

SUN HYDRAULICS CORP
Form 10-Q
November 04, 2009
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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 26, 2009

Commission file number 0-21835

SUN HYDRAULICS CORPORATION

(Exact Name of Registration as Specified in its Charter)

FLORIDA

59-2754337

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(State or Other Jurisdiction of

(I.R.S. Employer

Incorporation or Organization)

Identification No.)

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 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 (§ 229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "accelerated filer," "large 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 16,932,383 shares of common stock, par value \$.001, outstanding as of October 23, 2009.

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Sun Hydraulics Corporation

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For the quarter ended September 26, 2009

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Table of Contents**PART I: FINANCIAL INFORMATION****Item 1.****Sun Hydraulics Corporation****Consolidated Balance Sheets****(in thousands, except share data)**

| | September 26, 2009 (unaudited) | December 27, 2008 |
|---|---|--------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 30,109 | \$ 35,176 |
| Restricted cash | 134 | 127 |
| Accounts receivable, net of allowance for doubtful accounts of \$75 and \$92 | 10,719 | 12,502 |
| Inventories | 8,097 | 9,960 |
| Income taxes receivable | 1,673 | 1,353 |
| Deferred income taxes | 259 | 259 |
| Marketable securities | 5,158 | |
| Other current assets | 1,321 | 1,290 |
| Total current assets | 57,470 | 60,667 |
| Property, plant and equipment, net | 57,790 | 57,726 |
| Marketable securities | 2,308 | |
| Other assets | 3,515 | 3,992 |
| Total assets | \$ 121,083 | \$ 122,385 |
| Liabilities and shareholders' equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 3,529 | \$ 3,258 |
| Accrued expenses and other liabilities | 3,307 | 5,546 |
| Long-term debt due within one year | | 147 |
| Dividends payable | 1,520 | 1,499 |
| Total current liabilities | 8,356 | 10,450 |
| Long-term debt due after one year | | 125 |
| Deferred income taxes | 4,896 | 4,871 |
| Other noncurrent liabilities | 536 | 383 |
| Total liabilities | 13,788 | 15,829 |
| Commitments and contingencies | | |
| Shareholders' equity: | | |
| 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, 16,885,578 and 16,658,271 shares outstanding | 17 | 17 |
| Capital in excess of par value | 41,841 | 38,042 |

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| | | |
|---|-------------------|-------------------|
| Retained earnings | 64,623 | 70,099 |
| Accumulated other comprehensive income | 814 | (1,602) |
| Total shareholders' equity | 107,295 | 106,556 |
| Total liabilities and shareholders' equity | \$ 121,083 | \$ 122,385 |

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

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Sun Hydraulics Corporation
Consolidated Statements of Operations
(in thousands, except per share data)

| | September 26, 2009 (unaudited) | Three months ended September 27, 2008 (unaudited) |
|--|-----------------------------------|---|
| Net sales | \$ 23,316 | \$ 44,771 |
| Cost of sales | 17,965 | 30,033 |
| Gross profit | 5,351 | 14,738 |
| Selling, engineering and administrative expenses | 4,928 | 5,457 |
| Operating income | 423 | 9,281 |
| Interest income, net | (146) | (233) |
| Foreign currency transaction gain, net | (88) | (258) |
| Miscellaneous expense, net | 87 | 4 |
| Income before income taxes | 570 | 9,768 |
| Income tax provision | 16 | 3,111 |
| Net income | \$ 554 | \$ 6,657 |
| Basic net income per common share | \$ 0.03 | \$ 0.40 |
| Weighted average basic shares outstanding | 16,883 | 16,612 |
| Diluted net income per common share | \$ 0.03 | \$ 0.40 |
| Weighted average diluted shares outstanding | 16,917 | 16,642 |
| Dividends declared per share | \$ 0.090 | \$ 0.090 |

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

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Sun Hydraulics Corporation
Consolidated Statements of Operations
(in thousands, except per share data)

| | September 26, 2009 (unaudited) | Nine months ended September 27, 2008 (unaudited) |
|--|-----------------------------------|--|
| Net sales | \$ 70,131 | \$ 145,342 |
| Cost of sales | 54,968 | 94,436 |
| Gross profit | 15,163 | 50,906 |
| Selling, engineering and administrative expenses | 14,570 | 17,203 |
| Operating income | 593 | 33,703 |
| Interest income, net | (427) | (500) |
| Foreign currency transaction (gain) loss, net | 243 | (158) |
| Miscellaneous (income) expense, net | 387 | (213) |
| Income before income taxes | 390 | 34,574 |
| Income tax (benefit) provision | (179) | 11,319 |
| Net income | \$ 569 | \$ 23,255 |
| Basic net income per common share | \$ 0.03 | \$ 1.40 |
| Weighted average basic shares outstanding | 16,806 | 16,589 |
| Diluted net income per common share | \$ 0.03 | \$ 1.40 |
| Weighted average diluted shares outstanding | 16,837 | 16,621 |
| Dividends declared per share | \$ 0.360 | \$ 0.360 |

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 27, 2008 | | \$ | 16,658 | \$ 17 | \$ 38,042 | \$ 70,099 | \$ (1,602) | \$ 106,556 |
| Shares issued, stock options | | | 2 | | 7 | | | 7 |
| Shares issued, ESPP | | | 23 | | 310 | | | 310 |
| Stock-based compensation | | | 3 | | 686 | | | 686 |
| Shares issued, restricted stock | | | 1 | | 14 | | | 14 |
| Shares issued, ESOP | | | 199 | | 2,782 | | | 2,782 |
| Dividends declared | | | | | | (6,045) | | (6,045) |
| Comprehensive income: | | | | | | | | |
| Net income | | | | | | 569 | | 569 |
| Foreign currency translation adjustments | | | | | | | 2,418 | 2,418 |
| Unrealized loss on available-for-sale securities | | | | | | | (2) | (2) |
| Comprehensive income | | | | | | | | 2,985 |
| Balance, September 26, 2009 | | \$ | 16,886 | \$ 17 | \$ 41,841 | \$ 64,623 | \$ 814 | \$ 107,295 |

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 26, 2009 (unaudited) | September 27, 2008 (unaudited) |
| Cash flows from operating activities: | | |
| Net income | \$ 569 | \$ 23,255 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 5,269 | 5,297 |
| Loss on disposal of assets | 17 | 138 |
| Provision for deferred income taxes | 25 | (43) |
| Allowance for doubtful accounts | (17) | (75) |
| Stock-based compensation expense | 686 | 671 |
| Stock options income tax benefit | | (15) |
| (Increase) decrease in: | | |
| Accounts receivable | 1,800 | (1,817) |
| Inventories | 1,863 | (84) |
| Income taxes receivable | (320) | |
| Other current assets | (31) | 143 |
| Other assets | 457 | 97 |
| Increase in: | | |
| Accounts payable | 271 | 97 |
| Accrued expenses and other liabilities | 558 | 2,584 |
| Taxes payable | | 502 |
| Other noncurrent liabilities | 153 | 96 |
| Net cash provided by operating activities | 11,300 | 30,846 |
| Cash flows from investing activities: | | |
| Capital expenditures | (4,549) | (9,229) |
| Proceeds from dispositions of equipment | | 99 |
| Purchases of marketable securities | (8,928) | |
| Proceeds from sale of marketable securities | 1,451 | |
| Net cash used in investing activities | (12,026) | (9,130) |
| Cash flows from financing activities: | | |
| Repayment of debt | (261) | (301) |
| Proceeds from exercise of stock options | 7 | 87 |
| Proceeds from stock issued | 310 | 267 |
| Dividends to shareholders | (6,024) | (5,968) |
| Stock options income tax benefit | | 15 |
| Net cash used in financing activities | (5,968) | (5,900) |
| Effect of exchange rate changes on cash and cash equivalents | 1,634 | (1,875) |
| Net increase (decrease) in cash and cash equivalents | (5,060) | 13,941 |
| Cash and cash equivalents, beginning of period | 35,303 | 19,337 |

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| | | |
|--|-----------|-----------|
| Cash and cash equivalents, end of period | \$ 30,243 | \$ 33,278 |
|--|-----------|-----------|

Supplemental disclosure of cash flow information:

Cash paid:

| | | |
|--------------|--------|-----------|
| Interest | \$ 9 | \$ 19 |
| Income taxes | \$ 116 | \$ 10,875 |

Supplemental disclosure of noncash transactions:

| | | |
|--|----------|----------|
| Common stock issued to ESOP through accrued expenses and other liabilities | \$ 2,797 | \$ 2,255 |
|--|----------|----------|

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. High Country Tek, Inc. (HCT), a 48% equity method investment, is located in Nevada City, California, and designs and manufactures ruggedized electronic/hydraulic control solutions for mobile equipment markets. Sun Hydraulics also has a sales office in Bangalore, India, 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 27, 2008, filed by Sun Hydraulics Corporation (together with its subsidiaries, the Company) with the Securities and Exchange Commission on March 11, 2009. 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 nine month period ended September 26, 2009, are not necessarily indicative of the results that may be expected for the period ending January 2, 2010.

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

The following table represents the computation of basic and diluted earnings per common share (in thousands, except per share data):

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|--------------------|--------------------|--------------------|
| | September 26, 2009 | September 27, 2008 | September 26, 2009 | September 27, 2008 |
| Net income | \$ 554 | \$ 6,657 | \$ 569 | \$ 23,255 |
| Weighted average basic shares outstanding | 16,883 | 16,612 | 16,806 | 16,589 |
| Basic net income per common share | \$ 0.03 | \$ 0.40 | \$ 0.03 | \$ 1.40 |
| Effect of dilutive stock options | 34 | 30 | 31 | 32 |
| Weighted average diluted shares outstanding | 16,917 | 16,642 | 16,837 | 16,621 |
| Diluted net income per common share | \$ 0.03 | \$ 0.40 | \$ 0.03 | \$ 1.40 |

Table of Contents**SUN HYDRAULICS CORPORATION****NOTES TO THE CONSOLIDATED, UNAUDITED FINANCIAL STATEMENTS (Continued)****(Dollars in thousands except per share data)****3. STOCK-BASED COMPENSATION**

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 26, 2009, 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 27, 2008 | 19 | \$ 5.95 | | |
| Granted | | | | |
| Exercised | (2) | \$ 3.00 | | |
| Forfeitures | | | | |
| Options outstanding as of September 26, 2009 | 17 | \$ 6.34 | 2.03 | \$ 257 |
| Options exercisable as of September 26, 2009 | 14 | \$ 5.22 | 1.81 | \$ 232 |

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 both of the nine month periods ended September 26, 2009, and September 27, 2008, was \$5. 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**SUN HYDRAULICS CORPORATION****NOTES TO THE CONSOLIDATED, UNAUDITED FINANCIAL STATEMENTS (Continued)****(Dollars in thousands except per share data)**

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. 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 26, 2009, and September 27, 2008, totaled \$582 and \$527, respectively.

The following table summarizes restricted stock activity from December 27, 2008, through September 26, 2009:

| | Number of shares | Weighted average grant-date fair value |
|---|-----------------------------|---|
| Nonvested balance at December 27, 2008 | 73 | 21.45 |
| Granted | 1 | 16.39 |
| Vested | | |
| Forfeitures | | |
| Nonvested balance at September 26, 2009 | 74 | 21.39 |

The Company has \$728 of total unrecognized compensation cost related to restricted stock awards granted under the Plan as of September 26, 2009. That cost is expected to be recognized over a weighted average period of .94 years.

The Company maintains an Employee Stock Purchase Plan (ESPP), in which most employees are eligible to participate. Employees in the United States 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. Employees in the United Kingdom are granted an opportunity to purchase common stock at market value, on the first or last day of the quarterly purchase period, whichever is lower, with the Company issuing one additional free share of common stock for each six shares purchased by the employee under the ESPP. The ESPP authorizes the issuance, and the purchase by employees, of up to 731,250 shares of common stock through payroll deductions. No U.S. 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, and no U.K. employee is allowed to buy more than the lesser of £1.5 or 10% of their annual salary in any year. Employees purchased 22,270 shares at a weighted average price of \$13.92, and 11,789 shares at a weighted average price of \$22.63, under the ESPP during the nine months ended September 26, 2009, and September 27, 2008, respectively. The Company recognized \$55 and \$76 of compensation expense during the nine months ended September 26, 2009, and September 27, 2008, respectively. At September 26, 2009, 545,501 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 cash 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. Prior to June 2, 2008, under the Plan Nonemployee Directors were paid \$5 of which half was paid in Company common stock.

Table of Contents**SUN HYDRAULICS CORPORATION****NOTES TO THE CONSOLIDATED, UNAUDITED FINANCIAL STATEMENTS (Continued)****(Dollars in thousands except per share data)**

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. When so deferred, the shares of stock are converted to deferred stock units. Deferred stock units are treated as liabilities. At September 26, 2009, there were 23,064 deferred stock units outstanding.

Directors were granted 7,971 and 5,427 shares for the nine months ended September 26, 2009, and September 27, 2008, respectively. The Company recognized director stock compensation expense of \$213 and \$161, for the nine months ended September 26, 2009, and September 27, 2008, respectively. The Plan authorizes the issuance of up to 180,000 shares of common stock. At September 26, 2009, 145,682 shares remained available to be issued through the Plan.

4. RESTRICTED CASH

The restricted cash balance at September 26, 2009, consisted of \$48 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 Crédit Agricole Bank in France.

5. INVENTORIES

| | September 26, 2009 | December 27, 2008 |
|-------------------------------------|--------------------|-------------------|
| Raw materials | \$ 3,700 | \$ 4,428 |
| Work in process | 2,467 | 2,757 |
| Finished goods | 2,557 | 3,523 |
| Provision for slow moving inventory | (627) | (748) |
| Total | \$ 8,097 | \$ 9,960 |

6. GOODWILL

On September 26, 2009, 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 27, 2008. The analysis indicated that there was no impairment of the carrying value of the goodwill. As of September 26, 2009, no factors were identified that indicated impairment of the carrying value of the goodwill.

Table of Contents**SUN HYDRAULICS CORPORATION****NOTES TO THE CONSOLIDATED, UNAUDITED FINANCIAL STATEMENTS (Continued)****(Dollars in thousands except per share data)****7. LONG-TERM DEBT**

| | September 26, 2009 | December 27, 2008 |
|---|--------------------|-------------------|
| \$35,000 revolving line of credit, collateralized by U.S. assets, interest rate Libor + 1.5% or Bank's Base Rate at Company's discretion (1.75% at September 26, 2009), due August 1, 2011. | \$ | \$ |
| 10-year notes, fixed interest rates ranging from 3.5-5.1%, collateralized by equipment in Germany, due between 2009 and 2011. | | 272 |
| | | 272 |
| Less amounts due within one year | | (147) |
| Total | \$ | \$ 125 |

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 26, 2009, the Company was in compliance with all debt covenants.

8. INCOME TAXES

At September 26, 2009, the Company had an unrecognized tax benefit of \$157 including accrued interest. The amount is primarily attributable to research and development tax credits. 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 accrued as of September 26, 2009, 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.

The Company's federal returns are currently under examination by the Internal Revenue Service (IRS) in the United States for the periods 2004 through 2007. Subsequent to September 26, 2009, the IRS proposed a significant adjustment to the Company's research and development tax credit position. Management has disagreed with the proposed adjustment and has filed for Fast Track Mediation.

Audit outcomes and the timing of audit settlements are subject to significant uncertainty. It is reasonably possible that within the next twelve months the Company will resolve some or all of the matters presently under consideration for 2004 through 2007 with the IRS, and that there could be significant increases or decreases to unrecognized tax benefits. However, at this time, the Company cannot make a reasonable estimate of that range.

Table of Contents**SUN HYDRAULICS CORPORATION****NOTES TO THE CONSOLIDATED, UNAUDITED FINANCIAL STATEMENTS (Continued)****(Dollars in thousands except per share data)****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 |
|--|------------------|-----------|-----------|-------------------|-------------|--------------|
| Three Months Ended September 26, 2009 | | | | | | |
| Sales to unaffiliated customers | \$ 13,890 | \$ 2,621 | \$ 3,429 | \$ 3,376 | \$ | \$ 23,316 |
| Intercompany sales | 3,881 | | 43 | 217 | (4,141) | |
| Operating income (loss) | (340) | 193 | 498 | 24 | 48 | 423 |
| Depreciation | 1,284 | 27 | 125 | 268 | | 1,704 |
| Capital expenditures | 961 | 4 | 9 | 69 | | 1,043 |
| Three Months Ended September 27, 2008 | | | | | | |
| 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 |
| Nine Months Ended September 26, 2009 | | | | | | |
| Sales to unaffiliated customers | \$ 42,078 | \$ 6,966 | \$ 11,041 | \$ 10,046 | \$ | \$ 70,131 |
| Intercompany sales | 11,581 | | 118 | 915 | (12,614) | |
| Operating income (loss) | (2,430) | 403 | 1,772 | 600 | 248 | 593 |
| Depreciation | 4,018 | 80 | 379 | 762 | | 5,239 |
| Capital expenditures | 4,297 | 31 | 37 | 184 | | 4,549 |
| Nine Months Ended September 27, 2008 | | | | | | |
| 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 |

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 26, 2009, and September 27, 2008, in Management's Discussion and Analysis of Financial Condition and Results of Operations. 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**SUN HYDRAULICS CORPORATION****NOTES TO THE CONSOLIDATED, UNAUDITED FINANCIAL STATEMENTS (Continued)****(Dollars in thousands except per share data)****10. FAIR VALUE OF FINANCIAL INSTRUMENTS**

The Company uses the 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.

At September 26, 2009, the Company held available-for-sale securities with an aggregate fair value of \$765. The Company, on a recurring basis, measures available-for-sale securities at fair value using quoted prices in active markets. The net unrealized holding loss amounted to \$2 at September 26, 2009. The Company did 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 months ended September 26, 2009 and September 27, 2008.

Assets measured at fair value on a recurring basis include the following as of September 26, 2009:

| Description | September 26, 2009 | Fair Value Measurements at Reporting Date Using | | |
|-------------------------------|--------------------|--|--|--|
| | | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Available-for-sale securities | \$ 765 | \$ 765 | \$ | \$ |

The carrying amounts of cash and cash equivalents, restricted cash, accounts receivable, other current assets, accounts payable, accrued expenses and other liabilities approximate fair value based on their short-term status. Marketable securities not included in the above table are held to maturity and as such are recorded at amortized cost.

11. NEW ACCOUNTING PRONOUNCEMENTS

In August 2009, the Financial Accounting Standards Board (FASB) issued new accounting guidance that provides clarification for the fair value measurement of liabilities in circumstances in which a quoted price in an active market for an identical liability is not available. This guidance is effective for the Company for the interim period beginning September 27, 2009. The adoption of this guidance is not expected to have a material impact on the Company's Consolidated Financial Statements.

In June 2009, the FASB issued *The FASB Accounting Standards Codification and Hierarchy of Generally Accepted Accounting Principles (ASC 105)*. This standard establishes the FASB Standards Accounting Codification (Codification) as the source of authoritative GAAP recognized by the FASB to be applied to nongovernmental entities and rules and interpretive releases of the SEC as authoritative GAAP for SEC registrants. The Codification will supersede all the existing non-SEC accounting and reporting standards upon its effective date and subsequently, the FASB will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. This standard is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The adoption of this standard did not have a material impact on the Company's Consolidated Financial Statements.

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In June 2009, the FASB issued new accounting guidance for determining whether an entity is a variable interest entity and requires an enterprise to perform an analysis to determine whether the enterprise s

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variable interest or interests give it a controlling financial interest in a variable interest entity. This guidance also requires an enterprise to assess whether it has an implicit financial responsibility to ensure that a variable interest entity operates as designed when determining whether it has power to direct the activities of the variable interest entity that most significantly impacts the entity's economic performance. This guidance also requires ongoing assessments of whether an enterprise is the primary beneficiary of a variable interest entity, requires enhanced disclosures and eliminates the scope exclusion for qualifying special-purpose entities. This guidance is effective for annual reporting periods beginning after November 15, 2009. The adoption of this guidance is not expected to have a material impact on the Company's Consolidated Financial Statements.

In June 2009, the FASB issued new accounting guidance to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. This guidance is effective for annual reporting periods beginning after November 15, 2009. The adoption of this guidance 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.

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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 27, 2008, were approximately 58% of total net sales.

Approximately two-thirds 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 the mobile market include equipment used in off-road construction, agriculture, fire and rescue, utilities, oil fields, and mining.

The remaining one-third 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. Power units, 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.

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 8% and 1% in 2008 and 2007, respectively. The index of shipments of hydraulic products is down 47% for the three-month period ending September 2009, 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). When PMI is over 50, it indicates economic expansion; when it is below 50, it indicates contraction in the economy. The index increased to 52.6 in September 2009 compared to 43.5 in September 2008. In October 2009, the index increased to 55.7. This is the third consecutive month above 50, indicating the economy is expanding. Additionally, the rate of growth is the highest since April 2006. The portion of the index that represents production has been above 50, indicating a growth phase, for the last five months. Management believes these trends are a strong indication that Sun will see growth into 2010.

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Results for the third quarter

(Dollars in millions except net income per share)

| | September 26, 2009 | September 27, 2008 | Decrease |
|---------------------------|--------------------|--------------------|----------|
| Three Months Ended | | | |
| Net Sales | \$ 23.3 | \$ 44.8 | -48% |
| Net Income | \$ 0.6 | \$ 6.7 | -91% |
| Net Income per share: | | | |
| Basic | \$ 0.03 | \$ 0.40 | -93% |
| Diluted | \$ 0.03 | \$ 0.40 | -93% |
| Nine Months Ended | | | |
| Net Sales | \$ 70.1 | \$ 145.3 | -52% |
| Net Income | \$ 0.6 | \$ 23.3 | -97% |
| Net Income per share: | | | |
| Basic | \$ 0.03 | \$ 1.40 | -98% |
| Fully Diluted | \$ 0.03 | \$ 1.40 | -98% |

The Company experienced a modest rebound in sales and incoming order activity that began in the third quarter. The sequential revenue increase and recognition of the full benefit of the employee furlough programs helped earnings turn positive for the quarter.

Management is cautiously optimistic that the bottom of this recession has passed, as the fourth quarter forecast represents a 12% sequential sales increase in what is historically the weakest quarter of the year.

In addition to PMI, management's optimism is based, in part, on actions it took during this downturn. Investments made now will help reap rewards for Sun in the future. On the product side, the Company's electrically-actuated valves continue to gain attention in the marketplace and HCT (High Country Tek), as a by-product of its sales efforts, continues to uncover new opportunities for Sun products. Prototype development for integrated packages has remained very busy throughout the last three quarters and has led to new orders.

Through this downturn, Sun has been able to keep its workforce intact and the Company has continued to invest in machinery and equipment to improve quality and productivity. New product designs complement Sun's integrated packaging strategy and are helping the Company develop unique system solutions for customers.

Outlook

The Company's 2009 fourth quarter sales are expected to be \$26 million, a 21% decrease in revenue compared to last year, and earnings are expected to be \$0.05 to \$0.07 per share compared to earnings of \$0.15 per share in the same period of the prior year.

Sales for the year are estimated to be approximately \$96 million, a 46% decrease compared to 2008. Earnings per share for 2009 are estimated to be \$0.08 to \$0.10 compared to earnings of \$1.55 per share in 2008.

Sun's fourth quarter results are based on a 14-week quarter resulting in a 53-week year for 2009. This will result in approximately three additional shipping days.

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COMPARISON OF THE THREE MONTHS ENDED SEPTEMBER 26, 2009 AND SEPTEMBER 27, 2008

Net Sales

Net sales were \$23.3 million, a decrease of \$21.5 million, or 47.9%, compared to \$44.8 million in 2008. Net sales decreased 45.4% excluding the effect of exchange rates. The decrease in net sales was primarily driven by decreased demand in our end markets, which primarily include capital goods equipment. Price increases in October 2008 accounted for approximately 2% of sales. New product sales (defined as products introduced within the last five years) generally make up 10 - 15% of total sales.

North American sales decreased 50.0% or \$10.5 million, to \$10.5 million, Asian sales decreased 40.5% or \$3.0 million, to \$4.4 million, and European sales decreased 49.2% or \$7.4 million, to \$7.6 million.

The U.S. reporting segment had sales of \$13.9 million in the third quarter of 2009, down \$14.9 million or 51.8%, compared to sales of \$28.8 million during the third quarter last year. The decrease was driven by demand in our end markets and the general downturn in the global economy. International sales out of the U.S. were \$4.2 million during the third quarter of 2009, down 57.5% or \$5.7 million, compared to \$9.9 million during the third quarter last year. Significant decreases in sales were noted in almost all geographic regions.

The Korean reporting segment had sales of \$2.6 million during the third quarter of 2009, down \$1.2 million or 32.0%, compared to sales of \$3.9 million during the third quarter last year. Currency effect reduced 2009 third quarter sales by approximately \$0.5 million. The remaining decrease was related to a slowdown in sales to four major Korean customers that are in the construction equipment industry.

The German reporting segment had sales of \$3.4 million during the third quarter of 2009, down \$3.3 million or 49.2%, compared to sales of \$6.7 million during the third quarter last year. Currency effect reduced 2009 third quarter sales by approximately \$0.2 million. The remaining decrease was primarily related to demand within Germany. However, sales were down in almost all geographic markets.

The U.K. reporting segment had sales of \$3.4 million during the third quarter of 2009, down \$2.0 million or 37.0%, compared to sales of \$5.4 million during the third quarter last year. Currency effect reduced 2009 third quarter sales by approximately \$0.3 million. The largest reduction of sales was to customers within the U.K. However, sales were down in almost all geographic markets.

Gross Profit

Gross profit decreased \$9.4 million or 63.7% to \$5.4 million in the third quarter of 2009, compared to \$14.7 million in the third quarter last year. Gross profit as a percentage of net sales decreased to 22.9% in the third quarter of 2009, compared to 32.9% in the third quarter last year. The Company experienced a sharp decline in sales during the fourth quarter of 2008, which began the downward trend in gross profit margins. Sales continued to decline in the first half of 2009, resulting in further reductions in the gross profit margin. Sales have since increased sequentially in the third quarter. The increased sales coupled with changes in our production resources has resulted in a higher gross profit margin sequentially.

Third quarter gross profit decreases compared to the same period of the prior year were primarily related to lower sales volume, which contributed \$7.1 million of the decrease. The remaining decreases in gross profit were attributed to productivity declines of approximately \$0.3 million, and increases in overhead expenses as a percentage of sales of approximately \$2.7 million, both of which occurred primarily in the U.S. In periods of sharp declining sales, the Company cannot reduce costs at the same pace. However, the decrease in gross profit was partially offset by lower material costs as a percent of sales of approximately \$0.6 million and the elimination of overtime premiums of approximately \$0.3 million. These reductions were primarily in the U.S.

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In June 2009, the Company initiated rolling furloughs for the production workforce and a 3% salary reduction for non-production personnel. While the decision was not cost driven, the Company did experience cost savings of approximately \$0.7 million in the third quarter.

Selling, Engineering and Administrative Expenses

Selling, engineering and administrative expenses decreased 9.7%, or \$0.5 million, to \$4.9 million compared to the same quarter last year. The Company did not experience any significant decreases in any one particular category, but did see decreases in almost all areas.

Operating Income

Operating income decreased \$8.9 million or 95.4% to \$0.4 million in the third quarter of 2009, compared to \$9.3 million in the third quarter last year, with operating margins of 1.8% and 20.7% for the third quarters of 2009 and 2008, respectively. The sharp decline in sales is the primary cause for the operating income decline. While all reporting segments were able to reduce fixed costs, as sales fall sharply, the Company cannot decrease costs at the same pace.

The U.S. reporting segment experienced an operating loss of \$0.3 million in the third quarter of 2009, compared to operating income of \$6.2 million during the third quarter of 2008, a decrease of \$6.5 million. The sharp decline in sales volume reduced operating income \$3.2 million. The remaining decrease in operating income occurred from productivity declines as a result of keeping the Company's workforce intact, and increased variable and fixed overhead costs as a percent of sales. Decreases in operating income were partially offset by decreases in material costs, salaries and fringe benefits, and overtime premiums. Additionally, the Company had cost savings of approximately \$0.8 million during the third quarter, as a result of the furloughs and salary reductions. The Company continues to monitor and reduce fixed costs where it is deemed appropriate.

The Korean reporting segment contributed \$0.2 million to our consolidated operating income during the third quarter of 2009 compared to \$0.3 million during the third quarter last year, a decrease of \$0.1 million. The reduction in sales volume was responsible for the decrease in operating income.

The German reporting segment contributed \$0.5 million to our consolidated operating income during the third quarter of 2009 compared to \$2.1 million during the third quarter last year, a decrease of \$1.6 million. Reduction in sales volume resulted in a decrease of \$1.0 million to operating income. The remaining decrease was primarily related to material costs due to the strength of the U.S. Dollar against the Euro for material purchases made in U.S. Dollars.

The U.K. reporting segment contributed less than \$0.1 million to our consolidated operating income during the third quarter of 2009 compared to \$0.8 million during the third quarter last year, a decrease of \$0.7 million. The reduction in sales volume was responsible for \$0.3 million of the decrease in operating income. The remaining decrease was primarily related to increases in overhead costs as a percent of sales and increased material costs.

Interest Income, Net

Net interest income was \$0.1 million for the quarter ended September 26, 2009, compared to \$0.2 million for the quarter ended September 27, 2008. The Company currently has no outstanding debt compared to \$0.5 million the prior year. Total average cash and investments for the quarter ended September 26, 2009, was \$35.7 million compared to \$30.7 million for the quarter ended September 27, 2008. Although average cash increased, interest income decreased due to lower interest rates compared to the prior year.

Foreign Currency Transaction Gain, Net

There was a net foreign currency transaction gain of \$0.1 million for the quarter ended September 26, 2009, compared to \$0.3 million for the quarter ended September 27, 2008. The British Pound, Euro and

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Korean Won all made gains against the U.S. Dollar during the period. The prior period gain was primarily due to the strengthening of the U.S. Dollar against the British Pound, and the revaluation of assets and liabilities held in U.S. Dollars at our U.K. subsidiary.

Miscellaneous (Income) Expense, Net

There was net miscellaneous expense of \$0.1 for the quarter ended September 26, 2009, compared to a minimal expense for the quarter ended September 27, 2008. The net miscellaneous expense is primarily made up of earnings and losses from joint ventures.

Income Taxes

The provision for income taxes for the quarter ended September 26, 2009, was 2.8% of pretax income compared to 31.8% of pretax income for the quarter ended September 27, 2008. 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, particularly from the tax benefit recognized in the U.S. Additionally, the current period provision was affected by discrete items related to the return-to-provision true-up upon completion of the 2008 U.S. return and adjustments related to R&D tax credit calculations. Excluding these discrete items, the effective rate would have been approximately 29.0%.

COMPARISON OF THE NINE MONTHS ENDED SEPTEMBER 26, 2009 AND SEPTEMBER 27, 2008

Net Sales

Net sales were \$70.1 million, a decrease of \$75.2 million, or 51.7%, compared to \$145.3 million in 2008. Net sales decreased 47.6% excluding the effect of exchange rates. The decrease in net sales was primarily driven by decreased demand in our end markets, which primarily include capital goods equipment. Price increases in October 2008 accounted for approximately 2% of sales. New product sales (defined as products introduced within the last five years) generally make up 10 - 15% of total sales.

North American sales decreased 51.9% or \$34.1 million, to \$31.7 million, Asian sales decreased 55.0% or \$14.8 million, to \$12.1 million, and European sales decreased 50.6% or \$24.8 million, to \$24.2 million.

The U.S. reporting segment had sales of \$42.1 million in the period ended September 26, 2009, down \$46.8 million or 52.6%, compared to sales of \$88.8 million during the period ended September 27, 2008. The decrease was driven by demand in our end markets and the general downturn in the global economy. International sales out of the U.S. were \$13.3 million during 2009, down 56.1% or \$17.0 million, compared to \$30.3 million during the prior year. Significant decreases in sales were noted in almost all geographic regions.

The Korean reporting segment had sales of \$7.0 million during the period ended September 26, 2009, down \$8.7 million or 55.6%, compared to sales of \$15.7 million during period ended September 27, 2008. Currency effect reduced 2009 sales by approximately \$1.9 million. The remaining decrease was related to a slowdown in sales to four major Korean customers that are in the construction equipment industry.

The German reporting segment had sales of \$11.0 million during the period ended September 26, 2009, down \$11.5 million or 51.1%, compared to sales of \$22.6 million during the period ended September 27, 2008. Currency effect reduced 2009 sales by approximately \$1.4 million. The remaining decrease was primarily related to demand within Germany. However, sales were down in all geographic markets.

The U.K. reporting segment had sales of \$10.0 million during the period ended September 26, 2009, down \$8.2 million or 45.0%, compared to sales of \$18.3 million during the period ended September 27, 2008. Currency effect reduced 2009 sales by approximately \$1.4 million. The largest reduction of sales was to customers within the U.K. however, sales were down in all geographic markets.

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Gross Profit

Gross profit decreased \$35.7 million or 70.2% to \$15.2 million in the period ended September 26, 2009, compared to \$50.9 million in the period ended September 27, 2008. Gross profit as a percentage of net sales decreased to 21.6% in the period ended September 26, 2009, compared to 35.0% in the period ended September 27, 2008. The Company experienced a sharp decline in sales during the fourth quarter of 2008, which resulted in gross profit margins of 24.9%. Sales continued to decline during the first half of 2009, resulting in further reductions in the gross profit margin. Margins have begun to increase in the third quarter of 2009.

The 2009 gross profit decreases were primarily related to lower sales volume, which contributed \$26.4 million of the decrease. The remaining decreases in gross profit were attributed to productivity declines of approximately \$2.5 million, and increases in overhead expenses as a percentage of sales of approximately \$8.7 million, both of which occurred primarily in the U.S. In periods of sharp declining sales, the Company cannot reduce costs at the same pace. However, the decrease in gross profit was partially offset by lower material costs as a percent of sales of approximately \$1.6 million, primarily in the U.S. Additionally, the Company eliminated overtime premiums equal to approximately \$1.1 million, reduced retirement benefits primarily related to the shared distribution of approximately \$1.6 million that was included in the prior year results, and reduced health benefit costs of \$0.5 million. These reductions were all primarily in the U.S. Additionally, the Company had cost savings of approximately \$0.9 for the period ended September 26, 2009, resulting from the furloughs and salary reductions.

Selling, Engineering and Administrative Expenses

Selling, engineering and administrative expenses decreased 15.3%, or \$2.6 million, to \$14.6 million compared to the same period last year. The change was due to decreases in compensation of \$0.9 million, resulting primarily from salary freezes and reductions that began in January, fringe benefit costs of \$0.5 million, primarily related to retirement benefits associated with the shared distribution that was included in the prior year results, and travel of \$0.3 million.

Operating Income

Operating income decreased \$33.1 million or 98.2% to \$0.6 million in the period ended September 26, 2009, compared to \$33.7 million in the period ended September 27, 2008, with operating margins of 0.8% and 23.2% for 2009 and 2008, respectively. The sharp decline in sales was the primary cause for the reduction in operating income margins. While all reporting segments were able to reduce fixed costs, as sales fell sharply, the Company cannot decrease costs at the same pace. Therefore, at the current sales levels, it is difficult for all reporting segments to absorb their fixed costs.

The U.S. reporting segment experienced an operating loss of \$2.4 million in the period ended September 26, 2009, compared to operating income of \$22.8 million during the period ended September 27, 2008, a decrease of \$25.2 million. The sharp decline in sales volume reduced operating income \$12.0 million. Additional decreases in operating income occurred from productivity declines as a result of keeping its workforce intact, and increased variable and fixed overhead costs as a percent of sales. Decreases in operating income were partially offset by decreases in material costs. Additionally, the Company had cost savings of approximately \$1.0 million for the period ending September 26, 2009, as a result of the furloughs and salary reductions.

The Korean reporting segment contributed \$0.4 million to our consolidated operating income during the period ended September 26, 2009 compared to \$1.3 million during the period ended September 27, 2008, a decrease of \$0.9 million. The reduction in sales volume was responsible for \$0.7 million of the decrease in operating income.

The German reporting segment contributed \$1.8 million to our consolidated operating income during the period ended September 26, 2009 compared to \$6.9 million during the period ended September 27, 2008, a decrease of \$5.1 million. Reduction in sales volume resulted in a decrease of \$3.5 million to operating

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income. The remaining decrease was primarily related to material costs due to the strength of the U.S. Dollar against the Euro for material purchases made in U.S. Dollars, and increased fixed overhead costs as a percent of sales.

The U.K. reporting segment contributed \$0.6 million to our consolidated operating income during the period ended September 26, 2009, compared to \$2.9 million during the period ended September 27, 2008, a decrease of \$2.3 million. The reduction in sales volume was responsible for \$1.3 million of the decrease in operating income. The remaining decrease was primarily related to increased fixed overhead costs as a percent of sales.

Interest Income, Net

Net interest income was \$0.4 million for the period ended September 26, 2009, compared to \$0.5 million for the period ended September 27, 2008. The Company currently has no outstanding debt compared to \$0.6 million the prior year. Total average cash and investments for the nine months ended September 26, 2009, was \$36.5 million compared to \$26.3 million for the nine months ended September 27, 2008. Although average cash increased, interest income decreased due to lower interest rates compared to the prior year.

Foreign Currency Transaction (Gain) Loss, Net

There was a net foreign currency transaction loss of \$0.2 million for the period ended September 26, 2009, compared to a net gain of \$0.2 million for the period ended September 27, 2008. While the Euro, the Korean Won and the British Pound all strengthened against the U.S. Dollar, the UK operations experienced losses 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. The inverse was true of the prior year period.

Miscellaneous (Income)/Expense, Net

There was net miscellaneous expense of \$0.4 million for the period ended September 26, 2009, compared to \$0.2 million of net miscellaneous income for the period ended September 27, 2008. Net miscellaneous (income)/expense is primarily made up of earnings and losses from joint ventures. The prior year income includes proceeds from an insurance claim.

Income Taxes

The provision for income taxes for the period ended September 26, 2009, was a benefit of 45.9% of pretax income compared to a provision of 32.7% for the period ended September 27, 2008. 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, particularly from the tax benefit recognized in the U.S.

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.

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Cash from operations for the nine months ended September 26, 2009, was \$11.3 million, compared to \$30.8 million for the nine months ended September 27, 2008. The \$19.5 million decrease in the Company's net cash flow from operations during the period was due primarily to the decrease in net income of \$22.7 million, change in taxes payable/receivable of \$0.8 million, and lower cash inflow from accumulation of accounts payable and accrued expenses compared to the prior year. Decreases in accounts receivable and inventory totaling \$3.7 million compared to increases in the prior year totaling \$1.9 million partially offset the reduction in operating cash flows. Cash on hand decreased \$5.1 million from \$35.3 million in 2008 to \$30.2 million in 2009. However, this decrease was largely the result of net purchases of marketable securities totaling \$7.5 million. Days sales outstanding (DSO) were 42 and 38 at September 26, 2009, and September 27, 2008, respectively. Customer payments have not been an issue thus far and the Company does not anticipate collectability issues even in this difficult economic environment. Inventory turns decreased to 8.9 as of September 26, 2009, compared to 10.4 as of September 27, 2008.

Capital expenditures were \$4.5 million for the nine months ended September 26, 2009, compared to \$9.2 million for the nine months ended September 27, 2008. The current year includes purchases of machinery and equipment of \$2.8 million and a land purchase of \$1.7 million. The prior year includes purchases of machinery and equipment of \$6.7 million and a land purchase of \$2.5 million. The parcels of land along with already owned property that includes one of the Companies existing facilities combine to provide the Company with 27 contiguous acres. It provides the Company with excellent options if it determines that additional bricks and mortar are needed. Capital expenditures for the year are projected to be approximately \$6.5 million.

The Company declared a quarterly dividend of \$0.09 per share to shareholders of record as of September 30, 2009, payable on October 15, 2009. 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.

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 nor are they material to the financial statements of the Company at September 26, 2009.

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. However, due to the current economic conditions, this pattern was not evident in 2009.

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.

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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

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.

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 27, 2008. 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.

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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 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 27, 2008, and Management's Discussion and Analysis of Financial Conditions and Results of Operations in this Form 10-Q for the quarter ended September 26, 2009. 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 26, 2009.

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 26, 2009, 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

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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 26, 2009, in timely alerting them to material information required to be included in the Company's periodic SEC filings.

There were no changes in the Company's internal controls over financial reporting during the period ended September 26, 2009, that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II

OTHER INFORMATION

Item 1. Legal Proceedings.

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 27, 2008.

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. |

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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 3, 2009.

SUN HYDRAULICS CORPORATION

By: /s/ TRICIA L. FULTON
Tricia L. Fulton
Chief Financial Officer

(Principal Financial and Accounting Officer)