DONALDSON CO INC
Form 10-Q
June 03, 2013

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

# FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED APRIL 30, 2013 OR

o 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) | (I.R.S. Employer 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. x Yes o 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). x Yes o 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 x | Accelerated filer o |
| Non-accelerated filer o<br>(Do not check if a smaller reporting company) | Smaller reporting company o |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).o Yes x 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 146,949,730 shares as of April 30, 2013.

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 April 30, | | Nine Months Ended April 30, | |
|---|---|---|---|---|
| | **2013** | **2012** | **2013** | **2012** |
| Net sales | $ 619,371 | $ 647,237 | $ 1,804,354 | $ 1,836,415 |
| Cost of sales | 397,870 | 419,008 | 1,185,583 | 1,192,435 |
| Gross margin | 221,501 | 228,229 | 618,771 | 643,980 |
| Operating expenses | 122,914 | 129,792 | 375,455 | 380,448 |
| Operating income | 98,587 | 98,437 | 243,316 | 263,532 |
| Other income | (3,608) | (4,340) | (11,962) | (13,750) |
| Interest expense | 2,719 | 2,787 | 8,275 | 8,856 |
| Earnings before income taxes | 99,476 | 99,990 | 247,003 | 268,426 |
| Income taxes | 29,634 | 29,044 | 72,235 | 75,106 |
| Net earnings | $ 69,842 | $ 70,946 | $ 174,768 | $ 193,320 |
| Weighted average shares - basic | 148,136,620 | 150,536,631 | 148,404,503 | 150,385,389 |
| Weighted average shares - diluted | 150,234,445 | 153,207,471 | 150,591,003 | 153,067,148 |
| Net earnings per share - basic | $ 0.47 | $ 0.47 | $ 1.18 | $ 1.29 |
| Net earnings per share - diluted | $ 0.46 | $ 0.46 | $ 1.16 | $ 1.26 |
| Dividends paid per share | $ 0.100 | $ 0.080 | $ 0.280 | $ 0.230 |

See Notes to Condensed Consolidated Financial Statements.

**DONALDSON COMPANY, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

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

| | April 30, 2013 | July 31, 2012 |
|---|---|---|
| **Assets** | | |
| Current assets | | |
| Cash and cash equivalents | $ 263,988 | $ 225,789 |
| Short-term investments | 65,700 | 92,362 |
| Accounts receivable, less allowance of $7,128 and $6,418 | 437,414 | 438,796 |
| Inventories | 240,476 | 256,116 |
| Prepaids and other current assets | 65,752 | 72,599 |
| Total current assets | 1,073,330 | 1,085,662 |
| Property, plant, and equipment, at cost | 1,020,391 | 949,619 |
| Less accumulated depreciation | (607,570) | (564,710) |
| Property, plant, and equipment, net | 412,822 | 384,909 |
| Goodwill | 165,511 | 162,949 |
| Intangible assets, net | 42,596 | 46,200 |
| Other assets | 63,349 | 50,362 |
| Total assets | $ 1,757,608 | $ 1,730,082 |
| **Liabilities and shareholders equity** | | |
| Current liabilities | | |
| Short-term borrowings | $ 30,000 | $ 95,147 |
| Current maturities of long-term debt | 82,002 | 2,346 |
| Trade accounts payable | 178,028 | 199,182 |
| Other current liabilities | 167,802 | 201,848 |
| Total current liabilities | 457,832 | 498,523 |
| Long-term debt | 119,079 | 203,483 |
| Deferred income taxes | 5,326 | 4,611 |
| Other long-term liabilities | 93,838 | 113,451 |
| Total liabilities | 676,075 | 820,068 |
| **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, 151,643,194 shares issued | 758,216 | 758,216 |
| Retained earnings | 499,808 | 366,788 |
| Stock compensation plans | 21,401 | 24,948 |
| Accumulated other comprehensive loss | (40,926) | (101,888) |
| Treasury stock at cost, 4,585,928 and 3,980,832 shares at April 30, 2013 and July 31, 2012, respectively | (156,967) | (138,050) |
| Total shareholders equity | 1,081,533 | 910,014 |
| Total liabilities and shareholders equity | $ 1,757,608 | $ 1,730,082 |

See Notes to Condensed Consolidated Financial Statements.

**DONALDSON COMPANY, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**(Thousands of dollars)**
**(Unaudited)**

| | Three Months Ended April 30, 2013 | Three Months Ended April 30, 2012 | Nine Months Ended April 30, 2013 | Nine Months Ended April 30, 2012 |
|---|---|---|---|---|
| Net earnings | $ 69,842 | $ 70,946 | $ 174,768 | $ 193,320 |
| Foreign currency translation gain (loss) | (13,563) | 5,689 | 29,401 | (57,392) |
| Gain (loss) on hedging derivatives, net of deferred taxes of ($72), $145, ($269), and ($169), respectively | 13 | (448) | 144 | (21) |
| Pension and postretirement liability adjustment, net of deferred taxes of ($7,682), ($4,978), ($14,963), and ($9,219), respectively | 16,214 | 8,810 | 31,417 | 3,449 |
| Total comprehensive income | $ 72,506 | $ 84,997 | $ 235,730 | $ 139,356 |

See Notes to Condensed Consolidated Financial Statements.

**DONALDSON COMPANY, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(Thousands of dollars)**
**(Unaudited)**

| | Nine Months Ended April 30, 2013 | Nine Months Ended April 30, 2012 |
|---|---|---|
| **Operating Activities** | | |
| Net earnings | $ 174,768 | $ 193,320 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation and amortization | 48,527 | 46,214 |
| Changes in operating assets and liabilities | (8,346) | (43,836) |
| Tax benefit of equity plans | (9,483) | (9,698) |
| Stock compensation plan expense | 7,363 | 8,624 |
| Deferred taxes | (4,037) | 4,214 |
| Other, net | 8,597 | (16,437) |
| Net cash provided by operating activities | 217,389 | 182,401 |
| **Investing Activities** | | |
| Net expenditures on property, plant, and equipment | (69,425) | (57,987) |
| Change in short-term investments | 30,781 | (119,930) |
| Net cash used in investing activities | (38,644) | (177,917) |
| **Financing Activities** | | |
| Purchase of treasury stock | (60,975) | (82,573) |
| Repayments of long-term debt | (1,093) | (46,084) |
| Change in short-term borrowings | (66,530) | 70,519 |
| Dividends paid | (41,184) | (34,277) |
| Tax benefit of equity plans | 9,483 | 9,698 |
| Exercise of stock options | 12,131 | 12,345 |
| Net cash used in financing activities | (148,168) | (70,372) |
| Effect of exchange rate changes on cash | 7,622 | (18,586) |
| Increase (Decrease) in cash and cash equivalents | 38,199 | (84,474) |
| Cash and cash equivalents, beginning of year | 225,789 | 273,494 |
| Cash and cash equivalents, end of period | $ 263,988 | $ 189,020 |

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.) (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 nine month periods ended April 30, 2013, 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, 2012.

Note B Short-Term Investments

All short-term investments are time deposits and have original maturities in excess of three months but not more than twelve months. The Company had $65.7 million and $92.4 million in short-term investments as of April 30, 2013 and July 31, 2012, respectively.

Note C Inventories

The components of inventory as of April 30, 2013 and July 31, 2012 are as follows (thousands of dollars):

| | April 30, 2013 | July 31, 2012 |
|---|---|---|
| Materials | $ 101,528 | $ 111,808 |
| Work in process | 32,847 | 30,767 |
| Finished products | 106,101 | 113,541 |
| Total inventories | $ 240,476 | $ 256,116 |

Note D Accounting for Stock-Based Compensation

Stock-based compensation expense is recognized using the fair-value method for all awards. In addition to granting stock options, the Company also granted reload options related to options previously granted which were exercised during the nine months ended April 30, 2013. A reload stock option is granted for the number of shares tendered as payment for the exercise price and tax withholding obligation upon the exercise of a stock option with a reload provision. The exercise price of the reload option is equal to the market price of the stock on the date of grant and the reload option will expire on the same date as the original option which was exercised. 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 nine months ended April 30, 2013: range of less than 1 year to 8 years expected life; expected volatility range of 23.4 percent to 29.7 percent; risk-free interest rate range of 0.02 percent to 1.68 percent; and annual dividend yield of 1.0 percent. The expected life 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 have exercise prices equivalent to the fair market value of the Company s stock on the date of grant. The weighted average fair value for options granted during the nine months ended April 30, 2013 and 2012 was $8.37 per share and $9.38 per share, respectively. For the three and nine months ended April 30, 2013, the Company recorded pre-tax stock option expense of $1.4 million and $6.9 million, respectively, and recorded $0.4 million and $2.2 million, respectively, of related tax benefit. For the three and nine months ended April 30, 2012, the Company recorded pre-tax stock option expense of $1.3 million and $6.4 million, respectively, and recorded $0.4 million and $2.1 million, respectively, of related tax benefit.

The following table summarizes stock option activity during the nine months ended April 30, 2013:

| | **Options Outstanding** | **Weighted Average Exercise Price** |
|---|---|---|
| Outstanding at July 31, 2012 | 8,056,327 | $ 20.97 |
| Granted | 934,436 | 33.84 |
| Exercised | (1,314,912) | 14.48 |
| Canceled | (78,726) | 34.07 |
| Outstanding at April 30, 2013 | 7,597,125 | 23.54 |

The total intrinsic value of options exercised during the nine months ended April 30, 2013 and 2012 was $27.5 million and $27.6 million, respectively.

The following table summarizes information concerning outstanding and exercisable options as of April 30, 2013:

| **Range of Exercise Prices** | **Number Outstanding** | **Weighted Average Remaining Contractual Life (Years)** | **Weighted Average Exercise Price** | **Number Exercisable** | **Weighted Average Exercise Price** |
|---|---|---|---|---|---|
| $0.00 to $15.89 | 1,402,473 | 1.37 | $ 15.27 | 1,402,473 | $ 15.27 |
| $15.90 to $20.89 | 1,955,461 | 4.04 | 17.44 | 1,955,461 | 17.44 |
| $20.90 to $25.89 | 1,391,656 | 5.99 | 21.78 | 1,391,656 | 21.78 |
| $25.90 to $30.89 | 918,849 | 7.61 | 29.15 | 608,544 | 29.16 |
| $30.90 and above | 1,928,686 | 8.73 | 34.33 | 429,773 | 34.80 |
| | 7,597,125 | 5.53 | 23.54 | 5,787,907 | 20.48 |

At April 30, 2013, the aggregate intrinsic value of options outstanding and exercisable was $97.6 million and $92.0 million, respectively.

As of April 30, 2013, there was $8.9 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 the remainder of Fiscal Years 2013, 2014, 2015, and 2016.

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 share equivalents 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 nine months ended April 30, 2013, there were 29,800 options and 80,486 options excluded from the diluted net earnings per share calculation, respectively. For the three and nine months ended April 30, 2012, there were 11,606 options and 1,061,741 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 April 30, | | Nine Months Ended April 30, | |
|---|---|---|---|---|
| | **2013** | **2012** | **2013** | **2012** |
| Weighted average shares - basic | 148,137 | 150,537 | 148,405 | 150,385 |
| Common share equivalents | 2,097 | 2,670 | 2,186 | 2,682 |
| Weighted average shares - diluted | 150,234 | 153,207 | 150,591 | 153,067 |
| Net earnings for basic and diluted earnings per share computation | $ 69,842 | $ 70,946 | $ 174,768 | $ 193,320 |
| Net earnings per share - basic | $ 0.47 | | | |

Historical Closing Levels of the Underliers

The closing levels of the underliers have fluctuated in the past and may, in the future, experience significant fluctuations. Any historical upward or downward trend in the closing level of any underlier during the period shown below is not an indication that such index is more or less likely to increase or decrease at any time during the life of your notes.

You should not take the historical closing levels of an underlier as an indication of the future performance of an underlier. We cannot give you any assurance that the future performance of any underlier or the underlier stocks will result in you receiving the outstanding face amount of your notes on the stated maturity date.

Neither we nor any of our affiliates make any representation to you as to the performance of the underliers. Before investing in the offered notes, you should consult publicly available information to determine the relevant underlier levels between the date of this pricing supplement and the date of your purchase of the offered notes. The actual performance of an index over the life of the offered notes, as well as the cash settlement amount at maturity may bear little relation to the historical levels shown below.

The graphs below show the daily historical closing levels of each underlier from October 29, 2008 through October 29, 2018. We obtained the levels in the graphs below from Bloomberg Financial Services, without independent verification. Although the official closing levels of the Russell 2000® Index are published to six decimal places by the underlier sponsor, Bloomberg Financial Services reports the levels of the Russell 2000® Index to fewer decimal places.

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Historical Performance of the S&P 500® Index

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Historical Performance of the Russell 2000® Index



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SUPPLEMENTAL DISCUSSION OF U.S. FEDERAL INCOME TAX CONSEQUENCES

The following section supplements the discussion of U.S. federal income taxation in the accompanying prospectus supplement.

The following section is the opinion of Sidley Austin llp, counsel to GS Finance Corp. and The Goldman Sachs Group, Inc. In addition, it is the opinion of Sidley Austin llp that the characterization of the notes for U.S. federal income tax purposes that will be required under the terms of the notes, as discussed below, is a reasonable interpretation of current law.

This section does not apply to you if you are a member of a class of holders subject to special rules, such as:

- a dealer in securities or currencies;
- a trader in securities that elects to use a mark-to-market method of accounting for your securities holdings;
- a bank;
- a life insurance company;
- a tax exempt organization;
- a partnership;
- a regulated investment company;
- an accrual method taxpayer subject to special tax accounting rules as a result of its use of financial statements;
- a person that owns a note as a hedge or that is hedged against interest rate risks;
- a person that owns a note as part of a straddle or conversion transaction for tax purposes; or
- a United States holder (as defined below) whose functional currency for tax purposes is not the U.S. dollar.

Although this section is based on the U.S. Internal Revenue Code of 1986, as amended, its legislative history, existing and proposed regulations under the Internal Revenue Code, published rulings and court decisions, all as currently in effect, no statutory, judicial or administrative authority directly addresses how your notes should be treated for U.S. federal income tax purposes, and as a result, the U.S. federal income tax consequences of your investment in your notes are uncertain. Moreover, these laws are subject to change, possibly on a retroactive basis.

You should consult your tax advisor concerning the U.S. federal income tax and any other applicable tax consequences of your investments in the notes, including the application of state, local or other tax laws and the possible effects of changes in federal or other tax laws.

United States Holders

This section applies to you only if you are a United States holder that holds your notes as a capital asset for tax purposes. You are a United States holder if you are a beneficial owner of each of your notes and you are:

- a citizen or resident of the United States;
- a domestic corporation;
- an estate whose income is subject to U.S. federal income tax regardless of its source; or
- a trust if a United States court can exercise primary supervision over the trust’s administration and one or more United States persons are authorized to control all substantial decisions of the trust.

Tax Treatment. You will be obligated pursuant to the terms of the notes — in the absence of a change in law, an administrative determination or a judicial ruling to the contrary — to characterize your notes for all tax purposes as pre-paid derivative contracts in respect of the underliers. Except as otherwise stated below, the discussion herein assumes that the notes will be so treated.

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Upon the sale, exchange or maturity of your notes, you should recognize capital gain or loss equal to the difference, if any, between the amount of cash you receive at such time and your tax basis in your notes. Your tax basis in the notes will generally be equal to the amount that you paid for the notes. If you hold your notes for more than one year, the gain or loss generally will be long-term capital gain or loss. If you hold your notes for one year or less, the gain or loss generally will be short-term capital gain or loss. Short-term capital gains are generally subject to tax at the marginal tax rates applicable to ordinary income.

No statutory, judicial or administrative authority directly discusses how your notes should be treated for U.S. federal income tax purposes. As a result, the U.S. federal income tax consequences of your investment in the notes are uncertain and alternative characterizations are possible. Accordingly, we urge you to consult your tax advisor in determining the tax consequences of an investment in your notes in your particular circumstances, including the application of state, local or other tax laws and the possible effects of changes in federal or other tax laws.

Alternative Treatments. There is no judicial or administrative authority discussing how your notes should be treated for U.S. federal income tax purposes. Therefore, the Internal Revenue Service might assert that a treatment other than that described above is more appropriate. For example, the Internal Revenue Service could treat your notes as a single debt instrument subject to special rules governing contingent payment debt instruments. Under those rules, the amount of interest you are required to take into account for each accrual period would be determined by constructing a projected payment schedule for the notes and applying rules similar to those for accruing original issue discount on a hypothetical noncontingent debt instrument with that projected payment schedule. This method is applied by first determining the comparable yield – i.e., the yield at which we would issue a noncontingent fixed rate debt instrument with terms and conditions similar to your notes – and then determining a payment schedule as of the issue date that would produce the comparable yield. These rules may have the effect of requiring you to include interest in income in respect of your notes prior to your receipt of cash attributable to that income.

If the rules governing contingent payment debt instruments apply, any gain you recognize upon the sale, exchange or maturity of your notes would be treated as ordinary interest income. Any loss you recognize at that time would be ordinary loss to the extent of interest you included as income in the current or previous taxable years in respect of your notes, and, thereafter, capital loss.

If the rules governing contingent payment debt instruments apply, special rules would apply to a person who purchases notes at a price other than the adjusted issue price as determined for tax purposes.

It is also possible that your notes could be treated in the manner described above, except that any gain or loss that you recognize at maturity would be treated as ordinary gain or loss. You should consult your tax advisor as to the tax consequences of such characterization and any possible alternative characterizations of your notes for U.S. federal income tax purposes.

It is possible that the Internal Revenue Service could seek to characterize your notes in a manner that results in tax consequences to you that are different from those described above. You should consult your tax advisor as to the tax consequences of any possible alternative characterizations of your notes for U.S. federal income tax purposes.

Possible Change in Law

On December 7, 2007, the Internal Revenue Service released a notice stating that the Internal Revenue Service and the Treasury Department are actively considering issuing guidance regarding the proper U.S. federal income tax treatment of an instrument such as the offered notes, including whether holders should be required to accrue ordinary income on a current basis and whether gain or loss should be ordinary or capital. It is not possible to determine what guidance they will ultimately issue, if any. It is possible, however, that under such guidance, holders of the notes will ultimately be required to accrue income currently and this could be applied on a retroactive basis. The Internal Revenue Service and the Treasury Department are also considering other relevant issues, including whether foreign holders of such instruments should be subject to withholding tax on any deemed income accruals and whether the special "constructive ownership rules" of Section 1260 of the Internal Revenue Code might be applied to such instruments. Holders are urged to consult their tax advisors concerning the significance, and the potential impact, of the above considerations.

Except to the extent otherwise provided by law, we intend to continue treating the notes for U.S. federal income tax purposes in accordance with the treatment described above under "Tax Treatment" unless and until such time as Congress, the Treasury Department or the Internal Revenue Service determine that some other treatment is more appropriate. You are urged to consult your tax advisor as to the possibility that any legislative or administrative action may adversely affect the tax treatment and the value of your notes.

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Furthermore, in 2007, legislation was introduced in Congress that, if enacted, would have required holders that acquired instruments such as your notes after the bill was enacted to accrue interest income over the term of such instruments even though there will be no interest payments over the term of such instruments. It is not possible to predict whether a similar or identical bill will be enacted in the future, or whether any such bill would affect the tax treatment of your notes.

It is impossible to predict what any such legislation or administrative or regulatory guidance might provide, and whether the effective date of any legislation or guidance will affect notes that were issued before the date that such legislation or guidance is issued. You are urged to consult your tax advisor as to the possibility that any legislative or administrative action may adversely affect the tax treatment of your notes.

Backup Withholding and Information Reporting

Please see the discussion under "United States Taxation — Taxation of Debt Securities — Backup Withholding and Information Reporting—United States Holders" in the accompanying prospectus for a description of the applicability of the backup withholding and information reporting rules to payments made on your notes.

United States Alien Holders

This section applies to you only if you are a United States alien holder. You are a United States alien holder if you are the beneficial owner of notes and are, for U.S. federal income tax purposes:

- a nonresident alien individual;
- a foreign corporation; or
- an estate or trust that in either case is not subject to U.S. federal income tax on a net income basis on income or gain from the notes.

You will be subject to generally applicable information reporting and backup withholding requirements as discussed in the accompanying prospectus under "United States Taxation — Taxation of Debt Securities — Backup Withholding and Information Reporting — United States Alien Holders" with respect to payments on your notes at maturity and, notwithstanding that we do not intend to treat the notes as debt for tax purposes, we intend to backup withhold on such payments with respect to your notes unless you comply with the requirements necessary to avoid backup withholding on debt instruments (in which case you will not be subject to such backup withholding) as set forth under "United States Taxation — Taxation of Debt Securities — United States Alien Holders" in the accompanying prospectus.

As discussed above, alternative characterizations of the notes for U.S. federal income tax purposes are possible. Should an alternative characterization of the notes, by reason of a change or clarification of the law, by regulation or otherwise, cause payments at maturity with respect to the notes to become subject to withholding tax, we will withhold tax at the applicable statutory rate and we will not make payments of any additional amounts. Prospective United States alien holders of the notes should consult their tax advisors in this regard.

Furthermore, on December 7, 2007, the Internal Revenue Service released Notice 2008-2 soliciting comments from the public on various issues, including whether instruments such as your notes should be subject to withholding. It is therefore possible that rules will be issued in the future, possibly with retroactive effect, that would cause payments on your notes at maturity to be subject to withholding, even if you comply with certification requirements as to your foreign status.

In addition, the Treasury Department has issued regulations under which amounts paid or deemed paid on certain financial instruments ("871(m) financial instruments") that are treated as attributable to U.S.-source dividends could be treated, in whole or in part depending on the circumstances, as a "dividend equivalent" payment that is subject to tax at a rate of 30% (or a lower rate under an applicable treaty), which in the case of any amounts you receive upon the sale, exchange or maturity of your notes, could be collected via withholding. If these regulations were to apply to the notes, we may be required to withhold such taxes if any U.S.-source dividends are paid on the stocks included in the underliers during the term of the notes. We could also require you to make certifications (e.g., an applicable Internal Revenue Service Form W-8) prior to the maturity of the notes in order to avoid or minimize withholding obligations, and we could withhold accordingly (subject to your potential right to claim a refund from the Internal Revenue Service) if such certifications were not received or were not satisfactory. If withholding was required, we would not be required to pay any additional amounts with respect to amounts so withheld. These regulations generally will apply to 871(m) financial instruments (or a combination of financial instruments treated as having been entered into in connection with each other) issued (or significantly modified and treated as retired and reissued)

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on or after January 1, 2021, but will also apply to certain 871(m) financial instruments (or a combination of financial instruments treated as having been entered into in connection with each other) that have a delta (as defined in the applicable Treasury regulations) of one and are issued (or significantly modified and treated as retired and reissued) on or after January 1, 2017. In addition, these regulations will not apply to financial instruments that reference a “qualified index” (as defined in the regulations). We have determined that, as of the issue date of your notes, your notes will not be subject to withholding under these rules. In certain limited circumstances, however, you should be aware that it is possible for United States alien holders to be liable for tax under these rules with respect to a combination of transactions treated as having been entered into in connection with each other even when no withholding is required. You should consult your tax advisor concerning these regulations, subsequent official guidance and regarding any other possible alternative characterizations of your notes for U.S. federal income tax purposes.

Foreign Account Tax Compliance Act (FATCA) Withholding

Pursuant to Treasury regulations, Foreign Account Tax Compliance Act (FATCA) withholding (as described in “United States Taxation—Taxation of Debt Securities—Foreign Account Tax Compliance Act (FATCA) Withholding” in the accompanying prospectus) will generally apply to obligations that are issued on or after July 1, 2014; therefore, the notes will generally be subject to FATCA withholding. However, according to published guidance, the withholding tax described above will not apply to payments of gross proceeds from the sale, exchange or other disposition of the notes made before January 1, 2019.

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We have not authorized anyone to provide any information or to make any representations other than those contained or incorporated by reference in this pricing supplement, the accompanying general terms supplement no. 1,734, the accompanying prospectus supplement or the accompanying prospectus. We take no responsibility for, and can provide no assurance as to the reliability of, any other information that others may give you. This pricing supplement, the accompanying general terms supplement no. 1,734, the accompanying prospectus supplement and the accompanying prospectus is an offer to sell only the notes offered hereby, but only under circumstances and in jurisdictions where it is lawful to do so. The information contained in this pricing supplement, the accompanying general terms supplement no. 1,734, the accompanying prospectus supplement and the accompanying prospectus is current only as of the respective dates of such documents.

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GS Finance Corp.

Index-Linked Notes due

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The Goldman Sachs
Group, Inc.

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