



# Donaldson Company (DCI)

Updated September 5<sup>th</sup>, 2021, by Josh Arnold

## Key Metrics

<b>Current Price:</b>	\$62	<b>5 Year CAGR Estimate:</b>	10.8%	<b>Market Cap:</b>	\$8.1 B
<b>Fair Value Price:</b>	\$64	<b>5 Year Growth Estimate:</b>	9.0%	<b>Ex-Dividend Date:</b>	11/13/21 <sup>1</sup>
<b>% Fair Value:</b>	97%	<b>5 Year Valuation Multiple Estimate:</b>	0.5%	<b>Dividend Payment Date:</b>	11/25/21
<b>Dividend Yield:</b>	1.4%	<b>5 Year Price Target</b>	\$98	<b>Years Of Dividend Growth:</b>	34
<b>Dividend Risk Score:</b>	A	<b>Retirement Suitability Score:</b>	B	<b>Last Dividend Increase:</b>	4.8%

## 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 \$3.1 billion in revenue this year and trades with a current market capitalization of \$8.1 billion.

Donaldson reported fourth quarter and full-year earnings on September 2<sup>nd</sup>, 2021, with results coming in largely in line with expectations. Total revenue was \$773 million, up 25% year-over-year, and beating expectations marginally. Engine sales were up 28% year-over-year, which the company said was due to strong growth in all its engine segments. In addition, industrial sales were up 20%, driven by filtration solutions, slightly offset by gas turbine systems sales.

Gross margin was 34.4% of sales, up from 33.7% a year ago. The improvement in gross margin was due to strong volume leverage and pricing benefits, partially offset by higher raw material costs, as well as unfavorable sales mix.

Operating expenses were down 40bps to 19.9% of revenue, which was due to volume leverage that was partially offset by higher incentive compensation costs. As a percentage of revenue, operating income was up to 14.5% of revenue from 13.4% a year ago. Donaldson gave upside guidance to 2022, and we've initiated fiscal 2022 earnings-per-share at \$2.65.

## Growth on a Per-Share Basis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
<b>EPS</b>	\$1.73	\$1.64	\$1.76	\$1.49	\$1.42	\$1.69	\$2.00	\$2.05	\$2.03	\$2.32	<b>\$2.65</b>	<b>\$4.08</b>
<b>DPS</b>	\$0.34	\$0.45	\$0.61	\$0.67	\$0.69	\$0.70	\$0.76	\$0.82	\$0.84	\$0.86	<b>\$0.88</b>	<b>\$1.29</b>
<b>Shares<sup>2</sup></b>	148	146	140	135	133	131	130	130	128	126	<b>126</b>	<b>120</b>

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, and above-trend growth for 2022. 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 a high-income stock, choosing instead to use its excess cash for acquisitions and share repurchases. Share repurchases are relatively small in any particular year, but over time, add up to meaningful gains for shareholders.

<sup>1</sup> Estimated date

<sup>2</sup> 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	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Now	2027
Avg. P/E	19.2	21.7	23.1	25.5	21.9	24.9	23.9	24.7	24.2	24.6	<b>23.4</b>	<b>24.0</b>
Avg. Yld.	1.0%	1.3%	1.5%	1.8%	2.2%	1.7%	1.6%	1.5%	1.7%	1.5%	<b>1.4%</b>	<b>1.3%</b>

Donaldson's price-to-earnings multiple has been remarkably steady in the past decade. However, given where shares are today, we are forecasting a small tailwind to total returns as shares are now slightly under 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 rises slightly. 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	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2021	2026
Payout	18%	24%	32%	44%	48%	41%	38%	38%	41%	37%	<b>33%</b>	<b>32%</b>

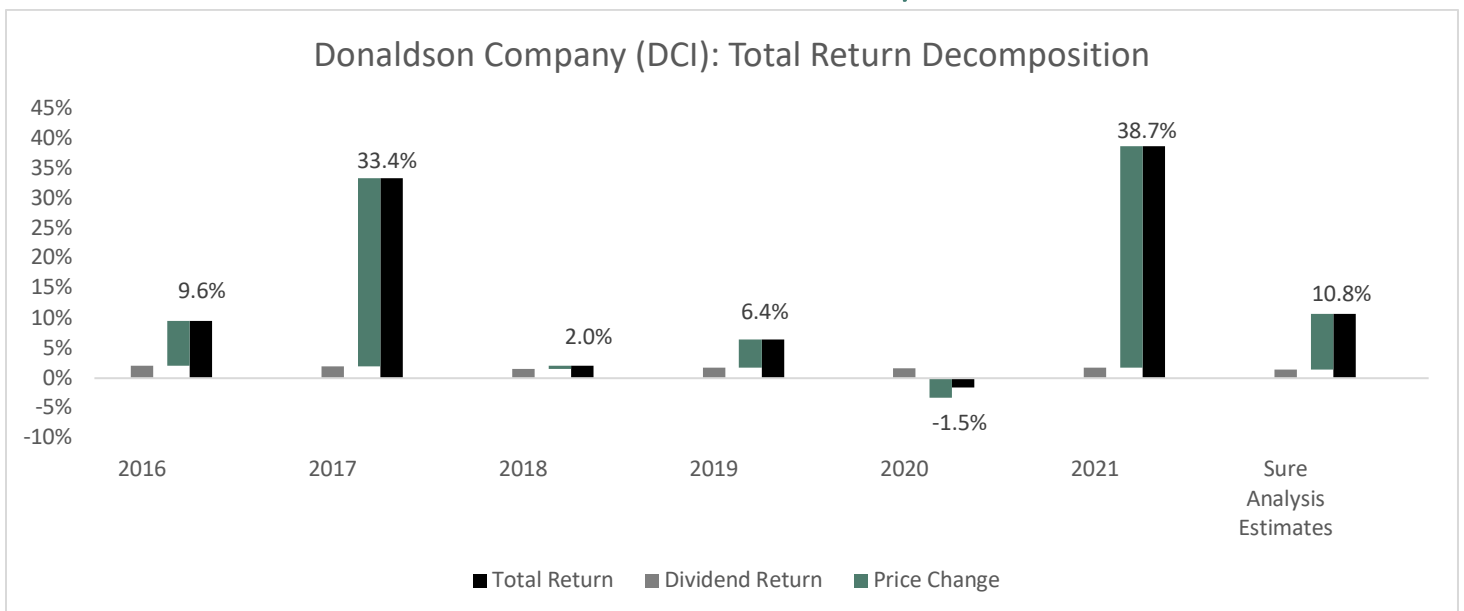
Donaldson's payout ratio remains well below 40% of earnings and we expect that is where it will stay for the foreseeable future. As mentioned, Donaldson prefers to use most of its excess cash for acquisitions and a small amount of share repurchases, but it does raise the dividend regularly.

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's stock price is now under our estimate of fair value, which is slightly boosting prospective returns. We are forecasting total annual returns of 10.8%, consisting of the current 1.4% yield, a modest tailwind from the valuation, and 9% earnings growth. The stock still offers investors growth potential, but the yield isn't good enough for income investors. However, given the improved valuation, we're moving Donaldson from hold to buy.

## Total Return Breakdown by Year



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## Income Statement Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
<b>Revenue</b>	2,493	2,437	2,474	2,371	2,220	2,372	2,734	2,845	2,582	2,854
<b>Gross Profit</b>	874	847	878	809	755	821	936	948	872	972
<b>Gross Margin</b>	35.0%	34.8%	35.5%	34.1%	34.0%	34.6%	34.2%	33.3%	33.8%	34.0%
<b>SG&amp;A Exp.</b>	451	441	460	460	425	443	499	498	470	519
<b>D&amp;A Exp.</b>	61	64	67	74	75	75	77	81	88	95
<b>Operating Profit</b>	363	343	356	288	274	324	377	388	340	385
<b>Operating Margin</b>	14.6%	14.1%	14.4%	12.2%	12.3%	13.6%	13.8%	13.6%	13.2%	13.5%
<b>Net Profit</b>	264	247	260	208	191	233	180	267	257	287
<b>Net Margin</b>	10.6%	10.2%	10.5%	8.8%	8.6%	9.8%	6.6%	9.4%	10.0%	10.1%
<b>Free Cash Flow</b>	182	221	221	119	218	252	165	195	263	344
<b>Income Tax</b>	106	101	101	81	67	89	183	108	78	94

## Balance Sheet Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
<b>Total Assets</b>	1,730	1,744	1,942	1,810	1,787	1,980	1,977	2,143	2,245	2,400
<b>Cash &amp; Equivalents</b>	226	224	296	190	243	308	205	178	237	223
<b>Accounts Receivable</b>	439	431	474	460	452	498	535	530	455	553
<b>Inventories</b>	256	235	253	265	234	294	334	333	323	385
<b>Goodwill &amp; Int. Ass.</b>	209	207	202	262	268	279	274	374	384	384
<b>Total Liabilities</b>	820	658	940	1,031	1,016	1,125	1,119	1,250	1,252	1,263
<b>Accounts Payable</b>	199	186	217	179	143	194	201	238	188	294
<b>Long-Term Debt</b>	301	211	431	578	567	611	543	637	627	510
<b>Shareholder's Equity</b>	910	1,085	1,002	775	767	850	853	887	987	1,137
<b>D/E Ratio</b>	0.33	0.19	0.43	0.75	0.74	0.72	0.64	0.72	0.64	0.45

## Profitability & Per Share Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
<b>Return on Assets</b>	15.3%	14.2%	14.1%	11.1%	10.6%	12.4%	9.1%	13.0%	11.7%	12.4%
<b>Return on Equity</b>	28.7%	24.8%	24.9%	23.4%	24.7%	28.8%	21.2%	30.7%	27.4%	27.0%
<b>ROIC</b>	21.9%	19.7%	19.1%	14.9%	14.2%	16.6%	12.6%	18.2%	16.3%	17.6%
<b>Shares Out.</b>	148	146	140	135	133	131	130	130	128	126
<b>Revenue/Share</b>	16.30	16.20	16.76	17.01	16.47	17.69	20.68	21.83	20.12	22.26
<b>FCF/Share</b>	1.19	1.47	1.49	0.85	1.62	1.88	1.25	1.50	2.05	2.68

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

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