

Donaldson Company (DCI)

\$40.26 (As of 03/12/20)

Price Target (6-12 Months): **\$42.00**

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:C

Value: D

Growth: B

Momentum: F

Summary

Donaldson reported impressive bottom-line results for second-quarter fiscal 2020 with earnings beating estimates by 6.4%. Capacity expansion, investments to enhance market shares, focus on innovation and supply-chain optimization are likely to be boons in the quarters ahead. Notably, Aerospace and Defense are expected to aid the Engine Products segment in fiscal 2020. Also, share buybacks and dividend payouts are the preferred modes of rewarding shareholders. However, it expects soft market conditions to impact its performance in fiscal 2020. Sales are predicted to decline 3-7%, versus decline of 2% to rise of 4% stated previously. Earnings per share are expected to be \$2.05-\$2.19, down from \$2.21-\$2.37. Also, forex woes and high debt levels are concerning. Over the past three months, the company's shares have underperformed the industry.

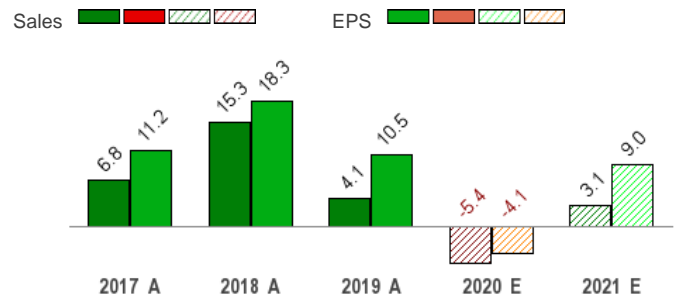
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$58.32 - \$39.50
20 Day Average Volume (sh)	654,867
Market Cap	\$5.1 B
YTD Price Change	-30.1%
Beta	1.50
Dividend / Div Yld	\$0.84 / 2.1%
Industry	Pollution Control
Zacks Industry Rank	Bottom 28% (182 out of 253)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	6.4%
Last Sales Surprise	-4.3%
EPS F1 Est- 4 week change	-6.1%
Expected Report Date	06/02/2020
Earnings ESP	0.0%
P/E TTM	18.3
P/E F1	19.0
PEG F1	1.8
P/S TTM	1.8

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021					2,774 E
2020	673 A	662 A	668 E	688 E	2,690 E
2019	701 A	704 A	713 A	727 A	2,845 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021					\$2.31 E
2020	\$0.51 A	\$0.50 A	\$0.53 E	\$0.58 E	\$2.12 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 03/12/2020. The reports text is as of 03/13/2020.

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.

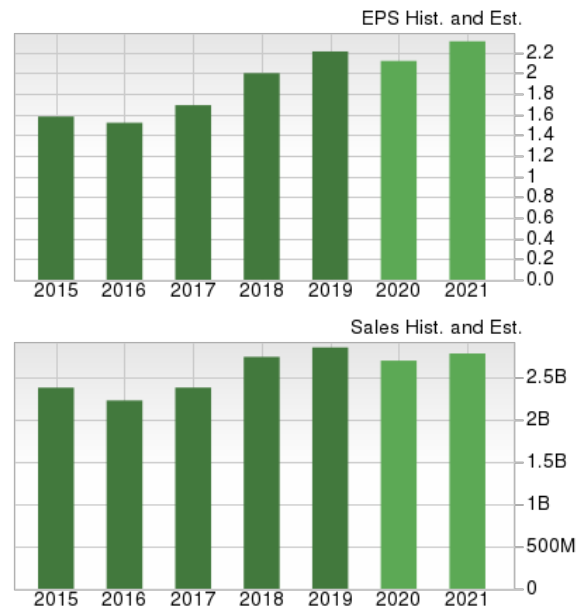
The company has two reportable business segments — Engine Products and Industrial Products. A brief discussion on the segments is provided below:

- **Engine Products** (accounted for 65.8% of net sales in second-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** (34.2%): 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 second-quarter fiscal 2020, the company's earnings beat estimates by 6.4%. Also, its earnings increased 6.4% year over year on the back of improved operating results and lower taxes. Donaldson anticipates benefiting from capacity expansion, investments to enhance market shares, focus on innovation and supply-chain optimization in the quarters ahead. Also, product launches, program wins and growing e-commerce business will be boons. Notably, the company's focus on enhancing sales of its Advance & Accelerate portfolio might also be a positive. Moreover, robust growth in Aerospace and Defense sales is anticipated to aid the Engine Products segment in fiscal 2020.
- ▲ In the second quarter of fiscal 2020, Donaldson's gross margin came in at 33.7%, up compared with 32% in the prior-year quarter on the back of price optimization and seamless supply chain operations. Lower cost of raw materials and favorable mix of sales further added to the benefit. Notably, the company is predicted to witness an improvement in operating results, with operating margin of 13.5-13.9% in fiscal 2020, primarily driven by lower incentive compensation, cost-effective procurement initiatives, streamlined expense management and supply chain optimization.
- ▲ Donaldson is poised to boost its competency, backed by ongoing capital expenditure and innovation investments. In the first half of 2020, capital expenditure totaled \$79.7 million, up 18.8% compared with \$67.1 million in the year-ago quarter. Also, in fiscal 2019, it met the target of \$150 million of capital expenditure. Notably, these investments were made toward capacity expansion projects. For fiscal 2020, the company expects capital expenditure of \$110-\$130 million. Beside capital expenditure, it uses resources for dividend payments, share buybacks, and mergers and acquisitions.
- ▲ Dividend payouts and share buybacks are Donaldson's preferred modes of rewarding shareholders. In the first six months of fiscal 2020, the company used \$65 million for purchasing treasury stocks and \$53.2 million for paying out dividends. It is worth mentioning that in late May 2019, Donaldson announced a 10.5% hike in its quarterly dividend rate. Also, it targets to repurchase 2% of its outstanding shares in fiscal 2020.

Solid product offerings and focus on innovation as well as effective use of resources in capital expenditure, buyouts and rewarding shareholders bode well for Donaldson.

Reasons To Sell:

- ▼ In the past three months, shares of Donaldson have decreased 29.1% compared with the industry's decline of 24%. In second-quarter fiscal 2020, the company's sales lagged estimates by 4.3%. For fiscal 2020, it predicts sales to be down 3-7% as compared with a decline of 2% to an increase of 4% mentioned previously. Notably, Donaldson predicts earnings of \$2.05-\$2.19 per share for the year, down from previously stated guidance of \$2.21-\$2.37. Moreover, in the past 30 days, the Zacks Consensus Estimate for fiscal 2020 and fiscal 2021 have decreased 6.2% and 7.2% respectively, thereby reflecting bearish investor sentiments.
- ▼ Soft segmental sales are concerns for Donaldson for fiscal 2020. Engine Products' sales for the year are predicted to be down 5-9%, as compared with a 4% decline to 2% increased stated previously. The decline is mainly due to a lower projection of fiscal 2020 Aftermarket sales. Both On-road and Off-road sales are also predicted to decline in the year. Moreover, Donaldson expects the Industrial Products segment's sales to be down 3% and up 1%, as compared with a growth of 2-8% expected previously. This unfavorable change is primarily attributable to lower projection for fiscal 2020 IFS sales and decline in the special applications business.
- ▼ 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 second-quarter fiscal 2020 revenues by 0.6%. For fiscal 2020, it predicts that forex woes will adversely impact the top line by 1-2%.
- ▼ 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 \$595.8 million at the end of second-quarter fiscal 2020 reflected 2% growth from the fourth-quarter of fiscal 2019. The company incurred interest expenses of \$4.5 million in the fiscal second quarter, reflecting a decline of 15.1% from the year-ago quarter. For fiscal 2020, it expects interest expenses of \$18 million.

Weakness in On-road, Off-road and special applications businesses as well as increase in debts and forex woes remain concerning for Donaldson.

Last Earnings Report

Donaldson Beats Q2 Earnings Estimates, Lowers View

Donaldson reported impressive bottom-line results for second-quarter fiscal 2020 (ended Jan 31, 2020), with earnings beating estimates by 6.4%. However, sales lagged estimates by 4.3%.

The company's adjusted earnings in the reported quarter were 50 cents per share, surpassing the Zacks Consensus Estimate of 47 cents. Also, the bottom line increased 6.4% from the year-ago quarter's figure of 47 cents on improved operating results and lower taxes.

Quarter Ending **01/2020**

Report Date	Mar 05, 2020
Sales Surprise	-4.34%
EPS Surprise	6.38%
Quarterly EPS	0.50
Annual EPS (TTM)	2.20

Top-Line Results

In the fiscal second quarter, Donaldson's net sales were \$662 million, reflecting a year-over-year decline of 5.9%. The results suffered from lower volumes and the negative impact of 0.6% from forex woes, offset by a positive impact of 0.7% from pricing.

However, the top line lagged the Zacks Consensus Estimate of \$692 million.

On a geographical basis, the company's net sales in the United States decreased 7.6% year over year. Results also suffered from a 6.4% decline in Europe, Middle East and Africa's sales, and a 3.2% dip in the Asia Pacific's sales. Sales in Latin America declined 2.8% 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 65.8% of net sales in second-quarter fiscal 2020) sales were \$435.6 million, reflecting a year-over-year decline of 7.1%.

The results were adversely impacted by a 14.5% fall in Off-Road, 21.1% in On-Road and 4% in Aftermarket sales. This was partially offset by a 0.6% increase in Aerospace and Defense sales.

Revenues generated from Industrial Products (accounting for 34.2% of net sales in second-quarter fiscal 2020) were \$226.4 million, decreasing 3.5% from the year-ago quarter.

Results suffered from a decline of 11.6% in Gas Turbine Systems and 5.9% in Industrial Filtration Solutions, partially offset by a 10.7% increase in Special Applications' sales.

Margin Profile

In the reported quarter, Donaldson's cost of sales decreased 8.2% year over year to \$438.8 million. It represented 66.3% of net sales versus 68% in the year-ago quarter. Adjusted gross margin in the quarter was 33.7%, up 170 basis points (bps) year over year. Results gained from pricing, procurement, production and supply-chain measures as well as reduced raw material costs and favorable sales mix. However, lower sales in the quarter were a setback.

Operating expenses grew 2.1% year over year to \$142.6 million. It represented 21% of net sales versus 19.9% in the year-ago quarter. Adjusted operating margin in the quarter under review was 12.8%, up 70 bps year over year. Adjusted effective tax rate in the quarter was 22.2%, down from 24.8% in the year-ago quarter.

Balance Sheet & Cash Flow

Exiting second-quarter fiscal 2020, Donaldson's cash and cash equivalents were \$211.1 million, up 0.5% from \$210 million recorded in the last reported quarter. Long-term debt was down 0.2% sequentially to \$595.8 million.

In the first two quarters of fiscal 2020, the company repaid long-term debt of \$111.1 million, while raised \$122.7 million from long-term debts.

In the first half of fiscal 2020, Donaldson generated net cash of \$176.8 million from operating activities, reflecting an increase of 23.8% from the year-ago figure. Capital expenditure totaled \$79.7 million versus \$67.1 million in the year-ago quarter. Free cash flow in the reported quarter was \$97.1 million, suggesting a year-over-year increase of 28.3%.

In the first half, the company used \$65 million for purchasing 1.4 million shares and \$53.2 million for paying out dividends.

Outlook

Donaldson revised down its projection for fiscal 2020 (ending July 2020), expecting soft market conditions. Sales in the year are now predicted to dip 3-7% as compared with a decline of 2% to increase of 4% mentioned previously.

It projects forex woes to have an adverse impact of 1-2% on sales, while pricing is likely to be positively impacted the same by 1%.

The company anticipates fiscal 2020 Engine Products' sales to be down 5-9% year over year. Earlier, it had predicted a 4% decline to 2% increase for the segment. The results will likely suffer from declines in Aftermarket, Off-Road and On-Road sales. However, Aerospace and Defense sales are predicted to grow from the previous year.

Donaldson anticipates Industrial Products' sales to be down 3% to grow 1% on a year-over-year basis. The change compares unfavorably with growth of 2-8% expected earlier. It expects sales from Industrial Filtration Solutions and Special Applications businesses to decline year over

year. Flat results are expected from the Gas Turbine Systems business.

It predicts operating margin of 13.5-13.9%, down from 13.9-14.5% expected earlier. Notably, operating margin was 13.6% in fiscal 2019 (ended July 2019). On a year-over-year basis, the operating margin will likely benefit from gross margin improvement, reduced incentive compensation and expense management.

The company anticipates interest expenses of \$18 million, down from \$18-\$20 million mentioned previously. Capital expenditure projection is maintained at \$110-\$130 million. It now expects effective income tax rate of 24.3-25.3%, lower than 25-27% stated earlier.

It projects earnings of \$2.05-\$2.19 per share for the year, down from previously stated \$2.21-\$2.37. Share buybacks in the fiscal year are likely to be 2% of the company's outstanding shares.

Recent News

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.

On **Feb 28, 2020**, Donaldson paid out a quarterly cash dividend of 21 cents per share to shareholders of record as of Feb 14, 2020.

On **Feb 24, 2020**, Donaldson announced that it has acknowledged a binding offer from a global supplier of exhaust systems — Nelson Global Products — to purchase the former's Exhaust and Emissions (E&E) business unit. The strategic divestiture underscores Donaldson's efforts to manage its infiltration business portfolio efficiently. Financial terms of the deal have not yet been disclosed. Incorporated with dedicated E&E sales functions, lab capabilities and production facilities, the transaction is anticipated to close in third-quarter fiscal 2020.

On **Feb 4, 2020**, Donaldson introduced protective vent designed for vehicle powertrains.

Valuation

Donaldson's shares have decreased 30.1% and 17.4% 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 16.7% and 22.8%, respectively, on a year-to-date basis. Over the past year, the Zacks sub-industry increased 3.5% but the sector moved down 16.8%.

The S&P 500 index has moved down 14.9% year to date and 3.4% in the past year.

The stock is currently trading at 17.37x forward 12-month earnings per share, which compares to 18.9x for the Zacks sub-industry, 14.42x for the Zacks sector and 15.84x for the S&P 500 Index.

Over the past five years, the stock has traded as high as 27.73x and as low as 16.1x, with a 5-year median of 21.5x. Our Neutral recommendation indicates that the stock will perform in line with the market. Our price target of \$42 reflects 18.10x 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	17.37	18.9	14.42	15.84
	5-Year High	27.73	22.47	19.89	19.34
	5-Year Low	16.1	14.23	12.6	15.18
	5-Year Median	21.5	18.26	16.43	17.42
EV/EBITDA F12M	Current	12.52	10.72	16.66	12.28
	5-Year High	16.87	10.72	18.27	12.64
	5-Year Low	9.9	5.16	10.71	9.09
	5-Year Median	13.14	7.8	14.06	10.79
EV/Sales F12M	Current	2.23	1.84	2.8	3.04
	5-Year High	2.73	1.84	3.15	3.51
	5-Year Low	1.63	0.86	1.76	2.3
	5-Year Median	2.27	1.36	2.3	2.8

As of 03/12/2020

Industry Analysis Zacks Industry Rank: Bottom 28% (182 out of 253)



Top Peers

Danaher Corporation (DHR)	Neutral
Eaton Corporation, PLC (ETN)	Neutral
Fuel Tech, Inc. (FTEK)	Neutral
Genuine Parts Company (GPC)	Neutral
Parker-Hannifin Corporation (PH)	Neutral
Tetra Tech, Inc. (TTEK)	Neutral
Cummins Inc. (CMI)	Underperform
Vertex Energy, Inc (VTNR)	Underperform

Industry Comparison Industry: Pollution Control				Industry Peers		
	DCI Neutral	X Industry	S&P 500	CMI Underperform	DHR Neutral	PH Neutral
VGM Score	C	-	-	B	D	B
Market Cap	5.10 B	30.18 M	17.38 B	19.78 B	89.74 B	16.74 B
# of Analysts	6	3	13	10	7	8
Dividend Yield	2.09%	0.00%	2.51%	4.06%	0.53%	2.70%
Value Score	D	-	-	C	D	B
Cash/Price	0.04	0.13	0.05	0.06	0.19	0.05
EV/EBITDA	11.63	6.69	10.90	5.50	20.19	9.29
PEG Ratio	1.85	1.35	1.54	1.33	2.12	1.25
Price/Book (P/B)	5.42	1.21	2.35	2.34	3.23	2.64
Price/Cash Flow (P/CF)	13.91	13.13	9.60	6.54	20.74	8.38
P/E (F1)	20.03	16.61	13.98	10.67	23.77	12.30
Price/Sales (P/S)	1.84	0.96	1.89	0.84	4.50	1.18
Earnings Yield	5.27%	5.27%	7.07%	9.37%	4.21%	8.13%
Debt/Equity	0.69	0.24	0.70	0.19	0.75	1.28
Cash Flow (\$/share)	2.89	0.06	7.01	19.73	6.21	15.57
Growth Score	B	-	-	B	C	C
Hist. EPS Growth (3-5 yrs)	10.06%	29.51%	10.85%	15.86%	2.72%	15.94%
Proj. EPS Growth (F1/F0)	-4.15%	25.20%	5.99%	-19.63%	22.66%	-10.55%
Curr. Cash Flow Growth	8.18%	4.93%	6.15%	9.29%	1.84%	6.37%
Hist. Cash Flow Growth (3-5 yrs)	2.27%	12.54%	8.52%	7.28%	5.87%	7.55%
Current Ratio	2.25	1.47	1.24	1.50	5.19	1.38
Debt/Capital	41.12%	21.57%	42.57%	15.70%	41.54%	56.21%
Net Margin	9.47%	-0.67%	11.64%	9.59%	15.09%	9.63%
Return on Equity	30.72%	3.16%	16.74%	26.49%	11.50%	25.18%
Sales/Assets	1.25	1.02	0.54	1.18	0.35	0.77
Proj. Sales Growth (F1/F0)	-5.45%	5.54%	3.54%	-10.08%	6.78%	-0.03%
Momentum Score	F	-	-	B	F	C
Daily Price Chg	-8.93%	0.00%	-10.03%	-8.49%	-7.52%	-11.69%
1 Week Price Chg	1.75%	0.00%	-0.67%	-1.78%	2.66%	-10.71%
4 Week Price Chg	-23.58%	-23.91%	-28.22%	-22.28%	-21.13%	-38.79%
12 Week Price Chg	-29.34%	-23.88%	-25.63%	-28.00%	-14.33%	-36.78%
52 Week Price Chg	-17.38%	-30.56%	-16.72%	-17.84%	0.61%	-23.29%
20 Day Average Volume	654,867	17,952	3,061,271	1,644,112	3,473,255	1,577,672
(F1) EPS Est 1 week change	-1.47%	0.00%	0.00%	0.00%	-0.48%	-0.09%
(F1) EPS Est 4 week change	-6.13%	-6.08%	-0.32%	0.00%	-0.48%	-0.09%
(F1) EPS Est 12 week change	-6.13%	-6.08%	-0.65%	-7.40%	-2.60%	-0.71%
(Q1) EPS Est Mthly Chg	-12.58%	-6.29%	-0.62%	0.00%	-0.03%	-0.87%

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	D
Growth Score	B
Momentum Score	F
VGM Score	C

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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