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Donaldson Company Inc at William Blair Growth Stock Conference

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PRESENTATION

Brian Paul Drab ***William Blair & Company L.L.C., Research Division - Partner & Analyst***

Okay. We will go ahead and get started. Good morning. I'm Brian Drab, the William Blair analyst, covering Donaldson. It's my pleasure to welcome you to the company's presentation today.

Before I begin, I'd like to inform you that a complete list of research disclosures and potential conflicts of interest can be found on our website, williamblair.com. As most of you probably know Donaldson is one of the world's leading manufacturers of filtration systems and replacement parts catering to a diverse set of end markets. We consider Donaldson to be a technology leader within the filtration industry known for the design of innovative first-fit filtration systems. The company also benefits from a meaningful recurring revenue stream through aftermarket filter sales. So today we're happy to have with us, CEO, Tod Carpenter; CFO, Scott Robinson; and Head of Investor Relations, Brad Pogalz. I'll also mention that the breakout session is in the [Jenning's Room B]. And at this point, I'll turn over to Tod. Thanks for being here.

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

Great. Thanks, Brian. And thanks to all of you for being here and your interest in Donaldson Company. Little housekeeping, the obligatory safe harbor statements. This presentation will contain forward-looking statements and you know all the rest and so we'll kind of move on. All right. We have 2 more seconds to read all of that and here we go. I've 5 key takeaways for the presentation today that I'd like you to go through. First one is that, Donaldson Company is a technology-led filtration company. Second, we have a diversified portfolio of businesses, and we've recently expanded our addressable market opportunities in order to focus on further diversifying the corporation and frankly taking the opportunity to acquire technologies that we have developed. Third, we have an experienced leadership team, both in the management team as well as the Board of Directors that are committed to our long-term strategic objectives. Fourth, we are everywhere in the world that the customer wants us to be, and we do that with a global thought process, but a localized touch. Fifth, we have a culture in our company where we say what we do and do what we say, and that drives a strong ownership culture across our corporation that aligns directly with our shareholders desires, and we are disciplined in our capital management so that we can drive our strategic plan forward. The alignment of the shareholders also goes so far as the stock ownership requirements across our leadership team. For example, my stock ownership requirements are 10x my base salary, which is double industry norms. So we intentionally carry higher-than-industry averages. The way to think about that is, we think like owners, we do not think like managers. Further, we are long-term in our thinking, and you can see that the compensation mix for myself, for example, is 64% on long-term incentives and then the annual basis down to 17%. That is a similar pattern that follows in with the balance of the named executive officers. On the long-term incentive, we have 2 primary metrics. One is ROI and the other is sales. It's important to note also that the ROI metric is a gate. So therefore, if we do not hit the ROI target, sales do not matter. So we're not going to go chasing sales for sales sake, we want profitable growth, and that helps our company to align directly with our shareholders. Now a little bit more about our company. We have 2 reporting segments. First segment is our Engine segment. It represents roughly 68% of the corporation, so far up to 9 months of this year or 3 quarters. Our industrial segment is about 32%.

Geographically we are 42% U.S. and then you can see that we have a global presence. I also want to call your attention onto the right side of the chart and talk about the markets that we play in. First largest is construction but notably the second largest is from our industrial segment and that's in our industrial air based business, so think about that as weld fumes or any type of a manufacturing process that creates some kind of a particle. Also, notice in that chart that we will through the presentation I'll say things like new equipment, I might say, First-Fit. We use new equipment in First-Fit applications synonymously, and you can think about that as proprietary razors that help us drive what you see as the replacement part on this chart. So we apply proprietary razors to sell razor blades across our portfolio of businesses and also you can see where it happens in these end markets. Further breaking that down into a way that we look at ourselves from a product standpoint of view, our engine air where our company got our start 104 years ago with

Frank Donaldson is the largest piece of our portfolio at roughly 39%. Again that second largest piece is our Industrial Air Filtration business at about 14%. Calling attention perhaps to some of important growth opportunities we have, about middle of the bottom row, we're very excited about what we're being able to accomplish in our process filtration business, a small part of our current portfolio, but 20% growth last fiscal year. So far this year roughly, 20%, again, and we believe we have good momentum that's driving growth there that aligns with our technology investments.

Our proprietary razors to sell razor blades has worked and here you can see, measuring 2012, when we were $2.5 billion, about 50% of our revenue was from replacement parts. As we've grown to become $2.7 billion and now on pace to be about $2.85 billion, you can see we've grown that replacement parts business to 62% of the overall portfolio. Looking at the businesses on the right, is how we break down that further. Clearly, Engine Aftermarket would be 100% replacement parts. Also, you can see in On and Off-Road First-Fit, that's 100% on that First-Fit side or new equipment side, and you can see how the balance breaks out, Gas Turbines, Aerospace Defense, Industrial Filtration Solutions. And Industrial Filtration Solutions is probably the best example, if you just wrap it all together where we have new equipment going out in order to help us drive replacement parts-based business, and you can see that's the about a split. We expect that to grow on the replacement part side over time. Special applications, which has a mix of businesses in there is largely the First-Fit side and it's really a consumable that's driving that. Our Disk Drive business, when you buy a disk drive in a computer, you don't buy filters to replace in your disk drive. We just throw the whole disk drive away and buy a new one. And therefore, that we have on our First-Fit side, but that's what drives special applications so high. It's really a consumable-based business. This is an important concept to understand and that our technology drives the proprietary based solutions. When we solve the customer's problems with legacy based opportunities you can see we will follow this gray-based chart. Our opportunity to capture the aftermarket falls rather quickly as more and more competitors come in. That is still prevalent today for indigenous emerging countries such as India, for example. However, when we innovate a product such as our PowerCore product, we follow the blue curve, where we're able to hold on to our aftermarket for much longer periods of time at higher percentages. Our PowerCore business, our company grew roughly mid-single digits in this last quarter. And so far this year, we have had our PowerCore business grow in the high teens. So you can see this works quite nicely throughout the model of our portfolio.

This is my favorite slide in the entire deck. And the reason it is, is because I believe that it really gets across what we're trying to accomplish and it helps you understand that the strategic investments that we're making, where we're putting them, how they're performing, et cetera. If we break down our company and we look at the portfolio into an Advance and Accelerate portion, also a critical core portion of our company, then a mature or some might call that a cash cow type of situation and then fix and reposition, you can see the businesses and how they map directly to that. Importantly, 53% of our portfolio is in the Advance and Accelerate portion of our company. Critical core then would follow 31%. Now look at the lower right, where we're putting our investments to drive growth, Advance and Accelerate, between F-16 and F-18, grew roughly 16% or clearly above the company average. This tells you that strategic choices we're making and the strategic investments we're making, they're working. It's helping us drive that growth throughout the corporation. So it's above company average. Critical core is at company average and as you would expect, the Mature-based businesses lag. That's primarily within the Disk Drive business, which is going to continue to lag overall company growth, and fix and reposition was a choice. So yes, it went down but we've talked to you a number of times prior. About 3 years ago, we changed our strategy to the GTS business and we walked away from large turbine project, those are multimillion dollar projects. And we intentionally did that knowing that there was tough moments ahead in the power-based industry. And we have now walked that down to roughly become about 5% to 10% of our overall GTS business, which is about $120 million. But we took tens of millions of dollars off the top line because, frankly, we just couldn't make money doing it anymore as the competition continued to be so fierce. As they were trying to cover their overhead, we subcontracted sheet metal manufacturing. We didn't have to fill a Donaldson plant and still we are able to just maintain that type of a strategic advantage while also applying our technology that we do build in Donaldson plant, which is somewhat common across the balance of the Donaldson portfolio and other businesses. It gives us a good leverage to be able to operate the GTS business, which I'm happy to say, today, we sell less and we make more on a percentage basis and a dollar basis in that business. So it's an excellent strategic choice. So if you look at that across that portfolio, it really aligns with what we're trying to accomplish. Our results speak -- directly align with our investors and speak for themselves.

Now we do want to recognize that our company does have some macro headwinds. First, the power industry. I talked a bit about it. The power industry clearly is in a tough moment. Our strategy change has worked quite nicely for us. It will continue for at least a couple of more years. However, for Donaldson, we feel as though we're at the bottom. We've already worked through that tough moments because

now that $120 million business for us is largely a replacement part business around the world as well as what we call small turbine projects though any kind of air movement under about a 100,000 cubic feet of air a minute which means moving oil through pipeline, offshore platform for oil and gas, customers like Solar turbines for example. So that will continue to be some headwind on a macro sense but we believe we are managing that quite nicely.

Our disk drive market. Disk drive is clearly in a secular decline. When you look at that and you take a look at the solid-state industry, which is replacing movable disks, we know that that will walk down over time. But it's not going away. And it will bottom out in the future. Until then, we'll have headwinds of, say, somewhere between 5% to 10% on an annual basis until it reaches the new normal. What we love about this business is that it drives us to invent new technology as the customers continue to ask more out of the future disk drive. And so we have been able to win more share. And if you look back at our performance at the start of this fiscal year and told you that we likely will decline this fiscal year in disk drive and so far we are very proud of the share gains that we've had because the technologies that we have been able to introduce, because the new drives require more chemical-based filtration protection, more particulate filtration, we have more contents to drive now and we have higher shares across the industry. So we're very proud of our performance there. However, still it will decline. We know it. It carries higher-than-company average margins and also allows us to invent new technology.

Electrification. In electrification, we have a number of people that work and study electrification every day. We are very aware of the progress across the world. We have very complex model across platforms from our customer base as to where we think it will first be introduced. We build those models out. And it is the reason why we confidently suggest to you that there is no appreciable difference for our company for the next decade. Why is that? First, I want to say, we are not a passenger car company. We had zero revenue on passenger cars. That's the story of the day, Tesla's etc. That's where it's being introduced. The first part that will be introduced for our company will be in the Class 5 to 6 vehicles and buses. Frankly, if you look at the unit of measure of what's called work and what it takes to do one unit of work in a bus is pretty simple. You can move people with the average battery as it is today and, therefore, it's adaptable in buses. It's also pretty simple with waste management and return-to-base type of trucks or municipal-type of activities, because the charge is able to happen overnight and you can reuse those. So clearly in Class 5 and 6 trucks it will happen. Now, you get to Class 8 and it's just not there yet. You look at what it takes to move that freight long term over the road, and electrification really has to have a step up. Pivot over into the Off-Road sector, which is the larger part, construction, agriculture and mining. And electrification clearly is -- the farmer is not going to stop plowing his field and wants to charge the battery and then get up and go and do it again after lunch. It just doesn't happen that way. So they need to have a breakthrough. Hybrids are probably going to win in that particular market. And frankly, hybrids are good for us. It still takes air on the -- it might be going from a 15-liter engine down to a 10-liter engine, but it still takes air. And in fact, that 10-liter engine we have found will work more frequently and more consistently than the 15-liter engine. And so now we're starting to find that the air that it will take is almost equivalent to the 15-liter engine, so it's all just fine for Donaldson Company. So those are the 3 ways that we look at those macro headwinds that we keep an eye on for our company.

We also have some tailwinds. First, increasing technology needs, so everyone wants to get more and more out of their machinery. That's good for us, because it really requires higher filtration capabilities. And being a technology-led filtration company, we will be there to be able to help our customers. Because they're trying to get more and more out of their machines, there's an increasing value put on the strategic partnerships or having somebody that can technically solve their issue. And so customers are more and more are linking directly and deeper into our engineering team. That's positive for us. Connectivity is clearly a focus for Donaldson Company both on the engine segment and in the industrial segment. And as we progress down that path, the old indicators, if you will, used to be red and green. The filter is now out of life or the filter still has life. And today, they want to know how much life. And so specifically to help the maintenance cycles, we have created all of that within the engine-based business. We are already offering that to all the OEMs, and we're connecting directly into their telematics-based solutions. They're doing that well. And on the industrial side, I'll show you where we're going after that here shortly, relative to how that drives service opportunities for Donaldson Company, and I'll talk deeper in a moment. On the increasing standards if you look at #1 which would be the China Blue Sky initiative, that itself drives our dust collection business in China where we have nice growth and they are having more adoption of overall western-based technologies in their manufacturing-based products as they chase 2.5 particulate and give their employees a proper environment. If you look at Donaldson Company, the overall filtration market is $65 billion. Our addressable, currently, where we are is about $27 billion. And we break that down into 2 segments: The Engine addressable market is about $16 billion. And so, therefore, when you think we're roughly about $2 billion type of a business in that segment, we have a lot of runway to grow within that addressable market.

Within Industrial, we have always been roughly a $6 billion addressable market, that industrial air piece that you see in the middle of the pie. We recently, in the last couple of years, expanded into food and beverage. You can see that darker slice of food and beverage. Food and beverage is a larger piece, but we're only going after the darker slice about $2 billion, because we see a technology answer that we've recently introduced into the marketplace. And so when I talk about 20% growth rate in food and beverage, that's where I'm talking about. Also we've expanded now connectivity and that allows us to go into a $3 billion opportunity and get into services. So our dust collection business, which is over $400 million worldwide business, we're connecting those dust collectors. We have tens of dust collectors across the United States. We've had them for years. We have millions of pieces of data that come in that we continue to analyze. And we've been studying this very detailed over the last couple of years to make sure we can find a right value proposition for our customer base. Connecting products just to connect them is not going to drive value for the customer and not revenue for us. So we took our time to make sure we got the right model. We've now built an application to where we can tell you if your dust collector, there's a thing in the bottom called a hopper. It captures all the particulate for you. If that hopper fills it could shut down your overall production system. That will take you potentially a 3 to 4 hour change out and shut your production opportunity. However, now using our technology you can get, as a maintenance person, you can get a notification on your phone that says, hey, you should go empty the hopper, which is a 15-minute job. And so we have advanced the technology to value proposition that far. We'll be looking to implement that across the larger customer base here in the year ahead. The reason the balance of the wheel is gray is because, as we continue to develop new technologies in food and beverage, we will advance those through wheels into electrical -- chemical and semicon type of activities. And the reason medical is black is because, the sales cycle for medical is a very, very long cycle. And so I don't want to really signal to you to say, hey, we're going into medical. If there's an opportunity, a niche, sure, we'll likely go into there when we have the technology that allows us to do so, but that's going to take time. But right now, we're focused on food and beverage and then, obviously, we'll pivot the next to specialty chem -- special chemical. We expand and focus our growth priorities through 3 ways: expand our technologies and solutions, being a technology-based company that -- how that aligns; extend market access or think about that as going into a further penetrating, underrepresented geographies and continuing to focus on and execute on acquisitions.

Moving ahead to capital deployment, we are a consistent capital deployment company. You can see we have over 60 years of dividend -- giving out a dividend and we are very proud to be a member of the Dividend Aristocrat Fund which means we have increased our dividend for at least over 20 years. Last week we announced a 10.5% increase in dividend. As Scott always says, he took over this and we're 60 years into issuing a dividend. And as a CFO, he doesn't want to mess that up. So we are doing very, very well for our shareholders in this regard, and we continue to hold this in high regard. We are also a consistent story relative to share repurchase. You can see our performance over time. We look to annually buyback 2% of shares to offset 1% of dilution, and so therefore have a net minus 1%. So minimally and a negative year, we buyback 1% to offset dilution. We have averaged 2% a year. Last year -- last week, we also announced the new share buyback program. We essentially refreshed the old one. So the old one is now canceled. We were roughly about a year away from running out of that authority. And so we re-up the authority and wanted to let you know that this still remains a capital priority for us.

And so that consistency over time will continue. Last week we also put out fiscal '19 guidance, so our revenue will grow roughly 4% this year to an all time record for our company. I do want to point out that roughly 6% to 7% on constant currency, so we're very proud of high single-digit growth. We do have FX headwinds, the 3% to 4% this given fiscal year. Also, you can see the 2 segments. We do expect to expand operating margins by at least 20 basis points. And we're also very proud to be able to perform and give a new EPS record this year for our company, and you can see the range.

Longer-term, as we told you at our Investor Day, our fiscal '21 targets are to become between $3 billion to $3.3 billion. We do expect to expand our operating margins to become between 15% to 15.8%. The way that we can look to do that is to continue to focus now on our pricing activities, which have become more of the normal type of a cycle after the high inflationary period, but also to execute on our strategy and continue to mix the company up. That Advance and Accelerate opportunities that we have carry higher than company average margins. So we'll look to focus on those and that will help bring the overall op margin up. And then we look to get our company back to the longer-term incremental margins of low 20% range.

All in, in summary, we're a technology-led filtration company. We are diversified by the number of businesses that we hold and the geographies in which we play. We have a very committed leadership team. We are global. We are everywhere as the customer wants us

to be, and we'll continue to expand our footprint point worldwide. And lastly, we're aligned with the shareholder and we look to drive strong shareholder returns through capital -- through a strong capital discipline. So with that, maybe we can take couple questions, Brian?

Brian Paul Drab ***William Blair & Company L.L.C., Research Division - Partner & Analyst***

We have 5 minutes for Q&A.

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

Sure.

QUESTIONS AND ANSWERS

Brian Paul Drab ***William Blair & Company L.L.C., Research Division - Partner & Analyst***

I'll kick off first the first question. That bucket, Advance and Accelerate. You said the faster growth bucket, What do you expect in that -- the businesses in that bucket to grow at going forward in a normal environment where...

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

So we're proud to have the Advance and Accelerate bucket. Even in the third quarter, the minimum growth we had in that was 5%. The highest growth was roughly around 20%. So we have good range above company average in all cases. We look for that to be about 1.5 to 2x company average, and we'll continue to invest and earn (inaudible).

Brian Paul Drab ***William Blair & Company L.L.C., Research Division - Partner & Analyst***

Okay. And then maybe can you talk about the time frame within which you -- some of those new TAM expansion opportunities will play out?

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

So we have, in the last few years invested back in our company about $300 million worth of CapEx. That's a record level for our company. And we did that because we grew 30%, and that's allowed us to advance some of our presence in countries where we were really winning share. Also, that allows us with a capacity expansion to renormalize the company. Our internal supply chain has some pressure whereby we're building things in high-cost countries that used to be in a low-cost countries. And that was because we grew so fast, we ran out of low-cost country capacity. We're now realigning that. And over the course of the next year to 2 years, our operations teams will properly readjust that and go after the projects, which will help expand our gross margins and therefore profitability overall. So we have that laid out in front of us with a number of projects we'll just be going through and just picking them off on execution here over the course of the next 2 years, and we'll continue to talk about those and then effectively complete them.

Unidentified Analyst

(inaudible)

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

So we've been in the food and beverage sector end market for -- since about 2002, but it was more of a buy/sell type of a relationship. Frankly, we were in it because we could. And so we learn -- we took a lot of time to learn what the value proposition will be for our customers. At that time, when we saw an opening, we invented a new product, brought forward what we thought was a strong value proposition and then took our sales team from about 5 to 45. And so now we're pressing that with a technology that's by patented by Donaldson. Longer-term, what really matters in that, in the filtration industry, is having a better filtration media and that starts with material sciences. And so within polymer-based solutions, which food and beverage is, that's the reason why we're building a research and development center, and we ground broke that here a couple of weeks ago, in Bloomington, Minnesota. So that we can continue to focus on that material science and therefore, continue to bring a better value proposition across that first food and beverage than in the specialty -- special chemical and so on. So we look to continue to advance that here over time.

Unidentified Analyst

(inaudible)

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

Well, what we have going in right now is we have a bunch of holes already created, and we're bringing our technology into someone else's created hole. In PowerCore, we create the hole, right? And so we're way upfront on that when we first sit up with an application. In time, we'll bring proprietary razors over to the food and beverage market when we feel like we have the technology opportunity to be able to do so. That's the reason why we're investing to advance that technology, so therefore, we'll then begin that type of application as well, But that's going to take time.

Brian Paul Drab ***William Blair & Company L.L.C., Research Division - Partner & Analyst***

All right. Thank you very much, Tod. We'll move to the breakout session.

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

Okay.

Brian Paul Drab ***William Blair & Company L.L.C., Research Division - Partner & Analyst***

Thank you.