Donaldson Company (DCI)

Updated September 7th, 2018 by Josh Arnold

Key Metrics

Current Price:	$54	**5 Year CAGR Estimate:**	10.3%	**Volatility Percentile:**	29.6%
Fair Value Price:	$51	**5 Year Growth Estimate:**	10.0%	**Momentum Percentile:**	56.4%
% Fair Value:	106%	**5 Year Valuation Multiple Estimate:**	-1.1%	**Valuation Percentile:**	51.8%
Dividend Yield:	1.4%	**5 Year Price Target**	$82	**Total Return Percentile:**	69.3%

Overview & Current Events

Donaldson 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 $2.7 billion in revenue this year and sports a market capitalization of $6.9 billion.

Donaldson reported Q4 earnings on 9/6/18 and results were characteristically strong. Total sales were up 9.8% as the Engine products segment rose 14% and a small tailwind from forex translation. That sales strength led to higher operating margins, which grew 40bps to 14.7% as gross margins grew and the company saw some SG&A leverage. In total, adjusted earnings-per-share rose 14% year-over-year as Donaldson finished out a record-setting year. In addition, guidance for this year is for earnings-per-share to rise roughly 18%.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$0.84	$1.05	$1.44	$1.73	$1.64	$1.76	$1.49	$1.42	$1.69	$2.00	***$2.36***	***$3.80***
DPS	$0.23	$0.24	$0.28	$0.34	$0.45	$0.61	$0.67	$0.69	$0.70	$0.76	***$0.84***	***$1.12***
Shares	155	153	151	148	146	140	135	133	131	130	***127***	***122***

Donaldson's earnings 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% earnings-per-share growth annually.

The company will achieve these results through a variety of methods. First, sales increases continue from organic growth, pricing increases, and acquisitions. Donaldson completed five acquisitions in the past three years and its stated strategy is to continue to do so. Revenue growth should continue in the mid-single digits or better through organic growth and acquisitions. Margins should at least remain flat in the coming years as pricing increases and cost savings look to offset rising raw material costs. Lastly, Donaldson is buying back stock each year, good for ~2% annually.

We are forecasting moderate dividend growth. With that said, Donaldson is not an income stock. The payout will remain low, particularly in light of forecast earnings growth going forward, as it prefers to use excess cash in other ways.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	20.3	19.8	19.1	19.2	21.7	23.1	25.5	21.9	24.9	23.9	***22.8***	***21.6***
Avg. Yld.	1.4%	1.2%	1.0%	1.0%	1.3%	1.5%	1.8%	2.2%	1.7%	1.6%	***1.4%***	***1.4%***

Donaldson's price-to-earnings 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 1.1% annually. With revenue growth set to slow slightly, we see a bit more risk of a lower price-to-earnings ratio.

We are forecasting the yield to be flat to where it is today as forecast dividend growth should roughly match earnings and share price growth. 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.

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
GP/A	31.6%	35.1%	35.5%	35.0%	34.8%	35.5%	34.1%	34.0%	34.7%	34.2%	***34.8%***	***35.0%***
Debt/A	48%	50%	46%	47%	38%	48%	57%	57%	57%	55%	***55%***	***52%***
Int. Cov.	10.5	20.2	25.9	33.3	32.9	36.4	20.0	13.4	17.5	19.0	***20.0***	***22.0***
Payout	27%	22%	18%	18%	24%	32%	44%	48%	41%	38%	***36%***	***29%***
Std. Dev.	44.3%	24.8%	34.6%	24.1%	17.5%	20.0%	21.1%	25.9%	18.3%	23.0%	***20.0%***	***28.0%***

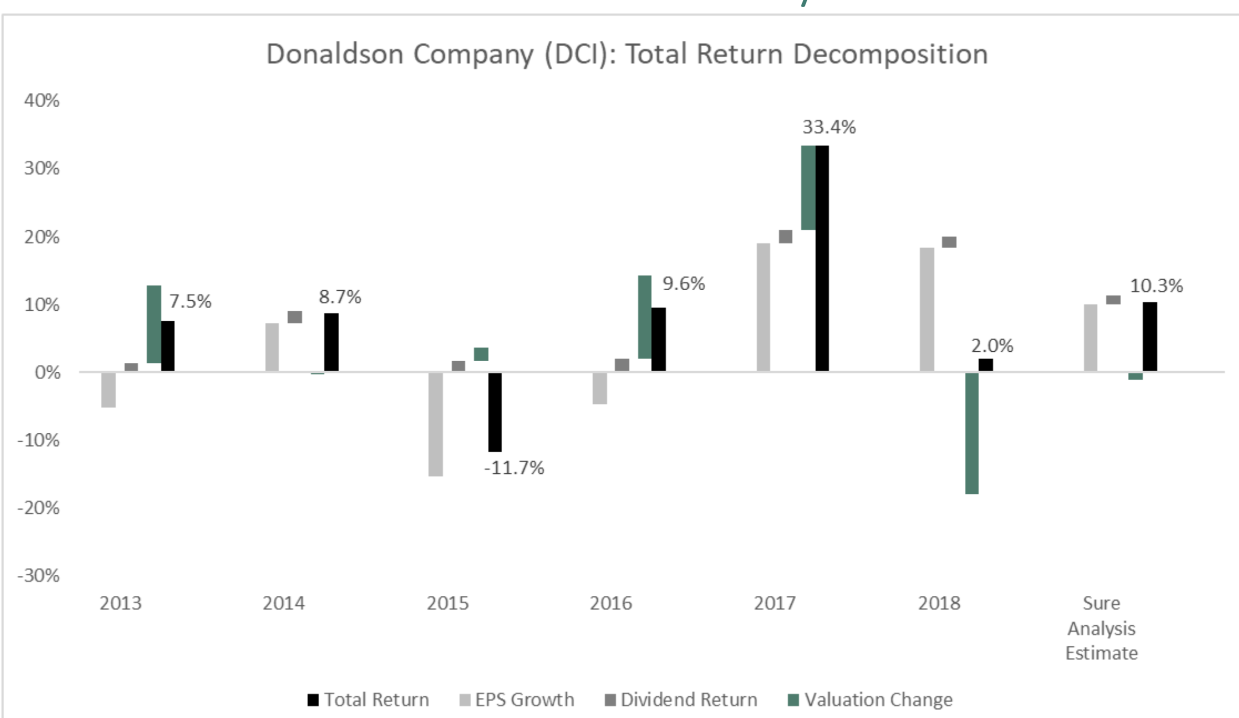
Donaldson's quality metrics have been very stable during the past decade as it has not experienced much movement in either direction. Gross margins are near their historical highs and should remain there given pricing increases as well as cost savings efforts working to offset rising input costs. Its 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 36% for this year but that should fall over time as well as earnings growth outpaces dividend growth. Donaldson's dividend is very safe.

Donaldson's recession performance is somewhat of an issue, as you'd expect for an industrial stock. Earnings will likely fall significantly during the next downturn. It does enjoy 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, Donaldson 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 10.3%, consisting of the current 1.4% yield, a 1.1% headwind from a contracting valuation, and 10% from earnings growth. Donaldson looks poised to deliver strong returns to shareholders and thus, it looks appropriate for investors seeking growth in the industrial sector. Donaldson 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 Donaldson attractive here for growth-oriented investors looking for exposure to industrials. The stock earns a buy recommendation from Sure Dividend at current prices.

Total Return Breakdown by Year



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