Donaldson Company (DCI)

Updated September 15th, 2019 by Josh Arnold

Key Metrics

Current Price:	$53	**5 Year CAGR Estimate:**	4.3%	**Volatility Percentile:**	63.5%
Fair Value Price:	$45	**5 Year Growth Estimate:**	6.0%	**Momentum Percentile:**	28.6%
% Fair Value:	118%	**5 Year Valuation Multiple Estimate:**	-3.3%	**Growth Percentile:**	56.5%
Dividend Yield:	1.6%	**5 Year Price Target**	$60	**Valuation Percentile:**	37.2%
Dividend Risk Score:	A	**Retirement Suitability Score:**	C	**Total Return Percentile:**	29.0%

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 just under $3 billion in revenue this year and sports a current market capitalization of $6.8 billion.

Donaldson reported Q4 and full-year earnings on 9/5/19 and results were somewhat weak, but better than expectations. Q4 sales increased 0.3% to $727 million, capping a year of record revenue. Q4 revenue was boosted 1.3% by the company's relatively recent BOFA acquisition, and another 0.9% from pricing increases. Currency translation reduced net sales by 2.0% in Q4 due to Donaldson's global operations.

Engine product sales fell 1.1% on a reported basis, but were up 0.9% on a currency-neutral basis. Pricing was strong in the category, and new revenue recognition procedures added another 0.9% to sales.

Industrial products saw sales rise 3.3% year-over-year in Q4 as BOFA added 3.9%, while pricing added another 0.5%. Currency translation reduced sales by 2.2%.

Operating income fell from 14.9% of revenue to 14.4% as gross margins declined significantly. That number fell from 34.9% of revenue to 33.5% in Q4. The reduction was driven by unfavorable mix of product sales as well as higher raw material and supply chain costs. Some of this weakness was offset by pricing increases, but it wasn't enough in Q4. On the bright side, full-year operating margin rose 80bps to 20% of revenue despite the weak Q4 performance.

We're out with an initial estimate of $2.25 in earnings-per-share for this year as we see margin headwinds moderating.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	$1.05	$1.44	$1.73	$1.64	$1.76	$1.49	$1.42	$1.69	$2.00	$2.05	***$2.25***	***$3.01***
DPS	$0.24	$0.28	$0.34	$0.45	$0.61	$0.67	$0.69	$0.70	$0.76	$0.78	***$0.84***	***$1.23***
Shares[1]	153	151	148	146	140	135	133	131	130	130	***128***	***123***

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 steady fashion. Looking forward, we are forecasting robust 6% earnings-per-share growth annually, with a ~10% growth forecast for 2020. Note that we've reduced our growth estimate from the prior 9% annually due to the issues in Q4, as we see Donaldson having a difficult time growing revenue from record levels, along with margin underperformance.

The company can achieve these results through a variety of methods. First, sales increases ought to continue from organic growth, pricing increases, and acquisitions, which should amount to mid-single-digit or better growth. Donaldson did, however, guide for slightly lower sales this year against fiscal 2019. 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

[1] Share count in millions

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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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.

Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	19.8	19.1	19.2	21.7	23.1	25.5	21.9	24.9	23.9	24.7	***23.6***	***20.0***
Avg. Yld.	1.2%	1.0%	1.0%	1.3%	1.5%	1.8%	2.2%	1.7%	1.6%	1.5%	***1.6%***	***2.0%***

Donaldson's price-to-earnings multiple has been remarkably steady in the past decade. Given where shares are today, we are forecasting a ~3% headwind to total returns as shares are still in excess of our estimate of fair value.

We are forecasting the yield to move up slightly in the years to come as the payout increases while the valuation moderates. 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	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	22%	18%	18%	24%	32%	44%	48%	41%	38%	38%	***37%***	***41%***

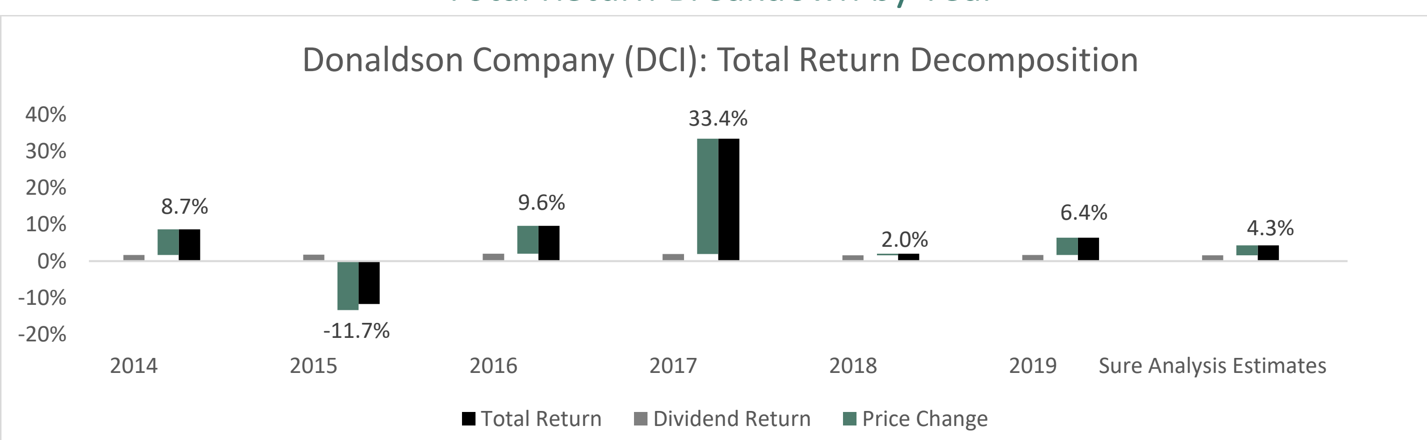
Donaldson's payout ratio remains around 30% of earnings and we expect that is where it will stay for the foreseeable future. As mentioned, Donaldson prefers to use most of its excess cash for acquisitions and a small amount of share repurchases, but it does raise the dividend regularly.

Donaldson's recession performance is somewhat of an issue, as you'd expect for an industrial stock, and 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

Donaldson looks less attractive at this time than it did during our last report. The stock is now meaningfully in excess of our estimate of fair value thanks to a higher share price, and we now see lower average growth moving forward. We are forecasting total annual returns of 4.3%, consisting of the current 1.6% yield, a modest headwind from the valuation, and 6% annual earnings growth. The stock still offers investors strong growth potential, but the valuation is an issue for value investors, and the yield isn't good enough for income investors. We're downgrading Donaldson from hold to sell due to these factors, and lower projected total returns.

Total Return Breakdown by Year



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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.