and continue to invest in organic growth opportunities.

We're delivering on our strategic and financial objectives so far in fiscal 2021, and we are planning for a strong finish to the year. Scott will talk more about our forecast later in the call. But first, let me provide some additional color on recent sales trends.

Total second quarter sales were up 2.6% from the prior year or 0.2% in local currency. Total Engine segment sales rose over 6%, and Industrial was down 4%. Geographically, the Asia-Pacific region led our positive performance as we continued to see very good growth in China.

In the Engine segment, the sales increase was driven by meaningful growth in both Off-Road and Aftermarket. The growth was partially offset by a slight decline in On-Road and a drop in Aerospace and Defense. Off-Road growth was widespread with sales in all major geographic regions up from the prior year. Importantly, our incoming order rates and backlog point to building momentum through the second half of fiscal 2021.

Within Off-Road, our second quarter sales in China were up about 70%. We are seeing momentum in the market with construction equipment build rates remaining at high levels. We are also seeing strong growth of PowerCore in China, and several new PowerCore programs for Tier 3 upgrades have gone into production.

On-Road sales were down about 1% in the quarter, which is our best year-over-year result since fiscal 2019, signaling to us that the second quarter was the cyclical trough in this business. Our view is supported by external data with order rates for Class 8 trucks launching higher in the past several months and higher build rates projected in the coming quarters. With increasingly favorable market conditions, combined with our strong share in North America heavy-duty trucks, we are optimistic about our opportunities to drive growth in our On-Road business. Second quarter sales of Aftermarket were up over 7% year-over-year, and they were also up 4% sequentially from the first quarter, which is atypical and serves as another indicator that market conditions are improving.

In China, second quarter sales of Engine Aftermarket were up over 30%. We are beginning to see service parts benefit from new equipment under warranty, which includes an increasing percentage that have proprietary PowerCore and PowerPleat air cleaners installed. Overall, PowerCore sales increased about 9% in second quarter with strong growth in both first-fit and replacement parts. As I mentioned earlier, in China, we are seeing significant growth, which we expect to continue as PowerCore becomes more mainstream.

Aerospace and Defense, which represents about 3% of our business, faced another tough quarter due primarily to the ongoing pandemic-related weakness in commercial aerospace while sales for helicopters continue to perform well. As we expect the time line for recovery in commercial aerospace to be protracted, we took restructuring actions within the quarter to improve our cost structure and better position the organization for the current business environment.

Turning now to the Industrial segment. Second quarter sales were down about 4%, including a 3% benefit from currency. We continue to face pressure on sales of dust collection sale products within Industrial Filtration Solutions, or IFS, as utilization rates were lower and customers remain cautious in making capital investments.

Once again, a bright spot in the quarter was Process Filtration. Our Process Filtration for the food and beverage market with our LifeTec brand continues to grow, particularly on the replacement side. Overall Process Filtration sales increased in the high teens with contributions from both first-fit and replacement. And we see a long runway for further expansion of this business.

We are making new inroads with some of the world's biggest food and beverage companies, and we are also gaining share with existing customers. The sales process for these massive brands involves winning at the parent and then selling one plant at a time, which is why



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we continue to grow our sales force and invest in new tools and resources. We launched LifeTec 5 years ago with fewer than 10 salespeople, and we're on track to be over 100 by the end of this fiscal year.

Sales of Gas Turbine Systems, or GTS, were down 3.5% in second quarter as large project deliveries, though a smaller part of our business, were less than the prior year. Our replacement parts business, on the other hand, delivered another quarter of double-digit growth. We continue to win share of aftermarket while being selective in which large turbine projects we pursue. The team has done a tremendous job of improving the profitability of GTS, and our more focused approach is clearly paying off.

In Special Applications, we again saw very good growth in integrated venting solutions as we continue to drive adoption in the automotive market with our high-tech products. However, overshadowing these wins were continuing softness in disk drive filters and lower sales of membrane products.

Second quarter results highlight the strength of our diversified portfolio of businesses and disciplined focus on the long game. We are well positioned to benefit from the recovery in cyclical end markets, and we continue to press forward on our strategic initiatives, including the recently announced investments to grow our life science business.

I'll talk more about that later. So now I'll turn the call to Scott. Scott?

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

Good morning, everyone. As Tod said, we are pleased with our second quarter performance. Sales were up 2.6% from the prior year, and adjusted operating income grew 7.6%. Given the uneven macroeconomic environment, it was a strong quarter in terms of both absolute growth and leverage. Looking ahead, we plan to build on that momentum.

As I said many times, we are committed to increasing levels of profitability on increasing sales. I know I'm repeating myself, but I also want all of you to know that statement is a guiding principle for us. One way we deliver on that commitment is through select optimization initiatives, which is how I would characterize the restructuring actions we took in the second quarter.

Most of these activities are happening in Europe, and all of them support our long-term objectives. For example, we are centralizing key aspects of our aerospace business, giving us a strong platform for when the market returns to growth. We are moving the production of certain compressed air products to Eastern Europe, where we have an excellent team and a competitive cost structure. And, we are centralizing our European accounts payable and customer service functions to improve standardization and optimization, giving us the ability to leverage common tools as we grow.

The projects we initiated in the second quarter should generate annual savings of about $8 million once fully implemented with about $1 million realized in this fiscal year. These actions drove a second quarter charge of $14.8 million and resulted in an operating margin headwind of about 220 basis points and an EPS impact of $0.08. We have excluded these charges from the calculation of our adjusted operating metrics, and the with and without details can be found in this morning's press release.

We are confident in the value these optimization projects will create for our company, but I also want to acknowledge that they can be tough on the team. I appreciate all the hard work that has gone into the planning, and I want to thank our employees for supporting these initiatives and helping us deliver our long-term goals.

With that, I'll dig into our second quarter results a bit more. As I said earlier, adjusted operating profit, which excludes restructuring charges, was up 7.6% from the prior year. That translates to an adjusted operating margin of 13.4%, which is 60 basis points up from the prior year.

Second quarter adjusted gross margin grew 30 basis points to 34%, accounting for half the operating margin increase. The price we paid for raw materials in second quarter was lower than last year due in part to our strategic procurement initiatives, and the gains were partially offset by an unfavorable mix of sales.



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While we expect gross margin will be up in the back half of fiscal '21, the drivers are predictably changing. As expected, raw materials will move from a tailwind to a headwind, and pressure from mix is going to increase with the anticipated sharp growth in our first-fit businesses over the next 2 quarters. As always, we remain focused on managing the price cost relationship. Net pricing for the company was a push last quarter, and we will take a proactive stance as raw material costs trend higher.

We also remain focused on being deliberate with our operating expenses. As a rate of sales, second quarter adjusted operating expense was 30 basis points favorable versus the prior year. Continued benefits from lower discretionary expenses due in part to the pandemic-related restrictions were partially offset by higher incentive compensation. Importantly, we continue to invest in our strategic priorities. Compared with last year, we invested more on research and development, and we increased our headcount-related expense to drive growth in our Advance and Accelerate portfolio of businesses.

You can see the impact of these choices more prominently in our Industrial segment, where many of our high-growth businesses are reported. If you exclude restructuring charges, the second quarter Industrial profit rate was down about 50 basis points from the prior year, reflecting incremental investments in businesses like Process Filtration and Venting Solutions.

On the other hand, solid growth in our Engine segment is creating leverage across the P&L. The team is doing an excellent job of focusing on share gains and market expansion, especially in China, and they are also thinking long term. We are aggressively pursuing share gains in new markets and driving higher aftermarket retention with innovative products. We have great partnerships with many of the world's largest equipment manufacturers. We will be leveraging those relationships as we all navigate inflationary pressures related to raw materials and fulfilling rapidly elevating demand.

Across our company, we believe the balanced approach we have taken throughout the pandemic puts us in a strong position to capitalize on the economic rebound. Instead of making deep cuts to manage the short-term demand pressure, we focused on supporting our investors and making targeted investments into our strategic growth priorities. While we anticipate uneven market trends will continue, we are confident in our long-term positioning.

Capital deployment is another area we have a disciplined and balanced approach. We invested about $12 million in the second quarter, which is down more than 70% from the prior year. With the economic environment improving and most of our new apps online, our focus is shifting toward driving productivity gains and working towards the operating margin targets we shared at our Investor Day in 2019.

We returned more than $57 million to shareholders through dividends and share repurchase, bringing our year-to-date total to almost $100 million. Maintaining our dividend is a priority for us, and we have demonstrated our willingness and ability to grow it over a long period of time. We have increased our dividend each calendar year for the past 25 years, making us part of the elite group included in the S&P High Yield Dividend Aristocrat index. Our position on the dividend is the same as it was 65 years ago when we began paying it every quarter. And I am proud of this trend.

Share repurchase is also an important part of our capital deployment priorities, but it's a bit more variable. At a minimum, we plan to offset dilution from stock-based compensation in any given year, and we are on track to meet or exceed that objective this year. Beyond that, our share repurchase is guided by our balance sheet metrics, strategic opportunities and overall market conditions.

Overall, our narrative is consistent over time. Our year-to-date results demonstrate both the strength of our business model and the value we create by taking a long-term focused view. We plan to build on this momentum in the back half of 2021. So let me share some details on our expectations.

As Tod mentioned, we've seen building momentum in our first-fit business throughout the past quarter. With this in mind, we expect sales this year to return to a pattern that is generally in line with our typical seasonality, where about 52% of our full year revenue occurs in the back half. Therefore, we expect full year sales will increase between 5% to 8%, which includes the benefit from currency translation of about 3%.

In the Engine segment, full year sales are projected to increase between 8% and 12% with our first-fit business comprising a bigger piece



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of the recovery story in the back half. We expect full year Off-Road sales to increase in the low 20% range with building strength in commodity prices driving an acceleration in equipment production in agriculture and other select markets.

In On-Road, we expect a full year increase in the low teens, driven by the strong rebound in global truck production rates. We expect the momentum to continue in our Aftermarket business with a full year sales increase in the high single digits. We expect to continue to benefit from improving equipment utilization trends globally and market share gains in the Asia-Pacific region, particularly in China, where PowerCore is experiencing significant growth.

Our Aerospace and Defense business is anticipated to decline in the high-teens digits overall as demand in the commercial aerospace is expected to remain depressed. We do expect to see sequential improvements as we lap the pandemic-related impacts, and helicopter and ground defense programs continue to grow over time.

In the Industrial segment, full year sales are projected to be between a 2% decline and a 2% increase as recovery in the capital investment environment is still emerging. We continue to press forward with market share gains during this period, and our investments in building the Advance and Accelerate portfolio are expected to continue to result in sales growth above the company average.

We expect IFS sales to be roughly flat for the full year, reflecting a return to growth in the back half of the year. While uncertainty remains, we are seeing signs of increased quoting activity and expect we are well positioned to capitalize on any recovery in addition to our gains in share and continued progress with our innovative products in important markets like food and beverage.

Our GTS revenue is expected to increase by mid-single digits, driven by continued growth in replacement parts. In Special Applications, we are anticipating a decline in low single digits based on our year-to-date results and expected softness in the market for disk drive products.

At a company level, we are expecting an adjusted operating margin to increase to within a range of 13.8% and 14.2% compared to 13.2% in 2020. This implies a sequential step up in our operating margin to 14.4% for the back half of the year and aligns with our commitment to increasing profitability on increasing sales.

Gross margin expansion continues to be an important lever for us. We expect to benefit from our ongoing initiatives to drive cost efficiency in our operations and are positioned to gain leverage on a higher sales volume. Over time, mix should also be a consistent factor in driving our gross margin up. As we think about the near term, however, mix is likely to be a headwind as improving market conditions and our strong position with our large OEM customers will likely result in stronger first-fit sales growth than replacement parts.

We are also beginning to see increases in our input costs, including steel and freight rates, so we are expecting a cost headwind for the remainder of fiscal 2021. We continue to invest in our customer relationships, and in maintaining our position as a top-tier supplier. We will continue to work to align our pricing with the increases in our input and supply chain costs.

Additionally, we expect to maintain a disciplined approach to our operating expenses and deliver further leverage in the back half of the year despite an expected full year headwind of approximately $20 million from increased incentive compensation, about 2/3 of which is in the back half of the fiscal year.

For our other operating metrics, we expect interest expense of about $13 million, other income of $2 million to $4 million, and a tax rate between 24% and 25%. Capital expenditures are planned meaningfully below last year, reflecting the completion of our multiyear investment cycle. Taking the midpoint of our sales and CapEx guidance for 2021 would put it at just over 2% of sales.

We expect to repurchase 1% to 2% of our outstanding shares. Finally, our cash conversion was very good in the first half, and we continue to expect to exceed 100%, reflecting strong first half conversion and anticipated increases in working capital later in the fiscal year.

As I close my section, I want to take a moment to thank my colleagues around the world for their continued dedication to Donaldson and



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our customers. We have had a solid first half of our fiscal year and are expecting even better results in the second half. I am very proud of what our employees have been able to achieve in this unprecedented time, and I'm optimistic about Donaldson's future.

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

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

Thanks, Scott. As we saw during the first year of our fiscal year, improving economic conditions are complementing the benefits from consistently strong execution of our strategic priorities. Of course, achieving the significant sales and profit growth projected in the second half is not without risks. Costs are going up. Demand for raw material is quickly increasing, the global supply chain is getting stretched, and above everything else, the pandemic is still hanging over all of us.

While the pandemic is certainly a new occurrence, the other pressures are not. We have successfully navigated them time and again due in large part to our talented employees and strong customer relationships. As always, we will manage our costs, execute strategic price increases and pursue profitable sales. It's a straightforward plan, and it has served us well for 106 years, giving me confidence we are in an excellent position to deliver a strong finish to fiscal 2021.

I will also say that I'm more excited than ever about our long-term prospects. As a reminder, our strategic priorities include expanding our technologies and solutions, extending our market access and executing thoughtful acquisitions. The recent announcement of our newly formed life sciences business development team represents a significant move that supports all those priorities.

As previously announced, we hired a new Vice President to build and lead the life sciences team and drive our growth strategy. This team comes to Donaldson with tremendous industry experience, including strong M&A backgrounds. With the leadership in place, we are now poised to drive our expansion plans into the fast-growing, highly technical and highly profitable life sciences markets.

While there are no specific details to share today, we are highly confident that technology-led filtration has a critical role in these spaces. With our strong balance sheet and disciplined approach to capital deployment, we are well positioned to pursue acquisition opportunities that make strategic and financial sense. And we are also enhancing our internal capabilities to drive organic growth.

Our new materials research center, which was completed last year, will further strengthen our material science capabilities. The technical skills we gain can be used right away by fueling growth in our current markets, like food and beverage, and they can be used to support longer-term growth in broader life sciences markets. We are committed to these new markets, and establishing the life sciences business development team is one step on a long journey, but it was an important step. I'm excited about our opportunities and look forward to sharing our success with all of you over time.

Before closing, I want to thank our employees for their hard work over the last two quarters and the last year. One year ago, we were all wondering about how COVID-19 was going to ripple through the economy, and there were more questions than answers. We all still have questions, but one thing that I am more certain about is the quality of our employees. They are truly remarkable. I've seen that personally, and we can all see it in our company's results.

To my more than 12,000 colleagues around the world, thank you for all you continue to do to support our goal of advancing filtration for a cleaner world. Now I'll turn the call back to Tabitha to open the line for questions. Tabitha?

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Your first question is from the line of Bryan Blair with Oppenheimer.

**Bryan Francis Blair** ***Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst***

I just wanted to level-set, if we can, on a couple of the guidance points. With IFS flattish for the year, that implies approaching high single-digit rate down in the back half, so decent momentum there. How does that break down between first-fit and replacement sales?



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

Bryan, what's happening is, right now, I would tell you, in the IFS markets, as we went into the pandemic, essentially, people started to -- on the CapEx side, pull back and go to, if it breaks, fix it type of mentality. We've now seen our CapEx-based orders change from just a fix-it mode to, hey, let's replace it. And you see that in our incoming order cycle.

What we have ahead of us is that mental shift from a replacement type of a cycle to an invest-and-expand cycle. So we see orders now picking up on the first-fit cycle of IFS and picking up on the equipment side, and that's being led by the U.S. and China. We haven't given specific breakouts of overall of the two pieces, but we do see an increasing momentum on the equipment side today.

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**Bryan Francis Blair** ***Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst***

Okay. Very helpful color. And it looks like the midpoint of guidance ranges implies a little over 20% incremental margin in the back half. How should we think about that by segments? And in that context, any additional color on volume, mix, price cost impacts would be appreciated.

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

Yes. So I mean there's a lot of factors in there. Maybe starting with Engine. First of all, we're going to have, in terms of gross margin, in general, we're going to have raw material increases and freight increases across both businesses. And so those will be a constant. In terms of volume, our volumes will be relatively flat in Industrial with a plus 2 to minus 2 guide and up pretty significantly in Engine with the guide. So Engine will have a stronger ability to leverage the volume, and that'll help them. And then our cost-reduction projects that we have going in operations will help reduce or offset the headwinds we're facing. So we expect positivity in both. Engine has a much larger growth foreseen, and so they'll have a little bit of an edge up because of their ability to leverage that Industrial won't have.

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**Bryan Francis Blair** ***Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst***

That makes sense. And Scott, you mentioned the Investor Day targets from 2019. And obviously, the world has changed since then. If we think of what was put out there by segment, it looks like Engine maybe made it comfortably in the revenue range that you had targeted initially for fiscal '21. Is the 14.8%-plus operating margin in play, assuming momentum continues into next year? And then on the Industrial side, I know that's a bit more of a stretch from run rate revenue, but as they scale to $1 billion plus, is the 17% margin or higher still achievable? Or have there been some structural changes or increased investment rate that may lower that target?

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

Yes. So I mean, I have the book right here in my hand. I carry it with me everywhere I go because we still keep these targets in mind, and we're still driving towards those numbers that we laid out. Certainly, Engine is further along than Industrial because their growth has picked up. So I think you've captured it appropriately in that we're closer to the Engine targets than we are in the Industrial targets because of their current growth trajectories. And so therefore, they're a little bit ahead in the race, but we expect and are still driving both sides of the equation to get to the finish line. And as we've said before, the targets are still in play, but we've just pushed them out because of the pandemic-related stalls in revenue growth.

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**Operator**

And the next question is from the line of Brian Drab with William Blair.

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

And I may have missed the answer to this one, but just quickly, the restructuring in EMEA is focused on which segments? Is it more Industrial? Or can you just talk about where that focus is or is aerospace?

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

Yes. I can take that, Brian. This is Scott. So the restructuring, the total charge was $14.8 million. If you break that down between gross margin and OpEx, it was about $5.8 million in gross margin and $8.9 million in OpEx. And that's split across the company, both in Engine and in Industrial. And Engine, it's a little more focused on aerospace, as we mentioned. And the Industrial example I gave was the move of some of the production to Eastern Europe. And then some corporate functions, which included, for example, centralization of accounts payable and also the centralization of the customer service functions. So it's relatively spread out and broad across various



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functions with the targeted initiatives that I talked to. So hopefully, that provides you with a little more color. It's approximately $0.08 of EPS.

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

Got it. And is that something that's been contemplated? Or is this more a response to situations that we're seeing now related to the pandemic?

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

Yes, Brian. This is Tod. So I would tell you on the Aerospace and Defense move, we had contemplated them. I think the pandemic exacerbated the need to do them much quicker than we had expected. So clearly, that's more of a pandemic response. All the rest of the other moves were in our longer-term plans. They were in our sights, and it was time to move forward.

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

Got it. And there's -- Tod, there's quite a bit of discussion around China. It sounds like things are going really well there now. Can you update us on whatever you're willing to disclose in terms of a percent of total sales that China accounted for in the quarter and percent of On-Road sales that China accounted for in the quarter?

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

Yes. Let me have Charley look that up within the model and get back to you here, Brian. So maybe (inaudible)

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

Maybe while he's looking that up, can I just ask, just generally, Tod, you also talked about PowerCore quite a bit in China. And how are your margins on PowerCore in China relative to the rest of the world? And just in general, Power margins in the, I guess, particularly in the Engine business in China versus outside China lately?

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

Overall PowerCore right now in China is a little bit tougher, but it's because it's an import product for us today. We don't have our PowerCore line up and running in China. It is now in China. It's being installed in China. So when we get that pivot to in-country for country revenue, then it will be on par with the balance of the world in PowerCore. Right now, it's a little bit of trouble because of importations and such a long way of shipping. Overall, the Engine-based margins in China are on par with the balance of the world, I would say. Off-Road is on par with Off-Road. On-Road is on par with On-Road with the rest of the world.

**Charley Brady** ***Donaldson Company, Inc. - Director, Investor Relations***

Brian, just to answer your question on China growth for the entire company in the quarter, China was up 31% or, in local currency, up 23%. And then we'll follow up with you on the balance of the splits relative to the segments, Brian.

**Operator**

Your next question is from the line of Richard Eastman with Baird.

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

Yes. Nice work on the quarter. Tod, just curious, we're all kind of watching the commodity prices, and you've referenced it a number of times here for the second half being a little bit more of a headwind. But I'm curious, if you kind of back up a little bit, I'm listening to a lot of the OEMs that you supply, and in particular, one of them, on the ag side, is really suggesting some pretty significant price increases for their products into the marketplace. But is there an acknowledgment on the OE side that customer base that maybe there's more of an acceptance if you were to raise prices as a vendor to them in the current market with the current commodities pressures emerging post-pandemic? Is the pricing environment to you feel a little bit more flexible than maybe it has in other past rebounds?

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

Short answer, no. I think it's -- really -- I think, Rick, it's going to behave as it has every other time. It's standard work for us. We know when overall inflationary pressure's up, down. We -- it's the same type of a cycle all the time. It's constant support of the OEs with what's happening. I would acknowledge the inflationary pressures that we're seeing, particularly on steel. Steel is a pretty rough commodity out



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there right now. The increases are, frankly, seeming excessive. And so that's forcing us, because of availability, to buy on the spot, so spot markets. And so consequently, we are seeing some inflationary pressures across steel. And as you know, that's our largest commodity across our products. We do have protections that would push some of that off into the fourth quarter. Those inflationary pressures, though, likely come harder next year because we have the full year of those than it would for the balance of this fiscal.

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

Okay, okay. Fair enough. So we'll have that headwind. And then just as a kind of dovetail into -- we see the pressures here on the commodity side. Obviously, the incentive recovery here -- wages incentives back into the model. But as you think about out to fiscal '22, and we're looking for maybe a normalized conversion margin -- incremental margin at the OP line, are we -- how do we feel about that? Because it looks like in the second half here, with the pressures we've spoken to, will be around 20% conversion. But how do you start to think about this model producing a conversion margin of -- give me a range where that should start to normalize here.

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

Yes, this is Scott. Rick, so we're definitely committed to higher levels of profitability on increasing sales. So we need to continue to drive the incremental earnings, and we're committed to that. And we had 37% this quarter, which is much higher than our historical average, say, in the 20% to 25% range. So we're going to continue to drive to those numbers. We wanted to invest in the company in our Advance and Accelerate portfolio, which we will continue to do, but with an eye towards we need to be able to deliver those incremental margins. I would say, consistent with our overall history, it can jump around in any one quarter. But longer term, I think you see we're in the 20%, 25% range. And we want to continue to drive to that because we're committed to increasing levels of profitability on increasing sales, and you got to have margins in that range to feel comfortable about delivering that, at least that's how we look at it.

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

Okay. All right. Fair enough. And then just my last question really quickly. Tod, as we add resources into the Advance and Accelerate portfolio and in particular on the life sciences and adding to those capabilities and maybe using M&A to boost the technology portfolio for life sciences, is there -- what's the willingness -- or what's the thought process around looking at more of an adjusted EPS type of metric? And I'm thinking as much about comp plans for senior management as I am, just from a reported standpoint. And again, the assumption being that it'd be somewhat costly. There could be some more -- could be increased purchase accounting amortization. And just curious how you think about that metric given the longstanding objective at Donaldson for EPS growth.

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

Yes, that's an excellent question, and something we've thought about. And it's a little bit hard to know until you have a deal in hand how you're going to address that. But I think those are all excellent points to consider as we move forward with this life sciences strategy, and I think we will consider those points.

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

Yes. And just maybe a little bit more color here for you, Rick. We certainly discussed that. We haven't landed on a hardcore spot as to whether an adjusted type of metric is the appropriate way to go. Certainly, it makes it all more comfortable if there are no adjustments. But we do have those conversations. We just haven't landed in a hard spot on that yet.

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

Yes, yes. I just -- I think of it more as, from my vantage point or our -- maybe our vantage point, an adjusted EPS number is almost accepted these days. But I think my point being that it's always felt like a bit of a restraint at Donaldson to pay up for some of these -- for developing a presence in some of these other markets.

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

I can tell you, Rick, that we have a strategic plan where we recognize, particularly in the life sciences sector, what the multiples are to enter that point and to do deals. We're very realistic about that multiple, and that type of behavior will not hold us back.

**Operator**

And our next question is from the line of Laurence Alexander with Jefferies.



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

Just following up on that. As you extend your footprint in the life sciences, should your R&D to sales or your capital intensity change? So if we think about just the total investments you'll be making in that area, would there be a shift in the intensity of the business?

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

Yes. It's a great question, Laurence. It's Tod. So if you remember, we have long been a 2% to 3% R&D as a percent of sales type of a company. And at Investors Day, I had referenced that we would be moving to 3% to 4% of sales. And it was all with this change in mind in order to support that. So we've already put that target out there, letting you know that hey, we're going to go to 3 to 4. That feels very comfortable to us in order to be able to do everything that we would need to do to go organically into the life sciences sector and then support it as well. Given the overall size of our corporation, it would support it on the R&D for supporting acquisitions as well.

**Operator**

And your next question is from the line of Nathan Jones with Stifel.

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

This is Adam Farley on for Nathan. So turning to Engine Aftermarket, the business returned to growth after 5 quarters of year-over-year decline [even] growth sequentially for the second straight quarter. So are you guys seeing any restocking yet in the different channels, the independent channel or the OE channel?

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

Yes, great question. So what we have seen is pull-through levels at the independent channel and the OE channel. And so we would tell you that the majority of our growth clearly is being pulled through. We would, however, caveat and say maybe 1% of that particular growth that we see would be increased as a result of some of the supply chain issues that is being felt across the industries and that we have some of the OEs as well as the independent channel worried about stock-outs. And so they probably ordered ahead just a little bit, but it's not like it's been a big inventory step-up or anything like that. It's really pull-through levels with this slight protection, if you will, for their markets.

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

Okay. And then on the pricing side, I know it's harder for the first-fit business, but are you guys going out with any price increases on the Aftermarket side?

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

We returned to our typical pricing behavior, which would suggest to you that we took pricing actions effective January 1 across multiple businesses in the corporation. We did that as normal. And so we are in the normal type of pricing activities in our businesses. Should we see that inflationary pressure increase as in other inflationary cycles, we would not hesitate to take a secondary -- a second pricing action where needed anywhere in the world. But right now, we returned to our normal pricing behavior.

**Operator**

The next question is from the line of Dillon Cumming with Morgan Stanley.

**Dillon Gerard Cumming** ***Morgan Stanley, Research Division - Research Associate***

Sorry to ask a question on your On-Road business. I think it's pretty clear that everyone is kind of expecting an inflection here over the next couple quarters. And I just wanted to ask, you've talked a little bit about in the past some of your exposure on the hydrogen side. So as you look across your order book, are you seeing customers within your On-Road business that are starting to look at more Industrial Air Filtration offerings for hydrogen trucks or [SCV.] That's the only detail. I guess, it's mostly still kind of legacy [SE] business?



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

We would tell you that, across the hydrogen sectors, we see more customers talking about it, curious about it, working with our engineers to try to understand what would be necessary from an absorption and a filtration stand point of view. They've not announced formal programs to actually build powertrains and that, in that sense, but it's certainly an increased level of conversation across the overall market, yes.

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**Dillon Gerard Cumming** ***Morgan Stanley, Research Division - Research Associate***

Got it. That's helpful. And then maybe if I can spin the conversation back to margins. I'm asking this question in a little bit different way. But Scott, you were very clear. You outlined the number of time lines that you see kind of in the back half and into next year talking about the price cost instead of comp, some mix headwind here. But you're obviously still giving a pretty strong margin guide. I think that's already been alluded to. Do you see the restructuring actions that you've taken that $8 million is fully offsetting those headwinds that you've outlined? Or do you still feel like there's some kind of cost creep in the back half that's kind of offsetting some of those restructuring tailwinds there?

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

Well, I mean we're really complete with the restructuring actions, so we don't foresee any more restructuring coming currently. So we wanted to show it with and without numbers, so we took the $14.8 million, and we pulled it out. And so all the guidance provided is on an adjusted metric basis. There'll be $1 million estimated of savings from the restructuring this year, and then an $8 million estimated savings once the actions are completed within the next 12 months. So we feel good about that. So we project margins to improve, so we're trying to offset that by improving nicely in the back half, but those costs are behind us now. And we expect margin and op margin improvements into the third and fourth quarters of this year.

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

Yes. And Dillon, this is Tod. It's important for everybody to understand that the restructuring actions that we took are complete and that we do not have any additional plans pending out there and that they have all been rolled out in the organization.

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**Dillon Gerard Cumming** ***Morgan Stanley, Research Division - Research Associate***

Got it. That's helpful. And then maybe just to wrap it up. It's clear, and you guys outlined at the Investor Day in 2019, obviously, Donaldson is definitely a different company now than it was over the last industrial cycle. You guys have taken a lot of cost out. You kind of realigned your capacity footprint, and you come out of some of these more attractive end markets. I guess, Scott, you alluded to kind of committing to profitable growth as revenues increase. But I guess, looking back versus the last cycle, are you kind of confident that you're not going to see the same level of margin choppiness as these inflationary prices impact that business? Or do you feel like it's still a bit too early to tell there?

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

I think it's a little bit too early to tell. When we talked about the inflationary pressures, clearly, the commodities that we have are steel. That's number one. Media is number two, call it. Oil-based products or urethanes, number three. You know what the long-term outlook for oil, a barrel of oil is, which would give us pressures. Media has its own pressures. And steel, frankly, right now is, frankly, a bit unfair to the world, I would expect if you look at the indexes that are going out there.

So there are clearly some headwinds that could crop up, that would provide choppiness to us. But in the company, the more choppiness, I think that could happen immediate is the mix situation that we typically get off of the OE-based balance that we're seeing on the Engine. And so the greater the OE mix up that we get, that would likely provide some choppiness in the more near-term quarters with the inflationary headwinds being in the out quarters. That's standard work for us. We get it. But as you build your model, that would be the type of thing to consider.

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**Operator**

And there are no further questions.

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

Thanks, Tabitha. 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 and healthy. Goodbye.

**Operator**

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

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