Donaldson Company (DCI)

Updated March 9th, 2020 by Josh Arnold

Key Metrics

Current Price:	$46	**5 Year CAGR Estimate:**	6.0%	**Market Cap:**	$5.8B
Fair Value Price:	$42	**5 Year Growth Estimate:**	6.0%	**Ex-Dividend Date:**	05/13/20[1]
% Fair Value:	109%	**5 Year Valuation Multiple Estimate:**	-1.7%	**Dividend Payment Date:**	05/28/20[2]
Dividend Yield:	1.8%	**5 Year Price Target**	$56	**Years Of Dividend Growth:**	33
Dividend Risk Score:	A	**Retirement Suitability Score:**	C	**Last Dividend Increase:**	10.5%

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 about $2.7 billion in revenue this year and sports a current market capitalization of $5.8 billion.

Donaldson reported Q2 earnings on March 5th and missed revenue expectations, but beat on earnings. Total revenue was down -5.9% to $662 million from $704 million in fiscal 2019's Q2. The decline was primarily attributable to lower unit volume, partially by a pricing benefit of 0.7%. Currency translation reduced revenue by -0.6% as well. Off-road and on-road engines both posted declines, coming in at -14.5% and -21.1%, respectively, during the quarter. Donaldson saw broad-based weakness in its segments in Q2, and this caused it to lower its revenue forecast for the year.

The company's margins improved in Q2 despite the weakness in revenue, with operating income rising from 12.1% to 12.8% year-over-year. Gross margin rose 170bps to 33.7% of revenue due to production, supply chain, procurement and pricing optimizations. In addition, a favorable mix of sales and input costs helped boost margins.

Donaldson lowered its guidance for the year to $2.05 to $2.21 in earnings-per-share, and we've lowered our estimate from $2.25 to $2.10 as a result.

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	***$2.10***	***$2.81***
DPS	$0.24	$0.28	$0.34	$0.45	$0.61	$0.67	$0.69	$0.70	$0.76	$0.82	***$0.84***	***$1.23***
Shares[3]	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 modest growth forecast for 2020. We remain somewhat cautious on the company's ability to grow revenue, as well as expand its margins despite recent pricing increases. Management is bullish, seeing improvement on the horizon in the near-term.

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 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 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.

[1] Estimated date
[2] Estimated date
[3] 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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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	***21.8***	***20.0***
Avg. Yld.	1.2%	1.0%	1.0%	1.3%	1.5%	1.8%	2.2%	1.7%	1.6%	1.5%	***1.8%***	***2.2%***

Donaldson's price-to-earnings multiple has been remarkably steady in the past decade. Given where shares are today, we are forecasting a ~2% 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%	***40%***	***44%***

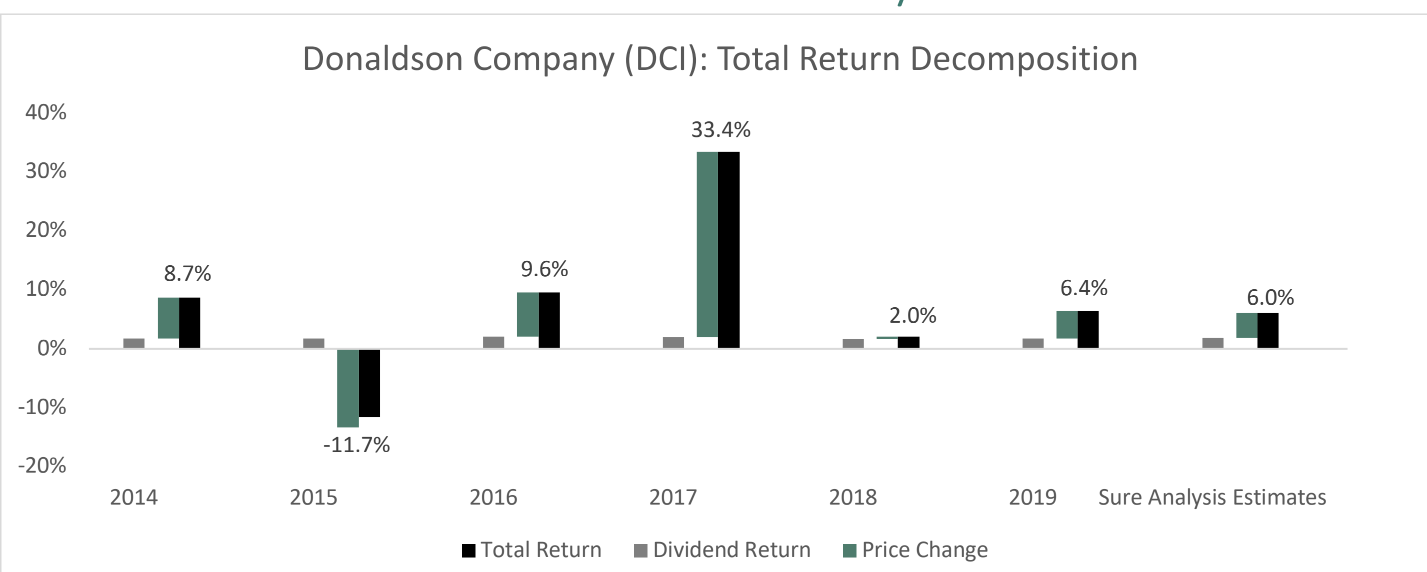
Donaldson's payout ratio remains near 40% of earnings and we expect that is where it will stay for the foreseeable future. As mentioned, Donaldson prefers to use most of its excess cash for acquisitions and a small amount of share repurchases, but it does raise the dividend regularly.

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 still in excess of our estimate of fair value thanks to a higher share price, and we see lower average growth moving forward. We are forecasting total annual returns of 6.0%, consisting of the current 1.8% yield, a modest headwind from the valuation, and 6% annual earnings growth. The stock still offers investors reasonable growth potential, but the valuation is an issue, and the yield isn't good enough for income investors. We're upgrading Donaldson from sell to hold on the improved valuation.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	1,877	2,294	2,493	2,437	2,474	2,371	2,220	2,372	2,734	2,845
Gross Profit	659	814	874	847	878	809	755	821	936	948
Gross Margin	35.1%	35.5%	35.0%	34.8%	35.5%	34.1%	34.0%	34.6%	34.2%	33.3%
SG&A Exp.	376	443	451	441	460	460	425	443	499	498
D&A Exp.	59	60	61	64	67	74	75	75	77	81
Operating Profit	238	315	363	343	356	288	274	324	377	388
Operating Margin	12.7%	13.7%	14.6%	14.1%	14.4%	12.2%	12.3%	13.6%	13.8%	13.6%
Net Profit	166	225	264	247	260	208	191	233	180	267
Net Margin	8.9%	9.8%	10.6%	10.2%	10.5%	8.8%	8.6%	9.8%	6.6%	9.4%
Free Cash Flow	160	185	182	221	221	119	218	252	165	195
Income Tax	64	87	106	101	101	81	67	89	183	108

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	1,500	1,726	1,730	1,744	1,942	1,810	1,787	1,980	1,977	2,143
Cash & Equivalents	232	273	226	224	296	190	243	308	205	178
Accounts Receivable	359	446	439	431	474	460	452	498	535	530
Inventories	204	271	256	235	253	265	234	294	334	333
Goodwill & Int. Ass.	224	225	209	207	202	262	268	279	274	374
Total Liabilities	753	791	820	658	940	1,031	1,016	1,125	1,119	1,250
Accounts Payable	166	216	199	186	217	179	143	194	201	238
Long-Term Debt	312	267	301	211	431	578	567	611	543	637
Shareholder's Equity	747	935	910	1,085	1,002	775	767	850	853	887
D/E Ratio	0.42	0.29	0.33	0.19	0.43	0.75	0.74	0.72	0.64	0.72

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	11.7%	14.0%	15.3%	14.2%	14.1%	11.1%	10.6%	12.4%	9.1%	13.0%
Return on Equity	23.2%	26.8%	28.7%	24.8%	24.9%	23.4%	24.7%	28.8%	21.2%	30.7%
ROIC	16.3%	19.9%	21.9%	19.7%	19.1%	14.9%	14.2%	16.6%	12.6%	18.2%
Shares Out.	153	151	148	146	140	135	133	131	130	130
Revenue/Share	11.85	14.59	16.30	16.20	16.76	17.01	16.47	17.69	20.68	21.83
FCF/Share	1.01	1.18	1.19	1.47	1.49	0.85	1.62	1.88	1.25	1.50

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