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Q4 2020 Donaldson Company Inc Earnings Call

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CORPORATE PARTICIPANTS

Brad Pogalz Donaldson Company, Inc. - Director of IR
Scott J. Robinson Donaldson Company, Inc. - Senior VP & CFO
Tod E. Carpenter Donaldson Company, Inc. - Chairman, CEO & President

CONFERENCE CALL PARTICIPANTS

Bryan Francis Blair Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst
Daniel Dalton Rizzo Jefferies LLC, Research Division - Equity Analyst
Dillon Gerard Cumming Morgan Stanley, Research Division - Research Associate
Joseph Aiken William Blair & Company L.L.C., Research Division - Associate
Nathan Hardie Jones Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst
Richard Charles Eastman Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Donaldson's Fourth Quarter and Full Year 2020 Earnings Conference Call. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Brad Pogalz, Director of Investor Relations. Thank you. Please go ahead.

Brad Pogalz Donaldson Company, Inc. - Director of IR

Thank you. Good morning, everyone. Thank you for joining Donaldson's Fourth Quarter and Full Year 2020 Earnings Conference Call. With me today are Tod Carpenter, Chairman, CEO and President of Donaldson; and Scott Robinson, Chief Financial Officer. This morning, Tod and Scott will provide a summary of our 2020 performance, along with an update on key considerations for 2021.

I want to remind everyone that we issued a business update press release on August 6, which included some details that we will reference on this morning's call.

During today's call, we will also reference non-GAAP metrics. We included a reconciliation of GAAP to non-GAAP metrics within the schedules attached to this morning's press release.

Finally, 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?

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

Thanks, Brad, and good morning, everyone. I want to start today by thanking our employees for their resilience, flexibility and commitment in fiscal 2020. I greatly appreciate the work they do every day to keep us moving forward.

As always, we remain focused on those things under our control. Despite a significant shift in the economic environment during fiscal '20, there were several things that went as planned, including sales of replacement parts performed better than new equipment and first-fit products, gross margin increased from the prior year, we reduced our discretionary expenses while investing in growth businesses, and we maintained a strong financial position while returning cash to shareholders through dividends and share repurchase. We are entering fiscal '21 with clear priorities and engaged employees. We do not anticipate strong market conditions overall this year, but our diverse business model and robust operational capabilities give me confidence that we can make progress on our strategic initiatives in any economic environment. We will talk more about our longer-term opportunities later in the call, so I'll now turn to a brief overview of fourth quarter sales.

Total sales were \$617 million in the quarter with sequential increases in June and July. Compared with the prior year, sales were down

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15%, which is consistent with the forecast we provided in early August. Both segments experienced a similar decline. However, there was quite a bit of variability within the results.

In the Engine segment, our first-fit businesses remain under the most pressure. Fourth quarter On-Road sales were down 44% from the prior year. The U.S. is the largest portion of On-Road, and it accounted for much of the decline as the cyclical slowdown in Class 8 truck production was magnified by the pandemic. As a reminder, On-Road first-fit in the U.S. is only about 3% of total Donaldson sales, so our aggregate exposure to that market is limited.

Sales in Off-Road were down 24% in the quarter. More than half the decline was due to Exhaust and Emissions. There were pre-buys in Europe last year related to an upcoming regulatory change, and new programs for our Exhaust and Emissions products are not yet at meaningful volumes. In the U.S., production of heavy-duty Off-Road equipment remains depressed, particularly for the construction and mining industries.

On the other hand, Off-Road sales in China were up nearly 50% in the fourth quarter. The Chinese government is investing to stimulate activity, which is benefiting our Off-Road business. Additionally, we continue to win new programs with local manufacturers, and some of those programs were won with PowerCore. These are new customer relationships in the country that produces more heavy-duty equipment than anywhere in the world. We are learning how to best support these local manufacturers, and we know that will come with order volatility, but our team in China is motivated as we see the opportunity for significant long-term growth.

Sales trends for Engine Aftermarket were predictably better than our first-fit businesses. Fourth quarter Aftermarket sales were down 11%, reflecting a decline in the mid-teens for sales through our independent channel. The headlines in our independent channel are fairly consistent with third quarter. Sales in the U.S. fell with the collapse of the oil and gas market, combined with slowing transportation activity. In Latin America, utilization is slowing across the region as the spread of the virus is compounding the impact from geopolitical uncertainty. And fourth quarter sales in Eastern Europe remain strong as we continue gaining share.

Sales through the OEM channel of Aftermarket experienced a more modest low single-digit decline. In the U.S., large customers pulled down inventory to match demand, which was partially offset by strong growth in China as we continue gaining share with local customers. In fact, Aftermarket sales in China were at a record level last quarter, and we see a long runway as we expect to continue winning new programs with innovative technology.

Our portfolio of innovative products performed well in the fourth quarter. This portfolio makes up nearly 1/4 of the total Aftermarket revenue, and fourth quarter sales were up in the low single digits. For nearly 2 decades, we have been improving, expanding and reinventing our offering related to these razor-to-sell razor-blade products. After all that time, we still have very strong retention rates. These products create a significant opportunity for growth and relative stability in our Engine business, so we will continue to invest in new technologies for a long time to come.

Sales of Aerospace and Defense were down 3% in fourth quarter driven by soft sales of products for commercial helicopters. The decline was partially offset by a strong increase in sales for ground defense vehicles, but some of the growth is timing related as key distributors built inventory in the quarter.

I also want to update you on a change to our strategic portfolio classifications. Beginning in fiscal '21, we are re-categorizing the Defense business to critical core from mature. Our mature businesses are committed to generating cash that allows for investment elsewhere, while critical core businesses are geared towards driving share gains in existing markets with new technology, services and relationships. The defense business has won new programs with our robust engineering capabilities, and we expect these wins will deliver solid returns over a long time horizon.

Turning to our Industrial segment. Fourth quarter sales were down 15% driven, in large part, by the dust collection business within Industrial Filtration Solutions, or IFS. Sales of new dust collectors and replacement parts were down as customers continue to defer investment and reduce output. The quote-to-order cycle remains elongated with large projects being put on hold, while smaller must-do projects tend to move forward. At the same time, our value proposition still resonates.

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Fourth quarter sales of our Downflo Evolution dust collection systems were up in the low teens, and the sales of those replacement parts grew more than 30%. The Downflo family of products is only about 15% of total dust collection sales today, but it has grown rapidly as customers appreciate the space and energy savings it offers, and we value the ability to retain the aftermarket. We are also building the dust collection business through our e-commerce platform, shop.donaldson.com. We turned on the ability to take guest orders earlier this year, and we are encouraged by the results. While incremental dollars are still small, we have seen a significant number of new dust collection customers. With our robust sales and delivery model, we believe the simplicity of our e-commerce platform gives customers another reason to choose Donaldson.

Fourth quarter sales of Process Filtration were down in the low single digits after an increase of more than 10% last year. The decline was driven by new equipment, while replacement parts were about flat with the prior year. We continue to make progress penetrating the highly valuable food and beverage industry. We position ourselves as an engaged partner, and we market our ability to quickly fulfill orders with a product that can help improve efficiency in our customers' processes. The pandemic gave us the opportunity to prove this value proposition to our customers in the food and beverage industry, and our process filtration team delivered. We remain very excited about this market, so we will continue to invest in growing the sales force and adding new tools to drive this profitable business.

Sales of Special Applications were down 10% in fourth quarter. Disk Drive was down from the prior year after having a significant increase in third quarter, while the slowdown in the automotive market resulted in lower sales of Venting Solutions.

Fourth quarter sales in Gas Turbine Systems, or GTS, were up 6% due primarily to strength in small turbines. Once again, the GTS team delivered another profit increase in terms of both dollars and rate. As you know, we shifted the GTS go-to-market strategy 4 years ago. We determined that the best path forward was to focus on replacement parts and small turbines while being highly selective in deciding which large turbine projects we pursue. The GTS team has done an incredible job executing their strategy, and we see it in the results. In the past quarter, we also chose to consolidate our joint venture in Saudi Arabia into our company. Once again, we are focused on rightsizing and streamlining GTS to enhance our profitability. Based on what the GTS team has delivered and the opportunities in front of us, we are reclassifying GTS as a mature business in our portfolio. The GTS team has transitioned from fixing the business to driving profitability, and we are on solid footing today. I want to thank them for the incredible job they did executing their strategy and delivering on their commitments.

The success in GTS is not an isolated incident. Our company is filled with great people working together to deliver results and create value for all our stakeholders. That's why I'm comfortable and confident in our future.

Before turning the call to Scott, I want to briefly touch on fiscal 2021. We are not sure how long the pandemic will last nor are we sure about its ultimate impact on our business. Given those uncertainties, we will remain focused on what we control: prioritizing the health and safety of our employees; fulfilling our customer commitments; pursuing market share and growth opportunities around the world; executing margin enhancement initiatives and maintaining a balanced approach to expense management, which includes making targeted investments to advance our strategic priorities.

Scott will share some more fiscal '21 details, so I will now turn the call over to him. Scott?

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

Thanks, Tod. Good morning, everyone. Like most companies, we had to quickly adjust to a new way of working over the past 6 months, and our employees did an excellent job with that pivot. We increased our level of collaboration. We deepened our relationships with customers and suppliers, and we supported critical businesses around the world with minimal disruption. Overall, I'm very impressed by what our team accomplished. To my colleagues around the world, thanks for all you're doing.

As we turn to fiscal '21, we have a solid foundation, but the markets are not yet on firm footing. Given the wide range of possible outcomes, including the timing and shape of the inevitable recovery, we are not issuing detailed guidance at this time. We do, however, want to provide some of our 2021 planning assumptions. I'll cover those later in the call, but first, I'll share some thoughts on fiscal '20 results.

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Decremental margin was a notable highlight for us. We delivered 20% in the fourth quarter and 18% for the full year. Those results are stronger than our historic averages, so let me walk through some of the details.

I'll start with operating expenses, which declined 10% to \$125 million in the fourth quarter. That's flat sequentially, and it's our lowest fourth quarter level in 4 years. Discretionary expenses were down significantly due, in part, to pandemic-related travel restrictions, and we maintained our investments in strategic growth businesses like Process Filtration, dust collection and connected solutions. We will continue to focus on balancing expense savings with investments, and we are pleased with the performance in the fourth quarter.

We are also pleased with our gross margin performance. Fourth quarter gross margin was up 20 basis points from the prior year, and our full year rate was up 50 basis points despite headwinds from lower sales and higher depreciation related to our capacity expansion projects. As a side note, many of these projects are now completed. That's why our capital expenditures in fiscal '21 are planned well below the \$122 million we invested last year. Our focus has now shifted to the optimization opportunities enabled by these investments. We plan to lower our cost structure while maintaining or improving service levels. While benefits from these initiatives will ramp up over time, our list of optimization projects give me confidence that we can deliver strong returns with these new assets.

Lower raw material costs are helping offset the loss of leverage impact on gross margin. We have seen favorability in market prices for steel media and petroleum-based products, and our procurement team is driving incremental savings as they strengthen our supplier network while improving terms.

I also want to touch on pricing. While it hasn't been a major contributor to the year-over-year gross margin increase, it hasn't been a headwind. We have more latitude to drive pricing in many of our replacement part businesses, and teams like those in the independent channel of Engine Aftermarket have done an excellent job consistently executing our pricing strategy. I know that takes a lot of work, so I have to thank our commercial teams around the world for meeting their customers' needs while promoting the value we bring in terms of technology and service. It makes a big difference, especially in this economic environment.

A favorable mix of sales is also making a difference to gross margin. In the fourth quarter and for most of the year, we have realized mix benefits as replacement parts make up a greater share of total sales. To a certain extent, these mix benefits are by design. We invest in technology to win first-fit programs that drive aftermarket retention. As we move through an economic cycle, our strong base of recurring revenue creates some relative stability and provide some gross margin insulation. Replacement parts now account for 64% of total sales, giving us confidence in the durability of our business model.

Before moving forward on the P&L, I want to quickly talk about segment profit margins. The story of Engine is consistent with the consolidated results. Mix benefits and lower raw material costs offset the loss of leverage, resulting in a year-over-year margin increase of 20 basis points in the fourth quarter. Within the Industrial segment, the loss of leverage was magnified by continued investments in our strategic growth businesses. We expect Industrial margins will bounce back, helping us deliver our goal of mixing the company's margin up over time.

Moving back to the P&L. Other income was \$2.7 million in the fourth quarter compared with an expense of \$0.5 million in the prior year. Improved performance in our joint ventures was a benefit in fiscal '20, and the fourth quarter expense in the prior year reflects a charge related to our global cash optimization initiatives. These initiatives, which allowed us to streamline our legal entity structure, were enabled by tax reform. We excluded the charge from last year's calculation of adjusted earnings per share, and we also excluded a nonrecurring charge related to tax reform legislation. With that in mind, it's best to compare the reported fourth quarter tax rate of 21.1% with the prior year's adjusted tax rate of 21.4%. While the delta between rates is not significant, I'll point out that current and prior year rates were well below what we would typically expect. The fourth quarter 2020 rate benefitted from a favorable mix of earnings across jurisdictions, while the 2019 adjusted rate included a nonrecurring benefit related to the favorable settlement of an audit. As we think about fiscal '21, we see our full year tax rate goes up in [2021] (corrected by company after the call) to be more in line with our long-term estimate of 24% to 27%.

In terms of our financial position, we feel good about where we ended the year. Our leverage ratio was 0.9x net debt to EBITDA. And in

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the fourth quarter, we paid off a term loan for \$50 million, and we reduced borrowings on our revolver by \$110 million. We proactively drew from our revolver in the early days of the pandemic as a way to bolster our liquidity out of an abundance of caution. While markets still are uncertain, we are confident in our current position and no longer feel the need for that extra layer of security. Receivables were down meaningfully from the prior year, which is what we expect in this environment. Inventory was also down, but we plan further improvements this year as we focus on leveling with demand. Our fourth quarter and full year 2020 cash conversion rates increased meaningfully to 165% and 103%, respectively, and we plan to exceed 100% again this year.

Our fiscal '21 assumptions for sales are directionally consistent with recent trends. Sales are expected to vary widely by geography and market, and sales of our replacement parts and products for new markets should continue to outperform the company average. Additionally, we expect sales during the first half of '21 will be down versus the prior year due to the timing of when the pandemic began. We are seeing these sales trends play out in August, which we expect will be down about 10% from the prior year. Total sales for the month will also be down from July, but that's typical seasonality.

Regional trends in August matched what we saw in the fourth quarter. Sales in the APAC region are performing the best versus the prior year, led by growth in China. Europe is faring better, due, in part, to currency, while the U.S. and Latin America remain under the most pressure. And as expected, we have pockets of relative strength from some of our more stable businesses, including Engine Aftermarket and Process Filtration, which are both up in Europe, while new equipment remains under more pressure.

In terms of fiscal '21 gross margin, benefits from product mix and lower raw material costs should lessen as we compare against strong tailwinds in the prior year. At the same time, we will execute our optimization projects to position ourselves for long-term increases in gross margin. Our fiscal '21 operating expenses will also have some puts and takes. Resetting our annual incentive compensation plan generates a headwind of about \$13 million, and we are planning to make further investments in our strategic growth businesses and technology development. We plan to substantially offset these increases by controlling expenses, which will likely see some benefits from pandemic-related restrictions and comparing against a higher level of spend in the first half of the prior year. Should we see an opportunity that makes sense, we will also explore additional optimization initiatives.

Finally, we plan to repurchase at least 1% of outstanding shares in fiscal '21, which would offset any dilution from stock-based compensation. Any repurchases beyond that level will be governed by macroeconomic conditions, our investment opportunities and our balance sheet metrics. Should conditions improve, it is not unreasonable to assume we would go above the 1% in fiscal '21.

At a high level, our objectives for the new year are consistent with our long-term strategic agenda. We will pursue growth and market share opportunities in our Advance and Accelerate portfolio of businesses, drive optimization initiatives that will strengthen gross margin, control discretionary expenses while making targeted investments and protect our strong financial position through disciplined capital deployment and working capital management. These are the actions we can control, and I am confident in our ability to deliver in 2021.

Before turning the call back to Tod, I want to share some news. After 5 years as our Investor Relations Director, Brad is going to be moving to Belgium to take over as Finance Director of our Europe, Middle East region. COVID makes the timing a little uncertain, but I know he's committed to facilitating a smooth transition when we find his replacement. Thanks, Brad, for all your work in IR. You have done an excellent job, and congratulations on the exciting new adventure with Donaldson.

I will now turn the call back to Tod. Tod?

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

Thanks, Scott, and I offer my congratulations to Brad as well. You'll clearly be missed in this role, but we all know it's a great opportunity, so we're very excited for you.

I'm confident in our ability to navigate the complexities of the current environment, and I'm equally confident in our ability to create long-term value by meeting the evolving needs of our customers. We have strong relationships with our customers, and they range from some of the world's biggest brands to small business owners. We are grateful for the partnerships we have, and I want to thank our

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customers around the world for their continued support of our company. Our goal is to solve our customers' complicated filtration challenges in a way that allows them to deliver great products efficiently. And I think we're doing well against that objective. Let me share some examples of what I mean.

In the Engine segment, our Filter Minder team released a wireless monitoring system that helps fleet managers optimize their maintenance schedules for On-Road and Off-Road equipment. Our system integrates into the existing telematics and fleet management infrastructure, making it easy for our customers to adopt this valuable technology. We're also expanding connected solutions into the dust collection market with our iCue offering. This service provides customers with real-time monitoring of their equipment performance, helping them save energy costs and reduce unplanned downtime. Once again, we made it easy to adopt. Our iCue setup can be used on any branded dust collector, and the retrofit process is very simple.

Our e-commerce platform is another tool for helping customers operate more efficiently. Shop.donaldson.com has a global reach and offers features like real-time availability and personalization functionality, making it easy for customers to find what they need and place new or repeat orders.

As always, new technology is a critical part of our success formula, and we continue to expand our technologies and solutions to drive growth. Many of our Engine customers are looking to improve fuel economy and reduce emissions, and our products can help them achieve their goals. We have shown that consistent use of our PowerCore products can help end users improve fuel economy, and it provides value to our OEM customers as they can retain more of their parts business. We still see many opportunities with diesel engines, and we also see a growing opportunity with alternative powertrains like hybrid solutions and hydrogen fuel cells. Hybrid platforms leverage the portfolio of air and liquid solutions we have today, so we have good opportunity with that equipment. The needs are different for fuel cells, and we have a specialized air filtration system that is specifically designed to meet those needs. In addition to our air systems, we also have venting products and specialized membranes for fuel cells. With our technical capabilities, we are well positioned to participate in this growing market. We are also pursuing non-engine markets like food and beverage. Sales of Process Filtration were about \$50 million in fiscal '20. That's an increase of more than 60% over the past 3 years. We have continued investing in new technologies, and we are building capabilities that will facilitate our future expansion into life sciences.

Our long-term success is dependent on our team, so we're committed to making our company a great place to work. We have a strong culture, and we place a high value on integrity, commitment, respect and innovation. We also have a continuous improvement mindset, so we recently created a diversity, equity and inclusion council that will help identify and implement practices to make us a stronger company. The council is being led by a passionate group of employees, and I want to thank them for stepping up to move us along in this important journey.

We are also on a journey with our sustainability practices. We began developing our global sustainability strategy last year. We have engaged our stakeholders, and we have identified a long list of projects for reducing greenhouse gas emissions, energy consumption and wastewater. Implementing and maintaining sustainable practices is one more way we drive towards our purpose of Advancing Filtration for a Cleaner World.

As I close today's call, I want to thank again our employees for their contributions during fiscal 2020. I'm proud of what we accomplished as One Donaldson, and I look forward to another successful new year.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Nathan Jones from Stifel.

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Nathan Hardie Jones Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst

Maybe to just start on the top line, fourth quarter sales, in aggregate, down about 15%, and you said August was down about 10%. Can you talk a little bit about how the comparisons in the fourth quarter progressed? And is that August down 10% a better comparison than the kind of the exit rate out of the fourth quarter? Or have things started to settle down here, and that's kind of hovering in that minus 10% range? Just any color you can give us on how that's progressed over the last few months.

Brad Pogalz Donaldson Company, Inc. - Director of IR

Nathan, this is Brad. I'll start. And as a reminder for you and the group, a few months ago, we announced that May sales would be down 24%. And of course, that came out the way we expected. So when you put June and July together, they were down in the low double digits, which is pretty consistent with the trend we saw year-over-year in April. The decline -- or excuse me, in August. The decline in August from July is also not atypical seasonality. We would typically see that falling off as we get more towards the fall and winter months.

Nathan Hardie Jones Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst

Maybe then -- okay. So June, July and August have been fairly consistent on the comparison levels there. Can you talk about which parts of the business are seeing a recovery, which parts are slower to recover? And would you anticipate some of those lagging parts of the business to gradually begin to improve as we go through the back half of the calendar year here?

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

Sure, Nathan. This is Tod. So the businesses are very mixed, as you might imagine. So any first-fit-type business, so On-Road vehicles or Off-Road vehicles with first-fit production have the most significant headwinds. And the most significant headwinds in the company is On-Road United States first-fit business. The rest of the businesses, such as Aftermarket, both in the independent channel and the OE channel, are more modest headwinds, and we do see that with the destocking that has occurred in the previous 2 quarters really had a pull-through-like level. As we turn to the Industrial side, the most significant headwinds are going to be first-fit equipment in our Industrial Air Filtration business. We also see slight headwinds in the replacement parts because Industrial production is -- has not come back, particularly in the United States, to the levels that we would expect.

That's where we are at the moment. We would expect the first half -- especially because COVID hit in the second half of last year, we would expect the headwind to be more predominant in the first half, and then, of course, with easier comps and such of growth overall for the company to be in the second half of our fiscal year.

Nathan Hardie Jones Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst

So I guess with where you're at now, kind of low double-digit declines in July and June, 10% in August, you should probably see some of those lagging businesses get a little bit better as we go through the back half. So is it at least fair to say that, that first half revenue comparison should be down in the single digit somewhere rather than the potential for it to be down in the double digits?

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

Tough to say specifically where. Clearly, a high single to low doubles in the first half is not out of any of the models that we have built here.

Operator

Our next question comes from the line of Bryan Blair from Oppenheimer.

Bryan Francis Blair Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst

So I was hoping you could dig in a little more on your gross margin performance, up 50 bps for the year despite top line headwinds, but that obviously stands out. I was hoping you could parse out the operational lift from your initiatives. I think you were targeting 50 to 75 basis points there. And then the benefits of favorable mix and lower material costs relative to the clear hit from utilization.

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

Yes. So I mean, we're pleased with the overall gross margin performance. It's obviously been something we've focused on for quite a while. And I think you've covered the main points there. If we look at kind of mix in raw materials, we would probably put that in the 100 basis points range. If you look at the loss of leverage, offset somewhat by all the imperatives that we've had, that probably took us down 80 basis points. And then you have a lot of little puts and takes on that of depreciation, some other things to kind of sum for that overall improvement. So it's been mix and raw materials on one hand and then lots of leverage, but we've saved or spared quite a bit of that by all the great projects that have been completed. And we look forward to those projects moving to more of an optimization phase this year, which will help our margins next year and into the future.

Bryan Francis Blair *Oppenheimer & Co. Inc.*, Research Division - Director & Senior Analyst

Got it. I appreciate the detail. And on that front, I mean, it sounds like gross margin dynamics will be somewhat similar in fiscal '21, just lessening impact from the favorable mix and then lower raws that you've had. Given your current outlook, is the expectation for further gross margin improvement this year? Or is it too early to call?

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

No. We're committed to improving those gross margins, and I think you hit it right on the head. And we're going to continue to push to drive margin improvements, pending reasonable levels of sales.

Bryan Francis Blair *Oppenheimer & Co. Inc.*, Research Division - Director & Senior Analyst

Got it. Okay. And kind of a housekeeping question and understanding you're not providing a hard number on your CapEx guide. Is there a range as a percentage of revenue we should think about for 2021? And then looking forward, any shift to normalized CapEx in that 3% of sales range?

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

Yes. So that's what I was going to say, kind of a normalized range, where we've always said it's 3% of sales. I think we can be under that for next year quite a bit. We said we were at a net number of \$122 million for this year, which is kind of the completion of our investment period that we're quite happy to be kind of done with. So we would expect to be under our normal run rate and then obviously significantly under FY '20. So we're going to get into a point -- I noted that we expect our cash conversion for next year to be greater than 100%, and that's driven partly by improvements in working capital and then a lower level of CapEx.

Bryan Francis Blair *Oppenheimer & Co. Inc.*, Research Division - Director & Senior Analyst

Got it. One last one, if I can. Any quick update you can offer on your M&A pipeline? Seems like there's been a little bit of an uptick in activity, at least for companies that have more proprietary funnels, and you certainly have capacity if the right deals are there.

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

Yes, Bryan. This is Tod. We continue to work the M&A pipeline that we have. We would suggest it still remains robust and no change in our stance, our philosophy, our ability to do a deal. We just continue to work it, and we'll continue to do so because we believe that's an important part of our long-term strategy.

Operator

Our next question comes from the line of Joe Aiken from William Blair.

Joseph Aiken *William Blair & Company L.L.C.*, Research Division - Associate

This is Joe on for Brian today. So first of all, just on the model. Looking at operating expense, you mentioned the \$13 million in incremental incentive comp expected for fiscal '21. Is that expected to hit any quarters in particular? Can you remind me?

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

Yes. That would be -- most of it, year-over-year in the second half of 2021.

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Joseph Aiken *William Blair & Company L.L.C., Research Division - Associate*

Okay. And looking at kind of the run rate OpEx dollar of \$1.5 million in the fourth quarter, how much of that -- is that primarily temporary costs that have been taken out? Or are there some permanent costs that have been taken out there as well?

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

I mean we haven't had any like big restructurings or permanent cost structure changes. We have been obviously working hard to control all our expenses. We do get some benefit from travel restrictions that are in existence in the world today. And we've been working hard to control our discretionary expenses that we could still spend because we're really trying to protect those investments that we're making to help drive the longer-term success of the company.

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

So Joe, I'll just add a little bit of color. So if you just look at the macro level from the way we're approaching this, we're playing a long-term game here. And our people around the world are doing a fantastic job at controlling what they can control, the discretionary expenses, while the company continues to invest in the long-term strategy, and the controlling of the expenses right now is allowing us to play offense where we can play offense. And so that's how we're looking at it, and we would congratulate and thank all the employees around the world for doing just an excellent job.

Joseph Aiken *William Blair & Company L.L.C., Research Division - Associate*

Got it. Appreciate the color there. And then just switching gears, looking at some of the momentum you're seeing in China right now. How long can some of these tailwinds last? Have you seen some projects pulled forward as a result of the Blue Sky initiative and some of the investments China is making stimulating the economy? Have you seen products pulled forward? And how long can some of those tailwinds last?

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

So it's important to understand that our representation in China is still low single digit across almost every one of our markets there. And so consequently, it can last a very, very, very long time. And we're just now getting some momentum with technology-based wins that are actually shipping to China-based -- China national-based customers, which is expansion for us from the multinational-based customers that we had there. So our expansion in China can last a very long time as we continue to gain momentum, and it's broad. It's in our engine-based business on the first-fit with first-fit technologies of PowerCore. It's on the Aftermarket side that we're gaining momentum, and it's also Blue Sky initiatives on the Industrial side, particularly in the IAF business.

Operator

Our next question comes from the line of Dillon Cumming from Morgan Stanley.

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

Great. I just wanted to kind of jump back to Industrial margins for a second. I think you guys have been expanding margins at a pretty good clip kind of year-to-date. But then obviously, the decremental stepped up a bit this quarter. I guess, Scott, you mentioned in your prepared remarks. But how much of that decremental, would you say, was kind of driven by some of the more internal investments you mentioned versus, say, like unfavorable mix of just kind of general lost operating leverage?

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

Yes. I mean I think you hit it exactly on the head. I would say it's spread across those 3 factors of just the leverage on loss of volume. We keep talking about, even on the questions here, about how we want to continue to make investments, and we're continuing those, and those are targeted higher percent to Industrial. And then finally, we had a little weaker mix in the quarter compared to the year-over-year comps, which drove it down a little bit. So we expect the mix to improve, and so that headwind will ultimately probably abate. And we've got to get those sales starting to increase over time, so we can get rid of deleveraging issue.

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

Got it. That's helpful. And then maybe on the Aftermarket side, I think that was kind of one of the few revenue verticals within Engine where the knife is still falling a bit. I guess if you kind of had to rank or the headwinds on Aftermarket sales there, how much would you

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say is kind of related to kind of general utilization versus more kind of acute end market pressure and kind of areas like oil and gas or something else?

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

Yes. We would tell you that the oil and gas, as well as the fracking pullback, specifically, were significant headwinds, even more so than we had originally modeled, to be fully transparent there. So that's the most significant headwind that we have. And then, of course, just a general more broad-based utilization slowdown would likely be the second largest hit.

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

Okay. Got it. And if I can just sneak one more in here. I mean it kind of seems like the Aftermarket inventory levels have been pretty volatile over the past few quarters. And particularly on the OEM side, it seems like that declined a bit in the quarter. I guess do you have a view on kind of whether inventory levels are rightsized at this point? Or are you kind of slowly anticipating some level of destock in the first half?

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

Yes. We'd say the independent channel actually destocked first. The OE channel just tweaked a little bit, not a dramatic destocking. And so we would suggest to you that, based upon the behaviors and the forward-looking orders that we have today, that both channels are at pull-through levels.

Operator

Our next question comes from the line of Laurence Alexander from Jefferies.

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

It's Dan Rizzo on for Lance. Can we just circle back on the pricing you mentioned before? How does it work? I mean just some color there. I mean is it negotiated every time? Do you have any rebates? Or I mean do you have to justify price increase? Just any color would be great.

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

On the first-fit side of pricing, particularly within the Engine side of our business, we have price downs on annual long-term contracts. So each year, we start in a negative position relative to that revenue. And that would also be in the OE aftermarket piece of that business. On the independent channels of Aftermarket and Engine, clearly, we have more leeway there, and we do it on a region-by-region basis based upon local conditions. On the Industrial side of the company, it more resets quickly with more of that revenue being project-based business. So as you wash out project-based lead times, typically 3, 4, 5 months, you'll wash out the old pricing and come back with the new quoted project base. And then Aftermarket, of course, is more like an independent channel where we have better control.

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

That's actually very, very helpful. And then just one other question on CapEx. You mentioned it's going down, and I'm sorry if I missed this. But is there a percentage of that that's just temporary in response to the pandemic? Because I know you had some big project in, but I was just wondering what the -- kind of what the mix was there and how we should think about it over the long term.

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

Yes. I think you had it right. So we had been -- and I said that we were in a period of high investment as we had many projects that were in flight, and we are happy to report that we've completed the majority of those projects. And so our investment will come way down. And next year, we're going to be really focused on driving the optimization of those projects instead of bringing in new equipment. So it's a great time for the company in that we get to fine-tune the things we already have and drive improvements from that versus having to invest additional dollars, which is why we expect a strong cash conversion in FY '21.

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

And just maybe a little bit of color. So people often will try to connect the dot of the pandemic equating to our CapEx-based reductions here this fiscal year, and that's not really what you're seeing in our behavior. Remember, the past 3 years, we've had a significant run-up based upon our strategic plan to optimize our supply chain internally. And so we are now coming to the end of that pretty significant

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investment. And now we'll be essentially shuffling the deck internally to continue to expand our gross margins and optimize our supply chain. So the fact that we have less CapEx this fiscal year is less connected to the pandemic and more to our strategic priorities and what we're executing longer term.

Operator

Our next question comes from the line of Richard Eastman from Baird.

Richard Charles Eastman Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Yes. Sorry I was on mute. Best of luck to Brad. Congrats, Brad. That's going to be exciting. Congrats.

Just a quick question around gross margins. I just want to go back to this for 1 second. In total, the gross margins for the full year were at plus 50 bps. And I'm curious the progress that was made in the Engine versus Industrial segments. And also, just -- Tod, you spoke to price there a little bit. But net-net, was price kind of a neutral on gross margin for the year? I mean, again, it's going to move with -- presumably move with the mix, but I presume it's more the volume than it is a price impact on gross margin for the year.

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

Yes. Net-net, Rick, pricing was flat across the company, obviously, a very mixed results in different businesses. But to a total company, it comes out flat.

Richard Charles Eastman Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Okay, okay. And then the progress on the Engine versus Industrial side relative to that 50 basis points overall consolidated.

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

Yes. I noted in my script, that, overall, the Engine story is kind of consistent with the consolidated results, which is mix benefit, lower raw material costs, offsetting by the loss of leverage. For Industrial, they had the similar factors, but they also have the added content of a little more investment and probably a little bit weaker mix. So those 2 additional factors come into play when you think about Industrial.

Richard Charles Eastman Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Okay. So was there any progress made in gross margin on the Industrial side year-over-year? Was that a bit of a drag and the 50 basis points consolidated was driven by the Engine side?

Brad Pogalz Donaldson Company, Inc. - Director of IR

Rick, this is Brad. I would say that there's progress made. It's just unfortunately masked a bit by all things I said. So the things that we've been talking about with procurement savings, for example, the team there is doing a lot of work to try and find ways to either negotiate differently locally, find new qualified vendors, things like that, that help us, and that benefits both segments. I would say the same is true on pricing discipline. That's happening across the company. As Tod mentioned, it is quite varying by business. And then this year, as we grow into some of the new capacity, Industrial will certainly benefit from that. And then one more thing, the long game with Industrial is also favorability with mix. These high-tech markets are and where we're putting a lot of technology dollars are going to benefit the Industrial segment, probably disproportionately over time.

Richard Charles Eastman Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Okay, okay. And then just maybe as a -- just kind of leads me into my next question, but lots of commentary around the puts and takes on the gross margin side, as you just addressed, and then also the OpEx. Obviously, we had the incentive coming back in and then some other cost actions there. I think the reference was also made to some additional cost optimization, if necessary. But I'm curious, when you look at where you exited or finished fiscal '20, I think your operating margins were 13.2%. With the puts and takes and the commentary here around gross margins and OpEx, under the assumption that maybe sales are flat this year -- that would be my assumption. But under that assumption, would the target be here to have flat operating margins here as well? I mean I'm trying to figure out how you're maybe looking at the incrementals, decrements. But if the assumption is flat revenue for the year, is the goal and the target here to hold margins flat as well as a percentage of sales?

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

Rick, this is Tod. So with all of the moving pieces, we would still expect, even on flat sales, to expand our operating margin, though very slightly, obviously. And that would likely be driven by the gross margin work that we continue to do across the company because we are very focused on gross margin.

Richard Charles Eastman *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Okay, okay. All right. Very good. And just maybe one last thought around some of the first-fit businesses and maybe IFS in particular. Anything that you're seeing -- you talked about elongated quote-to-order trend. But is there any sense there that your backlog around some of these first-fit businesses has hit bottom here, and we're waiting for maybe calendar '21 capital budgets to start kicking in? Or how do you look at where your backlog is in some of these -- in your first-fit business, in particular IFS.

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

So within IFS, we -- on the first-fit business, we've seen roughly on the conversion rate from quote to order, it's kind of doubled in its behavior, right? So it's out over 100 days before people are making decisions. They're deciding on the must-do projects, the things that they have to do in order to protect, say, a particular environmental issue or whatever the case may be. They're doing the must-dos. But the rest, they're really pushing out, and it's been slow. And that's pretty broad-based around the world with a notable exception of China. China is a little slower but not as slow as the rest of the world. They continue to move forward. So what do we look on the backlog? When will that change? I think people are waiting for Industrial production to gain a little bit more confidence that they can really gear up their factories again. And that level of confidence is just not out there yet across our customer base.

Richard Charles Eastman *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Okay, okay. Yes, yes Okay. Makes total sense. Okay. And again, thanks to Brad for all his help, and I'm sure he'll be fully engaged and a contributor from Europe.

Brad Pogalz *Donaldson Company, Inc. - Director of IR*

Thanks, Rick.

Richard Charles Eastman *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Yes, and congrats.

Operator

Our next question comes from the line of Nathan Jones from Stifel.

Nathan Hardie Jones *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

I just wanted to put a finer point on the operating expense expectations here, and I think maybe you've narrowed in on this. First half of the year is running in about that \$140 million level. Second half of the year is running at about \$125 million per quarter. You've got, obviously, the stock comp coming back in. And you're probably going to have some of these temporary cost reductions, things like travel, that are going to increase here as we go forward. I think you said, on flat sales, you'd look at operating margins expanding a little bit, a bit mostly on gross margins, which would imply that the annual operating expense in '21 is probably targeted to be roughly flat. So is it a reasonable expectation for us to think that kind of this low \$130 million is where we're going to go to and see that through 2021? And as these temporary costs start to naturally roll off as the economies reopen, are there any plans to take some more structural cost actions in order to offset those expenses coming back?

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

Nathan, below \$130 million would be aggressive. We would not expect on a quarterly basis to hit that level of rate, just simply because we do have the investments coming online. So for example, we have our new material research center that will be staffing up and putting online here in Q2 and other strategic investments that we have. So below \$130 million would be aggressive, we would suggest.

And then longer term, with all this expansion that we've done to normalize the internal supply chain to really get after our gross margin initiative, all we've done is we've advanced our strategic plan, our 3- to 5-year plan within operations, and we've built out our internal

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footprint, if you will. And so we continue to look at what are our next steps within that plan. And looking forward, should there be any kind of, say, tweaks or moves or restructuring actions relative to that operations plan that are necessary, clearly we would take those actions. And that would be the first place that we would look relative to where we're at in the company's actions. But what we're doing is we're just playing our operations playbook in order to continue to expand our gross margins, and that's how we're looking at it.

Nathan Hardie Jones Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst

Okay. So just to clarify that, Tod, I said low \$130 million, not below \$130 million.

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

Oh, I'm sorry. Okay. Thank you. I heard below \$130 million, and that would be aggressive. So low \$130 million makes more sense.

Operator

I'll now turn the call back over to Tod Carpenter for closing remarks.

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

That concludes today's call, and I want to thank everyone listening for your time and interest in Donaldson Company. And I hope that you and your families and friends are all safe. Goodbye.

Operator

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

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