

DONALDSON CO INC
Form 10-Q
March 01, 2012

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, 2012 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 (I.R.S. Employer
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, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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 – 74,463,429 shares as of January 31, 2012.

PART I. FINANCIAL INFORMATION**Item 1. Financial Statements****DONALDSON COMPANY, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS**

(Thousands of dollars, except share and per share amounts)
(Unaudited)

	Three Months Ended		Six Months Ended	
	January 31,		January 31,	
	2012	2011	2012	2011
Net sales	\$580,883	\$537,105	\$1,189,178	\$1,074,014
Cost of sales	380,066	347,562	773,427	696,381
Gross margin	200,817	189,543	415,751	377,633
Operating expenses	126,049	122,102	250,656	235,689
Operating income, net	74,768	67,441	165,095	141,944
Interest expense	2,899	2,936	6,069	6,589
Other income, net	(4,550)	(3,502)	(9,410)	(4,609)
Earnings before income taxes	76,419	68,007	168,436	139,964
Income taxes	22,598	23,428	46,062	42,251
Net earnings	\$53,821	\$44,579	\$122,374	\$97,713
Weighted average shares - basic	75,052,805	77,580,064	75,154,873	77,375,086
Weighted average shares - diluted	76,412,785	78,977,509	76,480,673	78,766,895
Net earnings per share - basic	\$0.72	\$0.57	\$1.63	\$1.26
Net earnings per share - diluted	\$0.70	\$0.56	\$1.60	\$1.24
Dividends paid per share	\$0.150	\$0.130	\$0.300	\$0.255

See Notes to Condensed Consolidated Financial Statements.

DONALDSON COMPANY, INC. AND SUBSIDIARIES**CONDENSED CONSOLIDATED BALANCE SHEETS**

(Thousands of dollars, except share amounts)
(Unaudited)

	January 31, 2012	July 31, 2011
Assets		
Current assets		
Cash and cash equivalents	\$ 180,930	\$ 273,494
Short-term investments	91,385	—
Accounts receivable, less allowance of \$6,671 and \$6,908	408,462	445,700
Inventories	270,212	271,476
Prepays and other current assets	78,697	75,912
Total current assets	\$ 1,029,686	\$ 1,066,582
Property, plant and equipment, at cost	944,494	945,874
Less accumulated depreciation	(561,537)	(554,372)
Property, plant and equipment, net	382,957	391,502
Goodwill	165,745	171,741
Intangible assets, net	49,543	53,496
Other assets	53,458	42,772
Total assets	\$ 1,681,389	\$ 1,726,093
Liabilities and shareholders' equity		
Current liabilities		
Short-term borrowings	\$ 92,728	\$ 13,129
Current maturities of long-term debt	2,356	47,871
Trade accounts payable	190,076	215,918
Other current liabilities	176,030	219,326
Total current liabilities	461,190	496,244
Long-term debt	205,217	205,748
Deferred income taxes	8,000	11,196
Other long-term liabilities	91,569	78,194
Total liabilities	765,976	791,382
Shareholders' equity		
Preferred stock, \$1.00 par value, 1,000,000 shares authorized, none issued	—	—
Common stock, \$5.00 par value, 240,000,000 shares authorized, 88,643,194 shares issued	443,216	443,216
Retained earnings	1,027,986	925,542
Stock compensation plans	23,966	24,736
Accumulated other comprehensive income (loss)	(27,988)	40,027

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Treasury stock at cost, 14,089,307 and 13,245,864 shares at January 31, 2012 and July 31, 2011, respectively	(551,767)	(498,810)
Total shareholders' equity	915,413	934,711
Total liabilities and shareholders' equity	\$1,681,389	\$1,726,093

See Notes to Condensed Consolidated Financial Statements.

DONALDSON COMPANY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Thousands of dollars)
(Unaudited)

	Six Months Ended January 31,	
	2012	2011
Operating Activities		
Net earnings	\$122,374	\$97,713
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	30,896	30,478
Changes in operating assets and liabilities	(43,485)	(19,947)
Tax benefit of equity plans	(7,576)	(7,445)
Stock compensation plan expense	6,440	6,089
Deferred taxes	(4,904)	5,784
Other, net	(1,547)	(19,612)
Net cash provided by operating activities	102,198	93,060
Investing Activities		
Net expenditures on property and equipment	(36,349)	(24,051)
Purchase of short-term investments	(93,455)	(66,494)
Acquisitions and divestitures	—	3,613
Net cash used in investing activities	(129,804)	(86,932)
Financing Activities		
Purchase of treasury stock	(73,558)	(6,491)
Proceeds from settlement of interest rate swap	—	4,710
Repayments of long-term debt	(45,917)	(5,294)
Change in short-term borrowings	79,369	(20,670)
Dividends paid	(22,342)	(19,542)
Tax benefit of equity plans	7,576	7,445
Exercise of stock options	9,791	12,113
Net cash used in financing activities	(45,081)	(27,729)
Effect of exchange rate changes on cash	(19,877)	9,236
Decrease in cash and cash equivalents	(92,564)	(12,365)
Cash and cash equivalents, beginning of year	273,494	232,000
Cash and cash equivalents, end of period	\$180,930	\$219,635

See Notes to Condensed Consolidated Financial Statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**Note A – 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 of America (U.S. 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 presentation have been included and are of a normal recurring nature. Operating results for the three and six month periods ended January 31, 2012 are not necessarily indicative of the results that may be expected for future periods. The year-end condensed balance sheet data was derived from audited financial statements but does not include all disclosures required by U.S. GAAP. For further information, refer to the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended July 31, 2011.

Note B – Short-Term Investments

Classification of the Company's investments as current or non-current is dependent upon management's intended holding period, the investment's maturity date and liquidity considerations based on market conditions. If management intends to hold the investments for longer than one year as of the balance sheet date, they are classified as non-current.

All short-term investments are certificates of deposit and have original maturities in excess of three months but not more than twelve months. There were no short-term investments as of July 31, 2011.

Note C – Inventories

The components of inventory as of January 31, 2012 and July 31, 2011 are as follows (thousands of dollars):

	January 31, 2012	July 31, 2011
Materials	\$112,153	\$110,466
Work in process	34,524	33,917
Finished products	123,535	127,093
Total inventories	\$270,212	\$271,476

As of January 31, 2012 and July 31, 2011, the Company had obsolete inventory reserves of \$13.7 million and \$14.5 million, respectively.

Note D – Accounting for Stock-Based Compensation

Stock-based employee compensation cost is recognized using the fair-value based method for all awards. The Company determined the fair value of its option awards using the Black-Scholes option pricing model. The following assumptions were used to value the options, including reload options which generally have a shorter contractual life, granted during the six months ended January 31, 2012: range of 1 year to 8 years expected life; expected volatility range of 25.8 percent to 31.9 percent; risk-free interest rate range of 0.10 percent to 1.80 percent; and annual dividend yield of 1.0 percent. The expected life selected for options granted during the period represents the period of time that the options are expected to be outstanding based on the contractual life and historical data of option holder exercise and termination behavior. Expected volatilities are based upon historical volatility of the Company's stock over a period at least equal to the expected life of each option grant. Option grants are priced at the fair market value of the Company's stock on the date of grant. The weighted average fair value for options granted during the six months ended January 31, 2012 and 2011 was \$18.86 per share and \$17.26 per share, respectively. For the three and six months ended January 31, 2012, the Company recorded pretax compensation expense associated with stock options of \$4.3 million and \$5.1 million, respectively, and recorded \$1.6 million and \$1.9 million of related tax benefit. For the three and six months ended January 31, 2011, the Company recorded pretax compensation expense associated with stock options of \$4.0 million and \$4.8 million, respectively, and recorded \$1.5 million and \$1.8 million of related tax benefit.

The following table summarizes stock option activity during the six months ended January 31, 2012:

	Options Outstanding	Weighted Average Exercise Price
Outstanding at July 31, 2011	4,193,997	\$ 35.44
Granted	530,164	69.48
Exercised	(525,497)	22.36
Canceled	(8,078)	50.40
Outstanding at January 31, 2012	4,190,586	41.36

The total intrinsic value of options exercised during the six months ended January 31, 2012 and 2011 was \$22.3 million and \$24.9 million, respectively.

The following table summarizes information concerning outstanding and exercisable options as of January 31, 2012:

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 17 to \$25	274,150	0.86	\$ 17.84	274,150	\$ 17.84
\$25 to \$33	1,288,309	2.73	30.65	1,288,309	30.65
\$33 to \$41	807,027	5.68	35.53	801,294	35.54
\$41 to \$49	797,904	7.11	43.55	711,208	43.70
\$49 and above	1,023,196	9.17	64.04	204,501	59.46
	4,190,586	5.58	41.36	3,279,462	35.40

At January 31, 2012, the aggregate intrinsic value of options outstanding and exercisable was \$126.8 million and \$118.7 million, respectively.

As of January 31, 2012, there was \$10.9 million of total unrecognized compensation cost related to non-vested stock options granted under the 2001 and 2010 Master Stock Incentive Plans. This unvested cost is expected to be recognized during the remainder of Fiscal Years 2012, 2013, 2014, and 2015.

Note E – Net Earnings Per Share

The Company's basic net earnings per share is computed by dividing net earnings by the weighted average number of outstanding common shares. The Company's diluted net earnings per share is computed by dividing net earnings by the weighted average number of outstanding common shares and common equivalent shares relating to stock options and stock incentive plans. Certain outstanding options were excluded from the diluted net earnings per share calculations because their exercise prices were greater than the average market price of the Company's common stock during those periods. For the three and six months ended January 31, 2012, there were 522,186 options and 526,915 options excluded from the diluted net earnings per share calculation, respectively. For the three and six months ended January 31, 2011, there were 495,533 options and 505,396 options excluded from the diluted net earnings per share calculation, respectively.

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

	Three Months Ended		Six Months Ended	
	January 31,		January 31,	
	2012	2011	2012	2011
Weighted average shares - basic	75,053	77,580	75,155	77,375
Common share equivalents	1,360	1,398	1,326	1,392
Weighted average shares - diluted	76,413	78,978	76,481	78,767
Net earnings for basic and diluted earnings per share computation	\$53,821	\$44,579	\$122,374	\$97,713
Net earnings per share - basic	\$0.72	\$0.57	\$1.63	\$1.26
Net earnings per share - diluted	\$0.70	\$0.56	\$1.60	\$1.24

Note F – Shareholders’ Equity

The Company reports accumulated other comprehensive income (loss) as a separate item in the shareholders’ equity section of the balance sheet.

Total comprehensive income and its components are as follows (thousands of dollars):

	Three Months Ended		Six Months Ended	
	January 31,		January 31,	
	2012	2011	2012	2011
Net earnings	\$53,821	\$44,579	\$122,374	\$97,713
Foreign currency translation gain (loss)	(29,143)	(3,670)	(63,081)	32,102
Currency realization upon sale of business	—	(101)	—	(101)
Net gain on hedging derivatives, net of deferred taxes	9	389	427	134
Pension and postretirement liability adjustment, net of deferred taxes	9,888	1,444	(5,361)	1,303
Total comprehensive income	\$34,575	\$42,641	\$54,359	\$131,151

Total accumulated other comprehensive income (loss) and its components at January 31, 2012 and July 31, 2011 are as follows (thousands of dollars):

	January 31, 2012	July 31, 2011
Foreign currency translation adjustment	\$68,618	\$131,699

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Net loss on hedging derivatives, net of deferred taxes	807	380
Pension and postretirement liability, net of deferred taxes	(97,413)	(92,052)
Total accumulated other comprehensive income (loss)	\$(27,988)	\$40,027

The Company's Board of Directors authorized the repurchase of 8.0 million shares of common stock on March 26, 2010. During the three months ended January 31, 2012 the Company did not repurchase any shares. During the six months ended January 31, 2012 the Company repurchased 1,375,513 shares for \$73.6 million at an average price of \$53.48 per share. As of January 31, 2012, the Company had remaining authorization to repurchase up to 3.7 million shares pursuant to the current authorization.

At the Company's Annual Meeting of Stockholders on November 18, 2011, the shareholders approved an increase in the number of authorized shares of common stock, par value \$5.00, from 120,000,000 to 240,000,000 and the total number of shares of stock which the Company has the authority to issue from 121,000,000 to 241,000,000.

On January 27, 2012, the Company's Board of Directors declared a cash dividend in the amount of \$0.16 per common share, payable to stockholders of record on February 17, 2012. The dividend will be paid on March 9, 2012. On the same date, the Company announced that its Board of Directors also declared a two-for-one stock split effected in the form of a 100 percent stock dividend. The stock split will be distributed March 23, 2012, to stockholders of record as of March 2, 2012. Earnings and dividends declared per share and weighted average shares outstanding are presented in this Form 10-Q before the effect of the 100 percent stock dividend.

Note G – Segment Reporting

The Company has two reportable segments, Engine Products and Industrial Products, that have been identified based on the Company's internal organization structure, management of operations, and performance evaluation. Corporate and Unallocated includes corporate expenses determined to be non-allocable to the segments and interest income and expense. 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 operating profit and other financial information shown below. Segment detail is summarized as follows (thousands of dollars):

	Engine Products	Industrial Products	Corporate & Unallocated	Total Company
Three Months Ended January 31, 2012:				
Net sales	\$370,834	\$210,049	\$ —	\$580,883
Earnings before income taxes	48,418	30,597	(2,596)) 76,419
Three Months Ended January 31, 2011:				
Net sales	\$331,122	\$205,983	\$ —	\$537,105
Earnings before income taxes	44,203	29,127	(5,323)) 68,007