



Donaldson
FILTRATION SOLUTIONS

Donaldson Company, Inc. 2010 SHAREHOLDERS' LETTER

"We know that together we have emerged from our trials leaner, stronger, and more determined."

— Frank Donaldson, Jr. (1983)

DEAR SHAREHOLDERS,

Frank wrote this after our Company went through a particularly challenging time – the recessions of the early 1980s. We have just emerged from a similarly trying period.

But what a difference a year makes! At this time last year, we were deep in the midst of the recession and unsure whether we had yet seen the bottom. As I wrote in last year's letter, we anticipated a modest recovery in our business during the 2nd half of our FY10.

I am happy to report that things turned out better than we had expected. Some of our early cycle businesses, including all of our replacement filter businesses and Special Applications, began to recover first. Then our mid cycle businesses, including our Engine Off-Road and On-Road Products, began to improve. Finally, our later cycle businesses, Dust Collection and Gas Turbine Systems (which had been our heroes in FY09), stabilized or began showing signs of an upturn. We experienced a steady recovery in our overall revenue with each quarter of FY10 performing sequentially higher than the previous quarter.

In addition, we saw an even more dramatic improvement in our operating performance. As a result of a relentless focus on our *Continuous Improvement* initiatives, we established new gross and operating margin records of 35.1% and 12.7%, respectively.

While our sales for the full year were still below our peak levels of FY08, we delivered Earnings Per Share (EPS) of \$2.10, the second best year in our history and only two cents less than our FY08 record of \$2.12. And we delivered the \$2.10 of EPS on sales which were about \$350 million less than FY08. This may be the best indication of how well our Company is now running and how well we are positioned to grow both sales and profits in the future.

Investments, New Products, and Technology Advances

While we prioritized our work as we navigated through the recession, we continued to invest in long-term projects



Our Gurgaon, India, Air Filter Plant

critical to our future. During the past year, we expanded our operation in India and completed a new Technical Center on our Leuven, Belgium, campus that greatly enhances our European product development capabilities.

Additionally, we continued our focus on the rapid introduction of new filtration technologies and products which benefit our business in two ways:

- 1. Improving the value and filtration performance for our Customers' new equipment, and**
- 2. Helping our Customers (and us) retain their future replacement filter business.**



Engineers testing liquid filters at our new Technical Center in Leuven, Belgium



Our PowerCore and PowerCore G2 filtration technology is used by leading on-road and off-road equipment manufacturers worldwide

A Torit PowerCore system installed at a concrete plant

Some of our Engine Product highlights include the shipment of our 10 millionth Generation 1 PowerCore® filter. We also began full-scale production of our Generation 2 PowerCore filter, another breakthrough which offers even better performance and value than Generation 1. Our PowerCore innovation continues as we are now building prototypes of Generation 3.

will significantly increase the performance and mission capability of these vehicles while reducing maintenance work for our soldiers.

We have also realized tremendous success with PowerCore in our Industrial Products. Recently, we announced the sale of the 1,000th Torit® PowerCore system. These breakthrough dust collectors offer our Customers a much smaller and higher performance system, better value, and much easier maintenance.

In our Special Applications business, we have leveraged the microfiltration technology in our Disk Drive filters and combined it with our Ultra-Web technology and chemical filtration expertise to develop a new line of vent filters. These filters are now being introduced in diverse applications, including colostomy bags for the medical market.

In addition to PowerCore, we launched other innovations in air filtration. One example is in our Gas Turbine business with a new static air filtration system. We introduced this product during FY10, and we have already sold more than 10 systems totaling over \$10 million.

Historically our Company has been primarily focused on air filtration; this is where Frank Donaldson, Sr. started in 1915. However, in recent years, we have significantly upgraded our capabilities and investments in liquid filtration, specifically targeting hydrocarbon-based liquids such as engine fuel and lubricants, as well as hydraulic system fluids in mobile vehicles, industrial equipment, and aerospace applications. Due to more demanding requirements in the market, improved filtration is required by our Customers for their vehicles and equipment. As a result, we have released a new line of liquid filtration products based on our new Synteq® XP media. During FY10, we set a new record with liquid filtration sales of over \$340 million.

In our Aerospace & Defense business, we introduced our Pulse Jet Air Cleaner (PJAC) Ultra™ product line using our Ultra-Web® fine fiber technology. This new product extends our Pulse Jet technology (which has become the standard for the U.S. Army main battle tank) into light- and medium-duty tactical vehicles. The PJAC Ultra

In addition to introducing new technologies and products, we have also continued to expand our geographic



Our new Wave air filters are used in static gas turbine filter systems

PJAC Ultra using our Ultra-Web fine fiber technology

Our microfiltration technology is also used for venting filters in colostomy bags



We are a major supplier of diesel fuel, lube and hydraulic filters

footprint – we want to be everywhere our current and new Customers need our capabilities. With the investments we have made in the fast growing emerging regions, we set new sales records in South Africa, Mexico, Brazil, Australia, India, China, and South Korea.

Looking Forward

In a major update to our Strategic Plan, we looked at all of our market opportunities with a fresh perspective. We involved many of our people from around the world and at multiple levels of our organization.

We began with a review of the overall filtration market. We estimate the overall market size is \$50 billion, with the portion we can target with our products and technologies at \$20 billion. The “good news” is that this means we have only a 10% share of our target market so there is plenty of room for us to grow. We also reaffirmed our assessment that the filtration market continues to grow faster than global GDP – yet another reason why we are optimistic about our future growth opportunities.

Our new Strategic Plan provides the roadmap for where and how we will achieve our new growth goals over the next decade. Our growth goals are to achieve sales of **\$3 billion in FY16** and then **\$5 billion in FY21**. We plan to accomplish this the same way we did between FY90 and FY08 – mostly through organic growth opportunities with new products and in new geographies, and then supplementing our portfolio of filtration businesses with

“bolt on” acquisitions. We will also work to expand our operating margins as we grow our sales line, thereby establishing new earnings records each and every year.

We are planning major investments to support our Strategic Plan. We will add significant resources and capabilities in Europe, Latin America, China, and in other parts of Asia. We are increasing our technology and product investments for liquid filtration. We have initiated a Supply Chain project to improve the global support for our Customers. During FY11, we plan to increase our R&D spending by 12% to \$50 million and our capital investment budget by 75% to \$75 million.

As we execute our Strategic Plan, our goal for FY11 and each fiscal year thereafter is a new EPS record driven by sales growth and our focus on operational excellence through *Continuous Improvement*. Prior to the recession, we established new earnings records for 19 consecutive years, and we will begin again in FY11.

Thanks

I would like to thank an incredible team of Donaldson Employees for their dedication to serving our Customers through a very challenging period and for making our Company even stronger. To further quote Frank Jr. (1983), “We know that our employees have responded magnificently to the extraordinary challenges of the past two years and have emerged with strength and dedication as we reach for new goals.” Our Employees all around the world turned in another outstanding performance in FY10.

I would also like to thank our Customers for the opportunity to satisfy their filtration needs and to add value to their products. We sincerely appreciate their business.

And finally, I would like to thank you, our Shareholders, for your continued confidence and support.

Sincerely,

Bill Cook, Chairman, President and CEO



Safe Harbor Statement

The Company desires to take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 (the “Act”) and is making this cautionary statement in connection with such safe harbor legislation. Some of the information provided in this annual report constitutes forward-looking statements which reflect the Company’s current views with respect to future events and financial performance, but involve uncertainties that could significantly impact results. All forecasts and projections are “forward-looking” statements and are based on management’s current expectations of the Company’s near-term results. There can be no assurance that actual results will not differ materially from its expectations. For a more detailed explanation of the safe harbor statement and the risks, see the Company’s Form 10-K filed with the SEC.

FIVE-YEAR COMPARISON OF RESULTS

July 31, 2010

(dollars in millions, except share and per share amounts)

	2010	2009	2008	2007	2006
Operating Results					
Net Sales	\$1,877	\$1,869	\$2,233	\$1,919	\$1,694
Gross margin percentage	35.1%	31.6%	32.5%	31.5%	32.8%
Operating income percentage	12.7%	9.1%	11.0%	11.0%	11.4%
Net earnings	\$ 166	\$ 132	\$ 172	\$ 151	\$ 132
Return on average shareholders' equity	23.2%	18.5%	25.2%	25.7%	24.7%
Return on investment	17.1%	14.2%	20.6%	21.5%	20.8%
Shareholder information (Adjusted for splits)					
Net earnings per share - assuming dilution	\$ 2.10	\$ 1.67	\$ 2.12	\$ 1.83	\$ 1.55
Dividends paid per share	\$0.470	\$0.455	\$0.420	\$0.360	\$0.320
Shares outstanding (millions)	76.3	77.3	77.5	79.0	80.5
Common stock price range, per share					
High	\$48.21	\$49.00	\$52.33	\$38.97	\$36.00
Low	\$32.60	\$21.82	\$34.40	\$31.83	\$28.60

CORPORATE OFFICERS

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Senior Vice President, Industrial Products

JAY L. WARD, 46
Senior Vice President, Engine Products

FRANKLIN G. CARDENAS, 42
Vice President, Global Engine Aftermarket

TOD E. CARPENTER, 51
Vice President, Europe and Middle East

PEGGY A. HERRMANN, 54
Vice President, Disk Drive
and Microelectronics

DENNIS D. JANDIK, 56
Vice President, Global Engine OEM Sales

SANDRA N. JOPPA, 45
Vice President, Human Resources

JOSEPH E. LEHMAN, 55
Vice President, Global Operations

NORMAN C. LINNELL, 51
Vice President, General Counsel,
and Secretary

MARY LYNNE PERUSHEK, 52
Vice President, Chief Information Officer

DAVID W. TIMM, 57
Vice President, Asia Pacific

THOMAS R. VERHAGE, 57
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DEBRA L. WILFONG, 55
Vice President, Chief Technology Officer

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Fastenal Company, Winona, MN

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A.O. Smith Corporation, Milwaukee, WI

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Chairman and CEO
C. H. Robinson Worldwide, Inc.,
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