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CORPORATE PARTICIPANTS

Sarika Dhadwal *Donaldson Company, Inc. - Director, Investor Relations*
Scott J. Robinson *Donaldson Company, Inc. - Senior VP & CFO*
Tod E. Carpenter *Donaldson Company, Inc. - Chairman, CEO & President*

CONFERENCE CALL PARTICIPANTS

Brian Paul Drab *William Blair & Company L.L.C., Research Division - Partner & Analyst*
Daniel Dalton Rizzo *Jefferies LLC, Research Division - Equity Analyst*
Dillon Gerard Cumming *Morgan Stanley, Research Division - Research Associate*
Robert W. Mason *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

PRESENTATION

Operator

Good morning. My name is Chris, and I'll be your conference operator today. At this time, I'd like to welcome everyone to the Donaldson's First Quarter 2022 Earnings Conference Call. (Operator Instructions) Now I'll turn the call over to Sarika Dhadwal, Donaldson's Director of Investor Relations.

Sarika Dhadwal ***Donaldson Company, Inc. - Director, Investor Relations***

Good morning. Thank you for joining Donaldson's First Quarter Fiscal 2022 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 first quarter performance and details on our outlook for the balance of fiscal 2022. 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 turn the call over to Tod Carpenter.

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

Good morning, everyone. I am pleased to report record first quarter results. We grew our sales to $761 million. Sales were up 20% and EPS was up 26% versus last year. It was an encouraging quarter for Donaldson, particularly given the backdrop of well-documented supply chain disruptions, labor shortages and significant cost inflation. In the face of these challenges, our team rose to the occasion and delivered, and I am proud of what we accomplished.

As we look to the remainder of the year, we expect the macro headwinds to persist. While we are well positioned to deal with these challenges, there is no doubt that we will feel near-term impacts. To address these macro challenges, we are pulling many levers, including raising prices to mitigate the impact of cost increases, utilizing our geographically diverse manufacturing and distribution footprint to meet the needs of our global customers and to mitigate labor constraint issues, particularly in the U.S., and aggressively recruiting and competing for talent to expand our strong team of dedicated employees.

As we navigate the year, we are also investing for future organic and inorganic growth. We continue to spend on our R&D to ensure we remain the leader in what we do best, technology-led filtration. I'm also pleased to have 2 new acquisitions under our belt. First, we recently announced the acquisition of Solaris Biotech. Solaris is a designer and manufacturer of bioprocessing and filtration equipment used in food and beverage, biotechnology and other life sciences markets. We've been working hard to expand our reach into life sciences, and this acquisition is the first step in our string of pearls strategy to get there. We can now leverage Solaris' technology and customer relationships to advance our capabilities in this space. I am confident in our ability to scale the Solaris business with our commercial capabilities and strong balance sheet.

Our second recent acquisition was that of P-A Industrial Services. We closed this transaction on November 1 with a purchase price of $4 million. While the company only generates a little under $4 million in revenue today, this acquisition allows us to support our Industrial segment with the addition of a services business. Donaldson and P-A Industrial share the vision of delivering superior service, along with great products to help our customers' operations run better.

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We believe we are heading into the balance of the year from a position of strength, and we feel good about our ability to navigate the near-term challenges while still building our business for the future. With that said, we are raising our top and bottom line guidance for fiscal 2022 based on a few factors. First quarter results, higher sales expectations, driven in part by incremental pricing, and operating expense leverage. We will share more details about our fiscal '22 outlook later in the call, so I'll now provide some context on our first quarter sales.

Total sales were $761 million, which is up 20% from last year, due in part to last year's softness related to the pandemic. In Engine, total sales were $527 million, up 21% with our first-fit businesses leading the charge once again. Sales in Off-Road were $94 million, up 45%. Nearly half the first quarter growth was driven by Exhaust and Emissions, reflecting a production ramp-up related to new emissions standards in Europe. As we've talked about before, the strength in this business does create mix pressure on margin.

Beyond Exhaust and Emissions, first quarter sales in Off-Road also benefited from increased levels of equipment production across the end markets and geographies. The exception was in the Asia Pacific region where we compared against a sales increase of nearly 40% in the prior year.

In On-Road, first quarter sales were $32 million or down 1.5% year-over-year. North America had the biggest decline, reflecting the discontinuation of some directed-buy equipment to a large OEM customer. Importantly, excluding this impact, total On-Road sales would have been up about 12% globally and up 7% in North America. As we look forward, we believe On-Road will be under additional pressure for the remainder of the year as many customers continue to struggle with supply chain issues, including the persistent chip shortage.

In Engine Aftermarket, sales in the first quarter were $374 million, an increase of 18% from the prior year. Aftermarket sales were up in all geographies and both channels. Independent channel sales grew in the mid-teens and OE channel sales were up in the low 20s. Our innovative proprietary products are always a big piece of the Aftermarket story. These products accounted for about 30% of total Aftermarket sales and grew about 20% year-over-year.

Our independent channel is benefiting from continued strength in less mature markets. Brazil, Russia and South Africa put up impressive growth rates in the first quarter, and we are excited about our prospects in these geographies.

In the OE channel of Aftermarket, proprietary products are again contributing to our growth. In the first quarter, sales of these products were up in the mid-20% range, and they now account for nearly 40% of our aftermarket OE channel sales. Included in these figures is PowerCore, which achieved another quarterly record for Aftermarket sales and increased more than 18%.

Moving to Aerospace and Defense. First quarter sales of $28 million were up 23% year-over-year as the commercial aerospace industry rebounds from the pandemic-related pressure a year ago. Activity remains below pre-COVID levels in Aerospace, so there should be more growth to come as the industry continues to recover.

Lastly, on Engine, I will quickly talk about China. Engine sales were down about 6% in the quarter. However, this is against a 40% increase last year. The increase last year reflects a faster rebound in China from the pandemic than we saw in other parts of the world. Overall, we remain pleased with our progress in the region. We are winning new business with local Chinese manufacturers. And over time, we continue to expand our share in this massive market.

Now on to Industrial. The Industrial segment had another solid quarter with total sales increasing 17% to $234 million. Sales of Industrial Filtration Solutions, or IFS, grew 22% to $166 million, with 2/3 of the increase coming from industrial dust collection. We had strong sales growth of new equipment and replacement parts, which reflects more investment and industrial capacity utilization. Process Filtration sales also contributed to first quarter growth in IFS. Process Filtration sales, which serve the food and beverage market, grew over 30% due to growth in new equipment and replacement parts in Europe.

First quarter sales of Special Applications were $52 million, up 23% with strong contributions across our product portfolio, including notable increases in our disk drive and membranes businesses. Also within Special Applications, first quarter sales of venting products

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grew 19%. We continue to build share in strategic markets, including high-tech vents for batteries and powertrains in the auto industry and expect venting solutions to contribute to our growth for years to come.

First quarter sales of Gas Turbine Systems, or GTS, were approximately $17 million, down 28% due almost entirely to timing of orders. Our outlook for the year has not changed and we expect to make up first quarter revenue shortfalls in the second quarter.

Overall, we are off to a strong start for fiscal 2022, and I feel confident about our ability to successfully navigate this uncertain and volatile environment. With that, I will turn it over to Scott for more details on our financials. Scott?

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

Thanks, Tod. Good morning, everyone. To sum up the first quarter, our employees did an excellent job delivering solid results in a tough environment. First quarter sales grew 20%. Operating income was up 23%, and EPS of $0.61 was 26% above the prior year. First quarter operating margin increased 40 basis points to 14.1%. The increase was from leverage on higher sales, which was partially offset by gross margin pressure.

Driving into gross margin a bit further, the impact on raw material cost inflation built through the quarter. This impact was compounded by the fact that we were experiencing a deflationary environment 1 year ago. As we look to the remainder of the year, we will be impacted by ongoing inflationary headwinds. We will continue to build on the success we have had implementing price increases in several of our businesses to offset the cost pressure. That said, the full impact of the pricing benefits may take longer to materialize due to certain large OEM customers. We are in ongoing discussions with these customers and will continue to drive towards offsetting the incremental costs we are currently absorbing.

On the operating expense front, we are pleased with our discipline and success in optimizing our levels of spend. We continue to invest in our Advance and Accelerate portfolio. This spend was offset by controlled expense management elsewhere in the organization. First quarter operating expense as a percent of sales was favorable by approximately 160 basis points driven primarily by volume leverage.

Other expense was favorable this quarter by $1.5 million, mostly due to a pension curtailment charge we took in the first quarter of last year.

Turning to the balance sheet and cash flow statements. I'd like to highlight a few things. Our first quarter cash conversion ratio was 32%, down meaningfully from last year, driven primarily by investments in inventory to further support our increasing demand. Inventory this quarter were up $60 million sequentially and $115 million year-over-year, mainly due to the impact of inflation, a commitment we've made to increase levels of inventory to ensure we're adequately prepared to meet demand, and supply chain challenges we have had internally with our customers on order deliveries.

As a result, working capital was a $71 million net use of cash this quarter versus a $33 million benefit last year. First quarter capital expenditures were $18 million as we invested in various projects, including PowerCore capacity expansion in North America. This quarter, we continued with our track record of returning cash to shareholders. We repurchased 1.3% of our outstanding shares for $103 million, and we paid dividends of $27 million.

Our strong balance sheet and financial flexibility has been an important asset while operating in this challenging supply environment. We ended the quarter with a net debt-to-EBITDA ratio of 0.7x.

Now I'd like to walk through our fiscal '22 outlook. First, on sales. We are now expecting fiscal 2022 sales to be up between 8% and 12%, with a nominal impact from currency translation. This increase from our previous guidance of 5% to 10% is driven by Q1 results as well as benefits from additional pricing actions that will be implemented and rolling over the balance of the year. We continue to expect a greater sales year-over-year increase in the first half versus the second driven in large part by prior year comparisons.

From a segment perspective, we've increased our full year sales expectations for both Engine and Industrial. For the Engine segment, we expect a revenue increase between 8% and 12%, up from our previous expectation of between 5% to 10%. Within Engine, sales of our

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first-fit businesses are forecasted to be mixed.

Off-Road sales are expected to grow in the high teens versus last year due to increased levels of equipment production and the continued success of new program wins in our Exhaust and Emissions business. The Off-Road forecast is up slightly from the low double-digit growth we previously projected.

In On-Road, we are seeing a slowdown in demand from some of our customers as they grapple with their own supply chain issues. Based on first quarter results and our current order trends, we now expect On-Road sales to be down-low-single digits versus our previous guide of up-low-single digits.

For Engine Aftermarket, we are increasing our expectations slightly to high single-digit growth from our previous guidance of mid-single-digit growth. Equipment utilization remains strong and we are continuing to gain share with proprietary products.

Our outlook for Aerospace and Defense has not changed. We are still forecasting low double-digit growth for the year due in large part to comping against the COVID-related market weakness in fiscal '21.

Now on to the Industrial segment. We expect sales to be up between 7% and 11% and which brings up the bottom end of our previous guidance range of 6% to 11% by 1 point. Sales of Industrial Filtration Solutions are planned up in the low double-digit range, consistent with the guidance we gave last quarter. Improved sales of new equipment and replacement parts, particularly for dust collection as well as strength in Process Filtration will continue to be the drivers. In terms of IFS, I would just like to mention that while revenue related to our recent acquisition of Solaris Biotech will fall in this segment, we do not expect a material impact this fiscal year. Solaris bookings for this calendar year are expected to be approximately EUR 11 million and revenue related to those bookings should flow through over the next several quarters.

Moving to GTS. We continue to expect fiscal '22 sales up high single digits. As Tod noted in his remarks, the first quarter sales decrease was a result of timing, and we do expect to recover those sales.

Special Applications revenue is forecasted to be up low single digits versus our initial guidance of down low single digits, reflecting stronger-than-expected growth across the portfolio in the first quarter.

Now let's move to operating margins. We maintain our expectation for a full year rate between 14.1% and 14.7%. As a reminder, last year's adjusted operating margin was 14.0%. Expense leverage will be the primary driver of the year-over-year benefit.

On gross margin, given what we saw in the first quarter and the trends we are seeing in raw material, freight and labor prices, we believe the inflation headwind will be more significant than we originally planned. We expect to offset the higher cost of pricing over time. However, the net impact on gross margin will be greater than anticipated and we now expect gross margin to be down 50 to 100 basis points from the prior year.

To expand further on this point, last quarter, we said we expected to pay 8% to 10% more for our raw materials this year which equated to about 300 basis points. That estimate is now 12% to 14% or a little shy of 400 basis points. Additionally, freight and labor costs have now become a more significant headwind than we anticipated, which results in additional 100 basis points of gross margin pressure.

So as a result of these dynamics, and our typical seasonality, we should see operating margin improve in the second half of the year versus the first half.

Based on our updated forecast, we plan for a new EPS record of between $2.57 and $2.73, implying an increase from last year's adjusted EPS of 11% to 18%.

Just briefly on the balance sheet and cash flow outlook. In terms of capital expenditures, we are lowering our planned spend for this year to a range of between $90 million and $110 million. So essentially a $10 million reduction to the range we provided in September of $100

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million to $120 million. The macro headwinds we've been talking about this quarter are impacting almost every part of our business. Given supply chain uncertainty and other variables, the timing of execution on some of our capacity expansion projects could be slowed, so we felt it prudent to bring the range down in line with current expectations. In terms of free cash flow, increased inventory levels, partially offset by the lower CapEx results in a reduction to our free cash flow conversion forecast to between 70% and 80% down from our initial guidance of 80% to 90%. On share repurchases, we still plan to repurchase about 2% of our outstanding shares this fiscal year.

In summary, I am pleased with our first quarter results. I am also confident our business model is equipped to manage the uncertain times ahead. While the results of our more recent pricing actions will take a bit of time to flow through our financials, we are taking the right steps to protect our margins and deliver record level of sales and profit this fiscal year. We are also committed to managing the business for long term and will continue to make thoughtful investments for future growth. I'll now turn the call back to Tod.

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

Thanks, Scott. As we look to the rest of the fiscal year and beyond, I would like to touch on a few key paths we are pursuing to build on our success and push the company forward to the next stage of its evolution through profitable growth.

First, we are continuing to invest in our existing Advance and Accelerate solutions, including Process Filtration, dust collection replacement parts and Engine Aftermarket.

Second, we are diversifying the company's offerings, both organically and inorganically to ensure we meet the needs of our existing and future customers globally. On the organic side, we are committed to our R&D. We previously invested $15 million for our materials research center, which will enable further development of our polymer-based chemistry solutions. It is also important to note, we increased our R&D budget this fiscal year by 10% over last year. On inorganic diversification, the recent acquisitions of Solaris and P-A Industrial Services are just the beginning. Solaris is the first inorganic step on our journey to create a Life Sciences business. We are excited about the value we can add through our global market reach, science and technology, filtration capabilities and our ability to invest for future growth. This, combined with Solaris' market reputation and product portfolio are a winning combination.

Third, we are investing in our people and recruiting the right talent to drive the company forward. We have made people investments in areas such as Life Sciences, food and beverage and the ESG. Donaldson employees with their dedication and hard work are the core of our business.

Before we close, I also want to touch on our ESG efforts as this is an important part of our culture. We began global implementation of our environmental health and safety policies in 2018. Safety and greenhouse gas emission reductions are near-term priorities, and we're making progress. We are well on our way of reducing CO2 emissions by 6,000 metric tonnes by the end of fiscal 2022. Our company is geographically and culturally diverse. We have strong governance, including a seasoned Board with balanced tenure. Also critically important is the alignment of the compensation of our Board and management with shareholder interest.

So as I look out over the long term, I strongly believe we have the right strategy in place to continue delivering value to our stakeholders for years to come.

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

QUESTIONS AND ANSWERS

Operator

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

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

First, can you -- and I may have missed this, but can you talk about the big step-up in the operating margin in Industrial versus what you saw in Engine and just the difference in the end markets and raw material situation that you're seeing in those 2 segments?

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

This is Scott. Brian, nice to talk to you. So our Industrial products operating margin last year was 13.7% and this year, it was 16.4%. So first of all, keep in mind we're coming off of COVID comps with tough volumes and then weaker leverage. So we're pleased with the performance of our Industrial business. We're investing in higher-margin opportunities that are driving the mix up and they're doing an excellent job of leveraging the new volumes that they're experiencing, especially as compared to last year when we were kind of under the COVID bug a bit. Engine margins were down 20 basis points from 13.9% to 13.7%. And that's a result of the inflationary pressures we're seeing and pricing actions we're executing and our pricing actions are behind our cost increases. And that's one of the reasons we brought our margin guidance down for the year because we're assessing our inflation in our pricing and trying to determine the ultimate impact of both of those two. So we're pleased with our margin performance this year.

Overall, we're committed to higher levels of profitability on higher sales. We did 14.0 total last year. This year, we have a guide of 14.1 to 14.7. So at the midpoint, that's 14.4 or 40 basis points of improvement this year, which I think would be a good accomplishment for the company and something I think we can deliver.

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

Yes, Brian, this is Tod. Maybe just one point to add. So as Scott referred to and as we have referred to in prior calls, our ability to mix up on the Industrial side with our strategic execution is really what you're seeing some of. But also, as we talked about multiple times about our pricing model in Industrial. And the fact that we can take quicker action in industrial rather than against some of the other backdrops and headwinds that we feel on the Engine-based OE side. So Industrial, it does reflect some positive pricing actions as well.

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

Got it. And in IFS, you have this momentum in food and beverage, is that higher-margin business?

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

Yes. It's higher than the company average.

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

Okay. And can you say -- give us a rough idea of what percentage now does Process Filtration account for within IFS?

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

Yes, I believe we said in the past, it's roughly between $80 million and $90 million. So we've grown it rather nicely, and we continue to have good momentum.

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

Okay. And then last one, just on this topic. Are there specific applications, I guess, particularly in Europe that you're winning? And are there some big share gain opportunities potentially in those applications as you look globally or even with other customers in Europe?

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

Yes. So we're pretty broad-based with the wins that we have. It's heavily replacement parts related at the moment. With the acquisition of Solaris, though, it brings us the opportunity to do more food and beverage type project-based work as well because they have the applications expertise, and we have the sales teams to be able to combine those strengths. And so we would look to grow our food and beverage business based upon a combination of those 2 into a broadening product portfolio, if you will.

Operator

Our next question is from Dillon Cumming with Morgan Stanley.

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

I wonder if I can actually just think on the theme of Solaris for a second. I mean, obviously, not a huge transaction from a revenue perspective, but it does seem like the technology and kind of market advantages were a big focus of the deal. So I guess just to what extent do you feel like some of the value proposition there was just being able to leverage any kind of technology advantages that they had within kind of the larger Donaldson's platform as you kind of go after these new customers and new end markets?

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

Sure. A couple of things that they bring to Donaldson Company from a product standpoint of view. So they manufacture bioreactors. So if you don't know, a bioreactor essentially it's a piece of equipment that allows you to grow cells or tissues in R&D or manufacturing in biopharmaceutical type applications, but also food and food additives. And so when you get into that overlap with our sales force, where we have growing momentum within the food and beverage activity, it allows us now to really take our sales team combined with their applications and equipment experience and look to drive into that type of the food and beverage type business as well.

But it also brings a foundational filtration capability called tangential flow filtration within biopharmaceuticals and within that whole business process. It's a filtration capability that Donaldson currently does not have. We have overall polymer chemistry-based membranes that we could use, but this is a specific type of application in biopharmaceuticals that allows us now to really step a little deeper into that medical space with the application of that technology, and we'll look to do that.

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

Okay. Yes, that's very interesting. Maybe I'm going to switch over to the guidance for a second. I mean given the level of kind of top line outperformance this quarter, it just seems like that might have supported a bit of a higher increase, I guess, in terms of the revenue outlook versus where you revised guidance to. I mean are you able to say are you kind of baking in any kind of caution with regards to the supply chain backdrop still? Or I guess, do you feel like you might have visibility into kind of a sharper growth acceleration in the back half of the year, on the kind of underwriting that view?

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

Yes. I mean, we talked about this last quarter, and we're trying to take a prudent view towards the overall supply chain difficulties that we face and trying to balance that with our revenue forecast. So we were able to do a bit better in the first quarter, but our costs are also up. So we have to factor in that we have to raise prices a bit more than we originally planned, and that also drives the revenues up. So it could always be higher. We try to take a reasonable approach. We were at a midpoint of 7.5 and now we're at a midpoint of 10. We think that's a reasonable place for the company based on where we sit right now.

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

Okay. That's helpful color, Scott. And then maybe just 1 last one for me. Tod, I think you mentioned the kind of efforts to grow out the Venting business for batteries and powertrains in the auto industry. I'm not sure if that's meant to be a comment around battery electric powertrains or kind of legacy IC auto. I was just curious if you could kind of provide some more color there. If it was the comment around battery electric, I guess I'd also be curious in learning how you can apply yet similar technology on batteries or kind of the class that you have off-highway space as well.

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

Sure. It's really meant to be a statement about our technology and our opportunity for growth where we feel like we have a very strong technological leadership position within that space that we have brought over from, frankly, our disk drive-based technologies as well as other foundational technologies invented in our Corporate Technology Group. And we often look to spread those across the technology that we invent, spread those across multiple business units. And in this case, Integrated Venting Solutions is clearly the winner there. And so we're looking to press hard into the automotive opportunities because we frankly can, and we see a lot of the battery-based automotive space really giving us double digit and above company average growth. And you'll see that we'll expand that business, and we'll continue to invest strongly in that business to be able to get that to at least between 3% and 4% of our overall company revenue.

Operator

Our next question is from Rob Mason with Baird.

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

I want to go just a little bit deeper on, I guess, the first quarter. You did outperform your typical seasonality in the quarter and delivered more revenue. Tod, I was wanting to see if you could comment just on how the incoming order rate look, where your backlog ended up at the end of the quarter versus year-end? And just your thoughts on where maybe channel inventories are at this stage as well?

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

Sure. Incoming order activity remains very strong across the corporation. The -- It's obviously led by the United States across both Industrial and Engine-based businesses, all end markets. So very strong in the U.S. I would say it's strong in Latin America, same across both segments. I would say it's strong in Europe across both segments, all end markets. Asia Pacific, I would say it's good across Asia Pacific, but a little bit more troubled in China. So China is the only weak spot in both Engine and Industrial, we have seen a bit of a pullback there. We've baked all of that within the guide.

Our backlog remains very high. Our delinquency rate to our customers remains at an uncomfortable position, a non-Donaldson-like position that we continue to work very hard to improve. And even as we see this higher order level come in, our backlogs -- or at our higher ship levels, our backlogs have not gone down. We do see the typical seasonality that you see in the December time frame. So nothing out of the ordinary, nothing suggesting that it's slowing down out there.

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

And so it's fair to infer that your customers really are not restocking. This is almost hand-to-mouth type deliveries.

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

Yes. On the inventory restocking question, the supply chains are really causing a more troubled ability for our customers to be able to accomplish restocking. And so consequently, at these high levels, it's still all pull through. And so we've not seen on the independent or the OE channels, the ability of our customers to be able to build that inventory up.

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

Yes. Just as a follow-up, I wanted to see if you could provide any color on how the gross margin curve may look as we go through the balance of the year to the extent you expect it to be down 50 to 100 basis points for the full year. Are you comfortable saying that the second quarter could be a trough in the gross margin? Do we go lower and then come back up with some better pricing, better volume leverage in the second half of the year?

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

Yes. So we -- maybe just at a high level, right, if you think about our prior guidance to our current guidance. So we essentially said at the end of last quarter, we thought we had 300 basis points of headwind. And if you go through my comments on the script, we now forecast that to be 500 basis points of headwind. And that's one of the reasons or that's the main reason we took the overall margin guidance from flat to slightly down to down 50 to 100. So you can see we have additional 200 basis points of headwind and we won't be able to offset that 100% this fiscal year. We do think over the longer term, we'll balance out the price versus cost. And we have to work through that with our customers. But the hardest quarter with the new headwind that we're seeing is the first -- the next quarter, right? So obviously, as we're raising prices, we're chasing the cost going up. So our next quarter will be the heaviest headwind quarter. So I think your thinking is correct. The biggest challenge will be the next quarter. And then as pricing layers in from what we've done last year and through this quarter and into next quarter, that will help offset the price increases that we're facing.

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

How much within the 50 to 100 basis points down for the year, how much -- we've seen inflation continue up since you guided in September. How much additional inflation is built into that from where we stand today?

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

Yes. So -- well, I mean, we originally projected the cost we were paying for raw materials, for example, to be up 8 to 10, and we now project that to be up 12 to 14. And so that's the additional headwind that we're facing. In addition, we've added 100 basis points of headwind for freight and labor costs. So that's the kind of the cost increases that we're experiencing and why we have to continue to raise prices to offset those headwinds.

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

And that assumes -- Scott, that assumes some -- the curve continues upward from your current spot rates at the high level?

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

Yes. There is some additional increases expected. I mean we -- our procurement does an excellent job of assessing all the indexes where we're purchasing and trying to forecast that forward and manage the price increase as the best we can. So it's a combination of current prices and expected future prices.

Operator

Our next question is from Laurence Alexander with Jefferies.

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

It's Dan Rizzo on for Laurence. If we look past 2022, you mentioned holding higher inventory to kind of meet customer needs. And I don't know if this has been asked before, but I was just wondering if this is kind of changing the way you think longer term with the amount of inventory that needs to be held given the logistical snarls we're seeing around the world?

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

Yes, that's -- it's a great question. As we spoke about during the last couple of quarters, we're going to use the strength of our balance sheet and really take our inventory up so that we can look to take care of our customers in the best possible fashion during all of these uncertain times. You see that clearly within our inventory actions. But we do think that this is more of finding a new normal. And after we get to the new normal, we'll get back to more properly managed inventory levels that we would expect the company to need in order to be able to meet our customer delivery expectation percentages. So we think this is likely not the new model going forward. In other words, we're not going to drive our overall inventory turns down to very low single digits, just to hold on. That doesn't make sense. But in this moment of uncertainty, we're just using every strength that the company has to make sure our customers are taken care of.

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

That's very helpful. And then with the price increases and again, this is just more -- a little bit more philosophical. Are we at the point where customers are kind of trying all (inaudible) so to speak, where -- I mean you have to raise prices because costs are so high. But are customers starting to push back? Or is it their demand trend is so much that it is just kind of accepted at this point and it will be for the foreseeable future?

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

I think we've got the best type of an environment, working cooperative environment relative to pricing that I've seen in my entire Donaldson career. I think people get it. They understand this is very unusual. Everybody is trying to work hard with each other in order to be able to get through it. Obviously, there is some back and forth with regards to it. But what's really important is you have to move quickly in order to wash out the old prices from your backlogs and get to the new situation, if you will. I think the receptivity is really good. We've had a lot of success. We do have some stubbornness out there, but we're working through that, and we'll drive that to ground here in short order.

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

And then finally then, in your history or have you in the past given price concessions during certain times? I mean, I guess would there be a giveback if things normalize?

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

Sure. On some of our longer-term contracts, particularly with the OEs, we have annual based price downs. And so we'll start on that part of the model in a negative position on an annual basis. Right now, it's a bit different, obviously. But then also, if inflation does abate and come -- and let's say they give all of this back down and the indexes for raw materials truly do go down and stay down, then sure. It's a matter of competitiveness. And so yes, we have done that in the past, and we would look to do that. The stable type of environment that you referenced there, though, is -- it's something we look forward to, let's say.

Operator

We have no further questions at this time. I'll turn the call back over to Mr. Carpenter for any closing remarks.

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

I want to wish everyone a happy and safe holiday season, and I look forward to reporting our second quarter results in the new year. That concludes today's call. Goodbye.

Operator

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

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