

Donaldson Company (DCI)

\$49.66 (As of 06/03/20)

Price Target (6-12 Months): **\$52.00**

Long Term: 6-12 Months

Zacks Recommendation:
Neutral

(Since: 11/11/19)

Prior Recommendation: Underperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

4-Sell

Zacks Style Scores:

VGM:B

Value: B

Growth: A

Momentum: D

Summary

Focus on innovation, supply-chain optimization, solid product offerings and diversified business structure are likely to aid Donaldson's performances in the quarters ahead. Also, its cost-reduction efforts will help it deal with the financial stress caused by the pandemic. Dividend payment and share buybacks remain its priorities. In third-quarter fiscal 2020, Donaldson's earnings and sales beat estimates by 31.6% and 3.9% respectively. The company kept its projections for fiscal 2020 and 2021 suspended due to uncertainties related to the pandemic. However, it did mention that sales will likely fall 24% year over year in May. Also, forex woes and high debt levels are concerning. Year to date, Donaldson's shares have underperformed the industry. Its consensus estimates have been lowered for fiscal 2020 and 2021 in the past seven days.

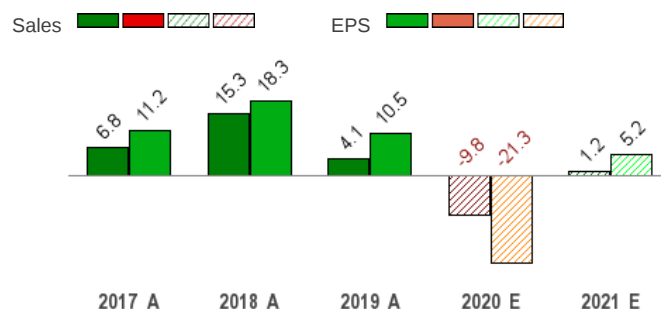
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$58.32 - \$31.08
20 Day Average Volume (sh)	539,247
Market Cap	\$6.3 B
YTD Price Change	-13.8%
Beta	1.40
Dividend / Div Yld	\$0.84 / 1.7%
Industry	Pollution Control
Zacks Industry Rank	Top 23% (58 out of 253)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	31.6%
Last Sales Surprise	4.1%
EPS F1 Est- 4 week change	-5.0%
Expected Report Date	09/03/2020
Earnings ESP	13.5%
P/E TTM	23.4
P/E F1	28.5
PEG F1	2.6
P/S TTM	2.3

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	673 E	700 E	730 E	757 E	2,598 E
2020	673 A	662 A	630 A	612 E	2,567 E
2019	701 A	704 A	713 A	727 A	2,845 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.47 E	\$0.48 E	\$0.52 E	\$0.53 E	\$1.83 E
2020	\$0.51 A	\$0.50 A	\$0.50 A	\$0.35 E	\$1.74 E
2019	\$0.56 A	\$0.47 A	\$0.58 A	\$0.61 A	\$2.21 A

*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 06/03/2020. The reports text is as of 06/04/2020.

Overview

Headquartered in Bloomington, MN, Donaldson Company, Inc is engaged in manufacturing and selling of filtration systems and replacement parts across the world. It was founded in 1915. Exiting fiscal 2019 (ended Jul 31, 2019), the company manufactured products across 50 plants placed globally.

Leading filtration technology, strong customer relationships and solid presence across diverse geographies are the company's three core strengths. Notably, it has operations in the United States; Europe, Middle East and Africa (EMEA); Asia Pacific and Latin America.

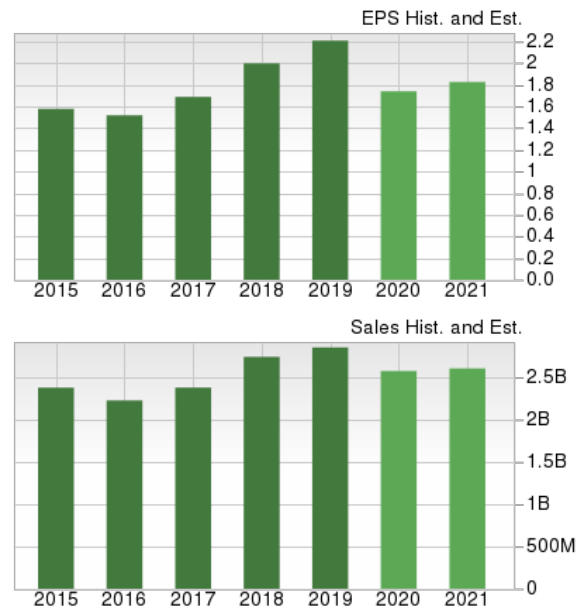
The company has two reportable business segments — Engine Products and Industrial Products. A brief discussion on the segments is provided below:

- **Engine Products** (accounted for 66.8% of net sales in third-quarter fiscal 2020): The segment engages in the manufacturing and selling of air filtration systems, liquid filtration systems (for hydraulics, fuel and lube applications), exhaust and emissions systems, and replacement filters.

The segment's products are mainly used by original equipment manufacturers (OEMs) in the agriculture, construction, aerospace, defense, mining and truck markets. Products are also sold to independent distributors, private label accounts, OEM dealer networks and large equipment fleets.

- **Industrial Products** (33.2%): The segment manufactures and sells dust, mist and fume collectors; air filtration systems (for gas turbines); compressed air purification systems; PTFE membrane-based products; and specialized air and gas filtration systems.

The products are sold to various OEMs (for replacement filters and specific markets), dealers and distributors.



Reasons To Buy:

- ▲ In third-quarter fiscal 2020, Donaldson's earnings beat estimates by 31.6%. Also, its sales surpassed the consensus estimate by 3.9%. In the quarter ahead, the company might benefit from solid product portfolio, focus on innovation and supply-chain optimization, growing e-commerce business, and growth investments. In April 2020, it noted that the safety of its workers, satisfaction of customers and measures to fight the pandemic are its priorities. Also, cost-reduction measures have been undertaken to deal with financial stress.
- ▲ Diversified business structure — with exposure in various end markets and geographies — is benefiting Donaldson, especially in the prevalent difficult conditions. For instance, it continued operating in critical markets and manufacturing replacement parts despite shutdowns ordered by governments to contain the virus from spreading. The company believes that process filtration business in the food and beverage market continues to grow and benefit the Industrial Products segment.
- ▲ Dividend payouts and share buybacks are Donaldson's preferred modes of rewarding shareholders. In the first nine months of fiscal 2020, the company used \$94.3 million for purchasing treasury stocks and \$79.8 million for paying out dividends. In April 2020, it mentioned that it is committed toward buying back shares (to the extent that offset the dilution caused by stock-based compensation) and rewarding shareholders with dividend payouts. For fiscal 2020, total share buybacks will likely be 1.6% of the company's outstanding shares (with no buybacks likely to happen in the fourth quarter).

Diversified business structure and focus on innovation as well as effective use of resources in growth investments, share buybacks and dividend payments bode well for Donaldson.

Reasons To Sell:

- ▼ Year to date, Donaldson's shares have fallen 13.8% compared with the industry's decline of 11.8%. In third-quarter fiscal 2020, the company's results were adversely impacted by the pandemic — with earnings declining 13.8% year over year due to an 11.7% decline in sales and weak margins. For the quarters ahead, the company is wary about the uncertainties associated with the pandemic and so kept its projections for both fiscal 2020 and 2021 suspended. In particular, it noted that sales in May will likely be down 24% from the year-ago period. In the past seven days, the consensus estimate for fiscal 2020 and fiscal 2021 have fallen 1.1% and 1.6%, respectively, thereby reflecting bearish investor sentiments.
- ▼ Donaldson intends to become more competent on the back of overseas business expansion. However, this exposes the company to several economic, political and environmental headwinds. Notably, the impact of unfavorable foreign currency translation affected its third-quarter fiscal 2020 revenues by 2%. The company noted that sales performance in May was the best in the Asia Pacific region, while challenges persist in North and South America.
- ▼ Rise in debts can be detrimental for Donaldson, as it inflates financial obligations and in turn, can adversely influence profitability. In the last five fiscal years (2015-2019), the company's long-term debt jumped 10.7% (CAGR), while the balance of \$735.1 million at the end of third-quarter fiscal 2020 reflected 23.4% growth from the previous quarter. The company's long-term debt to capital is at 45.6%, higher than the industry's 39.1%. Also, its debt to equity at 82.8% is above the industry's 73.7%. On the other hand, the company's cash and cash equivalents at the end of the third quarter were just \$326.5 million. Its times interest earned remained stable sequentially at 19.8x. Notably, times interest earned reflect the company's ability to meet its debt obligations.

The coronavirus outbreak is expected to hurt Donaldson's operations in the quarters ahead. Beside, forex woes and high leverage might be concerning for the company.

Last Earnings Report

Donaldson Q3 Earnings Beat Estimates, Decline Y/Y

Donaldson has reported better-than-expected results for third-quarter fiscal 2020 (ended Apr 30, 2020), with earnings beating estimates by 31.6%.

The company's adjusted earnings in the reported quarter were 50 cents per share, surpassing the Zacks Consensus Estimate of 38 cents. However, the bottom line decreased 13.8% from the year-ago quarter's figure of 58 cents due to sales weakness caused by the pandemic and a fall in margins.

Quarter Ending **04/2020**

Report Date	Jun 02, 2020
Sales Surprise	4.08%
EPS Surprise	31.58%
Quarterly EPS	0.50
Annual EPS (TTM)	2.12

Top-Line Results

In the fiscal third quarter, Donaldson's net sales were \$629.7 million, reflecting a year-over-year decline of 11.7%. The results suffered from a 9.7% fall in organic sales due mainly to the adverse impacts of the pandemic. Forex woes too had a negative impact of 2%.

However, the top line surpassed the Zacks Consensus Estimate of \$606.3 million.

On a geographical basis, the company's net sales in the United States decreased 12% year over year. Results also suffered from a 12.5% decline in Europe, Middle East and Africa's sales, and an 8.1% dip in the Asia Pacific's sales. Sales in Latin America declined 15.8% year over year.

The company reports revenues under the following segments — Engine Products and Industrial Products. A brief snapshot of the segmental sales is provided below:

Engine Products' (accounting for 66.8% of net sales in third-quarter fiscal 2020) sales were \$420.4 million, reflecting a year-over-year decline of 14.1%.

The results were adversely impacted by a 25.1% fall in Off-Road, 46.5% in On-Road and 7.9% in Aftermarket sales. Also, the company recorded a 0.3% fall in Aerospace and Defense sales.

Revenues generated from **Industrial Products** (accounting for 33.2% of net sales in third-quarter fiscal 2020) were \$209.3 million, decreasing 6.3% from the year-ago quarter.

Results suffered from a sales decline of 11.5% in Industrial Filtration Solutions, partially offset by a 6.2% rise in Gas Turbine Systems and a 4.9% increase in Special Applications' sales.

Margin Profile

In the reported quarter, Donaldson's cost of sales decreased 10.9% year over year to \$420.5 million. It represented 66.8% of net sales versus 66.2% in the year-ago quarter. Adjusted gross margin in the quarter was 33.2%, down 60 basis points (bps) year over year. Lower sales were a setback in the quarter, partially offset by pricing, procurement, production and supply-chain measures as well as reduced raw material costs and favorable sales mix.

Operating expenses dipped 11.3% year over year to \$124.7 million. It represented 19.8% of net sales versus 19.7% in the year-ago quarter. Adjusted operating margin in the quarter under review was 13.4%, down 50 bps year over year. Adjusted effective tax rate in the quarter was 24.9% as compared with 24.5% in the year-ago quarter.

Balance Sheet & Cash Flow

Exiting third-quarter fiscal 2020, Donaldson's cash and cash equivalents were \$326.5 million, up 54.7% from \$211.1 million recorded in the last reported quarter. Long-term debt was up 23.4% sequentially to \$735.1 million.

In the first three quarters of fiscal 2020, the company repaid the long-term debt of \$111.1 million, while raised \$262.7 million from long-term debts.

In the first three quarters of fiscal 2020, Donaldson generated net cash of \$265.2 million from operating activities, reflecting an increase of 18.8% from the year-ago figure. Capital expenditure totaled \$106.2 million versus \$112.4 million in the year-ago quarter. Free cash flow in the reported quarter increased 43.5% year over year to \$159 million.

In the first three quarters, the company used \$94.3 million for repurchasing shares and \$79.8 million for paying out dividends.

Outlook

Donaldson is wary about the uncertainties caused by the coronavirus outbreak. It kept its financial projections suspended for fiscal 2020 (ending July 2020) and fiscal 2021 (ending July 2021). Notably, estimates were withdrawn in April.

However, the company noted that share buybacks for the year will be 1.6% of outstanding shares. Capital expenditure will likely be lower, while liquidity will be solid. Sales in May will likely be down 24% year over year.

Recent News

On **May 29, 2020**, Donaldson's board of directors approved the payment of a quarterly cash dividend of 21 cents per share to shareholders of record as of Jun 15, 2020. The disbursement will be made on Jun 30.

On **Apr 29, 2020**, Donaldson communicated that safety of its workers, satisfaction of customers and measures to fight the pandemic are its priorities. Further, it mentioned that it remains committed toward making growth investments, buying back shares and rewarding shareholders with dividends. At March end, the company had \$438 million liquidity — including revolving credit facilities and cash on hand — at its disposal.

The company expects capital expenditure to decline year over year in fiscal 2021. It has withdrawn its projections for both fiscal 2020 and fiscal 2021.

On **Mar 12, 2020**, Donaldson announced the launch of PowerCore Edge, an innovative and high-performance air cleaner. Equipped with easier servicing facility, the avant-garde filtration device has been specifically designed to provide improved pre-cleaner performance in non-scavenged applications.

On **Mar 12, 2020**, Donaldson announced the launch of Filter Minder, a top-notch wireless monitoring system for air filters. Equipped with a connected technology, the trailblazing device has been tested in real-world conditions and aids in taking up-to-date air filtration maintenance decisions. It boosts fleet maintenance practices in off-road equipment and on-road truck fleets.

On **Mar 10, 2020**, Donaldson announced the extension of its iCue connected filtration service to Europe. Unveiled in September 2019, the service enables facilities to reduce production downtime by monitoring major parameters on dust collection equipment. Touted as an efficient dust collection management system, the connected filtration service leverages real-time information to solve troubleshoot problems, allowing its users to drive production efficiency and reduce maintenance costs.

Valuation

Donaldson's shares have decreased 13.8% and increased 1.6% in the year to date and over the trailing 12-month period, respectively. Stocks in the Zacks sub-industry and the Zacks Industrial Products sector have moved down 11.8% and 13.2%, respectively, on a year-to-date basis. Over the past year, the Zacks sub-industry decreased 0.6% and the sector moved down 5.2%.

The S&P 500 Index has moved down 4.4% year to date and increased 9.1% in the past year.

The stock is currently trading at 27.84x forward 12-month earnings per share, which compares to 27.43x for the Zacks sub-industry, 21.8x for the Zacks sector and 22.29x for the S&P 500 Index.

Over the past five years, the stock has traded as high as 27.84x and as low as 15.44x, with a 5-year median of 21.62x. Our Neutral recommendation indicates that the stock will perform in line with the market. Our price target of \$52 reflects 29.23x forward 12-month earnings.

The table below shows summary valuation data for DCI.

Valuation Multiples - DCI					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	27.84	27.43	21.8	22.29
	5-Year High	27.84	27.43	21.8	22.29
	5-Year Low	15.44	14.23	12.55	15.23
	5-Year Median	21.62	18.35	16.58	17.49
EV/EBITDA F12M	Current	16.39	12.52	19.12	13.52
	5-Year High	16.87	12.52	19.12	14.17
	5-Year Low	9.9	5.16	10.6	9.02
	5-Year Median	13.17	7.95	14.15	10.92
EV/Sales F12M	Current	2.56	1.8	3.1	3.21
	5-Year High	2.73	1.94	3.13	3.52
	5-Year Low	1.63	0.86	1.76	2.28
	5-Year Median	2.29	1.38	2.31	2.82

As of 06/03/2020

Industry Analysis Zacks Industry Rank: Top 23% (58 out of 253)



Top Peers

Company (Ticker)	Rec	Rank
Cummins Inc. (CMI)	Neutral	3
Danaher Corporation (DHR)	Neutral	3
Eaton Corporation, PLC (ETN)	Neutral	3
Fuel Tech, Inc. (FTEK)	Neutral	2
ParkerHannifin Corporation (PH)	Neutral	3
Tetra Tech, Inc. (TTEK)	Neutral	3
Vertex Energy, Inc (VTNR)	Neutral	3
Genuine Parts Company (GPC)	Underperform	4

Industry Comparison Industry: Pollution Control				Industry Peers		
	DCI	X Industry	S&P 500	CMI	DHR	PH
Zacks Recommendation (Long Term)	Neutral	-	-	Neutral	Neutral	Neutral
Zacks Rank (Short Term)	4	-	-	3	3	3
VGM Score	B	-	-	B	D	A
Market Cap	6.30 B	56.00 M	22.50 B	25.81 B	118.33 B	25.17 B
# of Analysts	6	2	14	6	9	9
Dividend Yield	1.69%	0.00%	1.88%	3.00%	0.42%	1.79%
Value Score	B	-	-	B	D	B
Cash/Price	0.04	0.13	0.06	0.08	0.04	0.03
EV/EBITDA	14.42	13.12	12.98	7.02	30.04	12.69
PEG Ratio	2.65	3.64	3.05	3.62	3.83	1.73
Price/Book (P/B)	6.67	1.04	3.11	3.22	4.01	3.99
Price/Cash Flow (P/CF)	17.16	16.01	12.18	8.87	27.30	12.61
P/E (F1)	28.65	45.22	22.19	23.50	34.75	20.33
Price/Sales (P/S)	2.34	0.83	2.40	1.14	6.10	1.77
Earnings Yield	3.50%	0.66%	4.31%	4.26%	2.88%	4.92%
Debt/Equity	0.83	0.31	0.76	0.20	0.77	1.28
Cash Flow (\$/share)	2.89	0.09	7.01	19.73	6.21	15.57
Growth Score	A	-	-	A	C	B
Hist. EPS Growth (3-5 yrs)	10.06%	29.67%	10.87%	16.19%	2.50%	17.20%
Proj. EPS Growth (F1/F0)	-21.19%	-28.50%	-10.74%	-50.53%	10.43%	-18.53%
Curr. Cash Flow Growth	8.18%	11.46%	5.48%	9.29%	1.84%	6.37%
Hist. Cash Flow Growth (3-5 yrs)	2.27%	14.25%	8.55%	7.28%	5.87%	7.55%
Current Ratio	2.82	1.77	1.29	1.40	1.32	1.49
Debt/Capital	45.63%	25.44%	44.75%	16.46%	42.26%	56.22%
Net Margin	9.32%	0.87%	10.59%	9.34%	16.85%	9.32%
Return on Equity	29.45%	7.05%	16.29%	24.86%	11.52%	24.30%
Sales/Assets	1.19	1.00	0.55	1.12	0.32	0.72
Proj. Sales Growth (F1/F0)	-9.77%	0.00%	-2.65%	-26.69%	2.71%	-6.53%
Momentum Score	D	-	-	D	C	C
Daily Price Chg	1.26%	0.00%	2.42%	2.04%	1.61%	6.02%
1 Week Price Chg	5.16%	0.00%	4.60%	9.39%	5.28%	7.84%
4 Week Price Chg	15.01%	13.56%	13.40%	13.87%	3.45%	28.00%
12 Week Price Chg	12.33%	6.38%	12.78%	24.02%	21.72%	32.94%
52 Week Price Chg	1.58%	-18.58%	0.89%	9.66%	26.41%	20.90%
20 Day Average Volume	539,247	23,712	2,528,787	1,415,927	3,674,247	1,397,141
(F1) EPS Est 1 week change	0.67%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	-5.03%	-3.99%	-0.14%	-0.84%	-0.04%	0.88%
(F1) EPS Est 12 week change	-18.99%	-61.48%	-16.00%	-38.45%	-10.40%	-8.40%
(Q1) EPS Est Mthly Chg	-11.22%	-5.61%	-0.02%	-2.84%	-13.53%	-1.52%

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	B
Growth Score	A
Momentum Score	D
VGM Score	B

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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