

Applied Industrial (AIT)

\$43.27 (As of 04/01/20)

Price Target (6-12 Months): **\$37.00**

Long Term: 6-12 Months | **Zacks Recommendation:** **Underperform**
(Since: 03/31/20)
Prior Recommendation: Neutral

Short Term: 1-3 Months | **Zacks Rank:** (1-5) **5-Strong Sell**
Zacks Style Scores: VGM:B
Value: B | Growth: B | Momentum: F

Summary

In the past three months, Applied Industrial's shares have underperformed the industry. The company is wary about weak industrial demand in the near term. It expects earnings per share of \$4.20-\$4.40 for fiscal 2020, down from \$4.20-\$4.50 stated previously. Sales in the year are predicted to be down 2% to flat year over year or decline 3-5% organically. Notably, the company earlier expected sales to be down 2% to up 2% or fall 1-5% organically. In addition to the headwinds, Applied Industrial faces risks from high debts and unfavorable movements in foreign currencies. Interest expenses in the year are expected to be at the high-end of the previously stated \$37-\$38 million. In the past 60 days, the company's earnings estimates have been lowered for both fiscal 2020 and 2021.

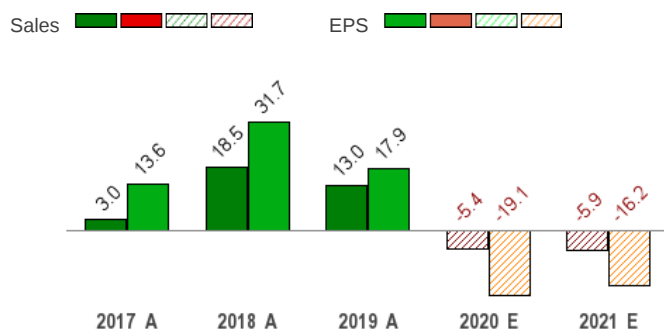
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$70.62 - \$30.66
20 Day Average Volume (sh)	343,300
Market Cap	\$1.7 B
YTD Price Change	-35.1%
Beta	1.39
Dividend / Div Yld	\$1.28 / 3.0%
Industry	Manufacturing - General Industrial
Zacks Industry Rank	Bottom 31% (176 out of 254)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	0.0%
Last Sales Surprise	-0.1%
EPS F1 Est- 4 week change	-17.0%
Expected Report Date	04/24/2020
Earnings ESP	0.0%
P/E TTM	10.4
P/E F1	12.1
PEG F1	1.0
P/S TTM	0.5

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021					3,092 E
2020	856 A	833 A	853 E	742 E	3,285 E
2019	865 A	840 A	885 A	883 A	3,473 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021					\$2.99 E
2020	\$1.02 A	\$0.97 A	\$1.00 E	\$0.58 E	\$3.57 E
2019	\$1.24 A	\$0.99 A	\$1.16 A	\$1.02 A	\$4.41 A

*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 04/01/2020. The reports text is as of 04/02/2020.

Overview

Applied Industrial Technologies, Inc. is a distributor of value-added industrial products — including engineered fluid power components, bearings, specialty flow control solutions, power transmission products and miscellaneous industrial supplies. These products are mainly sold to original equipment manufacturers (OEM) and maintenance, repair, and operations (MRO) customers in Australia, North America, Singapore and New Zealand.

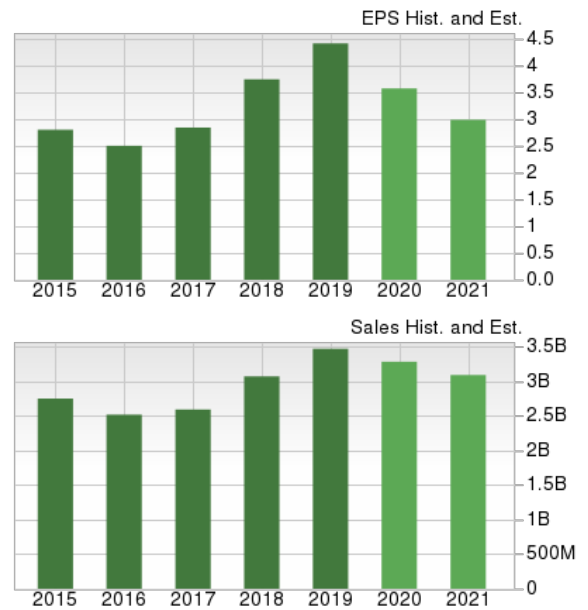
The company is also well known in the market for its engineering, design and systems integration services. Moreover, its inventory management solutions and maintenance training services boost the value of end users in the market. The company, founded in 1923, is currently headquartered in Cleveland, OH. At the end of second-quarter fiscal 2020 (ended Dec 31, 2019), it employed 6,500 people.

Applied Industrial reports revenues under two business segments — Service Center-Based Distribution, and Fluid Power & Flow Control. A brief discussion on the segments is provided below:

- **Service Center-Based Distribution** (69.1% of net revenues in the second quarter of fiscal 2020): The segment offers different types of industrial products majorly through service centers in New Zealand, Australia and North America.

This segment also provides services in the oil and gas industry as well as includes operations of fabricated rubber shops (regional) and rubber service field crews. Service offerings of Applied Maintenance Supplies & Solutions come under the ambit of this segment.

- **Fluid Power & Flow Control** (30.9%): The segment includes specialized regional companies that offer fluid power components, assembling and designing of fluid power systems, and provides equipment repairing services. These products and services are traded to the end-users directly in the absence of any service centers. In addition, the segment engages in the integration of flow control system, pump repair and others.



Reasons To Sell:

- ▼ In the past three months, shares of Applied Industrial have dipped 35% compared with the industry's decline of 25.8%. In second-quarter fiscal 2020, the company's earnings declined 2% year over year on weak sales performance and lower operating margin. For fiscal 2020, it expects earnings per share of \$4.20-\$4.40 versus the previously stated \$4.20-\$4.50. The mid-point of the new projection is \$4.30, suggesting a decline of 1.1% from the previous mid-point and 2.5% from \$4.41 recorded in fiscal 2019. Apart from this, the weak results and projections seem to have sparked bearish sentiments for the stock. Over the past 60 days, the company's earnings estimates have been revised downward by 10.5% to \$3.85 for fiscal 2020 and 26.4% to \$3.42 for fiscal 2021.
- ▼ In second-quarter fiscal 2020, Applied Industrial's revenues declined 0.8% from the prior-year quarter, with organic sales declining 4%. The company noted that the top line suffered from end-market challenges, including machinery, metals, mining and others. Also, customer activities were soft in December. Applied Industrial believes that industrial demand will be subdued in the near term. For fiscal 2020, the company predicts year-over-year sales to be down 2% to flat versus down 2% to up 2% stated previously. Organic sales are predicted to decline 3-5% compared with a fall of 1-5% expected earlier.
- ▼ The company's long-term debt rose 46.9% (CAGR) in the last three fiscal years (2017-2019). The balance at the end of second-quarter fiscal 2020 was \$874.4 million, suggesting a sequential increase of 1.8%. Net leverage ratio at the end of the second quarter was 2.5. We believe that high-debt levels can prove detrimental to the company's margins and profitability in the quarters ahead. For fiscal 2020, the company predicts interest expenses to be at the higher-end of the previously mentioned \$37-\$38 million.
- ▼ With operations across multiple continents, Applied Industrial's performance is exposed to the adverse impacts of macroeconomic cycles in the United States and international markets as well as unfavorable foreign currency movements. Forex woes had adversely impacted first-quarter sales by 0.1%, while its impact was neutral in the second quarter.

Subdued industrial demand in the near term, high interest expenses and woes related to international operations might prove detrimental for Applied Industrial in the quarters ahead.

Risks

- Applied Industrial remains committed to rewarding shareholders handsomely through dividend payments. From fiscal 2017 to 2019, the company's dividend payments grew from \$1.14 per share to \$1.22. In the first half of fiscal 2020, it used roughly \$24 million to pay out dividends to shareholders, reflecting 3.1% growth from the year-ago period. Also, the company's board of directors hiked the quarterly dividend rate by 3.2% in January 2020. Growth in net income will likely enable it to keep rewarding shareholders with dividends. Over the long term, the company will continue focusing on improving the product line, value-added services, initiatives to drive operational excellence and cost-saving initiatives. By fiscal 2023, it intends to generate revenues of more than \$4.5 billion, with organic sales growth in mid-single digits. Acquired assets are likely to contribute \$100 million annually.
 - Applied Industrial has been steadily strengthening inorganic growth trajectory on acquisitions. In this regard, buyouts of Sentinel Fluid Controls (in March 2017), FCX Performance (in January 2018) and Fluid Power Sales (in November 2018) are worth mentioning. Further, Applied Industrial acquired MilRoc Distribution and Woodward Steel in March 2019, while added Olympus Controls to its portfolio in August 2019. In second-quarter fiscal 2020, buyouts had a positive impact of 3.2% on the company's sales. On a segmental basis, acquired assets raised sales of the Fluid Power & Flow Control segment by 7.6% and that of the Service Center-Based Distribution segment by 1.2%. For fiscal 2020, Applied Industrial expects acquisitions to benefit its sales by 2%.
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Last Earnings Report

Applied Industrial Posts In-Line Q2 Earnings, Cuts View

Applied Industrial has reported mixed results for second-quarter fiscal 2020. The company's earnings were in line with estimates, while the top line lagged the same by 0.1%.

The company's earnings in fiscal second quarter were 97 cents per share, in line with the Zacks Consensus Estimate. However, quarterly earnings declined 2% from the year-ago quarter's figure of 99 cents on weak sales performance and lower operating margin.

Quarter Ending **12/2019**

Report Date	Jan 23, 2020
Sales Surprise	-0.09%
EPS Surprise	0.00%
Quarterly EPS	0.97
Annual EPS (TTM)	4.17

Weak Segmental Performance Impacts Revenues

In the reported quarter, Applied Industrial's net sales amounted to \$833.4 million, down 0.8% year over year. The results were adversely impacted by 4% fall in organic sales, partially offset by 3.2% gain from acquired assets. The company's organic sales suffered from soft customer activities in December. Weakness was witnessed in various end-markets, including machinery, metals, mining and others.

Also, the company's top line lagged the Zacks Consensus Estimate of \$834 million by 0.1%.

The company reports revenues under two market segments. A brief discussion of the quarterly results is provided below:

Service Center-Based Distribution's revenues totaled \$575.8 million, which contributed 69.1% to net revenues in the quarter under review. On a year-over-year basis, the segment's revenues declined 2.3%. Organic sales declined 3.5% and acquisitions had positive impact of 1.2%.

Weakness in manufacturing activities and lower demand in mining, oil & gas, metals and machinery end markets affected the segment's results. Internationally, business was weak in Mexico and Canada.

The **Fluid Power & Flow Control** segment generated revenues of \$257.6 million, contributing nearly 30.9% to net revenues in the reported quarter. The figure increased 2.8% year over year driven by 7.6% gain in acquisitions. Organic sales in the quarter declined 4.9%.

Organic sales suffered from weak OEM activity in industrial markets and softness in flow control market.

Gross Margin Flat Y/Y

In the reported quarter, Applied Industrial's cost of sales declined 0.8% year over year to \$592.1 million. Cost of sales was 71.1% of the quarter's net sales. Gross margin remained stable year over year at 28.9%.

Selling, distribution and administrative expenses (including depreciation) rose 0.3% year over year to \$182.5 million. It represented 21.9% of net sales in the reported quarter versus 21.7% in the year-ago quarter's figure. Operating profit declined 3.6% year over year to \$58.7 million. Operating margin fell 20 basis points (bps) year over year to 7.1%.

Balance Sheet & Cash Flow

Exiting the second quarter of fiscal 2020, Applied Industrial had cash and cash equivalents of \$128.1 million, up 30.5% from \$98.2 million recorded in the last reported quarter. Long-term debt inched up 1.8% sequentially to \$874.4 million.

During first-half fiscal 2020, long-term debt repaid totaled \$34.9 million while borrowings (long-term) were \$25 million.

The company generated net cash of \$104.9 million from operating activities in the first two quarters of fiscal 2020, up 60% from \$65.6 million generated in the year-ago period. Capital spent on property purchase totaled \$12 million compared with \$7.1 million in the previous year's first half. Free cash flow was \$47.9 million compared with \$49.9 million in the year-ago comparable period.

Applied Industrial rewarded shareholders with dividend payout of roughly \$24 million in the first two quarters of fiscal 2020. The amount represents growth of 3.1% year over year.

Outlook

Applied Industrial expects to benefit from cash generation abilities, technical expertise and cost discipline in the near term. However, industry demand is likely to be subdued.

The company revised its projections for fiscal 2020 (ending June 2020). Change in sales is predicted to be (2%)-0% year over year versus the previously mentioned (2%)-2%. Organic sales (on a daily basis) are predicted to decline 3-5% compared with fall of 1-5% expected earlier. Acquisitions are expected to benefit sales by 2% and selling days will likely have a positive impact of 1%.

Earnings per share are anticipated in the range of \$4.20-\$4.40, revised from \$4.20-\$4.50 stated earlier. Interest expenses are likely to be \$38 million (versus \$37-\$38 million expected earlier) and tax rate will be 24-25% (versus 25-26% stated previously). Free cash flow is anticipated in the range of \$200-\$220 million.

Recent News

Dividend

On **Feb 28, 2020**, Applied Industrial paid out a quarterly dividend of 32 cents per share to shareholders of record as of Feb 14. The quarterly rate was hiked by 3.2% or one cent per share in this January.

Valuation

Shares of Applied Industrial have dipped 35.1% in the year-to-date period and 27.1% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Industrial Products sector declined 25.3% and 27.2% in the year-to-date period, respectively. In a year, the Zacks sub-industry and the sector declined 18.3% and 24.1%, respectively.

The S&P 500 Index has moved down 19.7% year to date and 10.2% in the past year.

The stock is currently trading at 9.49x forward 12-month earnings per share, which compares to 17.56x for the Zacks sub-industry, 14.72x for the Zacks sector and 15.99x for the S&P 500 Index.

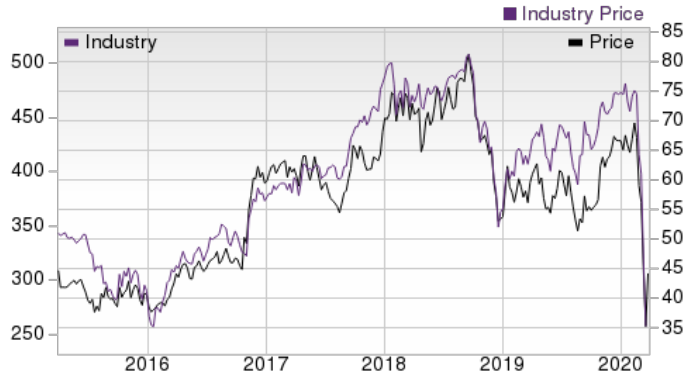
Over the past five years, the stock has traded as high as 24.14x and as low as 7.05x, with a 5-year median of 15.58x. Our Underperform recommendation indicates that the stock will perform worse than the market. Our price target of \$37 reflects 8.07x forward 12-month earnings per share.

The table below shows summary valuation data for AIT.

Valuation Multiples - AIT					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	9.49	17.56	14.72	15.99
	5-Year High	24.14	23.5	19.93	19.34
	5-Year Low	7.05	15.6	12.55	15.18
	5-Year Median	15.58	19.39	16.56	17.44
EV/EBITDA F12M	Current	7.58	10.8	16.38	12.28
	5-Year High	12.99	11.34	18.05	12.64
	5-Year Low	7.56	7.64	10.56	9.08
	5-Year Median	9.71	9.65	14.06	10.8
EV/Sales F12M	Current	0.72	2.41	2.31	2.58
	5-Year High	1.32	3.26	3.12	3.52
	5-Year Low	0.62	1.81	1.76	2.3
	5-Year Median	0.88	2.58	2.29	2.8

As of 04/01/2020

Industry Analysis Zacks Industry Rank: Bottom 31% (176 out of 254)



Top Peers

Fastenal Company (FAST)	Neutral
Genuine Parts Company (GPC)	Neutral
W.W. Grainger, Inc. (GWW)	Neutral
IDEX Corporation (IEX)	Neutral
Ingersoll-Rand Inc. (IR)	Neutral
MSC Industrial Direct Company, Inc. (MSM)	Neutral
DXP Enterprises, Inc. (DXPE)	Underperform
Park-Ohio Holdings Corp. (PKOH)	Underperform

Industry Comparison Industry: Manufacturing - General Industrial				Industry Peers		
	AIT Underperform	X Industry	S&P 500	DXPE Underperform	GPC Neutral	GWW Neutral
VGM Score	B	-	-	A	B	C
Market Cap	1.67 B	979.61 M	16.87 B	199.07 M	9.12 B	12.69 B
# of Analysts	2	3.5	13	2	6	11
Dividend Yield	2.96%	0.00%	2.53%	0.00%	5.04%	2.44%
Value Score	B	-	-	A	C	C
Cash/Price	0.08	0.11	0.06	0.24	0.03	0.03
EV/EBITDA	7.30	8.68	10.63	4.60	9.76	9.39
PEG Ratio	1.01	1.73	1.69	NA	7.42	1.20
Price/Book (P/B)	1.74	1.51	2.30	0.58	2.47	6.18
Price/Cash Flow (P/CF)	6.21	7.54	9.07	3.15	7.69	10.73
P/E (F1)	12.17	13.15	14.38	6.08	11.12	14.25
Price/Sales (P/S)	0.48	0.83	1.80	0.16	0.47	1.11
Earnings Yield	8.25%	7.39%	6.90%	16.49%	8.99%	7.01%
Debt/Equity	0.91	0.52	0.70	0.82	0.98	0.93
Cash Flow (\$/share)	6.96	2.49	7.01	3.58	8.16	22.04
Growth Score	B	-	-	A	A	C
Hist. EPS Growth (3-5 yrs)	13.61%	8.11%	10.92%	2.83%	5.50%	9.58%
Proj. EPS Growth (F1/F0)	-19.05%	-5.23%	1.52%	-5.36%	-0.88%	-4.02%
Curr. Cash Flow Growth	35.35%	3.36%	5.98%	-0.72%	10.00%	-1.82%
Hist. Cash Flow Growth (3-5 yrs)	13.96%	4.53%	8.55%	-21.68%	6.64%	2.17%
Current Ratio	2.72	2.03	1.24	2.76	1.24	2.12
Debt/Capital	47.61%	34.35%	42.33%	45.16%	49.54%	48.16%
Net Margin	3.85%	6.24%	11.67%	2.84%	3.20%	7.39%
Return on Equity	17.79%	11.10%	16.70%	10.81%	22.79%	45.63%
Sales/Assets	1.46	0.77	0.54	1.61	1.34	1.92
Proj. Sales Growth (F1/F0)	-5.41%	-1.23%	1.75%	-12.96%	-1.78%	-2.05%
Momentum Score	F	-	-	D	B	F
Daily Price Chg	-5.36%	-4.45%	-5.14%	-7.99%	-6.82%	-4.82%
1 Week Price Chg	25.48%	12.34%	12.29%	15.91%	16.46%	15.61%
4 Week Price Chg	-26.46%	-25.00%	-25.58%	-61.24%	-29.70%	-19.73%
12 Week Price Chg	-34.29%	-28.98%	-29.13%	-71.23%	-38.14%	-30.72%
52 Week Price Chg	-27.11%	-30.98%	-23.44%	-72.58%	-44.28%	-24.09%
20 Day Average Volume	343,300	66,511	4,261,481	173,296	1,635,541	517,871
(F1) EPS Est 1 week change	-16.98%	0.00%	-0.18%	-15.30%	0.00%	-5.19%
(F1) EPS Est 4 week change	-16.98%	-4.10%	-3.95%	-30.91%	-5.12%	-10.54%
(F1) EPS Est 12 week change	-18.21%	-11.80%	-5.28%	-32.18%	-7.20%	-12.16%
(Q1) EPS Est Mthly Chg	-52.08%	-13.94%	-5.80%	-74.07%	-7.47%	-23.30%

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	B
Growth Score	B
Momentum Score	F
VGM Score	B

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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