



Donaldson Company, Inc. 2012 SHAREHOLDERS' LETTER

DEAR SHAREHOLDERS,

Another Record Year

I am very pleased to report that my fellow 13,600 Employees around the world delivered many new records in FY12. Key highlights include:

- Record sales of \$2.5 billion, up 9%,
- Record operating margin of 14.6%,
- Record net earnings of \$264 million, up 17%, and
- Record EPS of \$1.73 per share, up 21%.

Last year, I wrote “there were many reports of a slowdown in global growth,” but that we “would continue to focus on those things we could control.” What actually happened is that there were a number of pluses and minuses during the year. Economic conditions in Asia, and specifically China, were weaker than we had planned, and much of Europe moved into a recession. We also had to deal with the impact on our disk drive filter sales resulting from the devastating flood in Thailand. On a more positive note, Australia, Mexico, South Africa, and the U.S. were even stronger than we had planned in local currency sales. The fact that we delivered another sales record in FY12 is further proof that our business model – *building a diversified portfolio of filtration businesses globally* – really does work.

The most significant growth in our Engine Products segment came from our first-fit businesses that provide new filtration systems for our off-road equipment and on-road truck OEM Customers. These Customers increased their build rates of new equipment to meet their market demand. Our Aftermarket business also had another good year.

In our Industrial Products segment, our late-cycle Gas Turbine Systems business began its recovery as investments in new power generation capacity were being made globally, particularly in the Middle East and China. Our Industrial Filtration Solutions businesses had a strong year as manufacturers continued investing in new and upgraded production capacity. In Special Applications, we achieved rapid growth in our newer product lines serving the membranes and venting markets.

While sales growth is important, we also have a target of investing back into our business to support future growth



230 bicyclists and 75 volunteers helped *Team Donaldson* raise over \$230,000 in the fight against the affects of Multiple Sclerosis in this year's MS 150 ride from Duluth to the Twin Cities

while increasing our profit margins. Obviously, there is inherent conflict in doing both. As the result of a lot of hard work, we were able to post our third straight year of record operating margins. Our relentless focus on *Continuous Improvement* allowed us to reduce the costs of our products and processes, improving our margin to 14.6%. Our historic focus on operational excellence, now called *Continuous Improvement*, means we are never satisfied with the status quo, and we are always looking for opportunities to further improve.

As I have shared before, we have a Strategic Growth Plan that includes the targets of growing our Company into \$3 billion in sales by FY16 and then \$5 billion by FY21. Are these aspirational targets? The answer is “no.” These goals are supported by very detailed action plans by business and by region. This gives us great confidence that we will achieve them.

This Strategic Growth Plan is also driving our key investment decisions. During the past year, we invested \$77 million into four major categories – new products, technology advancements, *Continuous Improvement* initiatives, and capacity expansions. Our new plant in Aguascalientes, Mexico, which we opened last February, is a great example of a capacity expansion investment. This new plant will help support our rapidly growing Latin American business. Another example is our new liquid filtration lab in Wuxi, China. This lab will support the development of new filtration products for our Customers across China.

We will continue to make these types of long-term investments in support of our Strategic Growth Plan. In May, we announced our plans to invest in a second China campus in Xuzhou – in support of our long-term plans for the



Our PowerCore air filtration technology is used by leading on-road and off-road equipment manufacturers worldwide

Chinese market. Across our Company, we anticipate that we will invest an additional \$125 million in capital in FY13.

“We have in place a package without peer, the components of which are advanced technology, worldwide service and quality people.”

— Frank Donaldson, Jr. (1980)

One of our key foundations over the past century has been technology. Starting with Frank Sr.’s invention of the first effective air filter for a farm tractor, this philosophy continues today. In all of our businesses, we strive to achieve and then maintain a technology leadership position. We do this by investing in R&D and then leveraging our technology achievements into a flow of innovative new products for our businesses.

Our PowerCore® technology platform is a great example of a transformational technology that also incorporates our proprietary UltraWeb® media technology. This powerful combination of PowerCore and UltraWeb is being leveraged in both our Engine and Industrial businesses. In Engine, we are using PowerCore for on-road vehicles as well as off-road equipment that operate in very severe environments, such as farm tractors and construction equipment. In Industrial, we have created a series of new dust collection platforms for our Torit® products using PowerCore with the most recent



A Torit PowerCore system used to collect metalworking fumes in a laser cutting operation

ones targeting the mining and material handling markets. Whether in Engine or in Industrial, our PowerCore products offer our Customers much improved filtration performance in a significantly smaller package, saving space, weight, and cost while also reducing their maintenance costs. In FY12, our total PowerCore sales were \$124 million, up 34% from the prior year. We are now in the process of releasing the next innovations in PowerCore technology (which will be even smaller and provide even better performance).

We are using the same approach as we continue to build our liquid filtration business. Our breakthrough media, Synteq™ XP, has allowed us to win 7 new fuel OEM platforms in the past 18 months. These will begin to go into production during FY13. Our liquid filtration sales were \$440 million in FY12 and our goal is to triple this business by FY21.

All of the above describes our “means” to an “end.” This “end” is creating Shareholder Value. We are pleased to report that our model of consistent growth and financial performance has worked. The market has recognized our consistent performance by valuing our shares at a premium and driving our stock price to a level that facilitated our two-for-one stock split in March. This was our 5th stock split in the past 20 years. Our FY12 EPS represents our 21st record in the past 23 years. Finally, our profit growth allowed us to increase our cash dividend by 20% in FY12.





The Grand Opening in Aguascalientes of our 3rd plant in Mexico with government officials including Governor Carlos Lozano de la Torre



Our gas turbine air filtration systems installed on an offshore oil and gas drilling platform

FY13

So here we are again. Yes, we are beginning yet another new year with many economic uncertainties in all of the major economies – Europe, China, Japan, and the U.S. How these uncertainties are resolved is anyone’s guess.

One thing that I am certain of is that our business model works. Despite last year’s challenges, we grew and improved our Company. We face our future and any new challenges even stronger than we were a year ago. The diversified portfolio of filtration businesses we have built over the past two decades provides us with a variety of end market exposures. Each year, due to the nature of the different cycles, our various businesses and regions cycle differently. In FY13, we anticipate that this will be the case

again as some of our late-cycle Industrial businesses, such as Gas Turbine Systems, are poised to perform very well. Combined with our focus on those things we can control, we plan to deliver record sales and earnings again in FY13!

Thanks

Many thanks to my 13,600 Colleagues for your outstanding efforts in achieving magnificent results this year. Your alignment with our Strategic Growth Plan combined with a fanatical focus on our Customers and operational excellence resulted in another record performance. We are on track to achieve our objectives of \$3 billion (by FY16) and \$5 billion (by FY21) in revenues.

I also want to thank our Customers for the opportunity to satisfy your filtration needs and to add value to your products. We sincerely appreciate your business.

And finally, I thank you, our Shareholders, for your continued confidence and support.

Sincerely,

Bill

Bill Cook,
Chairman, President, and CEO



Our Dixon, Illinois, plant received the 2012 Gold Certified Supplier Award from Caterpillar

Safe Harbor Statement

The Company desires to take advantage of the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995 (the “Act”) and is making this cautionary statement in connection with such safe harbor legislation. Some of the information provided in this annual report constitutes forward-looking statements which reflect the Company’s current views with respect to future events and financial performance, but involve uncertainties that could significantly impact results. All forecasts and projections are “forward-looking” statements and are based on management’s current expectations of the Company’s near-term results. There can be no assurance that actual results will not differ materially from its expectations. For a more detailed explanation of the safe harbor statement and the risks, see the Company’s Form 10-K filed with the SEC.

FIVE-YEAR COMPARISON OF RESULTS

July 31, 2012

(dollars in millions, except share and per share amounts)

	2012	2011	2010	2009	2008
Operating Results					
Net sales	\$2,493	\$2,294	\$1,877	\$1,869	\$2,233
Gross margin percentage	35.0%	35.5%	35.1%	31.6%	32.5%
Operating income percentage	14.6%	13.7%	12.7%	9.1%	11.0%
Net earnings	\$ 264	\$ 225	\$ 166	\$ 132	\$ 172
Return on average shareholders' equity	28.7%	26.8%	23.2%	18.5%	25.2%
Return on investment	23.5%	21.0%	17.1%	14.2%	20.6%
Shareholder information (Adjusted for splits)					
Net earnings per share - assuming dilution	\$ 1.73	\$ 1.43	\$ 1.05	\$.83	\$ 1.06
Dividends paid per share	\$0.320	\$0.268	\$0.235	\$0.228	\$0.210
Shares outstanding (millions)	147.5	150.6	152.7	154.5	155.1
Common stock price range, per share					
High	\$38.89	\$31.52	\$24.11	\$24.50	\$26.17
Low	\$23.19	\$20.43	\$16.30	\$10.91	\$17.20

CORPORATE OFFICERS

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CHARLES J. MCMURRAY, 58
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Chief Administrative Officer

JAY L. WARD, 48
Senior Vice President, Industrial Products

FRANKLIN G. CARDENAS, 44
Vice President, Global Engine Aftermarket

PEGGY A. HERRMANN, 56
Vice President, Disk Drive
and Microelectronics

DENNIS D. JANDIK, 58
Vice President, Global Engine OEM Sales

SANDRA N. JOPPA, 47
Vice President, Human Resources

JOSEPH E. LEHMAN, 57
Vice President, Global Operations

NORMAN C. LINNELL, 53
Vice President, General Counsel,
and Secretary

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JAMES F. SHAW, 43
Vice President, Chief Financial Officer

WIM VERMEERSCH 46
Vice President, Europe & Middle East

DEBRA L. WILFONG, 57
Vice President,
Chief Technology Officer

EUGENE X. WU, 44
Vice President, Asia Pacific

BOARD OF DIRECTORS

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A.O. Smith Corporation, Milwaukee, WI

JOHN P. WIEHOFF, 51
Chairman and CEO
C. H. Robinson Worldwide, Inc.,
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