PARKER HANNIFIN CORP
Form 10-Q
February 08, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended December 31, 2011

OR

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

For the transition period from ______ to ______

Commission File number 1-4982

PARKER-HANNIFIN CORPORATION

(Exact name of registrant as specified in its charter)

OHIO	**34-0451060**
(State or other jurisdiction of	**(IRS Employer**
incorporation or organization)	**Identification No.)**
6035 Parkland Blvd., Cleveland, Ohio	**44124-4141**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (216) 896-3000

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act (check one):

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

Number of Common Shares outstanding at December 31, 2011 150,902,888

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PARKER-HANNIFIN CORPORATION

CONSOLIDATED STATEMENT OF INCOME

(Dollars in thousands, except per share amounts)

(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	**2010**	**2011**	**2010**
Net sales	$ 3,106,832	$ 2,866,664	$ 6,340,713	$ 5,695,937
Cost of sales	2,381,322	2,195,728	4,795,764	4,333,602
Gross profit	725,510	670,936	1,544,949	1,362,335
Selling, general and administrative expenses	368,690	345,679	755,156	679,263
Interest expense	23,769	25,631	46,990	50,264
Other (income), net	(5,896)	(6,624)	(7,729)	(9,806)
Income before income taxes	338,947	306,250	750,532	642,614
Income taxes	96,604	74,432	210,031	161,766
Net income	$ 242,343	$ 231,818	$ 540,501	$ 480,848
Less: Noncontrolling interests in subsidiaries earnings	1,577	1,638	2,717	3,497
Net income attributable to common shareholders	$ 240,766	$ 230,180	$ 537,784	$ 477,351
Earnings per share attributable to common shareholders:				
Basic	$ 1.59	$ 1.42	$ 3.55	$ 2.96
Diluted	$ 1.56	$ 1.39	$ 3.47	$ 2.90
Cash dividends per common share	$ .37	$ .29	$ .74	$ .56

See accompanying notes to consolidated financial statements.

PARKER-HANNIFIN CORPORATION

CONSOLIDATED BALANCE SHEET

(Dollars in thousands)

	(Unaudited) December 31, 2011	June 30, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 487,984	$ 657,466
Accounts receivable, net	1,828,117	1,977,856
Inventories:		
Finished products	575,319	584,683
Work in process	726,721	670,588
Raw materials	150,624	156,882
	1,452,664	1,412,153
Prepaid expenses	129,439	111,934
Deferred income taxes	144,819	145,847
Total current assets	4,043,023	4,305,256
Plant and equipment	4,793,516	4,944,735
Less accumulated depreciation	3,102,354	3,147,556
	1,691,162	1,797,179
Goodwill	2,879,169	3,009,116
Intangible assets, net	1,101,020	1,177,722
Investments and other assets	613,210	597,532
Total assets	$ 10,327,584	$ 10,886,805
LIABILITIES		
Current liabilities:		
Notes payable and long-term debt payable within one year	$ 78,375	$ 75,271
Accounts payable, trade	1,069,503	1,173,851
Accrued payrolls and other compensation	327,261	467,043
Accrued domestic and foreign taxes	150,896	232,774
Other accrued liabilities	494,074	442,104
Total current liabilities	2,120,109	2,391,043
Long-term debt	1,659,434	1,691,086
Pensions and other postretirement benefits	838,644	862,938
Deferred income taxes	147,123	160,035
Other liabilities	306,371	293,367
Total liabilities	5,071,681	5,398,469
EQUITY		
Shareholders equity:		
Serial preferred stock, $.50 par value; authorized 3,000,000 shares; none issued		
Common stock, $.50 par value; authorized 600,000,000 shares; issued 181,046,128 shares at December 31 and June 30	90,523	90,523
Additional capital	619,174	668,332
Retained earnings	7,311,219	6,891,407
Accumulated other comprehensive (loss)	(765,350)	(450,990)

Treasury shares, at cost; 30,143,240 shares at December 31 and 25,955,619 shares at June 30	(2,097,440)	(1,815,418)
Total shareholders equity	5,158,126	5,383,854
Noncontrolling interests	97,777	104,482
Total equity	5,255,903	5,488,336
Total liabilities and equity	$ 10,327,584	$ 10,886,805

See accompanying notes to consolidated financial statements.

PARKER-HANNIFIN CORPORATION

CONSOLIDATED STATEMENT OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	Six Months Ended December 31, 2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 540,501	$ 480,848
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation	108,420	116,971
Amortization	55,711	53,322
Share incentive plan compensation	44,462	41,331
Deferred income taxes	(19,903)	31,121
Foreign currency transaction loss	5,194	9,419
(Gain) on sale of plant and equipment	(1,308)	(5,244)
Changes in assets and liabilities, net of effect of acquisitions:		
Accounts receivable, net	70,385	26,609
Inventories	(97,873)	(129,640)
Prepaid expenses	(19,204)	9,844
Other assets	(26,907)	(35,653)
Accounts payable, trade	(67,044)	40,491
Accrued payrolls and other compensation	(121,689)	(71,122)
Accrued domestic and foreign taxes	(78,788)	(39,497)
Other accrued liabilities	76,027	(8,056)
Pensions and other postretirement benefits	52,135	(136,394)
Other liabilities	43,297	23,807
Net cash provided by operating activities	563,416	408,157
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisitions (less cash acquired of $6,802 in 2011 and $1 in 2010)	(90,545)	(43,359)
Capital expenditures	(96,897)	(109,795)
Proceeds from sale of plant and equipment	11,179	17,243
Other	(14,498)	(9,369)
Net cash (used in) investing activities	(190,761)	(145,280)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from exercise of stock options	1,833	16,306
(Payments for) common shares	(313,544)	(30,000)
Tax benefit from share incentive plan compensation	2,964	18,557
(Payments of) notes payable, net	(1)	(18,908)
Proceeds from long-term borrowings	104	295,714
(Payments of) long-term borrowings	(1,192)	(257,133)
Dividends	(119,031)	(90,907)
Net cash (used in) financing activities	(428,867)	(66,371)
Effect of exchange rate changes on cash	(113,270)	36,704
Net (decrease) increase in cash and cash equivalents	(169,482)	233,210
Cash and cash equivalents at beginning of year	657,466	575,526

Cash and cash equivalents at end of period	$ 487,984	$ 808,736

See accompanying notes to consolidated financial statements.

PARKER-HANNIFIN CORPORATION

BUSINESS SEGMENT INFORMATION

(Dollars in thousands)

(Unaudited)

The Company operates in three reportable business segments: Industrial, Aerospace and Climate & Industrial Controls. The Industrial Segment is the largest and includes a significant portion of international operations.

Industrial - This segment produces a broad range of motion-control and fluid systems and components used in all kinds of manufacturing, packaging, processing, transportation, mobile construction, agricultural and military machinery and equipment. Sales are made directly to major original equipment manufacturers (OEMs) and through a broad distribution network to smaller OEMs and the aftermarket.

Aerospace - This segment designs and manufactures products and provides aftermarket support for commercial, business jet, military and general aviation aircraft, missile and spacecraft markets. The Aerospace Segment provides a full range of systems and components for hydraulic, pneumatic and fuel applications.

Climate & Industrial Controls - This segment manufactures motion-control systems and components for use primarily in the refrigeration and air conditioning and transportation industries.

	Three Months Ended December 31,		**Six Months Ended December 31,**	
	2011	**2010**	**2011**	**2010**
Net sales				
Industrial:				
North America	$ 1,183,352	$ 1,045,469	$ 2,388,169	$ 2,110,384
International	1,218,812	1,147,231	2,507,927	2,240,212
Aerospace	496,505	459,630	993,997	896,310
Climate & Industrial Controls	208,163	214,334	450,620	449,031
Total	$ 3,106,832	$ 2,866,664	$ 6,340,713	$ 5,695,937
Segment operating income				
Industrial:				
North America	$ 195,738	$ 159,429	$ 418,965	$ 348,791
International	165,940	167,776	374,159	351,576
Aerospace	70,262	63,644	138,899	107,420
Climate & Industrial Controls	9,823	9,501	29,615	31,053
Total segment operating income	441,763	400,350	961,638	838,840
Corporate general and administrative expenses	46,136	37,593	104,152	70,947
Income before interest expense and other	395,627	362,757	857,486	767,893
Interest expense	23,769	25,631	46,990	50,264
Other expense	32,911	30,876	59,964	75,015
Income before income taxes	$ 338,947	$ 306,250	$ 750,532	$ 642,614

PARKER-HANNIFIN CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Dollars in thousands, except per share amounts

1. Management representation

In the opinion of the management of the Company, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position as of December 31, 2011, the results of operations for the three and six months ended December 31, 2011 and 2010 and cash flows for the six months then ended. These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company s 2011 Annual Report on Form 10-K. Interim period results are not necessarily indicative of the results to be expected for the full fiscal year.

The Company has evaluated subsequent events that have occurred through the date these financial statements were issued. No subsequent events occurred that required either adjustment to or disclosure in these financial statements.

2. New accounting pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued new accounting guidance to improve consistency with fair value measurement and disclosure requirements. This guidance is effective for interim and annual periods beginning after December 15, 2011. The Company does not anticipate its fair value measurements or disclosures will significantly change as a result of applying this new guidance.

In June 2011, the FASB issued new accounting guidance requiring an entity to present net income and other comprehensive income (OCI) in either a single continuous statement or in separate consecutive statements. The guidance does not change the items reported in OCI or when an item of OCI must be reclassified to net income. The guidance, which must be presented retrospectively, is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011.

In September 2011, the FASB issued new accounting guidance related to testing goodwill for impairment. The new guidance allows an entity the option to make a qualitative evaluation about the likelihood of goodwill impairment to determine whether the entity should calculate the fair value of a reporting unit. It also expands the events and circumstances that an entity should consider between annual impairment tests in determining whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. This guidance is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The Company has not yet determined the effect, if any, that this new guidance will have on its goodwill impairment tests.

3. Product warranty

In the ordinary course of business, the Company warrants its products against defects in design, materials and workmanship over various time periods. The warranty accrual as of December 31, 2011 and June 30, 2011 is immaterial to the financial position of the Company and the change in the accrual for the current quarter and first six months of fiscal 2012 is immaterial to the Company s results of operations and cash flows.

4. Earnings per share

The following table presents a reconciliation of the numerator and denominator of basic and diluted earnings per share for the three and six months ended December 31, 2011 and 2010.

	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	2010	2011	2010
Numerator:				
Net income attributable to common shareholders	$ 240,766	$ 230,180	$ 537,784	$ 477,351
Denominator:				
Basic - weighted average common shares	150,960,202	161,701,219	151,699,614	161,486,878
Increase in weighted average from dilutive effect of equity-based awards	3,757,009	4,400,316	3,324,865	3,303,911
Diluted - weighted average common shares, assuming exercise of equity-based awards	154,717,211	166,101,535	155,024,479	164,790,789
Basic earnings per share	$ 1.59	$ 1.42	$ 3.55	$ 2.96
Diluted earnings per share	$ 1.56	$ 1.39	$ 3.47	$ 2.90

For the three months ended December 31, 2011 and 2010, 96,328 and 48,390 common shares subject to equity-based awards, respectively, were excluded from the computation of diluted earnings per share because the effect of their exercise would be anti-dilutive. For the six months ended December 31, 2011 and 2010, 753,316 and 2,993,100 common shares subject to equity-based awards, respectively, were excluded from the computation of diluted earnings per share because the effect of their exercise would be anti-dilutive.

5. Share repurchase program

The Company has a program to repurchase its common shares. Under the program, the Company is authorized to repurchase an amount of common shares each fiscal year equal to the greater of 7.5 million shares or five percent of the shares outstanding as of the end of the prior fiscal year. Repurchases are funded primarily from operating cash flows and commercial paper borrowings, and the shares are initially held as treasury stock. During the three-month period ended December 31, 2011, the Company repurchased 260,705 shares of its common stock at an average price of $76.72 per share. Fiscal year-to-date, the Company repurchased 4,615,527 shares at an average price of $67.59 per share.

6. Accounts receivable, net

The Accounts receivable, net caption in the Consolidated Balance Sheet is comprised of the following components:

	December 31, 2011	June 30, 2011
Accounts receivable, trade	$ 1,614,776	$ 1,780,137
Allowance for doubtful accounts	(11,721)	(10,472)
Non-trade accounts receivable	79,377	75,550
Notes receivable	145,685	132,641
Total	$ 1,828,117	$ 1,977,856

6. Accounts receivable, net, cont d

Accounts receivable, trade are initially recorded at their net collectible amount and are generally recorded at the time the revenue from the sales transaction is recorded. Receivables are written off to bad debt primarily when, in the judgment of the Company, the receivable is deemed to be uncollectible due to insolvency of the debtor.

7. Business realignment charges

To structure its businesses in light of current and anticipated customer demand, the Company incurred business realignment charges in fiscal 2012 and fiscal 2011.

Business realignment charges by business segment are as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	**2010**	**2011**	**2010**
Industrial	$ 1,194	$ 1,688	$ 6,898	$ 4,437
Aerospace				320
Climate & Industrial Controls			148	

Work force reductions by business segment are as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	**2010**	**2011**	**2010**
Industrial	33	41	204	208
Aerospace				22
Climate & Industrial Controls			4	

The charges primarily consist of severance costs related to plant closures as well as general work force reductions implemented by various operating units throughout the world. The Company believes the realignment actions will positively impact future results of operations but will not have a material effect on liquidity and sources and uses of capital. The charges are presented primarily in the Cost of sales caption in the Consolidated Statement of Income for the three and six months ended December 31, 2011 and December 31, 2010. As of December 31, 2011, approximately $1.2 million in severance payments have been made relating to charges incurred during fiscal 2012, with the remaining payments expected to be made by March 31, 2012. All required severance payments have been made relating to charges incurred in fiscal 2011.

Additional charges to be recognized in future periods related to the realignment actions described above are not expected to be material.

8. Equity

Changes in equity for the three months ended December 31, 2011 and December 31, 2010 are as follows (net of tax amounts relate to Shareholders Equity):

	Shareholders Equity	Noncontrolling Interests	Total Equity
Balance September 30, 2011	$ 5,017,264	$ 96,224	$ 5,113,488
Net income	240,766	1,577	242,343
Other comprehensive income (loss):			
Foreign currency translation (net of tax of $3,371)	(60,982)	(10)	(60,992)
Retirement benefits plan activity (net of tax of $11,640)	19,106		19,106
Net realized loss (net of tax of $25)	51		51
Total comprehensive income	198,941	1,567	200,508
Dividends paid	(56,013)	(14)	(56,027)
Stock incentive plan activity	17,934		17,934
Shares purchased at cost	(20,000)		(20,000)
Balance December 31, 2011	$ 5,158,126	$ 97,777	$ 5,255,903

	Shareholders Equity	Noncontrolling Interests	Total Equity
Balance September 30, 2010	$ 4,894,945	$ 97,632	$ 4,992,577
Net income	230,180	1,638	231,818
Other comprehensive income:			
Foreign currency translation (net of tax of $12,397)	9,301	2,337	11,638
Retirement benefits plan activity (net of tax of $11,647)	19,844		19,844
Net realized loss (net of tax of $32)	51		51
Total comprehensive income	259,376	3,975	263,351
Dividends paid	(46,984)	(275)	(47,259)
Stock incentive plan activity	25,924		25,924
Shares purchased at cost	(20,000)		(20,000)
Balance December 31, 2010	$ 5,113,261	$ 101,332	$ 5,214,593

8. Equity, cont d

Changes in equity for the six months ended December 31, 2011 and December 31, 2010 are as follows (the net of tax amounts relate to Shareholders Equity):

	Shareholders Equity	Noncontrolling Interests	Total Equity
Balance June 30, 2011	$ 5,383,854	$ 104,482	$ 5,488,336
Net income	537,784	2,717	540,501
Other comprehensive income (loss):			
Foreign currency translation (net of tax of $19,566)	(351,759)	1,492	(350,267)
Retirement benefits plan activity (net of tax of $22,524)	37,296		37,296
Net realized loss (net of tax of $50)	102		102
Total comprehensive income	223,423	4,209	227,632
Dividends paid	(112,091)	(6,940)	(119,031)
Stock incentive plan activity	39,832		39,832
Acquisition activity	(64,920)	(3,974)	(68,894)
Shares purchased at cost	(311,972)		(311,972)
Balance December 31, 2011	$ 5,158,126	$ 97,777	$ 5,255,903

	Shareholders Equity	Noncontrolling Interests	Total Equity
Balance June 30, 2010	$ 4,367,965	$ 91,435	$ 4,459,400
Net income	477,351	3,497	480,848
Other comprehensive income:			
Foreign currency translation (net of tax of $17,487)	288,701	6,675	295,376
Retirement benefits plan activity (net of tax of $22,289)	38,062		38,062
Net realized loss (net of tax of $68)	110		110
Total comprehensive income	804,224	10,172	814,396
Dividends paid	(90,632)	(275)	(90,907)
Stock incentive plan activity	61,704		61,704
Shares purchased at cost	(30,000)		(30,000)
Balance December 31, 2010	$ 5,113,261	$ 101,332	$ 5,214,593

9. Goodwill and intangible assets

The changes in the carrying amount of goodwill for the six months ended December 31, 2011 are as follows:

	Industrial Segment	Aerospace Segment	Climate & Industrial Controls Segment	Total
Balance June 30, 2011	$ 2,595,989	$ 98,914	$ 314,213	$ 3,009,116
Acquisitions	2,704	(193)		2,511
Foreign currency translation	(126,664)	(39)	(5,755)	(132,458)
Balance December 31, 2011	$ 2,472,029	$ 98,682	$ 308,458	$ 2,879,169

Acquisitions represent the original goodwill allocation and any purchase price adjustments for the acquisitions during the measurement period subsequent to the applicable acquisition dates.

Intangible assets are amortized on the straight-line method over their legal or estimated useful lives. The following summarizes the gross carrying value and accumulated amortization for each major category of intangible assets:

	December 31, 2011		June 30, 2011	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Patents	$ 118,220	$ 62,668	$ 124,015	$ 61,061
Trademarks	304,055	120,895	319,158	116,995
Customer lists and other	1,221,961	359,653	1,251,271	338,666
Total	$ 1,644,236	$ 543,216	$ 1,694,444	$ 516,722

Total intangible amortization expense for the six months ended December 31, 2011 was $53,830. The estimated amortization expense for the five years ending June 30, 2012 through 2016 is $98,601, $92,256, $88,671, $85,078 and $81,538, respectively.

Intangible assets are evaluated for impairment whenever events or circumstances indicate that the undiscounted net cash flows to be generated by their use over their expected useful lives and eventual disposition may be less than their net carrying value. No such events or circumstances occurred during the six months ended December 31, 2011.

10. Retirement benefits

Net pension benefit cost recognized included the following components:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	2010	2011	2010
Service cost	$ 21,000	$ 20,020	$ 42,624	$ 41,890
Interest cost	46,823	43,573	92,739	86,845
Expected return on plan assets	(50,101)	(49,201)	(100,270)	(97,934)
Amortization of prior service cost	3,523	3,197	7,007	6,326
Amortization of net actuarial loss	27,046	28,361	52,460	54,159
Amortization of initial net (asset)	(15)	(15)	(30)	(29)
Net pension benefit cost	$ 48,276	$ 45,935	$ 94,530	$ 91,257

Net postretirement benefit cost recognized included the following components:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	2010	2011	2010
Service cost	$ 181	$ 136	$ 362	$ 275
Interest cost	881	980	1,762	1,962
Net amortization and deferral and other	129	(113)	258	(228)
Net postretirement benefit cost	$ 1,191	$ 1,003	$ 2,382	$ 2,009

11. Income taxes

As of December 31, 2011, the Company had gross unrecognized tax benefits of $135,641, including $58,678 of additions for tax positions related to the current fiscal year. The total amount of gross unrecognized tax benefits that, if recognized, would affect the effective tax rate was $88,069. If recognized, a significant portion of the gross unrecognized tax benefits would be offset against an asset currently recorded in the Consolidated Balance Sheet. The accrued interest related to the gross unrecognized tax benefits, excluded from the amounts above, was $9,313.

The Company and its subsidiaries file income tax returns in the United States and various foreign jurisdictions. In the normal course of business, the Company is subject to examination by taxing authorities throughout the world. The Company is no longer subject to examinations of its federal income tax returns by the Internal Revenue Service for fiscal years through 2007. All significant state, local and foreign tax returns have been examined for fiscal years through 2001. The Company believes that it is reasonably possible that within the next 12 months examinations by taxing authorities in the United States and certain foreign jurisdictions will be settled. As a result of the settlement of these examinations, the Company anticipates that the total amount of gross unrecognized tax benefits related to various income and expense items may be reduced by an amount of up to $35 million.

12. Financial instruments and fair value measurement

The Company s financial instruments consist primarily of cash and cash equivalents, long-term investments, and accounts receivable as well as obligations under accounts payable, trade, notes payable and long-term debt. Due to their short-term nature, the carrying values for cash and cash equivalents, accounts receivable, accounts payable, trade and notes payable approximate fair value. The carrying value of long-term debt (excluding leases) was $1,737,467 and $1,765,892 at December 31, 2011 and June 30, 2011, respectively, and was estimated to have a fair value of $1,981,380 and $1,902,221 at December 31, 2011 and June 30, 2011, respectively. The fair value of long-term debt was estimated using discounted cash flow analyses based on the Company s current incremental borrowing rate for similar types of borrowing arrangements.

The Company utilizes derivative and non-derivative financial instruments, including forward exchange contracts, costless collar contracts, cross-currency swap contracts and certain foreign denominated debt designated as net investment hedges, to manage foreign currency transaction and translation risk. The derivative financial instrument contracts are with major investment grade financial institutions and the Company does not anticipate any material non-performance by any of the counterparties. The Company does not hold or issue derivative financial instruments for trading purposes.

The Company s Euro bonds and Japanese Yen credit facility have been designated as a hedge of the Company s net investment in certain foreign subsidiaries. The translation of the Euro bonds and Japanese Yen credit facility into U.S. dollars is recorded in accumulated other comprehensive income (loss) and remains there until the underlying net investment is sold or substantially liquidated.

Derivative financial instruments are recognized on the balance sheet as either assets or liabilities and are measured at fair value. Derivatives consist of costless collar and cross-currency swap contracts the fair value of which is calculated using market observable inputs including both spot and forward prices for the same underlying currencies. The fair value of the cross-currency swap contracts is calculated using a present value cash flow model that has been adjusted to reflect the credit risk of either the Company or the counterparty.

The following summarizes the location and fair value of derivative financial instruments reported in the Consolidated Balance Sheet as of December 31, 2011 and June 30, 2011:

	Balance Sheet Caption	December 31, 2011	June 30, 2011
Net investment hedges			
Cross-currency swap contracts	Other liabilities	$8,556	$ 36,582
Cash flow hedges			
Costless collar contracts	Accounts receivable	6,472	638
Costless collar contracts	Other accrued liabilities	1,952	2,979
Forward exchange contracts	Other accrued liabilities	7,992	

12. Financial instruments and fair value measurement, cont d

The fair values at December 31, 2011 and June 30, 2011 are classified within level 2 of the fair value hierarchy. There are no other financial assets or financial liabilities that are marked to market on a recurring basis.

Gains or losses on derivatives that are not hedges are adjusted to fair value through the cost of sales caption in the Consolidated Statement of Income. Gains or losses on derivatives that are hedges are adjusted to fair value through accumulated other comprehensive income (loss) in the Consolidated Balance Sheet until the hedged item is recognized in earnings.

The cross-currency swap contracts have been designated as hedging instruments. The costless collar contracts and forward exchange contracts have not been designated as hedging instruments and are considered to be economic hedges of forecasted transactions.

Gains (losses) on derivative financial instruments that were recorded in the Consolidated Statement of Income are as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	**2010**	**2011**	**2010**
Forward exchange contracts	$ 16,804	$ 3,245	$ (14,588)	$ 19,048
Costless collar contracts	(1,765)	(1,018)	5,850	(4,554)

Gains (losses) on derivative and non-derivative financial instruments that were recorded in accumulated other comprehensive income (loss) in the Consolidated Balance Sheet are as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2011	**2010**	**2011**	**2010**
Cross-currency swap contracts	$ 1,674	$ 3,244	$ 17,315	$ (11,577)
Foreign denominated debt	5,287	226	16,665	(36,334)

There was no ineffectiveness of the cross-currency swap contracts or foreign denominated debt, nor was any portion of these financial instruments excluded from the effectiveness testing, during the six months ended December 31, 2011 and 2010.

PARKER-HANNIFIN CORPORATION

FORM 10-Q

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

AND RESULTS OF OPERATIONS

FOR THE THREE AND SIX MONTHS ENDED DECEMBER 31, 2011

AND COMPARABLE PERIODS ENDED DECEMBER 31, 2010

OVERVIEW

The Company is a leading worldwide diversified manufacturer of motion and control technologies and systems, providing precision engineered solutions for a wide variety of mobile, industrial and aerospace markets.

The Company s order rates provide a near-term perspective of the Company s outlook particularly when viewed in the context of prior and future order rates. The Company publishes its order rates on a quarterly basis. The lead time between the time an order is received and revenue is realized generally ranges from one day to 12 weeks for mobile and industrial orders and from one day to 18 months for aerospace orders. The Company believes the leading economic indicators of these markets that have a strong correlation to the Company s future order rates are as follows:

- Purchasing Managers Index (PMI) on manufacturing activity specific to regions around the world with respect to most mobile and industrial markets;

- Global aircraft miles flown and global revenue passenger miles for commercial aerospace markets and Department of Defense spending for military aerospace markets; and

- Housing starts with respect to the North American residential air conditioning market and certain mobile construction markets.

A PMI above 50 indicates that the manufacturing activity specific to a region in the mobile and industrial markets is expanding. A PMI below 50 indicates the opposite. The PMI at the end of December 2011 for the United States, the Eurozone countries and China was 53.9, 46.9, and 48.7, respectively. Since June 30, 2011 and September 30, 2011, the PMI for the Eurozone countries and China have decreased while the PMI for the United States has declined since June 30, 2011 but has increased since September 30, 2011.

Global aircraft miles flown have increased approximately five percent and global revenue passenger miles have increased approximately four percent from their comparable fiscal 2011 levels. The Company anticipates that U.S. Department of Defense spending with regards to appropriations and operations and maintenance for the U.S. Government s fiscal year 2012 will be up slightly from the comparable fiscal 2011 level.

Housing starts in December 2011 were approximately 25 percent higher than housing starts in December 2010 and remained at essentially the same level of housing starts in September 2011.

The Company remains focused on maintaining its financial strength by adjusting its cost structure to reflect changing demand levels, maintaining a strong balance sheet and managing its cash. The Company continues to generate substantial cash flows from operations, has controlled capital spending and has proactively managed working capital. The Company has been able to borrow needed funds at affordable interest rates and had a debt to debt-shareholders equity ratio of 25.2 percent at December 31, 2011 compared to 25.8 percent at September 30, 2011 and 24.7 percent at June 30, 2011.

The Company believes many opportunities for profitable growth are available. The Company intends to focus primarily on business opportunities in the areas of energy, water, agriculture, environment, defense, life sciences, infrastructure and transportation.

The Company believes it can meet its strategic objectives by:

- Serving the customer;
- Empowering employees to become successful in its lean enterprise and fostering an entrepreneurial culture;
- Successfully executing its Win Strategy initiatives relating to premier customer service, financial performance and profitable growth;
- Engineering innovative systems and products to provide superior customer value through improved service, efficiency and productivity;
- Delivering products, systems and services that have demonstrable savings to customers and are priced by the value they deliver;
- Maintaining its decentralized division and sales company structure;
- Acquiring strategic businesses;
- Organizing the Company around targeted regions, technologies and markets; and
- Advancing business practices to achieve corporate sustainability goals.

During the first six months of fiscal 2012, the Company completed three acquisitions. Acquisitions will continue to be considered from time to time to the extent there is a strong strategic fit, while at the same time, maintaining the Company s strong financial position. The Company will also continue to assess its existing businesses and initiate efforts to divest businesses that are not considered to be a good long-term strategic fit for the Company. Future business divestitures could have a negative effect on the Company s results of operations.

The discussion below is structured to separately discuss the Consolidated Statement of Income, Results by Business Segment, Consolidated Balance Sheet and Consolidated Statement of Cash Flows.

CONSOLIDATED STATEMENT OF INCOME

	Three months ended December 31,		Six months ended December 31,	
(dollars in millions)	**2011**	**2010**	**2011**	**2010**
Net sales	$ 3,106.8	$ 2,866.6	$ 6,340.7	$ 5,695.9
Gross profit	$ 725.6	$ 670.9	$ 1,544.9	$ 1,362.3
Gross profit margin	23.4%	23.4%	24.4%	23.9%
Selling, general and administrative expenses	$ 368.7	$ 345.7	$ 755.2	$ 679.2
Selling, general and administrative expenses, as a percent of sales	11.9%	12.1%	11.9%	11.9%
Interest expense	$ 23.8	$ 25.6	$ 47.0	$ 50.3
Other (income), net	$ (5.9)	$ (6.6)	$ (7.7)	$ (9.8)
Effective tax rate	28.5%	24.3%	28.0%	25.2%
Net income	$ 242.3	$ 231.8	$ 540.5	$ 480.8

Net income, as a percent of sales	7.8%	8.1%	8.5%	8.4%

Net sales for the current-year quarter and first six months of fiscal 2012 increased 8.4 percent and 11.3 percent, respectively, over the comparable prior-year net sales amounts reflecting higher sales in the Industrial and Aerospace Segments. Acquisitions made in the last 12 months contributed approximately $10 million and $32 million in sales in the current-year quarter and first six months of fiscal 2012, respectively. The effect of currency rate changes did not significantly impact sales in the current-year quarter and increased net sales by approximately $86 million in first six months of fiscal 2012.

Gross profit margin for the current-year quarter reflects the effect of manufacturing inefficiencies and an unfavorable product mix in the Industrial Segment. Gross profit margin increased for the first six months of fiscal 2012 primarily due to manufacturing efficiencies.

Selling, general and administrative expenses increased for the current-year quarter and first six months of fiscal 2012 over the comparable prior-periods primarily due to the higher sales volume as well as higher expenses associated with the Company s incentive and deferred compensation programs.

Interest expense for the current-year quarter and first six months of fiscal 2012 was lower than the prior-year quarter and first six months of fiscal 2011 primarily due to a lower amount of average debt outstanding.

Other (income), net for the current-year quarter and first six months of fiscal 2012 includes a gain of $0.5 million and $2.1 million, respectively, related to the sale of real estate. Other (income), net for the prior-year quarter and first six months of fiscal 2011 includes a $2.3 million gain from the sale of intellectual property and a gain of $4.1 million and $4.6 million, respectively, related to the sale of real estate.

Effective tax rate for the current-year quarter and first six months of fiscal 2012 was higher than the prior-year quarter and first six months of fiscal 2011 due primarily to the comparable prior-year amounts reflecting the effect of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 and a favorable settlement of a tax examination. The Company expects that the effective tax rate for fiscal 2012 will be approximately 29 percent.

RESULTS BY BUSINESS SEGMENT

Industrial Segment

	Three months ended December 31,		Six months ended December 31,	
(dollars in millions)	**2011**	**2010**	**2011**	**2010**
Net sales				
North America	$ 1,183.4	$ 1,045.5	$ 2,388.2	$ 2,110.4
International	1,218.8	1,147.2	2,507.9	2,240.2
Operating income				
North America	195.7	159.4	419.0	348.8
International	$ 165.9	$ 167.8	$ 374.2	$ 351.6
Operating margin				
North America	16.5%			