



**Donaldson**  
FILTRATION SOLUTIONS

## Donaldson Company, Inc. 2013 SHAREHOLDERS' LETTER

*"The suddenness with which these events became critical forced us to cope with them on a pragmatic basis – the application of horse sense on the part of managers to the problems and opportunities that arose in uncharted areas."*

— Frank Donaldson, Jr., 1974

### DEAR SHAREHOLDERS,

At this time last year, we had just reported another year of record revenues and earnings. Our Customer open order backlogs were strong. Our Company was running very well with record operating margins and return on investment. We felt the wind at our back as we planned for another year of record revenue and earnings in FY13.

All of this changed very rapidly last September when many of our Engine OEM and Disk Drive Customers began to announce cuts in their production volumes. In addition, our Engine Aftermarket distributors began to quickly reduce their inventory levels as their end user demand dropped. At the same time, our Gas Turbine business was dealing with a surge of large filtration system projects for the power generation market. That put operational pressure on our engineering and manufacturing subcontractor resources. So we dealt with dropping volumes and surging workloads simultaneously in different parts of our Company.

We have been nimble as we have grown over the past 10 years. We demonstrated that again during FY13 by adjusting quickly to the unexpected decline in Customer demand in many of our markets, while ramping up in Gas Turbine. We prioritized our projects and initiatives, pursued targeted growth opportunities, focused on protecting our gross margin, and aggressively managed our operating expenses. In the end, we didn't achieve our original financial plan for FY13. However, I am proud of how quickly my fellow Employees responded to the challenging conditions facing our Company and our Customers. The effectiveness of their response can be demonstrated by the fact that we delivered **record** operating margins in our third and fourth quarters and **record** earnings in our fourth quarter!



Our Employees ranked us as a great place to work in the Minneapolis *Star Tribune's* Top 100 Workplaces

We achieved this outstanding operational performance because of our relentless focus on *Continuous Improvement*. Those of you who have followed our Company over the years know that we have always focused on operational excellence. Our vision of *Continuous Improvement* — i.e. never being satisfied with the status quo, and always looking for opportunities to improve our quality, reduce our costs, and provide better value to our Customers — has become embedded in our culture, from the operators in our plants and distribution centers to the staffs in our laboratories and offices. When the challenges of FY13 arose, it was our Employees who found ways to achieve these results.

### Investing in Our Future

While we had to reset our original FY13 Priorities when the downturn hit, we continued to invest in those key long-term projects critical to achieving our Strategic Growth Plan. This Plan includes targets of growing our Company to \$3 billion in sales by FY16 and then \$5 billion by FY21. Despite slowing the pace of some capacity expansion projects, we spent \$94 million on capital investments, a new **record**. We completed the expansion of our Latin American distribution center in Aguascalientes, Mexico. Latin America was our fastest growing region in FY13, increasing revenue by 23 percent. This expansion doubles our distribution capacity in that strategically important market.



Our vents protect devices (like underwater cameras) from pressure fluctuations, water, and contaminants



Our high flow liquid filters provide clean diesel fuel to protect our Customer's equipment

In FY13, we launched our Strategic Business Systems project. This is a multi-year, \$64 million project to standardize our processes and IT systems globally. During the year, we worked on designing the system and the business processes. This work is critical to achieving our Strategic Growth Plan: as our Customers continue to grow and become more global, they expect us to function more globally — with the same ordering processes, part numbers, quality, product availability, and on-time delivery metrics in every region. The common systems and processes that we are building will achieve these objectives while further improving our overall cost structure.

We will continue to make strategic investments in FY14. Recently, we announced plans to build a new air filter plant in Skarbimierz, Poland, in support of our long-term plans for the Eastern European and Russian markets. We also announced a \$10 million R&D investment for our Bloomington, Minnesota, campus. This state-of-the-art lab expansion project will enhance our capabilities for testing filter performance under various environmental conditions, extending our leadership in air and liquid filtration technology development.

Our PowerCore® platform is one great example of our ongoing air filtration technology development. Our

original PowerCore and now our newest-generation PowerCore G2 are the leading air filtration technologies for our Engine OEM Customers' new heavy-duty diesel on-road and off-road equipment platforms in the Americas, Europe, and Asia. We have also leveraged this innovative technology into our Industrial Products segment, where we have introduced PowerCore technology into our newly-designed dust collection platforms for our Torit® products. Whether in Engine or Industrial, our PowerCore products offer our Customers improved filtration performance in significantly smaller packages compared to competing technologies — saving space, weight, and product costs, while reducing our Customers' maintenance costs. In FY13, our total PowerCore sales were \$143 million, up 15% from the prior year.

We are achieving similar success in developing our next generation of liquid filters using our breakthrough filtration media, Synteq XP™. We are using this innovative media in our new SELECT™ Fuel product line and in our latest generation Duramax® hydraulic filters to capture ever-smaller contaminants, while increasing the working life of our filters.



Our PowerCore air filtration technology is used by leading heavy-duty equipment manufacturers around the world

Our Torit PowerCore CP Series dust collector is ideal for point-of-use air filtration on grain silos and conveyor transfer points



The Grand Opening of our expanded Latin American Distribution Center in Aguascalientes, Mexico with guests including Governor Carlos de la Torre



Our large air filtration systems help protect our Customer's gas turbines and help meet the growing global demand for electricity

**FY14**

While current global economic conditions are far from certain, there is now a sense that business activity levels have at least stabilized. We are confident that economic growth will eventually return to all of the major economies – only the exact timing remains uncertain. We remain very well positioned to respond quickly as conditions improve.

Until the winds of growth begin to fill our sails again, we will continue to manage our Company by focusing on operational excellence through our *Continuous Improvement* initiatives. In addition, we will remain focused and will continue to invest in those key projects that support our Strategic Growth Plan.

This combination of managing through the near-term challenges while remaining focused on our long-term objectives is not new. Our Company has been operating

this way since Frank Donaldson, Jr. and Bill Hodder set out to change our business model in the early 1980s. Using their model, we have transformed our Company into the modern, diversified Donaldson of today. We see exciting opportunities in our markets, and I remain excited about our future!

**Thanks**

I would like to thank the incredible team of Donaldson Employees for their relentless dedication to serving our Customers through a very challenging year, while making our Company even stronger.

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.



Our Brockville, Ontario liquid filter plant earned our Chairman's Cup award twice by having the highest scores on our key operating metrics

Sincerely,

Bill Cook,  
Chairman, President, and CEO



**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, 2013

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

	2013	2012	2011	2010	2009
<b>Operating Results</b>					
Net sales	\$2,437	\$2,493	\$2,294	\$1,877	\$1,869
Gross margin percentage	34.8%	35.0%	35.5%	35.1%	31.6%
Operating income percentage	14.1%	14.6%	13.7%	12.7%	9.1%
Net earnings	\$ 247	\$ 264	\$ 225	\$ 166	\$ 132
Return on average shareholders' equity	24.8%	28.7%	26.8%	23.2%	18.5%
Return on investment	21.5%	23.5%	21.0%	17.1%	14.2%

### Shareholder information (Adjusted for splits)

Net earnings per share - Assuming Dilution	\$ 1.64	\$ 1.73	\$ 1.43	\$ 1.05	\$ 0.83
Dividends paid per share	\$0.410	\$0.320	\$0.268	\$0.235	\$0.228
Shares outstanding (millions)	146.0	147.5	150.6	152.7	154.5
Common stock price range, per share					
High	\$39.36	\$38.89	\$31.52	\$24.11	\$24.50
Low	\$30.90	\$23.19	\$20.43	\$16.30	\$10.91

### CORPORATE OFFICERS

SANDRA N. JOPPA, 48 Vice President, Human Resources	JEFFREY E. SPETHMANN, 48 Vice President, Exhaust and Emissions	MICHAEL J. HOFFMAN, 58 Chairman and CEO The Toro Company, Minneapolis, MN
WILLIAM M. COOK, 60 Chairman, President and CEO	JOSEPH E. LEHMAN, 58 Vice President, Global Operations	PAUL DAVID MILLER, 71 Retired Chairman and CEO Alliant Techsystems, Inc., Minneapolis, MN
TOD E. CARPENTER, 54 Senior Vice President, Engine Products	NORMAN C. LINNELL, 54 Vice President, General Counsel, and Secretary	JEFFREY NODDLE, 67 Retired Executive Chairman SUPERVALU INC., Minneapolis, MN
CHARLES J. MCMURRAY, 59 Senior Vice President, Chief Administrative Officer	ROGER J. MILLER, 47 Vice President, Global Engine OEM Sales	WILLARD D. OBERTON, 55 CEO, Fastenal Company, Winona, MN
JAY L. WARD, 49 Senior Vice President, Industrial Products	MARY LYNNE PERUSHEK, 55 Vice President, Chief Information Officer	JAMES J. OWENS, 49 President and CEO H.B. Fuller Company, St. Paul, MN
FRANKLIN G. CARDENAS, 45 Vice President, Global Engine Aftermarket	SHEILA C. PEYRAUD, 57 Vice President, Chief Technology Officer	AJITA G. RAJENDRA, 61 President and CEO A.O. Smith Corporation, Milwaukee, WI
TIMOTHY H. GRAFE, 47 Vice President, Strategic Planning and Business Development	THOMAS R. SCALF, 47 Vice President, Global Industrial Air Filtration	JOHN P. WIEHOFF, 52 Chairman and CEO C. H. Robinson Worldwide, Inc., Minneapolis, MN
PEGGY A. HERRMANN, 57 Vice President, Disk Drive and Microelectronics	JAMES F. SHAW, 44 Vice President, Chief Financial Officer	
DENNIS D. JANDIK, 59 Vice President, Asia Pacific Operations		

### BOARD OF DIRECTORS

F. GUILLAUME BASTIAENS, 70 Retired Vice Chairman Cargill, Inc., Minneapolis, MN	ANDREW CECERE, 53 Vice Chairman and CFO U.S. Bancorp, Minneapolis, MN	WILLIAM M. COOK, 60 Chairman, President and CEO Donaldson Company, Inc.
JANET M. DOLAN, 63 President, Act 3 Enterprises, LLC, Minneapolis, MN		

Independent Registered Public Accounting Firm PricewaterhouseCoopers LLP, Minneapolis, MN



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