

SUN HYDRAULICS CORP

Form 10-Q

November 05, 2008

[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

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

For the quarterly period ended September 27, 2008

Commission file number 0-21835

**SUN HYDRAULICS CORPORATION**

(Exact Name of Registration as Specified in its Charter)

**FLORIDA**  
(State or Other Jurisdiction of  
  
Incorporation or Organization)

**59-2754337**  
(I.R.S. Employer  
  
Identification No.)

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1500 WEST UNIVERSITY PARKWAY

SARASOTA, FLORIDA  
(Address of Principal Executive Offices)

34243  
(Zip Code)

941/362-1200

(Registrant's Telephone Number, Including Area Code)

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

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

Large accelerated filer ☐ Accelerated filer ☒

Non-accelerated filer ☐ 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 ☒

The Registrant had 16,657,364 shares of common stock, par value \$.001, outstanding as of October 24, 2008.

**Table of Contents**

Sun Hydraulics Corporation

INDEX

For the quarter ended September 27, 2008

	<b>Page</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
Item <b><u>Financial Statements</u></b>	
<u>Consolidated Balance Sheets as of September 27, 2008 (unaudited) and December 29, 2007</u>	3
<u>Consolidated Statements of Operations for the Three Months Ended September 27, 2008 (unaudited) and September 29, 2007 (unaudited)</u>	4
<u>Consolidated Statements of Operations for the Nine Months Ended September 27, 2008 (unaudited) and September 29, 2007 (unaudited)</u>	5
<u>Consolidated Statement of Changes in Shareholders' Equity and Comprehensive Income for the Nine Months Ended September 27, 2008 (unaudited)</u>	6
<u>Consolidated Statements of Cash Flows for the Nine months ended September 27, 2008 (unaudited) and September 29, 2007 (unaudited)</u>	7
<u>Notes to the Consolidated, Unaudited Financial Statements</u>	8
Item <b><u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	16
<u>Forward Looking Information</u>	22
Item <b><u>Quantitative and Qualitative Disclosures About Market Risk</u></b>	23
Item <b><u>Controls and Procedures</u></b>	23
<b><u>PART II. OTHER INFORMATION</u></b>	24
Item <b><u>Legal Proceedings</u></b>	24
Item <b><u>Risk Factors</u></b>	24
Item <b><u>Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	24
Item <b><u>Defaults Upon Senior Securities</u></b>	24
Item <b><u>Submission of Matters to a Vote of Security Holders</u></b>	24
Item <b><u>Other Information</u></b>	24
Item <b><u>Exhibits</u></b>	24

**Table of Contents**

## PART I: FINANCIAL INFORMATION

Item 1.

**Sun Hydraulics Corporation****Consolidated Balance Sheets**

(in thousands, except share data)

	September 27, 2008 (unaudited)	December 29, 2007
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 33,137	\$ 19,191
Restricted cash	141	146
Accounts receivable, net of allowance for doubtful accounts of \$140 and \$215	18,921	17,029
Inventories	11,505	11,421
Deferred income taxes	301	301
Other current assets	1,067	1,210
<b>Total current assets</b>	<b>65,072</b>	<b>49,298</b>
Property, plant and equipment, net	59,803	56,999
Other assets	4,366	4,483
<b>Total assets</b>	<b>\$ 129,241</b>	<b>\$ 110,780</b>
<b>Liabilities and shareholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 5,765	\$ 5,668
Accrued expenses and other liabilities	5,186	4,857
Long-term debt due within one year	240	417
Dividends payable	1,495	1,484
Income taxes payable	1,161	674
<b>Total current liabilities</b>	<b>13,847</b>	<b>13,100</b>
Long-term debt due after one year	174	284
Deferred income taxes	5,065	5,108
Other noncurrent liabilities	502	406
<b>Total liabilities</b>	<b>19,588</b>	<b>18,898</b>
<b>Commitments and contingencies</b>		
<b>Shareholders' equity:</b>		
Preferred stock, 2,000,000 shares authorized, par value \$0.001, no shares outstanding		
Common stock, 20,000,000 shares authorized, par value \$0.001, 16,613,182 and 16,493,300 shares outstanding	17	16
Capital in excess of par value	37,685	34,390
Retained earnings	69,120	51,844
Accumulated other comprehensive income	2,831	5,632
<b>Total shareholders' equity</b>	<b>109,653</b>	<b>91,882</b>

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<b>Total liabilities and shareholders equity</b>	<b>\$</b>	<b>129,241</b>	<b>\$</b>	<b>110,780</b>
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The accompanying Notes to the Consolidated, Unaudited Financial Statements are an integral part of these financial statements.

**Table of Contents****Sun Hydraulics Corporation****Consolidated Statements of Operations**

(in thousands, except per share data)

	Three months ended	
	September 27, 2008 (unaudited)	September 29, 2007 (unaudited)
<b>Net sales</b>	<b>\$ 44,771</b>	<b>\$ 41,809</b>
Cost of sales	30,033	28,485
<b>Gross profit</b>	<b>14,738</b>	<b>13,324</b>
Selling, engineering and administrative expenses	5,457	5,279
<b>Operating income</b>	<b>9,281</b>	<b>8,045</b>
Interest income, net	(233)	(120)
Foreign currency transaction gain, net	(258)	
Miscellaneous (income)/expense, net	4	(115)
<b>Income before income taxes</b>	<b>9,768</b>	<b>8,280</b>
Income tax provision	3,111	3,034
<b>Net income</b>	<b>\$ 6,657</b>	<b>\$ 5,246</b>
<b>Basic net income per common share</b>	<b>\$ 0.40</b>	<b>\$ 0.32</b>
<b>Weighted average basic shares outstanding</b>	<b>16,612</b>	<b>16,460</b>
<b>Diluted net income per common share</b>	<b>\$ 0.40</b>	<b>\$ 0.32</b>
<b>Weighted average diluted shares outstanding</b>	<b>16,642</b>	<b>16,507</b>
<b>Dividends declared per share</b>	<b>\$ 0.090</b>	<b>\$ 0.090</b>

The accompanying Notes to the Consolidated, Unaudited Financial Statements are an integral part of these financial statements.

**Table of Contents****Sun Hydraulics Corporation****Consolidated Statements of Operations**

(in thousands, except per share data)

	Nine months ended	
	September 27, 2008 (unaudited)	September 29, 2007 (unaudited)
<b>Net sales</b>	<b>\$ 145,342</b>	<b>\$ 126,085</b>
Cost of sales	94,436	84,581
<b>Gross profit</b>	<b>50,906</b>	<b>41,504</b>
Selling, engineering and administrative expenses	17,203	15,932
<b>Operating income</b>	<b>33,703</b>	<b>25,572</b>
Interest income, net	(500)	(282)
Foreign currency transaction (gain)/loss, net	(158)	2
Miscellaneous income, net	(213)	(321)
<b>Income before income taxes</b>	<b>34,574</b>	<b>26,173</b>
Income tax provision	11,319	9,169
<b>Net income</b>	<b>\$ 23,255</b>	<b>\$ 17,004</b>
<b>Basic net income per common share</b>	<b>\$ 1.40</b>	<b>\$ 1.04</b>
<b>Weighted average basic shares outstanding</b>	<b>16,589</b>	<b>16,401</b>
<b>Diluted net income per common share</b>	<b>\$ 1.40</b>	<b>\$ 1.03</b>
<b>Weighted average diluted shares outstanding</b>	<b>16,621</b>	<b>16,468</b>
<b>Dividends declared per share</b>	<b>\$ 0.360</b>	<b>\$ 0.247</b>

The accompanying Notes to the Consolidated, Unaudited Financial Statements are an integral part of these financial statements.

**Table of Contents****Sun Hydraulics Corporation****Consolidated Statement of Changes in Shareholders' Equity and Comprehensive Income (unaudited)****(in thousands)**

	Preferred shares	Preferred stock	Common shares	Common stock	Capital in excess of par value	Retained earnings	Accumulated other comprehensive income	Total
Balance, December 29, 2007		\$	16,493	\$ 16	\$ 34,390	\$ 51,844	\$ 5,632	\$ 91,882
Shares issued, stock options			17	1	87			88
Shares issued, ESPP			12		267			267
Shares issued, ESOP			89		2,255			2,255
Stock-based compensation			2		671			671
Stock option income tax benefit					15			15
Dividends declared						(5,979)		(5,979)
Comprehensive income:								
Net income						23,255		23,255
Foreign currency translation adjustments							(2,801)	(2,801)
Comprehensive income								20,454
Balance, September 27, 2008		\$	16,613	\$ 17	\$ 37,685	\$ 69,120	\$ 2,831	\$ 109,653

The accompanying Notes to the Consolidated, Unaudited Financial Statements are an integral part of this financial statement.



**Table of Contents****Sun Hydraulics Corporation****Consolidated Statements of Cash Flows**

(in thousands)

	Nine months ended	
	September 27, 2008	September 29, 2007
	(unaudited)	(unaudited)
<b>Cash flows from operating activities:</b>		
Net income	\$ 23,255	\$ 17,004
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,297	4,657
(Gain)/Loss on disposal of assets	138	(60)
Provision for deferred income taxes	(43)	78
Allowance for doubtful accounts	(75)	(39)
Stock-based compensation expense	671	542
Stock options income tax benefit	(15)	(286)
(Increase) decrease in:		
Accounts receivable	(1,817)	(4,341)
Inventories	(84)	(935)
Other current assets	143	(1,484)
Other assets	97	(271)
Increase in:		
Accounts payable	97	1,235
Accrued expenses and other liabilities	2,584	2,759
Taxes payable	502	712
Other noncurrent liabilities	96	204
Net cash provided by operating activities	30,846	19,775
<b>Cash flows from investing activities:</b>		
Capital expenditures	(9,229)	(9,448)
Proceeds from dispositions of equipment	99	76
Net cash used in investing activities	(9,130)	(9,372)
<b>Cash flows from financing activities:</b>		
Repayment of debt	(301)	(322)
Proceeds from exercise of stock options	87	267
Proceeds from stock issued	267	191
Dividends to shareholders	(5,968)	(3,684)
Stock options income tax benefit	15	286
Net cash used in financing activities	(5,900)	(3,262)
Effect of exchange rate changes on cash and cash equivalents	(1,875)	713
Net increase in cash and cash equivalents	13,941	7,854
Cash and cash equivalents, beginning of period	19,337	9,497
Cash and cash equivalents, end of period	\$ 33,278	\$ 17,351

Supplemental disclosure of cash flow information:

Cash paid:

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Interest	\$ 19	\$ 35
Income taxes	\$ 10,875	\$ 8,884
Supplemental disclosure of noncash transactions:		
Common stock issued to ESOP through accrued expenses and other liabilities	\$ 2,255	\$ 1,386
The accompanying Notes to the Consolidated, Unaudited Financial Statements are an integral part of these financial statements.		

**Table of Contents**

## SUN HYDRAULICS CORPORATION

## NOTES TO THE CONSOLIDATED, UNAUDITED FINANCIAL STATEMENTS

(Dollars in thousands except per share data)

**1. BASIS OF PRESENTATION AND SUMMARY OF BUSINESS**

Sun Hydraulics Corporation, and its wholly-owned subsidiaries and joint ventures, design, manufacture, and sell screw-in cartridge valves and manifolds used in hydraulic systems. The Company has facilities in the United States, the United Kingdom, Germany, Korea, France, China, and India. Sun Hydraulics Corporation (Sun Hydraulics), with its main offices located in Sarasota, Florida, designs, manufactures, and sells its products primarily through distributors. Sun Hydraulik Holdings Limited (Sun Holdings), a wholly-owned subsidiary of Sun Hydraulics, was formed to provide a holding company for the European market operations; its wholly-owned subsidiaries are Sun Hydraulics Limited (a British corporation, Sun Ltd.) and Sun Hydraulik GmbH (a German corporation, Sun GmbH). Sun Ltd. operates a manufacturing and distribution facility located in Coventry, England, and Sun GmbH operates a manufacturing and distribution facility located in Erkelenz, Germany. Sun Hydraulics Korea Corporation (Sun Korea), a wholly-owned subsidiary of Sun Hydraulics, located in Incheon, South Korea, operates a manufacturing and distribution facility. Sun Hydraulics, SARL (Sun France), a wholly-owned subsidiary of Sun Hydraulics, located in Bordeaux, France, operates a sales and engineering support facility. Sun Hydraulics Systems (Shanghai) Co., Ltd. (Sun China), a 50/50 joint venture between Sun Hydraulics and Links Lin, the owner of Sun Hydraulics Taiwanese distributor, is located in Shanghai, China, and operates a manufacturing and distribution facility. WhiteOak Controls, Inc. (WhiteOak), a 40% equity method investment, is located in Mediapolis, Iowa, and designs and produces complementary electronic control products. Sun Hydraulics acquired a 48% equity method investment in High Country Tek, Inc. (HCT), on November 30, 2007. HCT, located in Nevada City, California, designs and manufactures ruggedized electronic/hydraulic control solutions for mobile equipment markets. Sun Hydraulics opened a sales office in Bangalore, India during 2007 to develop new business opportunities in the Indian market.

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission for reporting on Form 10-Q. Accordingly, certain information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements are not included herein. The financial statements are prepared on a consistent basis (including normal recurring adjustments) and should be read in conjunction with the consolidated financial statements and related notes contained in the Annual Report on Form 10-K for the fiscal year ended December 29, 2007, filed by Sun Hydraulics Corporation (together with its subsidiaries, the Company) with the Securities and Exchange Commission on March 12, 2008. In Management's opinion, all adjustments necessary for a fair presentation of the Company's financial statements are reflected in the interim periods presented. Operating results for the three and nine month periods ended September 27, 2008, are not necessarily indicative of the results that may be expected for the period ending December 27, 2008.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES****Earnings per share**

The following table represents the computation of basic and diluted earnings per common share as required by Statement of Financial Accounting Standard (FAS) No. 128, *Earnings Per Share* (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
<b>Net income</b>	<b>\$ 6,657</b>	<b>\$ 5,246</b>	<b>\$ 23,255</b>	<b>\$ 17,004</b>
Weighted average basic shares outstanding	16,612	16,460	16,589	16,401
<b>Basic net income per common share</b>	<b>\$ 0.40</b>	<b>\$ 0.32</b>	<b>\$ 1.40</b>	<b>\$ 1.04</b>
Effect of dilutive stock options	30	47	32	67
Weighted average diluted shares outstanding	16,642	16,507	16,621	16,468
<b>Diluted net income per common share</b>	<b>\$ 0.40</b>	<b>\$ 0.32</b>	<b>\$ 1.40</b>	<b>\$ 1.03</b>



## Table of Contents

### 3. STOCK-BASED COMPENSATION

Effective January 1, 2006, the Company adopted the provisions of FAS No. 123R, *Share-Based Payment*, ( FAS 123R ) for its share-based compensation plans, using the modified prospective method.

During 1996, the Company adopted the 1996 Stock Option Plan ( 1996 Plan ), which provides for the grant of incentive stock options and nonqualified stock options for the purchase of up to an aggregate of 2,250,000 shares of the Company's common stock by officers, employees and directors of the Company. Under the terms of the plan, incentive stock options may be granted to employees at an exercise price per share of not less than the fair value per common share on the date of the grant (not less than 110% of the fair value in the case of holders of more than 10% of the Company's voting stock). Nonqualified stock options may be granted at the discretion of the Company's Board of Directors. The maximum term of an option may not exceed 10 years, and options become exercisable at such times and in such installments as determined by the Board of Directors.

A summary of activity under the 1996 Plan for the nine months ended September 27, 2008, is as follows:

	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Options outstanding as of December 29, 2007	36	\$ 5.62		
Granted				
Exercised	(17)	\$ 5.23		
Forfeitures				
Options outstanding as of September 27, 2008	19	\$ 5.95	2.92	\$ 391
Options exercisable as of September 27, 2008	15	\$ 4.26	2.58	\$ 334

All options listed above vest over three to five years with a maximum term of seven to ten years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model using weighted average assumptions. Stock option compensation expense for the nine months ended September 27, 2008, and September 29, 2007, was \$5 and \$30, respectively. There were no options granted during these periods.

In September 2006, the Company adopted the 2006 Stock Option Plan ( 2006 Plan ), which provides for the grant of incentive stock options and nonqualified stock options for the purchase of up to an aggregate of 750,000 shares of the Company's common stock by officers, employees and directors of the Company. The Company adopted the 2006 Plan due to the expiration of the Company's 1996 Stock Option Plan in 2006. Under the terms of the plan, incentive stock options may be granted to employees at an exercise price per share of not less than the fair value per common share on the date of the grant (not less than 110% of the fair value in the case of holders of more than 10% of the Company's voting stock). Nonqualified stock options may be granted at the discretion of the Company's Board of Directors. The maximum term of an option may not exceed 10 years, and options become exercisable at such times and in such installments as determined by the Board of Directors. No awards have been granted under the 2006 Plan.

**Table of Contents**

During 2001, the Company adopted the 2001 Restricted Stock Plan, which provides for the grant of restricted stock of up to an aggregate of 618,750 shares of the Company's common stock to officers, employees, consultants and directors of the Company. Under the terms of the plan, the minimum period before any shares become non-forfeitable may not be less than six months. Effective January 1, 2006, the Company adopted the provisions of SFAS 123R. Accordingly, compensation cost is measured at the date of the grant and is recognized in earnings over the period in which the shares vest. Restricted stock expense for the nine months ended September 27, 2008, and September 29, 2007, totaled \$527 and \$346, respectively.

The following table summarizes restricted stock activity from December 29, 2007, through September 27, 2008:

	<b>Number of shares</b>	<b>Weighted average grant-date fair value</b>
Nonvested balance at December 29, 2007	68	21.22
Granted		
Vested		
Forfeitures		
Nonvested balance at September 27, 2008	68	21.22

The Company has \$749 of total unrecognized compensation cost related to restricted stock awards granted under the Plan as of September 27, 2008. That cost is expected to be recognized over a weighted average period of 1.27 years.

During 2001, the Company adopted the Employee Stock Purchase Plan ( ESPP ), which became effective August 1, 2001. Most employees are eligible to participate. Employees who choose to participate are granted an opportunity to purchase common stock at 85 percent of market value on the first or last day of the quarterly purchase period, whichever is lower. The ESPP authorizes the issuance, and the purchase by employees, of up to 731,250 shares of common stock through payroll deductions. No employee is allowed to buy more than \$25 of common stock in any year, based on the market value of the common stock at the beginning of the purchase period. Employees purchased 11,789 shares at a weighted average price of \$22.63 and 15,027 shares at a weighted average price of \$12.73, under the ESPP during the nine months ended September 27, 2008, and September 29, 2007, respectively. In accordance with FAS 123R, the Company recognized \$76 and \$123 of compensation expense during the nine months ended September 27, 2008 and September 29, 2007, respectively. At September 27, 2008, 571,953 shares remained available to be issued through the ESPP.

The Company has a Nonemployee Director Equity and Deferred Compensation Plan (the Plan ), which originally was adopted by the Board of Directors and approved by the shareholders in 2004. The Plan was amended on March 1, 2008 and was approved by the shareholders at the 2008 Annual Meeting. Under the Plan, Directors who are not officers of the Company are paid 250 shares of Company common stock and \$3 in fees for attendance at each meeting of the Board of Directors, as well as each meeting of each Board Committee on which they serve when the committee meeting is not held within one day of a meeting of the Board of Directors. Additionally, the Board of Directors has the authority to increase from time to time, as it deems desirable or appropriate, the number of shares of stock awarded to all or any one or more of the Nonemployee Directors. No more than 25,000 shares of stock, in the aggregate, may be issued under the Plan during any single calendar year. Committee Chairmen currently receive additional fees equal to 25% of normal compensation and the Chairman of the Board is paid twice the amount of normal compensation, with such additional compensation payable in Company common stock. Previously under the Plan, Nonemployee Directors were paid \$5 of which half was paid in Company common stock.

**Table of Contents**

Directors may elect under the Plan to receive all or part of their cash fees in Company stock and to defer receipt of their fees until a subsequent year. The Plan authorizes the issuance of up to 180,000 shares of common stock.

Directors were granted 5,427 and 3,034 shares for the nine months ended September 27, 2008, and September 29, 2007, respectively. At September 27, 2008, there were 14,980 deferred stock units outstanding. Deferred stock units are treated as liabilities in accordance with FAS 123R. The Company recognized director stock compensation expense of \$161 and \$239, for the nine months ended September 27, 2008, and September 29, 2007, respectively. At September 27, 2008, 156,187 shares remained available to be issued through the Plan.

**4. RESTRICTED CASH**

The restricted cash balance at September 27, 2008, consisted of \$55 in reserves as a required deferment for customs in the U.K. operation. The restricted amount was calculated as an estimate of two months of customs for items coming into the Company's U.K. operations and is held with Lloyd's TSB in the U.K. The remaining amount of \$86 relates to a guarantee of VAT in our France operation. The guarantee is held with Cr dit Agricole Bank in France.

**5. INVENTORIES**

	<b>September 27, 2008</b>	<b>December 29, 2007</b>
Raw materials	\$ 5,416	\$ 4,577
Work in process	3,626	3,863
Finished goods	3,193	3,627
Provision for slow moving inventory	(730)	(646)
<b>Total</b>	<b>\$ 11,505</b>	<b>\$ 11,421</b>

**6. GOODWILL**

On September 27, 2008, the Company had \$715 of goodwill, related to its acquisition of Sun Korea. Goodwill is held in other assets on the balance sheet. Valuation models reflecting the expected future cash flow projections were used to value Sun Korea at December 29, 2007. The analysis indicated that there was no impairment of the carrying value of the goodwill. As of September 27, 2008, no factors were identified that indicated impairment of the carrying value of the goodwill.

**Table of Contents**

## 7. LONG-TERM DEBT

	September 27, 2008	December 29, 2007
\$35,000 revolving line of credit, collateralized by U.S. assets, interest rate variable based upon the Company's leverage ratio, due August 1, 2011.	\$	\$
\$2,400 12-year mortgage note on the German facility, fixed interest rate of 6.05%, due September 30, 2008.	90	260
10-year notes, fixed interest rates ranging from 3.5-5.1%, collateralized by equipment in Germany, due between 2009 and 2011.	324	441
	414	701
Less amounts due within one year	(240)	(417)
Total	\$ 174	\$ 284

The revolving line of credit is subject to debt covenants (capitalized terms are defined therein) including: 1) Debt to Tangible Net Worth ratio of not more than 1.5:1.0, 2) Funded Debt to EBITDA ratio of not more than 2.5:1.0, and 3) EBIT to Interest Expense ratio of not less than 1.1:1.0; and requires the Company to maintain its primary domestic deposit accounts with the Bank. As of September 27, 2008, the Company was in compliance with all debt covenants.

## 8. INCOME TAXES

In July 2006, the FASB issued FIN 48, *Accounting for Uncertainty in Income Taxes, and Related Implementation Issues* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a Company's financial statements in accordance with FASB No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Company adopted FIN 48 effective January 1, 2007. The adoption of FIN 48 did not have a material effect on the Company's Consolidated Financial Statements.

At September 27, 2008, the Company had an unrecognized tax benefit of \$34 including accrued interest. If recognized, the unrecognized tax benefit would have a favorable effect on the effective tax rate in future periods. The Company recognizes interest and penalties related to income tax matters in income tax expense. Interest related to the unrecognized tax benefit has been recognized and included in income tax expense. Interest accrued as of September 27, 2008, is not considered material to the Company's Consolidated Financial Statements.

The Company files U.S. federal income tax returns as well as income tax returns in various states and foreign jurisdictions. The Company is no longer subject to income tax examinations by tax authorities for years before 2004 for the majority of tax jurisdictions.



**Table of Contents****9. SEGMENT REPORTING**

The individual subsidiaries comprising the Company operate predominantly in a single industry as manufacturers and distributors of hydraulic components. The Company is multinational with operations in the United States, and subsidiaries in the United Kingdom, Germany, Korea, and France. Amounts for France, due to their immateriality, are included with the U.S. In computing operating profit for the foreign subsidiaries, no allocations of general corporate expenses have been made. Management bases its financial decisions by the geographical location of its operations.

Identifiable assets of the foreign subsidiaries are those assets related to the operation of those companies. United States assets consist of all other operating assets of the Company.

Segment information is as follows:

	United States	Korea	Germany	United Kingdom	Elimination	Consolidated
<b>Three Months Ended</b>						
<b>September 27, 2008</b>						
Sales to unaffiliated customers	\$ 28,810	\$ 3,854	\$ 6,746	\$ 5,361	\$	\$ 44,771
Intercompany sales	6,300		48	607	(6,955)	
Operating income	6,204	257	2,131	752	(63)	9,281
Depreciation	1,273	37	147	313		1,770
Capital expenditures	2,080	19	140	129		2,368
<b>Three Months Ended</b>						
<b>September 29, 2007</b>						
Sales to unaffiliated customers	\$ 24,770	\$ 5,244	\$ 6,033	\$ 5,762	\$	\$ 41,809
Intercompany sales	7,551		65	609	(8,225)	
Operating income	4,871	613	1,583	1,007	(29)	8,045
Depreciation	1,142	46	131	284		1,603
Capital expenditures	1,957	55	5	547		2,564
<b>Nine Months Ended</b>						
<b>September 27, 2008</b>						
Sales to unaffiliated customers	\$ 88,834	\$ 15,673	\$ 22,567	\$ 18,268	\$	\$ 145,342
Intercompany sales	24,104		191	1,811	(26,106)	
Operating income	22,779	1,332	6,858	2,860	(126)	33,703
Depreciation	3,730	125	443	979		5,277
Capital expenditures	8,492	35	289	413		9,229
<b>Nine Months Ended</b>						
<b>September 29, 2007</b>						
Sales to unaffiliated customers	\$ 74,375	\$ 15,896	\$ 18,730	\$ 17,084	\$	\$ 126,085
Intercompany sales	23,715		115	2,143	(25,973)	
Operating income	16,767	1,759	4,604	2,529	(87)	25,572
Depreciation	3,301	129	403	804		4,637
Capital expenditures	7,675	263	52	1,458		9,448

Sales to unaffiliated customers represent sales from each of the individual subsidiaries. For information on sales to geographic locations, see the Comparisons of the Three and Nine Month Periods Ended September 27, 2008, and September 29, 2007, in Management's Discussion and Analysis of Financial Condition and Results. Operating income is total sales and other operating income less operating expenses. Segment operating income does not include interest income/expense and net miscellaneous income/expense.



## **Table of Contents**

### **10. FAIR VALUE OF FINANCIAL INSTRUMENTS**

SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ), defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 establishes a three-tier fair value hierarchy which prioritizes the inputs used in measuring fair value as follows:

*Level 1.* Observable inputs such as quoted prices in active markets;

*Level 2.* Inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and

*Level 3.* Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

The Company does not have any assets or liabilities measured at fair value on a recurring basis at September 27, 2008. The Company did not have any fair value adjustments for assets and liabilities measured at fair value on a nonrecurring basis during the three and nine months ended September 27, 2008.

### **11. NEW ACCOUNTING PRONOUNCEMENTS**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 157. SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB deferred the effective date of SFAS No. 157 until the fiscal year beginning after November 15, 2008 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The partial adoption of SFAS No. 157 for financial assets and liabilities did not have a material effect on the Company's Consolidated Financial Statements. The remaining requirements of SFAS 157 are not expected to have a material effect on the Company's Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ( SFAS 141R ). SFAS 141R establishes principles and requirements for an acquiring entity to recognize and measure in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS 141R expands on required disclosures to improve the statement users' abilities to evaluate the nature and financial effects of business combinations. SFAS 141R is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 141R on its Consolidated Financial Statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51* ( SFAS 160 ). SFAS 160 requires that a noncontrolling interest in a subsidiary be reported within equity and the amount of consolidated net income attributable to the noncontrolling interest be identified in the consolidated financial statements. SFAS 160 calls for consistency in the manner of reporting changes in the parent's ownership interest and requires fair value measurement of any noncontrolling equity investment retained in a deconsolidation. SFAS No. 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 160 on its Consolidated Financial Statements.

## **Table of Contents**

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133* ( SFAS 161 ). This statement amends SFAS No. 133 by requiring enhanced disclosures about an entity's derivative instruments and hedging activities, but does not change SFAS No. 133's scope or accounting. SFAS 161 requires increased qualitative, quantitative and credit-risk disclosures about the entity's derivative instruments and hedging activities. SFAS 161 is effective for fiscal years, and interim periods within those fiscal years, beginning after November 15, 2008, with earlier adoption permitted. The adoption of SFAS 161 is not expected to have a material impact on the Company's Consolidated Financial Statements.

In April 2008, The FASB issued FASB Staff Position ( FSP ) 142-3, *Determination of the Useful Life of Intangible Assets* ( FSP 142-3 ), which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets*. ( SFAS 142 ) The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under FASB Statement No. 141 (revised 2007), *Business Combinations*, and other U.S. generally accepted accounting principles (GAAP). FSP 142-3 is effective for fiscal years beginning after December 15, 2008. The adoption of FSP 142-3 is not expected to have a material impact on the Company's Consolidated Financial Statements.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* ( SFAS 162 ). This Statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). This Statement is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. The adoption of SFAS 162 is not expected to have a material impact on the Company's Consolidated Financial Statements.

In June 2008, the FASB issued FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*, which addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share (EPS) under the two-class method described in paragraphs 60 and 61 of FASB Statement No. 128, *Earnings per Share*. FSP EITF 03-6-1 is effective for fiscal years beginning after December 15, 2008, and interim periods within those years. The adoption of FSP EITF 03-6-1 is not expected to have a material impact on the Company's Consolidated Financial Statements.

## **12. COMMITMENTS AND CONTINGENCIES**

The Company is not a party to any legal proceedings other than routine litigation incidental to its business. In the opinion of management, the amount of ultimate liability with respect to these actions will not materially affect the results of operations, financial position or cash flows of the Company.

## **Table of Contents**

### **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS OVERVIEW**

Sun Hydraulics Corporation is a leading designer and manufacturer of high-performance screw-in hydraulic cartridge valves and manifolds, which control force, speed and motion as integral components in fluid power systems. The Company sells its products globally through wholly-owned subsidiaries and independent distributors. Sales outside the United States for the year ended December 29, 2007, were approximately 58% of total net sales.

Approximately 66% of product sales are used by the mobile market, which is characterized by applications where the equipment is not fixed in place, the operating environment is often unpredictable, and duty cycles are generally moderate to low. Some examples of mobile equipment include off-road construction equipment, fire and rescue equipment and mining machinery.

The remaining 34% of sales are used by industrial markets, which are characterized by equipment that is fixed in place, typically in a controlled environment, and which operates at higher pressures and duty cycles. Automation machinery, metal cutting machine tools and plastics machinery are some examples of industrial equipment. The Company sells to both markets with a single product line.

#### ***Company Focus***

In recent years, the Company has realized robust growth in all areas of the world. Management believes there are five key reasons why:

Product availability and on-time delivery performance,

New products, especially electrically actuated products,

Increased sales of integrated packages,

Our geographic presence, and

Our website.

The company is continuously engaged in efforts to improve productivity to enhance productive capacity and be in the best position to be able to respond to marketplace demand. Company engineering and manufacturing personnel redesign existing products, where necessary, to improve manufacturability. New product design efforts include personnel from engineering, manufacturing and marketing to help reduce the time and effort required to release products to the market. These on-going activities enable the Company to maintain a level of delivery performance and shipping reliability that it believes differentiates it from its competitors.

The Company continues to add to its electrically actuated hydraulic valve offerings with new products, including different types of solenoid and proportional valves and valves with position sensing devices. Electrically actuated cartridges help create new system opportunities as they enable the Company to offer complete integrated valve packages which could not be offered previously. The addition of electrically actuated hydraulic products allows integrated packages to be designed with 100% Sun content. In addition to electrically-actuated products, the Company routinely adds other new complementary products to its cartridge valve and manifold portfolio.

The Company has wholly-owned companies in North America, Europe and the Far East, augmented by what management believes to be the finest distribution network in the fluid power industry. In 2007, the Company opened a sales office in Bangalore, India. The Company's distributors are particularly skilled in applying products and developing integrated solutions for their local market. Through its wholly-owned companies and global distribution network, the Company is able to service all major industrialized market areas.



**Table of Contents**

The Company's major marketing tool is its website, [www.sunhydraulics.com](http://www.sunhydraulics.com). The Company's website is developed to appeal to and be used by design engineers. It provides all the detailed technical information and specifications to select, apply and obtain Sun products, 24 hours a day, seven days a week. The website continues to evolve by adding greater levels of detail in technical information and configuration capability.

**Industry conditions**

Demand for the Company's products is dependent on demand for the capital goods into which the products are incorporated. The capital goods industries in general, and the fluid power industry specifically, are subject to economic cycles. According to the National Fluid Power Association (the fluid power industry's trade association in the United States), the United States index of shipments of hydraulic products increased 1% and 9% in 2007 and 2006, respectively. The index of shipments of hydraulic products increased 11% for the three months period ending September 2008, compared to the same period of the prior year.

The Company's order trend has historically tracked closely to the United States Purchasing Managers Index (PMI). The index decreased to 43.5 in September 2008 compared to 52.0 in September 2007. In October 2008, the index decreased to 38.9. When PMI is over 50, it indicates economic expansion; when it is below 50, it indicates contraction in the economy.

**Results for the third quarter**

(Dollars in millions except net income per share)

	September 27, 2008	September 29, 2007	Increase
<b>Three Months Ended</b>			
Net Sales	\$ 44.8	\$ 41.8	7%
Net Income	\$ 6.7	\$ 5.2	29%
Net Income per share:			
Basic	\$ 0.40	\$ 0.32	25%
Diluted	\$ 0.40	\$ 0.32	25%
<b>Nine Months Ended</b>			
Net Sales	\$ 145.3	\$ 126.1	15%
Net Income	\$ 23.3	\$ 17.0	37%
Net Income per share:			
Basic	\$ 1.40	\$ 1.04	35%
Fully Diluted	\$ 1.40	\$ 1.03	36%

For the third quarter, Sun Hydraulics had moderate growth in sales and a significant increase in earnings. The Company's business, which is slowing in the fourth quarter, is cyclical and it is in the down slope of the cycle. The length of the downturn is outside of management's vision. However, the Company's focus remains on creating opportunities for long-term profitable growth.

Sun Hydraulics has a strong balance sheet, the right products for the marketplace and an agile workforce. Management will continue to do the things it has always done to ensure the Company is poised to take full advantage of the cyclical upturn when it occurs. Management believes the Company's ability to deliver product reliably throughout this cycle is at the heart of its market share gains and remains a primary focus.

## **Table of Contents**

### ***Outlook***

Fourth quarter 2008 sales are estimated to be approximately \$34 million and earnings per share are estimated to be in the range of \$0.20 to \$0.22. This would represent a decrease of approximately 18% in sales and 32% in earnings per share over the same period last year.

Year-end 2008 sales are estimated to be approximately \$180 million, an 8% increase compared to 2007. Earnings per share for 2008 are estimated to be between \$1.60 and \$1.62, up approximately 20% over last year.

## **COMPARISON OF THE THREE MONTHS ENDED SEPTEMBER 27, 2008 AND SEPTEMBER 29, 2007**

### ***Net Sales***

Net sales were \$44.8 million, an increase of \$3.0 million, or 7.1%, compared to \$41.8 million in 2007. The increase was due to the continued growth of sales in Europe and North America.

North American sales increased 8.8%, or \$1.7 million, to \$21.0 million.

European sales increased 11.9%, or \$1.6 million, to \$15.0 million. Sales to Germany increased 13.6% and to France 3.6%, while sales to U.K. decreased 9.5%. Significant increases were also noted in Austria, Italy and Scandinavia.

Asian sales decreased 6.3%, or \$0.5 million, to \$7.4 million. Sales to China increased 60.2%, while domestic sales in Korea decreased 26.5%. Business activity in Asia remained strong with the exception of a significant slowdown in sales to a single Korean customer that supplies products to a U.S. mobile equipment manufacturer.

### ***Gross Profit***

Gross profit increased \$1.4 million, or 10.6%, to \$14.7 million. Gross profit as a percentage of net sales increased to 32.9% in the third quarter of 2008, compared to 31.9% in the third quarter last year. Increases in gross profit were primarily due to fixed cost absorption from higher sales volume, productivity improvements in the U.S., and lower employee benefit expenses.

### ***Selling, Engineering and Administrative Expenses***

Selling, engineering and administrative expenses increased 3.4%, or \$0.2 million, to \$5.5 million compared to the same quarter last year. The change is primarily a result of increases in compensation and fringe benefit costs, R&D costs, and professional fees related to the R&D tax credit study. These amounts were partially offset by decreases in building maintenance.

### ***Interest Income, Net***

Net interest income was \$0.2 million for the quarter ended September 27, 2008, compared to \$0.1 million for the quarter ended September 29, 2007. Total average debt for the quarter ended September 27, 2008, was \$0.5 million compared to \$0.8 million for the quarter ended September 29, 2007. Total average cash for the quarter ended September 27, 2008, was \$30.7 million compared to \$15.5 million for the quarter ended September 29, 2007. The Company did not have any outstanding variable debt during the period ended September 27, 2008.

### ***Foreign Currency Transaction Gain, Net***

There was a net foreign currency transaction gain of \$0.3 million for the quarter ended September 27, 2008. There was no currency effect on the prior year quarter. The gain is primarily related to the strengthening of the U.S. Dollar against the British Pound, and the revaluation of Sun Ltd. balance sheet items, which were held in U.S. Dollars.



## **Table of Contents**

### ***Miscellaneous (Income)/Expense, Net***

There was a minimal net miscellaneous expense for the quarter ended September 27, 2008, compared to net miscellaneous income of \$0.1 for the quarter ended September 29, 2007. Net miscellaneous (income)/expense is primarily the result of earnings from joint ventures.

### ***Income Taxes***

The provision for income taxes for the quarter ended September 27, 2008, was 31.8% of pretax income compared to 36.6% for the quarter ended September 29, 2007. The change was primarily due to the relative levels of income and different tax rates in effect among the countries in which the Company sells its products and the decrease in the German Statutory tax rate. The 2008 third quarter provision includes tax expense of \$0.8 million related to the repatriation of cash from the German subsidiary and a tax benefit of \$0.9 million for R&D tax credits for the years 2004 through 2007.

## **COMPARISON OF THE NINE MONTHS ENDED SEPTEMBER 27, 2008 AND SEPTEMBER 29, 2007**

### ***Net Sales***

Net sales were \$145.3 million, an increase of \$19.3 million, or 15.3%. This increase reflected strong demand in Europe, Asia, and the United States throughout the first half of 2008. Moderate growth continued in the third quarter.

European sales increased 19.2%, or \$7.9 million, to \$49.0 million. Sales to Germany increased 20.5%, to the U.K. 8.2%, and to France 5.5%. Significant increases were also noted in Austria, Italy, Scandinavia, and the Netherlands.

Asian sales increased 18.0%, or \$4.1 million, to \$26.9 million. Domestic sales in Korea decreased 1.4%, while sales to China increased 122.8%. Asian sales were strong with significant increases noted in Singapore, United Arab Emirates, and India, in addition to China. The decrease in Korea relates to a significant slowdown in sales to a single customer that supplies products to a U.S. mobile equipment manufacturer.

North American sales increased 11.2%, or \$6.6 million, to \$65.8 million.

### ***Gross Profit***

Gross profit increased 22.7%, or \$9.4 million. Gross profit as a percentage of net sales increased to 35.0% from 32.9% last year. Increases in gross profit were primarily due to fixed cost absorption from higher sales volume, productivity improvements in the U.S., and lower material costs in the German operation due to the strength of local currencies against the U.S. dollar for material purchases made in U.S. dollars throughout the first half of 2008.

### ***Selling, Engineering, and Administrative Expenses***

Selling, engineering and administrative expenses increased 8.0%, or \$1.3 million, to \$17.2 million compared to last year. The change is primarily a result of increases in compensation and fringe benefit costs, including pension expense and group health insurance.

### ***Interest Income, Net***

Net interest income for the nine months ended September 27, 2008, was \$0.5 million compared to \$0.3 for the nine months ended September 29, 2007. Total average debt for the period ended September 27,

## **Table of Contents**

2008, was \$0.6 million compared to \$0.9 million for the period ended September 29, 2007. Total average cash for the period ended September 27, 2008, was \$26.3 million compared to \$13.4 million for the period ended September 29, 2007. The Company did not have any outstanding variable debt during the period ended September 27, 2008.

### ***Foreign Currency Transaction (Gain)/Loss, Net***

There was a net foreign currency transaction gain of \$0.2 million for the nine months ended September 27, 2008, compared to a minimal impact from foreign currency transactions during the nine months ended September 29, 2007. While the Euro, the Korean Won and the British Pound weakened against the U.S. Dollar, the UK operations experienced gains related to sales conducted in U.S. dollars and from the revaluation of Sun Ltd. balance sheet items, which were held in U.S. dollars.

### ***Miscellaneous Income, Net***

Miscellaneous income was \$0.2 for the nine months ended September 27, 2008, compared to \$0.3 for the nine months ended September 29, 2007. The current year income was primarily a result of proceeds from an insurance claim and equity earnings. These amounts were partially offset by a loss on disposal of assets.

### ***Income Taxes***

The provision for income taxes for the nine months ended September 27, 2008, was 32.7% of pretax income compared to 35.0% for the nine months ended September 29, 2007. The change was primarily due to the relative levels of income and different tax rates in effect among the countries in which the Company sells its products and the decrease in the German Statutory tax rate. The 2008 provision includes tax expense of \$0.8 million related to the repatriation of cash from the German subsidiary and a tax benefit of \$0.9 million for R&D tax credits for the years 2004 through 2007.

## **LIQUIDITY AND CAPITAL RESOURCES**

Historically, the Company's primary source of capital has been cash generated from operations, although fluctuations in working capital requirements have from time to time been met through borrowings under revolving lines of credit. The Company's principal uses of cash have been to pay operating expenses, make capital expenditures, pay dividends to shareholders, repurchase Company common stock and service debt.

Cash from operations for the nine months ended September 27, 2008, was \$30.8 million, compared to \$19.8 million for the nine months ended September 29, 2007. The \$11.1 million increase in the Company's net cash flow from operations during the period was due primarily to the increase in net income, offset by changes in working capital. A decrease in other current assets and a smaller increase in accounts receivable and inventory added to operational cash flows. These amounts were partially offset by a smaller increase in accounts payable. Days sales outstanding (DSO) were 38 and 40 at September 27, 2008, and September 29, 2007, respectively. Inventory turns increased to 10.4 as of September 27, 2008, compared to 10.1 as of September 29, 2007.

Capital expenditures, consisting primarily of purchases of machinery and equipment, were \$6.7 million for the nine months ended September 27, 2008, compared to \$9.4 million for the nine months ended September 29, 2007. Also included in capital expenditures for the nine months ended September 27, 2008, is the purchase of land for \$2.5 million. Capital expenditures for the year are projected to be approximately \$12.0 million.

The Company declared a quarterly dividend of \$0.09 per share to shareholders of record as of September 30, 2008, payable on October 15, 2008. The declaration and payment of future dividends is subject to the sole discretion of the Board of Directors, and any determination as to the payment of future dividends will depend upon the Company's profitability, financial condition, capital needs, future prospects and other factors deemed pertinent by the Board of Directors.

## **Table of Contents**

The Company believes that cash generated from operations and its borrowing availability under its revolving Line of Credit will be sufficient to satisfy the Company's operating expenses and capital expenditures for the foreseeable future. In the event that economic conditions were to severely worsen for a protracted period of time, the Company would have several options available to ensure liquidity in addition to increased borrowing. Capital expenditures could be postponed since they primarily pertain to long-term improvements in operations. Additional operating expense reductions also could be made. Finally, the dividend to shareholders could be reduced or suspended.

### ***Off Balance Sheet Arrangements***

The Company uses the equity method of accounting to account for its investments in Sun China, WhiteOak and High Country Tek. The Company does not have a majority ownership in or exercise control over any of these entities. The Company does not believe that its investments in Sun China, WhiteOak, or High Country Tek qualify as Variable Interest Entities, within the scope of FASB Interpretation (FIN) No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003)*, an interpretation of ARB No. 51, nor are they material to the financial statements of the Company at September 27, 2008.

### ***Seasonality***

The Company generally has experienced increased sales during the second quarter of the year, largely as a result of the order patterns of our customers. As a result, the Company's second quarter net sales, income from operations and net income historically are the highest of any quarter during the year.

### ***Inflation***

The impact of inflation on the Company's operating results has been moderate in recent years. While inflation has not had, and the Company does not expect that it will have, a material impact upon operating results, there is no assurance that the Company's business will not be affected by inflation in the future.

### ***Critical Accounting Policies and Estimates***

The Company currently applies judgment and estimates which may have a material effect on the eventual outcome of assets, liabilities, revenues and expenses for impairment of long-lived assets, accounts receivable, inventory, goodwill and accruals. The following explains the basis and the procedure for each account where judgment and estimates are applied.

#### ***Revenue Recognition***

The Company reports revenues, net of sales incentives, when title passes and risk of loss transfers to the customer. The effect of material non-recurring events is provided for when they become known.

#### ***Impairment of Long-Lived Assets***

In accordance with Statement of Financial Accounting Standards ( FAS ) No. 144, *Accounting for Impairment or Disposal of Long-lived Assets* ( FAS 144 ), long-lived assets, such as property and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the asset is measured by comparison of its carrying amount to future net cash flows the asset is expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the asset exceeds its fair market value.

The Company assesses the recoverability of goodwill and intangible assets not subject to amortization under FAS No. 142, *Goodwill and Other Intangible Assets* ( FAS 142 ). See Goodwill below.

## **Table of Contents**

### *Accounts Receivable*

The Company sells to most of its customers on a recurring basis, primarily through distributors with which the Company maintains long-term relationships. As a result, bad debt experience has not been material. The allowance for doubtful accounts is determined on a specific identification basis by a review of those accounts that are significantly in arrears. There can be no assurance that a distributor or a large direct sale customer with overdue accounts receivable balances will not develop financial difficulties and default on payment. See balance sheet for allowance amounts.

### *Inventory*

The Company offers a wide variety of standard products and as a matter of policy does not discontinue products. On an ongoing basis, component parts found to be obsolete through design or process changes are disposed of and charged to material cost. The Company reviews on-hand balances of products and component parts against specific criteria. Products and component parts without usage or that have excess quantities on hand are evaluated. An inventory reserve is then established for the full inventory carrying value of those products and component parts deemed to be obsolete or slow moving. See Note 5 for inventory reserve amounts.

### *Goodwill*

The Company acquired its Korean operations in September 1998 using the purchase method. As a result, goodwill is reflected on the consolidated balance sheet. A valuation based on the cash flow method was performed at December 29, 2007. It was determined that the value of the goodwill was not impaired. There is no assurance that the value of the acquired company will not decrease in the future due to changing business conditions. See Note 6 for goodwill amounts.

### *Accruals*

The Company makes estimates related to certain employee benefits and miscellaneous accruals. Estimates for employee benefit accruals are based on information received from plan administrators in conjunction with management's assessments of estimated liabilities related to workers compensation, health care benefits and annual contributions to an employee stock ownership plan, established in 2004 as part of the Company's retirement plan. Estimates for miscellaneous accruals are based on management's assessment of estimated liabilities for costs incurred.

## **FORWARD-LOOKING INFORMATION**

*Certain oral statements made by management from time to time and certain statements contained herein that are not historical facts are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and, because such statements involve risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements.*

*Forward-looking statements, including those in Management's Discussion and Analysis of Financial Condition and Results of Operations, are statements regarding the intent, belief or current expectations, estimates or projections of the Company, its Directors or its Officers about the Company and the industry in which it operates, and assumptions made by management, and include among other items, (i) the Company's strategies regarding growth, including its intention to develop new products; (ii) the Company's financing plans; (iii) trends affecting the Company's financial condition or results of operations; (iv) the Company's ability to continue to control costs and to meet its liquidity and other financing needs; (v) the declaration and payment of dividends; and (vi) the Company's ability to respond to changes in customer demand domestically and internationally, including as a result of standardization. Although the Company believes that its expectations are based on reasonable assumptions, it can give no assurance that the anticipated results will occur.*

*Important factors that could cause the actual results to differ materially from those in the forward-looking statements include, among other items, (i) the economic cyclicity of the capital goods industry in general and the hydraulic valve and manifold industry in particular, which directly affect customer orders, lead times and sales volume; (ii) conditions in the capital markets, including the interest rate environment and*

## **Table of Contents**

*the availability of capital; (iii) changes in the competitive marketplace that could affect the Company's revenue and/or cost bases, such as increased competition, lack of qualified engineering, marketing, management or other personnel, and increased labor and raw materials costs; (iv) changes in technology or customer requirements, such as standardization of the cavity into which screw-in cartridge valves must fit, which could render the Company's products or technologies noncompetitive or obsolete; (v) new product introductions, product sales mix and the geographic mix of sales nationally and internationally; and (vi) changes relating to the Company's international sales, including changes in regulatory requirements or tariffs, trade or currency restrictions, fluctuations in exchange rates, and tax and collection issues. Further information relating to factors that could cause actual results to differ from those anticipated is included but not limited to information under the headings Item 1. Business, and Item 1A. Risk Factors in the Company's Form 10-K for the year ended December 29, 2007, and Management's Discussion and Analysis of Financial Conditions and Results of Operations in this Form 10-Q for the quarter ended September 27, 2008. The Company disclaims any intention or obligation to update or revise forward-looking statements, whether as a result of new information, future events or otherwise.*

### **Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company is exposed to market risk from changes in interest rates on borrowed funds, which could affect its results of operations and financial condition. The Company's interest rate on its debt financing remains variable based upon the Company's leverage ratio. The Company had no variable-rate debt outstanding at September 27, 2008.

The Company's exposure to foreign currency exchange fluctuations relates primarily to the direct investment in its facilities in the United Kingdom, Germany and Korea. The Company does not use financial instruments to hedge foreign currency exchange rate changes.

### **Item 4. CONTROLS AND PROCEDURES**

As of September 27, 2008, the Company's management, under the direction of its Chief Executive Officer and the Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of the disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Our disclosure controls and procedures are designed to provide reasonable assurance that the information required to be disclosed in our SEC reports is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms, and is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Based upon that evaluation, the Company's Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level as of September 27, 2008, in timely alerting them to material information required to be included in the Company's periodic SEC filings.

There were no significant changes in the Company's internal controls over financial reporting during the period ended September 27, 2008, that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents**

PART II

OTHER INFORMATION

Item 1. Legal Proceedings.  
None.

Item 1A. Risk Factors.  
For information regarding risk factors, please refer to Part I, Item 1A in the Company's Annual Report on Form 10-K for the year ended December 29, 2007.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.  
None.

Item 3. Defaults Upon Senior Securities.  
None.

Item 4. Submission of Matters to a Vote of Security Holders.  
None.

Item 5. Other Information.  
None.

Item 6. Exhibits.  
Exhibits:

Exhibit Number	Exhibit Description
31.1	CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	CEO Certification pursuant to 18 U.S.C. § 1350.
32.2	CFO Certification pursuant to 18 U.S.C. § 1350.

**Table of Contents**

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Sarasota, State of Florida on November 5, 2008.

SUN HYDRAULICS CORPORATION

By: /s/ Tricia L. Fulton  
Tricia L. Fulton  
Chief Financial Officer (Principal Financial and  
Accounting Officer)