

APPLIED INDUSTRIAL TECHNOLOGIES INC
Form 10-Q
January 25, 2019
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UNITED STATES
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, 2018
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 every Interactive Data File required to be submitted 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 such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Emerging growth company

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If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. []

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes [] No [X]

There were 38,759,724 (no par value) shares of common stock outstanding on January 11, 2019.

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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		Six Months Ended	
	December 31,		December 31,	
	2018	2017	2018	2017
Net sales	\$840,038	\$667,187	\$1,704,553	\$1,347,888
Cost of sales	597,178	478,827	1,209,840	967,104
Gross profit	242,860	188,360	494,713	380,784
Selling, distribution and administrative expense, including depreciation	181,895	141,645	367,409	282,232
Operating income	60,965	46,715	127,304	98,552
Interest expense, net	9,578	2,139	20,054	4,305
Other expense (income), net	946	(20)	) 707	(731)
Income before income taxes	50,441	44,596	106,543	94,978
Income tax expense	11,724	13,646	18,888	30,307
Net income	\$38,717	\$30,950	\$87,655	\$64,671
Net income per share - basic	\$1.00	\$0.80	\$2.26	\$1.67
Net income per share - diluted	\$0.99	\$0.79	\$2.23	\$1.65
Cash dividends per common share	\$0.30	\$0.29	\$0.60	\$0.58
Weighted average common shares outstanding for basic computation	38,743	38,716	38,729	38,824
Dilutive effect of potential common shares	504	490	587	446
Weighted average common shares outstanding for diluted computation	39,247	39,206	39,316	39,270
See notes to condensed consolidated financial statements.				

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CONDENSED STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME

(Unaudited)

(In thousands)

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2018	2017	2018	2017
Net income per the condensed statements of consolidated income	\$38,717	\$30,950	\$87,655	\$64,671
Other comprehensive (loss) income, before tax:				
Foreign currency translation adjustments	(10,270)	(6,031)	(4,556)	2,128
Post-employment benefits:				
Reclassification of net actuarial gains and prior service cost into other expense (income), net and included in net periodic pension costs	(78)	(22)	(153)	(36)
Unrealized loss on investment securities available for sale	—	46	—	42
Cumulative effect of adopting accounting standard	—	—	(50)	—
Total of other comprehensive (loss) income, before tax	(10,348)	(6,007)	(4,759)	2,134
Income tax (benefit) expense related to items of other comprehensive (loss) income	(592)	57	(350)	46
Other comprehensive (loss) income, net of tax	(9,756)	(6,064)	(4,409)	2,088
Comprehensive income, net of tax	\$28,961	\$24,886	\$83,246	\$66,759

See notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands)

	December 31, 2018	June 30, 2018
ASSETS		
Current assets		
Cash and cash equivalents	\$ 79,827	\$ 54,150
Accounts receivable, less allowances of \$13,982 and \$13,566	512,034	548,811
Inventories	445,881	422,069
Other current assets	44,041	32,990
Total current assets	1,081,783	1,058,020
Property, less accumulated depreciation of \$182,812 and \$175,300	122,005	121,343
Identifiable intangibles, net	413,093	435,947
Goodwill	651,206	646,643
Other assets	21,901	23,788
TOTAL ASSETS	\$ 2,289,988	\$ 2,285,741
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	\$ 232,558	\$ 256,886
Current portion of long term debt	44,184	19,183
Compensation and related benefits	56,882	73,370
Other current liabilities	60,164	83,112
Total current liabilities	393,788	432,551
Long-term debt	923,410	944,522
Post-employment benefits	9,200	11,985
Other liabilities	73,675	81,720
TOTAL LIABILITIES	1,400,073	1,470,778
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; 38,758 and 38,703 outstanding, respectively	10,000	10,000
Additional paid-in capital	170,385	169,383
Retained Earnings	1,208,748	1,129,678
Treasury shares—at cost (15,455 and 15,510 shares, respectively)	(404,586	) (403,875
Accumulated other comprehensive loss	(94,632	) (90,223
TOTAL SHAREHOLDERS' EQUITY	889,915	814,963
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 2,289,988	\$ 2,285,741
See notes to condensed consolidated financial statements.		

Table of ContentsAPPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
CONDENSED STATEMENTS OF CONSOLIDATED CASH FLOWS

(Unaudited)

(In thousands)

	Six Months Ended December 31,	
	2018	2017
Cash Flows from Operating Activities		
Net income	\$87,655	\$64,671
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property	10,019	8,008
Amortization of intangibles	21,912	11,526
Unrealized foreign exchange transactions gain	(155)	(610)
Amortization of stock options and appreciation rights	1,257	1,013
Gain on sale of property	(105)	(333)
Other share-based compensation expense	2,351	1,577
Changes in operating assets and liabilities, net of acquisition	(55,922)	(65,007)
Other, net	(1,432)	339
Net Cash provided by Operating Activities	65,580	21,184
Cash Flows from Investing Activities		
Acquisition of businesses, net of cash acquired	(6,900)	(5,014)
Property purchases	(7,096)	(11,460)
Proceeds from property sales	244	596
Other	391	—
Net Cash used in Investing Activities	(13,361)	(15,878)
Cash Flows from Financing Activities		
Net (repayments) borrowings under revolving credit facility	(19,500)	23,000
Long-term debt borrowings	175,000	—
Long-term debt repayments	(151,868)	(1,679)
Payment of debt issuance costs	(685)	—
Purchases of treasury shares	—	(22,778)
Dividends paid	(23,275)	(22,571)
Acquisition holdback payments	(2,275)	(319)
Taxes paid for shares withheld for equity awards	(3,318)	(1,298)
Net Cash used in Financing Activities	(25,921)	(25,645)
Effect of Exchange Rate Changes on Cash	(621)	606
Increase (Decrease) in Cash and Cash Equivalents	25,677	(19,733)
Cash and Cash Equivalents at Beginning of Period	54,150	105,057
Cash and Cash Equivalents at End of Period	\$79,827	\$85,324
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, 2018, and the results of its operations and its cash flows for the six month periods ended December 31, 2018 and 2017, have been included. The condensed consolidated balance sheet as of June 30, 2018 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, 2018. Operating results for the six month period ended December 31, 2018 are not necessarily indicative of the results that may be expected for the remainder of the fiscal year ending June 30, 2019.

Recently Adopted Accounting Guidance
Revenue from Contracts with Customers

In May 2014, the FASB issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers (Topic 606)" ("ASC 606"). The standard outlines a single comprehensive model for entities to use in the accounting for revenue arising from contracts with customers. The core principle of this model is that "an entity recognizes revenue to depict the transfer of promised goods or services to a customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services." Subsequent to the issuance of ASU 2014-09, the FASB issued ASU 2015-14, ASU 2016-08, ASU 2016-10, and ASU 2016-12, which clarify the guidance in ASU 2014-09 but do not change the core principle of the revenue recognition model, and have been collectively codified into ASC 606. The provisions of ASC 606 are effective for interim and annual periods beginning after December 15, 2017. On July 1, 2018, the Company adopted ASC 606 using the modified retrospective method. As a result, the Company applied ASC 606 only to contracts that were not completed as of July 1, 2018. The adoption of ASC 606 resulted in a net increase to opening retained earnings of approximately \$3,429, net of tax, on July 1, 2018. See Note 2, Revenue Recognition, for further information on the impacts of these standard updates.

Income tax consequences of intra-entity transfer of assets other than inventory

In October 2016, the FASB issued its final standard on the income tax consequences of intra-entity transfers of assets other than inventory. This standard, issued as ASU 2016-16, requires that an entity recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs and eliminates the exception for an intra-entity transfer of an asset other than inventory. This update is effective for annual and interim financial statement periods beginning after December 15, 2017. The Company adopted ASU 2016-16 during the first quarter of fiscal 2019 using the modified retrospective method, and recorded a cumulative-effect adjustment decreasing retained earnings by \$424, recording a deferred tax asset of \$587 and reversing a prepaid asset of \$1,011 as of the beginning of the period. The deferred tax asset is included in other assets on the condensed consolidated balance sheet as of December 31, 2018.

Inventory

The Company uses the 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.

Recently Issued Accounting Guidance

In February 2016, the FASB issued its final standard on accounting for leases. This standard, issued as ASU 2016-02, requires that an entity that is a lessee recognize lease assets and lease liabilities on the balance sheet for all leases and disclose key information about leasing arrangements. The core principle of this update is that a "lessee should recognize the assets and liabilities that arise from leases." This update is effective for financial statement periods beginning after December 15, 2018, with earlier application permitted. In July 2018, the FASB issued ASU 2018-10

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

which clarifies the guidance in ASU 2016-02, and ASU 2018-11 which provides entities with an additional transition method option for adopting the new standard. The company plans to use this new transition method option upon adoption and recognize a cumulative-effect adjustment to the opening balance of retained earnings. In December 2018, the FASB issued ASU 2018-20 which further clarifies the guidance. The Company has established a cross-functional team to evaluate the new standard and has begun implementing new lease administration software. The Company is still determining the financial impact that this standard update will have on its consolidated financial statements, but anticipates it will have a material impact on its assets and liabilities due to the addition of right-of-use assets and lease liabilities to the consolidated balance sheet. The Company will continue to evaluate the impacts of the adoption of the standard and these assessments are subject to change.

In June 2016, the FASB issued its final standard on measurement of credit losses on financial instruments. This standard, issued as ASU 2016-13, requires that an entity measure impairment of certain financial instruments, including trade receivables, based on expected losses rather than incurred losses. This update is effective for annual and interim financial statement periods beginning after December 15, 2019, with early adoption permitted for financial statement periods beginning after December 15, 2018. In November 2018, the FASB issued ASU 2018-19 which clarifies the guidance in ASU 2016-13. The Company has not yet determined the impact of this pronouncement on its financial statements and related disclosures.

In August 2016, the FASB issued its final standard on the classification of certain cash receipts and cash payments within the statement of cash flows. This standard, issued as ASU 2016-15, makes a number of changes meant to add or clarify guidance on the classification of certain cash receipts and payments in the statement of cash flows. This update is effective for annual and interim financial statement periods beginning after December 15, 2018, with early adoption permitted. The Company has not yet determined the impact of this pronouncement on its financial statements and related disclosures.

In August 2018, the FASB issued its final standard on the accounting for implementation costs incurred in a cloud computing arrangement that is a service contract. This standard, issued as ASU 2018-15, aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. This update is effective for annual and interim periods beginning after December 15, 2019, with early adoption permitted. The Company has not yet determined the impact of this pronouncement on its financial statements and related disclosures.

2. REVENUE RECOGNITION

The Company adopted ASC 606 - Revenue from Contracts with Customers using the modified retrospective method effective July 1, 2018. The Company completed an analysis of revenue streams at each of its business units and evaluated the impact of adopting ASC 606 on revenue recognition. The Company primarily sells purchased products and the majority of its revenue is recognized at a point in time. The cumulative effect of initially applying ASC 606 resulted in a net increase to the opening retained earnings balance of \$3,429, net of tax, at July 1, 2018. The transition adjustment is comprised of two components. The first component is recognition of revenue from bill and hold arrangements. The second component is recognition of revenue from contracts that meet the criteria to recognize revenue over time as the underlying products have no alternative use and the Company has a right to payment for performance completed to date. Revenue for periods prior to July 1, 2018 has not been adjusted and continues to be reported under ASC Topic 605 - Revenue Recognition.

Revenue Recognition

The Company primarily sells purchased products distributed through its network of service centers and recognizes revenue at a point in time when control of the product transfers to the customer, typically upon shipment from an Applied facility or directly from a supplier. For products that ship directly from suppliers to customers, Applied acts as the principal in the transaction and recognizes revenue on a gross basis. Revenue recognized over time is not

significant. Revenue is measured as the amount of consideration expected to be received in exchange for the products and services provided, net of allowances for product returns, variable consideration, and any taxes collected from customers that will be remitted to governmental authorities. Shipping and handling costs are recognized in net sales when they are billed to the customer. The Company has elected to account for shipping and handling activities as fulfillment costs. There are no significant costs associated with obtaining customer contracts.

Payment terms with customers vary by the type and location of the customer and the products or services offered. The Company does not adjust the promised amount of consideration for the effects of significant financing components based on the expectation that the period between when the Company transfers a promised good or service to a

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

customer and when the customer pays for that good or service will be one year or less. Arrangements with customers that include payment terms extending beyond one year are not significant.

Accounts Receivable

Accounts receivable are stated at their estimated net realizable value and consist of amounts billed or billable and currently due from customers. The Company maintains an allowance for doubtful accounts, which reflects management's best estimate of probable losses based on an analysis of customer accounts, known troubled accounts, historical experience with write-offs, and other currently available evidence.

Variable Consideration

The Company's products are generally sold with a right of return and may include variable consideration in the form of incentives, discounts, credits or rebates. Product returns are estimated based on historical return rates. The Company estimates and recognizes variable consideration based on historical experience to determine the expected amount to which the Company will be entitled in exchange for transferring the promised goods or services to a customer. The Company records variable consideration as an adjustment to the transaction price in the period it is incurred. The realization of variable consideration occurs within a short period of time from product delivery; therefore, the time value of money effect is not significant.

Contract Assets

The Company's contract assets consist of un-billed amounts resulting from contracts for which revenue is recognized over time using the cost-to-cost method, and for which revenue recognized exceeds the amount billed to the customer. On July 1, 2018, \$13,823 of contract assets were recognized as part of the cumulative effect adjustment resulting from the adoption of ASC 606.

Activity related to contract assets, which are included in other current assets on the condensed consolidated balance sheet, is as follows:

	December 31, 2018	July 1, 2018	\$	%
Contract assets	\$ 9,324	\$ 13,823	\$(4,499)	(32.5)%

The following tables summarize the impacts of ASC 606 on the Company's condensed consolidated financial statements:

	For the three months ended December 31, 2018		
	As Reported	Adjustments	Balances without adoption of ASC 606
Net sales	\$840,038	\$ 1,005	\$841,043
Cost of sales	597,178	699	597,877
Gross profit	242,860	306	243,166
Selling, distribution and administrative expense, including depreciation	181,895	55	181,950
Operating income	60,965	251	61,216
Interest expense, net	9,578	—	9,578
Other expense, net	946	—	946
Income before income taxes	50,441	251	50,692
Income tax expense	11,724	64	11,788
Net income	\$38,717	\$ 187	\$38,904

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	For the six months ended December 31, 2018		
	As Reported	Adjustments	Balances without adoption of ASC 606
Net sales	\$ 1,704,553	\$ 4,317	\$ 1,708,870
Cost of sales	1,209,840	3,103	1,212,943
Gross profit	494,713	1,214	495,927
Selling, distribution and administrative expense, including depreciation	367,409	274	367,683
Operating income	127,304	940	128,244
Interest expense, net	20,054	—	20,054
Other expense, net	707	—	707
Income before income taxes	106,543	940	107,483
Income tax expense	18,888	236	19,124
Net income	\$87,655	\$ 704	\$88,359

As of December 31, 2018

	As Reported	Adjustments	Balances without adoption of ASC 606
Assets			
Other current assets	\$44,041	\$ (9,324)	\$34,717
Inventories	445,881	11,830	457,711
Other assets	21,901	192	22,093
Liabilities			
Other current liabilities	60,164	6,626	66,790
Compensation and related benefits	56,882	(456)	56,426
Other liabilities	73,675	(747)	72,928
Equity			
Retained Earnings	\$889,915	\$ (2,725)	\$887,190

Disaggregation of Revenues

The following tables present the Company's net sales by reportable segment and by geographic areas based on the location of the facility shipping the product for the three and six months ended December 31, 2018. Other countries consist of Mexico, Australia, New Zealand, and Singapore.

Three Months Ended December 31,
2018

	2018			2017		
	Service Center Based Distribution	Fluid Power & Flow Control	Total	Service Center Based Distribution	Fluid Power & Flow Control	Total
United States	\$479,335	\$247,862	\$727,197	\$448,819	\$108,212	\$557,031

Geographic Areas:

United States	\$479,335	\$247,862	\$727,197	\$448,819	\$108,212	\$557,031
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Canada	68,569	—	68,569	67,479	—	\$67,479
Other countries	41,394	2,878	44,272	39,309	3,368	\$42,677
Total	\$589,298	\$250,740	\$840,038	\$555,607	\$111,580	\$667,187

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

	Six Months Ended December 31, 2018			2017		
	Service Center Based Distribution	Fluid Center Power & Flow Control	Total	Service Center Based Distribution	Fluid Center Power & Flow Control	Total
Geographic Areas:						
United States	\$970,109	\$504,511	\$1,474,620	\$907,815	\$216,761	\$1,124,576
Canada	137,676	—	137,676	134,296	—	\$134,296
Other countries	85,562	6,695	92,257	82,409	6,607	\$89,016
Total	\$1,193,347	\$511,206	\$1,704,553	\$1,124,520	\$223,368	\$1,347,888

The following tables present the Company's percentage of revenue by reportable segment and major customer industry for the three and six months ended December 31, 2018:

	For the three months ended December 31, 2018		
	Service Center Based Distribution	Fluid Center Power & Flow Control	Total
General Industry	35.9 %	46.1 %	38.9 %
Industrial Machinery	9.7 %	20.3 %	12.9 %
Metals	13.6 %	8.5 %	12.1 %
Food	10.1 %	2.7 %	7.8 %
Oil & Gas	10.2 %	2.1 %	7.8 %
Chem/Petrochem	2.9 %	14.0 %	6.2 %
Forest Products	7.1 %	2.9 %	5.9 %
Cement & Aggregate	6.0 %	0.9 %	4.5 %
Transportation	4.5 %	2.5 %	3.9 %
Total	100.0%	100.0 %	100.0%
	For the six months ended December 31, 2018		
	Service Center Based Distribution	Fluid Center Power & Flow Control	Total
General Industry	35.8 %	44.9 %	38.4 %
Industrial Machinery	9.5 %	20.8 %	12.9 %
Metals	12.3 %	8.2 %	11.1 %
Food	10.4 %	2.6 %	8.1 %
Oil & Gas	9.9 %	2.1 %	7.6 %
Chem/Petrochem	3.2 %	14.8 %	6.7 %
Forest Products	8.0 %	2.8 %	6.4 %
Cement & Aggregate	6.4 %	1.0 %	4.8 %
Transportation	4.5 %	2.8 %	4.0 %
Total	100.0%	100.0 %	100.0%

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

The following tables present the Company's percentage of revenue by reportable segment and product line for the three and six months ended December 31, 2018:

	For the three months ended December 31, 2018			
	Service Based Distribution	Fluid Center Power & Flow Control		Total
Power Transmission	34.3 %	1.3 %		24.4 %
Fluid Power	13.7 %	38.1 %		21.0 %
General Maintenance; Hose Products	25.4 %	5.8 %		19.6 %
Bearings, Linear & Seals	26.6 %	0.4 %		18.8 %
Specialty Flow Control	— %	54.4 %		16.2 %
Total	100.0 %	100.0 %		100.0 %
	For the six months ended December 31, 2018			
	Service Based Distribution	Fluid Center Power & Flow Control		Total
Power Transmission	33.5 %	1.4 %		23.9 %
Fluid Power	13.8 %	37.9 %		21.0 %
General Maintenance; Hose Products	26.6 %	5.2 %		20.2 %
Bearings, Linear & Seals	26.1 %	0.2 %		18.3 %
Specialty Flow Control	— %	55.3 %		16.6 %
Total	100.0 %	100.0 %		100.0 %

3. BUSINESS COMBINATIONS

The operating results of all acquired entities are included within the consolidated operating results of the Company from the date of each respective acquisition.

Fiscal 2019 Acquisition

On November 2, 2018, the Company acquired substantially all of the net assets of Fluid Power Sales, Inc. (FPS), a Baldwinsville, New York based manufacturer and distributor of fluid power components, specializing in the engineering and fabrication of manifolds and power units. FPS is included in the Fluid Power & Flow Control segment. The purchase price for the acquisition was \$8,100, net tangible assets acquired were \$4,104, and goodwill was \$3,996 based upon estimated fair values at the acquisition date. The purchase price includes acquisition holdback payments of \$1,200, which is included in other current liabilities and other liabilities on the condensed consolidated balance sheet as of December 31, 2018, and which will be paid on the first and second anniversaries of the acquisition date with interest at a fixed rate of 1.5% per annum. The Company funded this acquisition using available cash. The acquisition price and the results of operations for the acquired entity are not material in relation to the Company's consolidated financial statements.

FCX Acquisition

On January 31, 2018, the Company completed the acquisition of 100% of the outstanding shares of FCX Performance, Inc. (FCX), a Columbus, Ohio based distributor of specialty process flow control products and services. The total consideration transferred for the acquisition was \$781,781, which was financed by cash-on-hand and a new credit

facility comprised of a \$780,000 Term Loan A and a \$250,000 revolver, effective with the transaction closing. See Note 5 - Debt. As a distributor of engineered valves, instruments, pumps and lifecycle services to MRO (Maintenance, Repair & Operations) and OEM (Original Equipment Manufacturer) customers across diverse industrial and process end markets, this business is included in the Fluid Power & Flow Control Segment.

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The following table summarizes the consideration transferred, assets acquired, and liabilities assumed in connection with the acquisition of FCX based on their preliminary estimated fair values at the acquisition date, which are subject to adjustment. The purchase accounting will be finalized within one year from the acquisition date.

Cash	\$11,141
Accounts receivable	80,836
Inventories	44,669
Other current assets	1,657
Property	8,282
Identifiable intangible assets	305,420
Goodwill	440,143
Other assets	775
Total assets acquired	\$892,923
Accounts payable and accrued liabilities	54,012
Other liabilities	2,677
Deferred tax liabilities	54,453
Net assets acquired	\$781,781
Purchase price	\$784,281
Reconciliation of fair value transferred:	
Working Capital Adjustments	(2,500)
Total Consideration	\$781,781

Goodwill acquired of \$161,452 is expected to be deductible for income tax purposes.

Net sales, operating income and net income from the FCX acquisition included in the Company's three and six months ended December 31, 2018 are as follows:

	Three Months Ended December 31, 2018	Six Months Ended December 31, 2018
Net sales	\$ 138,254	\$ 284,740
Operating income	10,906	22,458
Net income	8,463	17,683

The following unaudited pro forma consolidated results of operations have been prepared as if the FCX acquisition (including the related acquisition costs) had occurred at the beginning of fiscal 2018:

	Three Months Ended December 31, 2017	Six Months Ended December 31, 2017
Pro forma		
Net sales	\$ 789,407	\$ 1,565,890
Operating income	46,640	102,045
Net income	26,287	58,127

Diluted net income per share \$0.67 \$1.48

These pro forma amounts have been calculated after applying the Company's accounting policies and adjusting the results to reflect additional amortization that would have been recorded assuming the fair value adjustments to identified intangible assets had been applied as of July 1, 2017. In addition, pro forma adjustments have been made for the interest expense that would have been incurred as a result of the indebtedness used to finance the acquisitions. The pro forma net income amounts also incorporate an adjustment to the recorded income tax expense for the income

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tax effect of the pro forma adjustments described above. These pro forma results of operations do not include any anticipated synergies or other effects of the planned integration of FCX; accordingly, such pro forma adjustments do not purport to be indicative of the results of operations that actually would have resulted had the acquisitions occurred as of the date indicated or that may result in the future.

Other Fiscal 2018 Acquisition

On July 3, 2017, the Company acquired 100% of the outstanding stock of Diseño, Construcciones y Fabricaciones Hispanoamericanas, S.A. (DICOFASA), a distributor of accessories and components for hydraulic systems and lubrication, located in Puebla, Mexico. DICOFASA is included in the Service Center Based Distribution segment. The purchase price for the acquisition was \$5,920, net tangible assets acquired were \$3,395, and goodwill was \$2,525 based upon estimated fair values at the acquisition date. The purchase price includes \$906 of acquisition holdback payments, of which \$219 was paid during the six months ended December 31, 2018. Due to changes in foreign currency exchange rates, the remaining balance is \$634, which is included in other current liabilities and other liabilities on the condensed consolidated balance sheet as of December 31, 2018, and which will be paid on the second and third anniversaries of the acquisition date with interest at a fixed rate of 1.5% per annum. The Company funded this acquisition using available cash. The acquisition price and the results of operations for the acquired entity are not material in relation to the Company's consolidated financial statements.

4. GOODWILL AND INTANGIBLES

The changes in the carrying amount of goodwill for both the Service Center Based Distribution segment and the Fluid Power & Flow Control segment for the fiscal year ended June 30, 2018 and the six month period ended December 31, 2018 are as follows:

	Service Center Based Distribution	Fluid Power & Flow Control	Total
Balance at July 1, 2017	\$ 201,740	\$ 4,395	\$ 206,135
Goodwill acquired during the period	2,525	439,164	441,689
Other, primarily currency translation	(1,181)	—	(1,181)
Balance at June 30, 2018	\$ 203,084	\$ 443,559	\$ 646,643
Goodwill acquired/adjusted during the period	—	4,975	4,975
Other, primarily currency translation	(412)	—	(412)
Balance at December 31, 2018	\$ 202,672	\$ 448,534	\$ 651,206

The Company has six (6) reporting units for which an annual goodwill impairment assessment was performed as of January 1, 2018. The Company concluded that all of the reporting units' fair value exceeded their carrying amounts by at least 30% as of January 1, 2018. The fair values of the reporting units in accordance with the goodwill impairment test were determined using the Income and Market approaches. The Income approach employs the discounted cash flow method reflecting projected cash flows expected to be generated by market participants and then adjusted for time value of money factors. The Market approach utilizes an analysis of comparable publicly traded companies.

The techniques used in the Company's impairment tests have incorporated a number of assumptions that the Company believes to be reasonable and to reflect known market conditions at the measurement dates. Assumptions in estimating future cash flows are subject to a degree of judgment. The Company makes all efforts to forecast future cash flows as accurately as possible with the information available at the measurement date. The Company evaluates the appropriateness of its assumptions and overall forecasts by comparing projected results of upcoming years with actual

results of preceding years. Key Level 3 based assumptions relate to pricing trends, inventory costs, customer demand, and revenue growth. A number of benchmarks from independent industry and other economic publications were also used. Changes in future results, assumptions, and estimates after the measurement date may lead to an outcome where additional impairment charges would be required in future periods. Specifically, actual results may vary from the Company's forecasts and such variations may be material and unfavorable, thereby triggering the need for future impairment tests where the conclusions may differ in reflection of prevailing market conditions.

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At December 31, 2018 and June 30, 2018, accumulated goodwill impairment losses subsequent to fiscal year 2002 totaled \$64,794 related to the Service Center Based Distribution segment and \$36,605 related to the Fluid Power & Flow Control segment.

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

December 31, 2018	Amount	Accumulated Amortization	Net Book Value
Finite-Lived Identifiable Intangibles:			
Customer relationships	\$463,998	\$ 141,565	\$ 322,433
Trade names	112,757	26,179	86,578
Vendor relationships	11,376	7,758	3,618
Non-competition agreements	2,762	2,298	464
Total Identifiable Intangibles	\$590,893	\$ 177,800	\$ 413,093

June 30, 2018	Amount	Accumulated Amortization	Net Book Value
Finite-Lived Identifiable Intangibles:			
Customer relationships	\$465,691	\$ 125,009	\$ 340,682
Trade names	112,939	22,454	90,485
Vendor relationships	11,425	7,382	4,043
Non-competition agreements	2,761	2,024	737
Total Identifiable Intangibles	\$592,816	\$ 156,869	\$ 435,947

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

Estimated future amortization expense by fiscal year (based on the Company's identifiable intangible assets as of December 31, 2018) for the next five years is as follows: \$22,200 for the remainder of 2019, \$42,600 for 2020, \$40,200 for 2021, \$37,800 for 2022, \$35,400 for 2023 and \$31,000 for 2024.

5. DEBT

Revolving Credit Facility & Term Loan

In January 2018, in conjunction with the acquisition of FCX, the Company refinanced its existing credit facility and entered into a new five-year credit facility with a group of banks expiring in January 2023. This agreement provides for a \$780,000 unsecured term loan and a \$250,000 unsecured revolving credit facility. Fees on this facility range from 0.10% to 0.20% per year based upon the Company's leverage ratio at each quarter end. Borrowings under this agreement carry variable interest rates tied to either LIBOR or prime at the Company's discretion. At December 31, 2018 and June 30, 2018, the Company had \$623,375 and \$775,125, respectively, outstanding under the term loan. The interest rate on the term loan as of December 31, 2018 and June 30, 2018 was 4.31% and 4.13%, respectively. The Company had no amount outstanding under the revolver at December 31, 2018, and \$19,500 was outstanding under the revolver at June 30, 2018. Unused lines under this facility, net of outstanding letters of credit of \$4,674 and \$3,625, respectively, to secure certain insurance obligations, totaled \$245,326 and \$226,875 at December 31, 2018 and June 30, 2018, respectively, and were available to fund future acquisitions or other capital and operating requirements. The weighted average interest rate on the amount outstanding under the revolving credit facility as of June 30, 2018 was 3.93%.

Additionally, the Company had letters of credit outstanding with a separate bank, not associated with the revolving credit agreement, in the amount of \$2,698 as of December 31, 2018 and June 30, 2018, in order to secure certain insurance obligations.

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Trade Receivable Securitization Facility

In August 2018, the Company established a trade receivable securitization facility (the "AR Securitization Facility") with a termination date of August 31, 2021. The maximum availability under the AR Securitization Facility is \$175,000. Availability is further subject to changes in the credit ratings of our customers, customer concentration levels or certain characteristics of the accounts receivable being transferred and, therefore, at certain times, we may not be able to fully access the \$175,000 of funding available under the AR Securitization Facility. The AR Securitization Facility effectively increases the Company's borrowing capacity by collateralizing a portion of the amount of the Service Center Based Distribution reportable segment's U.S. operations' trade accounts receivable. The collateralized trade accounts receivable is equal to the borrowed amount outstanding under the AR Securitization Facility and there are no restrictions on cash or other assets. The Company uses the proceeds from the AR Securitization Facility as an alternative to other forms of debt, effectively reducing borrowing costs. Borrowings under this facility carry variable interest rates tied to LIBOR and fees on the AR Securitization Facility are 0.90% per year. As of December 31, 2018, the Company borrowed \$175,000 under the AR Securitization Facility, and the interest rate was 3.22%.

Other Long-Term Borrowings

At December 31, 2018 and June 30, 2018, the Company had borrowings outstanding under its unsecured shelf facility agreement with Prudential Investment Management of \$170,000. The "Series C" notes have a principal amount of \$120,000 and carry a fixed interest rate of 3.19%, and are due in equal principal payments in July 2020, 2021, and 2022. The "Series D" notes have a principal amount of \$50,000 and carry a fixed interest rate of 3.21%, and are due in equal principal payments in October 2019 and 2023. As of December 31, 2018, \$50,000 in additional financing was available under this facility.

In April 2014 the Company assumed \$2,359 of debt as a part of the headquarters facility acquisition. The 1.5% fixed interest rate note is held by the State of Ohio Development Services Agency, maturing in May 2024. At December 31, 2018 and June 30, 2018, \$1,322 and \$1,438 was outstanding, respectively.

Unamortized debt issue costs of \$551 are included as a reduction of current portion of long-term debt on the condensed consolidated balance sheets as of December 31, 2018 and June 30, 2018, respectively. Unamortized debt issue costs of \$1,552 and \$1,807 are included as a reduction of long-term debt on the condensed consolidated balance sheets as of December 31, 2018 and June 30, 2018, respectively.

6. FAIR VALUE MEASUREMENTS

Marketable securities measured at fair value at December 31, 2018 and June 30, 2018 totaled \$9,730 and \$10,318, respectively. The majority of 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 accompanying condensed consolidated balance sheets and their fair values were determined using quoted market prices (Level 1 in the fair value hierarchy).

As of December 31, 2018 and June 30, 2018, the carrying values of the Company's fixed interest rate debt outstanding under its unsecured shelf facility agreement with Prudential Investment Management approximated fair value (Level 2 in the fair value hierarchy).

The revolving credit facility, the term loan and the AR Securitization Facility contain variable interest rates and their carrying values approximate fair value (Level 2 in the fair value hierarchy).

7. INCOME TAXES

On December 22, 2017, the Tax Cuts and Jobs Act (the "Act") was enacted in the U.S., making significant changes to U.S. tax law. The Act reduced the U.S. federal corporate income tax rate from 35% to 21%, required companies to pay

a one-time transition tax on certain un-remitted earnings of foreign subsidiaries that were previously tax deferred, generally eliminated U.S. federal income tax on dividends from foreign subsidiaries, and created new taxes on certain foreign-sourced earnings. During the six months ended December 31, 2018, the Company's estimated annual effective tax rate reflects the change in the federal statutory rate from 35% to 21%. The corporate income tax rate change had a favorable impact to the Company of \$5,780 and \$13,634 for the three and six months ended December 31, 2018, respectively.

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As of December 31, 2018, we have completed our accounting for the tax effects of the Act. In fiscal 2018, we recognized a provisional tax liability of \$3,877 related to the one-time transition tax on certain un-remitted earnings of foreign subsidiaries, which is payable over eight years. During fiscal 2019, the Company recorded adjustments totaling \$3,497 to reduce the tax liability related to the one-time transition tax. We also recorded a net tax benefit of \$577 to increase the foreign tax credit related to the transition tax. The new taxes and deductions related to certain foreign-sourced earnings recognized in fiscal 2019 resulted in a net tax benefit of \$375.

Overall, considering the decrease in the corporate income tax rate, the tax benefit related to the transition tax adjustment, and the new taxes and deductions related to certain foreign earnings, the Act resulted in a tax benefit of \$5,977 and \$18,083 for the three and six months ended December 31, 2018, respectively, which is included as a component of income tax expense in the condensed statements of consolidated income.

8. SHAREHOLDERS' EQUITY

Accumulated Other Comprehensive Loss

Changes in the accumulated other comprehensive loss are comprised of the following amounts, shown net of taxes:

	Three Months Ended December 31, 2018			
	Foreign currency translation adjustment	Post-employment benefits	Total Accumulated other comprehensive (loss) income	
Balance at October 1, 2018	\$ (82,521)	\$ (2,355)	) \$ (84,876)
Other comprehensive loss	(9,699	) —	(9,699)
Amounts reclassified from accumulated other comprehensive (loss) income	—	(57	) (57)
Net current-period other comprehensive loss	(9,699	) (57	) (9,756)
Balance at December 31, 2018	\$ (92,220)	\$ (2,412)	) \$ (94,632)
	Three Months Ended December 31, 2017			
	Foreign currency translation adjustment	Unrealized gain (loss) on securities available for sale	Post-employment benefits	Total Accumulated other comprehensive (loss) income
Balance at October 1, 2017	\$ (71,288)	\$ 18	\$ (2,280)	) \$ (73,550
Other comprehensive (loss) income	(6,067	) 17	—	(6,050
Amounts reclassified from accumulated other comprehensive (loss) income	—	—	(14	) (14
Net current-period other comprehensive (loss) income	(6,067) 17	(14) (6,064
Balance at December 31, 2017	\$ (77,355)	\$ 35	\$ (2,294)) \$ (79,614

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	Six Months Ended December 31, 2018			Total Accumulated other comprehensive (loss) income
	Foreign currency translation adjustment available for sale	Unrealized gain (loss) on securities available for sale	Post-employment benefits	
Balance at July 1, 2018	\$(87,974)	\$ 50	\$ (2,299)	) \$ (90,223)
Other comprehensive loss	(4,246 )	—	—	) (4,246)
Amounts reclassified from accumulated other comprehensive (loss) income	—	—	(113)	) (113)
Cumulative effect of adopting accounting standard	—	(50 )	—	) (50)
Net current-period other comprehensive loss	(4,246)	(50)	(113)	) (4,409)
Balance at December 31, 2018	\$(92,220)	\$ —	\$ (2,412)	) \$ (94,632)

	Six Months Ended December 31, 2017			Total Accumulated other comprehensive (loss) income
	Foreign currency translation adjustment available for sale	Unrealized gain (loss) on securities available for sale	Post-employment benefits	
Balance at July 1, 2017	\$(79,447)	\$ 21	\$ (2,276)	) \$ (81,702)
Other comprehensive income (loss)	2,092	14	—	) 2,106
Amounts reclassified from accumulated other comprehensive (loss) income	—	—	(18)	) (18)
Net current-period other comprehensive income (loss)	2,092	14	(18)	) 2,088
Balance at December 31, 2017	\$(77,355)	\$ 35	\$ (2,294)	) \$ (79,614)

Other Comprehensive (Loss) Income

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

	Three Months Ended December 31,					
	2018			2017		
	Pre-Tax Amount	Tax Benefit	Net Amount	Pre-Tax Amount	Tax Expense (Benefit)	Net Amount
Foreign currency translation adjustments	\$(10,270)	\$(571)	\$(9,699)	\$(6,031)	\$ 36	\$(6,067)
Post-employment benefits:						
Reclassification of net actuarial gains and prior service cost into other expense (income), net and included in net periodic pension costs	(78)	(21)	(57)	(22)	(8)	(14)
Unrealized gain on investment securities available for sale	—	—	—	46	29	17
Other comprehensive (loss) income	\$(10,348)	\$(592)	\$(9,756)	\$(6,007)	\$ 57	\$(6,064)

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	Six Months Ended December 31,					
	2018			2017		
	Pre-Tax Amount	Tax Benefit	Net Amount	Pre-Tax Amount	Tax Expense (Benefit)	Net Amount
Foreign currency translation adjustments	\$(4,556)	\$(310)	\$(4,246)	\$2,128	\$ 36	\$2,092
Post-employment benefits:						
Reclassification of net actuarial gains and prior service cost into other expense (income), net and included in net periodic pension costs	(153)	(40)	(113)	(36)	(18)	(18)
Unrealized (loss) gain on investment securities available for sale	—	—	—	42	28	14
Cumulative effect of adopting accounting standard	(50)	—	(50)	—	—	—
Other comprehensive income	\$(4,759)	\$(350)	\$(4,409)	\$2,134	\$ 46	\$2,088

Anti-dilutive Common Stock Equivalents

In the three month periods ended December 31, 2018 and 2017, respectively, stock options and stock appreciation rights related to 242 and 234 shares of common stock, were not included in the computation of diluted earnings per share for the periods then ended as they were anti-dilutive. In the six month periods ended December 31, 2018 and 2017, respectively, stock options and stock appreciation rights related to 242 and 274 shares of common stock, were not included in the computation of diluted earnings per share for the periods then ended as they were anti-dilutive.

9. BENEFIT PLANS

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

	Pension Benefits		Retiree Health Care Benefits	
	2018	2017	2018	2017
Three Months Ended December 31,				
Components of net periodic cost:				
Service cost	\$11	\$31	\$ 4	\$ 4
Interest cost	174	184	13	13
Expected return on plan assets	(133)	(119)	—	—
Recognized net actuarial loss (gain)	46	106	(30)	(38)
Amortization of prior service cost	—	7	(92)	(92)
Net periodic cost (benefit)	\$98	\$209	\$(105)	\$(113)
Six Months Ended December 31,				
Components of net periodic cost:				
Service cost	\$22	\$62	\$ 8	\$ 9
Interest cost	348	367	26	26
Expected return on plan assets	(266)	(237)	—	—
Recognized net actuarial loss (gain)	92	212	(60)	(77)
Amortization of prior service cost	—	14	(184)	(184)
Net periodic cost (benefit)	\$196	\$418	\$(210)	\$(226)

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The Company contributed \$3,100 to its pension benefit plans and \$110 to its retiree health care plans in the six months ended December 31, 2018. Expected contributions for the remainder of fiscal 2019 are \$200 for the pension benefit plans to fund scheduled retirement payments and \$110 for retiree health care plans.

10. SEGMENT INFORMATION

In the first quarter of fiscal 2019, the Company performed a review of its management reporting structure and implemented changes to align with how the Company measures performance. As a result, the Company has revised its reportable segments to reflect how management currently reviews financial information and makes operating decisions. Certain supplier support benefits are now included within the Service Center Based Distribution segment operating income. Previously, these benefits were included in Corporate and other expense, net. All prior-period amounts have been adjusted to reflect the reportable segment change.

The accounting policies of the Company's reportable segments are generally the same as those used to prepare the condensed consolidated financial statements. Intercompany sales, primarily from the Fluid Power & Flow Control segment to the Service Center Based Distribution segment, of \$6,769 and \$5,664, in the three months ended December 31, 2018 and 2017, respectively, and \$13,685 and \$11,755 in the six months ended December 31, 2018 and 2017, respectively, have been eliminated in the Segment Financial Information tables below.

Three Months Ended	Service Center Based Distribution	Fluid Power & Flow Control	Total
December 31, 2018			
Net sales	\$ 589,298	\$250,740	\$840,038
Operating income for reportable segments	58,317	29,243	87,560
Depreciation and amortization of property	3,911	1,127	5,038
Capital expenditures	3,256	667	3,923
December 31, 2017			
Net sales	\$ 555,607	\$111,580	\$667,187
Operating income for reportable segments	52,642	13,766	66,408
Depreciation and amortization of property	3,802	279	4,081
Capital expenditures	4,822	302	5,124
Six Months Ended	Service Center Based Distribution	Fluid Power & Flow Control	Total
December 31, 2018			
Net sales	\$ 1,193,347	\$511,206	\$1,704,553
Operating income for reportable segments	121,126	60,123	181,249
Assets used in business	1,223,926	1,066,062	2,289,988
Depreciation and amortization of property	7,822	2,197	10,019
Capital expenditures	5,700	1,396	7,096
December 31, 2017			
Net sales	\$ 1,124,520	\$223,368	\$1,347,888

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Operating income for reportable segments	111,889	26,968	138,857
Assets used in business	1,199,704	206,178	1,405,882
Depreciation and amortization of property	7,471	537	8,008
Capital expenditures	10,370	1,090	11,460

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

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2018	2017	2018	2017
Operating income for reportable segments	\$87,560	\$66,408	\$181,249	\$138,857
Adjustment for:				
Intangible amortization—Service Center Based Distribution	3,973	4,425	7,991	8,937
Intangible amortization—Fluid Power & Flow Control	7,018	1,270	13,921	2,589
Corporate and other expense, net	15,604	13,998	32,033	28,779
Total operating income	60,965	46,715	127,304	98,552
Interest expense, net	9,578	2,139	20,054	4,305
Other expense (income), net	946	(20)	707	(731)
Income before income taxes	\$50,441	\$44,596	\$106,543	\$94,978

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

11. OTHER EXPENSE (INCOME), NET

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

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2018	2017	2018	2017
Unrealized loss (gain) on assets held in rabbi trust for a non-qualified deferred compensation plan	\$ 1,179	\$ (417)	\$ 837	\$ (784)
Foreign currency transactions loss (gain)	7	260	34	(51)
Net other periodic post-employment (benefits) costs	(22)	61	(44)	121
Other, net	(218)	76	(120)	(17)
Total other expense (income), net	\$ 946	\$ (20)	\$ 707	\$ (731)

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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

Results of Review of Interim Financial Information

We have reviewed the accompanying condensed consolidated balance sheet of Applied Industrial Technologies, Inc. and subsidiaries (the "Company") as of December 31, 2018, the related condensed consolidated statements of income and comprehensive income for the three-month and six-month periods ended December 31, 2018 and 2017, and of consolidated cash flows for the six-month periods ended December 31, 2018 and 2017, and the related notes (collectively referred to as the "interim financial information"). Based on our reviews, we are not aware of any material modifications that should be made to the accompanying interim financial information for it 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) (PCAOB), the consolidated balance sheet of the Company as of June 30, 2018, and the related statements of consolidated income, comprehensive income, shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated August 17, 2018, 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, 2018, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Basis for Review Results

This interim financial information is the responsibility of the Company's management. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our reviews in accordance with standards of the PCAOB. 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 PCAOB, 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.

/s/ Deloitte & Touche LLP

Cleveland, Ohio

January 25, 2019

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ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
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With approximately 6,700 employees across North America, Australia, New Zealand, and Singapore, Applied Industrial Technologies (“Applied,” the “Company,” “We,” “Us” or “Our”) is a leading distributor of bearings, power transmission products, engineered fluid power components and systems, specialty flow control solutions, and other industrial supplies, 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, fluid power, and flow control applications, as well as customized mechanical, fabricated rubber, fluid power, and flow control shop services. Applied also offers storeroom services and inventory management solutions that provide added value to its 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 2019, business was conducted in the United States, Puerto Rico, Canada, Mexico, Australia, New Zealand, and Singapore from 606 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 consolidated balance sheets, 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 (Stock Keeping Units) we sell in any given period were not necessarily sold in the comparable period of the prior year, resulting in the inability to quantify certain commonly used comparative metrics analyzing sales, such as changes in product mix and volume.

Overview

Consolidated sales for the quarter ended December 31, 2018 increased \$172.9 million or 25.9% compared to the prior year quarter, with acquisitions increasing sales by \$142.2 million or 21.3% and unfavorable foreign currency translation of \$4.7 million decreasing sales by 0.7%. Operating margin of 7.3% of sales, was up from 7.0% for the prior year quarter. Net income of \$38.7 million increased 25.1% compared to the prior year quarter. Shareholders' equity was \$889.9 million at December 31, 2018, up from the June 30, 2018 level of \$815.0 million. The current ratio was 2.7 to 1 at December 31, 2018 and 2.4 to 1 at June 30, 2018.

Applied monitors several economic indices that have been key indicators for industrial economic activity in the United States. These include the Industrial Production (IP) and Manufacturing Capacity Utilization (MCU) indices published by the Federal Reserve Board and the Purchasing Managers Index (PMI) published by the Institute for Supply Management (ISM). Historically, our performance correlates well with the MCU, which measures productivity and calculates a ratio of actual manufacturing output versus potential full capacity output. When manufacturing plants are running at a high rate of capacity, they tend to wear out machinery and require replacement parts.

The MCU (total industry) and IP indices have increased since June and September 2018. The MCU for December 2018 was 78.7, which is increased from both the June 2018 and September 2018 revised readings of 77.8 and 78.4, respectively. The ISM PMI registered 54.1 in December, down from the September 2018 reading of 59.8, but remained above 50 (its expansionary threshold). The indices for the months during the current quarter were as follows:

Month	Index Reading		
	MCU	PMI	IP
December 2018	78.7	54.1	106.2
November 2018	78.6	59.3	105.0
October 2018	78.4	57.7	105.0

The number of Company employees was 6,664 at December 31, 2018, 6,634 at June 30, 2018, and 5,546 at December 31, 2017. The number of operating facilities totaled 606 at December 31, 2018, 610 at June 30, 2018 and 552 at December 31, 2017.

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Results of Operations

Three months Ended December 31, 2018 and 2017

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

	Three Months Ended December 31, 2018		2017		Change in \$'s Versus Prior Period - % Increase
Net Sales	100.0%	100.0%	100.0%	100.0%	25.9 %
Gross Profit	28.9 %	28.2 %	28.9 %	28.2 %	28.9 %
Selling, Distribution & Administrative	21.7 %	21.2 %	21.7 %	21.2 %	28.4 %
Operating Income	7.3 %	7.0 %	7.3 %	7.0 %	30.5 %
Net Income	4.6 %	4.6 %	4.6 %	4.6 %	25.1 %

During the quarter ended December 31, 2018, sales increased \$172.9 million or 25.9% compared to the prior year quarter, with sales from acquisitions adding \$142.2 million or 21.3% and unfavorable foreign currency translation accounting for a decrease of \$4.7 million or 0.7%. There were 62 selling days in the quarter ended December 31, 2018 and 61 selling days in the quarter ended December 31, 2017. Excluding the impact of businesses acquired and currency translation, sales were up \$35.4 million or 5.3% during the quarter, driven by an increase of 3.7% organic growth from operations, primarily the Service Center Based Distribution segment, in addition to an increase of 1.6% due to one additional sales day.

The following table shows changes in sales by reportable segment.

Sales by Reportable Segment	Three Months Ended December 31, 2018		2017		Amount of change due to	
	Ended	Sales	Ended	Sales	Foreign Currency	Organic Change
Service Center Based Distribution	\$589.3	\$555.6	\$33.7	\$—	\$ (4.7)	\$ 38.4
Fluid Power & Flow Control	250.7	111.5	139.2	142.2	—	(3.0)
Total	\$840.0	\$667.1	\$ 172.9	\$ 142.2	\$ (4.7)	\$ 35.4

Sales from our Service Center Based Distribution segment, which operates primarily in MRO markets, increased \$33.7 million or 6.1%. Unfavorable foreign currency translation decreased sales by \$4.7 million or 0.8%. Excluding the impact of foreign currency translation, sales increased \$38.4 million or 6.9%, driven by an increase of 5.3% organic growth from operations which reflects the improvement in the industrial economy and correlates with the increases in the MCU and IP indices, despite a deceleration of sales in the last week of the calendar year, in addition to an increase of 1.6% due to one additional sales day.

Sales from our Fluid Power & Flow Control segment increased \$139.2 million or 124.7%. The acquisitions within this segment increased sales by \$142.2 million or 127.4%. Excluding the impact of businesses acquired, sales decreased

\$3.0 million or 2.7%, due to a 4.4% decrease from operations offset by an increase of 1.7% due to one additional sales day. The decrease from operations is due to softness and project delays in our fluid power businesses tied to technology markets, specifically electronic equipment and component manufacturers.

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The following table shows changes in sales by geographic area. Other countries includes Mexico, Australia, New Zealand, and Singapore.

Sales by Geographic Area	Three Months		Amount of change due to		
	Ended	Sales	Foreign	Organic	
	December 31, 2018	December 31, 2017	Increase	Acquisitions	Currency Change
United States	\$727.2	\$557.0	\$170.2	\$142.2	\$ —) \$ 28.0
Canada	68.5	67.4	1.1	—	(2.5) 3.6
Other countries	44.3	42.7	1.6	—	(2.2) 3.8
Total	\$840.0	\$667.1	\$172.9	\$142.2	\$(4.7) \$ 35.4

Sales in our U.S. operations were up \$170.2 million or 30.5%, as acquisitions added \$142.2 million or 25.5%. Excluding the impact of businesses acquired, U.S. sales were up \$28.0 million or 5.0%, driven by an increase of 3.4% organic growth from operations in addition to an increase of 1.6% due to one additional sales day. Sales from our Canadian operations increased \$1.1 million or 1.6%, and unfavorable foreign currency translation decreased Canadian sales by \$2.5 million or 3.8%. Excluding the impact of foreign currency translation, Canadian sales were up \$3.6 million or 5.4%, of which 3.8% is organic growth from operations in addition to an increase of 1.6% due to one additional sales day. Consolidated sales from our other country operations, which include Mexico, Australia, New Zealand, and Singapore, increased \$1.6 million or 3.7% from the prior year. Unfavorable foreign currency translation decreased other country sales by \$2.2 million or 5.1%. Excluding the impact of currency translation, other country sales were up \$3.8 million, or 8.8% during the quarter, driven by an increase of 7.2% organic growth from operations in addition to an increase of 1.6% due to one additional sales day.

Our gross profit margin for the quarter was 28.9% compared to the prior year's quarter of 28.2%. The acquisitions favorably impacted the gross profit margin by 93 basis points during the three months ended December 31, 2018, which was offset by 16 basis points of unfavorable impact from the change in LIFO expense in the current quarter compared to the prior year quarter.

The following table shows the changes in selling, distribution and administrative expense (SD&A).

SD&A	Three Months		Amount of change due to		
	Ended	SD&A	Foreign	Organic	
	December 31, 2018	December 31, 2017	Increase	Acquisitions	Currency Change
\$181.9	\$141.6	\$ 40.3	\$36.4	\$(1.1)	\$ 5.0

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, insurance, legal, and facility related expenses. SD&A was 21.7% of sales in the quarter ended December 31, 2018 compared to 21.2% in the prior year quarter. SD&A increased \$40.3 million or 28.4% compared to the prior year quarter. Changes in foreign currency exchange rates had the effect of decreasing SD&A during the quarter ended December 31, 2018 by \$1.1 million or 0.8% compared to the prior year quarter. SD&A from businesses

acquired added \$36.4 million or 25.7% of SD&A expenses, including \$5.7 million of intangibles amortization related to the FCX acquisition. Excluding the impact of businesses acquired and the favorable currency translation impact, SD&A increased \$5.0 million or 3.5% during the quarter ended December 31, 2018 compared to the prior year quarter. Excluding the impact of acquisitions, total compensation increased \$4.1 million during the quarter ended December 31, 2018 compared to the prior year quarter due to an increase in medical costs along with the impact of merit increases. All other expenses within SD&A were up \$0.9 million.

Operating income increased \$14.3 million or 30.5%, and as a percent of sales increased to 7.3% from 7.0% during the prior year quarter.

Operating income as a percentage of sales for the Service Center Based Distribution segment increased to 9.9% in the current year quarter from 9.5% in the prior year quarter. Operating income as a percentage of sales for the Fluid Power & Flow Control segment decreased to 11.7% in the current year quarter from 12.3% in the prior year quarter.

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Other expense, net, was expense of \$0.9 million in the quarter, which included unrealized losses on investments held by non-qualified deferred compensation trusts of \$1.2 million, offset by \$0.3 million of income from other items. During the prior year quarter, other income, net consisted of unrealized gains on investments held by non-qualified deferred compensation trusts of \$0.4 million, offset by \$0.3 million of net unfavorable foreign currency transaction losses and \$0.1 million of net other periodic post-employment costs.

The effective income tax rate was 23.2% for the quarter ended December 31, 2018 compared to 30.6% for the quarter ended December 31, 2017. The decrease in the effective tax rate is primarily due to the enactment of the Tax Cuts and Jobs Act in December 2017, which reduced the U.S. federal corporate income tax rate from 35% to 21%, effective January 1, 2018. Overall, the Act resulted in a net tax benefit of \$6.0 million for the quarter ended December 31, 2018. The corporate income tax rate change had a favorable impact to the Company of \$5.8 million and the new taxes and deductions related to certain foreign-sourced earnings recognized in the quarter ended December 31, 2018 resulted in a net tax benefit of \$0.2 million. We expect our full year tax rate for fiscal 2019 to be in the 21.0% to 23.0% range.

As a result of the factors addressed above, net income increased \$7.8 million or 25.1% compared to the prior year quarter. Net income per share was \$0.99 per share for the quarter ended December 31, 2018, compared to \$0.79 in the prior year quarter, an increase of 25.3%.

Results of Operations

Six months Ended December 31, 2018 and 2017

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

	Six Months Ended December 31, 2018		2017		Change in \$'s Versus Prior Period - % Increase
Net Sales	100.0%	100.0%	100.0%	100.0%	26.5 %
Gross Profit	29.0 %	28.3 %	28.3 %	29.9 %	29.9 %
Selling, Distribution & Administrative	21.6 %	20.9 %	20.9 %	30.2 %	30.2 %
Operating Income	7.5 %	7.3 %	7.3 %	29.2 %	29.2 %
Net Income	5.1 %	4.8 %	4.8 %	35.5 %	35.5 %

During the six months ended December 31, 2018, sales increased \$356.7 million or 26.5% compared to the prior year, with sales from acquisitions adding \$288.7 million or 21.4% and unfavorable foreign currency translation accounting for a decrease of \$10.4 million or 0.8%. There were 125 selling days in the six months ended December 31, 2018 and 124 selling days in the six months ended December 31, 2017. Excluding the impact of businesses acquired and currency translation, sales were up \$78.4 million or 5.9% during the quarter, driven by an increase of 5.1% organic growth from operations, primarily the Service Center Based Distribution segment, in addition to an increase of 0.8% due to one additional sales day.

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The following table shows changes in sales by reportable segment.

Sales by Reportable Segment	Six Months		Sales Increase	Amount of change due to		
	Ended			Foreign Currency Change	Organic Acquisitions	
	December 31, 2018	2017				
Service Center Based Distribution	\$1,193.4	\$1,124.5	\$ 68.9	\$—	\$(10.4)	)\$ 79.3
Fluid Power & Flow Control	511.2	223.4	287.8	288.7	—	(0.9)
Total	\$1,704.6	\$1,347.9	\$ 356.7	\$288.7	\$(10.4)	)\$ 78.4

Sales from our Service Center Based Distribution segment, which operates primarily in MRO markets, increased \$68.9 million or 6.1%. Unfavorable foreign currency translation decreased sales by \$10.4 million or 0.9%. Excluding the impact of foreign currency translation, sales increased \$79.3 million or 7.0%, driven by an increase of 6.3% organic growth from operations which reflects the improvement in the industrial economy and correlates with the increases in the MCU and IP indices, despite a deceleration of sales in the last week of the calendar year, in addition to an increase of 0.7% due to one additional sales day.

Sales from our Fluid Power & Flow Control segment increased \$287.8 million or 128.9%. The acquisitions within this segment increased sales by \$288.7 million or 129.2%. Excluding the impact of businesses acquired, sales decreased \$0.9 million or 0.4%, due to a 1.2% decrease from operations offset by an increase of 0.8% due to one additional sales day. The decrease from operations is due to softness and project delays in our fluid power businesses tied to technology markets, specifically electronic equipment and component manufacturers.

The following table shows changes in sales by geographic area. Other countries includes Mexico, Australia, New Zealand, and Singapore.

Sales by Geographic Area	Six Months		Sales Increase	Amount of change due to		
	Ended			Foreign Currency Change	Organic Acquisitions	
	December 31, 2018	2017				
United States	\$1,474.6	\$1,124.6	\$ 350.0	\$288.7	\$—	)\$ 61.3
Canada	137.7	134.3	3.4	—	(5.3)	)8.7
Other countries	92.3	89.0	3.3	—	(5.1)	)8.4
Total	\$1,704.6	\$1,347.9	\$ 356.7	\$288.7	\$(10.4)	)\$ 78.4

Sales in our U.S. operations were up \$350.0 million or 31.1%, as acquisitions added \$288.7 million or 25.7%. Excluding the impact of businesses acquired, U.S. sales were up \$61.3 million or 5.4%, driven by an increase of 4.6% organic growth from operations in addition to an increase of 0.8% due to one additional sales day. Sales from our Canadian operations increased \$3.4 million or 2.5%, and unfavorable foreign currency translation decreased Canadian sales by \$5.3 million or 3.9%. Excluding the impact of foreign currency translation, Canadian sales were up \$8.7 million or 6.4%. Consolidated sales from our other country operations, which include Mexico, Australia, New Zealand, and Singapore, increased \$3.3 million or 3.6% from the prior year. Unfavorable foreign currency translation decreased other country sales by \$5.1 million or 5.7%. Excluding the impact of currency translation, other country sales were up \$8.4 million, or 9.3% during the period, driven by an increase of 8.1% organic growth from operations in addition to an increase of 1.2% due to one additional sales day.

Our gross profit margin for the period was 29.0% compared to the prior year period of 28.3%. The acquisitions favorably impacted the gross profit margin by 95 basis points during the six months ended December 31, 2018, which was offset by 17 basis points of unfavorable impact from the change in LIFO expense in the current period compared to the prior year period.

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The following table shows the changes in selling, distribution and administrative expense (SD&A).

Six Months		Amount of change due to	
Ended	SD&A	Foreign	Organic
December 31,	Increase	Currency	Change
2018	2017	Acquisitions	
SD&A	\$367.4	\$282.2	\$ 85.2
		\$74.4	\$ (2.4)
			\$ 13.2

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, insurance, legal, and facility related expenses. SD&A was 21.6% of sales for the six months ended December 31, 2018 compared to 20.9% in the prior year period. SD&A increased \$85.2 million or 30.2% compared to the prior year period. Changes in foreign currency exchange rates had the effect of decreasing SD&A during the six months ended December 31, 2018 by \$2.4 million or 0.8% compared to the prior year period. SD&A from businesses acquired added \$74.4 million or 26.4% of SD&A expenses, including \$11.5 million of intangibles amortization related to the FCX acquisition. Excluding the impact of businesses acquired and the favorable currency translation impact, SD&A increased \$13.2 million or 4.6% during the six months ended December 31, 2018 compared to the prior year period. Excluding the impact of acquisitions, total compensation increased \$8.7 million during the six months ended December 31, 2018 compared to the prior year period due to an increase in medical costs along with the impact of merit increases. All other expenses within SD&A were up \$4.5 million.

Operating income increased \$28.8 million or 29.17%, and as a percent of sales increased to 7.5% from 7.3% during the prior year period.

Operating income as a percentage of sales for the Service Center Based Distribution segment increased to 10.2% in the current year from 9.9% in the prior year. Operating income as a percentage of sales for the Fluid Power & Flow Control segment decreased to 11.8% in the current year from 12.1% in the prior year.

Other expense, net, was expense of \$0.7 million in the six months ended December 31, 2018, which included unrealized losses on investments held by non-qualified deferred compensation trusts of \$0.8 million, offset by \$0.1 million of income from other items. During the prior year period, other income, net was \$0.7 million, which included unrealized gains on investments held by non-qualified deferred compensation trusts of \$0.8 million and net favorable foreign currency transaction losses of \$0.1 million, offset by \$0.1 million of net other periodic post-employment costs.

The effective income tax rate was 17.7% for the six months ended December 31, 2018 compared to 31.9% for the six months ended December 31, 2017. The decrease in the effective tax rate is primarily due to the enactment of the Tax Cuts and Jobs Act in December 2017, which reduced the U.S. federal corporate income tax rate from 35% to 21%, effective January 1, 2018. Overall, the Act resulted in a net tax benefit of \$18.1 million for the six months ended December 31, 2018. The corporate income tax rate change had a favorable impact to the Company of \$13.6 million, adjustments related to the transition tax had a favorable impact of \$4.1 million, and the new taxes and deductions related to certain foreign-sourced earnings recognized in the six months ended December 31, 2018 resulted in a net tax benefit of \$0.4 million. We expect our full year tax rate for fiscal 2019 to be in the 21.0% to 23.0% range.

As a result of the factors addressed above, net income increased \$23.0 million or 35.5% compared to the prior year. Net income per share was \$2.23 per share for the six months ended December 31, 2018, compared to \$1.65 in the prior year, an increase of 35.2%.

Liquidity and Capital Resources

Our primary source of capital is cash flow from operations, supplemented as necessary by bank borrowings or other sources of debt. At December 31, 2018, we had \$969.7 million in outstanding borrowings. At June 30, 2018, we had \$966.1 million in outstanding borrowings. Management expects that our existing cash, cash equivalents, funds available under the revolving credit and uncommitted shelf facilities, and cash provided from operations, 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.

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The Company's working capital at December 31, 2018 was \$688.0 million, compared to \$625.5 million at June 30, 2018. The current ratio was 2.7 to 1 at December 31, 2018 and 2.4 to 1 at June 30, 2018.

Net Cash Flows

The following table is included to aid in review of Applied's condensed statements of consolidated cash flows; all amounts are in thousands.

	Six Months Ended	
	December 31,	
	2018	2017
Net Cash Provided by (Used in):		
Operating Activities	\$65,580	\$21,184
Investing Activities	(13,361)	(15,878)
Financing Activities	(25,921)	(25,645)
Exchange Rate Effect	(621)	606
Increase (Decrease) in Cash and Cash Equivalents	\$25,677	\$(19,733)

Net cash provided by operating activities was \$65.6 million for the six months ended December 31, 2018 as compared to \$21.2 million provided by operating activities in the prior period. The increase in cash provided by operating activities during the six months ended December 31, 2018 is related to improved operating results and improvements in working capital compared to the prior year period.

Net cash used in investing activities during the six months ended December 31, 2018 decreased from the prior period as there was \$4.4 million less spent on property purchases in the current year quarter, primarily due to significant expenditures for building improvements and shop equipment in the prior year period. This was offset by an increase in cash paid for acquisitions, net of cash acquired, as \$6.9 million was used in the current year period for the acquisition of Fluid Power Sales while \$5.0 million was used in the prior year for the acquisition of DICOFASA.

Net cash used by financing activities was \$25.9 million for the six months ended December 31, 2018 versus \$25.6 million in the prior year period. The increase in cash used in financing activities is primarily due to cash used for the purchase of treasury shares in the prior year period of \$22.8 million, while no treasury shares were purchased in the current year period. This increase was offset by a decrease in net debt borrowings as there was \$3.6 million of net debt borrowings in the current year period compared to \$21.3 million of net debt borrowings in the prior year period.

Share Repurchases

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. At December 31, 2018, we had authorization to repurchase an additional 1,056,700 shares. During the six months ended December 31, 2017, we acquired 393,300 shares of treasury stock on the open market for \$22.8 million.

Borrowing Arrangements

In January 2018, in conjunction with the acquisition of FCX, the Company refinanced its existing credit facility and entered into a new five-year credit facility with a group of banks expiring in January 2023. This agreement provides for a \$780.0 million unsecured term loan and a \$250.0 million unsecured revolving credit facility. Fees on this facility range from 0.10% to 0.20% per year based upon the Company's leverage ratio at each quarter end. Borrowings under this agreement carry variable interest rates tied to either LIBOR or prime at the Company's discretion. At December 31, 2018 and June 30, 2018, the Company had \$623.4 million and \$775.1 million, respectively, outstanding

under the term loan. The interest rate on the term loan as of December 31, 2018 and June 30, 2018 was 4.31% and 4.13%, respectively. The Company had no amount outstanding under the revolver at December 31, 2018, and \$19.5 million was outstanding under the revolver at June 30, 2018. Unused lines under this facility, net of outstanding letters of credit of \$4.7 million and \$3.6 million, respectively, to secure certain insurance obligations, totaled \$245.3 million and \$226.9 million at December 31, 2018 and June 30, 2018, respectively, and were available to fund future acquisitions or other capital and operating requirements. The weighted average interest rate on the amount outstanding under the revolving credit facility as of June 30, 2018 was 3.93%.

Additionally, the Company had letters of credit outstanding with a separate bank, not associated with the revolving credit agreement, in the amount of \$2.7 million as of December 31, 2018 and June 30, 2018, in order to secure certain insurance obligations.

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In August 2018, the Company established a trade receivable securitization facility (the "AR Securitization Facility") with a termination date of August 31, 2021. The maximum availability under the AR Securitization Facility is \$175.0 million. Availability is further subject to changes in the credit ratings of our customers, customer concentration levels or certain characteristics of the accounts receivable being transferred and, therefore, at certain times, we may not be able to fully access the \$175.0 million of funding available under the AR Securitization Facility. The AR Securitization Facility effectively increases the Company's borrowing capacity by collateralizing a portion of the amount of the Service Center Based Distribution reportable segment's U.S. operations' trade accounts receivable. The collateralized trade accounts receivable is equal to the borrowed amount outstanding under the AR Securitization Facility and there are no restrictions on cash or other assets. The Company uses the proceeds from the AR Securitization Facility as an alternative to other forms of debt, effectively reducing borrowing costs. Borrowings under this facility carry variable interest rates tied to LIBOR and fees on the AR Securitization Facility are 0.90% per year. As of December 31, 2018, the Company borrowed \$175.0 million under the AR Securitization Facility, and the interest rate was 3.22%.

At December 31, 2018 and June 30, 2018, the Company had borrowings outstanding under its unsecured shelf facility agreement with Prudential Investment Management of \$170.0 million. The "Series C" notes have a principal amount of \$120.0 million and carry a fixed interest rate of 3.19%, and are due in equal principal payments in July 2020, 2021, and 2022. The "Series D" notes have a principal amount of \$50.0 million and carry a fixed interest rate of 3.21%, and are due in equal principal payments in October 2019 and 2023. As of December 31, 2018, \$50.0 million in additional financing was available under this facility.

In April 2014 the Company assumed \$2.4 million of debt as a part of the headquarters facility acquisition. The 1.5% fixed interest rate note is held by the State of Ohio Development Services Agency, maturing in May 2024. At December 31, 2018 and June 30, 2018, \$1.3 million and \$1.4 million was outstanding, respectively.

The new credit facility and the unsecured shelf facility contain restrictive covenants regarding liquidity, net worth, financial ratios, and other covenants. At December 31, 2018, the most restrictive of these covenants required that the Company have net indebtedness less than 4.25 times consolidated income before interest, taxes, depreciation and amortization. At December 31, 2018, the Company's indebtedness was less than 3.0 times consolidated income before interest, taxes, depreciation and amortization. The Company was in compliance with all covenants at December 31, 2018.

Accounts Receivable Analysis

The following table is included to aid in analysis of accounts receivable and the associated provision for losses on accounts receivable:

	December 31, 2018	June 30, 2018	
Accounts receivable, gross	\$526,016	\$562,377	
Allowance for doubtful accounts	13,982	13,566	
Accounts receivable, net	\$512,034	\$548,811	
Allowance for doubtful accounts, % of gross receivables	2.7	%2.4	%

	Three Months Ended December 31, 2018		Six Months Ended December 31, 2017	
	2018	2017	2018	2017

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Provision for losses on accounts receivable	\$921	\$372	\$2,085	\$1,091	
Provision as a % of net sales	0.11	%0.06	% 0.12	%0.08	%

Accounts receivable are reported at net realizable value and consist of trade receivables from customers. Management monitors accounts receivable by reviewing Days Sales Outstanding (DSO) and the aging of receivables for each of the Company's locations.

On a consolidated basis, DSO was 54.9 at December 31, 2018 compared to 55.0 at June 30, 2018. Accounts receivable increased 30.1% from December 31, 2017, of which 23.0% is accounts receivable for FCX. The remaining increase is due to

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an increase in sales excluding FCX for the six months ended December 31, 2018 compared to the six months ended December 31, 2017.

Approximately 4.8% of our accounts receivable balances are more than 90 days past due, an increase from 4.0% at June 30, 2018. On an overall basis, our provision for losses from uncollected receivables represents 0.12% of our sales in the six months ended December 31, 2018. Historically, this percentage is around 0.10% to 0.15%. Management believes the overall receivables aging and provision for losses on uncollected receivables are at reasonable levels.

Inventory Analysis

Inventories are valued at the average cost method, using the last-in, first-out (LIFO) method for U.S. inventories and the average cost method for foreign inventories. Management uses an inventory turnover ratio to monitor and evaluate inventory. Management calculates this ratio on an annual as well as a quarterly basis, and believes that using average costs to determine the inventory turnover ratio instead of LIFO costs provides a more useful analysis. The annualized inventory turnover based on average costs for the period ended December 31, 2018 was 4.2 compared to 4.0 at June 30, 2018. We believe our inventory turnover ratio at the end of the year will be similar or slightly better than the ratio at December 31, 2018.

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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 contains 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", "optimistic" and similar words or expressions. Similarly, 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; changes in the prices for products and services relative to the cost of providing them; reduction in supplier inventory purchase incentives; loss of key supplier authorizations, lack of product availability, or changes in supplier distribution programs; the cost of products and energy and other operating costs; changes in customer preferences for products and services of the nature and brands sold by us; changes in customer procurement policies and practices; competitive pressures; our reliance on information systems and risks relating to the security of those systems and the data stored in or transmitted through 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; our ability to retain and attract qualified sales and customer service personnel and other skilled executives, managers and professionals; our ability to identify and complete acquisitions, integrate them effectively, and realize their anticipated benefits; the variability, timing and nature 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 exchange fluctuations; the potential for goodwill and intangible asset impairment; changes in accounting policies and practices; our ability to maintain effective internal control over financial reporting; 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; potentially adverse government regulation, legislation, or policies, both enacted and under consideration, including with respect to federal tax policy, and international trade, such as recent tariffs and proposed tariffs on imports; and the occurrence of extraordinary events (including prolonged labor disputes, power outages, telecommunication outages, terrorist acts, earthquakes, extreme weather events, other natural disasters, 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 and other risk factors more fully throughout this Form 10-Q as well as other of our filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the year ended June 30, 2018.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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, 2018.

APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES
ITEM 4: CONTROLS AND PROCEDURES

Evaluation of Disclosure 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.

Changes in Internal Control Over Financial Reporting

On January 31, 2018, the Company completed the acquisition of FCX Performance, Inc ("FCX"). As permitted by SEC guidance, the scope of management's evaluation of internal control over financial reporting as of December 31, 2018 did not include the internal control over financial reporting of FCX. However, we are extending our oversight and monitoring processes that support our internal control over financial reporting to include FCX's operations.

There have not been any changes in internal control over financial reporting during the six months ended December 31, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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

Repurchases of common stock in the quarter ended December 31, 2018 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, 2018 to October 31, 2018	0	\$0.00	0	1,056,700
November 1, 2018 to November 30, 2018	0	\$0.00	0	1,056,700
December 1, 2018 to December 31, 2018	0	\$0.00	0	1,056,700
Total	0	\$0.00	0	1,056,700

(1) On October 24, 2016, the Board of Directors authorized the repurchase of up to 1.5 million shares of the Company's common stock, replacing the prior authorization. We publicly announced the new authorization on October 26, 2016. Purchases can be made in the open market or in privately negotiated transactions. The authorization is in effect until all shares are purchased, or the Board revokes or amends the authorization.

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ITEM 6. Exhibits

Exhibit No. Description

3.1	<u>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).</u>
3.2	<u>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).</u>
4.1	<u>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).</u>
4.2	<u>Private Shelf Agreement dated as of November 27, 1996, as amended through June 29, 2018, between Applied and PGIM, Inc. (formerly known as Prudential Investment Management, Inc.), conformed to show all amendments (filed as Exhibit 4.2 to the Company's Form 10-K for the fiscal year ended June 30, 2018, SEC File No. 1-2299, and incorporated here by reference).</u>
4.3	<u>Request for Purchase dated May 30, 2014 and 3.19% Series C Notes dated July 1, 2014, under Private Shelf Agreement dated November 27, 1996, as amended, between Applied Industrial Technologies, Inc. and Prudential Investment Management, Inc. (filed as Exhibit 10.1 to the Company's Form 8-K filed July 2, 2014, SEC File No. 1-2299, and incorporated here by reference).</u>
4.4	<u>Request for Purchase dated October 22, 2014 and 3.21% Series D Notes dated October 30, 2014, under Private Shelf Agreement dated November 27, 1996, as amended, between Applied Industrial Technologies, Inc. and Prudential Investment Management, Inc. (filed as Exhibit 4.5 to the Company's Form 10-Q for the quarter ended September 30, 2014, SEC File No. 1-2299, and incorporated here by reference).</u>
4.5	<u>Credit Agreement dated as of January 31, 2018, among Applied Industrial Technologies, Inc., KeyBank National Association as Agent, and various financial institutions (filed as Exhibit 10.1 to the Company's Form 8-K filed February 6, 2018, SEC File No. 1-2299, and incorporated here by reference).</u>
4.6	<u>Receivables Financing Agreement dated as of August 31, 2018 among AIT Receivables LLC, as borrower, PNC Bank, National Association, as administrative agent, Applied Industrial Technologies, Inc., as initial servicer, PNC Capital Markets LLC, as structuring agent and the additional persons from time to time party thereto, as lenders (filed as Exhibit 10.1 to the Company's Form 8-K filed September 6, 2018, SEC File No. 1-2299, and incorporated here by reference).</u>
15	<u>Independent Registered Public Accounting Firm's Awareness Letter</u>
31	<u>Rule 13a-14(a)/15d-14(a) certifications</u>
32	<u>Section 1350 certifications</u>
101.INS	XBRL Instance Document

- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

The Company will furnish a copy of any exhibit described above and not contained herein upon payment of a specified reasonable fee which shall be limited to the Company's reasonable expenses in furnishing the exhibit. Certain instruments with respect to long-term debt have not been filed as exhibits because the total amount of securities authorized under any one of the instruments does not exceed 10 percent of the total assets of the Company and its subsidiaries on a consolidated basis. The Company agrees to furnish to the Securities and Exchange Commission, upon request, a copy of each such instrument.

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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: January 25, 2019 By: /s/ Neil A. Schrimsher
Neil A. Schrimsher
President & Chief Executive Officer

Date: January 25, 2019 By: /s/ David K. Wells
David K. Wells
Vice President-Chief Financial Officer & Treasurer