

DONALDSON CO INC
Form 10-Q
March 09, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JANUARY 31, 2018 OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM _____ TO _____.

Commission File Number 1-7891

DONALDSON COMPANY, INC.

(Exact name of registrant as specified in its charter)

Delaware 41-0222640

(State or other jurisdiction of incorporation or organization) Identification No.)

1400 West 94th Street

Minneapolis, Minnesota 55431

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (952) 887-3131

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, \$5 Par Value - 129,873,356 shares as of February 28, 2018.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

DONALDSON COMPANY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF (LOSS) EARNINGS

(In millions, except per share amounts)

(Unaudited)

	Three Months Ended January 31,		Six Months Ended January 31,	
	2018	2017	2018	2017
Net sales	\$664.7	\$550.6	\$1,309.5	\$1,103.6
Cost of sales	445.8	362.7	866.3	721.5
Gross profit	218.9	187.9	443.2	382.1
Operating expenses	137.3	118.5	270.9	236.3
Operating income	81.6	69.4	172.3	145.8
Interest expense	5.1	4.8	10.3	9.6
Other expense (income), net	0.1	(1.7)	0.9	(9.8)
Earnings before income taxes	76.4	66.3	161.1	146.0
Income taxes	129.3	19.8	153.1	41.5
Net (loss) earnings	\$(52.9)	\$46.5	\$8.0	\$104.5
Weighted average shares – basic	130.6	132.9	130.7	133.2
Weighted average shares – diluted	130.6	134.4	132.8	134.5
Net (loss) earnings per share – basic	\$(0.40)	\$0.35	\$0.06	\$0.78
Net (loss) earnings per share – diluted	\$(0.40)	\$0.35	\$0.06	\$0.78
Cash dividends paid per share	\$0.180	\$0.175	\$0.360	\$0.350

See Notes to Condensed Consolidated Financial Statements.

DONALDSON COMPANY, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In millions)

(Unaudited)

	Three Months Ended January 31, 2018		Six Months Ended January 31, 2018	
	2017	2018	2017	2018
Net (loss) earnings	\$46.5	\$52.9	\$104.5	\$8.0
Other comprehensive income (loss):				
Foreign currency translation income (loss)	(8.4)	55.5	(20.8)	50.4
Pension liability adjustment, net of deferred taxes of \$(0.4), \$(0.8), \$(0.9) and \$(1.8), respectively	1.3	0.2	3.7	1.0
(Loss) gain on hedging derivatives, net of deferred taxes of \$0.3, \$0.1, \$(0.9) and \$(0.4), respectively	(0.3)	(0.6)	0.7	1.7
Comprehensive income	\$39.1	\$2.2	\$88.1	\$61.1

See Notes to Condensed Consolidated Financial Statements.

DONALDSON COMPANY, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(In millions, except share amounts)

(Unaudited)

	January 31, 2018	July 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	\$ 362.2	\$ 308.4
Accounts receivable, less allowance of \$8.5 and \$8.7, respectively	509.9	497.7
Inventories, net	344.9	293.5
Prepaid expenses and other current assets	62.9	51.4
Total current assets	1,279.9	1,151.0
Property, plant and equipment, net	507.7	484.6
Goodwill	242.0	238.1
Intangible assets, net	38.2	40.6
Deferred income taxes	24.9	30.3
Other long-term assets	38.6	35.1
Total assets	\$ 2,131.3	\$ 1,979.7
Liabilities and shareholders' equity		
Current liabilities:		
Short-term borrowings	\$ 17.7	\$ 23.3
Current maturities of long-term debt	0.4	50.6
Trade accounts payable	200.0	194.0
Other current liabilities	216.9	216.2
Total current liabilities	435.0	484.1
Long-term debt	667.7	537.3
Deferred income taxes	4.7	3.6
Other long-term liabilities	197.0	100.2
Total liabilities	1,304.4	1,125.2
Commitments and contingencies (Note 14)		
Shareholders' Equity:		
Preferred stock, \$1.00 par value, 1,000,000 shares authorized, none issued	—	—

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Common stock, \$5.00 par value, 240,000,000 shares authorized, 151,643,194 shares issued	758.2		758.2	
Retained earnings	1,016.4		1,056.9	
Non-controlling interests	4.6		4.4	
Accumulated other comprehensive loss	(103.9)	(157.0)
Treasury stock, 21,784,693 and 21,037,353 shares, respectively, at cost	(848.4)	(808.0)
Total shareholders' equity	826.9		854.5	
Total liabilities and shareholders' equity	\$	2,131.3	\$	1,979.7

See Notes to Condensed Consolidated Financial Statements.

DONALDSON COMPANY, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

(Unaudited)

	Six Months Ended January 31,	
	2018	2017
Operating Activities		
Net earnings	\$8.0	\$104.5
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	37.9	37.3
Deferred income taxes	7.0	(0.8)
Stock-based compensation expense	9.6	5.8
Other, net	98.1	0.7
Changes in operating assets and liabilities, excluding effect of acquired businesses	(50.8)	22.0
Net cash provided by operating activities	109.8	169.5
Investing Activities		
Net expenditures on property, plant and equipment	(45.8)	(25.0)
Acquisitions, net of cash acquired	0.8	(10.9)
Net cash used in investing activities	(45.0)	(35.9)
Financing Activities		
Proceeds from long-term debt	140.0	—
Repayments of long-term debt	(60.2)	(0.5)
Change in short-term borrowings	(4.1)	12.0
Purchase of treasury stock	(62.9)	(51.8)
Dividends paid	(46.8)	(46.3)
Tax withholding for stock compensation transactions	(2.2)	(2.2)
Exercise of stock options	13.6	12.1
Net cash used in financing activities	(22.6)	(76.7)
Effect of exchange rate changes on cash	11.6	(3.8)
Increase in cash and cash equivalents	53.8	53.1
Cash and cash equivalents, beginning of year	308.4	243.2
Cash and cash equivalents, end of period	\$362.2	\$296.3

See Notes to Condensed Consolidated Financial Statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1. Summary of Significant Accounting Policies

Basis of Presentation The accompanying unaudited condensed consolidated financial statements of Donaldson Company, Inc. and its subsidiaries (the Company) have been prepared in accordance with generally accepted accounting principles in the United States (GAAP) and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair statement of earnings, comprehensive income, financial position and cash flows have been included and are of a normal recurring nature. Operating results for the three and six month period ended January 31, 2018 are not necessarily indicative of the results that may be expected for future periods. The year-end condensed balance sheet information was derived from the Company's audited financial statements but does not include all disclosures required by GAAP. For further information, refer to the Audited Consolidated Financial Statements and Notes thereto included in the Company's Annual Report on Form 10-K for the year ended July 31, 2017.

New Accounting Standards Recently Adopted In July 2015, the FASB issued Accounting Standards Update (ASU) 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory (ASU 2015-11), which amended the guidance requiring companies not using the last-in, first-out (LIFO) method to measure inventory at the lower of cost and net realizable value rather than the lower of cost or market. This accounting guidance was effective for the Company beginning in the first quarter of fiscal 2018 and did not have an impact on its Consolidated Financial Statements.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting (ASU 2016-09). This update simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows. ASU 2016-09 was effective for the Company beginning in the first quarter of fiscal 2018 and the guidance affecting the effective tax rate was adopted prospectively. The Condensed Consolidated Statements of Cash Flows is also presented retrospectively with the guidance of this new standard and, for the six months ended January 31, 2017, resulted in an increase of \$5.2 million to net cash provided by operating activities and a corresponding \$5.2 million increase to net cash used in financing activities.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230) (ASU 2016-15). The new guidance is intended to reduce diversity in practice in how certain transactions are classified in the statement of cash flows. ASU 2016-15 is effective for the Company beginning in the first quarter of fiscal 2019. Early adoption is permitted, provided that all of the amendments are adopted in the same period. The guidance requires application using a retrospective transition method. The Company adopted ASU 2016-15 in the first quarter of fiscal 2018 and it did not have an impact on its Consolidated Financial Statements.

In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory (ASU 2016-16), which is intended to improve the accounting for the income tax consequences of intra-entity transfers of assets other than inventory. This update removes the current exception in GAAP prohibiting entities from recognizing current and deferred income tax expenses or benefits related to transfer of assets, other than inventory, within the consolidated entity. The current exception to defer the recognition of any tax impact on the transfer of inventory within the consolidated entity until it is sold to a third party remains unaffected. ASU 2016-16 is effective for the Company beginning in the first quarter of fiscal 2019, and early adoption is permitted. The Company adopted ASU 2016-16 in the first quarter of fiscal 2018 and it did not have an impact on its Consolidated Financial Statements.

In May 2017, the FASB issued ASU 2017-09, Compensation - Stock Compensation (Topic 718) (ASU 2017-09). The amendments in ASU 2017-09 provide guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. ASU 2017-09 is effective for the Company beginning in the first quarter of fiscal 2019, and early adoption is permitted. The Company adopted ASU 2017-09 in the first quarter of fiscal 2018 and it did not have an impact on its Consolidated Financial Statements.

New Accounting Standards Not Yet Adopted In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606) (ASU 2014-09), which amended revenue recognition guidance to clarify the principles

for recognizing revenue from contracts with customers. The guidance requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. The guidance also requires expanded disclosures relating to the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Additionally, qualitative and quantitative disclosures are required about customer contracts, significant judgments and changes in judgments and assets recognized from the costs to obtain or fulfill a contract. In 2016, the FASB issued ASU 2016-08, ASU 2016-10, ASU 2016-11, ASU 2016-12 and ASU 2016-20 to clarify, among other things, the implementation guidance related to principal versus agent considerations, identifying performance obligations and accounting for licenses of intellectual property. This accounting guidance is effective for the Company beginning

in the first quarter of fiscal 2019, and early adoption is permitted. The amendments in this update are to be applied on a retrospective basis, either to each prior reporting period presented or by presenting the cumulative effect of applying the update recognized at the date of initial application. The Company is evaluating the impact of the adoption of the standard on its Consolidated Financial Statements. A project team has been established, has conducted surveys of the businesses and is performing revenue contract analyses to gather information and identify where potential differences could result in applying the requirements of the new standard. Based on the results of the surveys and contract analyses, the Company will assess the financial impact of the new standard on its Consolidated Financial Statements and determine the method of adoption.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) (ASU 2016-02), which amends the guidance requiring companies to recognize assets and liabilities for leases with lease terms of more than twelve months. The new guidance will require companies to record both capital and operating leases on the balance sheet. This accounting guidance is effective for the Company beginning in the first quarter of fiscal 2020 on a modified retrospective basis, and early adoption is permitted. The Company is evaluating the impact of the adoption of ASU 2016-02 on its Consolidated Financial Statements.

In January 2017, the FASB issued ASU 2017-01, Business Combinations: Clarifying the Definition of a Business (ASU 2017-01). The new guidance provides a more robust framework to use in determining when a set of assets and activities is a business. The amendments provide more consistency in applying the guidance, reduce the costs of application and make the definition of a business more operable. ASU 2017-01 is effective for the Company beginning in the first quarter of fiscal 2019. The Company does not expect the application of ASU 2017-01 will have a material impact on its Consolidated Financial Statements.

In March 2017, the FASB issued ASU 2017-07, Compensation - Retirement Benefits (Topic 715) (ASU 2017-07). The new guidance requires employers to disaggregate and present separately the current service cost component from the other components of net benefit cost within the consolidated statement of earnings. ASU 2017-07 is effective for the Company beginning in the first quarter of fiscal 2019, and early adoption is permitted. The Company is evaluating the impact of the adoption of ASU 2017-07 on its Consolidated Statements of Earnings.

In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities (ASU 2017-12), which improves the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements and make certain targeted improvements to simplify the application of the hedge accounting guidance. The guidance expands the ability to hedge non-financial and financial risk components, reduces complexity in fair value hedges of interest rate risk, eliminates the requirement to separately measure and report hedge ineffectiveness, as well as eases certain hedge effectiveness assessment requirements. ASU 2017-12 is effective for the Company beginning in the first quarter of fiscal 2020, and early adoption is permitted. The Company is evaluating the impact of the adoption of ASU 2017-12 on its Consolidated Financial Statements.

Note 2. Acquisitions

On May 1, 2017, the Company acquired 100% of the shares of Hy-Pro Corporation (Hy-Pro). Hy-Pro designs and manufactures filtration systems and replacement filters for stationary hydraulic and industrial lubrication applications. Hy-Pro has manufacturing locations in Anderson, Indiana and Vancouver, Washington. Total consideration for the transaction was \$21.9 million after recording a working capital adjustment in accordance with the purchase agreement. The Company received cash of \$0.8 million for this adjustment during the first quarter of fiscal 2018, which reduced the purchase price and goodwill by a corresponding amount.

On August 31, 2016, the Company acquired the net assets of Industrias Partmo S.A. (Partmo) in Colombia. Partmo is a leading manufacturer of replacement air, lube and fuel filters in Colombia for medium and heavy duty engines. Total consideration for the transaction was \$12.1 million.

For the two acquisitions that occurred during the year ended July 31, 2017, the Company acquired \$18.1 million of net tangible assets, \$8.6 million of intangible assets that had estimated useful lives ranging from seven to twenty years at the time of acquisition and \$7.3 million of goodwill. Pro forma financial information for these acquisitions have not been presented because they are not material to the Company's consolidated results of operations.

Note 3. Supplemental Balance Sheet Information

The components of net inventories are as follows (in millions):

	January 31, 2018	July 31, 2017
Raw materials	\$ 111.3	\$96.3
Work in process	26.0	19.7
Finished products	207.6	177.5
Inventories, net	\$ 344.9	\$ 293.5

The components of net property, plant and equipment are as follows (in millions):

	January 31, 2018	July 31, 2017
Land	\$21.3	\$20.6
Buildings	305.6	292.5
Machinery and equipment	910.3	866.8
Construction in progress	65.6	48.9
Less: accumulated depreciation	(795.1)	(744.2)
Property, plant and equipment, net	\$ 507.7	\$ 484.6

Note 4. Earnings Per Share

The Company's basic net (loss) earnings per share is computed by dividing net (loss) earnings by the weighted average number of outstanding common shares. The Company's diluted net (loss) earnings per share is computed by dividing net (loss) earnings by the weighted average number of outstanding common shares and common share equivalents relating to stock options and stock incentive plans. All common share equivalents were excluded from the diluted net (loss) earnings per share calculation for the three months ended January 31, 2018 because the Company incurred a net loss for the period. Certain outstanding options were excluded from the diluted net (loss) earnings per share calculations for the other periods because their exercise prices are greater than the average market price of the Company's common stock during those periods. Options excluded from the diluted net (loss) earnings per share calculation were 2.2 million and 0.1 million for the three and six months ended January 31, 2018, respectively. Options excluded from the diluted net (loss) earnings per share calculation were 1.6 million for the three and six months ended January 31, 2017.

The following table presents the information necessary to calculate basic and diluted net earnings per share (in millions, except per share amounts):

	Three Months Ended January 31, 2018		Six Months Ended January 31, 2017	
Net (loss) earnings for basic and diluted earnings per share computation	\$(52.9)	\$46.5	\$8.0	\$104.5
Weighted average common shares outstanding:				
Weighted average common shares – basic	130.6	132.9	130.7	133.2
Dilutive impact of share based awards	—	1.5	2.1	1.3
Weighted average common shares – diluted	130.6	134.4	132.8	134.5
Net (loss) earnings per share – basic	\$(0.40)	\$0.35	\$0.06	\$0.78
Net (loss) earnings per share – diluted	\$(0.40)	\$0.35	\$0.06	\$0.78

Note 5. Goodwill and Other Intangible Assets

Goodwill is assessed for impairment annually or more frequently if an event occurs or circumstances change that would indicate impairment. The Company performed its annual impairment assessment during the third quarter of fiscal 2017. The results

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of this assessment were that the estimated fair values of the reporting units to which goodwill is assigned continued to exceed the corresponding carrying values of the reporting units, resulting in no goodwill impairment.

The following is a reconciliation of goodwill by reportable segment for the six months ended January 31, 2018 (in millions):

	Engine Products	Industrial Products	Total Goodwill
Balance as of July 31, 2017	\$ 84.3	\$ 153.8	\$ 238.1
Goodwill acquired	0.6	—	0.6
Foreign exchange translation	0.4	2.9	3.3
Balance as of January 31, 2018	\$ 85.3	\$ 156.7	\$ 242.0

The following is a reconciliation of net intangible assets for the six months ended January 31, 2018 (in millions):

	Gross Carrying Amount	Accumulated Amortization	Net Intangible Assets
Balance as of July 31, 2017	\$ 106.6	\$ (66.0)	\$ 40.6
Amortization expense	—	(2.8)	(2.8)
Foreign exchange translation	(2.2)	2.6	0.4
Balance as of January 31, 2018	\$ 104.4	\$ (66.2)	\$ 38.2

Note 6. Warranty

The Company estimates warranty expense on certain products at the time of sale. The following is a reconciliation of warranty reserves, included in other current liabilities and other long-term liabilities, for the six months ended January 31, 2018 and 2017 (in millions):

	Six Months Ended	
	January 31, 2018	2017
Balance at beginning of period	\$14.6	\$11.9
Accruals for warranties issued during the reporting period	1.5	1.5
Accruals related to pre-existing warranties (including changes in estimates)	1.1	3.8
Less: settlements made during the period	(2.6)	(2.5)
Balance at end of period	\$14.6	\$14.7

There were no material specific warranty matters accrued for or significant settlements made in the six months ended January 31, 2018 or 2017. The Company's warranty matters are not expected to have a material impact on the Company's results of operations, liquidity or financial position.

Note 7. Stock-Based Compensation

Stock-based compensation expense is recognized using the fair-value method for all awards. The Company determines the fair value of stock option awards using the Black-Scholes option pricing model. Options are granted whereby the option exercise price is equivalent to the market price of the Company's common stock at the date of grant. For the three and six months ended January 31, 2018, the Company recorded pretax stock-based compensation expense associated with stock options of \$1.7 million and \$5.5 million, respectively, and recorded \$0.1 million and \$1.3 million, respectively, of related tax benefits. For the three and six months ended January 31, 2017, the Company recorded pretax stock-based compensation expense associated with stock options of \$3.8 million and \$4.9 million, respectively, and recorded \$1.3 million and \$1.6 million, respectively, of related tax benefits. In addition, for the three and six months ended January 31, 2018, the Company recorded expense associated with performance-based awards of \$1.0 million and \$3.7 million, respectively. For the three and six months ended January 31, 2017, the Company recorded expense associated with performance-based awards of \$0.3 million and \$0.5 million, respectively.

The following table summarizes stock option activity during the six months ended January 31, 2018:

	Options Outstanding	Weighted Average Exercise Price
Outstanding as of July 31, 2017	6,685,551	\$ 32.60
Granted	877,050	\$ 45.69
Exercised	(530,916)	\$ 26.32
Canceled	(21,193)	\$ 37.60
Outstanding as of January 31, 2018	7,010,492	\$ 34.70

The total intrinsic value of options exercised during the six months ended January 31, 2018 and 2017 was \$11.8 million and \$8.6 million, respectively. The weighted average fair value for options granted during the six months ended January 31, 2018 and 2017 was \$9.29 and \$10.09 per share, respectively.

The following table summarizes information concerning outstanding and exercisable options as of January 31, 2018:

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price of Outstanding Options	Number Exercisable	Weighted Average Exercise Price of Exercisable Options
\$ 0.00 to \$22.69	983,883	1.54	\$ 19.68	983,883	\$ 19.68
\$22.70 to \$28.69	861,049	7.86	\$ 28.06	567,606	\$ 28.05
\$28.70 to \$34.69	1,383,480	3.92	\$ 31.64	1,366,082	\$ 31.64
\$34.70 to \$40.69	1,380,549	5.64	\$ 37.03	1,370,383	\$ 37.03
\$40.70 and above	2,401,531	8.34	\$ 43.65	947,730	\$ 42.39
	7,010,492	5.92	\$ 34.70	5,235,684	\$ 32.36

As of January 31, 2018, the aggregate intrinsic value of options outstanding and exercisable was \$111.9 million and \$95.8 million, respectively.

As of January 31, 2018, there was \$9.9 million of total unrecognized compensation expense related to non-vested stock options granted under the 2010 Master Stock Incentive Plan. This unvested expense is expected to be recognized during fiscal years 2018, 2019, 2020 and 2021.

Note 8. Employee Benefit Plans

The Company and certain of its international subsidiaries have defined benefit pension plans. There are two types of U.S. plans. The first type of U.S. plan (Hourly Pension Plan) is a traditional defined benefit pension plan primarily for union employees. The second plan (Salaried Pension Plan) is for some salaried and non-union production employees that provides defined benefits pursuant to a cash balance feature whereby a participant accumulates a benefit comprised of a percentage of current salary that varies with years of service, interest credits and transition credits. The Company no longer allows entrants into the U.S. Salaried Pension Plan and the employees in this plan no longer continue to accrue Company contribution credits under the plan. Employees are instead eligible for a 3% annual Company retirement contribution to their 401(k) in addition to the Company's normal 401(k) match. The non-U.S. plans generally provide pension benefits based on years of service and compensation level.

Net periodic benefit costs for the Company's pension plans include the following components (in millions):

	Three Months Ended January 31, 2018		Six Months Ended January 31, 2018	
	2017	2018	2017	2018
Net periodic benefit costs:				
Service cost	\$2.1	\$2.0	\$4.1	\$4.1
Interest cost	3.7	3.4	7.4	6.7
Expected return on assets	(6.6)	(6.6)	(13.1)	(13.2)
Prior service cost amortization	0.2	0.2	0.3	0.4
Actuarial loss amortization	1.1	1.8	2.3	3.6
Net periodic benefit costs	\$0.5	\$0.8	\$1.0	\$1.6

The Company's general funding policy for its pension plans is to make at least the minimum contributions as required by applicable regulations. Additionally, the Company may elect to make additional contributions up to the maximum tax deductible contribution. For the six months ended January 31, 2018, the Company made contributions of \$1.4 million to its U.S. pension plans and \$0.7 million to its non-U.S. pension plans. The estimated minimum funding requirement for the Company's U.S. plans for the year ending July 31, 2018 is \$3.7 million. In accordance with the Pension Protection Act of 2006, this contribution obligation may be met with existing credit balances that resulted from payments above the minimum obligation in prior years. The Company has sufficient credit balances to meet the minimum obligation for fiscal 2018. Due to favorable provisions in the U.S. Tax Cuts and Jobs Act, the Company is considering making additional contributions to one or both of its U.S. pension plans during fiscal 2018. The Company estimates that it will contribute an additional \$0.7 million to its non-U.S. pension plans during the remainder of fiscal 2018 based upon the local government prescribed funding requirements.

Note 9. Income Taxes

On December 22, 2017, the U.S. Tax Cuts and Jobs Act (TCJA) was enacted into law. The TCJA significantly reforms the Internal Revenue Code of 1986, including but not limited to reducing the U.S. federal corporate income tax rate from 35 percent to 21 percent and moving toward a territorial tax system with a one-time transition tax imposed on previously unremitted foreign earnings and profits.

On December 22, 2017, the SEC issued Staff Accounting Bulletin 118 (SAB 118) that includes additional guidance allowing companies to use a measurement period that should not extend beyond one year from the TCJA enactment date to account for the impacts of the law in their financial statements. The Company has accounted for certain income tax effects of the TCJA to the extent a reasonable estimate could be made during the three months ended January 31, 2018.

The most significant impacts of the enacted legislation for the Company's current fiscal year include lowering of the U.S. federal corporate income tax rate, the re-measurement of the Company's net deferred tax assets to reflect their value at the reduced tax rate and the one-time transition tax on the deemed repatriation of certain foreign earnings. The Company's U.S. federal statutory tax rate will be a blended rate of 26.9 percent for fiscal 2018 and 21 percent for fiscal 2019. The Company recorded a discrete tax charge of \$1.4 million during the three months ended January 31, 2018 for the re-measurement of its net deferred tax assets. The Company also recorded a discrete tax charge of \$108.3 million during the period for the one-time transition tax on deemed repatriated earnings of its non-U.S. subsidiaries. This charge is inclusive of U.S. state income tax on the portion of the earnings expected to be repatriated. The one-time transition tax is based on the Company's post-1986 earnings and profits not previously subjected to U.S. taxation. The tax is payable over an eight year period, and the portion not due within 12 months of \$99.4 million is classified within other long-term liabilities in the Condensed Consolidated Balance Sheet as of January 31, 2018. Although the Company made reasonable estimates in accounting for the impacts of the TCJA, these tax charges are provisional, as the Company is still analyzing certain aspects of the legislation and refining calculations as information becomes available during the measurement period as allowed by SAB 118. The accounting for the income tax effects of the TCJA is expected to be completed at fiscal year-end and any future adjustments will be recognized as discrete

income tax expense or benefit in the period the adjustments are determined.

The TCJA also adds many new provisions that do not apply to the Company until fiscal 2019, including the deduction for executive compensation and interest expense, a tax on global intangible low-taxed income (GILTI), the base erosion anti-abuse tax (BEAT) and a deduction for foreign-derived intangible income (FDII). The Company has not made any adjustments in its financial statements related to these new provisions during the three months ended January 31, 2018 and continues to evaluate the future impact of these provisions.

The TCJA moves toward a territorial tax system through the provision of a 100% dividends received deduction for the foreign-source portions of dividends received from controlled foreign subsidiaries. As a result, the Company is in the process of evaluating

its indefinite reinvestment assertions with regard to unremitted earnings for certain of its foreign subsidiaries. As part of this evaluation, the Company will consider estimated global working capital levels, capital investment requirements and the potential tax liabilities that would be incurred if the foreign subsidiaries distribute cash to the U.S. parent and make a determination in the SAB 118 measurement period as to whether earnings of these subsidiaries remain permanently invested or not. If the Company determines that a subsidiary should no longer remain subject to the indefinite reinvestment assertion, additional tax charges will be accrued, including but not limited to state income taxes, withholding taxes and other relevant foreign taxes in the period the conclusion is determined. As of January 31, 2018, the Company has determined that the earnings of certain subsidiaries are no longer subject to the indefinite reinvestment assertion and recorded an immaterial provisional estimate of the withholding taxes due on the repatriation of those earnings. The Company will continue to evaluate its global cash needs and opportunities to repatriate cash as part of an effort to more precisely compute this tax impact.

The Company files income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. With few exceptions, the Company is no longer subject to state and foreign income tax examinations by tax authorities for years before 2008. The United States Internal Revenue Service (IRS) has completed examinations of the Company's U.S. federal income tax returns through 2013. Currently, the Company is under examination by the IRS for fiscal years 2015 and 2016.

As of January 31, 2018, the gross unrecognized tax benefits were \$19.8 million and accrued interest and penalties on these unrecognized tax benefits were \$2.6 million. The Company recognizes accrued interest and penalties related to unrecognized tax benefits in income tax expense. If the Company were to prevail on all unrecognized tax benefits recorded, substantially all of the unrecognized tax benefits would benefit the effective tax rate. With an average statute of limitations of approximately five years, up to \$2.4 million of the unrecognized tax benefits could potentially expire in the next 12-month period, unless extended by an audit.

It is reasonably possible that matters associated with either current or future audits and disputes could cause adjustments to previously recorded reserves in the next 12-month period. Quantification of an estimated range and timing of future audit adjustments cannot be made at this time.

Note 10. Fair Value Measurements

As of January 31, 2018, the carrying values of cash and cash equivalents, accounts receivables, short-term borrowings and trade accounts payable approximate fair value because of the short-term nature of these instruments. As of January 31, 2018, the estimated fair value of long-term debt with fixed interest rates was \$271.8 million compared to its carrying value of \$275.0 million. The fair value is estimated by discounting the projected cash flows using the rate that similar amounts of debt could currently be borrowed. Long-term debt would be classified as Level 2 in the fair value hierarchy. The carrying values of long-term debt with variable interest rates approximate fair value.

Note 11. Shareholders' Equity

The Company's Board of Directors authorized the repurchase of up to 14.0 million shares of common stock under the Company's stock repurchase plan. This repurchase authorization is effective until terminated by the Board of Directors. During the six months ended January 31, 2018, the Company repurchased 1.3 million shares for \$62.9 million. As of January 31, 2018, the Company had remaining authorization to repurchase 5.8 million shares under this plan.

On January 26, 2018, the Company's Board of Directors declared a cash dividend in the amount of 18.0 cents per common share, payable March 6, 2018, to shareholders of record as of February 14, 2018.

Note 12. Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss by component for the three months ended January 31, 2018 and 2017 are as follows (in millions):

	Foreign Currency Translation Adjustment	Pension Benefits	Derivative Financial Instruments	Total
Balance as of October 31, 2017, net of tax	\$ (63.9)	\$ (94.3)	\$ (0.8)	\$ (159.0)
Other comprehensive income (loss) before reclassifications and tax	55.5	—	(0.4)	55.1
Tax benefit	—	—	0.1	0.1
Other comprehensive income (loss) before reclassifications, net of tax	55.5	—	(0.3)	55.2
Reclassifications, before tax	—	0.6	(0.5)	0.1
Tax (expense) benefit	—	(0.4)	0.2	(0.2)
Reclassifications, net of tax	—	0.2 ⁽¹⁾	(0.3) ⁽²⁾	(0.1)
Other comprehensive income (loss), net of tax	55.5	0.2	(0.6)	55.1
Balance as of January 31, 2018, net of tax	\$ (8.4)	\$ (94.1)	\$ (1.4)	\$ (103.9)
Balance as of October 31, 2016, net of tax	\$ (101.7)	\$ (113.4)	\$ 0.5	\$ (214.6)
Other comprehensive (loss) income before reclassifications and tax	(8.4)	—	0.3	(8.1)
Tax expense	—	—	(0.1)	(0.1)
Other comprehensive (loss) income before reclassifications, net of tax	(8.4)	—	0.2	(8.2)
Reclassifications, before tax	—	2.1	(0.7)	1.4
Tax (expense) benefit	—	(0.8)	0.2	(0.6)
Reclassifications, net of tax	—	1.3 ⁽¹⁾	(0.5) ⁽²⁾	0.8
Other comprehensive (loss) income, net of tax	(8.4)	1.3	(0.3)	(7.4)
Balance as of January 31, 2017, net of tax	\$ (110.1)	\$ (112.1)	\$ 0.2	\$ (222.0)

Primarily includes net amortization of prior service costs and actuarial losses included in net periodic benefit cost (1)(see Note 8) that were reclassified from accumulated other comprehensive loss to operating expenses or cost of sales.

(2) Relates to foreign currency cash flow hedges that were reclassified from accumulated other comprehensive loss to other income, net.

Changes in accumulated other comprehensive loss by component for the six months ended January 31, 2018 and 2017 are as follows (in millions):

	Foreign Currency Translation Adjustment	Pension Benefits	Derivative Financial Instruments	Total
Balance as of July 31, 2017, net of tax	\$ (58.8)	\$(95.1)	\$ (3.1)	\$(157.0)
Other comprehensive income before reclassifications and tax	50.4	—	2.0	52.4
Tax expense	—	—	(0.7)	(0.7)
Other comprehensive income before reclassifications, net of tax	50.4	—	1.3	51.7
Reclassifications, before tax	—	1.9	0.6	2.5
Tax expense	—	(0.9)	(0.2)	(1.1)
Reclassifications, net of tax	—	1.0	(1) ⁽¹⁾ 0.4	(2) ⁽²⁾ 1.4
Other comprehensive income, net of tax	50.4	1.0	1.7	53.1
Balance as of January 31, 2018, net of tax	\$ (8.4)	\$(94.1)	\$ (1.4)	\$(103.9)
Balance as of July 31, 2016, net of tax	\$ (89.3)	\$(115.8)	\$ (0.5)	\$(205.6)
Other comprehensive (loss) income before reclassifications and tax	(20.8)	—	1.9	(18.9)
Tax expense	—	—	(0.6)	(0.6)
Other comprehensive (loss) income before reclassifications, net of tax	(20.8)	—	1.3	(19.5)
Reclassifications, before tax	—	5.5	(0.8)	4.7
Tax (expense) benefit	—	(1.8)	0.2	(1.6)
Reclassifications, net of tax	—	3.7	(1) ⁽¹⁾ (0.6)	(2) ⁽²⁾ 3.1
Other comprehensive (loss) income, net of tax	(20.8)	3.7	0.7	(16.4)
Balance as of January 31, 2017, net of tax	\$ (110.1)	\$(112.1)	\$ 0.2	\$(222.0)

Primarily includes net amortization of prior service costs and actuarial losses included in net periodic benefit cost (1)(see Note 8) that were reclassified from accumulated other comprehensive loss to operating expenses or cost of sales.

(2) Relates to foreign currency cash flow hedges that were reclassified from accumulated other comprehensive loss to other income, net.

Note 13. Guarantees

The Company and Caterpillar Inc. equally own the shares of Advanced Filtration Systems Inc. (AFSI), an unconsolidated joint venture, and guarantee certain debt of the joint venture. As of January 31, 2018, AFSI had \$31.2 million of outstanding debt, of which the Company guarantees half. In addition, during the three months ended January 31, 2018 and 2017, the Company recorded earnings from this equity method investment of \$0.4 million and \$0.3 million, respectively. The Company recorded \$0.5 million and \$0.9 million of earnings from this equity method investment during the six months ended January 31, 2018 and 2017, respectively. During the three months ended January 31, 2018 and 2017, the Company recorded royalty income related to AFSI of \$1.7 million and \$1.4 million, respectively, in other expense (income), net. During the six months ended January 31, 2018 and 2017, the Company recorded royalty income related to AFSI of \$3.6 million and \$2.7 million, respectively, in other expense (income), net. As of January 31, 2018 and July 31, 2017, the Company had a contingent liability for standby letters of credit totaling \$8.4 million and \$10.5 million, respectively, that have been issued and are outstanding. The letters of credit guarantee payment to third parties in the event the Company is in breach of contract terms as detailed in each letter of credit. As of January 31, 2018 and July 31, 2017, there were no amounts drawn upon these letters of credit.

Note 14. Commitments and Contingencies

The Company records provisions with respect to identified claims or lawsuits when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Claims and lawsuits are reviewed quarterly and provisions are taken or adjusted to reflect the status of a particular matter. The Company believes the recorded estimated liability in its Condensed Consolidated Financial Statements is adequate in light of the probable and estimable outcomes. The recorded liabilities were not material to the Company's results of operations, liquidity or financial position and the Company believes it is remote that the settlement of any of the currently identified claims or litigation will be materially in excess of what is accrued.

Note 15. Segment Reporting

The Company has identified two reportable segments: Engine Products and Industrial Products. Segment determination is based on the internal organization structure, management of operations and performance evaluation by management and the Company's Board of Directors. Corporate and Unallocated includes corporate expenses determined to be non-allocable to the segments, such as interest income and interest expense.

The Company has an internal measurement system to evaluate performance and allocate resources based on earnings before income taxes. The Company's manufacturing facilities serve both reporting segments. Therefore, the Company uses an allocation methodology to assign costs and assets to the segments. A certain amount of costs and assets relate to general corporate purposes and are not assigned to either segment.

The Company is an integrated enterprise, characterized by substantial intersegment cooperation, cost allocations and sharing of assets. Therefore, the Company does not represent that these segments, if operated independently, would report the earnings before income taxes and other financial information shown below.

Segment detail is summarized as follows (in millions):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2018	2017	2018	2017
Net sales				
Engine Products segment	\$442.4	\$361.9	\$884.5	\$715.7
Industrial Products segment	222.3	188.7	425.0	387.9
Total	\$664.7	\$550.6	\$1,309.5	\$1,103.6

Earnings before income taxes

Engine Products segment	\$54.5	\$48.7	\$118.1	\$94.1
Industrial Products segment	32.2	24.3	62.2	62.6
Corporate and Unallocated	(10.3)	(6.7)	(19.2)	(10.7)
Total	\$76.4	\$66.3	\$161.1	\$146.0

There were no customers that accounted for over 10% of net sales for the three or six months ended January 31, 2018 or 2017. There were no customers that accounted for over 10% of gross accounts receivable as of January 31, 2018 or July 31, 2017.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

The Company is a worldwide manufacturer of filtration systems and replacement parts. The Company's core strengths are leading filtration technology, strong customer relationships and its global presence. Products are manufactured at 44 plants around the world and through three joint ventures.

The Company has two reportable segments: Engine Products and Industrial Products. Products in the Engine Products segment consist of replacement filters for both air and liquid filtration applications, air filtration systems, liquid filtration systems for fuel, lube and hydraulic applications and exhaust and emissions systems. The Engine Products segment sells to original equipment manufacturers (OEMs) in the construction, mining, agriculture, aerospace, defense and truck end markets and to independent distributors, OEM dealer networks, private label accounts and large equipment fleets. Products in the Industrial Products segment consist of dust, fume and mist collectors, compressed air

purification systems, air filtration systems for gas turbines, polytetrafluoroethylene (PTFE) membrane-based products and specialized air and gas filtration systems for applications

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including hard disk drives and semi-conductor manufacturing. The Industrial Products segment sells to various dealers, distributors, OEMs of gas-fired turbines and OEMs and end users requiring clean filtration solutions and replacement filters.

The following Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Company's Condensed Consolidated Financial Statements and Notes included in Item 1 of this report.

Consolidated Results of Operations

Three months ended January 31, 2018 compared with three months ended January 31, 2017

Operating results for the three months ended January 31, 2018 and 2017 are as follows (in millions):

	Three Months Ended January 31,				
	2018	% of sales	2017	% of sales	
Net sales	\$664.7		\$550.6		
Cost of sales	445.8	67.1	% 362.7	65.9	%
Gross profit	218.9	32.9	% 187.9	34.1	%
Operating expenses	137.3	20.6	% 118.5	21.5	%
Operating income	81.6	12.3	% 69.4	12.6	%
Interest expense	5.1	0.8	% 4.8	0.9	%
Other expense (income), net	0.1	—	% (1.7)	(0.3)	%
Earnings before income taxes	76.4	11.5	% 66.3	12.0	%
Income taxes	129.3	19.5	% 19.8	3.6	%
Net (loss) earnings	\$(52.9)	(8.0)	% \$46.5	8.4	%

Net loss for the three months ended January 31, 2018 was \$52.9 million, compared with net earnings of \$46.5 million for the three months ended January 31, 2017, a decrease of \$99.4 million. Included in net loss for the current year quarter is provisional tax charges of \$109.7 million related to TCJA, which was enacted into law during the quarter.

As a result of the TCJA, during the three months ended January 31, 2018, the Company recorded a tax charge of \$1.4 million for the re-measurement of its net deferred tax assets and a tax charge of \$108.3 million for the one-time transition tax on deemed repatriated earnings of its non-U.S. subsidiaries. See Note 9 in the Notes to Condensed Consolidated Financial Statements included in Item 1 of this report for additional information on the impact of TCJA. Net sales for the three months ended January 31, 2018 were \$664.7 million, compared with \$550.6 million for the three months ended January 31, 2017, an increase of \$114.1 million, or 20.7%. Net sales increased \$80.5 million, or 22.3%, in the Engine Products segment and increased \$33.6 million, or 17.7%, in the Industrial Products segment compared with the same period in the prior fiscal year. Refer to the Segment Results of Operations section for further discussion on the Engine Products and Industrial Products segments. Net sales for the three months ended January 31, 2018 were positively impacted by foreign currency translation, which increased net sales by \$25.6 million compared with the same period in the prior fiscal year.

Cost of sales for the three months ended January 31, 2018 was \$445.8 million, compared with \$362.7 million for the three months ended January 31, 2017, an increase of \$83.1 million, or 22.9%. Gross margin for the current year quarter was 32.9%, compared with 34.1% during the same period in the prior fiscal year. The decrease in gross margin resulted from selling an unfavorable mix of products and higher supply chain and raw material costs.

Operating expenses for the three months ended January 31, 2018 were \$137.3 million, compared with \$118.5 million for the three months ended January 31, 2017, an increase of \$18.8 million, or 15.8%. As a percent of net sales, operating expenses for the current year quarter were 20.6%, compared with 21.5% during the same period in the prior fiscal year. The decrease in operating expenses as a percentage of sales was primarily driven by expense leverage gained on increasing sales, partially offset by higher incentive compensation expense.

Other expense (income), net for the three months ended January 31, 2018 was \$0.1 million of expense, compared with \$1.7 million of income for the three months ended January 31, 2017, a decrease of \$1.8 million. The decrease was primarily due to higher losses on foreign exchange of \$2.9 million in the current year quarter compared with the prior year quarter. Interest expense was \$5.1 million for the three months ended January 31, 2018, compared with \$4.8 million for the three months ended January 31, 2017, an increase of \$0.3 million, or 6.8%. The increase was due to an

increase in the average level of debt outstanding in the current year quarter compared with the prior year quarter. The effective tax rate for the three months ended January 31, 2018 was 169.2%, compared with 29.8% for the three months ended January 31, 2017. Excluding the impact of the TCJA one-time adjustments, the effective tax rate for the three months ended

January 31, 2018 was 25.7%, compared with 29.8% for the three months ended January 31, 2017. The decrease was primarily due to \$2.2 million of excess tax benefits on stock-based compensation expense resulting from the adoption of ASU 2016-09 (refer to Note 1 in the Notes to Condensed Consolidated Financial Statements included in Item 1 of this report for further discussion of the new accounting standard), and the net impact of the TCJA enactment, which decreased the Company's base effective tax rate by 1.1 percentage points. The net impact of the TCJA enactment reflects a benefit from the reduced U.S. corporate income tax rate that is partially offset by a negative impact from foreign withholding tax and other matters related to the TCJA.

Six months ended January 31, 2018 compared with six months ended January 31, 2017

Operating results for the six months ended January 31, 2018 and 2017 are as follows (in millions):

	Six Months Ended January 31,				
	2018	% of sales	2017	% of sales	
Net sales	\$1,309.5		\$1,103.6		
Cost of sales	866.3	66.2	% 721.5	65.4	%
Gross profit	443.2	33.8	% 382.1	34.6	%
Operating expenses	270.9	20.7	% 236.3	21.4	%
Operating income	172.3	13.2	% 145.8	13.2	%
Interest expense	10.3	0.8	% 9.6	0.9	%
Other expense (income), net	0.9	0.1	% (9.8) (0.9)%
Earnings before income taxes	161.1	12.3	% 146.0	13.2	%
Income taxes	153.1	11.7	% 41.5	3.8	%
Net earnings	\$8.0	0.6	% \$104.5	9.5	%

Net earnings for the six months ended January 31, 2018 was \$8.0 million, compared with net earnings of \$104.5 million for the six months ended January 31, 2017, a decrease of \$96.5 million. Included in net loss for the current year period is provisional tax charges of \$109.7 million related to TCJA, which was enacted into law during the period. As a result of the TCJA, during the six months ended January 31, 2018 the Company recorded a tax charge of \$1.4 million for the re-measurement of its net deferred tax assets and a tax charge of \$108.3 million for the one-time transition tax on deemed repatriated earnings of its non-U.S. subsidiaries. See Note 9 in the Notes to Condensed Consolidated Financial Statements included in Item 1 of this report for additional information on the impact of TCJA. Net sales for the six months ended January 31, 2018 were \$1,309.5 million, compared with \$1,103.6 million for the six months ended January 31, 2017, an increase of \$205.9 million, or 18.7%. Net sales increased \$168.8 million, or 23.6%, in the Engine Products segment and increased \$37.1 million, or 9.6%, in the Industrial Products segment compared with the same period in the prior fiscal year. Refer to the Segment Results of Operations section for further discussion on the Engine Products and Industrial Products segments. Net sales for the six months ended January 31, 2018 were positively impacted by foreign currency translation, which increased net sales by \$35.1 million compared with the same period in the prior fiscal year.

Cost of sales for the six months ended January 31, 2018 was \$866.3 million, compared with \$721.5 million for the six months ended January 31, 2017, an increase of \$144.8 million, or 20.1%. Gross margin for the current year quarter was 33.8%, compared with 34.6% during the same period in the prior fiscal year. The decrease in gross margin resulted from selling an unfavorable mix of products and higher supply chain and raw material costs, partially offset by improved fixed cost absorption on higher sales than the prior year.

Operating expenses for the six months ended January 31, 2018 were \$270.9 million, compared with \$236.3 million for the six months ended January 31, 2017, an increase of \$34.6 million, or 14.6%. As a percent of net sales, operating expenses for the current year quarter were 20.7%, compared with 21.4% during the same period in the prior fiscal year. The decrease in operating expenses as a percentage of sales was primarily driven by expense leverage gained on increasing sales, partially offset by higher incentive compensation costs.

Other expense (income), net for the six months ended January 31, 2018 was \$0.9 million of expense, compared with \$9.8 million of income for the six months ended January 31, 2017, a decrease of \$10.7 million. The decrease was primarily due to \$6.8 million of income recognized in the prior year period that was related to a favorable settlement of claims associated with general representations and warranties in connection with the Company's acquisition of

Northern Technical. The decrease is also due to \$4.7 million of higher losses on foreign exchange in the current period compared with the prior period. Interest expense was \$10.3 million for the six months ended January 31, 2018, compared with \$9.6 million for the six months ended January 31, 2017, an increase of \$0.7 million, or 7.9%. The increase was due to an increase in the average level of debt outstanding in the current year period compared with the prior year period.

The effective tax rate for the six months ended January 31, 2018 was 95.0%, compared with 28.4% for the six months ended January 31, 2017. Excluding the impact of the TCJA one-time adjustments, the effective tax rate for the six months ended January 31, 2018 was 26.9%, compared with 28.4% for the six months ended January 31, 2017. The decrease was primarily due to \$3.5 million of excess tax benefits on stock-based compensation expense resulting from the adoption of ASU 2016-09 (refer to Note 1 in the Notes to Condensed Consolidated Financial Statements included in Item 1 of this report for further discussion of the new accounting standard), and the net impact of the TCJA enactment, which decreased the Company's base effective tax rate by 1.1 percentage points. The decrease in the effective tax rate for the six months ended January 31, 2018 was partially offset by an unfavorable shift in the mix of earnings between tax jurisdictions, which increased the Company's base effective tax rate by 1.7 percentage points.

Segment Results of Operations

Net sales and earnings before income taxes for the Engine Products and Industrial Products segments are summarized as follows (in millions):

	Three Months Ended		Six Months Ended	
	January 31, 2018	January 31, 2017	January 31, 2018	January 31, 2017
Net sales:				
Engine Products segment	\$442.4	\$361.9	\$884.5	\$715.7
Industrial Products segment	222.3	188.7	425.0	387.9
Total	\$664.7	\$550.6	\$1,309.5	\$1,103.6
Earnings before income taxes:				
Engine Products segment	\$54.5	\$48.7	\$118.1	\$94.1
Industrial Products segment	32.2	24.3	62.2	62.6
Corporate and Unallocated ⁽¹⁾	(10.3)	(6.7)	(19.2)	(10.7)
Total	\$76.4	\$66.3	\$161.1	\$146.0

⁽¹⁾ Corporate and Unallocated includes corporate expenses determined to be non-allocable to the segments, such as interest income and expense.

Engine Products Segment

The following is a summary of net sales by product group within the Company's Engine Products segment (in millions):

	Three Months Ended		Six Months Ended	
	January 31, 2018	January 31, 2017	January 31, 2018	January 31, 2017
Engine Products segment:				
Off-Road	\$78.9	\$57.6	\$153.9	\$112.4
On-Road	35.2	23.3	68.5	49.9
Aftermarket	303.5	256.6	612.6	504.2
Aerospace and Defense	24.8	24.4	49.5	49.2
Total Engine Products segment	\$442.4	\$361.9	\$884.5	\$715.7

Engine Products segment earnings before income taxes \$54.5 \$48.7 \$118.1 \$94.1

Net sales for the Engine Products segment for the three months ended January 31, 2018 were \$442.4 million, compared with \$361.9 million for the three months ended January 31, 2017, an increase of \$80.5 million, or 22.3%. Of this increase, \$15.1 million is attributable to foreign currency translation. The increase in Engine Products sales was driven by increases in Aftermarket of 18.3%, Off-Road of 37.0%, On-Road of 50.6% and Aerospace and Defense of 2.0%. Within Aftermarket, sales increased in all major regions as the Company benefited from improving market conditions and end-user demand and growth in innovative product categories, including both air and liquid filtration

products. Additionally, Aftermarket sales included approximately \$8.5 million of incremental sales from the Company's acquisition of Hy-Pro. The increase in Off-Road sales was driven by further strengthening of market conditions across all regions for heavy-duty off-road equipment production. The increase in On-Road sales reflects increasing production of heavy-duty trucks compared with depressed sales in the prior year, primarily in the U.S., combined with

benefits from new customer agreements. Sales within Aerospace and Defense were mixed, with an increase in sales of Aerospace products being partially offset by declining sales in Defense ground vehicles.

Net sales for the Engine Products segment for the six months ended January 31, 2018 were \$884.5 million, compared with \$715.7 million for the six months ended January 31, 2017, an increase of \$168.8 million, or 23.6%. Of this increase, \$21.3 million is attributable to foreign currency translation. The increase in Engine Products sales was driven by increases in Aftermarket of 21.5%, Off-Road of 37.0%, On-Road of 37.3% and Aerospace and Defense of 0.8%.

Within Aftermarket, sales increased in all major regions as the Company benefited from improving market conditions and end-user demand and growth in innovative product categories, including both air and liquid filtration products.

Additionally, Aftermarket sales included approximately \$17.2 million of incremental sales from the Company's acquisitions of Partmo and Hy-Pro. The increase in Off-Road sales was driven by further strengthening of market conditions across all regions for heavy-duty off-road equipment production. The increase in On-Road sales reflects increasing production of heavy-duty trucks compared with depressed sales in the prior year, primarily in the U.S., combined with benefits from new customer agreements. Sales within Aerospace and Defense were mixed, with an increase in sales of Aerospace products being partially offset by declining sales in Defense ground vehicles.

Earnings before income taxes for the Engine Products segment for the three months ended January 31, 2018 were \$54.5 million, or 12.3% of Engine Products' sales, a decrease from 13.5% for the three months ended January 31, 2017. The decrease is primarily due to selling an unfavorable mix of products and higher supply chain and raw material costs, partially offset by operating expense leverage on higher sales than the prior year.

Earnings before income taxes for the Engine Products segment for the six months ended January 31, 2018 were \$118.1 million, or 13.4% of Engine Products' sales, an increase from 13.1% for the six months ended January 31, 2017. Improved cost absorption on higher sales than the prior year drove the improvement, which was partially offset by higher raw material costs and incremental costs related to meeting higher-than-expected demand.

Industrial Products Segment

The following is a summary of net sales by product group within the Company's Industrial Products segment (in millions):

	Three Months Ended January 31, 2018		Six Months Ended January 31, 2017	
Industrial Products segment:				
Industrial Filtration Solutions	\$145.1	\$127.8	\$279.6	\$254.2
Gas Turbine Systems	33.0	21.2	59.3	53.7
Special Applications	44.2	39.7	86.1	80.0
Total Industrial Products segment	\$222.3	\$188.7	\$425.0	\$387.9

Industrial Products segment earnings before income taxes \$32.2 \$24.3 \$62.2 \$62.6

Net sales for the Industrial Products segment for the three months ended January 31, 2018 were \$222.3 million, compared with \$188.7 million for the three months ended January 31, 2017, an increase of \$33.6 million, or 17.7%. Of this increase, \$10.5 million is attributable to foreign currency translation. The increase in Industrial Products sales was driven by increases in Industrial Filtration Solutions of 13.4%, Gas Turbine Systems of 55.7% and Special Applications of 11.3%. The increase in Industrial Filtration Solutions sales was driven by growth in sales of both new equipment and replacement parts, reflecting some stabilization in the global markets combined with the Company's efforts to proactively manage the replacement cycle for its large customer base and grow its business in under-penetrated existing and new markets. The increase in Special Applications sales was widespread. Sales of disk drive filters increased, reflecting temporary moderation in the secular declining hard disk drive market combined with share gains with certain customers, sales of Membrane products improved following a sharp decline in the prior year quarter, and sales of Integrated Venting Solutions are benefitting from the Company's efforts to increase its product assortment and further penetrate new markets. The increase in Gas Turbine Systems sales was expected and reflects comparing against soft sales in the prior year quarter, particularly in first-fit, combined with continued strength in

sales of replacement parts.

Net sales for the Industrial Products segment for the six months ended January 31, 2018 were \$425.0 million, compared with \$387.9 million for the six months ended January 31, 2017, an increase of \$37.1 million, or 9.6%. Of this increase, \$13.8 million is attributable to foreign currency translation. The increase in Industrial Products sales was driven by increases in Industrial Filtration Solutions of 10.0%, Special Applications of 7.6% and Gas Turbine Systems of 10.5%. The increase in Industrial Filtration Solutions sales was driven by growth in sales of both new equipment and replacement parts, reflecting some stabilization in the global markets combined with the Company's efforts to proactively manage the replacement cycle for its large customer base and

grow its business in under-penetrated existing and new markets. The increase in Special Applications sales was widespread. Sales of disk drive filters increased, reflecting temporary moderation in the secular declining hard disk drive market combined with share gains with certain customers, sales of Membrane products improved following a decline in the prior year, and sales of Integrated Venting Solutions are benefitting from the Company's efforts to increase its product assortment and further penetrate new markets. The increase in Gas Turbine Systems sales was expected and reflects comparing against soft sales in the prior year period combined with continued strength in sales of replacement parts. While sales increased for the three month period, the first-fit sales within Gas Turbine Systems continue to be impacted by the Company's strategic decision to be more selective in pursuing new large-turbine projects combined with lower demand for new project installations and customer delays at project sites.

Earnings before income taxes for the Industrial Products segment for the three months ended January 31, 2018 were \$32.2 million, or 14.5% of Industrial Products' sales, an increase from 12.9% for the three months ended January 31, 2017. The earnings before income taxes percentage increase was primarily driven by selling a more favorable mix of products and expense leverage on higher sales than the prior year, partially offset by higher raw material costs.

Earnings before income taxes for the Industrial Products segment for the six months ended January 31, 2018 were \$62.2 million, or 14.6% of Industrial Products' sales, a decrease from 16.1% for the six months ended January 31, 2017. The earnings before income taxes percentage decrease was primarily driven by the \$6.8 million of income recognized in the prior year period that was related to a favorable settlement of claims associated with general representations and warranties in connection with the Company's acquisition of Northern Technical, partially offset by selling a more favorable mix of products and expense leverage on higher sales than the prior year.

Liquidity and Capital Resources

Cash provided by operating activities for the six months ended January 31, 2018 was \$109.8 million, compared with \$169.5 million for the six months ended January 31, 2017, a decrease in cash generated from operating activities of \$59.7 million. This decrease is primarily the result of changes in working capital associated with higher levels of sales and expected demand, as cash flows provided by accounts receivable decreased by \$35.1 million and cash flows used in inventories increased by \$11.7 million between the periods.

Cash used in investing activities for the six months ended January 31, 2018 was \$45.0 million, compared with \$35.9 million for the six months ended January 31, 2017. The increase in cash used in investing activities of \$9.1 million resulted from an increase in capital expenditures of \$20.8 million to expand capacity and invest in technology, partially offset by a decrease in net cash used for acquisitions of \$11.7 million.

Cash used in financing activities for the six months ended January 31, 2018 was \$22.6 million, compared with \$76.7 million for the six months ended January 31, 2017. The decrease in cash used in financing activities of \$54.1 million was primarily driven by an increase in cash provided by long-term debt of \$80.3 million, partially offset by a decrease in cash provided by short-term borrowings of \$16.1 million and an increase in cash used to purchase treasury stock of \$11.1 million.

Cash and cash equivalents as of January 31, 2018 were \$362.2 million, compared with \$308.4 million as of July 31, 2017. As of January 31, 2018, the Company had \$442.9 million available under existing credit facilities. The Company believes that the combination of existing cash, available credit under existing credit facilities and the expected cash generated by operating activities will be adequate to meet cash requirements for the next twelve months, including debt repayments and pension funding, payment of anticipated dividends, possible share repurchase activity, potential acquisitions and capital expenditures.

Accounts receivable, net as of January 31, 2018 were \$509.9 million, compared with \$497.7 million as of July 31, 2017, an increase of \$12.2 million. Days sales outstanding were 69 days as of January 31, 2018 and 67 days as of July 31, 2017. Days sales outstanding is calculated using the count back method, which calculates the number of days of most recent revenue that is reflected in the net accounts receivable balance. These increases were driven by the impact of foreign exchange translation.

Inventories, net as of January 31, 2018 were \$344.9 million, compared with \$293.5 million as of July 31, 2017, an increase of \$51.4 million. Inventory turns were 5.4 times per year as of January 31, 2018, compared to 6.1 times per year as of July 31, 2017. Inventory turns are calculated by taking the annualized cost of sales based on the trailing three-month period divided by the average of the beginning and ending net inventory values of the three-month

period. These changes were primarily driven by increases across the regions to meet current and expected customer demand given the sales momentum.

Long-term debt outstanding was \$667.7 million as of January 31, 2018, compared with \$537.3 million as of July 31, 2017, an increase of \$130.4 million. This increase is primarily to fund share repurchases and dividends and to support working capital needs associated with the higher levels of sales. In addition, during the period, \$50.0 million of current maturities of long-term debt was refinanced into long-term debt. As of January 31, 2018, long-term debt represented 44.7% of total long-term capital, defined as long-term debt plus total shareholders' equity, compared with 38.6% as of July 31, 2017.

The Company guarantees 50% of certain debt of its joint venture, AFSI, as further discussed in Note 13 in the Notes to Condensed Consolidated Financial Statements included in Item 1 of this report.

New Accounting Standards Not Yet Adopted

For new accounting standards not yet adopted, refer to Note 1 in the Notes to Condensed Consolidated Financial Statements included in Item 1 of this report.

Critical Accounting Policies

There have been no material changes to the Company's critical accounting policies as disclosed in the Company's Annual Report on Form 10-K for the year ended July 31, 2017.

SAFE HARBOR STATEMENT UNDER THE SECURITIES REFORM ACT OF 1995

The Company, through its management, may make forward-looking statements reflecting the Company's current views with respect to future events and financial performance. These forward-looking statements, which may be included in reports filed under the Securities Exchange Act of 1934, as amended (the Exchange Act), in press releases and in other documents and materials as well as in written or oral statements made by or on behalf of the Company, are subject to certain risks and uncertainties, including those discussed in Part I, Item 1A, "Risk Factors" of the Company's Annual Report on Form 10-K for the year ended July 31, 2017, which could cause actual results to differ materially from historical results or those anticipated. The words or phrases "will likely result," "are expected to," "will continue," "will allow," "estimate," "project," "believe," "expect," "anticipate," "forecast" and similar expressions are intended to identify forward-looking statements within the meaning of Section 21e of the Exchange Act and Section 27A of the Securities Act of 1933, as amended, as enacted by the Private Securities Litigation Reform Act of 1995 (PSLRA). In particular, the Company desires to take advantage of the protections of the PSLRA in connection with the forward-looking statements made in this Quarterly Report on Form 10-Q. All statements other than statements of historical fact are forward-looking statements. These statements do not guarantee future performance.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date such statements are made. In addition, the Company wishes to advise readers that the factors listed in Part I, Item 1A, "Risk Factors" of the Company's Annual Report on Form 10-K for the year ended July 31, 2017, as well as other factors, could affect the Company's performance and could cause the Company's actual results for future periods to differ materially from any opinions or statements expressed. These factors include, but are not limited to, world economic and industrial market conditions; the Company's ability to maintain certain competitive advantages over competitors; pricing pressures; the Company's ability to protect and enforce its intellectual property rights; the Company's dependence on global operations; customer concentration in certain cyclical industries; commodity availability and pricing; the Company's ability to develop new information technology systems and maintain and upgrade existing systems; information security and data breaches; foreign currency fluctuations; governmental laws and regulations; changes in tax laws, regulations and results of examinations; the Company's ability to attract and retain key personnel; changes in capital and credit markets; execution of the Company's acquisition strategy; the possibility of asset impairment; execution of restructuring plans; the Company's ability to maintain an effective system of internal control over financial reporting and other factors included in Part I, Item 1A, "Risk Factors" of the Company's Annual Report on Form 10-K for the year ended July 31, 2017. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless required by law.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in the reported market risk of the Company since July 31, 2017. See further discussion of these market risks in the Company's Annual Report on Form 10-K for the year ended July 31, 2017.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Management of the Company, with the participation of its Chief Executive Officer and the Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures as of the end of the period. Based on their evaluation, as of the end of the period covered, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) were effective. The Company's disclosure controls and

procedures are designed so that information required to be disclosed by the issuer in the reports that it files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and

forms, and that such information is accumulated and communicated to management of the Company, with the participation of its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

No change in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended) occurred during the fiscal quarter ended January 31, 2018, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company believes the recorded estimated liability in its Condensed Consolidated Financial Statements for claims or litigation is adequate in light of the probable and estimable outcomes. Any recorded liabilities were not material to the Company's financial position, results of operations or liquidity and the Company believes it is remote that the settlement of any of the currently identified claims or litigation will be materially in excess of what is accrued. The Company records provisions when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Claims and litigation are reviewed quarterly and provisions are taken or adjusted to reflect the status of a particular matter.

Item 1A. Risk Factors

There are inherent risks and uncertainties associated with the Company's global operations that involve the manufacturing and sale of products for highly demanding customer applications throughout the world. These risks and uncertainties could adversely affect the Company's operating performances or financial condition. The "Risk Factors" section in the Company's Annual Report on Form 10-K for the fiscal year ended July 31, 2017 outlines the risks and uncertainties that the Company believes are the most material to its business.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Repurchases of Equity Securities

The following table summarizes information in connection with purchases made by, or on behalf of, the Company or any affiliated purchaser of the Company, of shares of the Company's common stock during the three months ended January 31, 2018:

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Be Purchased Under the Plans or Programs
November 1 - November 30, 2017	—	\$ —	—	6,241,152
December 1 - December 31, 2017	—	—	—	6,241,152
January 1 - January 31, 2018	400,000	50.55	400,000	5,841,152
Total	400,000	\$ 50.55	400,000	5,841,152

The Board of Directors has authorized the repurchase of up to 14.0 million shares of the Company's common stock. This repurchase authorization is effective until terminated by the Board of Directors. There were no repurchases of common stock made outside of the Company's current repurchase authorization during the three months ended (1) January 31, 2018. While not considered repurchases of shares, the Company does at times withhold shares that would otherwise be issued under stock-based awards to cover the withholding of taxes due as a result of exercising stock options or payment of stock-based awards.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item Exhibits
6.

*3-A – Restated Certificate of Incorporation of Registrant as currently in effect (Filed as Exhibit 3-A to Form 10-Q Report for the second quarter ended January 31, 2012)

*3-B – Amended and Restated Bylaws of Registrant, dated as of July 29, 2016 (Filed as Exhibit 3-C to Form 8-K Report filed on July 29, 2016)

*4 – **

10-A – Compensation Plan for Non-Employee Directors

10-B – Form of Non-Employee Director Restricted Stock Unit Award Agreement under the 2010 Master Stock Incentive Plan

10-C – Form of Non-Employee Director Non-Qualified Stock Option Award Agreement under the 2010 Master Stock Incentive Plan

31-A – Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31-B – Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 – Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101 – The following information from the Donaldson Company, Inc. Quarterly Report on Form 10-Q for the fiscal quarter ended January 31, 2018, as filed with the Securities and Exchange Commission, formatted in Extensible Business Reporting Language (XBRL): (i) the Condensed Consolidated Statements of (Loss) Earnings, (ii) the Condensed Consolidated Balance Sheets, (iii) the Condensed Consolidated Statements of Comprehensive Income, (iv) the Condensed Consolidated Statements of Cash Flows and (v) the Notes to Condensed Consolidated Financial Statements.

* Exhibit has previously been filed with the Securities and Exchange Commission and is incorporated herein by reference as an exhibit.

Pursuant to the provisions of Regulation S-K Item 601(b)(4)(iii)(A), copies of instruments defining the rights of

**holders of certain long-term debts of the Registrant and its subsidiaries are not filed and in lieu thereof the Registrant agrees to furnish a copy thereof to the Securities and Exchange Commission upon request.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DONALDSON
COMPANY,
INC.
(Registrant)

Date: March 9, 2018 By: /s/ Tod E. Carpenter
Tod E. Carpenter
Chairman, President and
Chief Executive Officer
(duly authorized officer)

Date: March 9, 2018 By: /s/ Scott J. Robinson
Scott J. Robinson
Senior Vice President and
Chief Financial Officer
(principal financial officer)

Date: March 9, 2018 By: /s/ Melissa A. Osland
Melissa A. Osland
Corporate Controller
(principal accounting officer)