APPLIED INDUSTRIAL TECHNOLOGIES INC
Form 10-Q
February 03, 2014
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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended DECEMBER 31, 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 1-2299

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 41,965,748 (no par value) shares of common stock outstanding on January 15, 2014.

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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,	
	2013	2012	2013	2012
Net Sales	$581,949	$589,517	$1,187,254	$1,200,036
Cost of Sales	418,566	426,598	854,076	872,584
Gross Profit	163,383	162,919	333,178	327,452
Selling, Distribution and Administrative, including depreciation	123,546	122,350	253,802	242,565
Operating Income	39,837	40,569	79,376	84,887
Interest (Income) Expense, net	(152)	15	(91)	40
Other Income, net	(270)	(427)	(1,361)	(886)
Income Before Income Taxes	40,259	40,981	80,828	85,733
Income Tax Expense	14,350	13,938	28,075	29,158
Net Income	$25,909	$27,043	$52,753	$56,575
Net Income Per Share - Basic	$0.62	$0.64	$1.25	$1.35
Net Income Per Share - Diluted	$0.61	$0.64	$1.24	$1.33
Cash dividends per common share	$0.23	$0.21	$0.46	$0.42
Weighted average common shares outstanding for basic computation	42,076	42,052	42,116	42,009
Dilutive effect of potential common shares	386	442	431	477
Weighted average common shares outstanding for diluted computation	42,462	42,494	42,547	42,486

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,	
	2013	2012	2013	2012
Net income per the condensed statements of consolidated income	$25,909	$27,043	$52,753	$56,575
Other comprehensive income (loss), before tax:				
Foreign currency translation adjustments	(7,410)	(594)	(6,860)	8,408
Postemployment benefits:				
Reclassification of actuarial losses and prior service cost into SD&A expense and included in net periodic pension costs	96	218	191	436
Unrealized gain (loss) on investment securities available for sale	65	—	99	23
Total of other comprehensive income (loss), before tax	(7,249)	(376)	(6,570)	8,867
Income tax expense related to items of other comprehensive income	61	85	109	179
Other comprehensive income (loss), net of tax	(7,310)	(461)	(6,679)	8,688
Comprehensive income, net of tax	$18,599	$26,582	$46,074	$65,263

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, 2013	June 30, 2013
ASSETS		
Current assets		
Cash and cash equivalents	$66,584	$73,164
Accounts receivable, less allowances of $7,335 and $7,737	305,936	329,880
Inventories	323,257	281,417
Other current assets	54,702	52,819
Total current assets	750,479	737,280
Property, less accumulated depreciation of $163,179 and $157,506	80,056	83,243
Intangibles, net	91,669	91,267
Goodwill	111,356	106,849
Deferred tax assets	20,463	21,026
Other assets	20,136	19,041
TOTAL ASSETS	$1,074,159	$1,058,706
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Current liabilities		
Accounts payable	$140,869	$136,575
Short-term debt	15,000	—
Compensation and related benefits	48,769	63,899
Other current liabilities	46,216	45,426
Total current liabilities	250,854	245,900
Postemployment benefits	25,405	30,919
Other liabilities	24,421	22,272
TOTAL LIABILITIES	300,680	299,091
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	155,299	153,893
Income retained for use in the business	857,638	824,362
Treasury shares—at cost (12,224 and 12,044 shares)	(239,358)	(225,219)
Accumulated other comprehensive income (loss)	(10,100)	(3,421)
TOTAL SHAREHOLDERS’ EQUITY	773,479	759,615
TOTAL LIABILITIES AND SHAREHOLDERS’ EQUITY	$1,074,159	$1,058,706

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, 2013	2012
Cash Flows from Operating Activities		
Net income	$52,753	$56,575
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property	6,792	6,036
Amortization of intangibles	6,330	6,207
Unrealized foreign exchange transactions gain (loss)	79	(620)
Amortization of stock options and appreciation rights	931	1,197
Gain on sale of property	(10)	(193)
Other share-based compensation expense	2,286	1,982
Changes in operating assets and liabilities, net of acquisitions	(36,996)	(42,766)
Other, net	498	468
Net Cash provided by Operating Activities	32,663	28,886
Cash Flows from Investing Activities		
Property purchases	(4,126)	(6,843)
Proceeds from property sales	324	429
Net cash paid for acquisition of businesses, net of cash acquired	(17,000)	(66,055)
Net Cash used in Investing Activities	(20,802)	(72,469)
Cash Flows from Financing Activities		
Borrowings under revolving credit facility	15,000	33,000
Purchases of treasury shares	(13,838)	—
Dividends paid	(19,471)	(17,737)
Excess tax benefits from share-based compensation	2,057	1,461
Acquisition holdback payments	(1,032)	(1,845)
Exercise of stock options and appreciation rights	97	497
Net Cash provided by (used in) Financing Activities	(17,187)	15,376
Effect of Exchange Rate Changes on Cash	(1,254)	1,610
Decrease in Cash and Cash Equivalents	(6,580)	(26,597)
Cash and Cash Equivalents at Beginning of Period	73,164	78,442
Cash and Cash Equivalents at End of Period	$66,584	$51,845

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, 2013, and the results of its operations for the three and six month periods ended December 31, 2013 and 2012 and its cash flows for the six months ended December 31, 2013 and 2012, have been included. The condensed consolidated balance sheet as of June 30, 2013 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, 2013.

Operating results for the three and six month periods ended December 31, 2013 are not necessarily indicative of the results that may be expected for the remainder of the fiscal year ending June 30, 2014.

Change in Accounting Principle - Alignment of Canadian Subsidiary Reporting

Effective July 1, 2013, the Company aligned the consolidation of the Company’s Canadian subsidiary in the consolidated financial statements which previously included results on a one month reporting lag. The Company believes that this change in accounting principle is preferable as it provides contemporaneous reporting within our consolidated financial statements. In accordance with applicable accounting literature, the elimination of a one month reporting lag of a subsidiary is treated as a change in accounting principle and requires retrospective application. The Company has determined that the effect of this change is not material to the financial statements for all periods presented and therefore, the Company has not presented retrospective application of this change. The net impact of the lag elimination of $1.2 million of income for the month of June 2013 has been included within “Other (Income) Expense, net” on the Statement of Consolidated Income for the six months ended December 31, 2013. The three months ended December 31, 2013 reflect the same results, had the financial statements been retrospectively adjusted. The six months ended December 31, 2013 reflect the same results, had the financial statements been retrospectively adjusted, with the exception of net income which would have decreased $1.2 million. Net sales, operating income and net income for the three months ended December 31, 2012, would have decreased by $1.4 million, $0.4 million and $0.3 million respectively had the financial statements been retrospectively adjusted. Net sales, operating income and net income for the six months ended December 31, 2012, would have decreased by $2.9 million, $1.2 million and $1.2 million respectively had the financial statements been retrospectively adjusted.

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.

Reclassifications

Certain reclassifications have been made to the prior year financial statements to conform to the 2014 presentation.

2. BUSINESS COMBINATIONS

In December 2013, the Company acquired substantially all of the net assets of Texas Oilpatch Services Corporation, a Texas distributor of bearings, oil seals, power transmission products, and related replacement parts to the oilfield industry. The acquired business is included in the Service Center Based Distribution segment from December 31, 2013.

The results of operations for this acquisition are not material for any period presented.

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

3. GOODWILL AND INTANGIBLES

The changes in the carrying amount of goodwill for the six month period ended December 31, 2013 are as follows:

	Service Center Based Distribution	Fluid Power Businesses	Total
Balance at July 1, 2013	$105,920	$929	$106,849
Goodwill acquired during the period	5,590		5,590
Other, primarily currency translation	(1,083)		(1,083)
Balance at December 31, 2013	$110,427	$929	$111,356

At December 31, 2013, 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, 2013	Amount	Accumulated Amortization	Net Book Value
Finite-Lived Intangibles:			
Customer relationships	$107,226	$43,022	$64,204
Trade names	26,486	9,436	17,050
Vendor relationships	15,297	5,977	9,320
Non-competition agreements	2,789	1,694	1,095
Total Intangibles	$151,798	$60,129	$91,669

June 30, 2013	Amount	Accumulated Amortization	Net Book Value
Finite-Lived Intangibles:			
Customer relationships	$100,854	$38,844	$62,010
Trade names	26,690	8,643	18,047
Vendor relationships	15,433	5,443	9,990
Non-competition agreements	4,743	3,523	1,220
Total Intangibles	$147,720	$56,453	$91,267

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

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APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
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(Amounts in thousands, except per share amounts) (Unaudited)

During the six month period ended December 31, 2013, 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	$7,000	20 years
Trade names	120	5 years
Non-competition agreements	250	5 years
Total Intangibles Acquired	$7,370	19 years

Estimated future amortization expense by fiscal year (based on the Company's intangible assets as of December 31, 2013) is as follows: $6,500 for the remainder of 2014, $12,000 for 2015, $11,000 for 2016, $10,200 for 2017, $9,000 for 2018 and $8,000 for 2019.

4. FAIR VALUE MEASUREMENTS

Marketable securities measured at fair value at December 31, 2013 and June 30, 2013 totaled $11,582 and $10,483. 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).

5. SHAREHOLDERS' EQUITY

Accumulated Other Comprehensive Income (Loss)

Changes in the accumulated other comprehensive income (loss), are comprised of the following:

	Three Months Ended December 31, 2013			
	Foreign currency translation adjustment	Unrealized gain (loss) on securities available for sale	Postemployment benefits	Total Accumulated other comprehensive income (loss)
Balance at September 30, 2013	$910	$(29)	$(3,671)	$(2,790)
Other comprehensive income (loss)	(7,410)	42		(7,368)
Amounts reclassified from accumulated other comprehensive income (loss)	—	—	58	58
Net current-period other comprehensive income (loss), net of taxes	(7,410)	42	58	(7,310)
Balance at December 31, 2013	$(6,500)	$13	$(3,613)	$(10,100)

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

	Six Months Ended December 31, 2013			
	Foreign currency translation adjustment	Unrealized gain (loss) on securities available for sale	Postemployment benefits	Total Accumulated other comprehensive income (loss)
Balance at July 1, 2013	$360	$(52)	$(3,729)	$(3,421)
Other comprehensive income (loss)	(6,860)	65		(6,795)
Amounts reclassified from accumulated other comprehensive income (loss)	—	—	116	116
Net current-period other comprehensive income (loss), net of taxes	(6,860)	65	116	(6,679)
Balance at December 31, 2013	$(6,500)	$13	$(3,613)	$(10,100)

Other Comprehensive Income (Loss)

Details of other comprehensive income (loss) are as follows:

	Three Months Ended December 31, 2013			2012		
	Pre-Tax Amount	Tax Expense (Benefit)	Net Amount	Pre-Tax Amount	Tax Expense (Benefit)	Net Amount
Foreign currency translation adjustments	$(7,410)	$—	$(7,410)	$(594)	$—	$(594)
Postemployment benefits:						
Reclassification of actuarial losses and prior service cost into SD&A expense and included in net periodic pension costs	96	38	58	218	85	133
Unrealized gain (loss) on investment securities available for sale	65	23	42	—	—	—
Other comprehensive income (loss)	$(7,249)	$61	$(7,310)	$(376)	$85	$(461)

	Six Months Ended December 31, 2013			2012		
	Pre-Tax Amount	Tax Expense (Benefit)	Net Amount	Pre-Tax Amount	Tax Expense (Benefit)	Net Amount
Foreign currency translation adjustments	$(6,860)	$—	$(6,860)	$8,408	$—	$8,408
Postemployment benefits:						
Reclassification of actuarial losses and prior service cost into SD&A expense and included in net periodic pension costs	191	75	116	436	170	266
Unrealized gain (loss) on investment securities available for sale	99	34	65	23	9	14
Other comprehensive income (loss)	$(6,570)	$109	$(6,679)	$8,867	$179	$8,688

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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 and six month periods ended December 31, 2013 and 2012, respectively, stock options and stock appreciation rights related to the acquisition of 272 and 171 shares of common stock in the three month periods and 272 and 171 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.

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,	2013	2012	2013	2012
Components of net periodic cost:				
Service cost	$19	$20	$12	$20
Interest cost	295	315	34	47
Expected return on plan assets	(104)	(101)	—	—
Recognized net actuarial loss (gain)	153	184	(10)	(14)
Amortization of prior service cost	19	21	(67)	27
Net periodic cost	$382	$439	$(31)	$80

	Pension Benefits		Retiree Health Care Benefits	
Six Months Ended December 31, 2013	2013	2012	2013	2012
Components of net periodic cost:				
Service cost	$38	$39	$24	$40
Interest cost	590	630	69	94
Expected return on plan assets	(208)	(202)	—	—
Recognized net actuarial loss (gain)	306	368	(19)	(27)
Amortization of prior service cost	39	42	(135)	54
Net periodic cost	$765	$877	$(61)	$161

The Company contributed $5,295 to its pension benefit plans and $100 to its retiree health care plans in the six months ended December 31, 2013. Expected contributions for the remainder of fiscal 2014 are $1,400 for the pension benefit plans to fund scheduled retirement payments and $150 for retiree health care plans.

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APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(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. Sales primarily from the Fluid Power Businesses segment to the Service Center Based Distribution segment of $5,681 and $4,803, in the three months ended December 31, 2013 and 2012, respectively, and $11,110 and $8,732 in the six months ended December 31, 2013 and 2012, respectively, have been eliminated in the Segment Financial Information tables below.

Three Months Ended	Service Center Based Distribution	Fluid Power Businesses	Total
December 31, 2013			
Net sales	$465,955	$115,994	$581,949
Operating income for reportable segments	25,569	10,364	35,933
Depreciation and amortization of property	2,988	373	3,361
Capital expenditures	2,340	215	2,555
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

Six Months Ended	Service Center Based Distribution	Fluid Power Businesses	Total
December 31, 2013			
Net sales	$958,027	$229,227	$1,187,254
Operating income for reportable segments	53,941	19,821	73,762
Assets used in business	864,996	209,163	1,074,159
Depreciation and amortization of property	5,987	805	6,792
Capital expenditures	3,734	392	4,126
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

Enterprise Resource Planning system (ERP) related assets are included in assets used in business and capital expenditures within the Service Center Based Distribution segment. Expenses associated with 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
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 December 31,		Six Months Ended December 31,	
	2013	2012	2013	2012
Operating income for reportable segments	$35,933	$36,982	$73,762	$81,239
Adjustment for:				
Intangible amortization—Service Center Based Distribution	1,887	1,304	3,382	2,527
Intangible amortization—Fluid Power Businesses	1,194	1,847	2,948	3,680
Corporate and other expense (income), net	(6,985)	(6,738)	(11,944)	(9,855)
Total operating income	39,837	40,569	79,376	84,887
Interest (income) expense, net	(152)	15	(91)	40
Other (income) expense, net	(270)	(427)	(1,361)	(886)
Income before income taxes	$40,259	$40,981	$80,828	$85,733

The change in corporate and other expense (income), net is 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 and are as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2013	2012	2013	2012
Geographic Areas:				
United States	$479,488	$478,318	$980,539	$977,854
Canada	67,770	74,140	137,517	148,351
Other countries	34,691	37,059	69,198	73,831
Total	$581,949	$589,517	$1,187,254	$1,200,036

Other countries consisted of Mexico, Australia and New Zealand.

(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,	
	2013	2012	2013	2012
Unrealized (gain) loss on assets held in rabbi trust for a nonqualified deferred compensation plan	$(649)	$(140)	$(1,245)	$(580)
Foreign currency transaction (gains) losses	302	(343)	907	(425)
Elimination of one-month Canadian reporting lag effective July 1, 2013	—	—	(1,167)	—
Other, net	77	56	144	119
Total other income, net	$(270)	$(427)	$(1,361)	$(886)

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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, 2013, and the related condensed statements of consolidated income and consolidated comprehensive income for the three-month and six-month periods ended December 31, 2013 and 2012, and of consolidated cash flows for the six-month periods ended December 31, 2013 and 2012. 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, 2013, 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 20, 2013, 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, 2013 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 3, 2014

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APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS

With more than 5,000 associates across North America, Australia and New Zealand, Applied Industrial Technologies ("Applied," the "Company," "We," "Us" or "Our") is a leading industrial distributor serving MRO (Maintenance, Repair & Operations) and OEM (Original Equipment Manufacturer) customers in virtually every industry. In addition, Applied provides engineering, design and systems integration for industrial and fluid power applications, as well as customized mechanical, fabricated rubber and fluid power shop services. Applied also offers maintenance training and inventory management solutions that provide added value to our customers. 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 2014, business was conducted in the United States, Canada, Mexico, Puerto Rico, Australia and New Zealand from 521 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

Sales for the quarter ended December 31, 2013 decreased $7.6 million or 1.3% compared to the prior year quarter, with acquisitions contributing $7.4 million or 1.2%, an unfavorable foreign currency translation of $6.2 million decreasing sales by 1.0% and decreases in sales from our businesses not acquired in the current year of $8.8 million or 1.5%. Operating margin decreased slightly to 6.8% of sales from 6.9% for the prior year quarter driven by an increase in SD&A as a percentage of sales. Net income of $25.9 million decreased