Donaldson Company (DCI)

Updated December 7th, 2018 by Josh Arnold

Key Metrics

Current Price:	$51	**5 Year CAGR Estimate:**	11.6%	**Volatility Percentile:**	45.8%
Fair Value Price:	$51	**5 Year Growth Estimate:**	10.0%	**Momentum Percentile:**	52.1%
% Fair Value:	99%	**5 Year Valuation Multiple Estimate:**	0.1%	**Growth Percentile:**	88.8%
Dividend Yield:	1.5%	**5 Year Price Target**	$82	**Valuation Percentile:**	58.5%
Dividend Risk Score:	A	**Retirement Suitability Score:**	C	**Total Return Percentile:**	69.7%

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 $3.0 billion in revenue this year and sports a market capitalization of $6.5 billion.

Donaldson reported Q1 earnings on 12/4/18 and results were largely in line with expectations. Total sales increased 8.8% year-over-year as currency translation negatively impacted results by 1.9%, a new revenue recognition standard added 0.7%, and the BOFA International acquisition added 0.2%. Operationally, both the Engine and Industrial segments produced 8.8% revenue growth with the former led by strength in On-Road products and the latter seeing strength in Industrial Filtration. Donaldson did see some weakness in Gas Turbine Systems revenue in the Industrial segment, but it was not enough to offset what was otherwise another strong quarter from a revenue perspective.

Operating margin rose 30bps year-over-year to 14.1% of revenue. Gross margins fell 80bps thanks to a variety of negative factors, including the new revenue recognition practice, higher raw materials and supply chain costs, as well as an unfavorable sales mix. These factors were partially offset by better pricing, but overall, gross margins were weaker than last year's Q1.

However, operating expense as a percentage of sales improved 110bps to 19.9% from 21% in the comparable quarter last year, reflecting leverage on increasing sales and lower warranty costs, partially offset by costs related to the BOFA acquisition and higher freight costs. In total, Donaldson saw earnings-per-share rise 21.7% in Q1 and essentially reiterated prior guidance; our estimate of earnings-per-share for this year therefore remains unchanged at $2.36.

Just before the end of the quarter, Donaldson completed the acquisition of the aforementioned BOFA International, a company that sells fume extraction systems to OEM customers, distributors and end users, and has recurring sales of replacement filters. Its fume extraction systems are used in laser, electronics, printing, 3D printing and dental applications and will help Donaldson continue to build out its capabilities in its industrial markets.

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	***$0.76***	***$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, which should amount to mid-single digits or better growth. 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 forecast moderate dividend growth, but Donaldson is not an income stock, choosing instead to use its excess cash for acquisitions and share repurchases.

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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	***21.5***	***21.6***
Avg. Yld.	1.4%	1.2%	1.0%	1.0%	1.3%	1.5%	1.8%	2.2%	1.7%	1.6%	***1.5%***	***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 essentially no impact in the coming years. In other words, shares are trading at fair value today.

We are forecasting the yield to be roughly flat to where it is today as future 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.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	27%	22%	18%	18%	24%	32%	44%	48%	41%	38%	***32%***	***29%***

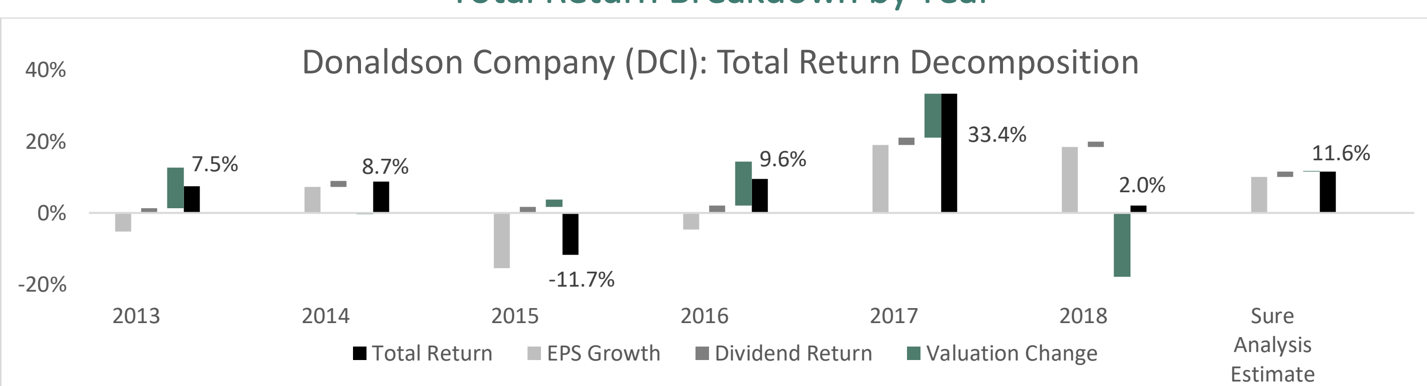
Donaldson's quality metrics have been very stable during the past decade as it has not experienced much movement in either direction. Gross margins are near their historical highs and should remain there given pricing increases as well as cost savings efforts working to offset rising input costs. Its 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 32% for this year but that should fall over time as well as earnings growth outpaces dividend growth; Donaldson's dividend, while small, 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. 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 11.6%, consisting of the current 1.5% yield, a 0.1% tailwind from the 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 for growth-oriented investors looking for exposure to industrials. Overall, the stock earns a buy recommendation from Sure Dividend at current prices.

Total Return Breakdown by Year



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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.

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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	1869	1877	2294	2493	2437	2474	2371	2220	2372	2734
Gross Profit	590	659	814	874	847	878	809	755	823	936
Gross Margin	31.6%	35.1%	35.5%	35.0%	34.8%	35.5%	34.1%	34.0%	34.7%	34.2%
SG&A Exp.	379	376	443	451	441	460	460	425	440	496
D&A Exp.	59	59	60	61	64	67	74	75	75	77
Operating Profit	170	238	315	363	343	356	288	274	329	380
Operating Margin	9.1%	12.7%	13.7%	14.6%	14.1%	14.4%	12.2%	12.3%	13.9%	13.9%
Net Profit	132	166	225	264	247	260	208	191	233	180
Net Margin	7.1%	8.9%	9.8%	10.6%	10.2%	10.5%	8.8%	8.6%	9.8%	6.6%
Free Cash Flow	231	160	185	182	221	221	119	218	252	165
Income Tax	30	64	87	106	101	101	81	67	89	183

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	1334	1500	1726	1730	1744	1942	1810	1787	1980	1977
Cash & Equivalents	144	232	273	226	224	296	190	243	308	205
Accounts Receivable	280	359	446	439	431	474	460	452	498	535
Inventories	180	204	271	256	235	253	265	234	294	334
Goodwill & Int. Ass.	234	224	225	209	207	202	262	268	279	274
Total Liabilities	645	753	791	820	658	940	1031	1016	1125	1119
Accounts Payable	123	166	216	199	186	217	179	143	194	201
Long-Term Debt	289	312	267	301	211	431	578	567	611	543
Shareholder's Equity	689	747	935	910	1085	1002	775	767	850	853
D/E Ratio	0.42	0.42	0.29	0.33	0.19	0.43	0.75	0.74	0.72	0.64

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	9.2%	11.7%	14.0%	15.3%	14.2%	14.1%	11.1%	10.6%	12.4%	9.1%
Return on Equity	18.5%	23.2%	26.8%	28.7%	24.8%	24.9%	23.4%	24.7%	28.8%	21.2%
ROIC	12.9%	16.3%	19.9%	21.9%	19.7%	19.1%	14.9%	14.2%	16.6%	12.6%
Shares Out.	155	153	151	148	146	140	135	133	131	130
Revenue/Share	11.80	11.85	14.59	16.30	16.20	16.76	17.01	16.47	17.69	20.68
FCF/Share	1.46	1.01	1.18	1.19	1.47	1.49	0.85	1.62	1.88	1.25

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.