ACHILLION PHARMACEUTICALS INC
Form 10-K
March 29, 2007
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-K

**x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the fiscal year ended December 31, 2006**

**OR**

**¨ TRANSITION REPORT PURSUANT TO SECTIONS 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the transition period from to**

**Commission File Number 001-33095**

# ACHILLION PHARMACEUTICALS, INC.

**(Exact name of registrant as specified in its charter)**

| **Delaware** | **52-2113479** |
|---|---|
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |

**300 George Street, New Haven, CT 06511**

**(Address of principal executive offices) (Zip Code)**

**Registrant s telephone number, including area code: (203) 724-6000**

**Securities registered pursuant to Section 12(b) of the Act:**

| Title of Class | Name of Exchange on Which Registered |
|---|---|
| **Common Stock, $0.001 par value per share** | **NASDAQ Global Market** |

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold on the NASDAQ Global Market on March 1, 2007 was $74,810,665. The registrant has provided this information as of March 1, 2007 because its common equity was not publicly traded as of the last business day of its most recently completed second fiscal quarter.

As of March 1, 2007, the registrant had 15,543,214 shares of Common Stock, $0.001 par value per share, outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Items 10, 11, 12, 13 and 14 of Part III (except for information required with respect to our executive officers, which is set forth under Part I, Item 1 Business Executive Officers of the Registrant ) and the information required by Item 5 relating to our equity compensation plans have been omitted from this report, as we expect to file with the Securities and Exchange Commission, not later than 120 days after the close of our fiscal year ended December 31, 2006, a definitive proxy statement for our annual meeting of stockholders. The information required by Items 10, 11, 12, 13 and 14 of Part III and the information required by Item 5 relating to our equity compensation plans, which will appear in our definitive proxy statement, is incorporated by reference into this report.

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*This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, that involve risks and uncertainties. All statements other than statements relating to historical matters (including statements to the effect that we believe, expect, anticipate, plan, target and similar expressions) should be considered forward-looking statements. Our actual results could differ materially from those discussed in the forward-looking statements as a result of a number of important factors, including the factors discussed in this section and elsewhere in this Annual Report on Form 10-K, including those discussed in Item 1A of this report under the heading Risk Factors, and the risks discussed in our other filings with the Securities and Exchange Commission. Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management s analysis, judgment, belief or expectation only as of the date hereof. We assume no obligation to update these forward-looking statements to reflect events or circumstances that arise after the date hereof.*

## PART I

### ITEM 1. BUSINESS

#### Overview

We are a biopharmaceutical company focused on the discovery, development and commercialization of innovative treatments for infectious diseases. Within the anti-infective market, we are currently concentrating on the development of antivirals for the treatment of HIV infection and chronic hepatitis C and the development of antibacterials for the treatment of serious hospital-based bacterial infections. We have advanced our lead drug candidate, elvucitabine for the treatment of HIV infection, into phase II clinical trials. In addition, we are advancing two late-stage preclinical candidates, ACH-702 for the treatment of serious hospital-based bacterial infections, and in collaboration with Gilead Sciences, a series of NS4A antagonists for the treatment of chronic hepatitis C.

We believe that there are several business advantages to developing anti-infective drugs as compared to developing drugs in other therapeutic areas. The emergence of drug resistance seen with current antiviral and antibacterial therapy creates a continuing need for new drugs, which we believe provides us with a large and growing business opportunity.

We have established our drug candidate pipeline through our internal discovery capabilities and through the in-licensing of an attractive drug candidate. Through these efforts we have identified and are developing the following three lead drug candidates:

**Elvucitabine for HIV Infection.** Elvucitabine, an antiviral we are developing for the treatment of HIV infection, is our most advanced clinical-stage drug candidate. We are currently evaluating elvucitabine in phase II clinical trials to further explore its safety and efficacy in HIV-infected patients. In May 2006, we completed one of these phase II clinical trials. Results from this trial demonstrated that patients who received a once-daily 10 mg dose of elvucitabine for seven days experienced a significant mean viral load reduction as compared to those patients who received a placebo. These results are based on a small number of patients in an early-stage clinical trial, and are not necessarily predictive of results in later-stage clinical trials with larger and more diverse patient populations. If we receive additional favorable data from our other phase II trials, we expect to hold discussions with the FDA in mid-2007 to receive guidance on the development of our phase III protocols. Elvucitabine is a member of the nucleoside reverse transcriptase inhibitor, or NRTI, class of compounds, the predominant class of drugs used in the current standard of care for HIV therapy. Currently marketed drugs have several therapeutic limitations, including the development of HIV strains that are resistant to currently approved drugs, short half-lives which exacerbate drug resistance, inadequate patient compliance due to adverse side effects and complex dosing schedules, and limited combination treatment options due to cross resistance and drug-to-drug interactions. Elvucitabine has demonstrated potent antiviral activity against HIV, including HIV strains that are resistant to frequently prescribed NRTIs, as well as

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a half-life significantly longer than that of currently approved NRTIs. We believe this profile will allow us to position elvucitabine, if approved, favorably in the NRTI market. We currently retain full development and marketing rights to elvucitabine.

**ACH-702 for Serious Hospital-Based Bacterial Infections.** Our most advanced preclinical candidate is ACH-702, which we are developing for the treatment of serious hospital-based bacterial infections. In several preclinical studies, ACH-702 has exhibited potent antibacterial activity against a large number of medically relevant bacteria, including methicillin resistant *staphylococcus aureus* strains, highly prevalent hospital-based infections. Preclinical studies to date have also suggested that the compound has a bacteria-killing mechanism of action and may be administered in both intravenous and oral formulations. We expect to submit an investigational new drug application, or IND, for ACH-702 to the U.S. Food and Drug Administration, or FDA, in mid- 2007.

**NS4A Antagonists for Chronic Hepatitis C Infection.** In our second preclinical-stage program, we are evaluating drug candidates for the treatment of chronic hepatitis C in collaboration with Gilead Sciences. In preclinical studies, these compounds demonstrate potent inhibition of the replication of HCV, the virus that causes hepatitis C, by targeting a non-structural, or NS, viral protein called 4A. We believe these NS4A antagonists offer several potential advantages compared to currently available treatments, including greater potency, a novel mechanism of action, lack of cross resistance and the potential for oral administration. We believe these compounds could be used in combination with the current standard of care, or with other therapies in development, to significantly improve treatment outcomes. In November 2004, we entered into a collaboration agreement and exclusive license with Gilead Sciences for the research, development and commercialization of compounds for the treatment of chronic hepatitis C, including these compounds. Our first drug candidate demonstrating this mechanism of action, ACH-806 (also known as GS-9132) was determined to have positive antiviral effect in a proof-of-concept clinical trial in HCV infected patients, but also to elevate serum creatinine levels, a marker of kidney function. A proof-of-concept clinical trial is generally a late stage Phase I or early stage Phase II clinical trial, the objective of which is to demonstrate that the tested drug shows a beneficial effect. As a result, we and Gilead elected to discontinue further clinical development of ACH-806 in favor of our next generation compounds. We are currently completing our assessment of new lead candidates in order to nominate one for clinical development.

In addition to our three lead drug candidates, we have earlier-stage preclinical programs focused on the treatment of HIV infection through the inhibition of viral proteins not targeted by currently marketed drugs, such as the capsid protein, and the treatment of HCV infection through compounds that have mechanisms of action that are distinct from NS4A antagonists.

We intend to focus on the discovery of new drug candidates through our extensive expertise in virology, microbiology and synthetic chemistry. Utilizing these capabilities, we have thus far internally discovered our previous lead HCV compound, ACH-806, our recently discontinued drug candidate, as well as back-up compounds such as ACH-1095, and our lead antibacterial candidate, ACH-702. In the aggregate, members of our drug discovery, preclinical and clinical development team have contributed to the selection and development of more than 80 clinical candidates and 50 marketed products throughout their careers. Although significant additional research and development will be required after the discovery of any new drug candidate, we believe our drug discovery capabilities will allow us to further expand our product candidate portfolio, providing us with strong growth potential and reducing our reliance on the success of any single drug candidate.

**Background**

Infectious diseases are caused by pathogens present in the environment, such as viruses, bacteria and fungi, which enter the body through the skin or mucous membranes and overwhelm its natural defenses. Some infections affect the entire body, while others may be localized in one organ or system within the body. The severity of infectious diseases varies depending on the nature of the infectious agent, as well as the degree to

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which the body s immune system can fight the infection. According to World Health Organization reports, infectious diseases, including HIV infection, chronic hepatitis C and drug-resistant bacterial infections, represent a significant cause of morbidity and mortality worldwide.

The market for anti-infective drugs can be divided into three main categories: antivirals, antibacterials (often referred to as antibiotics) and antifungals. To date, we have focused on the research and development of products for the antiviral and antibacterial markets.

The widespread use of anti-infective drugs has led to a significant reduction in morbidity and mortality associated with infectious diseases. However, for many infectious diseases, current treatment options are associated with suboptimal treatment outcomes, significant drug-related adverse side effects, complex dosing schedules and inconvenient methods of administration, such as injection or infusion. These factors often lead to patients discontinuing treatment or failing to comply fully with treatment dosing schedules. As a result, physicians are often required to modify therapy regimens throughout the course of treatment.

Moreover, in recent years, the increasing prevalence of drug resistance has created ongoing treatment challenges for antiviral and antibacterial therapies. The ability of both viruses and bacteria to adapt rapidly to these treatments through genetic mutations allows new strains to develop that are resistant to currently available drugs. In addition, a patient s failure to comply fully with a treatment regimen both accelerates and exacerbates drug resistance. This is particularly well documented for HIV treatments and antibacterials.

As a result of these treatment challenges, the industry is focused on developing anti-infective drugs that delay the emergence of drug resistance, improve patient compliance and improve treatment responses in infections associated with drug-resistant pathogens.

We believe there are significant business advantages to focusing on the development of drugs to treat infectious diseases, including the following:

- the emergence of drug resistance creates a continuing need for new drugs to combat infectious diseases, thus creating a large and growing business opportunity;
- infectious disease research and development programs generally have shorter development cycle times when compared to various therapeutic areas such as oncology, cardiovascular and central nervous system disorders; and
- evidence suggests systemic anti-infectives have a higher clinical success rate compared to various therapeutic areas such as oncology, cardiovascular and central nervous system disorders.

***Viruses***

Viruses are submicroscopic infectious agents consisting of an outer layer of protein surrounding a core of genetic material comprised of DNA or RNA. Viruses require living host cells to grow and multiply. In many cases, the body s immune system can effectively combat the viral infection. However, in certain viral infections, the body s immune system is unable to destroy the virus, and the infection becomes chronic. In chronic infections, persistent viral replication and subsequent infection of healthy cells may, over time, lead to the deterioration or destruction of the infected cells, resulting in disease. Antiviral drugs are utilized to assist the body s immune system in combating or eliminating the infection.

The development of resistance to antiviral drugs is a major challenge for the treatment of life-threatening viral infections such as HIV and chronic hepatitis C. The ability of viruses to mutate spontaneously during replication allows drug-resistant viral strains to emerge when patients are on treatment regimens that do not completely inhibit viral replication. This phenomenon has been particularly well documented in HIV. Resistance occurs because viruses continually make billions of copies of themselves, some of which will contain mutations

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in their genetic material. Mutations that confer a replication advantage in the presence of a suppressive antiviral drug will give rise to viral strains that are resistant or partially resistant to that antiviral drug. These mutated viruses, while initially found in low numbers, will eventually become the predominant strain in an infected patient. Once this occurs, the treatment benefit of the antiviral drug diminishes or disappears, which may result in treatment failure and create a need for an alternate therapy with new drugs.

Antiviral drug resistance is clinically managed by the administration of one or more potent direct-acting antiviral drugs and/or by enhancing the body s immune system through treatment with an immune response modifier to apply the highest possible level of suppression against viral replication. These direct acting antiviral drugs prevent viral replication by disrupting processes that are essential for completion of a viral infection cycle. The most effective disruption generally results from the use of multiple drugs that have different mechanisms of action.

***Bacteria***

Bacteria are unicellular, self-propagating microorganisms that multiply through growth in bacterial cell size and the subsequent division of the cell. Bacteria can be broadly classified into two categories based upon the composition of their cell walls: gram-positive or gram-negative. Many antibacterial drugs that are effective against gram-positive bacteria are less effective or ineffective against gram-negative bacteria, and vice versa. Antibacterial drugs that are active against a large number of both classes of bacteria are often referred to as broad-spectrum antibacterials.

Bacteria adapt remarkably well to their surroundings due to the high level of variation found within bacterial DNA and the ability of bacteria to reproduce rapidly. Replication of bacterial DNA is often error prone and can result in a high frequency of mutations. Because the bacterial reproductive cycle is very short, ranging from minutes to several days, a mutation that helps a bacterium survive exposure to an antibiotic drug may quickly become dominant throughout the population. Additionally, bacteria can acquire segments of DNA from other bacteria and organisms, which can also convey drug resistance.

Currently marketed antibacterials have historically proved highly successful in controlling the morbidity and mortality that accompany bacterial infections. The first antibacterials, introduced over 60 years ago, were highly effective in limiting or completely inhibiting bacterial reproduction, and thus were considered miracle drugs. A majority of the antibiotics currently in use were developed and introduced into the market before 1980. However, due to the widespread use of antibacterials over time and the ability of bacteria to develop drug resistance, many of these antibiotics now have diminished or limited antibacterial activity. This problem is particularly acute in the hospital setting, where approximately 70% of certain types of serious infections are associated with multi-drug-resistant bacteria. The inability to effectively treat serious infections caused by drug-resistant bacteria has led to increased mortality rates, prolonged hospitalizations and increased health care costs. The rate at which bacteria are now developing resistance to multiple antibacterials, and the pace at which those multi-drug-resistant bacteria are spreading, represent significant medical challenges.

**Our Strategy**

Our objective is to become a leading infectious disease-focused biopharmaceutical company. We believe the infectious disease market is highly attractive due to its size, continued demand for new products to address the consequences of drug resistance and generally shorter development cycle times. In order to achieve our objective, we intend to:

*Advance the Development of Our Current Drug Candidates*. We are developing our most advanced clinical compound, elvucitabine, for the treatment of HIV infection. We are also developing two late-stage preclinical compounds: ACH-702 for the treatment of serious hospital-based bacterial infection and, in a collaboration and exclusive license arrangement with Gilead Sciences, for the treatment of

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chronic HCV infection, our series of NS4A antagonists. In addition, we are progressing additional discovery stage candidates for the treatment of HIV infection and chronic hepatitis C. In particular, we expect to:

- complete our phase II clinical trials for elvucitabine in mid-2007 and, if supported by favorable data from the phase II trials, hold discussions later in 2007 with the FDA to receive guidance on the development of our phase III clinical trial protocols;
- submit an IND to the FDA for ACH-702 in mid 2007; and
- complete early preclinical testing of one of our NS4A antagonists such as ACH-1095 and nominate one of these compounds for clinical development in mid 2007.

*Expand our Infectious Disease Portfolio*. We intend to leverage our expertise in synthetic chemistry, virology and microbiology to quickly and efficiently discover and develop additional anti-infective compounds. As recent examples of our capabilities, our research team designated clinical lead candidates in our HCV program (both ACH-806, a recently discontinued drug candidate, and ACH-1095, a possible successor compound with a similar mechanism of action) and antibacterial program (ACH-702) in fewer than 24 months from program inception. We may augment our internal discovery capabilities and further expand our pipeline by in-licensing and/or acquiring differentiated drug candidates, as we did with elvucitabine, or additional discovery technologies.

*Accelerate Growth Through Selective Collaborations*. We intend to establish strategic collaborations where we believe we can accelerate the development or maximize the value of our drug candidates by utilizing the financial, clinical development, manufacturing and/or commercialization strengths of a leading biotechnology or pharmaceutical company. As part of this strategy, we entered into a collaboration with Gilead Sciences in November 2004 for the development and commercialization of certain of our HCV compounds demonstrating a mechanism of action we call NS4A antagonism, pursuant to which we received a significant up-front payment and are utilizing Gilead Sciences broad capabilities to accelerate the progress of this series of drug candidates.

*Pursue a Diversified Commercial Strategy.* If we successfully develop any drug candidates through regulatory approval, on a selected basis, we plan to participate in their commercialization. We have retained all commercialization rights for elvucitabine and ACH-702. We intend to eventually build and deploy a focused, North American sales force to support the sales and marketing of those drug candidates, if any, for which we receive FDA marketing approval and for which we believe it is possible to effectively and efficiently access the market. In addition, we may agree to collaborate with other companies to co-promote our drug candidates in North America, if and when they are approved by the FDA, in instances where we believe a larger sales and marketing presence will expand the market or accelerate market penetration. We intend to utilize strategic alliances with third parties to commercialize any drugs we successfully develop in markets outside North America. In addition, while we have granted Gilead Sciences worldwide commercialization rights for certain of our HCV compounds, we have the option to participate on a limited basis in marketing efforts in the United States.

We have spent substantial research and development funds to develop our product pipeline and expect to continue to do so in the future. We incurred approximately $22.7, $18.1 and $14.8 million in research and development costs for the years ended December 31, 2006, 2005 and 2004, respectively.

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**Our Drug Candidates**

The following table summarizes key information regarding our drug candidates:

| Drug Candidate/ Indication | Target | Stage of Development | Current Status | Current Marketing Rights |
|---|---|---|---|---|
| **Elvucitabine** *HIV Infection* | HIV reverse transcriptase | Phase II | Phase II placebo-controlled viral kinetics, safety and pharmacokinetics trial in HIV treatment-naive patients completed<br>Phase II comparative safety, antiviral efficacy and pharmacokinetics trial in HIV treatment-naive patients; currently screening expected completion in mid-2007<br>Phase II comparative viral kinetics, safety and pharmacokinetics trial in HIV treatment-experienced patients; currently screening expected trial completion in mid-2007 | Achillion |
| **ACH-702** *Serious Hospital-Based Bacterial Infections* | DNA replication enzymes | IND-enabling preclinical studies | IND-enabling preclinical studies complete IND submission expected in mid-2007 | Achillion |
| **NS4A Antagonists** *Chronic Hepatitis C Infection* | HCV protein NS4A | Preclinical studies | Preclinical studies in progress IND submission expected in mid-2008 | Gilead Sciences* |
| **HIV Inhibitor** *HIV Infection* | Nucleocapsid protein | Discovery | Lead optimization studies in progress | Achillion |
| **HCV Inhibitor** *Chronic HCV Infection* | Undisclosed | Discovery | Lead optimization studies in progress | Achillion |

* Achillion has a one-time option to participate on a limited basis in marketing in the United States.

**Elvucitabine for HIV**

Elvucitabine is an NRTI, which we are currently testing in phase II trials. Elvucitabine has demonstrated potent antiviral activity against HIV, including activity against HIV that contains mutations associated with resistance to other reverse transcriptase inhibitors such as Viread (tenofovir), Zerit (d4T) and Retrovir (AZT). Furthermore, elvucitabine has been demonstrated to have a significantly longer half-life than the other marketed drugs in its class. We believe that these attributes should allow elvucitabine to deliver consistent, potent antiviral activity to patients infected with HIV, particularly those patients with less than perfect compliance with their existing treatment regimens. We believe a treatment regimen containing elvucitabine may also delay the emergence of resistance and prolong the effectiveness of therapy. We have completed the first of our phase II clinical trials. The second of our phase II trials is fully enrolled and we anticipate that 12 week data will be available in mid 2007. Because of the strict entry criteria for our third phase II trial, which is based on genotype analysis, we anticipate that the enrollment period will continue through mid-2007. Therefore, we anticipate that the data from this trial will be available in mid to late 2007.

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If supported by favorable data from these phase II trials, we intend to hold discussions with the FDA to receive guidance on development of protocols for our phase III trials.

***Overview of HIV Market***

HIV is a viral infection that, if left untreated, results in the development of the Acquired Immune Deficiency Syndrome, or AIDS. HIV is a retrovirus that uses RNA to encode its genetic material. When a person is infected with HIV, the virus infects cells that are associated with the body s immune system. The most common cells infected are the T-helper lymphocytes, which are also called CD4 cells. After attaching to CD4 cells, the virus is taken inside the cell, where, using host-cell machinery, it replicates its genetic material into DNA, a process known as reverse transcription. This step is facilitated by the viral enzyme reverse transcriptase. The subsequent completion of the viral life cycle ultimately leads to the destruction of CD4 cells. When the CD4 cell count, as measured in the blood, falls below a certain level, a person s immune system starts to fail, and a person becomes at risk for the development of AIDS and opportunistic infections.

HIV-infected patients are clinically managed by monitoring two key parameters in the blood the number of CD4 cells and viral load, or the measurement of HIV RNA. The goal of antiviral treatment is to provide long-term suppression of HIV replication. This suppression allows the CD4 cells to increase toward normal levels, which decreases the likelihood of AIDS and/or death. Without treatment, HIV infection progresses to AIDS in 20-25% of infected individuals within six years and in 50% within ten years.

According to the Joint United Nations Programme on HIV/AIDS and the World Health Organization, an estimated 40 million people worldwide are infected with HIV. In addition, over 25 million people have died from AIDS since the epidemic began. The Centers for Disease Control and Prevention, or CDC, estimates that in the United States there were between 1,039,000 and 1,185,000 people living with HIV/AIDS in 2003, with 40,000 new infections annually. According to the Joint United Nations Programme on HIV/AIDS and the World Health Organization, in Europe and Central Asia there were approximately 2,320,000 people living with HIV/AIDS in 2005, with 292,000 new infections annually.

Currently, there is no cure for HIV infection. In addition, there are no preventative or therapeutic vaccines, but there are more than two dozen antiretroviral drugs on the market that target various steps in the HIV replication cycle. These can be divided into four drug classes that have been approved for the treatment of HIV infection:

- NRTIs;
- non-nucleoside reverse transcriptase inhibitors, or NNRTIs;
- protease inhibitors; and
- fusion inhibitors.

NRTIs and NNRTIs prevent HIV replication by interacting with reverse transcriptase. NRTIs, such as Epivir (3TC), Emtriva (FTC), Viread (tenofovir), Retrovir (AZT) and Zerit (d4T), have become the predominant class of drugs in HIV therapy. Without successful reverse transcription, the virus is unable to reproduce itself. When reverse transcription occurs in the presence of an NRTI, the NRTI is incorporated into the newly synthesized DNA strand and stops the reverse transcription process, thus preventing a complete copy of the viral RNA from being transcribed into DNA. NNRTIs, such as Sustiva (efavirenz), also prevent HIV replication through an interaction with reverse transcriptase, but with a mechanism of action distinct from NRTIs.

Protease inhibitors, such as Kaletra (lopinavir + ritonavir) and Viracept (nelfinavir), prevent viral assembly by blocking the action of HIV protease, an enzyme that is required to produce new, infectious viruses. Fusion inhibitors, also known as entry inhibitors, such as Fuzeon (enfuvirtide), prevent HIV from fusing to CD4 cells, thereby preventing the initial infection of CD4 cells by HIV.

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Because of its high spontaneous mutation rate, HIV is especially prone to the development of resistance to a single therapeutic drug. As a result, the treatment paradigm for HIV has evolved from monotherapy to triple combination treatment known as highly active antiretroviral therapy, or HAART, which includes drugs from multiple drug classes to maximally suppress HIV replication. In accordance with current Department of Health and Human Services HIV Treatment Guidelines, the initial or first-line HAART regimens typically include two NRTIs with non-overlapping resistance patterns and either an NNRTI or a protease inhibitor. The use of HAART to manage HIV infections has resulted in a dramatic reduction in disease progression to AIDS and/or death. It is now believed that HIV-infected individuals can often be clinically managed for decades through daily treatment with HAART.

***Limitations of Current Therapies***

In spite of the benefits of HAART, all currently approved drugs have significant limitations, including the following:

*Development of Drug Resistance.* Ongoing viral replication in patients on a HAART regimen results in the emergence of viral strains that are no longer susceptible to one or more components of the regimen. If left unchecked, this may lead to treatment failure. In addition, development of resistance to certain drugs can lead to cross resistance, or resistance to other drugs of the same class, thus rendering a whole class of drugs ineffective. In order to regain viral suppression, patients failing a HAART regimen are switched to a new regimen comprised of drugs that are not cross resistant with drugs from previous regimens.

*Short Half-Lives of Currently Available Therapies.* Many of the currently available drugs have relatively short plasma half-lives, meaning the length of time the drug remains in the patient s bloodstream, as well as relatively short intracellular half-lives, meaning the length of time the drug remains in the patient s cells. The plasma half-life of a majority of the NRTIs is in the range of one to several hours, and the intracellular half-life of a majority of the NRTIs is approximately 18-20 hours. Short half-lives require patients to take their medications more frequently, or in the case of once-daily dosing, to take doses within a certain timeframe. If patients miss this window, or forget entirely to take their medication, the amount of drug in the bloodstream diminishes, creating an opportunity for increased viral replication and the emergence of drug resistance.

*Inadequate Patient Compliance.* A patient s ability to adhere to a HAART regimen will impact the treatment outcome. Virologic failure rates have been found to directly correlate with the level of compliance. In studies, 61% of patients with 80 94.9% adherence and 80% of those with less than 80% adherence to their dosing regimen were found to experience virologic treatment failure. The chronic nature of HIV disease and the long-term adverse side effects associated with certain drugs, such as the loss of subcutaneous fat associated with certain NRTIs, affect the ability of HIV patients to adhere perfectly or nearly perfectly to dosing schedules.

*Limited Treatment Options.* Most current HAART regimens include two NRTIs. Although there are currently seven commonly used NRTIs, not all of them can be paired together due to cross resistance and drug-to-drug interactions. As resistance develops and the efficacy of treatment regimens diminishes over time, patients cycle through different HAART regimens, eventually exhausting all the available NRTI pairings. Therefore, we believe that there is a continuing need for new NRTIs.

***Achillion Approach: Elvucitabine***

Elvucitabine is an L-cytosine NRTI, belonging to the same class as 3TC and FTC. L-cytosine NRTIs represent the most frequently prescribed class of NRTIs based upon sales, accounting for approximately 34% of the worldwide NRTI market in 2004. We believe L-cytosine NRTIs are frequently prescribed given their established potency, favorable short and long-term safety profile and fewer and less adverse side effects. In addition, laboratory data demonstrate that HIV with the M184V genotype, the mutation conferring resistance to 3TC and FTC, is unable to replicate as effectively as HIV with other resistance mutations.

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We believe elvucitabine addresses the limitations of currently available NRTIs in the following ways:

*Long Half-Life.* Elvucitabine s plasma half-life has been demonstrated in clinical trials to be approximately 100 hours, or up to 20 times greater than that of Epivir (3TC) and up to ten times greater than that of Emtriva (FTC). In addition, elvucitabine s intracellular half-life has been demonstrated in a clinical trial to be over 100 hours, or more than five times greater than that of Epivir (3TC) and Emtriva (FTC). We believe this long half-life may mitigate the negative effects of less than perfect patient compliance, providing a more durable NRTI for use in HAART regimens.

*Superior Potency Against Common Resistance Mutations.* The laboratory antiviral profile of elvucitabine demonstrates superior potency against many of the most common resistance mutations associated with NRTIs typically used in combination with Epivir (3TC) and Emtriva (FTC), including those associated with Viread (tenofovir), Retrovir (AZT) and Zerit (d4T). In addition, although elvucitabine s resistance profile is similar to Epivir (3TC) and Emtriva (FTC), elvucitabine retains greater antiviral activity in laboratory tests against HIV with resistance to Epivir (3TC) and Emtriva (FTC). We believe this enhanced antiviral activity could provide an increased barrier to the emergence of drug resistance in patients and improve antiviral suppression in patients with emerging resistance to commonly used NRTIs.

*Patient Compliance.* We believe that a well-tolerated L-cytosine NRTI with convenient, flexible oral dosing will enhance patient compliance and will make elvucitabine attractive as a component of HAART regimens. With a projected daily dose of elvucitabine of 10 mg in a tablet formulation, compared to 200 mg for Emtriva (FTC) and 300 mg for Epivir (3TC), we also believe elvucitabine could be an attractive candidate as part of a combination product for use in HAART regimens.

***Ongoing and Planned Clinical Development***

Our current plans for clinical development of elvucitabine include the following phase II trials to further explore the safety and efficacy profile of elvucitabine in HIV-infected patients:

| Trial Design | Population | Sites and Location | Patient Number | Dosing Duration | Status |
|---|---|---|---|---|---|
| Phase II placebo-controlled viral kinetics, safety and pharmacokinetics trial | HIV treatment-naïve patients | Single site in Europe | 24 | 7 days | Complete. |
| Phase II comparative viral kinetics, safety and pharmacokinetics trial | HIV treatment-experienced patients | 17 sites in the United States, Europe and Latin America | 20 | 14 days, with extension of 24 additional weeks | Currently screening; trial expected to be completed in mid 2007. |
| Phase II comparative safety, antiviral efficacy and pharmacokinetics trial | HIV treatment-naïve patients | 21 sites in the United States and India | 60 | 12 weeks, with extension to 96 weeks | Currently screening; trial expected to be completed in mid 2007. |

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In May 2006 we completed a randomized, double-blind phase II trial in which we evaluated the viral kinetics, safety and pharmacokinetics of elvucitabine in 24 treatment-naïve HIV patients, that is, patients who have not previously been treated for their HIV infection. Patients received once daily either 10 mg of elvucitabine or a placebo for seven days. An acceptable treatment response for this trial was defined as the elvucitabine cohort demonstrating greater reduction in HIV viral load on day seven, as compared to the viral load observed in patients taking a placebo. The results from this trial demonstrated that patients who received a 10 mg dose of elvucitabine once daily experienced a mean viral load reduction of 0.85 logs, or 83%, on day seven. Patients who received a placebo experienced a mean -0.06 log change, or <1%, at day seven. In addition, patients who received elvucitabine experienced a mean increase in CD4 cells of approximately 20%, compared to a mean increase of <1% in patients receiving a placebo. This trial further demonstrated that the plasma half-life of elvucitabine is approximately 100 hours and that its intracellular half-life is also greater than 100 hours. During this trial, elvucitabine had not achieved steady state , that is, the point at which minimum plasma levels no longer increase after repeat dosing. Based upon our previous clinical studies of elvucitabine, we believe elvucitabine s steady state occurs following 21 days of dosing. Therefore, we believe that if we had dosed patients for longer than seven days, there would have been a further increase in patients viral reduction and CD4 cell counts, although we do not have any data from this clinical trial to support this belief. We observed no serious or clinically significant adverse events during this trial. These results are based on a small number of patients in an early-stage clinical trial and are not necessarily predictive of results in later-stage clinical trials with larger and more diverse patient populations.

We initiated a randomized, double-blind phase II trial in December 2005 in which we are evaluating the viral kinetics, safety and pharmacokinetics of elvucitabine in 20 HIV-infected patients who have failed a HAART regimen which included Epivir (3TC). Treatment failure is defined as the presence of the M184V mutation, which signifies Epivir (3TC) drug resistance. Patients receive either 10 mg of elvucitabine once daily in place of Epivir (3TC) or continue receiving 300 mg of Epivir (3TC) once daily for 14 days. The patients other two HAART regimen drugs remain unchanged. An acceptable treatment response for this trial is defined as the elvucitabine cohort demonstrating greater reduction in HIV viral load on day 14, as compared to the viral load observed in patients remaining on Epivir (3TC). If patients respond favorably, we expect to allow them to receive an additional 24 weeks of therapy with elvucitabine. Because of the strict entry criteria for this trial, which is based on genotype analysis, we anticipate that the enrollment period will continue through mid-2007. Therefore, we anticipate data from this trial will be available in mid to late 2007.

We initiated a randomized, double-blind phase II trial in May 2006 of elvucitabine in combination with two additional antiretrovirals (Sustiva (efavirenz) and Viread (tenofovir)), as compared to Epivir (3TC) in combination with the same two additional antiretrovirals, in 60 treatment-naïve HIV patients. We will evaluate the safety, antiviral efficacy and pharmacokinetics of 12 weeks of therapy with these two treatment regimens. An acceptable treatment response for this trial is defined as the patients demonstrating a viral load less than a specified level at the end of the initial 12-week period. If patients respond favorably, they may receive an additional 84 weeks of therapy with elvucitabine. We anticipate 12-week data from this trial to be available in mid 2007.

If we receive favorable data from these trials, we expect to hold discussions later in 2007 with the FDA to obtain guidance on development of our phase III protocols wherein we expect to collect data during 48 weeks of dosing in over 1,000 patients.

***Clinical Development History***

Between 2001 and 2003, we conducted several clinical trials to determine the safety, tolerability and pharmacokinetic profile of elvucitabine for use against both hepatitis B virus, or HBV, and HIV. Specifically, we conducted three phase I clinical trials in healthy subjects, two phase II clinical trials in patients infected with HBV, and one phase II clinical trial in patients infected with HIV. In the phase II clinical trials for HBV, we evaluated doses of 5, 10, 20 and 50 mg once daily and noted that all doses greater than 5 mg were effective in

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reducing HBV viral load by 99%, or 3.5log10 copies/ml. Despite this result, our current commercial plans do not include developing elvucitabine as a treatment for HBV. In the phase II clinical trial for HIV, we evaluated doses of 50 and 100 mg once daily and noted that both dose groups demonstrated reduction in viral load by 80%, or .7log10 copies/ml. We further noted that doses of 50 mg or greater per day were associated with an unacceptable reduction in the number of patients white and red blood cells. In 2003, the clinical trial was discontinued, and the elvucitabine program was placed on clinical hold while determination of the appropriate dosing regimen for elvucitabine was made.

In 2004, while operating under a partial clinical hold placed by the FDA, we evaluated the therapeutic window and pharmacokinetic profile of elvucitabine in HIV-infected patients with a 21-day, open label phase II clinical trial of 24 HIV treatment-naïve patients. The patients received elvucitabine at either 5 mg or 10 mg once daily, or 20 mg every 48 hours, in each case in combination with the protease inhibitor Kaletra (lopinavir + ritonavir). We made frequent measurements of elvucitabine plasma levels throughout the trial. Results from the trial demonstrated that all three doses are similar in antiviral activity, reducing the viral load by approximately 98%, or 1.9log10 copies/ml. All three doses also showed similar safety profiles without the occurrence of any serious adverse events, particularly white or red blood cell reduction. Importantly, the trial also demonstrated that the amount of elvucitabine present in patients plasma 24 hours following their previous dose was well in excess of those amounts necessary to deliver potent antiviral activity. From this trial, we concluded that the plasma half-life of elvucitabine is approximately 100 hours and chose a dose of 10 mg once daily for evaluation in our current phase II safety and efficacy trials in HIV-infected patients. Following the completion of this clinical trial, the FDA removed the partial clinical hold.

***Preclinical Development History***

We sublicensed elvucitabine from Vion Pharmaceuticals (which licensed the relevant patents and intellectual property from Yale University) and initiated development activities in 2000. In preclinical studies, elvucitabine has been shown to be approximately four-fold more potent *in vitro* than Epivir (3TC) against wild-type HIV, meaning HIV without mutations associated with drug resistance. In addition, elvucitabine demonstrates greater potency *in vitro* against HIV with resistance to most of the commonly used NRTIs such as Epivir (3TC), Retrovir (AZT), Zerit (d4T) and Viread (tenofovir). These studies were conducted at several laboratories with more than 70 clinical strains of HIV obtained from patients with drug resistance and eight laboratory strains of HIV with known reverse transcriptase resistance mutation profiles.

**ACH-702, Anti-MRSA Antibacterial**

ACH-702 is an internally discovered compound that we are developing as a treatment for serious nosocomial, or hospital-based, bacterial infections. We recently completed the IND-enabling preclinical studies to support clinical evaluation of this drug and are currently analyzing those results. We expect to submit an IND to the FDA in mid 2007.

***Overview of Hospital-Based Antibacterials Market***

CDC data shows that antibacterial resistance has been increasing dramatically over the past few decades. Antibacterial resistance is most pronounced in the hospital setting, where the heavy use of antibiotics creates an ideal environment for the development of drug resistance. Approximately 70% of nosocomial infections are resistant to at least one antibiotic.

One of the most common pathogenic bacteria is a gram-positive bacterium referred to as *Staphylococcus aureus*, or *S. aureus*. It can cause serious infections of the skin, bloodstream, bones or joints. In 2002, 57% of *S. aureus* infections in the hospital were due to infections with strains of *S. aureus* that were resistant to methicillin, part of a commonly used class of antibiotics. Frequently, these methicillin resistant *S. aureus* strains, commonly referred to as MRSA, are also resistant to other classes of antibacterials such as cephalosporins and

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quinolones. Consequently, MRSA is commonly used to refer to multi-drug-resistant bacteria associated with serious infections. The increasing difficulty in treating MRSA and other multi-drug-resistant hospital-based infections has led to higher morbidity and mortality rates, as well as increasing health care expenditures.

Historically, the pharmaceutical industry was able to keep pace with the need for new antibacterial drugs. However, since 1968, only two new classes of antibacterials have been brought to market. While alternative treatments are available for MRSA, such as vancomycin, Cubicin (daptomycin), Zyvox (linezolid) and Synercid (dalfopristin + quinupristin), they face one or more of the following limitations: limited potency, lack of a bactericidal, or bacteria-killing, mechanism of action, narrow spectrum of activity, the need for intravenous or injectable administration and adverse side effects.

***Achillion Approach: ACH-702***

We believe ACH-702 has the following benefits:

*Broad-Spectrum Potency*. ACH-702 has a novel target profile against bacterial DNA replication enzymes and potent broad-spectrum activity. We have established potent activity of ACH-702 against multi-drug-resistant bacteria in a laboratory evaluation of recent clinical isolates obtained from infected patients, as well as in preclinical models of infection. The spectrum of activity includes inhibition of the DNA replication enzymes: gyrase, topoisomerase IV and primase.

*Bactericidal Mechanism of Action.* ACH-702 has demonstrated bactericidal activity against multi-drug-resistant MRSA. A number of the other drugs currently used to treat MRSA infections are bacteriostatic, meaning they are able to prevent the growth of new bacteria, but have a limited effect on the bacteria existing at the time of treatment.

*Dosing.* We believe the properties of ACH-702 support potential administration through both intravenous and oral formulations. An orally administered drug would be more convenient for patients and may decrease health care costs by enabling patients to transition their treatment from the hospital to a home setting.

***Preclinical Development History***

In preclinical studies, ACH-702 has demonstrated potent antibacterial activity against a number of medically relevant bacteria, including drug-resistant strains such as MRSA and vancomycin-resistant enterococcus. The following table illustrates ACH-702 activity versus MRSA clinical strains, compared to other marketed antibacterial products. The standard measurement of antibacterial activity is minimum inhibitory concentration, or MIC, meaning the minimum amount of drug required to inhibit complete growth of bacteria (as measured in micrograms per ml, or μg/ml). The lower the MIC, the greater the potency of the compound. In this study, for example, ACH-702 demonstrated potent activity *in vitro* against three MRSA strains that are resistant to vancomycin and Zyvox (linezolid), which are current standards of care.

| | MIC (μg/ml) | | |
|---|---|---|---|
| | MRSA | MRSA | MRSA |
| **Compound** | **(F-2121)** | **(F-2128)** | **(F-2137)** |
| ACH-702 | 0.12 | 0.25 | 0.25 |
| Vancomycin | 8.00 | >32.00 | 2.00 |
| Linezolid | 2.00 | 2.00 | >16.00 |

In late-stage preclinical studies, ACH-702 demonstrated acceptable pharmacokinetic and safety profiles. Potent antibacterial activity has been demonstrated against both sensitive and drug-resistant strains in well-established preclinical infection models.

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**NS4A Antagonists for HCV Infection**

We identified through our internal drug discovery efforts a series of novel inhibitors which share a unique mechanism of action from other HCV inhibitors currently in development. These compounds function by targeting the NS4A protein of the hepatitis C virus, preventing formation of replicase complex, a necessary step in viral replication. In November 2004, we entered into a strategic alliance with Gilead Sciences for the discovery, development and commercialization of these compounds to treat chronic hepatitis C. These compounds include ACH-806 (also known as GS-9132), clinical development of which was discontinued in February 2007, as well as back-up compounds such as ACH-1095.

In February 2007, we announced that ACH-806 demonstrated positive antiviral activity in human patients infected with HCV, but also demonstrated early signs of elevated serum creatinine, a marker of kidney function. We continue to analyze data from this trial. As a result, however, we discontinued further clinical development of ACH-806 in favor of next-generation back-up compounds demonstrating the same mechanism of action. We, and Gilead Sciences, anticipate nominating one of these compounds for IND-enabling preclinical studies during the second quarter of 2007.

***Overview of HCV Market***

HCV is a virus which is a common cause of viral hepatitis, an inflammation of the liver. HCV infection is contracted by contact with the blood or other body fluids of an infected person. Hepatitis due to HCV can result in an acute process where a person is affected for only several months and then the virus is cleared from the body. However, the American Association of Liver Disease estimates that up to 85% of individuals become chronically infected following exposure. HCV disease progression then occurs over a period of 20 to 30 years during which patients are generally asymptomatic, meaning they exhibit no symptoms of the disease. Chronic hepatitis can lead to permanent liver damage, which can result in the development of liver cancer, liver failure or death.

The current standard of care for patients with chronic HCV infection is treatment with a combination of long-acting, pegylated forms of interferon alpha administered through weekly injections coupled with daily, oral doses of ribavirin. The duration of treatment for patients infected with non-genotype 1 virus is six months and results in undetectable viral load and normalization of liver function markers in up to 80% of patients receiving a full course of treatment. However, in individuals infected with the genotype 1 virus, the standard of care calls for 12 months of treatment and is successful in only approximately 50% of patients receiving a full course of treatment.

Treatment with pegylated interferon and ribavirin is further complicated by significant adverse side effects, including flu-like symptoms, anemia, depression, fatigue, suicidal tendencies and abnormal fetal development. Since chronic hepatitis C infection, with the exception of late-stage disease, is generally asymptomatic, the nature and extent of the treatment-related adverse side effects make patients feel sicker than they were prior to treatment. As a result of these treatment-related adverse side effects, nearly 40% of treated patients require dosage adjustments, and many of these patients may discontinue therapy altogether. In addition, current treatments are administered by injection, which is inconvenient and problematic for patients who are afraid of needles. Therefore, important goals for new HCV therapies are to:

- improve efficacy against the genotype 1 virus;
- offer a treatment response in patients who have failed an interferon and ribavirin based treatment;
- reduce the magnitude of treatment-related adverse side effects; and
- offer a more convenient, orally available, treatment option.

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We believe the lessons learned from the treatment of HIV infection, specifically the improved antiviral response achieved through the use of combination therapies, are relevant for the treatment of HCV due to its rapid replication and high frequency of mutations. One common approach to the discovery of new therapies to treat chronic hepatitis C focuses on the inhibition of viral proteins essential to the completion of the HCV replication cycle. The two most common of these HCV drug targets are NS5B polymerase and NS3 protease. NS5B polymerase is essential for viral replication, as it is directly involved in creating new copies of the viral RNA genome. NS3 protease is essential for viral protein processing and completion of the viral lifecycle. All of the NS3 inhibitors of which we are aware work by binding to the protein s active site, thus preventing protein processing. Both NS5B and NS3 inhibitors have demonstrated in clinical trials significant viral load reduction in infected patients. Many experts believe that these drugs, if approved, will need to be used in combination with other drugs in order to improve upon the efficacy obtained with the current standard of care.

***Achillion Approach: NS4A Anatagonists***

Compounds in our series of next-generation inhibitors that target NS4A are novel small molecule potent inhibitors of HCV replication which we identified through our internal research program. We believe these compounds have the following benefits:

*Novel Mechanism of Action*. Based upon extensive virology and biochemistry studies, we believe that the mechanism of action of our compounds is novel and involves targeting the NS4A protein of HCV, preventing the formation of a functional replicase complex, a necessary step in viral replication that occurs before copying the viral RNA genome, the step that polymerase inhibitors affect, but after viral protein processing, the step that protease inhibitors affect. Accordingly, we believe this unique mechanism may contribute to the lack of cross resistance between our compounds and other HCV inhibitors.

*Potency*. Data obtained in the standard laboratory assays used to determine anti-HCV activity against the genotype 1 virus demonstrate that our compounds have potency *in vitro* in a range similar to the published data on Boehringer Ingelheim s protease inhibitor under clinical development, and 14 to 21 times more potency *in vitro* than either the Schering-Plough or Vertex HCV protease inhibitors under clinical development.

*Lack of Cross Resistance*. In laboratory studies, our compounds have not demonstrated cross resistance to any of the polymerase inhibitors or protease inhibitors of which we are aware and have tested.

*Ease of Administration*. Based on current animal studies, we believe the compounds in this series could be administered orally.

*Potential for Combination Treatment*. Because of the lack of cross resistance in in vitro tests with all other known classes of HCV inhibitors, we believe that NS4A antagonists are well positioned for evaluation as a treatment for chronic hepatitis C in combination with the current standard of care and/or in combination with other direct acting antivirals.

***Clinical Development History***

In 2005, we initiated a single dose-escalating phase I clinical trial of ACH-806 in 20 subjects using a liquid formulation. There were no clinically significant findings in this trial, and we determined that this formulation is not suitable for further clinical trials or commercialization. We then evaluated the pharmacokinetics and safety of a tablet formulation of ACH-806 in a single dose-escalating phase I clinical trial in 20 subjects. We completed this trial in May 2006, and results revealed the drug was safe and well tolerated in healthy volunteers.

In 2006, we initiated a multiple dose proof-of-concept clinical trial in HCV-infected patients. A proof-of-concept trial is generally a late-stage phase I or early-stage phase II clinical trial, the objective of which

**Pension Benefits Other Benefits Nine Months Ended March 31, 2008 2007 2008 2007**

Components of net periodic benefit cost:

| | | | | |
|---|---|---|---|---|
| Service cost | $1,568 | $1,231 | $53 | $42 |
| Interest cost | 1,810 | 1,506 | 201 | 167 |
| Expected return on plan assets | (350) | (311) | | |
| Recognized net actuarial loss (gain) | 721 | 619 | (83) | (82) |
| Amortization of prior service cost | 476 | 449 | 89 | 36 |
| Net periodic pension cost | $4,225 | $3,494 | $260 | $163 |

The Company contributed $4,339 to its pension benefit plans and $19 to its other benefit plans in the nine months ended March 31, 2008. Expected contributions for the full fiscal year are $4,500 for the pension benefit plans and $200 for other benefit plans.

6. INCOME TAX

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, and various state, local and foreign jurisdictions. Effective July 1, 2007, the Company adopted FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes , ( FIN 48 ). This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109 Accounting for Income Taxes and prescribes a recognition threshold of more-likely-than-not to be sustained upon examination. The cumulative effect of adopting FIN 48 did not have a significant impact on the Company s financial position or results of operations.

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

The total gross unrecognized tax benefits as of July 1, 2007 were $2,280; of this amount, approximately $1,547 if recognized would have an effect on the effective tax rate. The Company recognizes accrued interest and penalties related to unrecognized tax benefits in the provision for income taxes. Included in the total gross unrecognized tax benefits as of July 1, 2007 is $397 for the potential payment of interest and penalties. The Company does not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months due to audit or the expiration of statutes of limitations.

The Company is subject to U.S. federal jurisdiction income tax examinations for the tax years 2004 through 2007. In addition, the Company is subject to foreign, state and local income tax examinations for the tax years 2003 through 2007.

Effective with the adoption of FIN 48, the majority of the Company s unrecognized tax benefits are classified as noncurrent liabilities because payment of cash is not expected within one year. Prior to the adoption of FIN 48, the Company classified unrecognized tax benefits in current liabilities.

There were no material changes to the total gross unrecognized tax benefits during the nine month period ended March 31, 2008.

7. BUSINESS COMBINATIONS

On December 14, 2007, the Company acquired certain assets of Vycmex S.A. de C.V. ( Vycmex ), a distributor of fluid power products in Mexico, for $13,100, including $1,700 of VAT taxes; $11,128 was paid in cash at closing.

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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 review of the financial statements follows.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Applied Industrial Technologies, Inc.

Cleveland, OH

We have reviewed the accompanying condensed consolidated balance sheet of Applied Industrial Technologies, Inc. and subsidiaries (the Company ) as of March 31, 2008, and the related condensed statements of consolidated income for the three-month and nine-month periods ended March 31, 2008 and 2007, and of consolidated cash flows for the nine-month periods ended March 31, 2008 and 2007. 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 Applied Industrial Technologies, Inc. and subsidiaries as of June 30, 2007, and the related consolidated statements of income, shareholders equity, and cash flows for the year then ended (not presented herein); and in our report dated August 17, 2007, 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, 2007, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Cleveland, OH

April 30, 2008

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APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

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

With more than 4,600 associates across North America, Applied Industrial Technologies ( Applied , the Company , We , Our ) is an industrial distributor that offers parts critical to the operations of maintenance repair operations and original equipment manufacturing customers in virtually every industry. In addition, Applied provides fluid power, mechanical, and fabricated rubber shop services, as well as storeroom management and maintenance training. We have a long tradition of growth dating back to 1923, the year our business was founded in Cleveland, Ohio. During the third quarter of fiscal 2008, business was conducted in the United States, Canada, Mexico and Puerto Rico from approximately 450 facilities.

The following is Management s Discussion and Analysis of certain significant factors which have affected our (1) financial condition at March 31, 2008 and June 30, 2007, and (2) results of operations and cash flows during the periods included in the accompanying Condensed Statements of Consolidated Income and Consolidated Cash Flows.

Applied is an authorized distributor for more than 2,000 manufacturers and offers access to approximately 3 million stock keeping units ( sku s ). A large portion of our business is selling replacement parts to manufacturers for repair or maintenance of machinery and equipment. When reviewing the discussion and analysis set forth below, please note that the majority of sku s we sell in any given period were not sold in the comparable period of the prior year, resulting in the inability to quantify commonly used comparative metrics such as changes in product mix and volume.

Overview

Our sales, operating income and earnings per share for the quarter ended March 31, 2008 increased 1.7%, 10.5% and 12.2%, respectively, compared to the prior year quarter. Higher gross margin percentage, lower selling, distribution and administrative expenses ( SD&A ) as a percent of sales and the impact of our share buyback program were the primary factors driving the improvement in operating income and earnings per share.

The balance sheet continues to strengthen; the current ratio climbed to 3.3 from 2.6 at June 30, 2007. The significant improvement reflects repayment of the $50.0 million senior unsecured term notes in December 2007.

Applied monitors the Purchasing Managers Index (PMI) published by the Institute for Supply Management and the Manufacturers Capacity Utilization (MCU) index published by the Federal Reserve Board and considers these indices key indicators of potential Company business environment changes. During the quarter the PMI and MCU declined slightly, a signal the economy may be weakening. Our performance traditionally lags these key indicators by up to 6 months.

The number of Company associates was 4,649 at both March 31, 2008 and June 30, 2007. We had 4,574 associates at March 31, 2007. Our operating facilities totaled 451 at March 31, 2008 and March 31, 2007. Both the associate and facility counts include the impact of our acquisition of Vycmex S.A. de C.V. ( Vycmex ) in Mexico in December 2007.

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

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes , ( FIN 48 ). FIN 48, which is an interpretation of SFAS No. 109, Accounting for Income Taxes, provides guidance on the manner in which tax positions taken or to be taken on tax returns should be reflected in an entity s financial statements prior to their resolution with taxing authorities. In accordance with FIN 48, the Company recognized an immaterial cumulative effect adjustment decreasing its liability for unrecognized tax benefits, interest, and penalties and increasing the July 1, 2007 balance of retained earnings. See Note 6 for more information on income taxes.

Results of Operations

**Three Months Ended March 31, 2008 and 2007**

During the quarter ended March 31, 2008 sales increased $9.0 million or 1.7% compared to the prior year, reflecting increased sales in both our service center based distribution segment and fluid power businesses. Sales attributed to acquisitions contributed 0.3% of the increase. The number of selling days for the three months ended March 31, 2008 and March 31, 2007 was 63.5 and 64 days, respectively.

Sales from our service center based distribution segment increased $3.4 million or 0.7% during the quarter ended March 31, 2008 from the same period in the prior year. The increase in sales was primarily driven by the addition of national contract business. The impact of favorable currency fluctuations between Canadian and U.S. dollars was largely offset by declines in our service center based Canadian business which is seeing declines in sales to customers in the natural gas, oil, lumber and wood products industries.

Sales from our fluid power businesses increased $5.7 million or 10.9% during the quarter from the same period in the prior year. Favorable foreign currency translation in the Canadian portion of these businesses accounted for $2.2 million of the increase between periods. Our recent acquisition of Vycmex accounted for approximately $1.5 million of the increase. The remainder of the increase is primarily attributed to higher volume in existing locations.

During the quarter ended March 31, 2008, industrial products and fluid power products accounted for 79.8% and 20.2%, respectively, of sales. In comparison, industrial products and fluid power products accounted for 80.6% and 19.4%, respectively, of sales for the same period in the prior year.

From a geographical perspective, sales from our Canadian operations increased $2.7 million or 5.6% during the quarter ended March 31, 2008 from the same period in the prior year. The net sales increase was due to foreign currency translation as sales in the local currency declined by 8.9% due to a slowdown in the Canadian economy. The slowdown was most notable in sales to

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customers in the lumber and wood products industry due to the current downturn in the housing market and sales to customers participating in natural gas and oil exploration activity.

Gross profit as a percentage of sales increased slightly to 27.3% compared to the prior year s 27.0%. We continue to experience gross profit margin pressures primarily due to increased sales to national contract customers which are generally at lower margins, as well as contractual limitations on immediately passing certain supplier price increases to our customers. Positive influences were improved margins in Canada, lower scrap costs and higher levels of supplier purchasing incentives during the quarter.

SD&A decreased as a percent of sales to 20.1% in the quarter ended March 31, 2008 from 20.4% in the prior year quarter. We continue to focus on overall cost control which has resulted in this percentage decline. In dollars, SD&A increased $0.3 million compared to the prior year quarter. Higher expenses due to foreign currency fluctuations, new service center locations, additional bad debt reserves and the acquisition were offset by lower depreciation expense and nonrecurrence of certain information technology and sales tax expenses.

Interest expense, net for the current quarter decreased $0.5 million or 67.8% from the same period in the prior year. This was due to lower interest expense as a result of the retirement of $50.0 million in debt last quarter.

Other expense (income), net for the quarter ended March 31, 2008 changed $0.5 million largely due to declines in market values in investments held by deferred compensation trusts offset partially by favorable changes in the fair value of the cross-currency swap.

The income tax rate was 36.7% for the quarter ended March 31, 2008 compared to 35.5% for the quarter ended March 31, 2007. The higher tax rate relates primarily to higher effective state tax rates in the current year quarter and U.S. federal tax law changes which have eliminated certain deductions related to foreign sourced income.

As a result of the above factors, net income increased $1.9 million or 8.7% compared to the prior year quarter. Earnings per share rose to $0.55 per share for the current quarter compared to $0.49 in the prior year quarter.

**Nine Months Ended March 31, 2008 and 2007**

Sales during the nine months ended March 31, 2008 increased $73.6 million or 5.0% compared to the prior year, reflecting increased sales in both our service center based distribution segment and fluid power businesses. The number of selling days during the nine months ended March 31, 2008 and 2007 were 188.5 days and 188 days, respectively.

Sales from our service center based distribution segment increased $63.3 million or 4.7% during the nine months ended March 31, 2008 from the same period in the prior year. The impact of

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currency fluctuations accounted for approximately 1% of the increase with the remainder relating to additional national contract business.

Sales from our fluid power businesses increased $10.3 million or 6.8% during the nine months ended March 31, 2008 from the same period in the prior year. The impact of favorable currency fluctuations between the Canadian and U.S. dollars represented approximately $5.3 million of the increase. Approximately $1.5 million of the increase was due to the Vycmex acquisition in the current year.

During the nine months ended March 31, 2008, industrial products and fluid power products accounted for 80.3% and 19.7%, respectively, of sales. In comparison, industrial products and fluid power products accounted for 80.4% and 19.6%, respectively, of sales for the same period in the prior year.

From a geographical perspective, sales from our Canadian operations increased $9.3 million or 6.1% during the nine months ended March 31, 2008 from the same period in the prior year. The net sales increase was due to the impact of favorable currency translation as sales in the local currency declined by 5.2% due to a slowdown in the Canadian economy. The slowdown was most notable in sales to customers in the lumber and wood products industry due to the current downturn in the housing market and in sales to customers participating in natural gas and oil exploration activity.

Gross profit as a percentage of sales was 27.3% for the nine months ended March 31, 2008 and March 31, 2007. We continue to experience gross profit margin pressures primarily due to increased sales to national contract customers which are generally at lower margins, as well as contractual limitations on immediately passing certain supplier price increases to our customers.

SD&A increased during the nine months ended March 31, 2008 by $2.4 million or 0.8% over the prior year period, but as a percentage of sales declined from 20.8% to 20.0%. The increase is primarily attributed to the impact of currency fluctuations in Canada and net increases in associate compensation and benefits, partially offset by lower depreciation expense of $1.1 million and an increase in gains on sales of properties of $0.8 million in the current year.

Interest expense, net for the nine months ended March 31, 2008 decreased $1.5 million or 74.3% from the same period in the prior year. Lower interest expense related to the repayment of the senior unsecured notes in December 2007 accounts for $1.0 million of this decline. An increase in interest income earned on cash equivalents represents another $0.9 million. Partially offsetting these declines are unfavorable currency fluctuations on the cross-currency swap of approximately $0.4 million.

Other expense (income), net for the nine months ended March 31, 2008 changed $1.7 million. Approximately three-fourths of the fluctuation relates to declines in market values on the deferred compensation trust assets. The remaining increase is largely due to unfavorable changes in the fair value of the cross-currency swap.

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The income tax rate was 37.2% for the nine months ended March 31, 2008 compared to 35.7% for the nine months ended March 31, 2007. The higher tax rate year-to-date relates primarily to higher effective state tax rates and U.S. federal tax law changes which have eliminated certain deductions related to foreign sourced income.

As a result of the above factors, net income increased by 15.7% compared to the same period of last year. Net income per share increased at a higher rate of 18.2% due to the lower number of shares outstanding from the stock buyback program.

Liquidity and Capital Resources

Cash provided by operating activities for the nine months ended March 31, 2008 was $62.0 million. This compares to approximately $31.7 million provided by operating activities in the same period a year ago. Cash flows from operations depend primarily upon generating operating income, controlling the investment in inventories and receivables and managing the timing of payments to suppliers. The improvement in cash flow from operations primarily relates to improvement in our collections of receivables and improved operating income.

Cash used in investing activities during the current year included $11.1 million paid to acquire a Mexican distributor in December 2007. Capital expenditures were $6.1 million for the nine months ended March 31, 2008 compared to $8.1 million in the prior year. Proceeds from property sales were up $0.9 million.

Cash used in financing activities was $98.0 million, an increase of $53.2 million over prior year period. We paid $50.0 million in December 2007 to retire our senior unsecured term notes. Our dividends paid were up $3.6 million to $19.4 million, reflecting the increased quarterly rate of $0.15 per share this year compared to $0.12 per share in the prior year period. Treasury share purchases of $33.2 million were also a significant use of cash; these are at a comparable level to repurchases in the prior year period.

We have a $150.0 million revolving credit facility with a group of banks expiring in June 2012. We had no borrowings outstanding under this facility at March 31, 2008. Unused lines under this facility, net of outstanding letters of credit, total $144.9 million, and are available to fund future acquisitions or other capital and operating requirements.

We have an uncommitted shelf facility with Prudential Investment Management, Inc. that enables the Company to borrow up to $100.0 million in additional long-term financing at the Company s discretion with terms of up to fifteen years. This agreement expires in March 2010. At March 31, 2008, there were no outstanding borrowings under this agreement.

The Company s $25.0 million in long-term debt matures in fiscal 2011.

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

The Board of Directors has authorized the purchase 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 434,900 shares of common stock in the quarter ending March 31, 2008 for $12.2 million. At quarter-end, the Company had remaining authorization to repurchase 1.1 million additional shares.

Cautionary Statement Under Private Securities Litigation Reform Act

Management s Discussion and Analysis and other sections of this report, including documents incorporated by reference, contain statements that are forward-looking, based on management s current expectations about the future. Forward-looking statements are often identified by qualifiers such as guidance , expect, expectation, forecast, belie plan, will , should , could , anticipate , and similar expressions. Similarly, descriptions of objectives, strategies, pla 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 customers and the economic factors that affect them; reduced demand for our products in targeted markets due to reasons including consolidation in customer industries and the transfer of manufacturing capacity to foreign countries; changes in customer preferences for products and services of the nature and brands sold by us; changes in customer procurement policies and practices; changes in the prices for products and services relative to the cost of providing them; loss of key supplier authorizations, lack of product availability, or changes in supplier distribution programs; competitive pressures; the cost of products and energy and other operating costs; disruption of our information systems; our ability to retain and attract qualified sales and customer service personnel; our ability to identify and complete acquisitions, integrate them effectively, and realize their anticipated benefits; disruption of operations at our headquarters or distribution centers; risks and uncertainties associated with our foreign operations, including more volatile economic conditions, political instability, cultural and legal differences, and currency exchange fluctuations; risks related to legal proceedings to which we

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are a party; the variability and timing of new business opportunities including acquisitions, alliances, customer relationships, and supplier authorizations; the incurrence of debt and contingent liabilities in connection with acquisitions; our ability to access capital markets as needed; changes in accounting policies and practices; organizational changes within the Company; the volatility of our stock price and the resulting impact on our financial statements; adverse regulation and legislation; and the occurrence of extraordinary events (including prolonged labor disputes, natural events and acts of god, terrorist acts, fires, floods, and accidents). Other factors and unanticipated events could also adversely affect our business, financial condition or results of operations. We discussed certain of these matters more fully in our Annual Report on Form 10-K for the year ended June 30, 2007.

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APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company has evaluated its exposure to various market risk factors, including but not limited to, interest rate and foreign currency exchange risks.

The Company can manage interest rate risk through the use of a combination of fixed rate long-term debt, variable rate borrowings under its committed revolving credit agreement and interest rate swaps. The Company had no variable rate borrowings under its committed revolving credit agreement and no interest rate swap agreements outstanding at March 31, 2008. All the Company s outstanding debt is currently at fixed interest rates at March 31, 2008 and scheduled for repayment in November 2010.

The Company mitigates its foreign currency exposure from the Canadian dollar through the use of cross currency swap agreements as well as foreign-currency denominated debt. Hedging of the U.S. dollar denominated debt, used to fund a substantial portion of the Company s net investment in its Canadian operations, is accomplished through the use of cross currency swaps. Any gain or loss on the hedging instrument offsets the gain or loss on the underlying debt. Translation exposures with regard to our Mexican business are not hedged, as our Mexican activity is not material.

For the nine months ended March 31, 2008, a uniform 10% strengthening of the U.S. dollar relative to foreign currencies that affect the Company would have resulted in a $0.7 million decrease in net income. A uniform 10% weakening of the U.S. dollar would have resulted in a $0.7 million increase in net income.

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APPLIED INDUSTRIAL TECHNOLOGIES, INC. AND SUBSIDIARIES

ITEM 4: CONTROLS AND PROCEDURES

The Company s management, under the supervision and with the participation of the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), evaluated the effectiveness of the Company s disclosure controls and procedures, as defined in Exchange Act Rule 13a-15(e), as of the end of the period covered by this report. Based on that evaluation, the CEO and CFO have concluded that the Company s disclosure controls and procedures are effective.

During the third quarter of fiscal 2008, there were no changes in the Company s internal controls or in other factors that materially affected, or are reasonably likely to materially affect, the Company s internal controls over financial reporting.

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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 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 in the quarter ended March 31, 2008 were as follows:

| Period | (a) Total Number of Shares | (b) Average Price Paid per Share ($) | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs [1][2] |
|---|---|---|---|---|
| January 1, 2008 to January 31, 2008 | -0- | -0- | -0- | 1,500,000 |
| February 1, 2008 to February 29, 2008 | 144,900 | 28.77 | 144,900 | 1,355,100 |
| March 1, 2008 to March 31, 2008 | 290,000 | 27.71 | 290,000 | 1,065,100 |
| Total | 434,900 | 28.06 | 434,900 | 1,065,100 |

(1) On January 23, 2008, the Board of Directors authorized the purchase of up to 1.5 million shares of the Company s common stock. The Company publicly announced the authorization that day. Purchases may be made in the open market or in privately negotiated transactions. This authorization is in effect until all

shares are purchased or the authorization is revoked or amended by the Board of Directors.

(2) During the quarter the Company purchased 9,573 shares in connection with the vesting of stock awards. These purchases are not counted within the aforementioned Board authorization.

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ITEM 6. Exhibits.

| Exhibit No. | Description |
|---|---|
| 3(a) | Amended and Restated Articles of Incorporation of Applied Industrial Technologies, Inc., as amended on October 25, 2005 (filed as Exhibit 3(a) to the Company s Form 10-Q for the quarter ended December 31, 2005, SEC File No. 1-2299, and incorporated here by reference). |
| 3(b) | Code of Regulations of Applied Industrial Technologies, Inc., as amended on October 19, 1999 (filed as Exhibit 3(b) to the Company s Form 10-Q for the quarter ended September 30, 1999, SEC File No. 1-2299, and incorporated here by reference). |
| 4(a) | Certificate of Merger of Bearings, Inc. (Ohio) (now named Applied Industrial Technologies, Inc.) and Bearings, Inc. (Delaware) filed with the Ohio Secretary of State on October 18, 1988, including an Agreement and Plan of Reorganization dated September 6, 1988 (filed as Exhibit 4(a) to the Company s Registration Statement on Form S-4 filed May 23, 1997, Registration No. 333-27801, and incorporated here by reference). |
| 4(b) | Private Shelf Agreement dated as of November 27, 1996, as amended on January 30, 1998, between the Company and Prudential Investment Management, Inc. (assignee of The Prudential Insurance Company of America) (filed as Exhibit 4(f) to the Company s Form 10-Q for the quarter ended March 31, 1998, SEC File No. 1-2299, and incorporated here by reference). |
| 4(c) | Amendment dated October 24, 2000 to 1996 Private Shelf Agreement between the Company and Prudential Investment Management, Inc. (assignee of The Prudential Insurance Company of America) (filed as Exhibit 4(e) to the Company s Form 10-Q for the quarter ended September 30, 2000, SEC File No. 1-2299, and incorporated here by reference). |

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| Exhibit No. | Description |
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| 4(d) | Amendment dated November 14, 2003 to 1996 Private Shelf Agreement between the Company and Prudential Investment Management, Inc. (assignee of The Prudential Insurance Company of America) (filed as Exhibit 4(d) to the Company s Form 10-Q for the quarter ended December 31, 2003, SEC File No. 1-2299, and incorporated here by reference). |
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| 4(g) | Credit Agreement dated as of June 3, 2005 among the Company, KeyBank National Association as Agent, and various financial institutions (filed as Exhibit 4 to the Company s Form 8-K dated June 9, 2005, SEC File No. 1-2299, and incorporated here by reference). |
| 4(h) | First Amendment Agreement dated as of June 6, 2007, among the Company, KeyBank National Association as Agent, and various financial institutions, amending June 3, 2005 Credit Agreement (filed as Exhibit 4 to the Company s Form 8-K dated June 11, 2007, SEC File No. 1-2299, and incorporated here by reference). |
| 15 | Independent Registered Public Accounting Firm s Awareness Letter. |
| 31 | Rule 13a-14(a)/15d-14(a) certifications. |
| 32 | Section 1350 certifications. |

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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: May 1, 2008

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

Date: May 1, 2008

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

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APPLIED INDUSTRIAL TECHNOLOGIES, INC.
EXHIBIT INDEX
TO FORM 10-Q FOR THE QUARTER ENDED MARCH 31, 2008

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