

APPLIED INDUSTRIAL TECHNOLOGIES INC
Form 10-Q
February 02, 2011

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 DECEMBER 31, 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 January 14, 2011 42,453,803 (No par value)

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
INDEX

| | Page No. |
|---|-------------|
| Part I: FINANCIAL INFORMATION | |
| Item 1: Financial Statements | |
| Condensed Statements of Consolidated Income Three and Six Months Ended December 31, 2010 and 2009 | 2 |
| Condensed Consolidated Balance Sheets December 31, 2010 and June 30, 2010 | 3 |
| Condensed Statements of Consolidated Cash Flows Six Months Ended December 31, 2010 and 2009 | 4 |
| Notes to Condensed Consolidated Financial Statements | 5 |
| Report of Independent Registered Public Accounting Firm | 15 |
| Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations | 16 |
| Item 3: Quantitative and Qualitative Disclosures About Market Risk | 25 |
| Item 4: Controls and Procedures | 26 |
| Part II: OTHER INFORMATION | |
| Item 1: Legal Proceedings | 27 |
| Item 1A: Risk Factors | 27 |
| Item 2: Unregistered Sales of Equity Securities and Use of Proceeds | 27 |
| Item 6: Exhibits | 28 |
| Signatures | 30 |
| Exhibit Index | |
| Exhibits | |

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, | |
|--|------------------------------------|------------|----------------------------------|------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net Sales | \$ 529,517 | \$ 446,253 | \$ 1,057,018 | \$ 883,996 |
| Cost of Sales | 385,236 | 329,348 | 769,617 | 651,647 |
| | 144,281 | 116,905 | 287,401 | 232,349 |
| Selling, Distribution and Administrative, including depreciation | 111,225 | 98,002 | 219,454 | 195,805 |
| Operating Income | 33,056 | 18,903 | 67,947 | 36,544 |
| Interest Expense, net | 458 | 1,333 | 1,582 | 2,547 |
| Other (Income) Expense, net | (421) | 58 | (764) | (245) |
| Income Before Income Taxes | 33,019 | 17,512 | 67,129 | 34,242 |
| Income Tax Expense | 11,826 | 7,025 | 25,181 | 12,568 |
| Net Income | \$ 21,193 | \$ 10,487 | \$ 41,948 | \$ 21,674 |
| Net Income Per Share Basic | \$ 0.50 | \$ 0.25 | \$ 0.99 | \$ 0.51 |
| Net Income Per Share Diluted | \$ 0.49 | \$ 0.24 | \$ 0.97 | \$ 0.51 |
| Cash dividends per common share | \$ 0.17 | \$ 0.15 | \$ 0.34 | \$ 0.30 |
| Weighted average common shares outstanding for basic computation | 42,411 | 42,298 | 42,391 | 42,287 |
| Dilutive effect of potential common shares | 887 | 532 | 826 | 506 |
| Weighted average common shares outstanding for diluted computation | 43,298 | 42,830 | 43,217 | 42,793 |

See notes to condensed consolidated financial statements.

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

| | December 31, 2010 (Unaudited) | June 30, 2010 |
|---|--|-------------------|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | \$ 53,915 | \$ 175,777 |
| Accounts receivable, less allowances of \$6,308 and \$6,379 | 250,671 | 246,402 |
| Inventories | 194,991 | 173,253 |
| Other current assets | 29,392 | 23,428 |
| Total current assets | 528,969 | 618,860 |
| Property, less accumulated depreciation of \$140,278 and \$138,790 | 67,357 | 58,471 |
| Intangibles, net | 93,389 | 85,916 |
| Goodwill | 74,587 | 63,405 |
| Deferred tax assets | 47,557 | 48,493 |
| Other assets | 17,771 | 16,375 |
| TOTAL ASSETS | \$ 829,630 | \$ 891,520 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities | | |
| Accounts payable | \$ 86,957 | \$ 94,529 |
| Short-term debt | | 75,000 |
| Compensation and related benefits | 42,134 | 50,107 |
| Other current liabilities | 43,049 | 51,696 |
| Total current liabilities | 172,140 | 271,332 |
| Postemployment benefits | 49,371 | 48,560 |
| Other liabilities | 18,878 | 16,589 |
| TOTAL LIABILITIES | 240,389 | 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 | 146,804 | 143,185 |
| Income retained for use in the business | 628,912 | 601,370 |
| Treasury shares at cost (11,760 and 11,837 shares) | (192,598) | (193,468) |
| Accumulated other comprehensive loss | (3,877) | (6,048) |
| TOTAL SHAREHOLDERS EQUITY | 589,241 | 555,039 |

| | | |
|--|------------|------------|
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 829,630 | \$ 891,520 |
|--|------------|------------|

See notes to condensed consolidated financial statements.

3

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

| | Six Months Ended December 31, | |
|---|----------------------------------|-------------------|
| | 2010 | 2009 |
| Cash Flows from Operating Activities | | |
| Net income | \$ 41,948 | \$ 21,674 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 5,496 | 5,770 |
| Amortization of intangibles | 5,678 | 5,047 |
| Amortization of stock options and appreciation rights | 1,569 | 2,275 |
| Gain on sale of property | (20) | (116) |
| Treasury shares contributed to employee benefit, deferred compensation and other share-based compensation plans | 2,110 | 777 |
| Changes in assets and liabilities, net of acquisitions | (37,934) | 59,705 |
| Other, net | 1,119 | 531 |
| Net Cash provided by Operating Activities | 19,966 | 95,663 |
| Cash Flows from Investing Activities | | |
| Property purchases | (13,804) | (2,951) |
| Proceeds from property sales | 124 | 421 |
| Net cash paid for acquisition of businesses, net of cash acquired | (27,739) | (100) |
| Net Cash used in Investing Activities | (41,419) | (2,630) |
| Cash Flows from Financing Activities | | |
| Repayments under revolving credit facility | (50,000) | (5,000) |
| Long-term debt repayments | (25,000) | |
| Settlements of cross currency swap agreements | (12,752) | |
| Dividends paid | (14,422) | (12,699) |
| Excess tax benefits from share-based compensation | 778 | 251 |
| Exercise of stock options and appreciation rights | 338 | 205 |
| Net Cash used in Financing Activities | (101,058) | (17,243) |
| Effect of Exchange Rate Changes on Cash | 649 | 771 |
| (Decrease) increase in cash and cash equivalents | (121,862) | 76,561 |
| Cash and cash equivalents at beginning of period | 175,777 | 27,642 |
| Cash and Cash Equivalents at End of Period | \$ 53,915 | \$ 104,203 |

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 December 31, 2010, and the results of its operations for the three and six month periods ended December 31, 2010 and 2009 and its cash flows for the six months ended December 31, 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 and six month periods ended December 31, 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.

LIFO layer liquidation benefits recognized in the three and six month periods ended December 31, 2010 were not significant. During the three and six month periods ended December 31, 2009, the Company recorded LIFO layer liquidations reducing cost of goods sold by \$1,800 and \$2,500, respectively and 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 \$3,900 in the three-months ended December 31, 2009 and \$7,500 for the six-months ended December 31, 2009. Thus, the combined overall effect of LIFO layer liquidations during the three months and six months ended December 31, 2009 increased gross profit by \$5,700 and \$10,000, respectively.

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. The net book value of software is \$13,800 and \$3,800 at December 31, 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 and six month periods ended December 31, 2010 and 2009, respectively, stock options and stock appreciation rights related to the acquisition of 102 and 1,423 shares of common stock in the three month periods and 297 and 1,310 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.

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.

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 December 31, 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 | 10,637 | | 10,637 |
| Other, including currency translation | 545 | | 545 |
| Balance at December 31, 2010 | \$ 74,587 | \$ 0 | \$74,587 |

At December 31, 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:

| December 31, 2010 | Amount | Accumulated Amortization | Net Book Value |
|------------------------------------|-------------------|-----------------------------|-------------------|
| Amortized Intangibles: | | | |
| Customer relationships | \$ 76,465 | \$ 19,060 | \$ 57,405 |
| Trade names | 25,664 | 4,612 | 21,052 |
| Vendor relationships | 13,945 | 3,067 | 10,878 |
| Non-competition agreements | 4,893 | 2,129 | 2,764 |
| Total Amortized Intangibles | 120,967 | 28,868 | 92,099 |
| Non-amortized trade name | 1,290 | | 1,290 |
| Total Intangibles | \$ 122,257 | \$ 28,868 | \$ 93,389 |
| | | | |
| 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 for each of the following fiscal years (based on the Company's intangible assets as of December 31, 2010) is estimated to be \$11,500 for 2011, \$10,800 for 2012, \$10,000 for 2013, \$8,700 for 2014, \$8,000, for 2015 and \$7,400 for 2016.

4. DEBT

In September 2010, the Company repaid \$50.0 million under the revolving credit facility. In November 2010, the Company repaid \$25.0 million under the private placement borrowing.

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 derivative instruments outstanding at June 30, 2010 have been settled in the first half of fiscal 2011. 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

The cross-currency swap agreements entered into in November 2000 were settled this quarter. Thus, there are no unrealized losses included in accumulated other comprehensive loss during the quarter for the \$20,000 cross-currency swap which was designated as a cash flow hedge. At June 30, 2010, this liability was included in other current liabilities in the condensed consolidated balance sheets.

The other cross-currency swap with a notional amount of \$5,000 was not designated as a hedging instrument under hedge accounting provisions. At June 30, 2010, this contract was classified in 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.

Interest Rate Risk

The interest rate swap entered into in September 2008 was settled in the first quarter of fiscal 2011, 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 at June 30, 2010 (there are no amounts outstanding at December 31, 2010):

| | Fair Value |
|--|---------------|
| Derivatives designated as hedging instruments: | |
| Cross-currency swap | \$ 8,728 |
| Interest rate swap | 316 |
| Total derivatives designated as hedging instruments | 9,044 |
| Derivative not designated as a hedging instrument cross-currency swap: | 2,182 |
| Total Derivatives | \$ 11,226 |

The following table summarizes the effects of derivative instruments on income and other comprehensive income (OCI) for the three and six months ended December 31, 2010 and 2009 (amounts presented exclude income tax effects):

| | Amount of Gain (Loss) Recognized in OCI on | | | | Amount of Loss Reclassified from Accumulated OCI into Income (Effective Portion), Included | | | |
|---|---|----------|------------------|------------|---|----------|------------------|----------|
| | Derivatives (Effective Portion) | | | | in Interest Expense, net | | | |
| | Three Months Ended | | Six Months Ended | | Three Months Ended | | Six Months Ended | |
| Derivatives in Cash Flow Hedging Relationships | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 | 2010 | 2009 |
| Cross-currency swap | \$ | \$ (496) | \$ | \$ (2,800) | | | | |
| Interest rate swap | | 271 | | 403 | \$ | \$ (355) | \$ (316) | \$ (706) |
| Total | \$ | \$ (225) | \$ | \$ (2,397) | \$ | \$ (355) | \$ (316) | \$ (706) |

| | Amount of Gain (Loss) Recognized in Income on Derivative, Included in Other (Income) Expense, net | | | |
|--|---|----------|------------------|----------|
| | Three Months Ended | | Six Months Ended | |
| | 2010 | 2009 | 2010 | 2009 |
| Derivative Not Designated as Hedging Instrument | | | | |
| Cross-currency swap | \$ 161 | \$ (124) | \$ 368 | \$ (700) |

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 December 31, 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 | | | |
| | December 31, 2010 | June 30, 2010 | December 31, 2010 | June 30, 2010 | December 31, 2010 | June 30, 2010 |
| Assets: | | | | | | |
| Marketable securities | \$ 10,369 | \$ 8,592 | \$ 10,369 | \$ 8,592 | | |
| Liabilities: | | | | | | |
| Cross-currency swaps | \$ | \$ 10,910 | | | \$ | \$ 10,910 |
| Interest rate swap | | 316 | | | | 316 |
| Total Liabilities | \$ | \$ 11,226 | | | \$ | \$ 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 were 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 were observable and the counterparties were creditworthy, the Company classified them as Level 2 inputs. These liabilities have all been settled in fiscal 2011, the balances at June 30, 2010 were 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 December 31, | |
|--|---------------------------------------|------------------|
| | 2010 | 2009 |
| Net income | \$ 21,193 | \$ 10,487 |
| Other comprehensive income (loss): | | |
| Unrealized gain on cash flow hedges, net of income tax of \$344 and \$134 | 846 | 314 |
| Reclassification of interest expense into income, net of income tax of \$135 in the quarter ended 12/31/09 | | 221 |
| Reclassification of pension and postemployment expense into income, net of income tax of \$212 and \$169 | 341 | 276 |
| Foreign currency translation adjustment, net of income tax of \$58 and \$30 | 3,088 | 2,944 |
| Unrealized gain on investment securities available for sale, net of income tax of \$43 and \$3 | 59 | 9 |
| Total comprehensive income | \$ 25,527 | \$ 14,251 |
| | | |
| | Six Months Ended December 31, | |
| | 2010 | 2009 |
| Net income | \$ 41,948 | \$ 21,674 |
| Other comprehensive (loss) income: | | |
| Unrealized loss on cash flow hedges, net of income tax of \$(82) and \$(678) | (184) | (1,487) |
| Reclassification of interest expense into income, net of income tax of \$116 and \$268 | 200 | 438 |
| Reclassification of pension and postemployment expense into income, net of income tax of \$347 and \$338 | 760 | 552 |
| Foreign currency translation adjustment, net of income tax of \$38 and \$17 | 1,291 | 1,750 |
| Unrealized gain on investment securities available for sale, net of income tax of \$68 and \$11 | 104 | 28 |
| Total comprehensive income | \$ 44,119 | \$ 22,955 |

8. BENEFIT PLANS

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

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

| Three Months Ended December 31, | Pension Benefits | | Retiree Health Care Benefits | |
|--|------------------|----------|------------------------------|-------|
| | 2010 | 2009 | 2010 | 2009 |
| Components of net periodic benefit cost: | | | | |
| Service cost | \$ 115 | \$ 144 | \$ 10 | \$ 13 |
| Interest cost | 564 | 673 | 59 | 65 |
| Expected return on plan assets | (96) | (88) | | |
| Recognized net actuarial loss (gain) | 362 | 231 | (21) | (22) |
| Amortization of prior service cost | 178 | 199 | 35 | 37 |
| Net periodic benefit cost | \$ 1,123 | \$ 1,159 | \$ 83 | \$ 93 |

| Six Months Ended December 31, | Pension Benefits | | Retiree Health Care Benefits | |
|--|------------------|----------|------------------------------|--------|
| | 2010 | 2009 | 2010 | 2009 |
| Components of net periodic benefit cost: | | | | |
| Service cost | \$ 230 | \$ 287 | \$ 20 | \$ 26 |
| Interest cost | 1,129 | 1,347 | 118 | 130 |
| Expected return on plan assets | (192) | (176) | | |
| Recognized net actuarial loss (gain) | 724 | 462 | (42) | (44) |
| Amortization of prior service cost | 355 | 399 | 69 | 74 |
| Net periodic benefit cost | \$ 2,246 | \$ 2,319 | \$ 165 | \$ 186 |

The Company contributed \$1,329 to its pension benefit plans and \$72 to its retiree health care plans in the six months ended December 31, 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 |
|--|--|------------------------------|-----------|
| December 31, 2010 | | | |
| Net sales | \$426,161 | \$ 103,356 | \$529,517 |
| Operating income for reportable segments | 25,288 | 9,875 | 35,163 |
| Depreciation | 2,286 | 497 | 2,783 |
| Capital expenditures | 12,832 | 99 | 12,931 |
| December 31, 2009 | | | |
| Net sales | \$366,373 | \$ 79,880 | \$446,253 |
| Operating income for reportable segments | 16,340 | 5,477 | 21,817 |
| Depreciation | 2,306 | 535 | 2,841 |
| Capital expenditures | 1,599 | 62 | 1,661 |

Segment Financial Information for the six months ended:

| | Service Center Based Distribution | Fluid Power Businesses | Total |
|--|--|------------------------------|-------------|
| December 31, 2010 | | | |
| Net sales | \$850,114 | \$ 206,904 | \$1,057,018 |
| Operating income for reportable segments | 51,356 | 19,309 | 70,665 |
| Assets used in the business | 630,572 | 199,058 | 829,630 |
| Depreciation | 4,463 | 1,033 | 5,496 |
| Capital expenditures | 13,549 | 255 | 13,804 |
| December 31, 2009 | | | |
| Net sales | \$729,682 | \$ 154,314 | \$ 883,996 |
| Operating income for reportable segments | 33,602 | 8,775 | 42,377 |
| Assets used in the business | 633,457 | 192,683 | 826,140 |
| Depreciation | 4,690 | 1,080 | 5,770 |
| Capital expenditures | 2,671 | 280 | 2,951 |

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 | |
|---|-----------------------------------|-----------|---------------------------------|-----------|
| | 2010 | 2009 | 2010 | 2009 |
| Operating income for reportable segments | \$ 35,163 | \$ 21,817 | \$ 70,665 | \$ 42,377 |
| Adjustment for: | | | | |
| Amortization of intangibles: | | | | |
| Service Center Based Distribution | 905 | 508 | 1,686 | 921 |
| Fluid Power Businesses | 1,986 | 2,063 | 3,992 | 4,126 |
| Corporate and other (income) expense, net | (784) | 343 | (2,960) | 786 |
| Total operating income | 33,056 | 18,903 | 67,947 | 36,544 |
| Interest expense, net | 458 | 1,333 | 1,582 | 2,547 |
| Other (income) expense, net | (421) | 58 | (764) | (245) |
| Income before income taxes | \$ 33,019 | \$ 17,512 | \$ 67,129 | \$ 34,242 |

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 facility shipping the sale and are as follows:

| Geographic Areas: | Three Months Ended December 31, | | Six Months Ended December 31, | |
|-------------------|------------------------------------|------------|----------------------------------|------------|
| | 2010 | 2009 | 2010 | 2009 |
| United States | \$ 450,951 | \$ 384,851 | \$ 910,244 | \$ 763,584 |
| Canada | 63,329 | 48,947 | 117,410 | 96,785 |
| Mexico | 15,237 | 12,455 | 29,364 | 23,627 |
| Total | \$ 529,517 | \$ 446,253 | \$ 1,057,018 | \$ 883,996 |

10. SUBSEQUENT EVENT

As disclosed in the Company's Annual Report on Form 10-K for the year ended June 30, 2010, the Company is the owner and beneficiary under life insurance policies with benefits in force of \$14,000 and a net cash surrender value of \$3,200 at June 30, 2010. In January 2011, the Company received \$1,800 in benefits under these policies and expects to realize a gain of \$1,700 in the quarter ending March 31, 2011.

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, 2010, and the related condensed statements of consolidated income for the three-month and six-month periods ended December 31, 2010 and 2009, and of consolidated cash flows for the six-month periods ended December 31, 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
February 2, 2011

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 second quarter of fiscal 2011, business was conducted in the United States, Canada, Mexico and Puerto Rico from 473 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 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 December 31, 2010 increased \$83.3 million or 18.7% compared to the prior year quarter, with acquisitions contributing \$11.4 million and favorable foreign currency translation accounting for \$3.3 million or a 0.7% increase over the prior year sales. Operating margin increased to 6.2% of net sales from 4.2% for the prior year quarter and net income increased \$10.7 million or 102.1% compared to the prior year quarter. Shareholders' equity at December 31, 2010 was \$589.2 million. The current ratio moved to 3.1 to 1 from 2.3 to 1 at June 30, 2010 as we retired \$75.0 million of debt in fiscal 2011. As of December 31, 2010, we had no borrowings outstanding under our existing credit facilities.

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 continued moderate growth in the industrial economy during the second quarter of fiscal 2011. The MCU for December is 73.5, up from September's 72.4 and still well above its last trough of 65.2 in June of 2009. The ISM was 57.0 in December, up from September's 54.4. While down from its 2010 high of 60.4 in April, the ISM appears stable and is in keeping with a forecast for moderate growth. Our second quarter average sales per day

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

increased 5.3% compared to our first quarter average sales per day and were 20.6% above our prior year second quarter average sales per day. We believe 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 4,655 at December 31, 2010, 4,468 at June 30, 2010, and 4,550 at December 31, 2009. During the six months ended December 31, 2010, exclusive of acquisitions, headcount fell by 40 associates. Acquisitions completed since June 30, 2010 added 227 associates. The number of operating facilities totaled 473 at December 31, 2010 and 463 at December 31, 2009.

Results of Operations**Three Months Ended December 31, 2010 and 2009**

The following table is included to aid in review of Applied's condensed statements of consolidated income. The percent increase (decrease) column is comparative to the same period in the prior year.

| | Three Months Ended December 31, | | |
|--|---------------------------------|--------|------------------------|
| | As a Percent of Net Sales | | Percent |
| | 2010 | 2009 | Increase (Decrease) |
| Net Sales | 100.0% | 100.0% | 18.7% |
| Gross Profit | 27.2% | 26.2% | 23.4% |
| Selling, Distribution & Administrative | 21.0% | 22.0% | 13.5% |
| Operating Income | 6.2% | 4.2% | 74.9% |
| Net Income | 4.0% | 2.4% | 102.1% |

During the quarter ended December 31, 2010, net sales increased \$83.3 million or 18.7% compared to the prior year quarter, with acquisitions accounting for additional sales of \$11.4 million or 2.6%. The number of selling days for the quarters ended December 31, 2010 and 2009 were 61 and 62 days, respectively.

Net sales from our Service Center Based Distribution segment increased \$59.8 million or 16.3% during the quarter from the same period in the prior year, primarily attributed to improvement in the industrial economy. Acquisitions within this segment increased sales by \$11.4 million, or 3.1%.

Net sales from our Fluid Power Businesses segment increased \$23.5 million or 29.4% during the quarter from the same period in the prior year, primarily attributed to improvements in the industrial economy.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

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

From a geographic perspective, sales from our U.S. operations were up \$66.1 million or 17.2%, with acquisitions accounting for \$6.0 million of the U.S. increase. Sales from our Canadian operations increased \$14.4 million or 29.4%. This increase consists of improvements in their industrial economy, \$5.4 million from acquisitions and \$2.4 million due to favorable foreign currency translation. Our Mexican operations increased \$2.8 million or 22.3%, with \$0.8 million due to favorable foreign currency.

During the quarter ended December 31, 2010, industrial products and fluid power products accounted for 71.4% and 28.6%, respectively, of net sales as compared to 72.3% and 27.7%, respectively, for the same period in the prior year. The increase in fluid power products is reflective of the increases in sales in the Fluid Power Businesses segment. Our gross profit margin for the quarter increased to 27.2% compared to the prior year quarter's 26.2%. The current quarter's gross profit was positively impacted by LIFO benefits of \$1.7 million or 0.3% resulting from effective price decreases from increased supplier purchasing incentives in fiscal 2011. These decreases flow through the LIFO calculation as a benefit as the price paid for product (net of inventory purchasing incentives) is lower this year versus last. We do not anticipate this to impact the third or fourth quarters. We are also experiencing competitive pricing pressures 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 21.0% of net sales in the quarter ended December 31, 2010 compared to 22.0% in the prior year quarter. On an absolute basis, SD&A increased \$13.2 million or 13.5% compared to the prior year quarter. Performance driven expenses and employee benefits increased \$6.9 million while acquisitions added \$5.1 million. SD&A as a percentage of sales for companies acquired this year is higher than our existing businesses. The companies acquired this year are higher margin, higher costs to serve businesses. Excluding the impact of our current year acquisitions, SD&A increased 8.3% which is near our goal of managing SD&A growth to 50% of our sales growth rate.

Interest, net is down \$0.9 million due to repayment of the revolver in September 2010 and the private placement debt in November 2010.

Operating income increased 74.9% to \$33.1 million during the quarter compared to \$18.9 million during the prior year quarter. Operating income as a percentage of sales for the Service Center Based Distribution segment increased to 5.9% in the current year quarter, from 4.5% in the prior year quarter. The Fluid Power Businesses operating margins increased to 9.6% in the current year quarter from 6.9% in the prior year quarter. These increases as compared to the prior year quarter reflect improved operating leverage on the increases in sales. Much of our improvement in sales and profitability has come from the Fluid Power Businesses segment.

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

These businesses are heavily focused on the OEM market and have experienced significant sales increases to customers in the hi-tech and construction machinery industries. Our Service Center Based Distribution segment is heavily focused on MRO which had seen a slower albeit steady rise in sales and profitability.

The effective income tax rate was 35.8% for the quarter ended December 31, 2010 compared to 40.1% for the quarter ended December 31, 2009. We reversed a valuation allowance on a deferred tax item in the quarter which accounted for a 4% decrease in the effective income tax rate. Partially offsetting this decrease in the rate was expense associated with providing for U.S. income tax expense on a portion of undistributed earnings not considered permanently reinvested in our Canadian subsidiaries. In the prior year second quarter, no such provision was made. The prior year quarter also reflected an expense for specific foreign deferred tax assets deemed unrealizable.

As a result of the factors addressed above, net income increased \$10.7 million or 102.1% compared to the prior year quarter. Net income per share was \$0.49 per share for the quarter ended December 31, 2010, compared to \$0.24 in the prior year quarter.

Six Months Ended December 31, 2010 and 2009

The following table is included to aid in review of Applied's condensed statements of consolidated income. The percent increase (decrease) column is comparative to the same period in the prior year.

| | Six Months Ended December 31, | | Percent Increase (Decrease) |
|--|-------------------------------|--------|-----------------------------------|
| | As a Percent of Net Sales | | |
| | 2010 | 2009 | |
| Net Sales | 100.0% | 100.0% | 19.6% |
| Gross Profit | 27.2% | 26.3% | 23.7% |
| Selling, Distribution & Administrative | 20.8% | 22.1% | 12.1% |
| Operating Income | 6.4% | 4.1% | 85.9% |
| Net Income | 4.0% | 2.5% | 93.5% |

During the six months ended December 31, 2010, net sales increased \$173.0 million or 19.6% compared to the same period in the prior year, with acquisitions accounting for additional sales of \$16.9 million or 1.9%. The number of selling days for the six months ended December 31, 2010 and 2009 were 125 and 126 days, respectively.

Net sales from our Service Center Based Distribution segment increased \$120.4 million or 16.5% during the six months ended December 31, 2010 from the same period in the prior year, primarily attributed to improvement in the industrial economy. Acquisitions within this segment increased sales by \$16.9 million, or 2.3%.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

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

Net sales from our Fluid Power Businesses segment increased \$52.6 million or 34.1% during the six months ended December 31, 2010 from the same period in the prior year, primarily attributed to improvement in the industrial economy.

From a geographic perspective, sales from our U.S. operations were up \$146.7 million or 19.2%, driven by improvement in the industrial economy, with acquisitions accounting for 1.3% of the U.S. increase. Sales from our Canadian operations increased \$20.6 million or 21.3%. Acquisitions accounted for \$7.2 million of the increase and favorable foreign currency translation accounted for \$5.8 million; the remaining increase is attributed to improvements in their industrial economy. Our Mexican operations increased \$5.7 million or 24.3%, with \$1.3 million attributed to favorable foreign currency fluctuations.

During the six months ended December 31, 2010, industrial products and fluid power products accounted for 71.4% and 28.6%, respectively, of net sales as compared to 72.9% and 27.1%, respectively, for the same period in the prior year. The increase in fluid power products is reflective of the increases in sales in the Fluid Power Businesses segment.

Our gross profit margin for the period increased to 27.2% compared to the prior year period's 26.3%. The gross profit for the first half of the year was positively impacted by LIFO benefits of \$4.4 million or 0.4% resulting from effective price decreases from increased supplier purchasing incentives in fiscal 2011. These decreases flow through the LIFO calculation as a benefit as the price paid for product (net of inventory purchasing incentives) is lower this year versus last. We do not anticipate this to impact the third or fourth quarters. We are also experiencing competitive pricing pressures within our Service Center Based Distribution segment.

SD&A was 20.8% of net sales in the six months ended December 31, 2010 compared to 22.1% in the prior year period. On an absolute basis, SD&A increased \$23.6 million or 12.1% compared to the prior year period. Performance driven expenses and employee benefits increased \$14.0 million while acquisitions added \$8.0 million. SD&A as a percentage of sales for companies acquired this year is higher than our existing businesses. The companies acquired this year are higher margin, higher costs to serve businesses. Excluding the impact of our current year acquisitions, SD&A increased 8.0% which is within our goal of managing SD&A growth to 50% of our sales growth rate.

Interest, net is down \$1.0 million due to repayment of the revolver in September 2010 and the private placement debt in November 2010.

Operating income increased 85.9% to \$67.9 million during the period compared to \$36.5 million during the prior year period. Operating income as a percentage of sales for the Service Center Based Distribution segment increased to 6.0% in the current year period, from 4.6% in the prior year period. The Fluid Power Businesses operating margins increased to 9.3% in the current year period from 5.7% in the prior year period. These increases as compared to the prior year period reflect improved operating leverage on the increases in sales. Much of our improvement in sales and profitability has come from the Fluid Power Businesses segment. These businesses

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

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

are heavily focused on the OEM market and have experienced significant sales increases to customers in the hi-tech and construction machinery industries. Our Service Center Based Distribution segment is heavily focused on MRO which had seen a slower albeit steady rise in sales and profitability.

The effective income tax rate was 37.5% for the six months ended December 31, 2010 compared to 36.7% for the same period in the prior year. The increase from the prior year 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. This is partially offset by reversal of a valuation allowance in the second quarter.

As a result of the factors addressed above, net income increased \$20.3 million or 93.5% compared to the prior year period. Net income per share was \$0.97 per share for the six months ended December 31, 2010, compared to \$0.51 in the prior year period.

Liquidity and Capital Resources

Net cash provided by operating activities for the six months ended December 31, 2010 was \$20.0 million. This compares to \$95.7 million provided by operating activities in the same period a year ago. The most significant factor in the \$75.7 million fluctuation relates to changes in inventory. In fiscal 2010, the Company undertook an inventory management program which by June 30, 2010 had resulted in a \$101.4 million reduction in U.S. bearing and drives products from the June 30, 2009 levels. These inventory reductions were targeted to reduce excess quantities of certain products within our system. Inventory has increased in the current year, due to acquisitions, increased business levels and some increases to compensate for an increase in manufacturer lead times.

Net cash used in investing activities during the current year was \$41.4 million; \$27.7 million was used for acquisitions and \$13.8 million for capital expenditures. In the first half of fiscal 2010, we used \$2.6 million in investing activities primarily for capital expenditures. The increase in capital expenditures primarily relates to spending on our ERP project announced in the first quarter of fiscal 2011.

Net cash used in financing activities was \$101.1 million for the six months ended December 31, 2010. In the first half of fiscal 2011, we repaid \$50.0 million under our revolving credit facility, \$25.0 million under our private placement debt and \$12.8 million related to the associated cross-currency swaps. Additionally, we paid dividends of \$14.4 million. In the prior year, financing activities used \$17.2 million of cash; we repaid a net \$5.0 million on our revolving credit facility and paid dividends of \$12.7 million. We did not repurchase shares of treasury stock in the first half 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

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

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

\$18.5 million. We expect SD&A expenses associated with this project to be approximately \$5.0 million in fiscal year 2011. Our overall capital expenditures for fiscal 2011 are expected to reach \$26.0 to \$27.5 million.

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 December 31, 2010. At December 31, 2010, unused lines under this facility, net of outstanding letters of credit, total \$143.1 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 December 31, 2010, there were no outstanding borrowings under this agreement.

In November 2010, we repaid the \$25.0 million private placement debt, bringing our outstanding debt to zero at December 31, 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 first half of fiscal 2011. At December 31, 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 dividends, acquisitions, investments in properties, facilities and equipment, and the purchase of 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.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

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

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," "will," "should," "could," "would," "anticipate," "estimate," "forecast," "may," and derivative or similar words or expressions. Such 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 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

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

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

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 six months ended December 31, 2010, we settled the cross-currency swaps related to our private placement debt for \$12.8 million. In September 2010, we settled the interest rate swap outstanding at June 30, 2010. There were no additional material changes in our market risk exposure in the first half of fiscal 2011. 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 second 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.

In Part II, Item 1A, of its quarterly report on Form 10-Q for the quarter ended September 30, 2010, the Company set forth changes from the risk factors disclosed under Part I, Item 1A, of the annual report on Form 10-K for the fiscal year ended June 30, 2010. You should carefully consider the risk factors from these previous reports in addition to the other information set forth in this quarterly report that could materially affect our business, financial condition, or future results. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also impact our business and operations.

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

Repurchases in the quarter ended December 31, 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) |
|---------------------------------------|-------------------------------------|---|--|--|
| October 1, 2010 to October 31, 2010 | -0- | -0- | -0- | 837,200 |
| November 1, 2010 to November 30, 2010 | -0- | -0- | -0- | 837,200 |
| December 1, 2010 to December 31, 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.

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, 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).

| Exhibit No. | Description |
|-------------|---|
| 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 for the quarter ended December 31, 2009, 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). |
| 15 | Independent Registered Public Accounting Firm's Awareness Letter. |
| 31 | Rule 13a-14(a)/15d-14(a) certifications. |
| 32 | Section 1350 certifications. |
| 101 | Interactive data files: (i) the Condensed Statements of Consolidated Income for the three and six month periods ended December 31, 2010 and 2009; (ii) the Condensed Consolidated Balance Sheets at December 31, 2010 and June 30, 2010; (iii) the Condensed Statements of Consolidated Cash Flows for the six months ended December 31, 2010 and 2009; and (iv) the Notes to the Condensed Consolidated Financial Statements submitted herewith pursuant to Rule 406T. |

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.

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: February 2, 2011

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

Date: February 2, 2011

By: /s/ Mark O. Eisele
Mark O. Eisele
Vice President-Chief Financial Officer &
Treasurer
30

APPLIED INDUSTRIAL TECHNOLOGIES, INC.
EXHIBIT INDEX
TO FORM 10-Q FOR THE QUARTER ENDED DECEMBER 31, 2010

| 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, 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 for the quarter ended December 31, 2009, SEC File No. 1-2299, and incorporated here by reference). |

| EXHIBIT NO. | DESCRIPTION | |
|-------------|---|----------|
| 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). | |
| 15 | Independent Registered Public Accounting Firm's Awareness Letter. | Attached |
| 31 | Rule 13a-14(a)/15d-14(a) certifications. | Attached |
| 32 | Section 1350 certifications. | Attached |
| 101 | Interactive data files: (i) the Condensed Statements of Consolidated Income for the three and six month periods ended December 31, 2010 and 2009; (ii) the Condensed Consolidated Balance Sheets at December 31, 2010 and June 30, 2010; (iii) the Condensed Statements of Consolidated Cash Flows for the six months ended December 31, 2010 and 2009; and (iv) the Notes to the Condensed Consolidated Financial Statements submitted herewith pursuant to Rule 406T. | Attached |