

APPLIED INDUSTRIAL TECHNOLOGIES INC  
Form 10-Q  
October 26, 2017  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

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

For the quarterly period ended SEPTEMBER 30, 2017

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

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

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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)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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  (Do not check if a smaller reporting company) 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

There were 38,815,205 (no par value) shares of common stock outstanding on October 13, 2017.

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## PART I: FINANCIAL INFORMATION

## ITEM I: FINANCIAL STATEMENTS

## APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

## CONDENSED STATEMENTS OF CONSOLIDATED INCOME

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended	
	September 30,	
	2017	2016
Net Sales	\$680,701	\$624,848
Cost of Sales	488,277	446,518
Gross Profit	192,424	178,330
Selling, Distribution and Administrative, including depreciation	140,587	134,911
Operating Income	51,837	43,419
Interest Expense, net	2,166	2,146
Other Income, net	(711)	(197)
Income Before Income Taxes	50,382	41,470
Income Tax Expense	16,661	14,099
Net Income	\$33,721	\$27,371
Net Income Per Share - Basic	\$0.87	\$0.70
Net Income Per Share - Diluted	\$0.86	\$0.70
Cash dividends per common share	\$0.29	\$0.28
Weighted average common shares outstanding for basic computation	38,932	39,044
Dilutive effect of potential common shares	404	338
Weighted average common shares outstanding for diluted computation	39,336	39,382
See notes to condensed consolidated financial statements.		

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CONDENSED STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME

(Unaudited)

(In thousands)

	Three Months Ended September 30,	
	2017	2016
Net income per the condensed statements of consolidated income	\$33,721	\$27,371
Other comprehensive income (loss), before tax:		
Foreign currency translation adjustments	8,159	(2,349 )
Post-employment benefits:		
Reclassification of net actuarial (gains) losses and prior service cost into other income, net and included in net periodic pension costs	(14	) 127
Unrealized (loss) gain on investment securities available for sale	(4	) 26
Total of other comprehensive income (loss), before tax	8,141	(2,196 )
Income tax (benefit) expense related to items of other comprehensive income	(11	) 61
Other comprehensive income (loss), net of tax	8,152	(2,257 )
Comprehensive income, net of tax	\$41,873	\$25,114

See notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands)

	September 30, 2017	June 30, 2017
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 77,769	\$ 105,057
Accounts receivable, less allowances of \$9,812 and \$9,628	405,572	390,931
Inventories	364,979	345,145
Other current assets	28,559	41,409
Total current assets	876,879	882,542
Property, less accumulated depreciation of \$170,163 and \$166,143	111,313	108,068
Identifiable intangibles, net	159,848	163,562
Goodwill	209,834	206,135
Deferred tax assets	9,242	8,985
Other assets	17,791	18,303
<b>TOTAL ASSETS</b>	<b>\$ 1,384,907</b>	<b>\$ 1,387,595</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities		
Accounts payable	\$ 165,233	\$ 180,614
Current portion of long term debt	5,595	4,814
Compensation and related benefits	49,774	58,785
Other current liabilities	59,658	65,540
Total current liabilities	280,260	309,753
Long-term debt	285,175	286,769
Post-employment benefits	15,603	16,715
Other liabilities	30,201	29,102
<b>TOTAL LIABILITIES</b>	<b>611,239</b>	<b>642,339</b>
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; 38,815 and 39,041 outstanding, respectively	10,000	10,000
Additional paid-in capital	164,998	164,655
Retained Earnings	1,067,473	1,033,751
Treasury shares—at cost (15,398 and 15,172 shares, respectively)	(395,253)	(381,448)
Accumulated other comprehensive loss	(73,550)	(81,702)
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>773,668</b>	<b>745,256</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 1,384,907</b>	<b>\$ 1,387,595</b>
See notes to condensed consolidated financial statements.		

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

(Unaudited)

(In thousands)

	Three Months Ended September 30,	
	2017	2016
Cash Flows from Operating Activities		
Net income	\$33,721	\$27,371
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property	3,927	3,650
Amortization of intangibles	5,831	6,237
Unrealized foreign exchange transactions (gain) loss	(601 )	248
Amortization of stock options and appreciation rights	577	809
Gain on sale of property	(198 )	(1,068 )
Other share-based compensation expense	778	555
Changes in operating assets and liabilities, net of acquisition	(35,025 )	2,835
Other, net	430	1,227
Net Cash provided by Operating Activities	9,440	41,864
Cash Flows from Investing Activities		
Acquisition of businesses, net of cash acquired	(5,014 )	—
Property purchases	(6,336 )	(2,999 )
Proceeds from property sales	283	1,747
Net Cash used in Investing Activities	(11,067 )	(1,252 )
Cash Flows from Financing Activities		
Net repayments under revolving credit facility	—	(22,000 )
Long-term debt repayments	(839 )	(838 )
Purchases of treasury shares	(13,761 )	(3,048 )
Dividends paid	(11,327 )	(10,943 )
Acquisition holdback payments	(319 )	(4,444 )
Exercise of stock options and appreciation rights	—	108
Taxes paid for shares withheld for equity awards	(1,056 )	(987 )
Net Cash used in Financing Activities	(27,302 )	(42,152 )
Effect of Exchange Rate Changes on Cash	1,641	(299 )
Decrease in Cash and Cash Equivalents	(27,288 )	(1,839 )
Cash and Cash Equivalents at Beginning of Period	105,057	59,861
Cash and Cash Equivalents at End of Period	\$77,769	\$58,022
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 September 30, 2017, and the results of its operations and its cash flows for the three month periods ended September 30, 2017 and 2016, have been included. The condensed consolidated balance sheet as of June 30, 2017 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, 2017.

Operating results for the three month period ended September 30, 2017 are not necessarily indicative of the results that may be expected for the remainder of the fiscal year ending June 30, 2018.

Change in Accounting Principle - Net Periodic and Post-retirement Benefit Costs

In March 2017, the FASB issued its final standard on improving the presentation of net periodic pension and postretirement benefit costs. This standard, issued as ASU 2017-07, requires that an employer report the service cost component for defined benefit plans and postretirement plans in the same line item in the income statement as other compensation costs arising from services rendered by the employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations. This update is effective for annual financial statement periods beginning after December 15, 2017, including interim periods within those annual periods. Early adoption is permitted as of the beginning of an annual period. The Company early adopted ASU 2017-07 in the first quarter of fiscal 2018. The impact of the adoption of this guidance resulted in the reclassification of the other components of net benefit cost from selling, distribution, and administrative expense to other income, net in the condensed statements of consolidated income, resulting in an increase to operating income. There is no impact to income before income taxes, net income, or net income per share. The amounts reclassified resulted in an increase in operating income of \$201 for the three months ended September 30, 2016.

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 May 2014, the FASB issued its final standard on the recognition of revenue from contracts with customers. The standard, issued as ASU 2014-09, outlines a single comprehensive model for entities to use in the accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including

industry specific guidance. 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." In August 2015, the FASB issued ASU 2015-14 to delay the effective date of ASU 2014-09 by one year. In accordance with the delay, the update is effective for financial statement periods beginning after December 15, 2017 and may be adopted either retrospectively or on a modified retrospective basis. Early adoption is permitted, but not before financial statement periods beginning after December 15, 2016. In March 2016 the FASB issued ASU 2016-08 and ASU 2016-10, and in May 2016 the FASB issued ASU 2016-12, which clarify the guidance in ASU 2014-09 but do not change the core principle of the revenue recognition model. The Company has evaluated the provisions of the new standard and is in the process of assessing its impact on financial statements, information systems, business processes, and financial statement disclosures. We are completing an analysis of revenue streams at each of the business units and are evaluating the impact the new standard may have

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

on revenue recognition. The Company primarily sells purchased products and recognizes revenue at point of sale or delivery and this is not expected to change under the new standard. Preliminarily, the Company plans to use the modified retrospective method of adoption, and based on initial reviews, the standard is not expected to have a material impact on the Company's consolidated financial statements. We do anticipate expanded disclosures on revenue in order to comply with the new ASU. The Company will continue to evaluate the impacts of the adoption of the standard and the preliminary assessments are subject to change.

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 annual and interim financial statement periods beginning after December 15, 2018, with earlier application permitted. The Company has not yet determined the impact of this pronouncement on its financial statements and related disclosures.

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. 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 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, with early adoption permitted. The Company has not yet determined the impact of this pronouncement on its financial statements and related disclosures.

In January 2017, the FASB issued its final standard on simplifying the test for goodwill impairment. This standard, issued as ASU 2017-04, eliminates step 2 from the goodwill impairment test and instead requires an entity to perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge would be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value, not to exceed the total amount of goodwill allocated to that reporting unit. This update is effective for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019, with early adoption permitted. Upon adoption, the Company will apply this guidance prospectively to its annual and interim goodwill impairment tests and disclose the change in accounting principle.

In May 2017, the FASB issued its final standard on scope of modification accounting. This standard, issued as 2017-09, provides guidance about which change to the terms or conditions of a share-based payment award require an

entity to apply modification accounting. This update is effective for annual and interim financial statement periods beginning after December 15, 2017, with early adoption permitted. The Company has not yet determined the impact of this pronouncement on its financial statements and related disclosures.

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## 2. 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 2018 Acquisition

On July 3, 2017, the Company acquired 100% of the outstanding stock of 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 \$3,460, and goodwill was \$2,460 based upon preliminary estimated fair values at the acquisition date, which are subject to adjustment. The purchase price includes \$906 of acquisition holdback payments, included in other current liabilities and other liabilities on the condensed consolidated balance sheets, which will be paid on the first three anniversaries of the acquisition 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.

## Fiscal 2017 Acquisition

On March 3, 2017, the Company acquired substantially all of the net assets of Sentinel Fluid Controls ("Sentinel"), a distributor of hydraulic and lubrication components, systems and solutions operating from four locations - Toledo, OH, New Berlin, WI, Valparaiso, IN, and Indianapolis, IN. Sentinel is included in the Fluid Power Businesses segment. The purchase price for the acquisition was \$3,755, net tangible assets acquired were \$3,130, and goodwill was \$625 based upon estimated fair values at the acquisition date. The purchase price included \$982 of acquisition holdback payments. The remaining balance of \$807 is included in other current liabilities and other liabilities on the condensed consolidated balance sheets, which will be paid plus interest at various times in the future. The Company funded the amount paid for the acquisition at closing 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.

## 3. GOODWILL AND INTANGIBLES

The changes in the carrying amount of goodwill for both the Service Center Based Distribution segment and the Fluid Power Businesses segment for the fiscal year ended June 30, 2017 and the three month period ended September 30, 2017 are as follows:

	Service Centers	Fluid Power	Total
Balance at July 1, 2016	\$198,486	\$4,214	\$202,700
Goodwill acquired during the period	3,220	625	3,845
Other, primarily currency translation	34	(444)	(410)
Balance at June 30, 2017	\$201,740	\$4,395	\$206,135
Goodwill acquired during the period	2,460	—	2,460
Other, primarily currency translation	1,239	—	1,239
Balance at September 30, 2017	\$205,439	\$4,395	\$209,834

During the first quarter of fiscal 2017, the Company recorded an adjustment to the preliminary estimated fair value of intangible assets related to the HUB acquisition. The fair values of the customer relationships and trade names intangible assets were decreased by \$2,636 and \$584, respectively, with a corresponding total increase to goodwill of \$3,220. The changes to the preliminary estimated fair values resulted in a decrease to amortization expense of \$156 during the three months ended September 30, 2016, which is recorded in selling, distribution and administrative expense on the condensed statements of consolidated income.

The Company has six (6) reporting units for which an annual goodwill impairment assessment was performed as of January 1, 2017. The Company concluded that all of the reporting units' fair value exceeded their carrying amounts by at least 20% as of January 1, 2017. 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

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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 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. Further, continued adverse market conditions could result in the recognition of additional impairment if the Company determines that the fair values of its reporting units have fallen below their carrying values.

At September 30, 2017 and June 30, 2017, 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 Businesses segment.

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

September 30, 2017	Amount	Accumulated Amortization	Net Book Value
Finite-Lived Identifiable Intangibles:			
Customer relationships	\$235,945	\$ 106,142	\$ 129,803
Trade names	44,223	20,164	24,059
Vendor relationships	14,179	9,404	4,775
Non-competition agreements	3,780	2,569	1,211
Total Identifiable Intangibles	\$298,127	\$ 138,279	\$ 159,848

June 30, 2017	Amount	Accumulated Amortization	Net Book Value
Finite-Lived Identifiable Intangibles:			
Customer relationships	\$235,009	\$ 102,414	\$ 132,595
Trade names	43,873	19,295	24,578
Vendor relationships	14,152	9,141	5,011
Non-competition agreements	3,788	2,410	1,378
Total Identifiable Intangibles	\$296,822	\$ 133,260	\$ 163,562

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 September 30, 2017) for the next five years is as follows: \$17,100 for the remainder of 2018, \$21,000 for 2019, \$19,200 for 2020, \$17,600 for 2021, \$16,100 for 2022 and \$14,600 for 2023.

4. DEBT

Revolving Credit Facility & Term Loan

In December 2015, the Company entered into a five-year credit facility with a group of banks expiring in December 2020. This agreement provides for a \$125,000 unsecured term loan and a \$250,000 unsecured revolving credit facility. Fees on this facility range from 0.09% to 0.175% per year based upon the Company's leverage ratio at each quarter

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

end. Borrowings under this agreement carry variable interest rates tied to either LIBOR or prime at the Company's discretion. At September 30, 2017 and June 30, 2017, the Company had \$119,531 and \$120,313, respectively, outstanding under the term loan, and no amounts outstanding under the revolver. Unused lines under this facility, net of outstanding letters of credit of \$2,534 and \$2,441 to secure certain insurance obligations, totaled \$247,466 and \$247,559 at September 30, 2017 and June 30, 2017, respectively and are available to fund future acquisitions or other capital and operating requirements. The interest rate on the term loan was 2.25% as of September 30, 2017 and as of June 30, 2017.

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 September 30, 2017 and June 30, 2017, in order to secure certain insurance obligations.

**Other Long-Term Borrowings**

At September 30, 2017 and June 30, 2017, 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 September 30, 2017, \$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 September 30, 2017 and June 30, 2017, \$1,612 and \$1,669 was outstanding, respectively.

Unamortized debt issue costs of \$105 are included as a reduction of current portion of long-term debt on the condensed consolidated balance sheets as of September 30, 2017 and June 30, 2017. Unamortized debt issue costs of \$268 and \$294 are included as a reduction of long-term debt on the condensed consolidated balance sheets as of September 30, 2017 and June 30, 2017, respectively.

**5. FAIR VALUE MEASUREMENTS**

Marketable securities measured at fair value at September 30, 2017 and June 30, 2017 totaled \$10,584 and \$10,481, 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 valued using quoted market prices (Level 1 in the fair value hierarchy).

As of September 30, 2017 and June 30, 2017, 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 and the term loan contain variable interest rates and their carrying values approximate fair value (Level 2 in the fair value hierarchy).

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

## 6. SHAREHOLDERS' EQUITY

## Accumulated Other Comprehensive Loss

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

	Three Months Ended September 30, 2017			
	Foreign currency translation adjustment	Unrealized gain (loss) on securities available for sale	Postemployment benefits	Total Accumulated other comprehensive (loss) income
Balance at July 1, 2017	\$(79,447)	\$ 21	\$ (2,276)	) \$ (81,702 )
Other comprehensive income (loss)	8,159	(3 )	) —	8,156
Amounts reclassified from accumulated other comprehensive (loss) income	—	—	(4 )	) (4 )
Net current-period other comprehensive income (loss)	8,159	(3 )	(4 )	) 8,152
Balance at September 30, 2017	\$(71,288)	\$ 18	\$ (2,280)	) \$ (73,550 )
	Three Months Ended September 30, 2016			
	Foreign currency translation adjustment	Unrealized (loss) gain on securities available for sale	Postemployment benefits	Total Accumulated other comprehensive (loss) income
Balance at July 1, 2016	\$(81,685)	\$ (38 )	\$ (3,823)	) \$ (85,546 )
Other comprehensive (loss) income	(2,349 )	15	—	(2,334 )
Amounts reclassified from accumulated other comprehensive (loss) income	—	—	77	77
Net current-period other comprehensive (loss) income	(2,349 )	15	77	(2,257 )
Balance at September 30, 2016	\$(84,034)	\$ (23 )	\$ (3,746)	) \$ (87,803 )

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

## Other Comprehensive Income (Loss)

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

	Three Months Ended September 30,					
	2017			2016		
	Pre-Tax Amount	Tax Benefit	Net Amount	Pre-Tax Amount	Tax Expense	Net Amount
Foreign currency translation adjustments	\$8,159	\$ —	\$8,159	\$(2,349)	\$ —	\$(2,349)
Post-employment benefits:						
Reclassification of net actuarial (gains) losses and prior service cost into other income, net and included in net periodic pension costs	(14 )	(10 )	(4 )	127	50	77
Unrealized (loss) gain on investment securities available for sale	(4 )	(1 )	(3 )	26	11	15
Other comprehensive loss	\$8,141	\$ (11 )	\$8,152	\$(2,196)	\$ 61	\$(2,257)

## Antidilutive Common Stock Equivalents

In the three month periods ended September 30, 2017 and 2016, respectively, stock options and stock appreciation rights related to 293 and 680 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.

## 7. BENEFIT PLANS

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

Three Months Ended September 30,	Pension Benefits		Retiree Health Care Benefits	
	2017	2016	2017	2016
Components of net periodic cost:				
Service cost	\$31	\$31	\$ 5	\$ 7
Interest cost	183	173	13	16
Expected return on plan assets	(118 )	(115 )	—	—
Recognized net actuarial loss (gain)	106	218	(39 )	(45 )
Amortization of prior service cost	7	22	(92 )	(68 )
Net periodic cost	\$209	\$329	\$ (113 )	\$ (90 )

In accordance with the Company's adoption of ASU 2017-07, the Company reports the service cost component of the net periodic post-employment costs in the same line item in the income statement as other compensation costs arising from services rendered by the employees during the period. The other components of net periodic post-employment costs are presented in the income statement separately from the service cost component and outside a subtotal of income from operations. Therefore, \$36 and \$38 of service costs are included in selling, distribution and administrative expense, and \$60 and \$201 of net other periodic post-employment costs are included in other income, net in the condensed statements of consolidated income for the three months ended September 30, 2017 and 2016, respectively. The Company contributed \$900 to its pension benefit plans and \$47 to its retiree health care plans in the three months ended September 30, 2017. Expected contributions for the remainder of fiscal 2018 are \$1,920 for the pension benefit plans to fund scheduled retirement payments and \$143 for retiree health care plans.



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## 8. SEGMENT AND GEOGRAPHIC INFORMATION

Effective July 1, 2017, the Company completed a number of changes to its organizational structure that resulted in a change in how the Company manages its businesses, allocates resources and measures performance. As a result, the Company has revised its reportable segments to reflect how management currently reviews financial information and makes operating decisions. All Canadian and Mexican subsidiaries are now grouped under the Service Center Based Distribution segment. 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 Businesses segment to the Service Center Based Distribution segment of \$6,091 and \$5,264, in the three months ended September 30, 2017 and 2016, respectively, have been eliminated in the Segment Financial Information tables below.

Three Months Ended	Service Center Fluid		
	Based Distribution	Power Businesses	Total
September 30, 2017			
Net sales	\$ 568,913	\$ 111,788	\$ 680,701
Operating income for reportable segments	33,722	13,290	47,012
Assets used in business	1,182,784	202,123	1,384,907
Depreciation and amortization of property	3,669	258	3,927
Capital expenditures	5,548	788	6,336
September 30, 2016			
Net sales	\$ 529,230	\$ 95,618	\$ 624,848
Operating income for reportable segments	26,996	10,478	37,474
Assets used in business	1,147,199	152,240	1,299,439
Depreciation and amortization of property	3,416	234	3,650
Capital expenditures	2,924	75	2,999

Enterprise Resource Planning system (ERP) related assets are included within the Service Center Based Distribution segment.

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

	Three Months Ended September 30,	
	2017	2016
Operating income for reportable segments	\$47,012	\$37,474
Adjustment for:		
Intangible amortization—Service Center Based Distribution	4,512	4,846
Intangible amortization—Fluid Power Businesses	1,319	1,391
Corporate and other income, net	(10,656 )	(12,182 )
Total operating income	51,837	43,419
Interest expense, net	2,166	2,146

Other income, net	(711 )	(197 )
Income before income taxes	\$50,382	\$41,470

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

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Net sales are presented in geographic areas based on the location of the facility shipping the product and are as follows:

Geographic Areas:	Three Months Ended September 30,	
	2017	2016
United States	\$567,545	\$523,367
Canada	66,817	62,581
Other countries	46,339	38,900
Total	\$680,701	\$624,848

Other countries consist of Mexico, Australia, New Zealand, and Singapore.

## 9. OTHER INCOME , NET

Other income, net consists of the following:

	Three Months Ended September 30,	
	2017	2016
Unrealized gain on assets held in rabbi trust for a non-qualified deferred compensation plan	\$ (368 )	\$ (330 )
Foreign currency transactions gain	(311 )	(150 )
Net other periodic post-employment costs	60	201
Other, net	(92 )	82
Total other income, net	\$ (711 )	\$ (197 )

## 10. SUBSEQUENT EVENTS

We have evaluated events and transactions occurring subsequent to September 30, 2017 through the date the financial statements were issued.

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

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

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have reviewed the accompanying condensed consolidated balance sheet of Applied Industrial Technologies, Inc. and subsidiaries (the "Company") as of September 30, 2017, and the related condensed statements of consolidated income, consolidated comprehensive income, and consolidated cash flows for the three-month periods ended September 30, 2017 and 2016. These interim financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of the Company as of June 30, 2017, 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 18, 2017, 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, 2017 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Deloitte & Touche LLP

Cleveland, Ohio  
October 26, 2017



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ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
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With more than 5,500 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, fluid power components, 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 and fluid power applications, as well as customized mechanical, fabricated rubber and fluid power 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 first quarter of fiscal 2018, business was conducted in the United States, Canada, Mexico, Puerto Rico, Australia, New Zealand and Singapore from 554 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 September 30, 2017 increased \$55.9 million or 8.9% compared to the prior year quarter, with the acquisitions of Sentinel and DICOFASA increasing sales by \$4.7 million or 0.8% and favorable foreign currency translation of \$4.5 million increasing sales by 0.7%. Operating margin of 7.6% of sales, was up from 6.9% for the prior year quarter. Net income of \$33.7 million increased 23.2% compared to the prior year quarter. Shareholders' equity was \$773.7 million at September 30, 2017, up from the June 30, 2017 level of \$745.3 million. The current ratio was 3.1 to 1 at September 30, 2017 and 2.8 to 1 at June 30, 2017.

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 generally remained stable since June 2017. The MCU for September 2017 was 76.0, which is down slightly from the June 2017 reading of 76.6. The ISM PMI registered 60.8 in September, an increase from the June 2017 reading of 57.8, and remained above 50 (its expansionary threshold). The indices for the months during the current quarter were as follows:

Month	Index Reading		
	MCU	PMI	IP
September 2017	76.0	60.8	103.0
August 2017	75.8	58.8	102.9
July 2017	76.5	56.3	103.2

The number of Company employees was 5,529 at September 30, 2017, 5,554 at June 30, 2017, and 5,516 at September 30, 2016. The number of operating facilities totaled 554 at September 30, 2017, 552 at June 30, 2017 and 556 at September 30, 2016.

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## Results of Operations

Three months Ended September 30, 2017 and 2016

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

	Three Months Ended September 30, As a Percent of Net Sales		Change in \$'s Versus Prior Period - % Increase	
	2017	2016		
Net Sales	100.0%	100.0%	8.9	%
Gross Profit	28.3 %	28.5 %	7.9	%
Selling, Distribution & Administrative	20.7 %	21.6 %	4.2	%
Operating Income	7.6 %	6.9 %	19.4	%
Net Income	5.0 %	4.4 %	23.2	%

During the quarter ended September 30, 2017, sales increased \$55.9 million or 8.9% compared to the prior year quarter, with sales from acquisitions adding \$4.7 million or 0.8% and favorable foreign currency translation accounting for \$4.5 million or 0.7%. There were 63 selling days in the quarter ended September 30, 2017 and 64 selling days in the quarter ended September 30, 2016. Excluding the impact of businesses acquired and the impact of currency translation, sales were up \$46.7 million or 7.4% during the quarter, driven by an increase of 8.0% from the Service Center Based Distribution segment in addition to an increase of 1.2% from the Fluid Power Businesses segment, offset by a 1.8% decrease due to one less sales day.

Sales from our Service Center Based Distribution segment, which operates primarily in MRO markets, increased \$39.7 million or 7.5%. Acquisitions within this segment increased sales by \$0.8 million or 0.1%, and favorable foreign currency translation increased sales by \$4.5 million or 0.9%. Excluding the impact of businesses acquired and the impact of currency translation, sales increased \$34.4 million or 6.5%, driven by an increase of 5.0% from within the traditional core operations in addition to a 3.2% increase from the upstream oil and gas-focused subsidiaries, offset by a 1.7% decrease due to one less sales day.

Sales from our Fluid Power Businesses segment, which operates primarily in OEM markets, increased \$16.2 million or 16.9%. Acquisitions within this segment increased sales by \$3.9 million or 4.1%. Excluding the impact of businesses acquired, sales increased \$12.3 million or 12.8%, driven by an increase from operations of 14.7%, offset by a decrease of 1.9% due to one less sales day.

Sales in our U.S. operations were up \$44.2 million or 8.4%, as acquisitions added \$3.9 million or 0.8%. Excluding the impact of businesses acquired, U.S. sales were up \$40.3 million or 7.6%, of which 6.6% is from our traditional core operations and 2.8% is from our upstream oil and gas-focused subsidiaries, offset by a 1.8% decrease due to one less sales day. Sales from our Canadian operations increased \$4.2 million or 6.8%, and favorable foreign currency translation increased Canadian sales by \$2.6 million or 4.1%. Excluding the impact of foreign currency translation, Canadian sales were up \$1.6 million or 2.7%. Consolidated sales from our other country operations, which include Mexico, Australia, New Zealand, and Singapore, increased \$7.5 million or 19.1% from the prior year. Acquisitions

added sales of \$0.8 million or 2.0% and favorable foreign currency translation increased other country sales by \$1.9 million or 5.0%. Excluding the impact of businesses acquired and the impact of currency translation, other country sales were up \$4.8 million, or 12.1% during the quarter.

During the quarter ended September 30, 2017, industrial products and fluid power products accounted for 73.7% and 26.3%, respectively, of sales, as compared to 72.5% and 27.5%, respectively, for the same period in the prior year.

Our gross profit margin for the quarter was 28.3% compared to the prior year's quarter of 28.5%. The gross profit margin was unfavorably impacted by 14 bps related to change in the LIFO adjustment recorded during the three months ended September 30, 2017 compared to the three months ended September 30, 2016.

Selling, distribution and administrative expense (SD&A) consists of associate compensation, benefits and other expenses associated with selling, purchasing, warehousing, supply chain management and providing marketing and distribution of the Company's products, as well as costs associated with a variety of administrative functions such as human resources,

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information technology, treasury, accounting, legal, and facility related expenses. SD&A was 20.7% of sales in the quarter ended September 30, 2017 compared to 21.6% in the prior year quarter. SD&A increased \$5.7 million or 4.2% compared to the prior year quarter. Changes in foreign currency exchange rates had the effect of increasing SD&A during the quarter ended September 30, 2017 by \$1.0 million or 0.7% compared to the prior year quarter. SD&A from businesses acquired added \$0.9 million or 0.6% of SD&A expenses, none of which is associated with intangibles amortization. Excluding the impact of businesses acquired and the unfavorable currency translation impact, SD&A increased \$3.8 million or 2.9% during the quarter ended September 30, 2017 compared to the prior year quarter. Excluding the impact of acquisitions, total compensation increased \$3.8 million during the quarter ended September 30, 2017 compared to the prior year quarter as a result of merit increases and improved Company performance.

Operating income increased \$8.4 million or 19.4%, and as a percent of sales increased to 7.6% from 6.9% during the prior year quarter.

Operating income as a percentage of sales for the Service Center Based Distribution segment increased to 5.9% in the current year quarter from 5.1% in the prior year quarter. Operating income as a percentage of sales for the Fluid Power Business segment increased to 11.9% in the current year quarter from 11.0% in the prior year quarter. These increases are due to the positive leveraging impact from the increase in sales in the current year.

Other income, net, was \$0.7 million in the quarter which included unrealized gains on investments held by non-qualified deferred compensation trusts of \$0.4 million, as well as \$0.3 million of net favorable foreign currency transaction gains. During the prior year quarter, other income, net was \$0.2 million which included unrealized losses on investments held by non-qualified deferred compensation trusts of \$0.3 million, as well as \$0.2 million of net unfavorable foreign currency transaction losses, offset by \$0.3 million of expense from other items.

The effective income tax rate was 33.1% for the quarter ended September 30, 2017 compared to 34.0% for the quarter ended September 30, 2016. This decrease in the effective tax rate is primarily the result of a discrete tax item related to state income taxes positively impacting the rate. We expect our full year tax rate for fiscal 2018 to be in the 34.0% to 35.0% range.

As a result of the factors addressed above, net income increased \$6.4 million or 23.2% compared to the prior year quarter. Net income per share was \$0.86 per share for the quarter ended September 30, 2017, compared to \$0.70 in the prior year quarter, an increase of 22.9%. Net income per share was also favorably impacted due to lower weighted average common shares outstanding as a result of our share repurchases program.

#### 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 September 30, 2017, we had \$291.1 million in outstanding borrowings. At June 30, 2017, we had \$292.0 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.

The Company holds, from time to time, relatively significant cash and cash equivalent balances in tax jurisdictions outside of the United States. The following table shows the Company's total cash as of September 30, 2017 by tax jurisdiction.

Country	Amount
United States	\$32,904
Canada	31,286
Other countries	13,579
Total	\$77,769

To the extent cash in foreign countries is distributed to the U.S., it could become subject to U.S. income taxes. Foreign tax credits may be available to offset all or a portion of such taxes. At September 30, 2017, all foreign earnings are considered permanently reinvested.

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The Company's working capital at September 30, 2017 was \$596.6 million, compared to \$572.8 million at June 30, 2017. The current ratio was 3.1 to 1 at September 30, 2017 and 2.8 to 1 at June 30, 2017.

## 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.

	Three Months Ended September 30,	
Net Cash Provided by (Used in):	2017	2016
Operating Activities	\$9,440	\$41,864
Investing Activities	(11,067 )	(1,252 )
Financing Activities	(27,302 )	(42,152 )
Exchange Rate Effect	1,641	(299 )
Decrease in Cash and Cash Equivalents	\$(27,288)	\$(1,839)

Net cash provided by operating activities was \$9.4 million for the three months ended September 30, 2017 as compared to \$41.9 million provided by operating activities in the prior period. The decrease in cash provided by operating activities during the three months ended September 30, 2017 is related to increased working capital levels due to increasing sales compared to the prior period.

Net cash used in investing activities during the three months ended September 30, 2017 is more than the prior period as \$5.0 million was used for the current period acquisition, while there were no acquisitions in the prior year period. Further, there was \$3.3 million more spent on property purchases in the current year quarter primarily due to an increase in expenditures for building improvements and shop equipment.

Net cash used by financing activities was \$27.3 million for the three months ended September 30, 2017 versus \$42.2 million in the prior year period. The decrease in cash used in financing activities is primarily due to a decrease in debt payments, as there were no amounts outstanding on the revolver at September 30, 2017 and at June 30, 2017. We had \$0.8 million of debt payments in the current period compared to \$22.8 million of net payments in the prior year period. Also, cash was used in the current period for the purchase of treasury shares in the amount of \$13.8 million and dividends paid in the amount of \$11.3 million. In the prior period, \$3.0 million of cash was used for the purchase of treasury shares and \$10.9 million of cash was used for the payment of dividends. Further, \$0.3 million of cash was used in the current period to make acquisition holdback payments, compared to \$4.4 million used 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. We acquired 247,500 shares of treasury stock on the open market in the three months ended September 30, 2017 for \$13.8 million. At September 30, 2017, we had authorization to repurchase an additional 1,202,500 shares. During the three months ended September 30, 2016, we acquired 65,000 shares of treasury stock on the open market for \$3.0 million.

## Borrowing Arrangements

In December 2015, the Company entered into a five-year credit facility with a group of banks expiring in December 2020. This agreement provides for a \$125.0 million unsecured term loan and a \$250.0 million unsecured revolving credit facility. Fees on this facility range from 0.09% to 0.175% 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 September 30, 2017 and June 30, 2017, the Company had \$119.5 million and \$120.3 million, respectively, outstanding under the term loan, and no amounts outstanding under the revolver. Unused lines under this facility, net of outstanding letters of credit of \$2.5 million and \$2.4 million to secure certain insurance obligations, totaled \$247.5 million and \$247.6 million at September 30, 2017 and June 30, 2017, respectively and are available to fund future acquisitions or other capital and operating requirements. The interest rate on the term loan was 2.25% as of September 30, 2017 and as of June 30, 2017.

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 September 30, 2017 and June 30, 2017, in order to secure certain insurance obligations.



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At September 30, 2017 and June 30, 2017, 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 September 30, 2017, \$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 September 30, 2017 and June 30, 2017, \$1.6 million and \$1.7 million was outstanding, respectively.

The revolving credit facility and unsecured shelf facility contain restrictive covenants regarding liquidity, net worth, financial ratios, and other covenants. At September 30, 2017, the most restrictive of these covenants required that the Company have net indebtedness less than 3.25 times consolidated income before interest, taxes, depreciation and amortization. At September 30, 2017, the Company's indebtedness was less than two times consolidated income before interest, taxes, depreciation and amortization. The Company was in compliance with all covenants at September 30, 2017.

## Accounts Receivable Analysis

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

	September 30, 2017	June 30, 2016	
Accounts receivable, gross	\$415,384	\$400,559	
Allowance for doubtful accounts	9,812	9,628	
Accounts receivable, net	\$405,572	\$390,931	
Allowance for doubtful accounts, % of gross receivables	2.4	%2.4	%
	Three Months Ended September 30,		
	2017	2016	
Provision for losses on accounts receivable	\$719	\$862	
Provision as a % of net sales	0.11	%0.14	%

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 53.6 at September 30, 2017 compared to 51.6 June 30, 2017. Accounts receivable increased 3.7% this year, compared to a 8.9% increase in sales in the three months ended September 30, 2017.

Approximately 2.1% of our accounts receivable balances are more than 90 days past due, an increase from 1.7% at June 30, 2017. On an overall basis, our provision for losses from uncollected receivables represents 0.11% of our sales

in the three months ended September 30, 2017. Historically, this percentage is around 0.10% to 0.15%. The decrease in the provision as a percentage of sales for the first quarter is the result of recoveries of amounts reserved for in the prior year periods for our subsidiaries focused on upstream oil and gas customers, in conjunction with the recovery of the energy markets in the U.S. Management believes the overall receivables aging and provision for losses on uncollected receivables are at reasonable levels.

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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 September 30, 2017 was 3.8 compared to 3.7 at June 30, 2017. We believe our inventory turnover ratio at the end of the year will be similar or slightly better than the ratio at September 30, 2017.

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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; adverse government regulation, legislation, or policies, both enacted and under consideration, including with respect to federal tax policy (e.g., affecting tax rates, the use of the LIFO inventory accounting method, or the taxation of foreign-sourced income), and international trade; 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, 2017.

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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, 2017.

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

There have not been any changes in internal control over financial reporting during the three months ended September 30, 2017 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 September 30, 2017 were as follows:

Period	(a) Total Number of Shares (1)	(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 (2)
July 1, 2017 to July 31, 2017	341	\$59.60	0	1,450,000
August 1, 2017 to August 31, 2017	247,500	\$55.60	247,500	1,202,500
September 1, 2017 to September 30, 2017	0	\$0.00	0	1,202,500
Total	247,841	\$55.61	247,500	1,202,500

(1) During the quarter the Company purchased 341 shares in connection with the Deferred Compensation Plan.

(2) 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 December 23, 2015, between Applied Industrial Technologies, Inc. and Prudential Investment Management, Inc. (assignee of The Prudential Insurance Company of America), conformed to show all amendments (filed as Exhibit 4.2 to the Company's Form 10-Q for the quarter ended December 31, 2015, 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 dated July 1, 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 December 22, 2015, 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 dated December 28, 2015, SEC File No. 1-2299, and incorporated here by reference).</u>
10.1	<u>Stock Appreciation Rights Award Terms and Conditions</u>
10.2	<u>Restricted Stock Units Terms and Conditions</u>
10.3	<u>Performance Shares Terms and Conditions</u>
10.4	<u>Schedule of executive officer participants in the Key Executive Restoration Plan, as amended and restated.</u>
15	<u>Independent Registered Public Accounting Firm's Awareness Letter</u>

- 31 Rule 13a-14(a)/15d-14(a) certifications
- 32 Section 1350 certifications
- 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: October 26, 2017 By: /s/ Neil A. Schrimsher  
Neil A. Schrimsher  
President & Chief Executive Officer

Date: October 26, 2017 By: /s/ David K. Wells  
David K. Wells  
Vice President-Chief Financial Officer & Treasurer