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PRESENTATION

Operator

Good day,and thank you for standing by. Welcome to the Donaldson Third Quarter 2021 Earnings Conference Call. (Operator Instructions) But please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Charlie Brady, Director, Investor Relations. You may begin.

Charley Brady *Donaldson Company, Inc. - Director of IR*

Good morning. Thank you for joining Donaldson's Third Quarter 2021 Earnings Conference Call. With me today are Tod Carpenter, Chairman, CEO and President; and Scott Robinson, Chief Financial Officer. This morning, Tod and Scott will provide a summary of our third 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'll now turn the call over to Tod Carpenter. Tod?

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

Good morning, everyone. I am very pleased with our third quarter results, which exceeded our expectations and was the highest sales quarter in our Company's history. Third quarter highlights include, sales increased 22% year-over-year and 13% sequentially from second quarter, the largest second to third quarter increase in over 10 years.

Gross margin improved 50 basis points year-over-year and earnings per share grew 32%. This could not have been accomplished without our dedicated Donaldson employees who come to work every day, whether at home or in the office, to ensure we are meeting our goals and serving our customers. Thank you to all of my fellow teammates for the work you do.

Now let me provide some insights on our third quarter sales. Total company sales increased 22% in third quarter from prior year. In local currency, sales rose 17%. While we acknowledge this is a soft comparison to last year when the pandemic slowed things, we also note this result is 7% above the strong pre-pandemic third quarter of fiscal 2019. We are pleased with this level of growth and believe our momentum will continue.

Engine sales recorded strong year-over-year growth of 26%, 22% in local currency. Our 51% Off-Road business growth was widespread with all regions experiencing an increase in sales. In particular, local currency sales in Europe and Asia Pacific were up 78% and 42%, respectively. China sales increased almost 50%. Several factors give us confidence in the outlook for Off-Road. Global demand for construction and agriculture equipment remained high, and mining is also seeing increased demand. PowerCore continues to gain traction in China, and we are on track to deliver 2x as many PowerCore air cleaners in 2021 compared to 2020, and our backlogs continue to build as we exited third quarter.

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On-Road sales experienced a sharp rebound from the 1% year-over-year decline in second quarter, increasing 58% from 2020. Order and build rates for Class 8 trucks in the U.S. have risen significantly over the past few months and are projected by external data sources to remain at a high level over the next several quarters. In China, our On-Road sales more than doubled, driven by increased heavy-duty truck production and market share gains. With a favorable economic backdrop, our strong market position in North America and the significant opportunity to grow in China, we are optimistic on the outlook for our On-Road business.

Aftermarket sales increased 23% in third quarter, including a 4% currency benefit. Utilization rates for construction and agriculture equipment and heavy-duty trucks remain at a high level, which is driving increased demand for replacement products. In local currency sales, Latin America increased by over 40%, and Europe and Asia Pacific were up 17% and 18%, respectively.

Aerospace and Defense continues to be pressured, primarily due to a weak commercial aerospace market as a result of the COVID-19 pandemic. A bright spot in Aerospace and Defense is rotary aircraft, where sales increased due to previous program wins now coming online.

Looking at the Industrial segment, sales in third quarter increased 12% or 7%, excluding the favorable impact of currency translation, and growth was widespread across geographies.

Industrial Filtration Solutions, or IFS, saw a significant sequential uptick in quoting activity for dust collection systems in third quarter. IFS benefited from increased sales of dust collection products on both a first-fit and replacement parts basis. This is a nice turnaround from the declines experienced in second quarter, which we believe was the trough. We have seen this business move from the "if it breaks, you fix it cycle" to the "if it breaks, you replace it cycle", and now move to the investment and expansion cycle where we see increased purchases for new projects. We also saw increased sales in first-fit and replacement products across the rest of the IFS businesses, including greater than 50% growth at BOFA and mid-20s percentage growth in Process Filtration sales. These growth rates indicate to us that not only are we winning share in targeted growth areas, we are also retaining the replacement business, which should only increase as our installed base becomes larger.

Sales of Gas Turbine Systems, or GTS, declined about 13% year-over-year due to a decline in demand for gas turbines used in the oil and gas market, a slowing of retrofit activity and the timing of projects. Sales in Special Applications saw a double-digit growth in Integrated Venting Solutions and Membranes, which was partially offset by a high single-digit decline in our disk drive business. These broad-based positive Company results give us increased confidence in our ability to have a strong finish to our fiscal 2021.

Finally, we believe supporting the communities in which our people live and work and where we do business is the right thing to do. Therefore, in third quarter, Donaldson contributed $1 million to support our local community and help rebuild areas in Minneapolis and St. Paul that were damaged from the unrest over the last year.

With that, I'll now turn the call over to Scott.

Scott?

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

Good morning, everyone. Like Tod, I'm also very pleased with our results in the third quarter, which were stronger than our expectations and, as previously mentioned, the highest quarterly sales in the Company's history. I want to thank our employees for this remarkable accomplishment in light of the challenges faced.

Total sales increased 22% year-over-year, and operating margin increased 90 basis points to 14.3%. As you have heard me say many times, we are committed to generating higher levels of profitability on higher sales, and our third quarter results demonstrate our commitment to this, even in the face of pressures from higher raw material costs and supply chain disruptions.

As we entered the third quarter, we were building momentum, and that continued through the end of the quarter. Given our incoming

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order rates and backlog levels, we expect this momentum should maintain through the end of fiscal '21.

Now, let me get into our third quarter results in a bit more detail. Our Engine segment profitability increased 250 basis points year-over-year, as we leveraged a significant uptick in sales. The Industrial segment, in contrast, recorded a 50-basis decline in profitability. This decline is a result of the business unit mix with an industrial and weaker gross margins in GTS and Disk Drive products. Third quarter company gross margin improved by 50 basis points to 33.7%, which accounted for a bit over half of the 90-basis point increase in operating margin. Raw material and freight cost inflation were headwinds, and a reversal from the tailwind we experienced in the first half of the fiscal year.

Sales mix was also unfavorable to gross margin, primarily as a result of strong Engine sales. However, we were able to offset the margin pressures with sales leverage and pricing. We continue to expect second half gross margin will be up year-over-year. However, the headwinds from higher raw material and freight costs are increasing from what we experienced in the third quarter. Given the sharp increases in our raw material and freight costs, we are focused on pricing actions to mitigate the impact on our margins. We remain committed to managing our price-cost relationship, particularly in an environment of strong demand for our products.

We are also committed to controlling operating expenses. In the third quarter, operating expenses as a percentage of sales declined 40 basis points year-over-year. This was driven by a leverage on increased sales, partially offset by increased incentive compensation expense.

Investing in our strategic priorities remains a focus for us. Our Advance and Accelerate portfolio receives the largest amount of our investment and, over time, is expected to generate [greater] (added by company after the call) sales growth and higher margins than the Company average.

We are also excited about the growth opportunities with our first-fit Engine businesses. These businesses tend to be more cyclical and command leadership positions in their markets. In the case of On-Road, Off-Road and Defense, there are multi-year programs that provide a solid base of business and help to grow our Aftermarket sales. We see opportunities for additional program wins and further penetration into markets where we have a smaller share. One example is China where the market is large. There is an increasing willingness of OEMs to adopt the filtration technology that we provide, and we are winning new programs. We have taken a disciplined approach to managing our business and opportunities by focusing on selective cost optimization projects and leveraging our global presence, while continuing to invest in growth areas. As the world recovers from the pandemic, we are in a great position to participate in the post-pandemic upswing, some of which is represented in our third quarter results.

We made capital investments of approximately $10 million in the third quarter, a decline of over 60% from the third quarter of last year as we bring to completion many of our significant capital projects from the prior two years. We paid over $26 million in dividends and repurchased over $32 million of our stock in the third quarter. Year-to-date, we have returned almost $160 million to shareholders. We have paid a dividend every quarter for the past 65 years and increased our dividend every calendar year for the past 25 years, making Donaldson among a small group of companies that are included in the S&P High-Yield Dividend Aristocrat Index. Maintaining this track record is important to us.

Our results through the third quarter of fiscal '21 demonstrate that our focus on higher margins and higher sales is working. The results also underscore the diversification of our business model and in our long-term view that adds value to the Company and our shareholders. We have good sales momentum as we head towards the end of our fiscal year, which should carry through into fiscal '22. As such, we are raising our fiscal '21 sales and EPS guidance.

With that, let me share our updated expectations for fiscal '21. In the third quarter, we saw a continued sales momentum in our Off-Road, On-Road and Aftermarket Engine businesses, and an uptick in our Industrial Filtration Solutions business. Given the strong results we experienced and our visibility into the remainder of our fiscal year, we expect full year sales will be up 9% to 11% year-over-year versus our prior guidance of a 5% to 8% increase. Our annual guidance assumes a full year a 3% benefit from currency translation.

In our Engine segment, we project a sales increase of 12% to 14%, which is up from our prior guidance of an 8% to 11% increase. We

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project full-year Off-Road sales will now increase in the mid-to-high 20% range, driven by continued strong demand for construction and agricultural equipment and increased order activity in mining. Our prior guidance was for a low 20% range growth.

In On-Road, we expect full year sales will increase in the mid-teens compared to our prior guidance of low teens. This increase is due to a stronger improvement in global heavy-duty truck production rates.

Our Engine Aftermarket business has continued to see stronger-than-expected sales momentum as global equipment utilization continues to improve. We now believe sales will increase in the mid-teens compared to our prior guidance of a high single-digit increase. We believe utilization rates for construction and agriculture equipment as well as On-Road trucks will remain at a high level through our fiscal year-end.

We continue to expect our full-year sales of Aerospace and Defense to decline in the mid-to-high 20% range given the pandemic-related soft conditions in commercial aerospace resulting in weak demand.

In the Industrial segment, we expect a full year sales increase of 3% to 5% versus our previous guidance of down 2% to up 2%. As Tod mentioned earlier, we are experiencing increased demand for industrial dust collection products, particularly replacement parts.

We have increased our outlook for IFS sales and now project sales growth in the mid-single digits compared to our previous expectation of flat sales. Quote and sales activity have increased more quickly than we previously forecasted.

GTS sales are expected to decline in the low single digits versus our prior expectation of a mid-single-digit increase.

In Special Applications, we continue to anticipate a decline in the low single digits based on our year-to-date results and expected softness in the market for disk drive products.

Expanding our gross margin remains a key focus for us. We continue to work to reduce costs and drive operational efficiency to leverage higher sales. In the near term, however, increases in raw material prices and higher freight costs will pressure margins through fiscal '21 and into at least the early part of fiscal '22. To offset some of the sharp increases in our input costs, we have selectively raised prices and may do so again. We know the value we bring to our customers, and we will continue to demonstrate this value with technology-led products and best-in-class service.

We are expecting adjusted operating margin [to increase with] (added by company after the call) in a range of 13.8% to 14.2% compared to 13.2% in 2020. The midpoint of this range implies a sequential step-up in operating margin to about 14.5% for the back half of the year, compared to 13.5% in the first half. Additionally, we expect to maintain a disciplined approach to our operating expenses and deliver further leverage in the remainder of the year, despite an expected full-year headwind of approximately $25 million from increased incentive compensation, about half of which was incurred in the third quarter.

Other fiscal '21 operating metrics expectations are: interest expense of about $13 million; other income of $5 million to $7 million; and a tax rate between 24% and 25%.

Capital expenditures are planned to be in the range of $55 million to $60 million. Taking the midpoint of our sales and capital expenditure guidance for 2021 would put us at just over 2% of sales which, as we previously noted, is lower in the last few years due to the completion of major projects. We also plan to repurchase 1.5% to 2.0% of our shares outstanding.

Our cash conversion has been very good in the first nine months of fiscal '21, and we expect to exceed 100% cash conversion for the full year. We will provide detailed guidance for fiscal '22 with our fourth quarter earnings release. However, I did want to provide a framework to help with modeling.

The sales momentum we're currently experiencing is likely to carry through to the first half of fiscal 2022. We expect first half fiscal 2022 sales to account for a greater percentage of our full year sales as compared to the first half of fiscal 2021. Looking at our fiscal '22 gross

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margin, we expect the headwinds from higher raw material and freight costs to increase from what we've experienced in FY 2021, particularly in the first half of FY 2022. Our operating expenses in fiscal '22 will have some pluses and minuses relative to fiscal '21. As we begin to operate under a more normal post-pandemic environment, we expect to see an increase in expenses related to, in-person customer engagement costs, including marketing and travel costs as our sales and engineering employees return to on-site visits and attend trade shows; investment in our Donaldson employees, including training and development; and increased headcount to meet demand. However, we should see an offset in reduced incentive compensation expense on a year-over-year basis as we reset our annual compensation plans.

Our objectives for the remainder of this fiscal year and [fiscal] (added by company after the call) '22 are unchanged. We will continue to invest for growth and market share gains in our Advance and Accelerate portfolio, including inorganic growth in life sciences; execute productivity initiatives and pricing actions that will strengthen gross margin; maintain controlled operating expenses, and protect our strong financial positions through disciplined capital deployment and working capital management.

As I finish my commentary, I want to acknowledge all the Donaldson employees globally for the outstanding work they have done and continue to do every day. Our second half started off strong, and we have solid momentum to carry us through the end of fiscal '21 and into fiscal '22.

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

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

Thanks, Scott. Our third quarter results demonstrate the momentum we have in our business and the benefits of having a diversified portfolio. We continue to maintain a disciplined, long-term focus on our strategy.

To remind you, our strategic priorities remain unchanged, and we are focused on expanding our technologies and solutions, extending our market access and executing thoughtful acquisitions, particularly in Life Sciences. Some recent examples of new products include our new Ultrapack Smart Dryer for compressed air process filtration. An upgrade to our iCue connected filtration service, which now comes standard on many of our industrial dust collectors and, over time, will provide recurring revenue. The expansion of our FilterMinder real-time monitoring service to engine liquid filtration in addition to air filtration and our Rugged Pleat baghouse industrial dust collector that we introduced in first quarter, which is already on pace to generate two times our initial first year forecasted sales.

Our strategy also involves seeking out inorganic growth opportunities, and we are well positioned to expand our addressable market in life sciences. We have a solid roadmap and a pipeline of potential opportunities in Life Sciences. While I can't comment on when or if a deal might happen, I can say I am very encouraged by the work the life sciences business development team is doing. They have increased our understanding of the Life Sciences market and improved our strategic focus in that area. We have the right people in place to execute our strategy.

We continue to maintain a strong balance sheet and discipline on our capital deployment, which positions us well to make acquisitions that will expand our markets, increase our margins over time, and allow us to further leverage our filtration technology expertise. We have the ability to continue to invest in organic growth, extend our market reach, increase market share, and maintain our market leadership positions. This is a very exciting time for Donaldson, and I look forward to sharing our successes with you.

Before I close, I want to again thank our employees around the world for their continued dedication to Donaldson, each other and our customers to meet our goal of advancing filtration for a cleaner world.

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

QUESTIONS AND ANSWERS

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Operator

(Operator Instructions)

First question comes from the line of Bryan Blair with Oppenheimer.

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

Really strong momentum. Overall, for the most part in the quarter, definitely encouraging to see growth accelerate in IFS. And Tod, you mentioned kind of the mentality shifts in the markets from break and fix to replace to now more of an investment cycle, at least the early stages of one. I was wondering if you could parse out replacement first-fit growth rates in the quarter or order rates going into your fourth quarter? Any color there would be very helpful.

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

Sure. So typically, that business runs at about 40% replacement parts and 60% on the first-fit cycle. And so we're starting -- that had shifted during the pandemic, almost reversed itself. And so now we start to see that first-fit bounce starting to happen with momentum carrying forward, first, with replacement parts bouncing. So, we see strong replacement part orders led by U.S. as well as Western Europe. And now, especially with our new products that we have brought online within Q1 year, we really start to see the momentum on the first-fit picking up quite nicely. We also see a reduction in the quote-to-order cycle.

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

Understood. Okay. And when you look across your businesses, I mean, you noted increasing backlog entering the fourth quarter, expecting momentum into the first half of your fiscal '22. But as you think about the related moving parts, how does your team look at underlying demand inflection versus the pull forward of shipments based on your own pricing actions, general supply chain uncertainties, et cetera? Just trying to get a sense of, I guess, that mosaic as we look at the next couple of quarters.

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

Yes, it's good. If we step and look at the macro -- step back within the macro. We've seen, overall, our backlogs increasing through the quarter, and that also continued as we turn the page into the fourth quarter. We see -- if you just take an important data point, which is our Engine Aftermarket business, and you look at the Aftermarket OE versus the Aftermarket independent channel, the growth within those 2 pieces of our company was roughly equal. And so therefore, we see everything as a pull-through-based demand taking place within the corporation. We have not really begun to see the stocking event happen. That still lies ahead of us, as evidenced by the growing backlogs that we have.

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

That's very helpful. And last one for me, if I can. Any additional detail you can offer on any major supply chain challenges that you faced in the quarter, what's anticipated in your fiscal Q4? And on that front, if you could describe how your capacity investments and the scale that you now have and the efficiencies that you now have, have allowed your team to manage the unique environment we're in and meet surging demand relative to what you faced in the run-up for fiscal '18?

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

Sure. As you remember, we were talking, 3 years ago or so, that we were going to accelerate investments back in capacity expansion as a corporation, and we made that strategic thrust to do so as much as our competitors stood pat, so to speak, within that last ramp up. That is paying quite a dividend -- wonderful dividends to us right now. Clearly, we got that strategic decision correct. It is the reason why we have good sales momentum. We would tell you that our capacity utilization rates right now in the Engine business are roughly in the mid-80s and in the Industrial business are in the 70s, so we have room to run. However, we would also say the supply chain challenges within the quarter and that we see progressing are really continuing into the fourth quarter have been significant.

Now that said, I would tell you that our operations teams, worldwide, are doing absolutely a stellar job. We feel comfortable that we are out executing our competition. And we hear that through our customer feedback on a pretty consistent basis. We do have supply chain challenges still remaining with the most notable being the Texas storm, the 4-day event that happened earlier in this calendar year, still presenting force majeures on us for some of the raw material base. We look for those force majeures to start to abate within the fourth

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quarter. Some may go into the first quarter of next fiscal year, but we are continuing to work through those. We do see those challenges kind of holding us back a bit in the fourth quarter, should they abate a little bit better. And again, our supply chain teams are really doing absolutely yeoman's work. I was -- it's just really exemplary what's taken place. Should they start to abate a little quicker, we do see that we can have a better outcome than is currently envisioned.

Operator

Next question comes from the line of Nathan Jones with Stifel.

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

I'm going to see what I can do on a 2022 question here. If I go back to your 2018 Analyst Day, the target revenue for '21, which will give you a pass on not hitting, obviously with COVID, with $3 billion to $3.3 billion, current revenue trends looks like you'll be kind of around the middle of that range somewhere next year. And you had a 15% to 15.8% operating margin target on that revenue. Is there any reason why if that's the kind of revenue range that you're in that you can't get to that 15%, 15.8% operating margin? Or are there -- the price cost dynamics and things going on around that at the moment maybe negate you being able to get to quite that level next year?

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

Nathan, this is Scott. So, if you take the midpoint of our guidance, sales finished for this year, it would take about a 6% growth to hit the low end of the range of the target. And so we could likely get to the low end of that range at a 6% revenue growth in FY '22. So that's clearly in sight for FY '22.

In terms of operating margin, you saw that we had maintained the guidance of 13.8% to 14.2% because of some of the supply chain and the input cost challenges that we've noted. The guidance in the Investor Day targets was 15% to 15.8%. So that would be a 100 basis point improvement over a 2-year period. And so that would be a pretty significant growth. I think we could get in that vicinity, but probably still a little bit below that range. So probably, it's sort of reasonable to get into the revenue range and probably around the operating margin range.

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

Fair enough. That's helpful. Maybe a question on price cost here. You guys had some fixed-price contracts, particularly the OEM Engine side, and have to balance obtaining pricing with driving customers towards more of your proprietary products that generate better revenue and better retention over time. I got a hint on today's comments that you're maybe being a little more aggressive with pricing this time around than you were in 2018, which is reasonable, we've got significantly more inflation. Can you talk about how you're balancing those 2 things? And if you are being a little more aggressive on pricing this go around?

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

Sure, Nathan. This is Tod. So if you just split our company into that OE first-fit side, which is 35% of revenue, 65% on that replacement parts or project-based activities. You're right. On the 65% of the corporation, we are being aggressive. There are pricing activities in-flight everywhere in the world as we speak. We will start to see those coming. Early next fiscal year, they will be in effect. I do want to caution, though, that we do have to work through some backlogs to see the new pricing actually take effect and then start to leverage, right? But we are being more aggressive with the pricing to, say, mid-single-digit to low double-digit based -- increases depending upon the business.

With regards to the OE side of things, the OE-based conversations with the bumps of as much as 50% of business expansion on the OE side has really taken all the energy of both our customers as well as us to coordinate more of the demand satisfaction, if you will, rather than the pricing conversation. Some pricing conversations are happening. And you're right, they are absolutely more aggressive than they have been in the past. And it is a better environment than perhaps we've ever felt on the OE side relative to being able to enact pricing actions. But as you know, and as we've talked about many times, they'll likely stretch out longer than the options that we have in-flight with regards to that 65% of our corporation.

Operator

We have our next question from Richard Eastman with Baird.

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

Just to pick up on that -- Scott, just to pick up on the last question there. Was the price cost positive or negative in the quarter?

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

Well, we were able to increase our margin. So all things being considered, it was positive. But there's a lot of pluses and minuses going on in there, right? We have -- price is, obviously, a benefit. Mix is a headwind. Commodities are obviously a headwind. Freight is obviously a headwind. We talked about the bonus increase being a headwind, and then you get a big benefit from leverage. So there's a lot of pieces in there that make the margin probably a bit more complicated than typical, but we were pleased that we were able to continue to drive up the margins for the company on increasing sales. But there's a lot in the soup there as you can see.

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

Yes. And just to clarify your comments, Scott, I think you made them first, Tod. But as we roll into the first half of '22, your comment was the first half of '22 would be a greater percentage of the full year revenue than was the first half of '21. Is that what you're suggesting?

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

That is correct. So if you take the midpoint of our guidance, this year, we're 46% in the first half and 54% in the second half. So that's a pretty big difference for us. Generally, we're a bit closer to even. And so we expect the momentum that we're seeing this -- towards the end of the year to continue into next year. And -- but we don't think that kind of 50% growth rates in Off-Road kind of momentum can continue for an extended period of time. So we've seen it reversing next year. So we wanted you to help with your models in that. Those percentages will probably flip next year because the momentum will be strong, and it will be harder to keep growing sequentially to keep those kind of percentages continuing.

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

Yes. Understood. And Tod, just maybe to build off of that point. When you look at build slots as for the OEs, both on the Off-Road and on the On-Road side. We're hearing a lot about the build slots for the next 12 to 18 months being pretty full. Maybe just your thoughts around how that may or may not impact that number that Scott just referenced. But your sales outlook on the OE side, is it being constrained by your customer supply chain issues as well as the forecast looking like maybe build slots are getting pretty tight.

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

Yes. Thanks, Rick. So as you really look back at our business where we are in the backlog. Clearly, the On-Road sector is really seeing quite a nice bump. The Off-Road sector on the first-fit is also seeing a bump, but the level of jump on the On-Road sector is really quite impressive year-over-year as they are just looking to build more trucks as we turn into fiscal '22. But really, all they're doing is getting back to 2019 base levels, maybe a little bit above that. So we've been able to satisfy that base requirement during that time frame. And we have, since that time, additional capacity expansion online. So what we really need to do to be able to get the necessary bump and take care of our customers is get past the -- mostly raw material base shortages that we have been seeing and really continue working hard on the supply chain activities because our capacity is there. And so once we get past the raw material portions, then it becomes a people-based conversation in the United States and can we get more additional personnel into our manufacturing plants.

Other parts of the world, Latin America, Western Europe, we're absolutely fine. And even in China, we're doing really quite well there. So that will likely become a little bit of a U.S.-based story as you have been hearing in the news. We are not immune to some of those conversations.

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

Okay. Okay. And just -- I'm sorry, one last thing. And just from your comments around the Analyst Day plan, some of your comments here around raw materials pricing. When you put this all in the bucket and shake it up, it does sound like the expectations going into fiscal '22 are still somewhere around this 100 bps of op margin leverage with all the levers being pulled and pushed. Is that still just a realistic starting spot assumption for op profit in '22?

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

Yes. So we're working hard through our plan right now. Our FP&A team is faced with a very dynamic environment and doing an excellent job keeping track of things. And so back to the FY -- the targets that were in the Investor Day. So we had a -- 15% was the low end of the range. And as you pointed out, our current range is 14% at the midpoint. And so I would view that more as a 2-year journey versus a 1-year journey. I mean, we're committed to increasing levels of profitability on increasing sales, and we think we can do that, while continuing to invest in our growth initiatives. So we want to continue to push money into the places that have good growth opportunities. And so I would look at that journey more of a 2-year step. And I think you might have been looking at it more as a 1-year step.

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

Okay. With incentive, one more lever -- with investment, you're suggesting 50 bps would be the better '22 target, but that's what you're implying there?

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

Yes. I mean, we have to finish our plan, and we'll give you detailed guidance at the end of Q4 here, but I look at it as more as a 2-year journey.

Operator

Next question, we have the line of Brian Drab with William Blair.

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

First one, just -- so a specific question just on the cost that you're seeing this year. For the full year fiscal '21 as a result of supply chain issues, input costs and freight, just with the thought that these are temporary. I know you said, clearly, some of this will trail into fiscal '22. But I'm just trying to gauge the magnitude of a potential gross margin tailwind in fiscal '22 relative to '21 with all of these unusual items that are happening this year.

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

Yes. So I mean, it's -- like I said, it's kind of a dynamic environment. To predict where some of these input costs will go and will they come back down, or when will they come back down. So we're expecting, obviously, pressure in the fourth quarter and into next year. And so our raw materials and our freight are going to be pressured. And so we'll have to see where that goes and where we want to kind of cast our final plan assumptions.

And so right now, I don't know if I can predict whether there's a headwind or a tailwind. I would predict, for sure, there's a headwind in the first part of next year. And then the big question is, right, when will the costs start to abate or will they abate, and when will that happen and how will that flow through our results. So, we want to get a bit smarter with another 90 days. So again, the big pieces will be raw materials and freight, will certainly start out as a headwind. We have a $25 million incentive comp tailwind that will get because we can reset bonuses. So that will obviously bring us some relief against those first 2 items I mentioned. And then we'll expect to get continued leverage on increasing sales. So those are the big pieces that will go into our calculus on the plan. And I promised to come back to you at the end of the fourth quarter with some more specifics in that regard.

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

Yes, Brian, this is Tod. I'd just add a little bit of color and tell you that we are laser-focused on the issue, laser-focused on the math and also the commodity-based spreadsheets that we have in order to be able to put pricing actions in-flight, and that is consuming our energy these days across the organization in order to make sure we can press forward. But as Scott says, the more difficult piece to predict is the back half of next fiscal year. And so therefore, we'll be smarter in about 90 days and really update the full year picture.

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

Okay. Got it. And then one more question. I just want to understand what you're thinking for the fourth quarter here because the Industrial sales were up 8% sequentially and Engine sales were up 15% sequentially in the third quarter, but the full year guide implies a sequential downtick slightly in Engine and about flat in Industrial. I'm just wondering why that's not conservative in this environment? And also, the fourth quarter historically is up seasonally, isn't it?

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

Yes. Historically, our fourth quarter would be up just slightly. And so as you know, we're kind of more in the flat, but just barely down in the fourth quarter with the current guidance. So we're really focused on the supply chain issues that are there. That's governing how fast we can run the plants, and our operations team is doing an excellent job of procuring all the materials they can get their hands on to build as many filters as we can get and get them out the door. We have May in hand for the most part. May was a little bit softer than the current run rate, and we expect June and July will pick up. And so therefore, we wanted to take what we thought was a reasonable posture with regard to a Q4. With even being generally in that flattish area, we'll still be up 25% over the last year. And pretty consistent with this third quarter, which was a really big quarter for the company. In fact, our biggest quarter in our company's history. So, we wanted to keep that in mind as we look at the fourth quarter.

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

Yes. Brian, this is Tod. Maybe a little bit more color. I would tell you, this is not an incoming order question. This is not our ability to execute inside our manufacturing plants-based question. This is a raw material ramp-up question and also really the supply chain issues and challenges that we continue to work through. We're really proud of the way that we are executing in the moment, but that is the question that still remains, could we get even more than our current record that we just set in third quarter.

Operator

Next question comes from the line of Laurence Alexander with Jefferies.

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

It's Dan Rizzo on for Laurence. You mentioned that the capital projects were coming to an end and CapEx is a bit lower. I was just wondering, as we look out over the next 2 or 3 years, what your thought process is for additional capital projects? Are you comfortable with where you are? Or I mean are you looking at more expansions or what?

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

Yes. So that's a good question. So we've said for the last several quarters that our CapEx was going to come down this year as we really focus on completion of many of the large-scale projects that we have undertaken. And so we're very pleased to be bringing these projects to completion and beginning to get the return out of those projects that we always expected. And so this year, we spent more time kind of fine-tuning and completing projects than really buying new equipment. And we said that, that would happen. And that next year, we would expect to return to a more normal level.

So our CapEx is clearly going to go up from this year, probably back to more along the lines of our historical average. If you look in the Investor Day, it seems like people have the Investor Day book out, you'll see there's a slide in there that shows our long-term history and then projected an increase for a short period of time. And we would expect to be down from the big years that we've had and more in line with what we've done in the past.

So you can take a 2.5% to 3% of sales is kind of a reasonable range for us. If we can find projects that are bigger that have a good return, we'll always be willing to execute on those projects. We want to be good stewards of capital, but we want to deploy capital to help increase the capital investment and help increase the return on capital invested. So, we look at that as part of our planning process, but maybe, in short, it will go up from this year.

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

That's very helpful. And then just one other question. You mentioned, obviously, improving profitability is a focus. I was wondering if there's still areas where you could do some bottom slicing or discontinuing certain sales of products or just areas where you would be removing things just to improve overall profitability, that would maybe be a sales headwind?

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

Yes. So, I mean, I think our -- we've talked for years about our Oracle implementation that we completed about four years ago. And our finance team and our IT team have done excellent work to improve the visibility and information we get out of the system, such that we have much more granular information at a product level. And so, I think our business units have been doing an excellent job looking at

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their product level profitability by part, by region. And so, we can give them reports that show their weakest products or projects, and then they can begin to focus on those by either deemphasizing the product and/or increasing the prices on those products. So, I would say that's something we work on, on a daily basis. And our finance people, I think, are doing a good job helping identify those opportunities. Instead of growing revenue, improving the profitability on your existing revenues. So, I would say we're doing that, and we still have room to improve, but that's something we will definitely continue to focus on.

Operator

Our next question, we have Dillon Cumming with Morgan Stanley.

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

I just wanted to go back to the kind of commentary around the restocking. I guess you kind of alluded to this in earlier comments, but is your sense just kind of that the supply chain is not in a position to kind of meet the demands of the restock. And I say that, I guess, if I'm looking at the approximate rate at your early partners and then your commentary about utilization in the Aftermarket channel? I mean, that to me, it kind of should be suggesting a more meaningful restock at this point in the cycle. So, is it just a question of, you can't produce to that? And do you kind of expect to see that more meaningfully as you look into next year?

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

I think you handicapped that very well.

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

Okay. Got it. Maybe this is kind of along the same lines. I'll kind of piggyback into this question, but you kind of laid out some of the commentary around the capacity investments. You clearly feel like you're kind of well aligned for the next, I should say, a cycle here. But I guess taking a step back, when you look at, where inventories are relative to cycle averages, your kind of customers and within the independent distribution channel. And you kind of see the utilization and the production trends that are materializing more recently. What is your view of this kind of current industrial up-cycle or maybe versus the one you saw in '17 and '18? I mean are you expecting this could be a 3 to 4-year cycle versus the kind of 2 to 2.5 one that we saw over the '17,'18 period?

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

Yes, it's a great question. So we take a look at that and debate it internally as well. Clearly, we think it's a multiyear cycle for sure. Because of the fact that if you just look at ag, we're probably early cycle on ag. If you look at mining, mining is, frankly, just waking up compared to its heyday. Construction might be early, late cycle. However, if we do get an infrastructure bill, then overall utilization goes up across the country. And so consequently, that probably then goes mid-cycle because we should see a bump and a pickup from that. Overall truck rate production, they are not building yet at the level that they were at, say, 350,000 trucks. Sure, they have the orders, but they're not being kicked out at this point in time. So, we see a lift there. That is going to be a multiyear lift.

And then on the Industrial side, what we just talked about as a result of all the OE-based demand that we have, that's when CapEx starts to flow real well and bodes well for our project-based industrial businesses. So, we -- overall, when we step back and we look at our corporation, we do see this as a multiyear uptick. And we look to be in a position based upon the capacity investments that we've made across our corporation and the strategic choices to invest in our people and really protect the foundation of our corporation long-term throughout the pandemic as really excellent strategic choices that will be paying dividends for our company for this multi-year cycle for sure.

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

Got it. And that's really helpful color. And maybe just one last one to wrap it up. I wanted to go back to your commentary on kind of On-Road, in particular. I think you were calling out higher build rates in China and kind of an increase in revenues there just for the On-Road business. I guess, it's kind of a bit surprising to me because, I think, in some of the more recent market data we've seen coming out of there. It suggests that, that market seems to be rolling over a bit. I mean, obviously, you've had a lot of share gain there over the past few years. So, I guess, do you feel like that level of outperformance is just more reflective in some of those share gain efforts? Or what's kind of going on in the end market for you guys?

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

Yes. We do believe that we can outperform the market rate within China. But please remember, we're coming from a low share. And so, we were low single digits, and so the number and percentages look pretty wonderful. But that also gets us, say, to a mid-single-digit share. And so, we have some wonderful runway ahead of us. And the share gains that we're winning on the first-fit production does see us have capacity expansion in China be able to meet our region-for-region-based manufacturing strategy going forward. But we do expect to outperform the growth rates within the China-based markets, just simply because of the share gains that we have. But also because, frankly, the comps are a little easier.

Operator

There are no further questions.

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

Thanks, Brian. So that concludes today's call. I want to thank everyone listening for your time and interest in Donaldson Company. Goodbye.

Operator

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

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