Donaldson Company (DCI)

Updated April 21th, 2018 by Josh Arnold

Key Metrics

Current Price:	$46	**5 Year CAGR Estimate:**	11.1%	**Quality Percentile:**	N/A
Fair Value Price:	$44	**5 Year Growth Estimate:**	10.0%	**Momentum Percentile:**	N/A
% Fair Value:	103%	**5 Year Valuation Multiple Estimate:**	-0.5%	**Total Return Percentile:**	N/A
Dividend Yield:	1.6%	**5 Year Price Target**	$71	**Valuation Percentile:**	N/A

Overview & Current Events

Donaldson Co. has been creating filtration solutions for a wide array of applications since 1915. Its sales consist of filters in various engine and industrial applications as core categories, but continuous innovation and acquisitions have expanded the portfolio. It is expected to produce $2.7B in revenue this year and sports a market cap of $5.9B.

The company's recent Q2 report was terrific as sales were 21% higher and adjusted EPS jumped 23%. DCI's results were boosted by strong end-market conditions as well as a continued focus on cost savings, but that strength was somewhat offset by raw material and input cost inflation. In addition, DCI recently implemented a series of pricing increases in its core engine and industrial applications, targeted by product and region, to help alleviate gross margin pressure.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$1.06	$0.84	$1.05	$1.44	$1.73	$1.64	$1.76	$1.49	$1.42	$1.69	***$2.05***	***$3.30***
DPS	$0.22	$0.23	$0.24	$0.28	$0.34	$0.45	$0.61	$0.67	$0.69	$0.70	***$0.72***	***$0.84***

DCI's EPS growth has been inconsistent in the past decade as it is very much beholden to economic conditions around the world. Its customer base is diverse and deep but growth seems to come in bunches, not in a linear fashion. Looking forward, we are forecasting robust 10% EPS growth annually.

The company will achieve these results through a variety of methods. First, sales increases continue from organic growth, pricing increases, and acquisitions. DCI completed five acquisitions in the past three years and its stated strategy is to continue to do so. Total revenue is up 18.7% through Q2 this year on forex gains and organic growth through improving market conditions; guidance for this year is for 13% to 15% sales growth. Margins should at least remain flat in the coming years as pricing increases and cost savings look to offset rising raw material costs. The company's recent pricing increase was good for between 4% and 15% on a variety of its core products, and those should work their way into revenue over the next few quarters. Lastly, DCI is committed to buying back stock each year, good for ~2% annually.

We are forecasting moderate dividend growth as well, however, DCI is not an income stock. The payout will remain low, particularly in light of forecast EPS growth going forward, as DCI prefers to use excess cash in other ways.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	20.1	20.3	19.8	19.1	19.2	21.7	23.1	25.5	21.9	24.9	***22.2***	***21.6***
Avg. Yld.	1.0%	1.4%	1.2%	1.0%	1.0%	1.3%	1.5%	1.8%	2.2%	1.7%	***1.6%***	***1.2%***

DCI's PE multiple has been remarkably steady in the past decade and given where it is today, we are forecasting a slight decline over the coming years. However, the headwind from such a decline would amount to only 0.5% annually, so DCI looks to be trading right at fair value today. There would appear to be more upside risk than downside to this if DCI's growth picks up and/or gross margins improve more than expected. But for now, it looks fairly priced.

We are also forecasting the yield to fall back to more normalized levels as EPS growth should drive the stock price higher while the slow rate of dividend growth fails to keep up. That should push the yield down to 1.2% from 1.6% today.

Again, this is not a stock one buys for the current yield or dividend growth as the company's stated strategy requires the use of excess cash for acquisitions and buybacks.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	32.5%	31.6%	35.1%	35.5%	35.0%	34.8%	35.5%	34.1%	34.0%	34.7%	***35.0%***	***35.0%***
Debt/A	52%	48%	50%	46%	47%	38%	48%	57%	57%	57%	***55%***	***52%***
Int. Cov.	15.3	10.5	20.2	25.9	33.3	32.9	36.4	20.0	13.4	17.5	***19.0***	***22.0***
Payout	19%	27%	22%	18%	18%	24%	32%	44%	48%	41%	***35%***	***25%***
Std. Dev.	50.9%	44.3%	24.8%	34.6%	24.1%	17.5%	20.0%	21.1%	25.9%	18.3%	***23.0%***	***28.0%***

DCI's quality metrics have been very stable as well during the past decade as it hasn't experienced much movement in either direction. Gross margins are near their historical highs and should remain there given pricing increases as well as cost savings efforts working to offset rising input costs. Its assets are financed by 55% debt at present but that number should gradually fall unless significant debt is needed for acquisitions. Given its ample interest coverage, however, there is plenty of room for additional debt. The payout ratio is about 35% for this year but that should fall over time as well as EPS growth outpaces dividend growth; the dividend is very safe.

DCI's recessionary performance is somewhat of an issue, as you'd expect for an industrial stock, so EPS will likely fall significantly during the next downturn. It does sport the competitive advantage of more than 100 years of experience in its field as well as a strong history of innovation and a sizable installed customer base.

Final Thoughts & Recommendation

Overall, DCI looks attractive here. The stock is fairly valued and growth moving forward should be a vast improvement over the past few years. We are forecasting total annual returns of 11.1%, consisting of the current 1.6% yield, a 0.5% headwind from a resetting valuation, and 10% from EPS growth. DCI looks poised to deliver strong returns to shareholders and thus, it looks appropriate for investors seeking growth in the industrial sector. DCI is not an income stock and likely never will be, so it would be inappropriate for those seeking current yield or dividend growth. However, strong growth forecasts make DCI attractive here for growth-oriented investors looking for exposure to industrials.

Total Return Breakdown by Year