

Donaldson Company (DCI)

\$52.68 (As of 02/13/20)

Price Target (6-12 Months): **\$55.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 11/11/19)

Prior Recommendation: Underperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

3-Hold

Zacks Style Scores:

VGM:B

Value: D

Growth: A

Momentum: B

Summary

Donaldson believes that capacity expansion, investments to enhance market shares, focus on innovation and supply-chain optimization will be boons in the quarters ahead. Also, synergistic gains from the BOFA International buyout, dividend payments and share buybacks bode well. Notably, the company targets to repurchase 2% of its outstanding shares in fiscal 2020. However, the company faces headwinds from weakness in on-road, off-road and special applications businesses. It predicts fiscal 2020 sales between down 2% and up 4% compared with 4% growth recorded in fiscal 2019. Also, forex woes and increase in debts are concerning. Over the past three months, the company's shares have underperformed the industry.

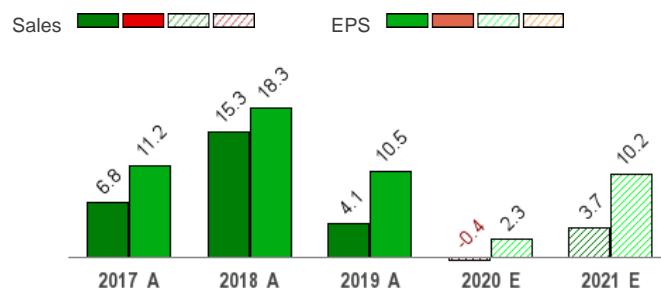
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$58.32 - \$45.82
20 Day Average Volume (sh)	328,282
Market Cap	\$6.7 B
YTD Price Change	-8.6%
Beta	1.46
Dividend / Div Yld	\$0.84 / 1.6%
Industry	Pollution Control
Zacks Industry Rank	Top 25% (63 out of 255)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	-3.8%
Last Sales Surprise	-3.4%
EPS F1 Est- 4 week change	0.0%
Expected Report Date	03/05/2020
Earnings ESP	0.0%
P/E TTM	24.3
P/E F1	23.3
PEG F1	2.2
P/S TTM	2.4

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021					2,941 E
2020	673 A	692 E	720 E	749 E	2,835 E
2019	701 A	704 A	713 A	727 A	2,845 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021					\$2.49 E
2020	\$0.51 A	\$0.47 E	\$0.60 E	\$0.67 E	\$2.26 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 02/13/2020. The reports text is as of 02/14/2020.

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.

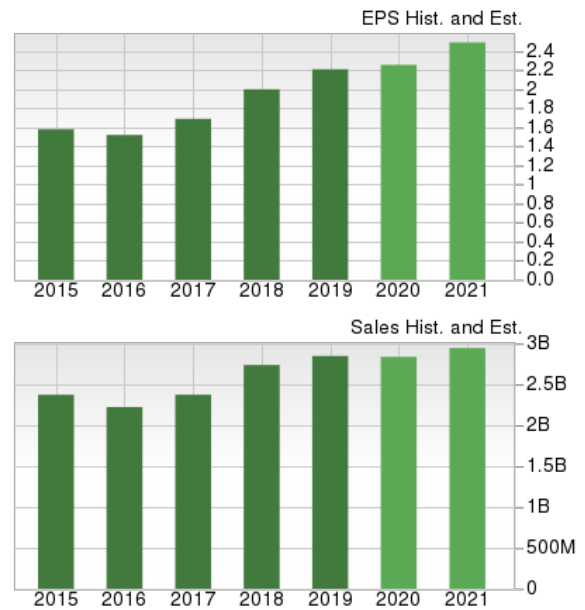
The company has two reportable business segments — Engine Products and Industrial Products. A brief discussion on the segments is provided below:

- **Engine Products** (accounted for 68.3% of net sales in first-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** (31.7%): 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:

- ▲ 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. For fiscal 2020, the company believes that growth in aftermarket (driven by popularity of innovative products, including PowerCore) as well as aerospace and defense sales will aid the Engine Products segment. Moreover, growth in industrial filtration solutions and gas turbine systems' sales will likely support the Industrial Products segment. Notably, the company's focus on enhancing sales of its Advance & Accelerate portfolio might also be a boon. Also, gross margin improvement is predicted to aid operating results, with operating margin of 13.9-14.5%. The margin projection reflects a year-over-year improvement of 30-90 basis points.
- ▲ Donaldson is poised to boost its competency, backed by ongoing capital expenditure and innovation investments. In the fiscal first quarter, the company's capital expenditure totaled \$37.1 million, up 31.6% year over year. 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 (explained below).
- ▲ Acquisitions have proved conducive to Donaldson's businesses over time. Notably, the BOFA International LTD buyout in October 2018 is considered to be one of the most important transactions. Being one of the leading manufacturers of fume extraction systems, BOFA International has strengthened Donaldson's industrial filtration solutions business in the Industrial Products segment. In the first quarter of fiscal 2020, the acquisition boosted Donaldson's sales by 1.1%. In the quarters ahead, BOFA will continue adding more values to the industrial filtration solutions business.
- ▲ Dividend payments and share buybacks are Donaldson's preferred modes of rewarding shareholders. In first-quarter fiscal 2020, the company used \$65 million for purchasing treasury stocks and \$26.6 million for paying dividends. Notably, in late May 2019, Donaldson announced a 10.5% hike in its quarterly dividend rate. Also, it received the board of director's approval for repurchasing up to 13 million shares. Notably, the company 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 4.1% compared with the industry's growth of 6.6%. In first-quarter fiscal 2020, the company's earnings and sales lagged estimates by 3.77% and 3.4%, respectively. Also, earnings declined 8.9% year over year on weak sales and lower operating margin. For fiscal 2020, it predicts sales between down 2% and up 4%, whereas it reported 4% growth in fiscal 2019.
- ▼ Soft segmental sales are added concerns for Donaldson for fiscal 2020. Engine Products' sales for the year are predicted to be between down 4% and up 2%, whereas it reported 4.2% growth in fiscal 2019. Both on-road and off-road sales are predicted to decline in mid-teens in the year. While softness in truck (Class A) production will likely adversely impact the on-road business, headwinds related to emissions and exhaust might hurt the off-road business. Moreover, Donaldson expects the Industrial Products segment's sales to be hurt by an expected low-single-digit sales 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 first-quarter fiscal 2020 revenues by 1.4%. 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 8.5% (CAGR), while the balance of \$597 million at the end of first-quarter fiscal 2020 indicated 2.1% growth from the previous quarter. The company incurred interest expenses of \$4.7 million in the fiscal first quarter, reflecting an increase of 11.9% from the year-ago quarter. For fiscal 2020, it expects interest expenses of \$18-\$20 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 Q1 Earnings & Sales Lag Estimates, Down Y/Y

Donaldson reported weaker-than-expected results for first-quarter fiscal 2020 (ended Oct 31, 2019). Its earnings and sales in the quarter lagged estimates by 3.77% and 3.4%, respectively.

The company's adjusted earnings in the reported quarter were 51 cents per share, lagging the Zacks Consensus Estimate of 53 cents. Also, the bottom line decreased 8.9% from the year-ago quarter's figure of 56 cents on weak sales and lower operating margin.

Quarter Ending **10/2019**

Report Date	Dec 03, 2019
Sales Surprise	-3.40%
EPS Surprise	-3.77%
Quarterly EPS	0.51
Annual EPS (TTM)	2.17

Weak Top-Line Results

In the fiscal first quarter, Donaldson's net sales were \$672.7 million, reflecting a year-over-year decline of 4.1%. Notably, the BOFA International acquisition added 1.1% to sales growth, while pricing had a positive 0.6% impact. Also, business for new equipment was soft in the quarter and unfavorable movements in foreign currencies had 1.4% negative impact.

However, the top line lagged the Zacks Consensus Estimate of \$696 million.

On a geographical basis, the company's net sales in the United States decreased 6% year over year. Results also suffered from a 0.8% decline in Europe, Middle East and Africa's sales and a 9.4% dip in the Asia Pacific's sales. Sales in Latin America expanded 9.1% 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 68.3% of net sales in first-quarter fiscal 2020) sales were \$459.2 million, reflecting a year-over-year decline of 4.5%.

The results were adversely impacted by a 10% fall in off-road, 11.4% in on-road and 3.6% in aftermarket sales. This was partially offset by a 10.6% increase in aerospace and defense sales.

Revenues generated from Industrial Products (accounting for 31.7% of net sales in first-quarter fiscal 2020) amounted to \$213.5 million, decreasing 3.2% from the year-ago quarter.

Results suffered from a decline of 18.8% in gas turbine systems, 0.3% in industrial filtration solutions and 4% fall in special applications' sales.

Margin Profile

In the reported quarter, Donaldson's cost of sales decreased 4.7% year over year to \$441.4 million. It represented 65.6% of net sales versus 66% in the year-ago quarter. Adjusted gross margin in the quarter was 34.4%, up 40 basis points (bps) year over year. Results gained from pricing activities, supply-chain optimization and lower costs related to raw materials, partially offset by weak sales.

Operating expenses grew 2.1% year over year to \$142.6 million. It represented 21.2% of net sales versus 19.9% in the year-ago quarter. Adjusted operating margin in the quarter under review was 13.2%, down 90 bps year over year. Adjusted effective tax rate in the quarter was 24.9%, up from 24.3% in the year-ago quarter.

Balance Sheet & Cash Flow

Exiting first-quarter fiscal 2020, Donaldson's cash and cash equivalents were \$210 million, up 18.1% from \$177.8 million recorded in the last reported quarter. Long-term debt was up 2.1% sequentially to \$596.8 million.

In the fiscal first quarter, the company repaid long-term debt of \$111.1 million, while raised \$122.9 million from long-term debts.

In the reported quarter, Donaldson generated net cash of \$86.1 million from operating activities, reflecting an increase of 36% from the year-ago figure. Capital expenditure totaled \$37.1 million versus \$28.2 million in the year-ago quarter. Free cash flow in the reported quarter was \$49 million, suggesting a year-over-year increase of 39.6%.

In the first quarter of fiscal 2020, the company used \$65 million for purchasing 1.4 million shares and \$26.6 million for paying out dividends.

Outlook

Going forward, Donaldson believes that capacity expansion, investments to enhance market shares, focus on innovation and optimization of supply chain will be boon.

The company expects sales in fiscal 2020 (ending July 2020) to decline 2% to increase 4% from the previous year. It projects forex woes to have an adverse impact of 1-2% on sales, while pricing will positively impact the same by 1%.

The company anticipates fiscal 2020 Engine Products' sales between 4% decline and 2% increase. The results will likely benefit from growth in aftermarket as well as aerospace and defense sales. However, it projects year-over-year declines in off-road and on-road sales. The company expects forex woes to hurt results by 1-2%.

Donaldson anticipates Industrial Products' sales growth of 2-8%. The results will likely gain from growth in industrial filtration solutions and gas turbine systems sales, partially offset by a decline in special applications sales. The company expects forex woes to hurt results by 1-2%.

It predicts operating margin of 13.9-14.5%, up from 13.6% in fiscal 2019 (ended July 2019). The results will likely benefit from gross margin improvement, partially offset by the adverse impact of rise in operating expenses.

The company anticipates interest expenses of \$18-\$20 million and capital expenditure of \$110-\$130 million. It expects effective income tax rate of 25-27%.

It projects earnings of \$2.21-\$2.37 per share, higher than \$2.05 in fiscal 2019. Share buybacks in the fiscal year are likely to be 2% of the company's outstanding shares.

Recent News

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

On **Jan 30, 2020**, Donaldson's board of directors approved payment of a quarterly cash dividend of 21 cents per share to shareholders of record as of Feb 14, 2020. The payment will be made on Feb 28.

Valuation

Donaldson's shares have decreased 8.6% year to date and increased 4.4% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Industrial Products sector have moved up 2.6% and 1%, respectively, on a year-to-date basis. Over the past year, the Zacks sub-industry increased 25.4% and the sector moved up 8.3%.

The S&P 500 index has moved up 4.7% year to date and 20.7% in the past year.

The stock is currently trading at 22.1x forward 12-month earnings per share, which compares to 22.33x for the Zacks sub-industry, 18.45x for the Zacks sector and 19.37x for the S&P 500 Index.

Over the past five years, the stock has traded as high as 27.73x and as low as 16.10x, with a 5-year median of 21.45x. Our Neutral recommendation indicates that the stock will perform in line with the market. Our price target of \$55 reflects 23.21x 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	22.1	22.33	18.45	19.37
	5-Year High	27.73	22.5	19.89	19.37
	5-Year Low	16.1	14.23	12.6	15.18
	5-Year Median	21.45	18.24	16.62	17.47
EV/EBITDA F12M	Current	15.84	12.5	17.81	12.66
	5-Year High	16.94	12.5	18.2	12.66
	5-Year Low	9.77	5.16	10.68	9.08
	5-Year Median	13.22	7.8	14.03	10.79
EV/Sales F12M	Current	2.48	1.84	3.14	3.26
	5-Year High	2.73	1.84	3.14	3.37
	5-Year Low	1.63	0.86	1.76	2.3
	5-Year Median	2.26	1.35	2.28	2.79

As of 02/13/2020

Industry Analysis Zacks Industry Rank: Top 25% (63 out of 255)



Top Peers

CECO Environmental Corp. (CECE)	Neutral
Casella Waste Systems, Inc. (CWST)	Neutral
Energy Recovery, Inc. (ERII)	Neutral
Heritage-Crystal Clean, Inc. (HCCI)	Neutral
Tetra Tech, Inc. (TTEK)	Neutral
Vertex Energy, Inc (VTNR)	Neutral
Avalon Holdings Corporation (AWX)	NA
H2O Innovation Inc. (HEOFF)	NA

Industry Comparison Industry: Pollution Control				Industry Peers		
	DCI Neutral	X Industry	S&P 500	CMI Neutral	DHR Neutral	PH Neutral
VGM Score	B	-	-	C	C	C
Market Cap	6.67 B	49.35 M	24.56 B	25.45 B	117.38 B	27.35 B
# of Analysts	6	3	13	10	8	8
Dividend Yield	1.59%	0.00%	1.78%	3.16%	0.42%	1.65%
Value Score	D	-	-	C	D	B
Cash/Price	0.03	0.09	0.04	0.06	0.17	0.04
EV/EBITDA	14.93	11.73	14.00	7.35	26.19	13.44
PEG Ratio	2.14	1.80	2.10	2.11	2.58	2.20
Price/Book (P/B)	7.25	1.98	3.31	3.01	4.09	4.31
Price/Cash Flow (P/CF)	18.21	20.62	13.68	8.42	26.30	13.68
P/E (F1)	23.21	21.97	19.23	13.73	30.00	20.08
Price/Sales (P/S)	2.37	1.29	2.69	1.08	5.89	1.93
Earnings Yield	4.29%	4.29%	5.20%	7.28%	3.33%	4.98%
Debt/Equity	0.71	0.24	0.71	0.19	0.75	1.28
Cash Flow (\$/share)	2.89	0.06	6.92	19.73	6.21	15.57
Growth Score	A	-	-	B	C	C
Hist. EPS Growth (3-5 yrs)	8.85%	30.35%	10.85%	15.86%	2.72%	15.94%
Proj. EPS Growth (F1/F0)	2.11%	43.83%	7.17%	-19.63%	23.25%	-10.46%
Curr. Cash Flow Growth	8.18%	-4.80%	8.56%	9.29%	-1.09%	6.37%
Hist. Cash Flow Growth (3-5 yrs)	2.27%	12.53%	8.36%	8.38%	5.87%	7.55%
Current Ratio	2.18	1.47	1.23	1.50	5.19	1.38
Debt/Capital	41.92%	21.57%	42.91%	15.70%	41.54%	56.21%
Net Margin	9.17%	-0.88%	11.81%	9.59%	15.09%	9.63%
Return on Equity	30.87%	2.92%	16.86%	26.49%	11.50%	25.18%
Sales/Assets	1.28	1.02	0.54	1.18	0.35	0.77
Proj. Sales Growth (F1/F0)	-0.34%	7.98%	3.85%	-10.08%	6.62%	0.01%
Momentum Score	B	-	-	F	A	F
Daily Price Chg	-1.44%	0.00%	0.00%	-1.15%	-0.25%	-0.41%
1 Week Price Chg	1.62%	0.00%	2.47%	0.52%	0.70%	6.20%
4 Week Price Chg	-6.31%	0.00%	0.56%	-5.23%	1.18%	2.54%
12 Week Price Chg	-3.62%	0.00%	6.96%	-8.14%	14.14%	8.25%
52 Week Price Chg	6.51%	0.51%	16.68%	9.72%	48.08%	26.00%
20 Day Average Volume	328,282	28,132	2,020,569	1,334,652	2,180,781	982,734
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	-0.66%	0.00%	0.00%
(F1) EPS Est 4 week change	0.00%	0.00%	-0.05%	-7.18%	0.69%	-1.67%
(F1) EPS Est 12 week change	-0.88%	0.00%	-0.17%	-11.65%	-2.13%	-0.71%
(Q1) EPS Est Mthly Chg	0.00%	0.00%	-0.24%	-25.29%	5.64%	-9.50%

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	A
Momentum Score	B
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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