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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 Third Quarter 2022 Earnings Conference Call. (Operator Instructions) Thank you. Sarika Dhadwal, Director Investor Relations. You may begin.

Sarika Dhadwal ***Donaldson Company, Inc. - Director of IR***

Good morning. Thank you for joining Donaldson's Third 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 third 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 now turn the call over to Tod Carpenter.

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

Thanks, Sarika. Good morning, everyone. Before getting into our performance this quarter, I want to make a few comments about the impact of the ongoing conflict in Eastern Europe. From a business perspective, we complied with all sanctions and have taken a further step to stop direct product shipments into Russia and Belarus. As a reminder, our sales to this region represent less than 2% of total company sales, and we are not forecasting any revenue for the foreseeable future.

On the personal side, on behalf of the Donaldson team, I would like to extend our support and sympathy to all of those impacted.

We recently donated EUR 150,000 to the Polish Red Cross, which is facilitating relief efforts with the Ukrainian Red Cross. Several of our local teams in Europe have also contributed by creating various

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donation drive to help the communities where they operate.

These actions exemplify our commitment to corporate responsibility, which has always been an important part of Donaldson.

To that end, this quarter, we also published our fiscal 2021 sustainability report in which we outlined our commitment and efforts in reducing our environmental impact, engaging and empowering our people and maintaining our strong corporate governance.

I look forward to reporting our progress and future initiatives over time.

Now I'll turn to our third quarter results. Donaldson had another quarter of record sales at $853 million, up 12% year-over-year. As expected, pricing was the largest sales driver and I'm pleased with the agility of the organization to increase these efforts as cost inflation has continued to outpace our projections. Raw material, freight, energy and labor costs were up significantly year-over-year, negatively impacting our profitability. Consequently, third quarter EPS increased to $0.67 versus $0.66 a year ago.

This quarter, we made progress in meeting demand and saw some leveling in our backlogs, which remain at or near historic highs.

While inflation, supply chain challenges and labor shortages continued to be our biggest headwinds, we are not immune from newer increasingly impactful factors such as FX or business disruptions, including those from the COVID-19 lockdowns in China and the conflict in Eastern Europe.

Touching a bit more on the impact of the COVID-19 lockdowns in China. China is a strategically important area for us over the long-term. We have been continuing to win platforms using our PowerCore technology and are confident in our ability to gain share in this market. This quarter, we felt primary and secondary supply chain and end market impacts from the COVID-19 lockdowns. These included OEM shutdowns, logistics issues and a decrease in working hours. Year-over-year, total sales in China declined about 16%. However, our current exposure is somewhat limited. To size this, third quarter China sales were about 6% of total company sales, and this compares to 8% a year ago.

Going back to the overall company this quarter to combat the headwinds we are facing, we made progress in the following areas:

Pricing. We realized the benefits from our pricing actions and as costs continue to rise, we will continue to implement increases.

Utilization of our global footprint. We leveraged our global footprint to circumvent certain supply chain challenges. For example, while facing constraints in one region, we have been able to pivot and tap into a different region to support our customers. Also, in some geographies where demand has exceeded capacity, we have sourced product from out-of-region plants that have sufficient capacity.

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Inventory investments. We have followed through with our commitment to utilize our balance sheet and proactively increase our inventory levels as we make every effort to meet the needs of our customers.

While this fiscal year has been full of unforeseen challenges, the Donaldson team has not lost sight of our longer-term strategy. We continue to focus on gaining share within our current and future end markets including Life Sciences. Through our investments in R&D and acquisitions, we are cementing our position as the leader in technology-led filtration. The ongoing integration of the Solaris and Pace acquisitions is going well, and we are focused on scaling these businesses.

Looking ahead, we expect sales to reflect continued high levels of demand and incremental pricing benefits, partially offset by negative currency translation. With that, we are increasing our sales expectations for the full year. However, we continue to see gross margin pressure mainly driven by inflation. Despite this challenging backdrop, we are making progress in offsetting these headwinds through the previously mentioned efforts of the Donaldson team. As such, we are forecasting another sequential gross margin uptick and improved incremental margins in the fourth quarter. As a net result of these factors and with increased visibility, we are narrowing our EPS guidance range to be between $2.67 and $2.73. When compared to our fiscal 2021 adjusted results, this reflects an approximate increase of between 15% and 18%.

Scott will elaborate on the details of our fiscal '22 outlook later in the call, so I will now provide some context on third quarter sales.

Total sales were $853 million, up 12% from last year. Pricing contributed roughly 9% and currency translation was a headwind of approximately 3 percentage points. In Engine, total sales were $601 million, up 13% due to sales growth in both our first-fit and replacement parts businesses.

Sales in Off-Road of $108 million were up 13% with growth in all major regions, except China, as high levels of equipment production continue. We also saw ongoing strength in our Exhaust and Emissions business in Europe. As a reminder, these sales come at a lower margin presenting a modest mix headwind.

On-Road sales of $36 million were down 9% from the prior year. Global customer supply chain challenges, including chip shortages continue to limit near-term growth in this segment. Also negatively impacting results were the discontinued sales of some directed buy equipment to a large OEM customer in North America. Excluding this impact, total On-Road sales were flat globally and up 12% in North America.

In Engine Aftermarket, sales were $425 million, an increase of 15% as end market demand for our replacement products continues. Sales in both aftermarket channels were up double digits. In the OE channel of aftermarket, proprietary products are again contributing to our growth. PowerCore sales in aftermarket increased about 35% over prior year, another quarterly record.

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In Aerospace and Defense, sales of $31 million were up 29% year-over-year as we benefited from the strengthening commercial aerospace industry and market share gains.

Now turning to the industrial segment. Industrial sales increased 12% to $252 million. Sales of Industrial Filtration Solutions, or IFS, grew 9% to $179 million, mainly driven by industrial dust collection and with growth in all regions except APAC. Continued strength in process filtration also contributed to the results.

Third quarter sales of Gas Turbine Systems, or GTS, were approximately $31 million, reflecting a 19% increase due to new equipment sales in Europe and the U.S.

Sales of Special Applications were $43 million, down 4% as the COVID-19 shutdown in China negatively impacted disk drive sales. Also within Special Applications, sales of venting products were up as customers expand the use of our high-tech vents for batteries and powertrains in the auto industry. This is a key strategic area for Donaldson given the strong pipeline of opportunities in this rapidly expanding market.

Overall, I am proud of the excellent work the team has done to meet underlying demand, execute on pricing and work through the macro challenges to deliver another quarter of record sales.

Now I will turn it over to Scott for more details on the financials. Scott?

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

Thanks, Tod. Good morning, everyone. This quarter, we were pleased with the top line results. However, inflation and supply chain challenges were greater than our expectations, negatively impacting our profitability.

In summary, third quarter sales grew 12%, operating income was up 2% and EPS of $0.67 was $0.01 above last year. Operating margin this quarter is up 13%, it was down 130 basis points year-over-year on continued gross margin pressure. Gross margin, while up sequentially was below our expectations mainly due to the continued step-up in raw materials, freight, energy and labor costs. Other more temporary headwinds, such as manufacturing inefficiencies and driven by an acute supply issue of one of our key raw materials was also a factor in the quarter.

Operating expense as a percentage of sales was 18.5% favorable by 90 basis points over prior year, driven primarily by sales leverage. We continue to actively manage our expenses by strategically investing in growth areas such as our Advance and Accelerate portfolio.

Now I'll touch on segment profitability before turning to the balance sheet and cash flow statement. Third quarter Engine pretax profit margin was 14.8%, down 110 basis points year-over-year. The decline was driven by the timing lag of pricing realization as we catch up to costs. Unfavorable sales mix also

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negatively impacted margins.

Industrial margin was 15.4%, down 70 basis points year-over-year. There are 2 things I would highlight on the industrial margin. First, the recent integration of the Solaris and Pace acquisitions into the Industrial segment has resulted in additional expenses this quarter. Overall, we are pleased with the progress we have made in integrating these businesses and expect them to be margin accretive over time as they scale. Excluding the acquisitions, industrial margin was flat to prior year. Secondly, unfavorable sales mix also negatively impacted results.

Now turning to the balance sheet and cash flow statements. Our free cash flow continues to be negatively impacted by our elevated working capital, which is primarily due to increased inventories.

We ended the quarter with inventories up $30 million sequentially and $151 million year-over-year. Inflation, our deliberate approach to increasing our positions and supply chain challenges, both internally and externally were the drivers. As we have talked about before, we made the proactive decision earlier this year to increase our inventory. Product availability in this type of environment is highly valued, and we are committed to being as prepared as possible to answering the call.

Also negatively impacting working capital in the quarter was a higher accounts receivable balance due to our increased sales.

Third quarter capital expenditures were $23 million mainly driven by investments in capacity expansion, including for PowerCore.

Returning capital to shareholders is always a priority, and this quarter, we returned $65 million in the form of dividends and share repurchases. Last week, we announced a quarterly cash dividend increase and year-to-date, we have repurchased 2% of our shares outstanding, already reaching our initial fiscal 2022 target.

Our balance sheet continues to be an important asset allowing us to have a proactive approach towards managing their capital and investments. We ended the quarter with a net debt-to-EBITDA ratio of 0.9x.

Now I'll walk through our updated fiscal '22 outlook, starting with sales.

We are increasing our fiscal 2022 sales guidance to a range between 14.5% and 16.5%, which includes a negative impact from currency translation of about 3%. This increase from our previous guidance of 11% to 15% as driven by our third quarter Engine business performance and outlook. Our expectations for the Industrial segment are unchanged. For both segments from a geographical standpoint, we expect stronger results in the Americas and Europe to offset APAC softness.

For Engine, we expect an increase of between 16% and 18%, up from our previous forecast of between 12% to 16%, driven by off-road and aftermarket year-to-date results combined with additional pricing

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realization expected in the fourth quarter.

In Off-Road, we are now forecasting growth in the mid-20s versus our previous guidance of high teens. And your Aftermarket sales are now expected to be up in the high teens, up from our previous low teens estimate.

We are maintaining our guidance for On-Road and Aerospace and Defense. On-Road sales are expected to be down low-single-digits, given continued customer supply chain challenges, including chip shortages and the discontinuation of the low-margin product line in North America. Aerospace and Defense sales supported by year-over-year strength in the commercial aerospace market are projected to increase in the low 20s. In the Industrial segment, we expect sales growth of 10% to 12% with the midpoint of this range in line with prior guidance.

Sales of IFS are projected to increase in the low double digits as sales of new equipment and replacement parts, particularly for dust collection and process filtration continued to grow.

Moving to GTS. We expect fiscal '22 sales to be up high-single-digits, led by Aftermarket and Large Turbine sales.

Special Applications growth is forecasted to be up mid-single digits versus prior year with growth in most business units.

Now I'll touch on our margin outlook. Looking to the fourth quarter, as mentioned, we do anticipate another quarter of sequential gross margin improvement. However, given the underperformance in the third quarter, we are lowering our full year guidance range by 50 basis points, resulting in a year-over-year decline of approximately 150 to 200 basis points.

Digging a little deeper on the gross margin outlook, we expect to pay over 14% more year-over-year for our raw materials or between 400 and 450 basis points. Adding to this pressure are additional headwinds, including freight, energy and labor inflation, as well as more temporary pressures, including manufacturing and efficiencies.

Driven by the decrease in gross margin outlook for the year, we are now forecasting an operating margin range between 13.5% and 13.9%, down from our previous 14.0% to 14.4% range and below last year's adjusted operating margin of 14%.

Based on our updated forecast, we revised our EPS outlook to a range between $2.67 and $2.73 versus our previous guidance of $2.66 to $2.76.

Moving to our balance sheet and cash flow outlook.

Capital expenditures are forecasted to be between $90 million and $100 million versus our previous

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expectation of $90 million to $110 million, given longer-than-expected project lead times as a result of ongoing supply chain issues.

In terms of free cash flow, we now expect conversion to be about 50% to 60% for the year, down from our previous guidance of 70% to 80%. This is primarily due to working capital investments related to inventory build along with the previously discussed higher receivables.

In summary, while the macro challenges that are out of our control have weighed on our near-term financial results, we have been aggressive in controlling what we can and thoughtfully investing for the future laying the foundation for increasing profits on increasing sales over time. I would like to thank my colleagues around the world for all they do to ensure our successful future. Now I'll turn the call back to Tod.

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

Thanks, Scott. We've talked a lot over the past few quarters about the difficulties we have faced operating within this extremely volatile and inflationary environment. I want to extend my sincerest gratitude to the hardworking Donaldson employees who have showed up every day with a commitment to the organization, our customers and our shareholders. I would also like to thank our customers and suppliers as we jointly work through these challenging times.

At Donaldson, we have a clear vision and a path to achieving our long-term goals, and I know we are taking the right steps in achieving our purpose of advancing filtration for a cleaner world.

We will reap the benefits of the investments we are making now for years to come.

Within our existing businesses, we are committed to providing our Advance and Accelerate businesses with the capital required to increase sales and market share and optimize margins.

We are also expanding our new product portfolio through our R&D and inorganic investments. On the acquisition front, we completed our first Life Sciences acquisition with Solaris in the second quarter and continue to look for ways to expand our reach in this sector.

Looking beyond the fourth quarter and into fiscal 2023, we are encouraged by the resiliency of the team and know that we have the right people, the right investments and the right strategy in place to profitably grow the company. 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.

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Brian Paul Drab ***William Blair & Company L.L.C., Research Division - Partner & Analyst***
So I just want to make sure that I have this right and this is probably a risk to ask this question since we're kind of updating the model as we speak here. But did you make a comment specifically about fourth quarter operating margin because to get to the midpoint of the guide, I think I'm getting something in the 15.5% type of range for operating margin in the fourth quarter. I just want to make sure that's what you're implying.

Scott J. Robinson ***Donaldson Company, Inc. - Senior VP & CFO***
Well, we gave the updating guidance for operating margin for the full year of 13.5% to 13.9%. And that's 10 [basis points] down on the high point compared to last year. But to back into that math, I think you'd have to get over 15% for the fourth quarter as you calculate.

Brian Paul Drab ***William Blair & Company L.L.C., Research Division - Partner & Analyst***
Yes. Okay. So yes, I'm getting over 15%. And I just wanted to confirm that we're doing the math right. So -- and then here's a question that I guess you won't answer it. I'm just curious what you would say about this. As you look as you look forward from there, is this -- is that kind of a one pop because pricing is now caught up and just the dynamics of volatility with input costs and pricing? Or is that a level that we can extrapolate in any way?

Scott J. Robinson ***Donaldson Company, Inc. - Senior VP & CFO***
Well, I mean, first of all, I would say our fourth quarter is always our -- generally our seasonally strongest quarter. And I think if you look back historically, has pretty good margins, but we do expect year-over-year margins will continue to improve. As we said, we had a bit of a tougher quarter on gross margin this quarter, and that was driven by factors whereby our pricing increases are lagging our material cost increases.

We had a big supplier issue this quarter that's now behind us. So we would expect our margins to continue to improve. We're always committed to higher levels of profitability on higher sales, and we're investing for that.

And so we feel not the greatest about the margin performance this quarter, but we do expect continued improvement on a year-over-year basis as we move forward.

Brian Paul Drab ***William Blair & Company L.L.C., Research Division - Partner & Analyst***
Okay. Great. And then I was wondering if you could just -- you touched on a couple of areas, but if you could just update on what kind of growth you're seeing in the Advance and Accelerate as you segmented the business how you think about it a couple of years ago.

What are you seeing in some of the higher growth Advance and Accelerate markets? And specifically, I'm wondering also about some of the -- even the newer markets like getting into the water filtration, et cetera.

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Tod E. Carpenter ***Donaldson Company, Inc. - Chairman, CEO & President***
Right. Sure. So when you take a look at our Advance and Accelerate portion of the portfolio, what we experienced in the third quarter is mid-teens growth across that portion of our portfolio. In the core, we would suggest it was mid-single digits. So you can see how Advance and Accelerate really is significantly more than other portions of our company. So we feel good about that.

Operator
The next question is from Laurence Alexander with Jefferies.

Kevin Michael Grundy ***Jefferies LLC, Research Division - Senior VP & Equity Analyst***
This is actually Kevin (inaudible) I'm on for Laurence Alexander. I just had one about I guess, the mix between price and volume contributions for the increase in the midpoint of your top line outlook. And I guess I was just wondering if it's largely price or which it likely maybe is -- I guess I'm just wondering if you guys thought about, I guess, demand destruction from those pricing actions? I guess I just want to get your thoughts behind that.

Scott J. Robinson ***Donaldson Company, Inc. - Senior VP & CFO***
Yes. So in the third quarter, pricing impacted revenues by 9% and volume was 6%, offset by currency headwinds of 3%. In the fourth quarter, pricing will be even a larger impact. And so we're layering these price increases and we don't feel like it's impacting demand. I mean we're trying to have reasonable commercial relationships with our customers.

They're raising their prices. They certainly understand that costs are up, and we have to pass those cost increases. One, we see them from our suppliers and then two, pass them on to our customers. And we're going to continue to do that to maintain reasonable margins as our part of the profit pool as long as costs continue to grow up.

So we do hope and expect that the cost increases we're seeing will start to level off and hopefully neutralize here at some point relatively soon. But right now, I don't think it's affecting demand. I mean, demand is very strong. I think we continue to slowly gain market share through our program wins with proprietary technology and we continue to invest in the company and work hard on our strategy even in light of kind of some challenging conditions that are out there.

Operator
(Operator Instructions) The next question is from Rob Mason with Baird.

Robert W. Mason ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***
I wanted to go back around the commentary on your gross margin outlook for gross margins to be up sequentially as you said, I'm teasing out a fairly healthy sequential increase. I'm just curious to provide a little visibility on that. How did gross margins exit the quarter? Or how have they played out thus far in the month of May relative to the 31.5% in the third quarter.

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Tod E. Carpenter ***Donaldson Company, Inc. - Chairman, CEO & President***
Yes. Rob, this is Tod. So maybe I'll start, and then I'll let Scott get a little bit more detail. One thing that really happened to us in the third quarter was we had an acute supply issue Scott referenced that in his prepared remarks, that was pretty significant for us. We did not see that coming into the quarter, but it presented significant headwinds relative to the gross margin on our execution across multiple manufacturing plants.

It was a petroleum-based chemical that suddenly became unobtainable. And it goes in about 90% of all the air-based products that we manufacture as a company. As a result of that, we lost a significant amount of plant shifts between 25 and 30 shifts of work were lost. And as a direct result of that, that did affect our margins in the third quarter. We have solved that issue now. We have enough clearly to get through the third quarter, et cetera. But that was a significant action to us in Q3 that should not repeat. So I'll let Scott pick margin building...

Scott J. Robinson ***Donaldson Company, Inc. - Senior VP & CFO***
In terms of pricing, Rob, I said we had a 9% price impact on revenues in the third quarter. We expect we'll have a larger impact in the fourth quarter as we layer in additional pricing mechanisms. The plants are cranked back up. We have additional pricing that we're going to catch here as we move forward each month. And so we feel pretty good back to Brian's original question about the sequential operating margin improvement pick up in the fourth quarter as well as a reasonable gross margin pickup in the fourth quarter.

Certainly, third quarter margins were behind our expectations based in part on what Tod just mentioned, and we expect to recover that and improve from there. So we're committed to increasing that margin in the fourth quarter and into next year on higher levels of sales.

Robert W. Mason ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***
And Scott, in your earlier commentary, you referenced margins higher, I thought, year-over-year, that, that would apply to the fourth quarter operating margin. Does that apply to the fourth quarter gross margin?

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

Robert W. Mason ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***
Okay. Okay. Just a follow-up question. Last year, on the third quarter call, you did make some preliminary commentary around your, I'll just call it, calendar second half view a peak into that. I'm just curious if you have any thoughts for this calendar second half as you look in particular around maybe seasonality given your backlog it sounds like they're still elevated, whether that causes any change in your seasonality?

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

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Yes. I mean we still expect fourth quarter to be you know our best quarter, and you can kind of back into that based on the guidance provided. I mean last year, we had just COVID kind of madness. So we felt obligated to try to give a little bit more guidance into, like you said, the early part of next year. I mean we feel good about our growth prospects our demand continues to be strong. As we said, the backlogs are high. Channel inventories are still at low levels.

And so we feel like there's plenty of demand there, at least for what we can see reasonably well in the future. And we're, as I said, committed to higher levels of profitability on higher sales. If you think about next year, with all this pricing that we've had to layer in, that comes in month by month, quarter by quarter, there'll be a tailwind next year -- in next year's revenues based solely on the price increases that we're layering this year.

And so we would kind of put that in the mid-single-digit range. One offsetting factor is currencies to that. Currencies were a headwind this quarter, certainly. And if they stay at this level, they would be a headwind into next year. So I think, overall, we feel pretty good. We're working through our planning process. The finance teams are cranking away along with their business partners as we speak to come up with a good solid plan. for next year, and we look forward to coming back to you with that in about 90 days.

Operator
The next question is from Nathan Jones with Stifel.

Adam Michael Farley ***Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst***
This is Adam Farley on for Nathan. I wanted to first talk about the Engine Aftermarket channel continues to show very robust growth. Are you seeing any channel inventory builds?

Tod E. Carpenter ***Donaldson Company, Inc. - Chairman, CEO & President***
Yes. So this is Tod. So when you really look at the overall aftermarket, there have not been inventory builds. We within the quarter, took the opportunity to visit a number of different distributors. And so we know firsthand that the levels that we're at, at this point in time, our pull-through we have not seen the channel build. It's what also gives us confidence that the current levels would continue, as Scott mentioned, when he talked about in the fourth quarter.

Adam Michael Farley ***Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst***
Okay. And then on the free cash flow guidance, I understand the higher inventory and accounts receivable impacting working capital. Maybe looking ahead into 2023, would you expect the return of cash from working capital? Or would you run higher inventory levels in the medium-term?

Scott J. Robinson ***Donaldson Company, Inc. - Senior VP & CFO***
Well, as I said, our trustee finance team is still cranking away on the plan. But we would certainly expect cash conversion to improve next year. We'll have to make a call on what we want to do with inventories based on the supply chain situation. But we would expect cash conversion will improve.

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I would say, while we're not really to commit to this, I would expect our raw material balances to start to trend down as we hopefully catch up. Things seem to be improving slightly right now, and we're hoping that those things will continue. But certainly, we would expect to see cash conversion improve next year.

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

Yes. Just maybe a little bit of color. Going into the fourth quarter, I would say that our supply chain issues that we've been experiencing as compared to going into third quarter, we've seen some slight improvements on that, clearly we had that acute issue in the -- unforeseen in the third quarter that hurt us. But again, that has been solved. We do see that we have been gaining on supply chain-based issues. And so we'll be making a call as to when to put pressure to bring the inventories down.

Operator

We have no further questions at this time. I'll turn it back to the presenters for any closing remarks.

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

Thanks, Chris. That concludes the call today. Thanks to everyone who participated, and I look forward to reporting our fourth quarter and full year fiscal 2022 results in late August. Goodbye.

Operator

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

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