APPLIED INDUSTRIAL TECHNOLOGIES INC
Form 10-Q
February 08, 2013
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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended DECEMBER 31, 2012
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 1-2299

APPLIED INDUSTRIAL TECHNOLOGIES, INC.
(Exact name of registrant as specified in its charter)

Ohio (State or other jurisdiction of incorporation or organization)	34-0117420 (I.R.S. Employer Identification Number)
One Applied Plaza, Cleveland, Ohio (Address of principal executive offices)	44115 (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 x No o

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 x No o

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	x	Accelerated filer	o
Non-accelerated filer	o (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). Yes o No x

There were 42,106,725 (no par value) shares of common stock outstanding on January 15, 2013.

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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 December 31,		Six Months Ended December 31,	
	2012	2011	2012	2011
Net Sales	$589,517	$570,397	$1,200,036	$1,149,971
Cost of Sales	426,598	414,928	872,584	835,798
Gross Profit	162,919	155,469	327,452	314,173
Selling, Distribution and Administrative, including depreciation	122,350	122,134	242,565	237,571
Operating Income	40,569	33,335	84,887	76,602
Interest Expense, net	15	10	40	57
Other (Income) Expense, net	(427)	778	(886)	2,710
Income Before Income Taxes	40,981	32,547	85,733	73,835
Income Tax Expense	13,938	11,612	29,158	26,518
Net Income	$27,043	$20,935	$56,575	$47,317
Net Income Per Share - Basic	$0.64	$0.50	$1.35	$1.12
Net Income Per Share - Diluted	$0.64	$0.49	$1.33	$1.11
Cash dividends per common share	$0.21	$0.19	$0.42	$0.38
Weighted average common shares outstanding for basic computation	42,052	41,965	42,009	42,181
Dilutive effect of potential common shares	442	669	477	620
Weighted average common shares outstanding for diluted computation	42,494	42,634	42,486	42,801

See notes to condensed consolidated financial statements.

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2012	2011	2012	2011
Net income per the condensed statements of consolidated income	$27,043	$20,935	$56,575	$47,317
Other comprehensive income (loss), before tax:				
Foreign currency translation adjustments	(594)	(8,117)	8,408	(11,159)
Postemployment benefits:				
Actuarial loss on remeasurement		(492)		(492)
Reclassification of actuarial losses and prior service cost into SD&A expense and included in net periodic pension costs	218	467	436	934
Impact of reduction in postemployment benefit liability (as forecasted salary increases will not be realized) due to the plan curtailment		8,860		8,860
Reclassification of prior service cost into SD&A expense upon plan curtailment		3,117		3,117
Unrealized gain (loss) on investment securities available for sale		47	23	(175)
Total of other comprehensive income (loss), before tax	(376)	3,882	8,867	1,085
Income tax expense related to items of other comprehensive income	85	4,619	179	4,717
Other comprehensive income (loss), net of tax	(461)	(737)	8,688	(3,632)
Comprehensive income, net of tax	$26,582	$20,198	$65,263	$43,685

See notes to condensed consolidated financial statements.

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

	December 31, 2012	June 30, 2012
ASSETS		
Current assets		
Cash and cash equivalents	$51,845	$78,442
Accounts receivable, less allowances of $8,106 and $8,332	304,628	307,043
Inventories	294,651	228,506
Other current assets	46,820	51,771
Total current assets	697,944	665,762
Property, less accumulated depreciation of $155,455 and $148,623	85,596	83,103
Intangibles, net	100,914	84,840
Goodwill	105,026	83,080
Deferred tax assets	26,209	26,424
Other assets	21,937	18,974
TOTAL ASSETS	$1,037,626	$962,183
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$123,796	$120,890
Short-term debt	33,000	—
Compensation and related benefits	52,935	63,149
Other current liabilities	45,763	46,130
Total current liabilities	255,494	230,169
Postemployment benefits	35,038	39,750
Other liabilities	24,982	20,133
TOTAL LIABILITIES	315,514	290,052
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	151,508	150,070
Income retained for use in the business	782,236	743,360
Treasury shares—at cost (12,108 and 12,246 shares)	(225,751)	(226,730)
Accumulated other comprehensive income (loss)	4,119	(4,569)
TOTAL SHAREHOLDERS' EQUITY	722,112	672,131
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$1,037,626	$962,183

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)

	Six Months Ended December 31,	
	2012	2011
Cash Flows from Operating Activities		
Net income	$56,575	$47,317
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property	6,036	5,598
Amortization of intangibles	6,207	5,544
Amortization of stock options and appreciation rights	1,197	1,139
Gain on sale of property	(193)	(492)
Other share-based compensation expense	1,982	2,523
Changes in operating assets and liabilities, net of acquisitions	(42,766)	(33,246)
Other, net	(152)	1,833
Net Cash provided by Operating Activities	28,886	30,216
Cash Flows from Investing Activities		
Property purchases	(6,843)	(14,022)
Proceeds from property sales	429	981
Net cash paid for acquisition of businesses, net of cash acquired	(66,055)	(1,241)
Net Cash used in Investing Activities	(72,469)	(14,282)
Cash Flows from Financing Activities		
Borrowings under revolving credit facility	33,000	—
Purchases of treasury shares	—	(18,990)
Dividends paid	(17,737)	(16,077)
Excess tax benefits from share-based compensation	1,461	569
Acquisition holdback payments	(1,845)	—
Exercise of stock options and appreciation rights	497	154
Net Cash provided by (used in) Financing Activities	15,376	(34,344)
Effect of Exchange Rate Changes on Cash	1,610	(2,170)
Decrease in Cash and Cash Equivalents	(26,597)	(20,580)
Cash and Cash Equivalents at Beginning of Period	78,442	91,092
Cash and Cash Equivalents at End of Period	$51,845	$70,512

See notes to condensed consolidated financial statements.

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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 December 31, 2012, and the results of its operations for the three and six month periods ended December 31, 2012 and 2011 and its cash flows for the six months ended December 31, 2012 and 2011, have been included. The condensed consolidated balance sheet as of June 30, 2012 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, 2012.

Operating results for the three and six month periods ended December 31, 2012 are not necessarily indicative of the results that may be expected for the remainder of the fiscal year ending June 30, 2013.

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.

2. BUSINESS COMBINATIONS

During the six month period ended December 31, 2012, the Company acquired four distributors to complement and extend its business.

In December 2012, the Company acquired substantially all of the net assets of Parts Associates, Inc., a distributor, headquartered in Cleveland, Ohio, of maintenance supplies and solutions. The acquired business is included in the Service Center Based Distribution segment from December 21, 2012.

In November 2012, the Company acquired substantially all of the net assets of HyQuip, Inc., a Wisconsin distributor of a broad line of hydraulic, rubber and plastic industrial hose and tubing, plus related accessories. The acquired business is included in the Fluid Power Businesses segment from November 1, 2012.

In September 2012, the Company acquired 100% of the outstanding stock of Bearings & Oil Seals Specialists Inc., a distributor, located in Hamilton, Ontario, of gaskets, seals, bearing and power transmission equipment for the manufacturing and service industries. The acquired business is included in the Service Center Based Distribution segment from October 1, 2012.

In August 2012, the Company acquired 100% of the outstanding stock of SKF Group's company-owned distribution business in Australia and New Zealand (“Applied Australia”). As one of the largest bearing suppliers in these markets, Applied Australia also distributes seals, lubrication products, and power transmission products. The acquired business is included in the Service Center Based Distribution segment from August 1, 2012.

The results of operations for these acquisitions are not material for any period presented.

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3. GOODWILL AND INTANGIBLES

The amounts of goodwill and intangible assets acquired during the six month period ended December 31, 2012 include acquisitions for which the allocation of the acquisition cost is preliminary and is subject to revision in future periods based on the final determination of fair values. The changes in the carrying amount of goodwill for both the Service Center Based Distribution segment and the Fluid Power Businesses segment for the six month period ended December 31, 2012 are as follows:

	Service Centers	Fluid Power	Total
Balance at July 1, 2012	$83,080	$—	$83,080
Goodwill acquired during the period	19,814	825	20,639
Other, primarily currency translation	1,307		1,307
Balance at December 31, 2012	$104,201	$825	$105,026

At December 31, 2012, accumulated goodwill impairment losses, subsequent to fiscal year 2002, totaled $36,605 and related to the Fluid Power Businesses segment.

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

December 31, 2012	Amount	Accumulated Amortization	Net Book Value
Finite-Lived Intangibles:			
Customer relationships	$103,635	$34,380	$69,255
Trade names	26,324	8,537	17,787
Vendor relationships	15,696	4,930	10,766
Non-competition agreements	5,146	3,330	1,816
Total Finite-Lived Intangibles	150,801	51,177	99,624
Indefinite-Lived Trade Names	1,290		1,290
Total Intangibles	$152,091	$51,177	$100,914

June 30, 2012	Amount	Accumulated Amortization	Net Book Value
Finite-Lived Intangibles:			
Customer relationships	$84,249	$29,905	$54,344
Trade names	25,677	7,428	18,249
Vendor relationships	13,605	4,500	9,105
Non-competition agreements	4,740	2,888	1,852
Total Finite-Lived Intangibles	128,271	44,721	83,550
Indefinite-Lived Trade Names	1,290		1,290
Total Intangibles	$129,561	$44,721	$84,840

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

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

During the six month period ended December 31, 2012, the Company acquired intangible assets with a preliminary acquisition cost allocation and weighted-average life as follows:

	Acquisition Cost Allocation	Weighted-Average Life
Customer relationships	$18,411	16 years
Trade names	458	9 years
Vendor relationships	2,138	10 years
Non-competition agreements	388	5 years
Total Intangibles Acquired	$21,395	15 years

Estimated future amortization expense by fiscal year (based on the Company’s intangible assets as of December 31, 2012) is as follows: $6,800 for the remainder of 2013, $14,100 for 2014, $12,700 for 2015, $11,400 for 2016, $9,600 for 2017 and $8,700 for 2018.

4. FAIR VALUE MEASUREMENTS

Marketable securities measured at fair value at December 31, 2012 and June 30, 2012 totaled $10,817 and $10,322. These marketable securities 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 and their fair values were based upon quoted market prices (Level 1 in the fair value hierarchy).

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Amounts in thousands, except per share amounts) (Unaudited)

5. SHAREHOLDERS' EQUITY

Other Comprehensive Income (Loss)
Details of other comprehensive income (loss) are as follows:

	Three Months Ended December 31,					
	2012			2011		
	Pre-Tax Amount	Tax Expense (Benefit)	Net Amount	Pre-Tax Amount	Tax Expense (Benefit)	Net Amount
Foreign currency translation adjustments	$(594)	$—	$(594)	$(8,117)	$—	$(8,117)
Postemployment benefits:						
Actuarial loss on remeasurement				(492)	(190)	(302)
Reclassification of actuarial losses and prior service cost into SD&A expense and included in net periodic pension costs	218	85	133	467	180	287
Impact of reduction in postemployment benefit liability (as forecasted salary increases will not be realized) due to a plan curtailment				8,860	3,411	5,449
Reclassification of prior service cost into SD&A expense upon plan curtailment				3,117	1,200	1,917
Unrealized gain (loss) on investment securities available for sale				47	18	29
Other comprehensive income (loss)	$(376)	$85	$(461)	$3,882	$4,619	$(737)

	Six Months Ended December 31,					
	2012			2011		
	Pre-Tax Amount	Tax Expense (Benefit)	Net Amount	Pre-Tax Amount	Tax Expense (Benefit)	Net Amount
Foreign currency translation adjustments	$8,408	$—	$8,408	$(11,159)	$—	$(11,159)
Postemployment benefits:						
Actuarial loss on remeasurement				(492)	(190)	(302)
Reclassification of actuarial losses and prior service cost into SD&A expense and included in net periodic pension costs	436	170	266	934	360	574
Impact of reduction in postemployment benefit liability (as forecasted salary increases will not be realized) due to a plan curtailment				8,860	3,411	5,449
Reclassification of prior service cost into SD&A expense upon plan curtailment				3,117	1,200	1,917
Unrealized gain (loss) on investment securities available for sale	23	9	14	(175)	(64)	(111)
Other comprehensive income (loss)	$8,867	$179	$8,688	$1,085	$4,717	$(3,632)

Antidilutive Common Stock Equivalents

In the three and six month periods ended December 31, 2012 and 2011, respectively, stock options and stock appreciation rights related to the acquisition of 171 and 251 shares of common stock in the three month periods and 171 and 276 shares of common stock in the six month periods were not included in the computation of diluted earnings per share for the periods then ended as they were anti-dilutive.

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

6. BENEFIT PLANS

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

	Pension Benefits		Retiree Health Care Benefits	
Three Months Ended December 31,	2012	2011	2012	2011
Components of net periodic cost:				
Service cost	$20	$127	$20	$8
Interest cost	315	588	47	59
Expected return on plan assets	(101)	(99)		
Recognized net actuarial loss (gain)	184	265	(14)	(18)
Amortization of prior service cost	21	185	27	35
Curtailment loss		3,117		
Net periodic cost	$439	$4,183	$80	$84

	Pension Benefits		Retiree Health Care Benefits	
Six Months Ended December 31,	2012	2011	2012	2011
Components of net periodic cost:				
Service cost	$39	$254	$40	$15
Interest cost	630	1,176	94	118
Expected return on plan assets	(202)	(198)		
Recognized net actuarial loss (gain)	368	529	(27)	(36)
Amortization of prior service cost	42	370	54	70
Curtailment loss		3,117		
Net periodic cost	$877	$5,248	$161	$167

The Company contributed $4,711 to its pension benefit plans and $105 to its retiree health care plans in the six months ended December 31, 2012. Expected contributions for the remainder of fiscal 2013 are $1,300 for the pension benefit plans to fund scheduled retirement payments and $135 for retiree health care plans.

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

7. SEGMENT AND GEOGRAPHIC INFORMATION

The accounting policies of the Company’s reportable segments are generally the same as those used to prepare the condensed consolidated financial statements. Intercompany sales primarily from the Fluid Power Businesses segment to the Service Center Based Distribution segment of $4,803 and $3,708, in the three months ended December 31, 2012 and 2011, respectively, and $8,732 and $7,955 in the six months ended December 31, 2012 and 2011, respectively, have been eliminated in the Segment Financial Information tables below.

Three Months Ended	Service Center Based Distribution	Fluid Power Businesses	Total
December 31, 2012			
Net sales	$480,476	$109,041	$589,517
Operating income for reportable segments	28,367	8,615	36,982
Depreciation and amortization of property	2,565	449	3,014
Capital expenditures	2,880	71	2,951
December 31, 2011			
Net sales	$458,315	$112,082	$570,397
Operating income for reportable segments	29,280	10,151	39,431
Depreciation and amortization of property	2,353	427	2,780
Capital expenditures	6,546	334	6,880

Six Months Ended	Service Center Based Distribution	Fluid Power Businesses	Total
December 31, 2012			
Net sales	$978,302	$221,734	$1,200,036
Operating income for reportable segments	62,088	19,151	81,239
Assets used in business	834,839	202,787	1,037,626
Depreciation and amortization of property	5,129	907	6,036
Capital expenditures	6,594	249	6,843
December 31, 2011			
Net sales	$922,173	$227,798	$1,149,971
Operating income for reportable segments	58,674	21,388	80,062
Assets used in business	681,019	216,994	898,013
Depreciation and amortization of property	4,651	947	5,598
Capital expenditures	13,346	676	14,022

The company is in the process of implementing a new ERP system (SAP). ERP related assets are included in assets used in business and capital expenditures within the Service Center Based Distribution segment. Expenses associated with the development and implementation of the ERP are included in Corporate and other expense (income) net, line in the reconciliation of operating income for reportable segments to the consolidated income before income taxes table below.

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APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
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(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 December 31,		Six Months Ended December 31,	
	2012	2011	2012	2011
Operating income for reportable segments	$36,982	$39,431	$81,239	$80,062
Adjustment for:				
Intangible amortization—Service Center Based Distribution	1,304	841	2,527	1,718
Intangible amortization—Fluid Power Businesses	1,847	1,894	3,680	3,826
Corporate and other expense (income), net	(6,738)	3,361	(9,855)	(2,084)
Total operating income	40,569	33,335	84,887	76,602
Interest expense, net	15	10	40	57
Other (income) expense, net	(427)	778	(886)	2,710
Income before income taxes	$40,981	$32,547	$85,733	$73,835

Corporate and other expense (income) net, for fiscal 2011 included approximately $4,400 of non-recurring SD&A expense, mostly pertaining to the curtailment loss recognized upon freezing our Supplemental Executive Retirement Benefits Plan as well as certain one-time CEO transition related expenses. Additional fluctuations in corporate and other expense (income), net are due to changes in the amounts and levels 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 facility shipping the product are as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2012	2011	2012	2011
Geographic Areas:				
United States	$478,318	$478,222	$977,854	$965,650
Canada	74,140	73,502	148,351	147,075
Other countries	37,059	18,673	73,831	37,246
Total	$589,517	$570,397	$1,200,036	$1,149,971

Other countries consisted of Mexico, Australia and New Zealand for the periods ended December 31, 2012, and Mexico for the periods ended December 31, 2011.

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APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Amounts in thousands, except per share amounts) (Unaudited)

8. OTHER (INCOME) EXPENSE , NET

Other (income) expense, net consists of the following:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2012	2011	2012	2011
Unrealized (gain) loss on assets held in rabbi trust for a nonqualified deferred compensation plan	$(140)	$(374)	$(580)	$1,006
Foreign currency transaction (gains) losses	(343)	1,047	(425)	1,556
Other, net	56	105	119	148
Total other (income) expense, net	$(427)	$778	$(886)	$2,710

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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 December 31, 2012, and the related condensed statements of consolidated income and consolidated comprehensive income for the three-month and six-month periods ended December 31, 2012 and 2011, and of consolidated cash flows for the six-month periods ended December 31, 2012 and 2011. 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, 2012, and the related statements of consolidated income, consolidated comprehensive income, consolidated shareholders' equity, and consolidated cash flows for the year then ended (not presented herein); and in our report dated August 15, 2012, 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, 2012 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
February 8, 2013

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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 a leading industrial distributor serving MRO (Maintenance, Repair & Operations), OEM (Original Equipment Manufacturer) and government markets. Applied is an authorized source for a diverse range of products, including bearings, power transmission components, fluid power components and systems, industrial rubber products, linear motion components, tools, safety products, and general maintenance and mill supply products. The Company also provides customized shop services for mechanical, fabricated rubber and fluid power products, as well as services to meet storeroom management and maintenance training needs. We have a long tradition of growth dating back to 1923, the year our business was founded in Cleveland, Ohio. During the second quarter of fiscal 2013, business was conducted in the United States, Canada, Mexico, Puerto Rico, Australia and New Zealand from 524 facilities.

The following is Management's Discussion and Analysis of 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, consolidated comprehensive 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 necessarily 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 sales for the quarter ended December 31, 2012 increased $19.1 million or 3.4% compared to the prior year quarter, with acquisitions contributing $25.3 million or 4.4% and a favorable foreign currency translation of $2.5 million increasing sales by 0.4%. Operating margin increased to 6.9% of sales from 5.8% for the prior year quarter largely driven by an increase in sales without a commensurate increase in SD&A costs. Net income of $27.0 million increased 29.2% compared to the prior year quarter. Shareholders' equity was $722.1 million at December 31, 2012, up from the June 30, 2012 level of $672.1 million. The current ratio was 2.7 to 1 at December 31, 2012 and 2.9 to 1 at June 30, 2012.

Applied monitors several economic indices that have been key indicators for industrial economic activity in the United States. These include the Industrial Production and Manufacturing Capacity Utilization (MCU) indices published by the Federal Reserve Board and the Purchasing Managers Index (PMI) 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.

In the December quarter, Industrial Production increased at an annual rate of 1%. The MCU for December was 77.4, up from the September 2012 revised reading of 76.7. The ISM PMI averaged 50.7 in the December quarter, a slight decrease from 51.5 in the September quarter, and above 50 (its expansionary threshold).

The number of Company associates was 5,160 at December 31, 2012, 4,664 at June 30, 2012, and 4,682 at December 31, 2011. The number of operating facilities totaled 524 at December 31, 2012 and 476 at June 30, 2012 and 475 at December 31, 2011.

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Results of Operations

Three months Ended December 31, 2012 and 2011

The following table is included to aid in review of Applied's condensed statements of consolidated income.