

APPLIED INDUSTRIAL TECHNOLOGIES INC
Form 10-Q
November 05, 2010

**SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10 - Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended SEPTEMBER 30, 2010

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 1-2299

APPLIED INDUSTRIAL TECHNOLOGIES, INC.

(Exact name of registrant as specified in its charter)

Ohio

34-0117420

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification Number)

One Applied Plaza, Cleveland, Ohio

44115

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: (216) 426-4000

(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 (§232.405 of this chapter) 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.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a 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

Shares of common stock outstanding on October 31, 2010 42,429,677 (No par value)

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
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PART I: FINANCIAL INFORMATION

ITEM I: Financial Statements

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

CONDENSED STATEMENTS OF CONSOLIDATED INCOME

(Unaudited)

(In thousands, except per share amounts)

| | Three Months Ended September 30, | |
|--|-------------------------------------|------------|
| | 2010 | 2009 |
| Net Sales | \$ 527,501 | \$ 437,743 |
| Cost of Sales | 384,381 | 322,299 |
| | 143,120 | 115,444 |
| Selling, Distribution and Administrative, including depreciation | 108,229 | 97,803 |
| Operating Income | 34,891 | 17,641 |
| Interest Expense, net | 1,124 | 1,214 |
| Other (Income) Expense, net | (343) | (303) |
| Income Before Income Taxes | 34,110 | 16,730 |
| Income Tax Expense | 13,355 | 5,543 |
| Net Income | \$ 20,755 | \$ 11,187 |
| Net Income Per Share Basic | \$ 0.49 | \$ 0.26 |
| Net Income Per Share Diluted | \$ 0.48 | \$ 0.26 |
| Cash dividends per common share | \$ 0.17 | \$ 0.15 |
| Weighted average common shares outstanding for basic computation | 42,370 | 42,277 |
| Dilutive effect of potential common shares | 716 | 510 |
| Weighted average common shares outstanding for diluted computation | 43,086 | 42,787 |

See notes to condensed consolidated financial statements.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Unaudited)
 (In thousands)

| | September 30, 2010 | June 30, 2010 |
|--|--------------------------|-------------------|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | \$ 94,593 | \$ 175,777 |
| Accounts receivable, less allowances of \$6,306 and \$6,379 | 261,042 | 246,402 |
| Inventories | 190,758 | 173,253 |
| Other current assets | 24,822 | 23,428 |
| Total current assets | 571,215 | 618,860 |
| Property, less accumulated depreciation of \$141,048 and \$138,790 | 67,044 | 58,471 |
| Intangibles, net | 95,671 | 85,916 |
| Goodwill | 73,743 | 63,405 |
| Deferred tax assets | 48,346 | 48,493 |
| Other assets | 16,690 | 16,375 |
| TOTAL ASSETS | \$ 872,709 | \$ 891,520 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities | | |
| Accounts payable | \$ 109,266 | \$ 94,529 |
| Short-term debt | 25,000 | 75,000 |
| Compensation and related benefits | 37,999 | 50,107 |
| Other current liabilities | 63,292 | 51,696 |
| Total current liabilities | 235,557 | 271,332 |
| Postemployment benefits | 48,966 | 48,560 |
| Other liabilities | 19,108 | 16,589 |
| TOTAL LIABILITIES | 303,631 | 336,481 |
| Shareholders Equity | | |
| Preferred stock -no par value; 2,500 shares authorized; none issued or outstanding | | |
| Common stock -no par value; 80,000 shares authorized; 54,213 shares issued | 10,000 | 10,000 |
| Additional paid-in capital | 145,366 | 143,185 |
| Income retained for use in the business | 614,919 | 601,370 |
| Treasury shares at cost (11,795 and 11,837 shares) | (192,996) | (193,468) |
| Accumulated other comprehensive loss | (8,211) | (6,048) |
| TOTAL SHAREHOLDERS EQUITY | 569,078 | 555,039 |

| | | |
|--|------------|------------|
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 872,709 | \$ 891,520 |
|--|------------|------------|

See notes to condensed consolidated financial statements.

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APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
CONDENSED STATEMENTS OF CONSOLIDATED CASH FLOWS
(Unaudited)
(In thousands)

| | Three Months Ended September 30, | |
|---|-------------------------------------|------------------|
| | 2010 | 2009 |
| Cash Flows from Operating Activities | | |
| Net income | \$ 20,755 | \$ 11,187 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 2,713 | 2,929 |
| Amortization of intangibles | 2,787 | 2,476 |
| Amortization of stock options and appreciation rights | 1,259 | 1,398 |
| (Gain) loss on sale of property | (10) | 31 |
| Treasury shares contributed to employee benefit, deferred compensation and other share-based compensation plans | 996 | 322 |
| Changes in operating assets and liabilities, net of acquisitions | (24,301) | 31,779 |
| Other, net | 317 | 127 |
| Net Cash provided by Operating Activities | 4,516 | 50,249 |
| Cash Flows from Investing Activities | | |
| Property purchases | (873) | (1,290) |
| Proceeds from property sales | 41 | 40 |
| Net cash paid for acquisition of businesses, net of cash acquired | (27,697) | |
| Net Cash used in Investing Activities | (28,529) | (1,250) |
| Cash Flows from Financing Activities | | |
| Repayments under revolving credit facility | (50,000) | (5,000) |
| Dividends paid | (7,206) | (6,351) |
| Excess tax benefits from share-based compensation | 392 | 223 |
| Exercise of stock options and appreciation rights | 143 | 196 |
| Net Cash used in Financing Activities | (56,671) | (10,932) |
| Effect of Exchange Rate Changes on Cash | (500) | (22) |
| (Decrease) increase in cash and cash equivalents | (81,184) | 38,045 |
| Cash and cash equivalents at beginning of period | 175,777 | 27,642 |
| Cash and Cash Equivalents at End of Period | \$ 94,593 | \$ 65,687 |
| Non-cash Investing Activities: | | |
| Property purchases, unpaid at September 30 | \$ 10,000 | |
| See notes to condensed consolidated financial statements. | | |

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share amounts) (Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the financial position of Applied Industrial Technologies, Inc. (the Company, or Applied) as of September 30, 2010, and the results of its operations for the three month periods ended September 30, 2010 and 2009 and its cash flows for the three months ended September 30, 2010 and 2009, have been included. The condensed consolidated balance sheet as of June 30, 2010 has been derived from the audited consolidated financial statements at that date. This Quarterly Report on Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended June 30, 2010.

Operating results for the three month period ended September 30, 2010 are not necessarily indicative of the results that may be expected for the remainder of the fiscal year ending June 30, 2011.

Inventory

The Company uses the last-in, first-out (LIFO) method of valuing U.S. inventories. An actual valuation of inventory under the LIFO method can be made only at the end of each year based on the inventory levels and costs at that time. Accordingly, interim LIFO calculations are based on management's estimates of expected year-end inventory levels and costs and are subject to the final year-end LIFO inventory determination.

There were no LIFO layer liquidation benefits recognized in the three months ended September 30, 2010 nor are any expected to be realized for the year ending June 30, 2011. During the three months ended September 30, 2009, the Company recorded a LIFO benefit connected to LIFO layer liquidations that reduced cost of goods sold by \$710 and reduced the LIFO reserve by the same amount. If inventory levels had remained constant with the June 30, 2009 levels, the Company would have recorded LIFO expense of \$3,640 in the three-months ended September 30, 2009. Thus, the combined overall effect of LIFO layer liquidations during the three months ended September 30, 2009 increased gross profit by \$4,350.

Property

Cost incurred for software developed or obtained for internal use are capitalized in accordance with Accounting Standard Codification 350-40, are classified as property in the condensed consolidated balance sheets and are depreciated once placed in service over the estimated useful life of the software, generally three to ten years. The net book value of software is \$13,300 and \$3,800 at September 30, 2010 and June 30, 2010, respectively.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share amounts) (Unaudited)

Antidilutive Common Stock Equivalents

In the three month period ended September 30, 2010 and 2009, respectively, stock options and stock appreciation rights related to the acquisition of 451 and 1,202 shares of common stock in the three month period were not included in the computation of diluted earnings per share for the periods then ended as they were anti-dilutive.

2. **BUSINESS COMBINATIONS**

In July and August 2010, the Company completed two acquisitions for an aggregate cash purchase price of \$32,000. UZ Engineered Products (UZ) is a distributor of industrial supply products for maintenance, repair, and operational needs, in the government and commercial sectors, throughout the U.S. and Canada. SCS Supply Group (SCS) is a distributor of bearings, power transmission components, electrical components, fluid power products and industrial supplies in Canada.

The projected annual sales run rate for these businesses is approximately \$45,000. Results of operations for the acquired businesses are included in the Company's Service Center Based Distribution segment results of operations from the date of closing.

3. **GOODWILL AND INTANGIBLES**

The changes in the carrying amount of goodwill by reportable segment for the period ended September 30, 2010 are as follows:

| | Service Center Based Distribution | Fluid Power Businesses | Total |
|---------------------------------------|---|------------------------------|----------|
| Balance at July 1, 2010 | \$ 63,405 | \$ 0 | \$63,405 |
| Goodwill acquired during the period | 10,595 | | 10,595 |
| Other, including currency translation | (257) | | (257) |
| Balance at September 30, 2010 | \$ 73,743 | \$ 0 | \$73,743 |

At September 30, 2010, accumulated goodwill impairment losses, subsequent to fiscal year 2002, totaled \$36,605 and related to the Fluid Power Businesses segment.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share amounts) (Unaudited)

The Company's intangible assets resulting from business combinations are amortized over their estimated period of benefit and consist of the following:

| September 30, 2010 | Amount | Accumulated Amortization | Net Book Value |
|------------------------------------|-------------------|-----------------------------|----------------------|
| Amortized Intangibles: | | | |
| Customer relationships | \$ 75,942 | \$ 16,964 | \$ 58,978 |
| Trade names | 25,542 | 4,104 | 21,438 |
| Vendor relationships | 13,798 | 2,757 | 11,041 |
| Non-competition agreements | 4,818 | 1,894 | 2,924 |
| Total Amortized Intangibles | 120,100 | 25,719 | 94,381 |
| Non-amortized trade name | 1,290 | | 1,290 |
| Total Intangibles | \$ 121,390 | \$ 25,719 | \$ 95,671 |
| | | | |
| June 30, 2010 | Amount | Accumulated Amortization | Net Book Value |
| Customer relationships | \$ 65,324 | \$ 15,328 | \$ 49,996 |
| Trade names | 25,648 | 3,777 | 21,871 |
| Vendor relationships | 13,842 | 2,511 | 11,331 |
| Non-competition agreements | 4,394 | 1,676 | 2,718 |
| Total Intangibles | \$ 109,208 | \$ 23,292 | \$ 85,916 |

Amounts include the impact of foreign currency translation. Fully amortized amounts are written off.

Amortization expense based on the Company's intangible assets as of September 30, 2010 is estimated to be \$11,400 for 2011, \$10,800 for 2012, \$10,000 for 2013, \$8,700 for 2014, \$8,000 for 2015 and \$7,300 for 2016.

4. DEBT

At September 30, 2010, debt outstanding under a private placement borrowing due in November 2010, totaled \$25,000. The Company's outstanding debt approximates fair value as of September 30, 2010.

As of September 30, 2010, the Company has no amounts outstanding on its committed revolving credit facility.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share amounts) (Unaudited)

5. RISK MANAGEMENT ACTIVITIES

The Company is exposed to market risks, primarily resulting from changes in currency exchange rates. To manage this risk, the Company may enter into derivative transactions pursuant to the Company's written policy. Derivative instruments are recorded on the condensed consolidated balance sheet at their fair value and changes in fair value are recorded each period in current earnings or comprehensive income. The Company does not hold or issue derivative financial instruments for trading purposes. The criteria for designating a derivative as a hedge include the assessment of the instrument's effectiveness in risk reduction, matching of the derivative instrument to its underlying transaction, and the probability that the underlying transaction will occur.

Foreign Currency Exchange Rate Risk

In November 2000, the Company entered into two 10-year cross-currency swap agreements to manage its foreign currency risk exposure on private placement borrowings related to its wholly-owned Canadian subsidiary. The cross-currency swaps effectively convert \$25,000 of debt, and the associated interest payments, from 7.98% fixed rate U.S. dollar denominated debt to 7.75% fixed rate Canadian dollar denominated debt. The terms of the two cross-currency swaps mirror the terms of the private placement borrowings. One of the cross-currency swaps with a notional amount of \$20,000 is designated as a cash flow hedge. For the three months ended September 30, 2010, there was no ineffectiveness of this cross-currency swap. The unrealized losses on this swap are included in accumulated other comprehensive loss and the corresponding fair value is included in other current liabilities in the condensed consolidated balance sheets.

The other cross-currency swap with a notional amount of \$5,000 is not designated as a hedging instrument under hedge accounting provisions. The balance sheet classification for the fair value of this contract is other current liabilities in the condensed consolidated balance sheets. The income statement classification for the fair value of this swap is to other (income) expense, net for both unrealized gains and losses.

These cross-currency swaps are expected to be settled in November 2010 when the associated private placement borrowings are repaid.

Interest Rate Risk

The interest rate swap entered into in September 2008 was settled this quarter, thus there was no unrealized gain or loss recognized in accumulated other comprehensive loss during the quarter. At June 30, 2010, this liability was included in other current liabilities in the condensed consolidated balance sheets.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share amounts) (Unaudited)

The following table summarizes the fair value of derivative instruments as recorded in other current liabilities in the condensed consolidated balance sheets:

| | Fair Value at September 30, 2010 | Fair Value at June 30, 2010 |
|--|---|-----------------------------------|
| Derivatives designated as hedging instruments: | | |
| Cross-currency swap | \$ 9,555 | \$ 8,728 |
| Interest rate swap | 0 | 316 |
| Total derivatives designated as hedging instruments | 9,555 | 9,044 |
| Derivative not designated as a hedging instrument cross-currency swap: | 2,389 | 2,182 |
| Total Derivatives | \$ 11,944 | \$ 11,226 |

The following table summarizes the effects of derivative instruments on income and other comprehensive income (OCI) for the three months ended September 30, 2010 and 2009 (amounts presented exclude income tax effects):

| Derivatives in Cash Flow | Amount of Gain (Loss) Recognized in OCI on Derivatives (Effective Portion) | | Amount of Loss Reclassified from Accumulated OCI into Income (Effective Portion), Included in | |
|----------------------------------|---|------------|--|----------|
| | 2010 | 2009 | Interest Expense, net 2010 | 2009 |
| Hedging Relationships | | | | |
| Three Months Ended September 30, | | | | |
| Cross-currency swap | \$ (827) | \$ (2,304) | | |
| Interest rate swap | 0 | 132 | \$ (316) | \$ (350) |
| Total | \$ (827) | \$ (2,172) | \$ (316) | \$ (350) |

| Derivative Not Designated as Hedging Instrument | Amount of Loss (Gain) Recognized in Income on Derivative, Included in Other (Income) Expense, net | |
|--|---|--------|
| | 2010 | 2009 |
| Three Months Ended September 30, | | |
| Cross-currency swap | \$ 207 | \$ 576 |

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share amounts) (Unaudited)

6. FAIR VALUE MEASUREMENTS

Assets and liabilities measured at fair value are as follows at September 30, 2010 and June 30, 2010 (there are currently no items categorized as Level 3 within the fair value hierarchy):

| | Recorded Value | | Fair Value Measurements | | Significant Other | |
|-----------------------|--------------------|---------------|---|---------------|--------------------|---------------|
| | | | Quoted Prices in Active Markets for Identical Instruments | | Observable Inputs | |
| | | | Level 1 | | Level 2 | |
| | September 30, 2010 | June 30, 2010 | September 30, 2010 | June 30, 2010 | September 30, 2010 | June 30, 2010 |
| Assets: | | | | | | |
| Marketable securities | \$ 9,541 | \$ 8,592 | \$9,541 | \$8,592 | | |
| Liabilities: | | | | | | |
| Cross-currency swaps | \$11,944 | \$10,910 | | | \$11,944 | \$10,910 |
| Interest rate swap | 0 | 316 | | | 0 | 316 |
| Total Liabilities | \$11,944 | \$11,226 | | | \$11,944 | \$11,226 |

Marketable securities in the previous table are held in a rabbi trust for a non-qualified deferred compensation plan. The marketable securities are included in other assets on the condensed consolidated balance sheets. The fair values were derived using quoted market prices.

Fair values for cross-currency and interest rate swaps in the previous table are derived based on valuation models using foreign currency exchange rates and inputs readily available in the public swap markets for similar instruments adjusted for terms specific to these instruments. Since the inputs used to value these instruments are observable and the counterparties are creditworthy, the Company has classified them as Level 2 inputs. The liabilities are included in other current liabilities on the condensed consolidated balance sheets.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share amounts) (Unaudited)

7. COMPREHENSIVE INCOME (LOSS)

The components of comprehensive income (loss) are as follows:

| | Three Months Ended September 30, | |
|--|-------------------------------------|-----------|
| | 2010 | 2009 |
| Net income | \$ 20,755 | \$ 11,187 |
| Other comprehensive (loss) income: | | |
| Unrealized loss on cash flow hedges, net of income tax of \$(426) and \$(812) | (1,030) | (1,801) |
| Reclassification of interest expense into income, net of income tax of \$116 and \$133 | 200 | 217 |
| Reclassification of pension and postemployment expense into income, net of income tax of \$135 and \$169 | 419 | 276 |
| Foreign currency translation adjustment, net of income tax of \$(20) and \$(13) | (1,797) | (1,194) |
| Unrealized gain on investment securities available for sale, net of income tax of \$25 and \$8 | 45 | 18 |
| Total comprehensive income | \$ 18,592 | \$ 8,703 |

8. BENEFIT PLANS

The following table provides summary disclosures of the net periodic postemployment costs recognized for the Company's postemployment benefit plans:

| Three Months Ended September 30, Components of net periodic benefit cost: | Pension Benefits | | Retiree Health Care Benefits | |
|--|------------------|----------|---------------------------------|-------|
| | 2010 | 2009 | 2010 | 2009 |
| Service cost | \$ 115 | \$ 144 | \$ 10 | \$ 13 |
| Interest cost | 565 | 673 | 59 | 65 |
| Expected return on plan assets | (96) | (88) | | |
| Recognized net actuarial loss (gain) | 362 | 231 | (21) | (22) |
| Amortization of prior service cost | 177 | 199 | 35 | 37 |
| Net periodic benefit cost | \$ 1,123 | \$ 1,159 | \$ 83 | \$ 93 |

The Company contributed \$1,129 to its pension benefit plans and \$42 to its retiree health care plans in the three months ended September 30, 2010. Expected contributions for all of fiscal 2011 are \$1,700 for the pension benefit plans and \$250 for retiree health care plans.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share amounts) (Unaudited)

9. SEGMENT INFORMATION

The accounting policies of the Company's reportable segments are the same as those used to prepare the condensed consolidated financial statements. Sales between the Service Center Based Distribution segment and the Fluid Power Businesses segment have been eliminated in the table below.

Segment Financial Information for the three months ended:

| | Service Center Based Distribution | Fluid Power Businesses | Total |
|--|--|------------------------------|-----------|
| September 30, 2010 | | | |
| Net sales | \$423,953 | \$ 103,548 | \$527,501 |
| Operating income for reportable segments | 26,068 | 9,434 | 35,502 |
| Assets used in the business | 666,871 | 205,838 | 872,709 |
| Depreciation | 2,177 | 536 | 2,713 |
| Capital expenditures | 717 | 156 | 873 |
| September 30, 2009 | | | |
| Net sales | \$363,310 | \$ 74,433 | \$437,743 |
| Operating income for reportable segments | 17,262 | 3,298 | 20,560 |
| Assets used in the business | 619,891 | 190,614 | 810,505 |
| Depreciation | 2,417 | 512 | 2,929 |
| Capital expenditures | 1,071 | 219 | 1,290 |

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share amounts) (Unaudited)

A reconciliation of operating income for reportable segments to the condensed consolidated income before income taxes is as follows:

| | Three Months Ended September 30, | |
|---|-------------------------------------|-----------|
| | 2010 | 2009 |
| Operating income for reportable segments | \$ 35,502 | \$ 20,560 |
| Adjustment for: | | |
| Amortization of intangibles: | | |
| Service Center Based Distribution | 781 | 413 |
| Fluid Power Businesses | 2,006 | 2,063 |
| Corporate and other (income) expense, net | (2,176) | 443 |
| Total operating income | 34,891 | 17,641 |
| Interest expense, net | 1,124 | 1,214 |
| Other (income) expense, net | (343) | (303) |
| Income before income taxes | \$ 34,110 | \$ 16,730 |

The change in corporate and other (income) expense, net is due to changes in the levels and amounts of expenses being allocated to the segments. The expenses being allocated include corporate charges for working capital, logistics support and other items.

Net sales are presented in geographic areas based on the location of the company making the sale and are as follows:

| | Three Months Ended September 30, | |
|----------------------|-------------------------------------|------------|
| | 2010 | 2009 |
| Geographic Location: | | |
| United States | \$ 459,053 | \$ 378,698 |
| Canada | 54,321 | 47,838 |
| Mexico | 14,127 | 11,207 |
| Total | \$ 527,501 | \$ 437,743 |

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The accompanying condensed consolidated financial statements of the Company have been reviewed by the Company's independent registered public accounting firm, Deloitte & Touche LLP, whose report covering their reviews of the condensed consolidated financial statements follows.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
Applied Industrial Technologies, Inc.
Cleveland, Ohio

We have reviewed the accompanying condensed consolidated balance sheet of Applied Industrial Technologies, Inc. and subsidiaries (the Company) as of September 30, 2010, and the related condensed statements of consolidated income and cash flows for the three-month periods ended September 30, 2010 and 2009. These interim financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole.

Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of the Company as of June 30, 2010, and the related statements of consolidated income, shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated August 13, 2010, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of June 30, 2010 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Deloitte & Touche LLP

Cleveland, Ohio

November 5, 2010

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

**ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS**

Applied Industrial Technologies (Applied, the Company, We, Us or Our) is an industrial distributor that offers products critical to the operations of MRO and OEM customers in a wide range of industries. In addition, Applied provides engineering, design and systems integration for industrial and fluid power applications, as well as customized fluid power shop, mechanical and fabricated rubber services. Applied is an authorized distributor for more than 2,000 manufacturers, and we offer access to approximately 4 million stock keeping units (SKUs). A large portion of our business is selling replacement parts to manufacturers and other industrial concerns for repair or maintenance of machinery and equipment. We have a long tradition of growth dating back to 1923, the year our business was founded in Cleveland, Ohio. During the first quarter of fiscal 2011, business was conducted in the United States, Canada, Mexico and Puerto Rico from 475 facilities.

The following is Management's Discussion and Analysis of certain significant factors which have affected our financial condition, results of operations and cash flows during the periods included in the accompanying condensed statements of consolidated income and consolidated cash flows. When reviewing the discussion and analysis set forth below, please note that the majority of SKUs we sell in any given period were not sold in the comparable period of the prior year, resulting in the inability to quantify certain commonly used comparative metrics analyzing sales, such as changes in product mix and volume.

Overview

Consolidated net sales for the quarter ended September 30, 2010 increased \$89.8 million or 20.5% compared to the prior year quarter, with acquisitions contributing 1.3% of the increase. Operating margin increased to 6.6% of net sales from 4.0% for the prior year quarter and net income increased \$9.6 million or 85.5% compared to the prior year quarter. Shareholders' equity at September 30, 2010 was \$569.1 million. The current ratio moved to 2.4 to 1 from 2.3 to 1 at June 30, 2010.

Applied monitors several economic indices that have been key indicators for industrial economic activity. These include the Manufacturing Capacity Utilization (MCU) index published by the Federal Reserve Board and the Manufacturing Index published by the Institute for Supply Management (ISM). Historically, our performance correlates well with the MCU, which measures productivity and calculates a ratio of actual manufacturing output versus potential full capacity output. When manufacturing plants are running at a high rate of capacity, they tend to wear out machinery and require replacement parts. Our sales tend to lag the MCU on the upswing by up to six months and move closer in alignment with the declines.

These indices showed moderating growth in the industrial economy during the first quarter of fiscal 2011. The MCU increased in July and August and then declined slightly in September to 72.4, still well above its last trough of 65.2 in June of 2009. The ISM was 54.4 in September, down from 56.2 in June. The ISM has been generally declining since its year-long high of 60.4 in April. Our first quarter sales per day run rate was consistent with our June 2010 quarter run rate. We did experience our normal seasonality with the July and August sales per day rates being down slightly compared to June. We then saw an improvement in September. We believe

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that the recovery of the U.S. industrial economy will continue, but for the remainder of the fiscal year will settle into a slower pace of growth.

The number of Company associates was 4,652 at September 30, 2010, 4,468 at June 30, 2010, and 4,635 at September 30, 2009. During the quarter, our same-store operations experienced a headcount reduction of 43 associates and our recent acquisitions added 227 associates. Our operating facilities totaled 475 at September 30, 2010, 455 at June 30, 2010, and 462 at September 30, 2009. The net increase in operating facilities from June 30, 2010 is due to recent acquisitions (9) and a redefinition of how we classify certain shop operations (11).

Results of Operations

Three Months Ended September 30, 2010 and 2009

During the quarter ended September 30, 2010, net sales increased \$89.8 million or 20.5% compared to the prior year quarter. Acquisitions accounted for additional sales of \$5.5 million or 1.3% of the net sales growth, with the remaining increase related to same-store business. The number of selling days for the quarters ended September 30, 2010 and 2009 were 64 days each.

Net sales from our Service Center Based Distribution segment increased \$60.6 million or 16.7% during the quarter from the same period in the prior year, primarily attributed to increases in our same-store business. Acquisitions within this segment increased sales by \$5.5 million, or 1.5%.

Net sales from our Fluid Power Businesses segment increased \$29.1 million or 39.1% during the quarter from the same period in the prior year, attributed to increases in same-store business and in particular, sales to customers in high-tech industries.

From a geographic perspective, sales from our U.S. operations were up \$80.4 million or 21.2%, driven by same-store business, acquisitions accounted for 0.9% of the U.S. increase. Sales from our Canadian operations increased \$6.5 million or 13.6%. This increase consists of \$3.3 million due to favorable foreign currency translation, \$2.0 million from acquisitions and the remaining increase attributed to increases in same-store business. Our Mexican operations increased \$2.9 million or 26.1% primarily due to increases in same-store business.

During the quarter ended September 30, 2010, industrial products and fluid power products accounted for 71.5% and 28.5%, respectively, of net sales as compared to 73.5% and 26.5%, respectively, for the same period in the prior year. The increase in fluid power products is reflective of the Fluid Power Businesses segment being favorably impacted by a quicker economic recovery, largely driven by customers in high-tech industries.

Our gross profit margin for the quarter increased to 27.1% compared to the prior year quarter's 26.4%. The current quarter's gross profit was positively impacted by LIFO benefits of \$2.7 million or 0.5% resulting from effective price decreases. These decreases flow through the LIFO calculation as a benefit as the price paid for product (net of inventory purchasing incentives) is

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lower this year versus last. We expect to see a minor additional benefit from this in the December quarter and we do not anticipate any impact in the third or fourth quarters. We are also experiencing competitive market pressures in passing on supplier price increases within our Service Center Based Distribution segment.

Selling, distribution and administrative expense (SD&A) consists of associate compensation, benefits and other expenses associated with selling, purchasing, warehousing, supply chain management and providing marketing and distribution of the Company's products, as well as costs associated with a variety of administrative functions such as human resources, information technology, treasury, accounting, legal, and facility related expenses. SD&A was 20.5% of net sales in the quarter ended September 30, 2010 compared to 22.3% in the prior year quarter. On an absolute basis, SD&A increased \$10.4 million or 10.7% compared to the prior year quarter. Of this amount, acquisitions added \$2.9 million, while increases in wages and benefits totaled \$7.1 million, primarily driven by variable compensation tied to improved performance.

Operating income increased 97.8% to \$34.9 million during the quarter compared to \$17.6 million during the prior year quarter. Operating income as a percentage of sales for the Service Center Based Distribution segment increased to 6.1% in the current year quarter, from 4.8% in the prior year quarter. This increase as compared to the prior year quarter reflects improved operating leverage on the increase in sales. The Fluid Power Businesses operating margins increased to 9.1% in the current year quarter from 4.4% in the prior year quarter. This improvement is driven largely by significant leverage in increases in sales.

The effective income tax rate was 39.2% for the quarter ended September 30, 2010 compared to 33.1% for the quarter ended September 30, 2009. The increase from the prior year quarter is due to a provision made for U.S. income tax expense on a portion of undistributed earnings not considered permanently reinvested in our Canadian subsidiaries. Additionally, the first quarter of fiscal 2010 included \$0.5 million of benefits relating to foreign and state income taxes which did not recur.

As a result of the factors addressed above, net income increased \$9.6 million or 85.5% compared to the prior year quarter. Net income per share was \$0.48 per share for the quarter ended September 30, 2010, compared to \$0.26 in the prior year quarter.

Liquidity and Capital Resources

Net cash provided by operating activities for the three months ended September 30, 2010 was \$4.5 million. This compares to \$50.2 million provided by operating activities in the same period a year ago. The most significant factor in the \$45.7 million fluctuation relates to changes in inventory. In the prior year, we were reducing inventory levels whereas inventory has increased slightly in the current year.

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Net cash used in investing activities during the current year was \$28.5 million; \$27.7 million was used for acquisitions and \$0.9 million for capital expenditures. In the first three months of fiscal 2010, we used \$1.3 million in investing activities primarily for capital expenditures.

Net cash used in financing activities was \$56.7 million for the three months ended September 30, 2010. In the first quarter of fiscal 2011, we repaid \$50.0 million under our revolving credit facility and we paid dividends of \$7.2 million. In the prior year, financing activities used \$10.9 million of cash; we repaid a net \$5.0 million on our revolving credit facility and paid dividends of \$6.4 million. We did not repurchase shares of treasury stock in the first quarter of fiscal 2011 or 2010.

On October 1, 2010, Applied announced its selection of SAP to help transform the Company's technology platforms and enhance its business information and transaction systems for future growth. We expect capital expenditures for this ERP project for all of fiscal 2011 to be around \$16.0 million, of which \$10.0 million is included in the September quarter. These amounts primarily relate to hardware and software fees. This capital expenditure amount of \$16.0 million should be added to the previous capital expenditure guidance of \$8.0 to \$9.5 million provided in our fiscal year 2010 annual report. We expect SD&A expenses associated with this project to be approximately \$3.5 million in fiscal year 2011.

We have a \$150.0 million revolving credit facility with a group of banks expiring in June 2012. There are no borrowings outstanding under this facility at September 30, 2010. At September 30, 2010, unused lines under this facility, net of outstanding letters of credit, total \$143.2 million and are available to fund future acquisitions or other capital and operating requirements.

We have an uncommitted shelf facility with Prudential Insurance Company that enables us to borrow up to \$100.0 million in additional long-term financing with terms of up to fifteen years. This agreement expires in February 2013. At September 30, 2010, there were no outstanding borrowings under this agreement. We believe in the current borrowing environment, that any funds drawn down under this facility would carry interest rates in the 4.0% to 5.0% range.

The \$25.0 million of debt classified as short-term is private placement debt which matures in November 2010.

The Board of Directors has authorized the repurchase of shares of the Company's common stock. These purchases may be made in open market and negotiated transactions, from time to time, depending upon market conditions. We did not acquire shares of common stock in the quarter ended September 30, 2010. At September 30, 2010, we had authorization to repurchase an additional 837,200 shares.

Management expects that our existing cash, cash equivalents, funds available under the revolving credit facility, cash provided from operations, and the use of operating leases will be sufficient to finance normal working capital needs, payment of short-term debt, payment of dividends, acquisitions, investments in properties, facilities and equipment, and the purchase of

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ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
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additional Company common stock. Management also believes that additional long-term debt and line of credit financing could be obtained based on the Company's credit standing and financial strength, however, any additional debt may be at higher rates than under the terms of the revolving credit facility.

Cautionary Statement Under Private Securities Litigation Reform Act

Management's Discussion and Analysis and other sections of this report, including documents incorporated by reference, contain statements that are forward-looking, based on management's current expectations about the future. Forward-looking statements are often identified by qualifiers, such as guidance, expect, believe, plan, intend, v should, could, would, anticipate, estimate, forecast, may, and derivative or similar words or expressions. S descriptions of objectives, strategies, plans, or goals are also forward-looking statements. These statements may discuss, among other things, expected growth, future sales, future cash flows, future capital expenditures, future performance, and the anticipation and expectations of the Company and its management as to future occurrences and trends. The Company intends that the forward-looking statements be subject to the safe harbors established in the Private Securities Litigation Reform Act of 1995 and by the Securities and Exchange Commission in its rules, regulations and releases.

Readers are cautioned not to place undue reliance on any forward-looking statements. All forward-looking statements are based on current expectations regarding important risk factors, many of which are outside the Company's control. Accordingly, actual results may differ materially from those expressed in the forward-looking statements, and the making of those statements should not be regarded as a representation by the Company or any other person that the results expressed in the statements will be achieved. In addition, the Company assumes no obligation publicly to update or revise any forward-looking statements, whether because of new information or events, or otherwise, except as may be required by law.

Important risk factors include, but are not limited to, the following: risks relating to the operations levels of our customers and the economic factors that affect them; the impact of economic conditions on the collectability of trade receivables; reduced demand for our products in targeted markets due to reasons including consolidation in customer industries and the transfer of manufacturing capacity to foreign countries; changes in customer preferences for products and services of the nature and brands sold by us; changes in customer procurement policies and practices; changes in the prices for products and services relative to the cost of providing them; loss of key supplier authorizations, lack of product availability, or changes in supplier distribution programs; the potential for product shortages if suppliers are unable to fulfill in a timely manner increased demand in the economic recovery; competitive pressures; the cost of products and energy and other operating costs; our reliance on information systems; our ability to implement our ERP system in a timely, cost-effective, and competent manner, and to capture its planned benefits; our ability to retain and attract qualified sales and customer service personnel; our ability to identify and complete acquisitions, integrate them effectively, and realize their anticipated benefits; the variability and timing of new business opportunities

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

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including acquisitions, alliances, customer relationships, and supplier authorizations; the incurrence of debt and contingent liabilities in connection with acquisitions; our ability to access capital markets as needed on reasonable terms; disruption of operations at our headquarters or distribution centers; risks and uncertainties associated with our foreign operations, including volatile economic conditions, political instability, cultural and legal differences, and currency exchange fluctuations; the potential for goodwill and intangible asset impairment; changes in accounting policies and practices; organizational changes within the Company; the volatility of our stock price and the resulting impact on our consolidated financial statements; risks related to legal proceedings to which we are a party; adverse regulation and legislation, including potential changes in tax regulations (e.g., those affecting the use of the LIFO inventory accounting method and the taxation of foreign-sourced income); and the occurrence of extraordinary events (including prolonged labor disputes, natural events and acts of God, terrorist acts, fires, floods, and accidents). Other factors and unanticipated events could also adversely affect our business, financial condition or results of operations. We discuss certain of these matters more fully in our Annual Report on Form 10-K for the year ended June 30, 2010.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company has evaluated its exposure to various market risk factors, including its primary market risk exposure through the effects of changes in exchange rates. We occasionally utilize derivative instruments as part of our overall financial risk management policy, but do not use derivative instruments for speculative or trading purposes.

During the three months ended September 30, 2010, there were no material changes in our market risk exposure. In September 2010, we settled the interest rate swap outstanding at June 30, 2010. For quantitative and qualitative disclosures about market risk, see Item 7A Quantitative and Qualitative Disclosures About Market Risk in our Annual Report on Form 10-K for the year ended June 30, 2010.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

ITEM 4: CONTROLS AND PROCEDURES

The Company's management, under the supervision and with the participation of the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), evaluated the effectiveness of the Company's disclosure controls and procedures, as defined in Exchange Act Rule 13a-15(e), as of the end of the period covered by this report. Based on that evaluation, the CEO and CFO have concluded that the Company's disclosure controls and procedures are effective.

During the first quarter of fiscal 2011, there were no changes in the Company's internal controls or in other factors that materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings.

The Company is a party to pending legal proceedings with respect to various product liability, commercial, and other matters. Although it is not possible to predict the outcome of these proceedings or the range of possible loss, the Company believes, based on circumstances currently known, that the likelihood is remote that the ultimate resolution of any of these proceedings will have, either individually or in the aggregate, a material adverse effect on the Company's consolidated financial position, results of operations, or cash flows.

ITEM 1A. Risk Factors.

Except as set forth below, there are no material changes from the risk factors set forth under Part I, Item 1A, Risk Factors, in our annual report on Form 10-K for the fiscal year ended June 30, 2010. You should carefully consider these factors in addition to the other information set forth in this report which could materially affect our business, financial condition, or future results. The risks and uncertainties described in this report and in our annual report on Form 10-K for the year ended June 30, 2010, are not the only risks and uncertainties facing us. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also impact our business and operations.

We face risks in connection with the implementation of a new integrated information technology platform for our business.

We have announced our intent to replace multiple legacy applications with a common SAP information technology platform. The implementation is expected to occur over several years in planned phases, primarily based on geographic region. The process will be technically intensive, requiring design, testing, modifications, and project coordination. Because of the project's complexity, we could experience disruptions in our business operations related to the implementation effort. Disruptions could result in material adverse consequences, including delays, loss of information, damage to our ability to process transactions or harm to our control environment, and unanticipated increases in costs.

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

Repurchases in the quarter ended September 30, 2010 were as follows:

| Period | (a) Total Number of Shares | (b) Average Price Paid per Share (\$) | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1) (2) |
|---|-------------------------------------|---|--|---|
| July 1, 2010 to July 31, 2010 | -0- | -0- | -0- | 837,200 |
| August 1, 2010 to August 31, 2010 | -0- | -0- | -0- | 837,200 |
| September 1, 2010 to September 30, 2010 | -0- | -0- | -0- | 837,200 |
| Total | -0- | -0- | -0- | 837,200 |

(1) On January 23, 2008, the Board of Directors authorized the purchase of up to 1.5 million shares of the Company's common stock. The Company publicly announced the authorization that day. These purchases may be made in the open market or in privately negotiated transactions. This authorization is in effect until all shares are purchased or the authorization is

revoked or amended by the Board of Directors.

- (2) During the quarter the Company purchased 236 shares in connection with the deferred compensation program and the vesting of stock awards.

ITEM 6. Exhibits.

Exhibit No. Description

- 3.1 Amended and Restated Articles of Incorporation of Applied Industrial Technologies, Inc., as amended on October 25, 2005 (filed as Exhibit 3(a) to the Company's Form 10-Q for the quarter ended December 31, 2005, SEC File No. 1-2299, and incorporated here by reference).
- 3.2 Code of Regulations of Applied Industrial Technologies, Inc., as amended on October 19, 1999 (filed as Exhibit 3(b) to the Company's Form 10-Q for the quarter ended September 30,

| Exhibit No. | Description |
|-------------|--|
| | 1999, SEC File No. 1-2299, and incorporated here by reference). |
| 4.1 | Certificate of Merger of Bearings, Inc. (Ohio) (now named Applied Industrial Technologies, Inc.) and Bearings, Inc. (Delaware) filed with the Ohio Secretary of State on October 18, 1988, including an Agreement and Plan of Reorganization dated September 6, 1988 (filed as Exhibit 4(a) to the Company's Registration Statement on Form S-4 filed May 23, 1997, Registration No. 333-27801, and incorporated here by reference). |
| 4.2 | Private Shelf Agreement dated as of November 27, 1996, between the Company and Prudential Investment Management, Inc. (assignee of The Prudential Insurance Company of America), conformed to show all amendments (filed as Exhibit 4.2 to the Company's Form 10-Q for the Quarter ended March 31, 2010, SEC File No. 1-2299, and incorporated here by reference). |
| 4.3 | Credit Agreement dated as of June 3, 2005 among the Company, KeyBank National Association as Agent, and various financial institutions (filed as Exhibit 4.7 to the Company's Form 10-Q dated February 9, 2010, SEC File No. 1-2299, and incorporated here by reference). |
| 4.4 | First Amendment Agreement dated as of June 6, 2007, among the Company, KeyBank National Association as Agent, and various financial institutions, amending June 3, 2005 Credit Agreement (filed as Exhibit 4 to the Company's Form 8-K dated June 11, 2007, SEC File No. 1-2299, and incorporated here by reference). |
| 10 | Performance Shares Terms and Conditions, as amended for performance shares awarded to executive officers in September 2010. |
| 15 | Independent Registered Public Accounting Firm's Awareness Letter. |
| 31 | Rule 13a-14(a)/15d-14(a) certifications. |
| 32 | Section 1350 certifications. |

The Company will furnish a copy of any exhibit described above and not contained herein upon payment of a specified reasonable fee which shall be limited to the Company's reasonable expenses in furnishing the exhibit.

Certain instruments with respect to long-term debt have not been filed as exhibits because the total amount of securities authorized under any one of the instruments does not exceed 10 percent of the total assets of the Company and its subsidiaries on a consolidated basis. The Company agrees to furnish to the Securities and Exchange Commission, upon request, a copy of each such instrument.

SIGNATURES

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

APPLIED INDUSTRIAL TECHNOLOGIES, INC.
(Company)

Date: November 5, 2010

By: /s/ David L. Pugh
David L. Pugh
Chairman & Chief Executive Officer

Date: November 5, 2010

By: /s/ Mark O. Eisele
Mark O. Eisele
Vice President-Chief Financial Officer &
Treasurer
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APPLIED INDUSTRIAL TECHNOLOGIES, INC.
EXHIBIT INDEX
TO FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2010

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