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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Donaldson's Fourth Quarter 2021 Earnings Conference Call. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Charley Brady, Director of Investor Relations. Please go ahead.

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

Good morning. Thank you for joining Donaldson's Fourth Quarter and Full-Year 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 fourth quarter performance and the key considerations for our fiscal 2022 outlook.

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. Additionally, 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. We had an excellent finish to a strong year. We achieved another quarterly sales record, and EPS was up 32% in fourth quarter, resulting in full year sales and EPS that were both near the high end of our guidance ranges. Our team did an incredible job over the past 12 months, and I want to thank them for their contributions.

As we look ahead, conditions will likely become more challenging, particularly in the first half of fiscal '22. We are already facing supply chain disruptions, primarily due to labor shortages in the Americas, and raw materials inflation puts significant pressure on gross margin. While the magnitude of these issues is greater than what we have experienced in recent years, our playbook for addressing them is time tested.

We are pursuing growth opportunities in our Advance and Accelerate businesses. We are raising prices to mitigate the impact of cost increases, and we are leveraging our strong relationships to remediate and overcome the current supply chain challenges. When we roll these things together, we feel good about where we land. Our plan reflects continued progress on our strategic initiatives, and we expect to deliver record levels of sales and record profit in fiscal '22. We will share more details about that later in the call, so I will now provide some context on fourth quarter sales.

Total sales were $773 million, which is up 25% from last year, as we compared against the toughest patch from the pandemic. If you normalize the trend with a two-year stack comparison, fourth quarter is right in line with what we had in the third quarter, suggesting we are maintaining sales momentum. In Engine, total sales were up 28%, and the increase was again led by our first-fit businesses.

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Fourth quarter sales in Off-Road were up 58%, including about 15 points of growth from Exhaust and Emissions. We won a significant amount of new business over the past few years in anticipation of a new emissions standard in Europe. These programs were slower to launch due in part to COVID, and we are now seeing a dramatic ramp-up in demand.

It is worth noting these sales create mix pressure for us. We are enhancing the Exhaust and Emissions cost structure to reduce the impact on margin. But based on the nature of this business, that will only get us part of the way. I want to thank the operations and business teams for doing an excellent job balancing the needs of improving profitability while managing through a massive amount of new demand.

Staying with Off-Road, we continue to have strong growth in our innovative razor-to-sell razor blades products. These products make up about one-third of Off-Road filter sales, and they grew substantially faster than their nonproprietary counterparts in fourth quarter. This trend continues to reinforce that our strategy is working. We develop value-added products that drive aftermarket retention for our customers and us.

We are experiencing similar trends in On-Road. Fourth quarter sales were up 36% from prior year, and innovative products, which make up nearly half the business, grew twice as fast as the nonproprietary counterparts. In the U.S., fourth quarter On-Road sales continue to benefit from higher Class 8 truck production, and there was also an impact from a strategic choice we made.

During the quarter, we stopped selling some directed-buy equipment to a large OEM customer. If we adjust our current and prior year sales to exclude these products, the like-for-like growth in the U.S. is about 35%, and we are left with a more profitable business that allows us to focus on what we do best, technology-led filtration.

I also want to call out Latin America, where fourth quarter sales of On-Road tripled versus a year ago. The growth was from large OEM customers in Brazil. And although it is exciting to see the sharp growth, I want to note that it is on a very small base.

In Engine Aftermarket, sales were up almost 26%. In fact, fourth quarter sales of $376 million were the highest ever, beating the record we set last quarter. Supplier constraints are one of the more challenging parts of the Aftermarket business right now, and those issues seem to be more severe in the Americas. Despite that pressure, independent channel sales grew in the high 20% range, and fourth quarter sales in the Aftermarket OE channel were up in the low 20% range.

Innovative products remain a strong contributor to growth in Aftermarket. These razor blade products accounted for more than a quarter of total Aftermarket sales, and they grew in the mid-20% range during fourth quarter.

I would be remiss if I did not mention PowerCore. We launched the brand almost 20 years ago, and sales of these products have grown every year since at least 2010. We finished fiscal '21 at another record, and we anticipate a long runway for continued growth. We are compounding Aftermarket growth with share gains in less developed markets like Latin America, Russia, and South Africa. These were some of our fastest-growing markets, and we believe our strong distribution and comprehensive product offering position us for long-term success in these regions.

In Aerospace and Defense, fourth quarter sales declined 8%. Commercial aerospace remains under pressure from the pandemic, particularly in Europe. That decrease was partially offset by higher sales of ground defense equipment. As always, Aerospace and Defense sales can be lumpy quarter-to-quarter, but we are optimistic about returning to growth in the new fiscal year.

Before turning to the Industrial segment, I want to make a point about our Engine business in China. One year ago, Engine sales in China were up almost 25%, while the rest of the regions suffered through the pandemic. Fourth quarter Engine sales were up again this year by about 2%. The strategy in China continues to do well as we win new programs with local manufacturers, but it is the one place in the world where we faced a tough comparison from last year, so I wanted to point that out.

The Industrial segment also had a solid quarter with total sales growing 19.5%. Sales of Industrial Filtration Solutions, or IFS, were up more than 23% in fourth quarter, reflecting strong growth in new equipment and replacement parts. New equipment makes up nearly

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half of IFS sales, and these products grew in the mid-teens last quarter, which builds on the recovery that began six months ago. There is still a cautious tone in the market, but we see some signs of improvement, and our order intake trends add to our confidence.

The replacement parts of dust collection are a more optimistic story with fourth quarter sales up nearly 40%. Activity continues to accelerate in factories, and we continue to gain share with our proprietary dust collection products. Another growth engine within IFS is Process Filtration, which serves the food and beverage market. Fourth quarter sales were up almost 20%, reflecting growth in new equipment and replacement parts. The market opportunity for Process Filtration is fantastic, and new high-growth areas like plant-based food and beverages only increase our opportunities. Consequently, we will continue to expand the team and look for another year of strong growth in fiscal '22.

Sales of Special Applications grew 27% in fourth quarter with strong contributions from both Disk Drive and Venting Solutions. Disk Drive benefited from timing, and Venting Solutions continue to make ground with automotive customers. Fourth quarter sales of Venting products grew 50% with almost two-thirds of the increase coming from Asia Pacific. With our high-tech powertrain and battery vents, we are winning new programs and expanding with existing customers across the world, resulting in another year of growth for Venting Solutions.

Fourth quarter sales of Gas Turbine Systems, or GTS, were down 11%. The decline came from the U.S., which is typically our largest GTS market as sales to small turbines were under pressure. We continue to operate this business with discipline. So our focus in GTS remains squarely on growing replacement parts while being selective in which new turbine projects we pursue. Overall, the theme of discipline comes into everything we do, and that gave us a significant advantage during the pandemic.

We achieved record sales in each of the last two quarters, and our full-year EPS is an all-time high. We did that work safely. We focused on our people. We implemented protocols that made sense based on local conditions, and our employees acted as one team to deliver outstanding results. We plan to follow that up with another year of record sales and record profit in fiscal '22, and I'm excited about what we can accomplish.

Now I will turn the call to Scott for his update. Scott?

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

Thanks, Tod. Good morning, everyone. Every way we look at it, fiscal '21 was a solid year. We generated strong sales despite the pandemic hanging over us, and margin growth contributed to record full-year EPS. What was more impressive was how our people operated. The level of teamwork was unbelievable, and I am inspired by the commitment they showed. I want to thank my colleagues around the world for all they did in fiscal '21 and for putting us in an excellent position to deliver record sales and profit in fiscal '22.

Before getting to the details of the new year, let me share some 2021 highlights. Fourth quarter sales grew 25%. Operating income was up 36%. And EPS of $0.66 was 32% above the prior year. As I know you've heard me say, we are committed to increasing levels of profitability on increasing sales, and we did that in 2021. I want to add a short disclaimer. That commitment is over time, and it won't be easy to achieve in the first half of fiscal '22. I'll touch on that in a few minutes.

So back to the fourth quarter recap. Fourth quarter operating margin was 14.5%, an increase of 110 basis points from the prior year. Most of the increase was from gross margin, which grew 70 basis points to 34.4%. Strong volume leverage and initial pricing benefits more than offset the impact from higher raw materials costs and mix headwinds. The impact from raw materials increased throughout the quarter as inflation has begun coming through in full force. We were in front of this impact with price increases in certain businesses while increases in areas with supply agreements that have index clauses tend to lag the market. That's true when prices go up or down, so it works out over time.

Leverage and pricing also accounted for higher fourth quarter gross margin both segments. However, challenges from inflation and unfavorable mix will likely be the themes in fiscal '22. Operating expense as a rate of sales was favorable at 40 basis points, driven primarily by volume leverage. That was true in both segments with Industrial gaining a lot of improvement from leverage. The strong volume leverage was partially offset by higher incentive compensation due in part to a soft comparison last year and incremental

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investments in our strategic growth priorities, which will continue in fiscal '22.

I also want to touch on Corporate and Unallocated line in our segment reporting. The fourth quarter increase of almost $10 million reflects a couple of factors. This year's expense, which includes additional incentive compensation and higher benefits costs and a much easier comparison in the prior year.

Moving down the P&L, fourth quarter other income was $5 million. While the amount itself is not material, I bring it up because we ended the year above our guidance. So, in case there are questions, the favorability reflects a handful of nonrecurring items including a tax settlement in Brazil and lower loss on foreign exchange.

In terms of our other financial metrics, fourth quarter was in line with expectations. Therefore, our full-year interest expense and tax rate were both consistent with guidance. Fiscal '21 capital expenditures were also in line with our forecast and way down from 2020, as we took a planned pause following the investment cycle over the past 3 years.

We directed about a quarter of a billion dollars to shareholders in fiscal '21. We repurchased 1.9% of our outstanding shares for $142 million, and we paid dividends of $107 million. Including the 5% increase we announced earlier this year, we are on pace for more than 25 years in a row of annual dividend increases, which is a trend we are extremely proud of.

I also want to highlight the fiscal '21 adjusted cash conversion of 116%. Our DSO and DPO metrics were both favorable versus the prior year. Inventory turns improved, and CapEx was down. While strong net income obviously helped our cash conversion, I am pleased with the way we managed our balance sheet. We continue to have the flexibility we need to invest in our strategic priorities, including organic and inorganic growth. That's the setup for fiscal '22. We begin the year on solid ground, and we are well positioned to deliver our objectives.

Before getting into the details, I want to acknowledge that there is still a lot of economic uncertainty and high variability across our end markets and geographies. Based on that, we used wide ranges for total and segment-level guidance to reflect our reality. Of course, we will tighten things up as the year progresses. With that, fiscal '22 sales are expected to grow between 5% and 10%, with currency translation being negligible.

Engine is also planned up between 5% and 10%, and Industrial is a bit higher at 6% to 11%. Within Engine, sales of our first-fit businesses are expected to remain healthy, particularly in the first half of the year. Fiscal '22 On-Road sales are planned up in the low-single digits, while Off-Road sales are projected up in the low-double digits. The Off-Road first-fit growth also includes benefits from new programs and Exhaust and Emissions, which give us top-line leverage and gross margin mix headwinds.

For Engine Aftermarket, we expect full-year sales growth in the mid-single-digits, with equipment utilization being complemented by share gains from our innovative products and under-penetrated markets. We anticipate low double-digit growth in Aerospace and Defense due in large part to comparing against the challenges of fiscal '21. Sales of Industrial Filtration Solutions are planned up in the low double-digit range, reflecting a few things. We expect a rebound in sales of new equipment, particularly for dust collection and continued growth in dust collection replacement parts. We also expect another year of strong growth in Process Filtration, which reflects benefits from further investments to expand the team.

Fiscal '22 sales in GTS are planned up in the high-single digits, while sales of Special Applications are planned down in the low-single digits. Within Special Applications, we expect lower sales of disk drive filters, should be partially offset by growth in Venting Solutions.

In terms of operating margin, we expect a full year rate between 14.1% and 14.7%. This range implies an increase of 10 to 70 basis points from the fiscal '21 adjusted operating margin, and we expect the improvement to come from expense leverage. Gross margin is expected to be flat-to-slightly down from the prior year, with raw materials being the single biggest headwind.

At today's prices, we expect to pay 8% to 10% more for our raw materials this year, and that translates to a gross margin impact of nearly 3 full points in fiscal '22 margin. There is still a lot of variability, and where prices have come down some, it is only a modest change

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relative to the massive run-up over the past few months. So we do not yet have signs of meaningful relief. And one final dynamic to keep in mind is that we had raw materials favorability during the first half of fiscal '21.

Consequently, we expect substantial pressure on our first half gross margin and then moderating pressure as the timing of our price increases roll in and catch up to the current market pricing. Importantly, we have already taken action to limit the impact. We implemented several off-cycle pricing actions over the past few months, and we have more planned for this fiscal year, but those will take time to roll in.

As benefits from pricing compound and costs stabilize, we anticipate gross margin in the second-half of fiscal '22 should be up versus '21. Restructuring actions we initiated in fiscal '21 will help reduce the impact a bit. We continue to expect annualized savings of about $8 million with about $5 million to $6 million landing in fiscal '22. A large portion of those savings benefit operating expense, and there are a handful of other puts and takes we considered in our operating expense budget.

For example, we anticipate savings from incentive compensation, as we reset our annual bonus plans. And we expect to increase travel expense as the pandemic-related restrictions subside and we get back to visiting customers. We are also making incremental investments in our Advance and Accelerate businesses including another 10% increase in research and development spending. Altogether, we expect total operating expenses will be up from the prior year, but to a lesser extent than sales, resulting in net leverage that drives year-over-year growth in operating margin.

In terms of other key financial metrics, fiscal '22 interest expense is planned to be about $14 million. Other income is projected between $7 million and $11 million, and the tax rate is expected between 24% and 26%. Capital expenditures are planned up in fiscal '22 with a full-year estimate of $100 million to $120 million.

We are expanding PowerCore capacity, primarily in North America, and investing in tooling for new programs and cost reduction initiatives. At the same time, we will further optimize and leverage the investments we made a few years ago with the goal of growing ROI again this year. Additionally, we expect to repurchase about 2% of our shares in fiscal '22, keeping with our multi-decade trend and reaffirming our commitment to shareholders.

Finally, we will maintain a strong balance sheet to allow us to act on any acquisition opportunities in the Life Sciences space. Based on these forecasts, we plan for a new EPS record between $2.50 and $2.66 and applying an increase from last year's adjusted EPS of 8% to 15%.

To help with modeling, I want to also offer a few comments about the anticipated cadence of results in fiscal '22. It's actually pretty straightforward. The first-half has an easier sales comparison, meaning we planned for more of our full-year increase to come from the first-half than the second. The reverse is true for operating margin.

As I said a moment ago, gross margin will be under substantial pressure in the first half. While we foresee expense leverage all year, it won't be enough in the first-half. Then as things normalize and pricing takes hold, operating margin should be up year-over-year in the second-half.

Overall, our company has a long history of solid expense management, and we have responsible leaders across the world that will invest where appropriate. What we need to do is achieve pricing, and that takes a global coordinated response. We talked about it a lot during our plan process, and I know every level of the organization is committed to protecting gross margin and delivering another year of strong profit improvement.

I think we are in an excellent position to deliver on our strategic and financial goals in fiscal '22 due to the dedicated employees around the world. To all my Donaldson colleagues, I want to thank you again for a great year and your continued commitment to our long-term success.

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

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

Thanks, Scott. While there is a lot to consider in our fiscal '22 plan, our priorities are straightforward; gain share and outperform our markets, protect gross margin, deliver best-in-class levels of service and continue to invest in our team and company culture.

Let me share a few of the ways we are attacking these priorities. The best tactic for growing our share is continued investment in our Advance and Accelerate portfolio. We are adding staff and developing tools to help these teams deliver strong growth again in fiscal '22. Areas like Process Filtration, dust collection replacement Parts and Engine Aftermarket are all positioned to have another very successful year. We will also drive above-market growth by capitalizing on the market recovery related to new equipment. We seek opportunities to plant first-fit seeds in both segments from Engine products to new industrial equipment, and we must take advantage of this moment to capture future aftermarket growth.

We have a strong value proposition for every customer. And this year, we have aggressive plans to get back into the field and drive selling. Additionally, we remain committed to growth through acquisitions. We continue to work a robust pipeline of potential targets with the primary focus on expanding into life sciences and supporting our Industrial segment growth. While there is no update to share today, I am confident that our strong balance sheet, laser focus and disciplined adherence to our long-term strategy give us an excellent opportunity for success.

Another priority in fiscal '22 is protecting our gross margin. At our Investor Day two years ago, we talked about our plans to improve gross margin. Since then, we have executed. Compared with fiscal '19, fiscal '21 sales are about flat and gross margin is up 90 basis points. We acted with speed, and fiscal '22 will be no different. We proactively took price increases when we saw early signs of inflation, and we planned for additional increases to catch up with the massive acceleration we saw in raw materials costs.

Given the magnitude of the incremental headwind, especially in the first-half of fiscal '22, we will stay vigilant and continue to pursue margin-accretive price and cost-reduction opportunities. We are also closely monitoring our supply chain to improve the situation. With labor shortages now superseding raw materials availability as a top concern, our global operations team is having to adapt quickly. With our global footprint and strong relationships with customers and suppliers, I am confident we will navigate the situation and deliver the best-in-class service Donaldson is known for.

Finally, we will continue to invest in our team as part of our multi-year journey to further strengthen our human resources processes. This year, our focus is on global alignment around career planning and development. We are also expanding our diversity, equity and inclusion efforts, which will be part of how we continue to build out and strengthen our ESG program.

We turn 106 years old this year, so we clearly value long-term thinking. Our investments in supporting our team and embracing the positive changes in society are critical parts of how we will succeed in advancing filtration for a cleaner world.

As I close, I want to again acknowledge our Donaldson employees, I have been with the company for 25 years, and this team continues to find new ways to impress me. Thank you all for what you accomplished in fiscal '21, and I am looking forward to another great year in fiscal '22.

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

QUESTIONS AND ANSWERS

Operator

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

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

I was hoping you could frame run rate demands versus pre-pandemic levels a bit more. Total 4Q sales were up a little over 6% versus fiscal '19, although I suspect supply chain constraints may be masking some underlying strength beyond that level. Can you offer a little more color on backlog, order rates or any other metrics we should keep in mind versus pre-pandemic rate?

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

Yes, this is Tod. So if you take a look at our backlog, our backlog is obviously very high, higher than, frankly, we would like to see it. And it really reflects the difficulties across the supply chain, primarily a U.S.-based story. It's very difficult right now to get steel and urethane-based products. And so given the guide that we have, we have baked that consideration in.

Additionally, we are really under pressure now to get employees hired in the United States in order to be able to build off the backlog. That said, other parts of the world are really uneven as a result of COVID. And so what we have tried to do is recognize and embrace those difficulties, and we have put that into our guidance.

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

It's helpful color. And in terms of your guide, topline dynamics certainly makes sense, particularly first versus second half in Engine, and we'll see how the next couple of quarters shake out overall. Is there any more detail you can offer on segment margin outlook and how understood price/cost headwinds and some potentially unique mix impacts are likely to flow through during the year?

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

Bryan, it's Scott here. So I mean, we were obviously pleased with the margin performance of both segments this year. We had good volume growth and good pricing and good leverage. And next year, we see headwinds for both segments. As Tod mentioned, supply chain is pretty stressed, and obviously, raw material pricing is way up. And so we said in my script that we have an 8% to 10% increase in typical commodity cost, representing a 300 basis points of operating margin headwind that we need to offset. And so we're focused on driving pricing in both segments to counter that, and we've done some already, and we have some to go.

We said our gross margins would be flat to just slightly down. So we're expecting to pull both -- pull that 300 basis points back through our own actions that we're focused on, which again is really price-driven and then volume leverage. So I think both segments are equally challenged in terms of commodities and raw materials pricing. And the guide overall is expecting another year of operating margin growth. That comes from a relatively flat gross margin and then leverage on the operating expenses to allow us to drive an operating margin improvement from 10 to 70, 80 basis points.

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

Okay. I appreciate that detail, Scott. And I think you mentioned Process Filtration sales up around 20% in 4Q. Sorry if I missed the detail, what was the full-year sales level? And what's contemplated for process growth in your '22 guidance?

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

Yes. So we'd be mid-teens for the full year on a growth level for Process Filtration, and we also expect to have double-digit growth looking forward in '22.

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

That's excellent. And one more if I can, a portfolio question, what was Advance and Accelerate revenue as a percentage of fiscal '21 total? And on the other side of things, is it only Exhaust and Emissions at this point in the fix and reposition bucket?

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

Yes. So, well, Charley looks at the portion of the first question -- or the first portion of the question. Exhaust and Emissions remains in the fix and reposition, but we also have our Aerospace business in there, as you might imagine. We do expect Aerospace to come out of it at the end of this year, but we actually bring portions of the company out of fix and reposition after they've delivered. We're very confident and comfortable with the plan that we obviously had this year. However, now I have to deliver it, and then I will -- we would expect them to probably come out of it next year.

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Operator

Your next question comes from the line...

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

Hold on.

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

Yes. Yes. So before the next question, Charley, do you have that number?

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

Yes. So the Advance and Accelerate portfolio, fourth quarter sales were up in the mid-20% range. They were about 950 basis points better on a margin than the overall company, excluding the A&A business.

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

Okay. And as a percentage, the company is about?

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

60%.

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

60% to 65%. Yes. Okay. Thank you, operator.

Operator

Your next question comes from the line of Nathan Jones with Stifel.

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

I wanted to start off digging a bit further into gross margins. Overall, roughly flat, but there's a lot of moving pieces in there. And you guys have added some capacity to remove some bottlenecks a couple of years ago, leveraging the ERP system. We're supposed to be lifting up gross margins. And you're offset here obviously by significant cost inflation and where the pricing is making up for that or not. So I was hoping you could maybe give us a little bit more color on puts and takes there? What is the headwind from price cost to gross margins? Just any more color you can give us around the puts and takes in the gross margin line?

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

Yes. So certainly, there's a fair amount going on in there, Nathan, as you noted. Again, we -- the biggest impact is obviously the commodity cost increase is, of say, 8% to 10%, which gives us a 300 basis point headwind that we have to offset, okay? And we're offsetting that with pricing and higher volume, which allows us to leverage our facilities. And so the way we see the year rolling out is what we have termed a bit of a bathtub curve.

And so your first quarter will be down the most significant, and that will be offset by improvements in the fourth quarter. Your second quarter will be down a bit, and that will be offset by improvements in the third quarter. So as we layer in pricing, and hopefully, commodities begin to stabilize a bit, we're going to work our way out of this cycle, and hopefully, gross margins for the year will be flat to just slightly down. And so you can imagine the first quarter being the toughest quarter, and then things slowly start to improve, whereby when you land in the fourth quarter, you're essentially offsetting your gross profit negativity from the first quarter to allow flat to slightly down margins for the whole year.

So it's number one, commodity pricing that drives our raw material input costs up. There's also certainly some interest that we have in increasing our salaries because demand is high for people, and that's a headwind. We have our cost reduction improvements at our operations team that's consistently operating on. We've had the capacity expansion that we've talked about previously, which allows us

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to operate more efficiently. We had increased volume, which gives us better leverage and ability to leverage the overall fixed cost in the plants. So that's kind of all in the soup. And we expect this year to be flat to just slightly down in terms of gross margin with improving operating margin based on expense leverage.

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

Maybe just a strategic comment on it too Nathan is the capacity expenses that we did across the company here in the last three years. we stand in really good shape to take advantage of leverage with the higher book of business. Clearly, if we can work through the supply chain problems that we're experiencing in raw materials activities right now, I like our competitive position given our ability to produce and where we stand right now.

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

And do you expect for the full year of fiscal 2022 to offset the cost headwinds with price on a dollar basis, but it's still dilutive to margin?

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

Well, we think our gross margin will be flat to just slightly down, okay? So from a percentage perspective, we should be flat to just slightly down. But our dollars -- because our sales are up significantly, our gross profit dollars will be higher, obviously. And we're going to leverage our OpEx. So we're going to grow OpEx, but not nearly as fast as revenues. And so that gives us a bigger driver in operating margin as well as operating profit.

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

Got it. And just a question on the labor shortages. You're talking about labor shortages for your own facilities in order to produce products. What kind of steps are you taking to try and get more skilled labor in, retain the labor that you've got currently? And how you see that playing out going forward?

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

It is not just Donaldson company with labor shortages. It is our supply base that has labor shortages. To the point of where we have actually called retirees in to help Donaldson Company to sit at our supply base to try to help with overall scheduling, to get our demands. We have done overall typical type of salary-based adjustments across the manufacturing plants and recruiting-base adjustments with sign-on bonuses, et cetera.

It's primarily U.S.-based story relative to that, and we're pulling all the levers that you typically would read anyone else doing right now across United States. But I would suggest to you that in other parts of the world, it's not a labor story, it is really more of a raw material story.

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

Do you have an expectation for labor inflation this year?

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

We've baked it into the guidance that we've given you at this point.

Operator

Your next question comes from the line of Brian Drab with William Blair.

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

Yes, yes, too many buttons to press here. Sorry.

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

We all know that.

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

Myself quite didn't get to the right app first thing. Congratulations on a great year in such a tough environment.

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

Thank you.

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

Yes. So I just want to make sure first of all that I understand what we're saying about the 300 basis points. Is that from -- what's the time period that we're talking about there? Because we just finished the year at 34% gross margin. Is that to say that first quarter '22 is going to be around 31% and then we build from there?

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

No, I don't -- I think we already have some things that are building. So clearly, our first quarter would be less than 300. That's the total dollar impact of the raw materials cost. But we've been layering in price increases, and we'll have good volume growth in the first half because of the softer comps. So it will be less than 300, and it will be the highest in the first quarter and then a little bit less in the second quarter, but less than 300 because we have some things that are already in place, and we'll also be working on that in the first quarter.

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

I see. So the 300 is just the impact related to raw materials, and you're already dealing with some significant. I mean, what's the magnitude of -- how would you quantify what the headwind from raw materials was in the second half of '21 -- fiscal '21?

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

Yes. Well, I mean we had -- right, good question. So we had -- actually, that's an interesting dynamic of last fiscal year is that we actually had raw material favorability in the first half because things were really hadn't started to take off yet. And so the impacts that we've seen from a negative perspective are primarily related to the second half of the fiscal year, and now those are layering into next year. So I think you have it kind of analyzed properly.

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

Okay. And then you talked about the segments and the margin, but just to kind of help us model there, the segments ended the year with Industrial operating margin above Engine, but kind of for the year, they're pretty even. And I know you said you expect to see kind of similar pressure from raw materials across both segments. But should we -- and I don't know if you said this in the guidance already, but are the segments going to probably have similar operating margins in the next year or one will have more pressure than the other?

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

Yes. I mean from a cost perspective, they're going to both have similar raw material issues. Obviously, mix is a big driver. And we generally don't provide specific guidance in terms of each segment and their profitability. But we look for continued growth in profitability from both sides.

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

Yes, Brian, maybe a little bit more color itself for the model is that if you just remember how we drive our Industrial base business, it's a project-based business. And so as we wash those projects out, we're able to adjust to the pricing across that business as well as the independent channels on our aftermarket, which we control more on the Industrial side than we do on the Engine side. We do quite well on the independent aftermarket channels, but it's the OE portion of the business, which is roughly 35% of the business, that always lags within the pricing. And so you'll see likely more headwinds on the Engine side in the first portion of the year as we work through it.

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

Okay. And then just the last question is the high level kind of strategic question. Over the last 18 months, I imagine just given how fragmented the filtration industry is that you have seen some competitors either really struggling or disappearing. And obviously, that's not the case with Donaldson, very strong established company. So I'm just wondering, are you seeing opportunities to take care, win customers and are there new opportunities that you're hoping to capitalize on over the next year?

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

So we have seen some small kind of call them mom-and-pop shops go away. Obviously, they've been pressured across the world. But that really hasn't changed the overall long-term environment for us. And we look to win every single day, and we look to plant seeds for future growth with our leading technology-based products. Those that are falling off by the wayside are typically chasing the commodity-based activities. And so while that may change the filtration landscape, it doesn't change Donaldson's ability to capture share or to go off and really inventing cool things, which we continue to do every day. So not really a lot of competitive changes, if you will, in the landscape.

Operator

Your next question comes from the line of Laurence Alexander with Jefferies.

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

This is Dan Rizzo on for Laurence. You mentioned urethane, I think, as one of the raw material costs that are kind of on the rise and inventory or supply being a little constrained. I was wondering if the storm in the Gulf earlier in this week, if your suppliers have signaled to you that, that might make things even worse?

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

Yes. It's a fantastic question. Actually, we've been dealing with that here obviously throughout the last short period of time. And yes, we do have some urethane-based concerns taking place across the supply chain right now. We are working with that group of suppliers. We do have that concern. It's an immediate concern, and damage is being really inventoried at this point to see how quickly they can come back online.

So yes, we have that concern. But we did bake as what we think we understand about all that into the guidance that we gave you as well. That's part of the risk that we have talked about on the overall top line and our ability to deliver. It's more than the typical things. Now we have the storm. The last water event in Texas that the bad one really hurt the supply chain significantly, and this hurricane season has us all very concerned as well.

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

Okay. That's very helpful. And then just with the labor issues. I guess it's not happening, but I was wondering if at the end to enhance the benefits might make things ease starting like now, basically, I don't know, but I guess you're not seeing that?

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

We've done some of that already across the corporation. It's not really driving people to come back into the offices or into the -- look for jobs and come to our manufacturing plants. So we clearly have done those things. I'm not sure what's going to change the overall psyche in the labor force here in the United States, but we'll look to see where we are as schools open up and kids go back in September and hope for labor force to pick up back then. And until then, right now, it's very good to be a global company.

Operator

(Operator Instructions) Your next question comes from the line of Dillon Cumming with Morgan Stanley.

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

Tod and Scott, I want to like just ask you, you made some comments on your prepared remarks saying kind of an immediate update here. So curious kind of around the outlook for the Life Sciences M&A over the next year or so. I think we're kind of coming up on a couple of quarters now where you made some hires in that area. So I was just curious if you kind of update us around the pipeline and what your kind of expectations are around M&A for this year?

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

Sure. I'd tell you that. Our pipeline is more robust than it's ever been. It's really healthy within the Life Science sectors. We like the game that we're playing here, continue to knock on doors. We have very talented people helping us to really execute that. Obviously, we can't predict when deals will happen. I wouldn't comment on any specific deal. But strategically, what we're trying to accomplish, I'm very pleased with our progress and the execution to date.

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

Got it. That's helpful color. And then maybe to ask the kind of competitive question in the landscape there a different way, like one of your larger peers, they've made public their intentions to kind of spin or sell their own filtration business. I was just curious your kind of view there as to whether that business is kind of operating as a standalone entity that might actually contribute to a more disciplined market or kind of any other competitive implications you might call out as a result of that dynamic?

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

So we're very aware of what they have been talking about and the potential options that they face. And so we'll follow that very closely. Obviously, we wouldn't specifically comment about a competitor like that. It's inappropriate. And so, consequently, we'll just continue to keep a keen eye on that, watch the proceedings and move forward.

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

Got it. That's understandable. And maybe 1 last question for me. I think you were kind of clear calling out the disconnect between your kind of On-Road build guidance versus where you call it ACT might have their Class 8 forecast of the year. I know you kind of attributed to that with some product line exits you were discussing. So just curious if you kind of quantify the headwind for the year and kind of whether or not we should expect that over the next few quarters or so?

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

So, Dillon, does that -- you mean for the -- could you maybe say that again?

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

Yes, sorry, that was just with the On-Road business that you were discussing. In the prepared remarks you were saying that you were kind of exiting some product lines there.

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

Yes. So what we did is there's a particular directed by its non-filter business that we've been doing because we have a strong customer relationship. We've been doing it in the On-Road business. It's emissions related. It's not even our typical emissions business, and we were subcontracting a portion of that, and we just helped with the sourcing transfer to make it go to a subcontractor directly and balancing that out of the business. And that's really helped. That's a positive mix to us.

And frankly, it's also good for our customer in the On-Road segment. So that's part of the positive mix. Overall mix headwinds that we have on the Emissions business is certainly overall a tough headwind for us. It typically operates on a profitability level of roughly half of Donaldson average. And so we're going to have significant growth in that business as well as some other mix challenges that we have, OE business, for example.

Operator

(Operator Instructions) Your next question comes from the line of Rob Mason with Baird.

Robert W. Mason ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Just quickly, a lot of discussions around price, but I'm just curious, within the 5% to 10% revenue guidance for the year, what are you assuming for price? Or what range is built into that?

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

Yes. So we talked about the 300 basis points of commodity cost headwind that we face. And we think our gross margins can be flat to just slightly down. So our plan is to offset a significant portion of that commodity cost increase with pricing.

Robert W. Mason ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

In volume as well?

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

And volume leverage.

Robert W. Mason ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Just -- you also had discussed the backlog, backlog maybe above where you would normally expect it like it. Just how are you thinking about your ability to work down that backlog either in the first half or the second half? And really maybe where I'm going with this is just trying to get at how you think about your second half of the year visibility versus how that you may typically start out a fiscal year whether on the first-fit side or the aftermarket side?

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

Yes. So we typically are in a much more comfortable position with our backlog execution, as we started fiscal year than we are at this point. We'll grind through the supply shortages. Inventory levels across the independent channels and the OE channels are low, lower than they want, lower than we want them. So we look to execute and get back on our feet. But it's going to take into the next calendar year as we see it.

So we're going to be working through this first half of this fiscal year for us. And then we should be able to see some improvement on the back half. And that also goes into the guide. We had -- we're typically a 48%, 52% type of a company on the swings. And of course, last year, we were more like 46%, 54%. And so we look to return a bit more normal. We're actually thinking we'll do about a 49%, 51% on the split this year. So you can see how much of a jump in the first half, as we walk through that backlog and get our customers really serviced. And that's how we're kind of breaking it out working through it.

Robert W. Mason ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Tod, how much of your backlog is a function of your first-fit customers planning further ahead given the supply chain challenges. Are you seeing that? Are you seeing longer ranging forecast? Or is there a situation so dynamic it may be the inverse?

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

Tough to quantify. We talk about that all the time. It's clear, absolutely clear. We are seeing some order ahead in order to try to -- the theory being, if you have more on order, you'll get more, not really working that way, but people do think that way. And we do see that behavior in our backlog, no question about it. But we can't really quantify it, Rob. I mean the computers are linked to each other on the OE side, and we look at it all the time.

I would suggest to you that what will happen over time is right now, we would tell you our backlogs are probably extended to maybe as much as 4 and 5 months as being solid, is the way we look at it. And in a normal behavioral period, we would tell you it's 90 days. So it's probably like 3 months. And then in really tough cycles, it cuts down to 30 days. But we would tell you that our backlogs for probably 4, 5 -- as much as 5 months are solid and they're high. And that's an indication that people are trying to restock to us. And now we just have to work through it and get it to them.

Robert W. Mason ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Just the last question is, again, framing the outlook for the year. How do you think about that geographically? And in particular, China, obviously, you had a tough comp this past quarter, but how are you thinking about China in particular in the context of the 5 to 10?

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

Yes. China, it's interesting, right? Because if we just look at Q4 '20, China as a country had record excavator production, record equipment utilization as they were coming out of the pandemic, right? And we're big in excavators, heavy-duty trucks and off-road equipment utilization in China. However, in '21 Q4, excavator production was down double digits -- low-double digits. Heavy-duty truck production was down in the high-teens, and equipment utilization was down in the mid-teens. And yet, our business was actually in local currency down single digits.

So we know we're winning share there. We baked that into our overall China-based model, if you will, into the guidance. And one other thing that's really important to note -- to suggest how we're doing in China is we have quoted in the last year high-teens' worth of first-fit production products with proprietary products first-fit programs in China. And of those high-teens, we won them all. So that's planting seeds for future growth, and that's the momentum that we see ahead of us in China. And so we're still very bullish on the excellent work that our teams are doing over there.

Operator

There are no further questions. I will now turn the call over to Tod Carpenter for any closing remarks.

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

Thank you. Before signing off, I just want to acknowledge that we have talked to a number of our customers that have been affected by the hurricane of the past week, and I just want to acknowledge that you're important to us and that our company stands by to help you get through the difficult times. So please raise your hand. We'll help where we can. And we wish you and your families nothing but very best. That concludes today's call. I want to thank everyone listening for your time and your interest in Donaldson Company. Goodbye.

Operator

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

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