Donaldson Company (DCI)

Updated December 9th, 2023, by Josh Arnold

Key Metrics

Current Price:	$61	**5 Year CAGR Estimate:**	11.5%	**Market Cap:**	$7.4 B
Fair Value Price:	$67	**5 Year Growth Estimate:**	8.0%	**Ex-Dividend Date:**	12/04/23
% Fair Value:	91%	**5 Year Valuation Multiple Estimate:**	2.0%	**Dividend Payment Date:**	12/20/23
Dividend Yield:	1.6%	**5 Year Price Target**	$99	**Years Of Dividend Growth:**	27
Dividend Risk Score:	A	**Retirement Suitability Score:**	B	**Rating:**	Buy

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 $3.6 billion in revenue this year and trades with a current market capitalization of $7.4 billion.

Donaldson posted first quarter earnings on November 29th, 2023, and results were mixed. Adjusted earnings-per-share were better than expected at 75 cents, three cents ahead of estimates. However, revenue was flat year-over-year at $846 million, missing estimates by almost $9 million.

Gross margin was 35.6% of revenue, up 170 basis points from 33.9% a year ago. This was driven by pricing benefits, deflation in freight costs, as well as product mix.

Operating expenses were 20.8%, up 100 basis points over the year-ago period. This was due to increased hiring and acquisition-related charges. Operating income as a percentage of revenue was 15.0% on an adjusted basis, as gross margin improvements more than offset rising operating expenses.

Donaldson paid $30 million in dividends and repurchased $54 million in shares during the quarter. Donaldson also boosted its buyback authorization to 12 million shares, or a staggering 10% of its outstanding float going forward, indicating the company's plans for capital allocation for the foreseeable future.

We've boosted our estimate of earnings-per-share for this year by a nickel to $3.20.

Growth on a Per-Share Basis

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029
EPS	$1.76	$1.49	$1.42	$1.69	$2.00	$2.05	$2.03	$2.32	$2.68	$3.04	***$3.20***	***$4.70***
DPS	$0.61	$0.67	$0.69	$0.70	$0.76	$0.82	$0.84	$0.86	$0.89	$0.96	***$1.00***	***$1.47***
Shares[1]	140	135	133	131	130	130	128	126	123	121	***120***	***116***

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 8% earnings-per-share growth annually. 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.

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. That was not the case in Q1, but Donaldson has proven the ability to do this consistently in the past.

[1] Share count in millions

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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. With the new authorization, we expect share repurchases to increase.

Valuation Analysis

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Now	2029
Avg. P/E	23.1	25.5	21.9	24.9	23.9	24.7	24.2	24.6	18.0	20.7	***19.1***	***21.0***
Avg. Yld.	1.5%	1.8%	2.2%	1.7%	1.6%	1.5%	1.7%	1.5%	1.8%	1.5%	***1.6%***	***1.5%***

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 under our estimate of fair value. Shares go for 19.1 times earnings today, modestly under our fair value estimate of 21 times.

We are forecasting the yield to stay flat in the years to come as the payout increases while the valuation rises. 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	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029
Payout	32%	44%	48%	41%	38%	38%	41%	37%	33%	32%	***31%***	***31%***

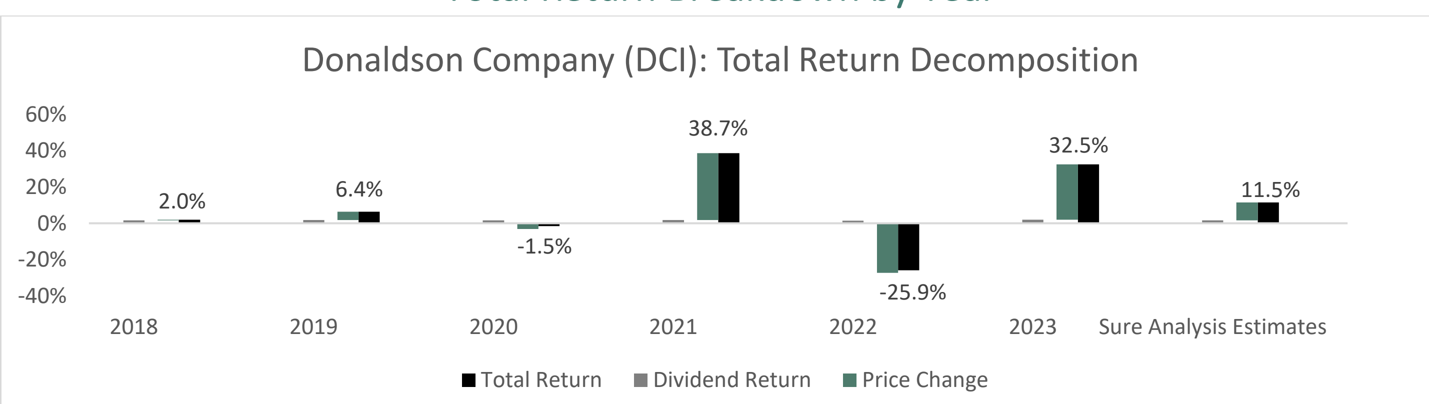
Donaldson's payout ratio remains well below 40% of earnings and we expect that is where it will stay for the foreseeable future. As mentioned, Donaldson prefers to use most of its excess cash for acquisitions and a small amount of share repurchases, but it does raise the dividend regularly, as we note a 27-year streak of dividend increases.

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 under our estimate of fair value, which is boosting prospective returns. We are forecasting total annual returns of 11.5%, consisting of the current 1.6% yield, a 2% tailwind from the valuation, and 8% earnings growth. The stock still offers investors growth potential, but the yield is somewhat low for income investors. With the move up in total returns, we're moving from hold to buy after Q1 results.

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	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Revenue	2,474	2,371	2,220	2,372	2,734	2,845	2,582	2,854	3,307	3,431
Gross Profit	878	809	755	821	936	948	872	972	1,067	1,161
Gross Margin	35.5%	34.1%	34.0%	34.6%	34.2%	33.3%	33.8%	34.0%	32.3%	33.8%
SG&A Exp.	460	460	425	443	499	498	470	519	555	602
D&A Exp.	67	74	75	75	77	81	88	95	94	92
Operating Profit	356	288	274	324	377	388	340	385	444	480
Operating Margin	14.4%	12.2%	12.3%	13.6%	13.8%	13.6%	13.2%	13.5%	13.4%	14.0%
Net Profit	260	208	191	233	180	267	257	287	333	359
Net Margin	10.5%	8.8%	8.6%	9.8%	6.6%	9.4%	10.0%	10.1%	10.1%	10.5%
Free Cash Flow	221	119	218	252	165	195	263	344	168	426
Income Tax	101	81	67	89	183	108	78	94	106	110

Balance Sheet Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Total Assets	1,942	1,810	1,787	1,980	1,977	2,143	2,245	2,400	2,600	2,771
Cash & Equivalents	296	190	243	308	205	178	237	223	193	187
Accounts Receivable	474	460	452	498	535	530	455	553	617	600
Inventories	253	265	234	294	334	333	323	385	502	418
Goodwill & Int. Ass.	202	262	268	279	274	374	384	384	446	669
Total Liabilities	940	1,031	1,016	1,125	1,119	1,250	1,252	1,263	1,467	1,450
Accounts Payable	217	179	143	194	201	238	188	294	339	305
Long-Term Debt	431	578	567	611	543	637	627	510	648	656
Shareholder’s Equity	1,002	775	767	850	853	887	987	1,137	1,133	1,321
LTD/E Ratio	0.43	0.75	0.74	0.72	0.64	0.72	0.64	0.45	0.57	0.50

Profitability & Per Share Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Return on Assets	14.1%	11.1%	10.6%	12.4%	9.1%	13.0%	11.7%	12.4%	13.3%	13.4%
Return on Equity	24.9%	23.4%	24.7%	28.8%	21.2%	30.7%	27.4%	27.0%	29.3%	29.2%
ROIC	19.1%	14.9%	14.2%	16.6%	12.6%	18.2%	16.3%	17.6%	19.4%	19.1%
Shares Out.	140	135	133	131	130	130	128	126	125	124
Revenue/Share	16.76	17.01	16.47	17.69	20.68	21.83	20.12	22.26	26.41	27.76
FCF/Share	1.49	0.85	1.62	1.88	1.25	1.50	2.05	2.68	1.34	3.45

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