Donaldson Company (DCI)

Updated December 8th, 2020 by Josh Arnold

Key Metrics

Current Price:	$55	**5 Year CAGR Estimate:**	6.8%	**Market Cap:**	$6.9 B
Fair Value Price:	$46	**5 Year Growth Estimate:**	9.0%	**Ex-Dividend Date:**	12/04/20
% Fair Value:	119%	**5 Year Valuation Multiple Estimate:**	-3.4%	**Dividend Payment Date:**	12/22/20
Dividend Yield:	1.5%	**5 Year Price Target**	$71	**Years Of Dividend Growth:**	33
Dividend Risk Score:	A	**Retirement Suitability Score:**	B	**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. The company is expected to produce about $2.6 billion in revenue this year and trades with a current market capitalization of $6.9 billion.

Donaldson reported first quarter earnings on December 3rd, 2020 with results coming in better than expected on the top and bottom lines. Sales declined -5.4% to $637 million year-over-year, with currency translation adding 1% to the top line. Strength was seen in the Engine and Industrial Products segments, although overall, revenue generation remains weak. Gross margin was up from 34.4% to 35% of revenue, reflecting lower raw material costs, as well as a favorable mix of sales. Operating expenses were down -5% from the year-ago period but were flat as a percentage of revenue given the decline in the top line.

Operating income as a rate of sales was up 50bps to 13.7%. Earnings-per-share fell -4.4% year-over-year to $0.48 given weakness in revenue but held up fairly well considering the circumstances.

Donaldson guided for second quarter sales to be up sequentially from Q1, and for the second half to see further improvement. We've boosted our estimate of earnings-per-share to $2.10 as a result of the strong report and guidance for the remainder of the year.

Growth on a Per-Share Basis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
EPS	$1.44	$1.73	$1.64	$1.76	$1.49	$1.42	$1.69	$2.00	$2.05	$2.03	***$2.10***	***$3.23***
DPS	$0.28	$0.34	$0.45	$0.61	$0.67	$0.69	$0.70	$0.76	$0.82	$0.84	***$0.84***	***$1.23***
Shares[1]	151	148	146	140	135	133	131	130	130	128	***128***	***126***

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 9% earnings-per-share growth annually, with a more subdued estimate for 2021. We remain somewhat cautious on the company's ability to grow revenue, as well as expand its margins despite recent pricing increases. However, management is bullish, seeing improvement on the horizon in the near-term, and recent results have been supportive of higher revenue and better margins, excluding COVID-19.

The company can grow 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. We see margin improvement activities as key to the company producing meaningfully higher earnings in the coming years, as well as a rebound in revenue producing leverage on SG&A costs.

Lastly, Donaldson is buying back stock each year. 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] 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	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Now	2026
Avg. P/E	19.1	19.2	21.7	23.1	25.5	21.9	24.9	23.9	24.7	24.2	***26.2***	***22.0***
Avg. Yld.	1.0%	1.0%	1.3%	1.5%	1.8%	2.2%	1.7%	1.6%	1.5%	1.7%	***1.5%***	***1.7%***

Donaldson's price-to-earnings multiple has been remarkably steady in the past decade. However, given where shares are today, we are forecasting a 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, as the company's stated strategy requires the use of excess cash for acquisitions and buybacks.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
Payout	18%	18%	24%	32%	44%	48%	41%	38%	38%	41%	***40%***	***38%***

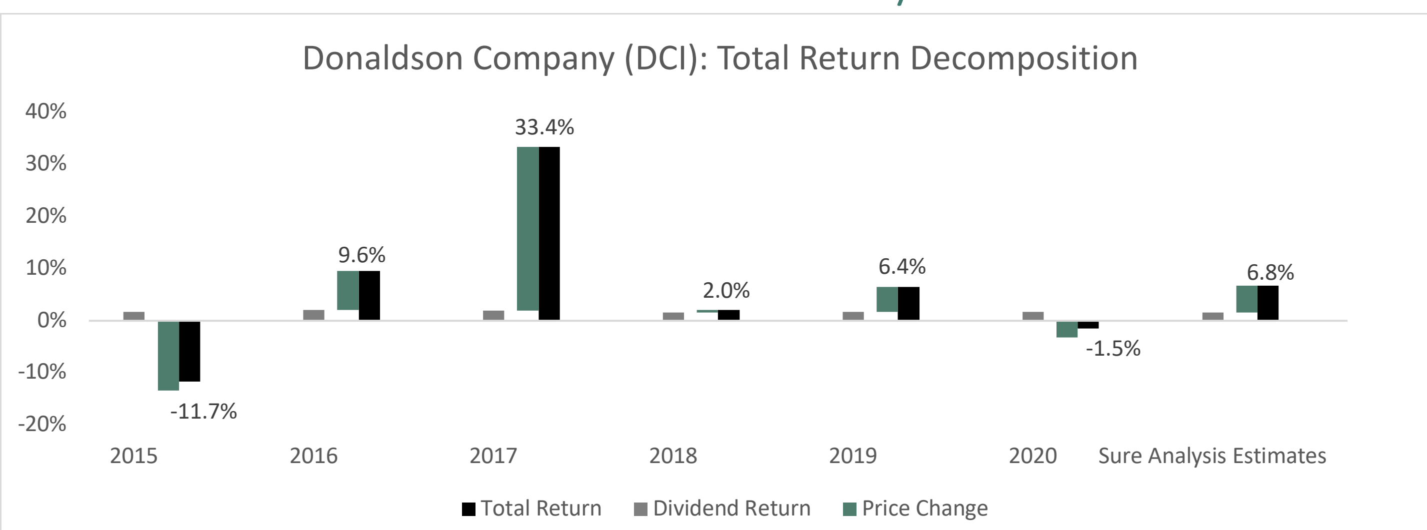
Donaldson's payout ratio remains near 40% of earnings and we expect that is where it will stay for the foreseeable future. As mentioned, Donaldson prefers to use most of its excess cash for acquisitions and a small amount of share repurchases, but it does raise the dividend regularly.

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 much more attractive at this time than it did during our last report. The stock is still in excess of our estimate of fair value, which is driving lower prospective returns. We are forecasting total annual returns of 6.8%, consisting of the current 1.5% yield, a modest headwind from the valuation, and strong earnings growth. The stock still offers investors reasonable growth potential, but the yield isn't good enough for income investors. We're moving Donaldson to hold from buy given the valuation that is well in excess of our estimate of fair value.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	2,294	2,493	2,437	2,474	2,371	2,220	2,372	2,734	2,845	2,582
Gross Profit	814	874	847	878	809	755	821	936	948	872
Gross Margin	35.5%	35.0%	34.8%	35.5%	34.1%	34.0%	34.6%	34.2%	33.3%	33.8%
SG&A Exp.	443	451	441	460	460	425	443	499	498	---
D&A Exp.	60	61	64	67	74	75	75	77	81	88
Operating Profit	315	363	343	356	288	274	324	377	388	340
Operating Margin	13.7%	14.6%	14.1%	14.4%	12.2%	12.3%	13.6%	13.8%	13.6%	13.2%
Net Profit	225	264	247	260	208	191	233	180	267	257
Net Margin	9.8%	10.6%	10.2%	10.5%	8.8%	8.6%	9.8%	6.6%	9.4%	10.0%
Free Cash Flow	185	182	221	221	119	218	252	165	195	265
Income Tax	87	106	101	101	81	67	89	183	108	78

Balance Sheet Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Assets	1,726	1,730	1,744	1,942	1,810	1,787	1,980	1,977	2,143	2,245
Cash & Equivalents	273	226	224	296	190	243	308	205	178	237
Accounts Receivable	446	439	431	474	460	452	498	535	530	455
Inventories	271	256	235	253	265	234	294	334	333	323
Goodwill & Int. Ass.	225	209	207	202	262	268	279	274	374	384
Total Liabilities	791	820	658	940	1,031	1,016	1,125	1,119	1,250	1,252
Accounts Payable	216	199	186	217	179	143	194	201	238	188
Long-Term Debt	267	301	211	431	578	567	611	543	637	627
Shareholder's Equity	935	910	1,085	1,002	775	767	850	853	887	993
D/E Ratio	0.29	0.33	0.19	0.43	0.75	0.74	0.72	0.64	0.72	0.63

Profitability & Per Share Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Return on Assets	14.0%	15.3%	14.2%	14.1%	11.1%	10.6%	12.4%	9.1%	13.0%	11.7%
Return on Equity	26.8%	28.7%	24.8%	24.9%	23.4%	24.7%	28.8%	21.2%	30.7%	27.3%
ROIC	19.9%	21.9%	19.7%	19.1%	14.9%	14.2%	16.6%	12.6%	18.2%	16.3%
Shares Out.	151	148	146	140	135	133	131	130	130	128
Revenue/Share	14.59	16.30	16.20	16.76	17.01	16.47	17.69	20.68	21.83	20.12
FCF/Share	1.18	1.19	1.47	1.49	0.85	1.62	1.88	1.25	1.50	2.06

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