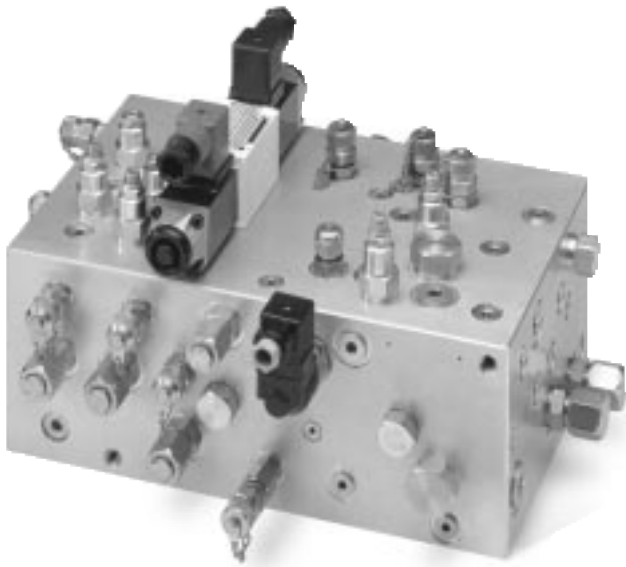




Sun Hydraulics Corporation 1997 Annual Report

## About Sun Hydraulics

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*A custom manifold used to control blade yaw and pitch.*

Windmills at one time were solitary devices, dotting rural landscapes and farmland. Today, windmills are often grouped together in large “wind farms” to provide an alternative means of power generation for electrical utilities. To harness wind power on a scale suitable for mass power generation, windmills must operate at maximum efficiency. Modern windmills are complex machines that require precise control and a high degree of reliability. Controlling the yaw of the windmill’s blades allows the windmill to gain maximum wind advantage. Controlling the blade’s pitch can allow the machine to be shut down in the event wind velocity is too great. In some windmill designs, these control functions are accomplished with hydraulics.

The hydraulic manifold pictured here uses a variety of Sun Hydraulics load control, pressure control, flow control and circuit saver cartridge valves to help control blade yaw and pitch. As the manifold is mounted at the top of the windmill tower, close to blades and drive mechanisms, size, weight and reliability of components are extremely important. Sun Hydraulics screw-in cartridge valves offer machine designers size, weight and performance advantages and the day-in, day-out dependability required in many critical applications.

### Some of Our End Product Uses

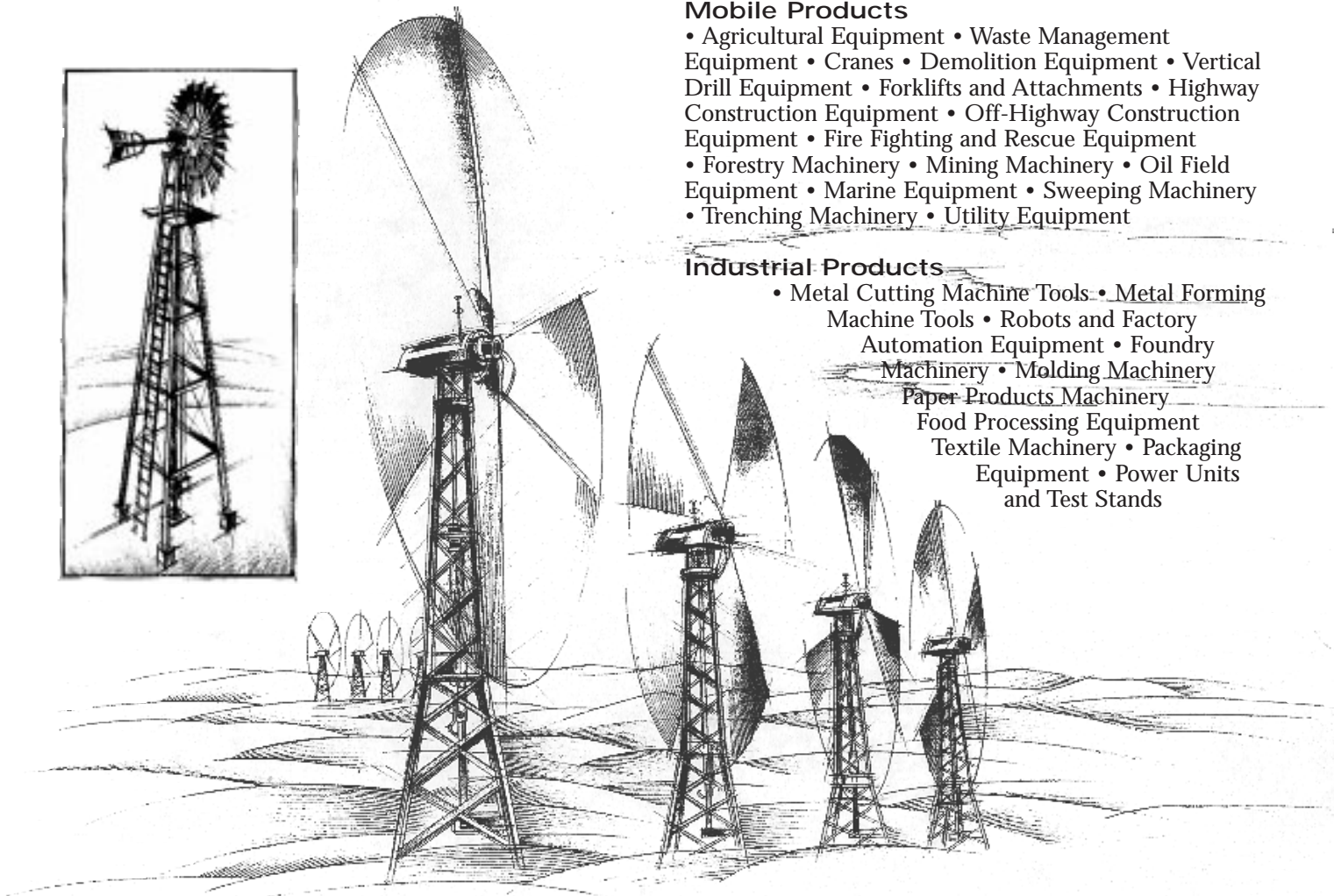
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#### Mobile Products

- Agricultural Equipment
- Waste Management Equipment
- Cranes
- Demolition Equipment
- Vertical Drill Equipment
- Forklifts and Attachments
- Highway Construction Equipment
- Off-Highway Construction Equipment
- Fire Fighting and Rescue Equipment
- Forestry Machinery
- Mining Machinery
- Oil Field Equipment
- Marine Equipment
- Sweeping Machinery
- Trenching Machinery
- Utility Equipment

#### Industrial Products

- Metal Cutting Machine Tools
- Metal Forming Machine Tools
- Robots and Factory Automation Equipment
- Foundry Machinery
- Molding Machinery
- Paper Products Machinery
- Food Processing Equipment
- Textile Machinery
- Packaging Equipment
- Power Units and Test Stands



Growing companies don't necessarily grow up. How do companies mature? Character is usually developed during a crisis where leadership often emerges spontaneously from unexpected sources. Companies grow stronger. Lemonade is made from lemons.

In early December, while disassembling a counterbalance cartridge that had failed to pass our functional test, an alert assembly worker scratched a steel poppet spring retainer, a part the size of a pea. The part was supposed to be heat treated hard. She rubbed a file across it and found it soft. She checked with Engineering. Counterbalance valves are often used in aerial manlifts to hold platforms in position... the problem might be serious.

Accelerated life cycle tests were run with severe shock at various pressures and flows. Worst case: 10,000 life cycles, most likely well over 100,000, but some valves might fail in a potentially unsafe mode. There was a strong probability that no valves would ever fail during the normal life of the equipment on which they were installed. Still, a failure might occur. 39,000 valves had been built with soft retainers in November and December.

No field failures had been reported and typical product recalls usually follow field failures. Everyone agreed there was only one thing to do. On Thursday, December 3, 1997, distributors were notified of the date codes of valves with soft spring retainers, along with the results of Sun's tests and Sun's recommendation that all valves be returned. There was no "finger pointing" at Sun.

One manufacturer of hydraulic cylinders that include this type of cartridge for use in aerial manlifts quickly located 1,500 cartridges and packed and shipped them overnight to Sun. On Friday morning, Sun employees volunteered to set up a temporary disassembly, re-assembly and retest line. Less experienced workers were taught the tedious job of taking valves apart (with tiny parts, not an easy task). Skilled workers supervised everything and did the critical work. By Friday afternoon, new and repaired valves were being shipped to keep customers' production alive. On Monday morning, the president of the cylinder manufacturer arrived at Sun, along with two key staff members, to offer their help. There was no acrimony, just a sincere desire to help. The feeling was warm and understanding. Nice.

Over four weeks, Sun volunteers worked incredible hours, day and night through the holidays (some canceling family get-togethers). Worldwide cooperation was amazing. 39,000 valves were torn down, rebuilt, re-tested and re-shipped. There was no shortage of snacks. A professional masseur was hired to work "kinks" out of sore backs. Nice.

Now, un-heat treated parts supplied by our vendor are shipped directly to our heat treating facility (rather than to general receiving). The cost? We shipped 136,000 new cartridges of all types in December instead of 166,000. Overtime was astronomical. We lost maybe 2 cents per share in earnings but still met our analysts' projections of 70+ cents per share for 1997.

I had nothing to do with any of this.

In my eyes at least, Sun stands a bit taller today.

*Bob Koski*



Personally, I could do without these "character building" experiences! It is interesting, though, that no one at Sun resisted the recommendation to return these valves. As our analysis unfolded, consensus and support naturally developed.

Clearly, our objective is to make reliable products in the first place. We've done a very good job in the past and we're determined to do a better job as we go forward.

1997 was a memorable year for Sun. We went public in January. We opened major new factories in Sarasota and Germany. We added almost 100 new employees to our worldwide workforce, an increase of more than 20%. We switched from departmental operations, where similar machines are grouped, to cellular production in both our cartridge and manifold plants. We implemented new operating software in our manifold plant and new accounting software in both U.S. plants. We continued the introduction of Series 0 products and expanded our cartridge assembly capability at our plant in England.

Our move to the new manifold plant was not as smooth as we had hoped. Consolidated shipments in the first half of the year increased only 8%, while orders exploded and lead times went out. Wherever possible, we used outside sources to buy our way out of trouble. For awhile we had a mess.

By mid summer, our new capacity was in place and shipments for the last half of the year increased 27% over the same period in 1996. We began to reduce our backlog. Things were looking up.

We are still behind in our shipments and this is frustrating and embarrassing for everyone at Sun. Increasing production of high quality products in the U.S. and Europe is receiving the same focus as the recall. Progress is being made. Manifold deliveries, way behind last summer, are now current, cartridges continue to improve.

Orders remain strong, both for Sun and the industry. We have seen a slowing of business in Asia, but are confident it will eventually bounce back. Otherwise, all markets continue to expand. We appreciate the tremendous support we received in 1997 from our customers, distributors, vendors, employees and our new shareholders.

Sun is looking forward to a more tranquil year in 1998 and is working hard to avoid more "character building" opportunities.

*Clyde Nixon*



## Selected Consolidated Financial Data

(in thousands except per share data)

| YEARS ENDED DECEMBER 31,                              | 1993            | 1994            | 1995            | 1996              | 1997            |
|---|-----------------|-----------------|-----------------|-------------------|-----------------|
| <b>Statement of Income Data:</b>                      |                 |                 |                 |                   |                 |
| Net sales   | \$32,431        | \$42,853        | \$55,388        | \$54,572          | \$64,198        |
| Cost of sales   | <u>21,971</u>   | <u>27,512</u>   | <u>34,581</u>   | <u>37,185</u>     | <u>44,621</u>   |
| Gross profit  | 10,460          | 15,341          | 20,807          | 17,387            | 19,577          |
| Selling, engineering and administrative expenses      | <u>7,346</u>    | <u>8,605</u>    | <u>10,578</u>   | <u>12,097 (1)</u> | <u>11,275</u>   |
| Operating income                                      | 3,114           | 6,736           | 10,229          | 5,290             | 8,302           |
| Interest expense                                      | 931             | 859             | 814             | 823               | 905             |
| Miscellaneous (income) expense                        | <u>249</u>      | <u>66</u>       | <u>(79)</u>     | <u>267</u>        | <u>133</u>      |
| Income before income taxes                            | 1,934           | 5,811           | 9,494           | 4,200             | 7,264           |
| Deferred tax provision (2)                            | -               | -               | -               | 2,425             | -               |
| Income tax provision (benefit) (3)                    | <u>(148)</u>    | <u>408</u>      | <u>633</u>      | <u>704</u>        | <u>2,554</u>    |
| Net income  | <u>\$ 2,082</u> | <u>\$ 5,403</u> | <u>\$ 8,861</u> | <u>\$ 1,071</u>   | <u>\$ 4,710</u> |
| Basic net income per common share                     | \$ .56          | \$ 1.41         | \$ 2.29         | \$ 0.27           | \$ 0.75         |
| Weighted average shares outstanding                   | 3,740           | 3,825           | 3,878           | 3,978             | 6,308           |
| Diluted net income per common share                   | \$ .50          | \$ 1.30         | \$ 2.15         | \$ 0.26           | \$ 0.73         |
| Weighted average shares outstanding                   | 4,150           | 4,156           | 4,123           | 4,178             | 6,499           |
| <b>Pro Forma Statement of Income (Unaudited) (4):</b> |                 |                 |                 |                   |                 |
| Income before income taxes                            |                 |                 | 9,494           | 4,200             | 7,264           |
| Income tax provision                                  |                 |                 | <u>3,611</u>    | <u>1,583</u>      | <u>2,554</u>    |
| Net income  |                 |                 | <u>\$ 5,883</u> | <u>\$ 2,617</u>   | <u>\$ 4,710</u> |
| Basic net income per common share                     |                 |                 | \$ .95          | \$ 0.42           | \$ 0.75         |
| Weighted average shares outstanding                   |                 |                 | 6,224           | 6,300             | 6,308           |
| Diluted net income per common share                   |                 |                 | \$ .92          | \$ 0.40           | \$ 0.73         |
| Weighted average shares outstanding                   |                 |                 | 6,433           | 6,519             | 6,499           |
| <b>Balance Sheet and Other Financial Data:</b>        |                 |                 |                 |                   |                 |
| Cash and cash equivalents                             | \$ 1,883        | \$ 2,371        | \$ 2,434        | \$ 1,038          | \$ 1,249        |
| Working capital                                       | 4,557           | 5,085           | 4,326           | 958               | 6,100           |
| Total assets  | 22,674          | 27,868          | 33,864          | 48,416            | 53,389          |
| Total debt  | 8,184           | 8,025           | 6,186           | 17,218            | 9,564           |
| Shareholders' equity                                  | 12,051          | 15,624          | 21,529          | 22,397            | 35,000          |
| Depreciation  | 2,112           | 2,197           | 2,556           | 2,857             | 3,706           |
| Capital expenditures                                  | 3,005           | 5,130           | 7,657           | 16,963            | 6,490           |

(1) Includes a non-recurring, non-cash compensation expense of approximately \$1.4 million related to the termination of employee phantom stock compensation agreements and the issuance of options to Directors. See Note 13 of the Notes to Financial Statements. Excluding such expense, pro forma net income for the twelve months ended December 31, 1996 would have been approximately \$3.8 million.

(2) Resulting from the termination of the Company's S Corporation status as of December 31, 1996.

(3) The Company previously operated as an S Corporation. Therefore, the historical income tax provision for the years ended December 31, 1993 to December 31, 1996 represents primarily foreign taxes.

(4) The 1997 information reflects actual data. The pro forma 1995 and 1996 net income is based on historical income as adjusted to reflect a provision for income taxes calculated using the statutory rates in effect during the applicable periods, as if the Company had been a C Corporation since inception. See Notes 2, 3 and 13 of the Notes to the Consolidated Financial Statements. The pro forma net income per share is based on estimated weighted average number of shares outstanding during the period, after giving effect to the reorganization and the initial public offering.



# 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's innovative product design, consistent high quality and superior product performance have allowed it to generate a profit in every year since 1972. In recent years, the Company's sales have been comprised of approximately 75% screw-in cartridge valves and approximately 25% manifolds, and the Company expects that relationship to remain relatively constant. The Company sells its products globally through independent distributors. In 1997, the Company generated approximately 35% of its net sales outside the United States, and the Company's single largest end user customer represented less than 3% of net sales.

Demand for the Company's products is dependent upon demand for the capital goods into which the Company's products are incorporated. The capital goods industry in general, and the fluid power industry in particular, is subject to economic cycles. In 1997, the United States fluid power industry experienced favorable growth. However, the Company is unable to predict the length or amplitude of the current upturn.

Product demand was strong in all of the Company's major markets during 1997, and net sales increased 17.6% over 1996 sales. Production output, however, failed to keep pace with demand during the first half of the year and customer delivery lead times increased. In 1996 and 1995 the United States production facility operated at near 100% capacity and the Company embarked on a capacity expansion program in 1996. The capacity expansion of the United States manufacturing operation was completed during the first half of 1997. Manifold production was relocated to a new facility and the existing manufacturing facility was reconfigured to take advantage of the increased floor space. Cellular production was implemented for certain high volume models. Concurrent with the United States expansion, a new manufacturing facility was completed in Germany for future production requirements. Following the completion of the United States capacity expansion, production increased significantly in the third and fourth quarters. For the last half of the year, shipping levels kept pace with strong incoming order levels.

North American distributor inventories increased approximately 33%, from June 1997 to December 1997. Through the first half of 1997, distributors depleted inventories at a faster rate than normal to assist the Company in meeting its customer commitments. Management believes that in the second half of the year, the increase in production replenished distributor inventories.

Profit margins in 1997 were adversely affected by incremental manufacturing costs associated with expediting to meet increased customer demand and start-up costs related to capacity expansion programs. Expediting costs included direct labor overtime premiums and increased material costs associated with outsourcing. Management believes that the costs associated with expediting were necessary to improve customer satisfaction in light of the Company's extended lead times. In the second half of 1997 production rates kept pace with incoming order rates, however, the Company expects that the product mix requirement of the marketplace will require continued expediting into 1998.

In November 1997, the Company produced approximately 39,000 cartridges that were subsequently found to have spring retainers that had not been heat treated. Of this total, 21,000 had been shipped. In December 1997, the Company recommended to its distributors and customers that all cartridges be returned and the spring retainer replaced. Substantially all of the cartridges were repaired and returned to customers by December 31, 1997. No significant costs remain to be incurred in 1998 concerning this event.

## Results of Operations

The following table sets forth, for the periods indicated, certain items in the Company's statements of income as a percentage of net sales.

|  | 1995         | 1996        | 1997         |
|--|--------------|-------------|--------------|
| Net sales  | 100.0%       | 100.0%      | 100.0%       |
| Cost of sales                                    | <u>62.4</u>  | <u>68.1</u> | <u>69.5</u>  |
| Gross profit                                     | 37.6         | 31.9        | 30.5         |
| Selling, engineering and administrative expenses | <u>19.1</u>  | <u>22.2</u> | <u>17.6</u>  |
| Operating income                                 | 18.5         | 9.7         | 12.9         |
| Interest expense                                 | 1.5          | 1.5         | 1.4          |
| Miscellaneous (income) expense                   | <u>(0.1)</u> | <u>0.5</u>  | <u>0.2</u>   |
| Income before income taxes                       | <u>17.1%</u> | <u>7.7%</u> | <u>11.3%</u> |

## Management's Discussion and Analysis of Financial Condition and Results of Operations

(Continued)

### Comparison of Years Ended December 31, 1997 and 1996

**Net sales** increased 17.6%, or \$9.6 million, to \$64.2 million in 1997, compared to \$54.6 million in 1996. Domestic net sales increased 16.7%, or \$6.0 million, to a total of \$42.0 million in 1997, compared to \$35.9 million in 1996. International net sales increased 19.4%, or \$3.6 million, to \$22.2 million in 1997, compared to \$18.6 million in 1996. Demand was strong in all major markets with an increase in orders of approximately 26% in 1997 compared to 1996. Sales in the first half of the year were restricted by capacity constraints and the disruptions of completing the capacity expansion in the United States. With the additional space gained through bringing the new plant in the United States on line in March 1997, worldwide shipments in the last six months of 1997 increased 27.4% over the same period in 1996 and increased 14.7% over the first six months of 1997.

**Gross profit** increased 12.6%, or \$2.2 million, to \$19.6 million in 1997, compared to \$17.4 million in 1996. Gross profit as a percentage of net sales decreased to 30.5% in 1997 from 31.9% in 1996. The decrease in gross profit as a percent of sales was due to a higher fixed cost base associated with the new plants in the United States and Germany. In addition, there were production start-up costs in the United States and incremental production costs associated with expediting product shipments to meet the significant increase in customer demand.

**Selling, engineering and administrative expenses** decreased 6.8%, or \$0.8 million, to \$11.3 million in 1997, compared to \$12.1 million in 1996. For the year ended December 31, 1996, these expenses included a non-cash, non-recurring compensation expense of \$1.4 million related to the termination of phantom stock compensation agreements and the issuance of options to directors. Excluding this expense, selling, engineering and administrative expenses increased 5.2%, or \$0.6 million, to \$11.3 million compared to \$10.7 million in 1996. This increase was due to application software expenses in the United States and the United Kingdom and increased fixed administrative expenses in the new manifold plant in the United States. Expenses as a percentage of net sales excluding the non-recurring charge in 1996 decreased to 17.6% in 1997 from 19.6% in 1996. The decrease in these expenses as a percentage

of net sales resulted from allocating these higher expenses over greater net sales.

**Interest expense** increased \$0.1 million, or 10%, to \$0.9 million in 1997 compared to \$0.8 million in 1996. This was due to the use of the unsecured credit line in the United States throughout 1997 which required higher working capital related to increased sales volumes.

**Miscellaneous (income) expense** decreased \$0.1 million to \$0.1 million in 1997 due to interest income related to the temporary investment of cash received from the Company's initial public offering, offset by currency exchange losses, primarily in the German operation.

**The income tax** provision for the year ended December 31, 1997 was 35.2% of pretax income. The 1996 provision for income taxes included a \$2.4 million deferred charge resulting from the termination of the Company's S Corporation status as of December 31, 1996. Excluding this charge, the pro forma 1996 provision for income taxes was 37.7% of income before taxes. The decrease in the effective tax rate from 1996 to 1997 was primarily due to the mix of pretax income between the United States, the United Kingdom and Germany.

Prior to January 1, 1997, the Company was an S Corporation for federal and state income tax purposes. As a result, the Company was not subject to federal and state income taxes, but was subject to foreign taxes. The Company terminated its S Corporation status as of December 31, 1996, and since that date has been subject to federal and state income taxes. Upon termination of its S Corporation status, the Company recognized approximately \$2.4 million of deferred income taxes in the year ended December 31, 1996.

### Comparison of Years Ended December 31, 1996 and 1995

**Net sales** decreased 1.5%, or \$0.8 million, to \$54.6 million in the year ended December 31, 1996, compared to \$55.4 million in the year ended December 31, 1995. Domestic net sales decreased 1.9%, or \$0.7 million to \$35.9 million in the year ended December 31, 1996. The decline primarily was due to a general decrease in fluid power industry shipments for the first three quarters of the year, United States distributor inventory corrections in the first half of the year and capacity constraints throughout the year. International net sales decreased 1.5%, or \$0.3 million, to \$18.5

million in the year ended December 31, 1996. United Kingdom, Pacific Rim and other foreign net sales increased 8.1% offset by net sales decreases in Germany and Canada of 11.2% and 26.2%, respectively.

**Gross profit** decreased 16.4%, or \$3.4 million, to \$17.4 million in the year ended December 31, 1996, compared to \$20.8 million in the year ended December 31, 1995. Gross profit as a percentage of net sales decreased to 31.9% for the year ended December 31, 1996, from 37.6% for the year ended December 31, 1995. The decrease in gross profit was primarily due to increased costs in the United States plant as new machinery for future growth was installed in severely restricted space, creating excess down time and start-up costs. In addition, material cost increases also were experienced due to an increase in outsourcing necessitated because the United States plant was operating near capacity.

**Selling, engineering and administrative expenses** increased 14.4% or \$1.5 million, to \$12.1 million in the year ended December 31, 1996, compared to \$10.6 million in the year ended December 31, 1995. These expenses as a percentage of net sales increased to

22.2% for the year ended December 31, 1996, from 19.1% for the year ended December 31, 1995. The increase in selling, engineering and administrative expenses primarily was due to a non-recurring, non-cash compensation expense of \$1.4 million related to the issuance of stock options and the cancellation of phantom stock compensation agreements. Excluding the \$1.4 million compensation expense, selling, engineering and administrative expenses as a percentage of sales would have been 19.4% for the year ended December 31, 1996, compared to 19.1% for the year ended December 31, 1995.

### Quarterly Results of Operations

The following table sets forth certain quarterly financial information for each of the Company's last eight quarters. The Company believes that this information includes all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of such quarterly information when read in conjunction with the Financial Statements and the Notes thereto included elsewhere herein. The income tax provision and net income for the 1996 quarters are pro forma results and are presented as if the Company were a C Corporation in the periods presented.

### Quarterly Results of Operations

(in thousands)

| Quarter Ended  | March 31<br>1996 | June 30<br>1996 | Sept. 30<br>1996 | Dec. 31<br>1996 | March 31<br>1997 | June 30<br>1997 | Sept. 30<br>1997 | Dec. 31<br>1997 |
|--|------------------|-----------------|------------------|-----------------|------------------|-----------------|------------------|-----------------|
| Net sales  | \$13,806         | \$13,831        | \$13,596         | \$13,339        | \$14,599         | \$15,276        | \$17,301         | \$17,022        |
| Cost of sales  | 9,491            | 9,125           | 9,287            | 9,282           | 10,202           | 10,444          | 11,842           | 12,133          |
| Gross profit   | 4,315            | 4,706           | 4,309            | 4,057           | 4,397            | 4,832           | 5,459            | 4,889           |
| Selling, engineering<br>and administrative<br>expenses (1) | 2,665            | 2,929           | 3,694            | 2,809           | 2,717            | 2,849           | 3,018            | 2,691           |
| Operating income   | 1,650            | 1,777           | 615              | 1,248           | 1,680            | 1,983           | 2,441            | 2,198           |
| Interest expense   | 205              | 218             | 255              | 145             | 152              | 216             | 285              | 252             |
| Miscellaneous (income)<br>expense                          | 53               | (63)            | 117              | 160             | (58)             | 72              | 27               | 92              |
| Income before<br>income taxes                              | 1,392            | 1,622           | 243              | 943             | 1,586            | 1,695           | 2,129            | 1,854           |
| Tax provision (2)  | 554              | 646             | 55               | 328             | 568              | 616             | 777              | 593             |
| Net income   | \$ 838           | \$ 976          | \$ 188           | \$ 615          | \$ 1,018         | \$ 1,079        | \$ 1,352         | \$ 1,261        |

(1) September 30, 1996 includes non-recurring compensation expense of \$1.4 million.

(2) Pro forma income tax provision as if the Company was a C Corporation for all quarters in 1996.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

(Continued)

### Liquidity and Capital Resources

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

At December 31, 1997, the Company had working capital of \$6.1 million. Cash flow from operations in 1997 was \$6.5 million, compared to \$7.0 million in 1996 and \$12.7 million in 1995. The decrease in the Company's cash flow from operations in 1997 compared to 1996 was due primarily to increased inventory levels in the plants in the United States and increased accounts receivable related to increased sales volume, offset partially by increases in net income and depreciation.

Capital expenditures in 1997 were \$6.5 million, compared to \$17.0 million in 1996 and \$7.7 million in 1995. In 1997, approximately \$1.1 million was spent to complete the new manufacturing plants in the United States and Germany, both of which commenced operations in March 1997. In 1996, the Company was awarded a grant of \$0.4 million by the German government, which helped to offset the cost of the German facility. This grant requires that the German operation employ 26 people by June 30, 1998. The Company anticipates that this headcount requirement will not be met until the first half of 1999. The Company believes that an extension may be available from the German authorities. If the Company fails to obtain an extension of time to meet the terms of the grant, then the \$0.4 million will have to be repaid. This amount has been recorded as a deferred grant. The repayment of the \$0.4 million would only affect cash and would have no effect on net income. The balance of 1997 capital expenditures included \$5.4 million for machinery and equipment. Capital expenditures in 1996 included \$12.6 million for buildings and land improvements for the United States and German facilities and \$4.4 million for machinery and equipment.

The Company has three revolving lines of credit: one in the United States, one in England, and one in Germany. None of these arrangements contain prepayment penalties.

The United States had a \$1.7 million revolving credit agreement, secured by all inventory and accounts

receivable, bearing interest at the lender's prime rate with a maturity date of March 1, 1997. In February 1997, the Company negotiated a one-year, unsecured revolving credit facility to replace the \$1.7 million revolving credit agreement. The new credit facility provides for a maximum availability of \$10.0 million, payable on demand at the lender's prime rate of interest. There are no debt covenants related to this facility. At December 31, 1997, \$0.7 million was outstanding under this credit facility. In February 1998, the Company renegotiated this unsecured credit facility with a term of one year and an interest rate equal to the bank lender's prime rate less 1%, or LIBOR plus 1.9% for predetermined periods of time at the Company's option.

In England, the Company has a \$1.2 million line of credit, denominated in British pounds, which bears interest at a floating rate equal to 2.25% over the bank's base rate and is a demand note. At December 31, 1997, there was no balance outstanding on this credit facility.

The German line of credit is denominated in German Marks, and is a demand note with interest payable at the lender's prime rate.

A 10-year mortgage note of \$6.1 million was obtained in May 1996, at a fixed interest rate of 8.25% for construction of the manifold facility. Terms on the new mortgage note were interest-only on the balance drawn down through the completion of construction and then conversion to a 10-year note with a 15-year amortization schedule. In March 1998, this mortgage note was renegotiated to an interest rate of 7.875%. New terms are monthly principal and interest payments for 8.25 years with remaining principal due July 1, 2006.

In May 1996, the Company obtained a mortgage loan of approximately \$2.4 million, denominated in German marks, for the new facility in Erkelenz, Germany. The loan has a term of 12 years and bears interest at 6.47%.

In addition, the Company has \$1.9 million in notes payable to former stockholders, which bear interest at a weighted rate of 15%, and which have terms ranging from three to five years. These notes were issued by the Company in connection with the repurchase of shares of Common Stock from the former shareholders, and do not allow for prepayment by the Company.

In January 1997, the Company received \$20.3 million of proceeds from its initial public offering of 2,300,00 shares of common stock. Net proceeds after



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expenses were approximately \$19.3 million of which \$10.5 million was distributed to shareholders of record as of December 31, 1996; \$2.9 million was used to repay the equipment note; \$2.4 million was used to repay the mortgage on the Florida cartridge facility; \$1.0 million was paid on the mortgage on the Florida manifold facility; \$1.4 million was paid on the United States revolving line of credit; and the remaining \$1.1 million was used for working capital.

The Company has submitted a business interruption insurance claim of \$2.3 million to its insurance carrier. The claim is related to a fire in the manifold plant in the United States which occurred while the plant was under construction. The Company believes that this fire delayed the opening of the new plant which, in turn, delayed the rearrangement of the cartridge operation and the creation of the cellular production for high volume models. The validity and amount of the claim currently are under evaluation by the Company's insurance carrier.

The Company believes that cash generated from operations and borrowing availability under the \$10 million bank line of credit will be sufficient to satisfy the Company's operating expenses and capital expenditures for the foreseeable future.

## Year 2000

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Management believes that the computer systems in three of the Company's four locations are currently capable of processing data related to the year 2000. The systems in the United States cartridge plant are not capable of properly processing year 2000 data. The Company plans to replace the current system in time to meet year 2000 requirements. The new system cost is not expected to significantly impact the results of operations. As with any new system implementation, there can be no assurance that the conversion will not significantly impact operations. Also, there can be no assurance that the systems of other companies on which the Company relies will be timely converted or that any such failure to convert by another company would not have an adverse effect on the Company's operations.

## Seasonality

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The Company generally has experienced reduced activity during the fourth quarter of the year, largely as a result of fewer working days due to holiday shutdowns.

As a result, the Company's fourth quarter net sales, income from operations and net income typically have been the lowest of any quarter during the year. This was not true in 1997 because of the ramp-up in production related to the increased capacity in the United States operations.

## Inflation

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The impact of inflation on the Company's operating results has been moderate in recent years, reflecting generally lower rates of inflation in the economy and relative stability in the Company's cost of sales. 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.

## FORWARD-LOOKING INFORMATION

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*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 and Observations from Bob Koski and Clyde Nixon 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.*

## Report of Independent Certified Public Accountants

### FORWARD-LOOKING INFORMATION (Cont.)

*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 cyclicality of the capital goods industry in general and the hydraulic valve and manifold industry in particular; (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; and (v) 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.*

To the Board of Directors and Shareholders  
of Sun Hydraulics Corporation

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, changes in shareholders' equity and of cash flows present fairly, in all material respects, the financial position of Sun Hydraulics Corporation and its subsidiaries (the "Company") at December 31, 1997 and 1996, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1997, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

*Price Waterhouse LLP*

Price Waterhouse LLP  
Tampa, Florida  
February 27, 1998



## Consolidated Balance Sheets

(in thousands)

| YEARS ENDED DECEMBER 31,   | 1996            | 1997            |
|--|-----------------|-----------------|
| <b>ASSETS</b>  |                 |                 |
| Current Assets:  |                 |                 |
| Cash and cash equivalents  | \$ 1,038        | \$ 1,249        |
| Accounts receivable, net of allowance for doubtful accounts of \$62 and \$47 | 3,535           | 4,558           |
| Inventories  | 4,451           | 6,775           |
| Other current assets   | 1,132           | 932             |
| <b>TOTAL CURRENT ASSETS</b>  | 10,156          | 13,514          |
| Property, Plant and Equipment, Net   | 37,212          | 39,789          |
| Other Assets   | 1,048           | 86              |
| <b>TOTAL ASSETS</b>  | <u>\$48,416</u> | <u>\$53,389</u> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                                  |                 |                 |
| Current Liabilities:   |                 |                 |
| Accounts payable   | \$ 3,273        | \$ 2,847        |
| Accrued expenses and other liabilities                                       | 1,961           | 2,174           |
| Long-term debt due within one year   | 2,340           | 1,035           |
| Notes payable to related parties due within one year                         | 655             | 757             |
| Dividends payable  | 508             | 221             |
| Income taxes payable   | 461             | 380             |
| <b>TOTAL CURRENT LIABILITIES</b>   | 9,198           | 7,414           |
| Long-Term Debt Due After One Year  | 12,314          | 6,620           |
| Notes Payable to Related Parties Due After One Year                          | 1,909           | 1,152           |
| Deferred Income Taxes  | 2,578           | 3,203           |
| Other Liabilities  | 20              | -               |
| <b>TOTAL LIABILITIES</b>   | <u>26,019</u>   | <u>18,389</u>   |
| Commitments & Contingencies (Note 17)  |                 |                 |
| Shareholders' Equity:  |                 |                 |
| Preferred stock  | -               | -               |
| Common stock (Note 2)  | 2,179           | 6               |
| Capital in excess of par value   | 2,719           | 24,163          |
| Retained earnings  | 17,450          | 10,732          |
| Equity adjustments for foreign currency translation                          | 49              | 99              |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>  | <u>22,397</u>   | <u>35,000</u>   |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>                            | <u>\$48,416</u> | <u>\$53,389</u> |

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



## Consolidated Statements of Income

(in thousands except per share data)

| YEARS ENDED DECEMBER 31,                            | 1995            | 1996            | 1997            |
|---|-----------------|-----------------|-----------------|
| Net sales   | \$55,388        | \$54,572        | \$64,198        |
| Cost of sales                                       | 34,581          | 37,185          | 44,621          |
| Gross profit  | 20,807          | 17,387          | 19,577          |
| Selling, engineering and<br>administrative expenses | 10,578          | 12,097          | 11,275          |
| Operating income                                    | 10,229          | 5,290           | 8,302           |
| Interest expense                                    | 814             | 823             | 905             |
| Miscellaneous (income)<br>expense                   | (79)            | 267             | 133             |
| Income before income taxes                          | 9,494           | 4,200           | 7,264           |
| Income tax provision                                | 633             | 3,129           | 2,554           |
| <b>Net income</b>                                   | <u>\$ 8,861</u> | <u>\$ 1,071</u> | <u>\$ 4,710</u> |
| <b>Basic net income per common share</b>            | \$ 2.29         | \$ 0.27         | \$ 0.75         |
| <b>Weighted average shares outstanding</b>          | 3,878           | 3,978           | 6,308           |
| <b>Diluted net income per common share</b>          | \$ 2.15         | \$ 0.26         | \$ 0.73         |
| <b>Weighted average shares outstanding</b>          | 4,123           | 4,178           | 6,499           |

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





## Consolidated Statement of Changes in Shareholders' Equity

(in thousands)

|  | Shares           | Common<br>Stock | Capital in<br>Excess of<br>Par Value | Retained<br>Earnings | Equity<br>Adjustment<br>For Foreign<br>Currency<br>Translation | Total           |
|--|------------------|-----------------|--------------------------------------|----------------------|--|-----------------|
| <b>Balance, December 31, 1994</b>              | 3,858,244        | \$ 2,181        | \$ 848                               | \$12,969             | \$ (374)   | \$15,624        |
| Exercise of stock options                      | 99,756           |                 | 149                                  |                      |  | 149             |
| Net income                                     |                  |                 |                                      | 8,861                |  | 8,861           |
| Distributions to shareholders                  |                  |                 |                                      | (3,154)              |  | (3,154)         |
| Adjustment for foreign<br>currency translation |                  |                 |                                      |                      | 49   | 49              |
| <b>Balance, December 31, 1995</b>              | 3,958,000        | 2,181           | 997                                  | 18,676               | (325)  | 21,529          |
| Issuance of stock options                      |                  |                 | 2,110                                |                      |  | 2,110           |
| Suninco step-up for purchase accounting        |                  |                 | 185                                  |                      |  | 185             |
| Exercise of stock options                      | 42,002           |                 | 70                                   |                      |  | 70              |
| Repurchase and retirement of shares            |                  |                 | (41)                                 |                      |  | (41)            |
| Exchange of shares in merger                   |                  | (2)             | (602)                                | 604                  |  | -               |
| Net income                                     |                  |                 |                                      | 1,071                |  | 1,071           |
| Distributions to shareholders                  |                  |                 |                                      | (2,901)              |  | (2,901)         |
| Adjustment for foreign<br>currency translation |                  |                 |                                      |                      | 374  | 374             |
| <b>Balance, December 31, 1996</b>              | 4,000,002        | 2,179           | 2,719                                | 17,450               | 49   | 22,397          |
| Net proceeds from stock offering               | 2,300,000        | 2               | 19,250                               |                      |  | 19,252          |
| Distributions to shareholders                  |                  |                 |                                      | (10,545)             |  | (10,545)        |
| Dividends declared                             |                  |                 |                                      | (883)                |  | (883)           |
| Net income                                     |                  |                 |                                      | 4,710                |  | 4,710           |
| Merger with Sun Holdings (Note 2)              |                  | (2,175)         | 2,123                                |                      |  | (52)            |
| Exercise of stock options                      | 22,000           |                 | 71                                   |                      |  | 71              |
| Adjustment for foreign<br>currency translation |                  |                 |                                      |                      | 50   | 50              |
| <b>Balance, December 31, 1997</b>              | <u>6,322,002</u> | <u>\$ 6</u>     | <u>\$24,163</u>                      | <u>\$10,732</u>      | <u>\$ 99</u>   | <u>\$35,000</u> |

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



## Consolidated Statements of Cash Flows

(in thousands)

| YEARS ENDED DECEMBER 31,  | 1995            | 1996            | 1997            |
|---|-----------------|-----------------|-----------------|
| <b>Cash Flows From Operating Activities:</b>                                      |                 |                 |                 |
| Net income  | \$ 8,861        | \$ 1,071        | \$ 4,710        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                 |                 |                 |
| Depreciation  | 2,556           | 2,857           | 3,706           |
| Compensation expense of stock options   | –               | 2,110           | –               |
| (Benefit from) provision for deferred income taxes                                | (110)           | 2,494           | 625             |
| (Increase) decrease in:   |                 |                 |                 |
| Accounts receivable   | (479)           | 39              | (1,023)         |
| Inventories   | (679)           | 27              | (2,324)         |
| Other current assets  | 307             | (910)           | 200             |
| Other assets  | (4)             | (1,021)         | 962             |
| Increase (decrease) in:   |                 |                 |                 |
| Accounts payable  | 1,146           | 281             | (426)           |
| Accrued expenses and other liabilities  | 280             | 773             | 213             |
| Income taxes payable, net   | 490             | (29)            | (81)            |
| Other liabilities   | 369             | (732)           | (20)            |
| Net cash provided by operating activities   | <u>12,737</u>   | <u>6,960</u>    | <u>6,542</u>    |
| <b>Cash Flows From Investing Activities:</b>                                      |                 |                 |                 |
| Capital expenditures  | (7,657)         | (16,963)        | (6,490)         |
| Proceeds from dispositions of equipment   | 23              | 23              | 207             |
| Net cash used in investing activities   | <u>(7,634)</u>  | <u>(16,940)</u> | <u>(6,283)</u>  |
| <b>Cash Flows From Financing Activities:</b>                                      |                 |                 |                 |
| Proceeds from debt  | 3,337           | 16,502          | 5,580           |
| Repayment of debt   | (4,661)         | (4,896)         | (12,579)        |
| Repayment of notes payable to related parties                                     | (515)           | (574)           | (655)           |
| Purchase accounting-Suninco   | –               | 185             | –               |
| Proceeds from exercise of stock options   | 149             | 70              | 71              |
| Repurchase of shares  | –               | (41)            | –               |
| Net proceeds from stock offering  | –               | –               | 19,252          |
| Cash paid for Sun Holdings merger (Note 2)  | –               | –               | (52)            |
| Dividends to shareholders   | –               | –               | (663)           |
| Distributions to shareholders   | (3,399)         | (3,036)         | (11,052)        |
| Net cash provided by (used in) financing activities                               | <u>(5,089)</u>  | <u>8,210</u>    | <u>(98)</u>     |
| <b>Adjustment for Foreign Currency Translation</b>                                | <u>49</u>       | <u>374</u>      | <u>50</u>       |
| <b>Net Increase (Decrease) in Cash and Cash Equivalents</b>                       | <u>63</u>       | <u>(1,396)</u>  | <u>211</u>      |
| <b>Cash and Cash Equivalents, Beginning of Period</b>                             | <u>2,371</u>    | <u>2,434</u>    | <u>1,038</u>    |
| <b>Cash and Cash Equivalents, End of Period</b>                                   | <u>\$ 2,434</u> | <u>\$ 1,038</u> | <u>\$ 1,249</u> |
| <b>Supplemental Disclosure of Cash Flow Information:</b>                          |                 |                 |                 |
| Cash paid for:  |                 |                 |                 |
| Interest (including amounts capitalized)  | <u>\$ 815</u>   | <u>\$ 324</u>   | <u>\$ 1,206</u> |
| Income taxes  | <u>\$ 109</u>   | <u>\$ 587</u>   | <u>\$ 2,010</u> |

The accompanying Notes to Combined Financial Statements are an integral part of these financial statements.

## 1. Business

Sun Hydraulics Corporation and its wholly-owned subsidiary (the "Company") 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 and Germany. Sun Hydraulics Corporation ("Sun Hydraulics"), located in Sarasota, Florida, designs, manufactures and sells through independent distributors in the United States. Sun Hydraulik Holdings Limited ("Sun Holdings") was formed to provide a holding company vehicle 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, "GmbH"). Sun Ltd. was originally formed in 1985, and operates a manufacturing and distribution facility located in Coventry, England. GmbH was incorporated on January 1, 1991, to market the Company's products in German-speaking European markets.

## 2. Reorganization and Initial Public Offering

The consolidated financial statements of the Company consist of the financial position and results of operations of Sun Hydraulics and Sun Holdings. Sun Hydraulics and Suninco, Inc. ("Suninco") completed a merger on June 28, 1996 by exchanging Sun Hydraulics' common stock for all of the outstanding stock of Suninco. The share exchange was accounted for in a manner similar to a pooling of interest, except for shares held by the minority shareholders which were accounted for at the fair market values of the proportionate share of related assets and liabilities. The fair market value of their minority interest shares in excess of net book value were allocated to Sun Hydraulics' long-term assets on a pro-rata basis, resulting in an increase of \$38 and \$245 to land and buildings, respectively.

In January 1997, Sun Hydraulics effected a 9.90372627 for 1 stock split. All prior year share amounts reflected in the financial statements include the effect of the stock split. Additionally, Sun Hydraulics issued 374,811 shares of common stock and made a nominal cash payment of \$52 in exchange for all of the issued and outstanding stock of Sun Holdings (the "Reorganization"). The Reorganization was accounted for in a manner similar to a pooling of interest except for shares held by the minority shareholders which were accounted for at the fair market value of their proportionate share of related assets and liabilities, which approximated book value on the date of the

transaction. Accordingly, financial statements for 1997 are on a consolidated basis, and financial statements for 1996 and 1995 are on a combined basis.

The Company filed a Registration Statement on Form S-1 with the Securities and Exchange Commission effective January 9, 1997, and issued 2,300,000 shares of common stock in an initial public offering ("IPO"), with an initial offering price of \$9.50. The IPO net proceeds of \$19,252, the exchange of shares with Sun Holdings, and the distribution of previously taxed S Corporation retained earnings are reflected in the statement of changes in shareholders' equity.

The \$19,252 of net proceeds from the IPO were used as follows: a payment of \$9,446 of the S Corporation distribution was made, representing 90% of the total distribution of \$10,545, \$7,676 was paid to extinguish debt, \$1,000 was paid to reduce the mortgage on the manifold facility, and \$1,130 was retained as working capital.

The Company has 20,000,000 authorized shares of common stock, par value \$0.001, with 6,322,002 shares outstanding at December 31, 1997. The Company also has 2,000,000 authorized shares of preferred stock, par value \$0.001, with no shares outstanding.

### *Earnings Per Share*

During the first quarter of 1997, Statement on Financial Accounting Standards No. 128 ("SFAS 128"), "Earnings per Share," was issued. SFAS 128 is in effect for the year ended December 31, 1997 and requires a restatement of previously reported earnings per share. SFAS 128 requires the Company to report both basic earnings per common share, which is based on the weighted average number of common shares outstanding, and diluted earnings per common share, which is based on the weighted average number of common shares outstanding and all dilutive potential common shares outstanding. All prior years' earnings per share data in this report have been recalculated to reflect the provisions of SFAS 128.

3. Pro Forma Net Income (Unaudited)

|  | Pro Forma<br>1995 | Pro Forma<br>1996 | Actual<br>1997 |
|--|-------------------|-------------------|----------------|
| <b>Statement of Income Data:</b>                 |                   |                   |                |
| Net sales  | \$55,388          | \$54,572          | \$64,198       |
| Cost of sales                                    | 34,581            | 37,185            | 44,621         |
| Gross profit                                     | 20,807            | 17,387            | 19,577         |
| Selling, engineering and administrative expenses | 10,578            | 12,097            | 11,275         |
| Operating income                                 | 10,229            | 5,290             | 8,302          |
| Interest expense                                 | 814               | 823               | 905            |
| Miscellaneous (income) expense                   | (79)              | 267               | 133            |
| Income before income taxes                       | 9,494             | 4,200             | 7,264          |
| Income tax provision (benefit)                   | 3,611             | 1,583             | 2,554          |
| Net income                                       | \$ 5,883          | \$ 2,617          | \$ 4,710       |
| Basic net income per common share                | \$ .95            | \$ 0.42           | \$ 0.75        |
| Weighted average shares outstanding              | 6,224             | 6,300             | 6,308          |
| Diluted net income per common share              | \$ .92            | \$ 0.40           | \$ 0.73        |
| Weighted average shares outstanding              | 6,433             | 6,519             | 6,499          |

Pro forma net income reflects a provision for income taxes as if Sun Hydraulics had been a C Corporation for all periods presented. Additionally, selling, engineering and administrative expense for the year ended December 31, 1996 reflects a \$1,378 non-recurring, non-cash compensation expense related to the termination of employee phantom stock compensation agreements and the issuance of options to Directors. Without this expense, pro forma net income for the year ended December 31, 1996 would have been \$3,800, and pro forma basic and diluted earnings per share would have been \$.60 and \$.58, respectively.

The computation of pro forma earnings per share is based on the pro forma weighted average number of common shares outstanding during the period plus vested common stock equivalents, if dilutive, consisting of certain shares subject to stock options, after giving effect to the Reorganization and the IPO. The assumed exercise of dilutive stock options less the number of treasury shares assumed to be purchased from the proceeds were calculated using the average market price for the period ended December 31, 1997, the appraised fair market value of the Company from 1995 to 1996.

4. Summary of Significant Accounting Policies

A summary of the significant accounting policies followed in the preparation of the Company's consolidated financial statements is set forth below:

**Principles of Combination**

The consolidated financial statements include the accounts and operations of Sun Hydraulics and its direct and indirect subsidiaries. All significant intercompany

accounts and transactions are eliminated in consolidation. As a result of the Reorganization in 1996 (See Note 2), financial statements for 1997 are on a consolidated basis, and financial statements for 1996 and 1995 are on a combined basis.

**Management Estimates and Assumptions**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Cash and Cash Equivalents**

The Company considers all short-term highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

**Inventories**

Inventories are valued at the lower of cost or market, cost being determined on a first-in, first-out basis.

**Property, Plant and Equipment**

Property, plant and equipment is stated at cost. Expenditures for repairs and improvements that significantly add to the productive capacity or extend the useful life of an asset are capitalized. Repairs and maintenance are expensed as incurred. Depreciation is computed using the straight line method over the following useful lives:



(in thousands except share and per share data)

|                                 | YEARS |
|---------------------------------|-------|
| Machinery and equipment         | 4-12  |
| Furniture and fixtures          | 4-10  |
| Land and leasehold improvements | 5-15  |
| Buildings                       | 40    |

Capitalized interest was \$9, \$293, and \$160 in 1995, 1996 and 1997, respectively.

### **Valuation Assessment of Long-Lived Assets**

Management periodically evaluates long-lived assets for potential impairment, and will reserve for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be fully recoverable. As of December 31, 1997, management does not believe that an impairment reserve is required.

### **Other Assets**

Other assets at December 31, 1996 consisted primarily of deferred costs associated with the IPO. Such costs have been charged against the proceeds of the IPO in 1997.

### **Revenue Recognition**

Sales are recognized when products are shipped. Sales incentives are granted to customers based upon the volume of purchases. These sales incentives are recorded at the time of sales as a reduction of gross sales.

### **Research and Development Expense**

Included in selling, engineering and administrative expenses are amounts incurred for research and development costs paid to third parties for the Company's manufacturing processes and related software which approximated \$1,337, \$1,007 and \$630 for the years ended December 31, 1995, 1996 and 1997, respectively.

### **Advertising Costs**

The Company expenses the costs for advertising and promotional literature during the year incurred. Included in selling, engineering and administrative expenses are amounts incurred for advertising and promotional literature which approximated \$792, \$641 and \$719 for the years ended December 31, 1995, 1996 and 1997, respectively.

### **Foreign Currency Translation and Transactions**

The Company follows the translation policy provided by Statement of Financial Accounting Standards No. 52, "Foreign Currency Translation." The Pound Sterling is the functional currency of Sun Ltd. The Deutsche Mark is the functional currency of GmbH. The U.S. Dollar is the functional currency for Sun Hydraulics and the reporting

currency for the consolidated group. The assets and liabilities of Sun Ltd. and GmbH are translated at the exchange rate in effect at the balance sheet date, while income and expense items are translated at the average annual rate of exchange for the period. The resulting unrealized translation gains and losses are included in the component of shareholders' equity designated "equity adjustment for foreign currency translation." Realized gains and losses from foreign currency translations are included in miscellaneous (income) expense.

### **Income Taxes**

The Company follows the income tax policy provided by Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." This Statement provides for a liability approach under which deferred income taxes are provided for based upon enacted tax laws and rates applicable to the periods in which the taxes become payable. These differences result from items reported differently for financial reporting and income tax purposes, primarily depreciation and stock options.

Prior to December 31, 1996, Sun Hydraulics had elected to be taxed under the S Corporation provisions of the Internal Revenue Code. Historically, the shareholders of Sun Hydraulics included their pro rata share of income or loss in their individual returns. A portion of the distributions to shareholders was related to their individual income tax liabilities, resulting from S Corporation taxable earnings (see Note 12). Effective December 31, 1996, Sun Hydraulics converted to C Corporation status and Sun Hydraulics' subsequent earnings are subject to corporate income taxes. Accordingly, for informational purposes, the December 31, 1996 statement of income reflects an unaudited pro forma income tax provision which would have been recorded if Sun Hydraulics had been a C Corporation, based on the tax laws in effect during those periods.

### **Stock-Based Compensation**

The Company adopted Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("FAS 123") during 1996. Upon adoption, the Company retained the intrinsic value method of accounting for stock-based compensation and has disclosed the effects of adopting this pronouncement in the notes to the financial statements (see Note 13).

### **Reclassifications**

Certain prior year balances have been reclassified to be consistent with current year presentation.

**5. Fair Value of Investments**

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation. The following methods and assumptions were used to estimate the fair value of each class of financial instruments.

The carrying amounts of cash and cash equivalents, accounts receivable, other current assets, accounts payable, accrued expenses and other liabilities approximate fair value because of their short maturity of those instruments.

The carrying amount of long-term debt approximates fair value, as the interest rates on the debt approximate rates currently available to the Company for debt with similar terms and remaining maturities.

The fair value of the notes payable to related parties is estimated based on the current rates offered to the Company for similar debt. The estimated fair value of the Company's related party notes payable is approximately \$2,111 and \$1,630 at December 31, 1996 and 1997, respectively.

**6. Inventories**

| DECEMBER 31,    | 1996            | 1997            |
|-----------------|-----------------|-----------------|
| Raw materials   | \$ 147          | \$ 214          |
| Work in process | 2,758           | 4,348           |
| Finished goods  | 1,546           | 2,213           |
|                 | <u>\$ 4,451</u> | <u>\$ 6,775</u> |

**7. Property, Plant and Equipment**

| DECEMBER 31,                    | 1996            | 1997            |
|---------------------------------|-----------------|-----------------|
| Machinery and equipment         | \$24,930        | \$28,165        |
| Furniture and fixtures          | 4,938           | 5,880           |
| Buildings                       | 5,071           | 17,663          |
| Leasehold and land improvements | 586             | 760             |
| Construction in progress        | 14,558          | 838             |
| Land                            | 1,410           | 1,581           |
|                                 | <u>51,493</u>   | <u>54,887</u>   |
| Less: Accumulated depreciation  | (14,281)        | (15,098)        |
|                                 | <u>\$37,212</u> | <u>\$39,789</u> |

**8. Accrued Expenses and Other Liabilities**

| DECEMBER 31,              | 1996            | 1997            |
|---------------------------|-----------------|-----------------|
| Compensation and benefits | \$ 1,161        | \$ 1,348        |
| Deferred grant            | 462             | 424             |
| Taxes                     | 112             | 117             |
| Interest                  | 93              | 75              |
| Warranty expense          | 44              | 30              |
| Other accrued expenses    | 89              | 180             |
|                           | <u>\$ 1,961</u> | <u>\$ 2,174</u> |

**9. Long-Term Debt**

| DECEMBER 31,   | 1996            | 1997           |
|--|-----------------|----------------|
| Lines of credit agreements, interest payable at lender's prime rate (8.5% at December 31, 1996 and December 31, 1997)  | \$ 1,512        | \$ 666         |
| Construction line of credit at 8.25% converted to a mortgage note in April 1997 with a maturity of 10 years, 15 year amortization, due in monthly principal and interest installments of approximately \$60. | 5,789           | 4,990          |
| Construction line of credit at 6.47% converted to a mortgage note in April 1997 with a maturity of 12 years, due in monthly principal and interest installments of approximately \$42.                       | 2,078           | 1,999          |
| Secured equipment loan, interest only payable monthly at 8.25% at December 31, 1996.   | 2,874           | -              |
| 8.25% mortgage note payable secured by real property due in monthly principal and interest installments of \$20.   | 2,355           | -              |
| Notes payable secured by equipment, payable in monthly principal and interest installments with interest rates varying from 4.90% to 5.60% with maturity dates from March 1996 to June 1998.                 | 46              | -              |
|  | <u>14,654</u>   | <u>7,655</u>   |
| Less amounts due within one year   | (2,340)         | (1,035)        |
|  | <u>\$12,314</u> | <u>\$6,620</u> |

The remaining principal payments are due as follows: 1999-\$400; 2000-\$433; 2001-\$469; 2002-\$509; 2003 and thereafter \$4,809.

The Company has three revolving lines of credit; one in the United States, one in England, and one in Germany. None of these arrangements contain pre-payment penalties. The United States had a \$1,700 revolving credit agreement, secured by all inventory and accounts receivable, bearing interest at the lender's prime rate with a maturity date of March 1, 1997. In February 1997, the Company negotiated a one-year, unsecured revolving credit facility to replace the \$1,700 revolving credit agreement. The new credit facility provides for a maximum availability of \$10,000, payable on demand at

the lender's prime rate of interest. There are no debt covenants related to this facility. At December 31, 1997, \$650 was outstanding under this credit facility. In February 1998, the Company renegotiated this unsecured credit facility with a term of one year and an interest rate equal to the bank lender's prime rate less 1%, or LIBOR plus 1.9% for predetermined periods of time at the Company's option.

In England, the Company has a \$1.2 million line of credit, denominated in British pounds, which bears interest at a floating rate equal to 2.25% over the bank's base rate and is a demand note. At December 31, 1997 there was no balance outstanding on this credit facility.

The German line of credit is a demand note denominated in German Marks with interest payable at the lender's prime rate. At December 31, 1997, \$16 was outstanding under this credit facility.

A 10-year mortgage note of \$6,187 was obtained at a fixed interest rate of 8.25% for construction of the manifold facility. Terms on the new mortgage note were interest-only on the balance drawn down through the completion of construction and then conversion to a 10-year note with a 15-year amortization schedule. The Company applied \$1,000 of the IPO proceeds toward repayment of this note. In March 1998, this mortgage note was renegotiated to an interest rate of 7.875%. New terms are principal and interest payments of \$43 for 8.25 years with remaining principal due July 1, 2006.

In May 1996, the Company obtained a mortgage loan of approximately \$2.4 million, denominated in German marks, for the new facility in Erkelenz, Germany. The loan has a term of 12 years and bears interest at 6.47%.

In January 1997, the Company repaid the secured equipment loan and the 8.25% mortgage note payable with proceeds from the IPO.

## 10. Related Parties

Notes payable to related parties include the following:

| DECEMBER 31,   | 1996           | 1997           |
|--|----------------|----------------|
| 15% unsecured notes payable for repurchase and retirement of stock, quarterly principal and interest installments ranging from \$43 to \$142 through 2001. | \$2,303        | \$1,680        |
| 10% unsecured notes payable for phantom compensation, quarterly principal and interest payments of \$14 payable through 2002.                              | 261            | 229            |
|  | 2,564          | 1,909          |
| Less amounts due within one year   | (655)          | (757)          |
|  | <u>\$1,909</u> | <u>\$1,152</u> |

The remaining principal payments are due as follows: 1999-\$586; 2000-\$365; 2001-\$135; 2002-\$66.

The 15% notes payable represents the repurchase and retirement of stock to related parties for the years 1989 to 1993. These notes represent the repurchase of shares of common stock from four retiring employees, one employee of retirement age who was still employed by the Company at the time the shares were repurchased, and nine former shareholders related to the principal shareholder of the Company. These agreements contain a provision disallowing prepayment.

During 1995, Sun Hydraulics entered into a 35-month agreement with SunOpTech ("SunOpTech"), a limited partnership formed to further the development of the manufacturing software used in the Company's production process. A significant shareholder of Sun Hydraulics, who owns approximately 36% of the Company, owns 51% of the stock of SunOpTech. In exchange for the development of computer software and computer support, Sun Hydraulics will pay approximately \$1,000 over the three-year period. Fees paid under this agreement for the year ended December 31, 1997 were \$317. For the years ended December 31, 1995, 1996 and 1997, Sun Hydraulics paid SunOpTech's expenses of \$25, \$203 and \$291, respectively. These expenses are included in selling, engineering and administrative expenses. Additionally, Sun Hydraulics provided certain administrative support and office space to SunOpTech at no charge.

A Director of the Company is the President, Chief Executive Officer and controlling stockholder of a fluid power distributorship that purchases and sells the Company's products pursuant to one of the Company's standard distributor agreements. This distributorship purchased approximately \$1,310, \$1,104 and \$900 of products from the Company in fiscal 1995, 1996 and 1997, respectively.

## 11. Distributions to Shareholders

The Company declared distributions of \$3,154, \$2,901 and \$10,545 to shareholders in 1995, 1996 and 1997, respectively, a portion of which was to fund shareholders' individual income tax liabilities related to the S Corporation taxable earnings.

Subsequent to the IPO, the Company distributed all of Sun Hydraulics' previously undistributed retained earnings totaling \$10,545 related to the S Corporation. A distribution of \$9,446 representing 90% of the total undistributed retained earnings was paid in January 1997. The remaining 10% of \$1,099 was paid in May 1997.

The Company declared quarterly cash dividends of \$.035 per share, to shareholders of record on March 31, 1997, July 3, 1997, October 1, 1997 and December 31, 1997. These dividends were paid on April 15, 1997, July 15, 1997, October 15, 1997 and January 15, 1998, respectively. The Company declared a cash dividend of \$.04 per share on March 4, 1998, to shareholders of record on March 31, 1998, payable on April 15, 1998.

## Notes to Combined Financial Statements

(Continued)

### 12. Income Taxes

Pretax income from continuing operations is taxed under the following jurisdictions:

| DECEMBER 31,  | 1995           | 1996           | 1997           |
|---------------|----------------|----------------|----------------|
| United States | \$7,489        | \$2,190        | \$4,962        |
| Foreign       | 2,005          | 2,010          | 2,302          |
| Total         | <u>\$9,494</u> | <u>\$4,200</u> | <u>\$7,264</u> |

The income tax provision consists of the following:

| DECEMBER 31,                    | 1995          | 1996           | 1997           |
|---------------------------------|---------------|----------------|----------------|
| Current tax expense (benefit):  |               |                |                |
| United States                   | \$ (3)        | \$ 7           | \$1,157        |
| State and local                 | -             | -              | 75             |
| Foreign                         | 746           | 621            | 697            |
| Total current                   | <u>743</u>    | <u>628</u>     | <u>1,929</u>   |
| Deferred tax expense (benefit): |               |                |                |
| United States                   | (88)          | 2,170          | 615            |
| State and local                 | (16)          | 255            | 14             |
| Foreign                         | (6)           | 76             | (4)            |
| Total deferred                  | <u>(110)</u>  | <u>2,501</u>   | <u>625</u>     |
| Total income tax provision      | <u>\$ 633</u> | <u>\$3,129</u> | <u>\$2,554</u> |

The income tax provision for the year ended December 31, 1995 relates to Suninco, which was a C corporation until June 28, 1996 when it was merged with Sun Hydraulics.

The reconciliation between the effective income tax rate and the U.S. federal statutory rate is as follows:

| DECEMBER 31,                         | 1995          | 1996            | 1997            |
|--------------------------------------|---------------|-----------------|-----------------|
| U.S. federal taxes at statutory rate | \$ 3,228      | \$ 1,428        | \$ 2,461        |
| Increase (decrease):                 |               |                 |                 |
| Foreign income taxed at higher rates | 28            | 14              | (80)            |
| Conversion of S to C Corporation     | -             | 2,354           | -               |
| S Corporation income                 | (2,684)       | (724)           | -               |
| Nondeductible items                  | 46            | 57              | 39              |
| State and local taxes, net           | (16)          | -               | 138             |
| Other                                | 31            | -               | (4)             |
| Income tax provision                 | <u>\$ 633</u> | <u>\$ 3,129</u> | <u>\$ 2,554</u> |

Deferred tax assets and liabilities at December 31 are as follows:

| DECEMBER 31,   | 1996           | 1997           |
|--|----------------|----------------|
| Deferred taxes, non-current:   |                |                |
| Assets   |                |                |
| Accrued expenses and reserves not currently deductible               | \$ 182         | \$ 139         |
| Compensation expense recognized for book, not yet deductible for tax | 558            | 451            |
| Florida NOL carry forward  | 18             | -              |
| Deferred tax asset, non-current                                      | <u>758</u>     | <u>590</u>     |
| Liabilities  |                |                |
| Depreciation   | 3,336          | 3,793          |
| Net deferred tax liability, non-current                              | <u>\$2,578</u> | <u>\$3,203</u> |

Upon termination of the S Corporation status (see Note 2), the Company was required to recognize deferred income taxes for financial and tax reporting purposes and recognize deferred income taxes for cumulative temporary differences.

#### Pro Forma Taxes (unaudited)

The reconciliation between the effective income tax rate and the U.S. federal statutory rate is as follows:

| DECEMBER 31,                         | 1995           | 1996           |
|--------------------------------------|----------------|----------------|
| U.S. federal taxes at statutory rate | \$3,228        | \$1,428        |
| Increase:                            |                |                |
| Foreign income taxed at higher rates | 28             | 14             |
| Nondeductible items                  | 81             | 57             |
| State and local taxes, net           | 243            | 84             |
| Other                                | 31             | -              |
| Income tax provision                 | <u>\$3,611</u> | <u>\$1,583</u> |

Pro forma deferred tax assets and liabilities at December 31, 1996 are as follows:

|  |                |
|--|----------------|
| Pro forma deferred taxes, non-current:                               |                |
| Assets   |                |
| Accrued expenses and reserves not currently deductible               | \$ 182         |
| Compensation expense recognized for book, not yet deductible for tax | 558            |
| Florida NOL carry forward  | 18             |
| Pro forma deferred tax asset, non-current                            | <u>\$ 758</u>  |
| Liabilities  |                |
| Depreciation   | <u>\$3,336</u> |
| Pro forma net deferred tax liability, non-current                    | <u>\$2,578</u> |



(in thousands except share and per share data)

### 13. Stock Option Plans

During 1995 and part of 1996, the Company maintained a phantom stock option plan (the "Plan"). Compensation cost was measured as the amount by which the market value, as defined in the Plan, of the stock on the measurement date exceeded the market value on the date the phantom stock options were granted. The market value was defined in the Plan as the higher of: the last arm's length sale price of said stock between unrelated parties if there had been a sale in the preceding six-months period, or the book value of said stock. Compensation cost was accrued over the service period and adjusted in periods subsequent to the measurement date for changes in the market value of the stock.

During 1996, the Company adopted the 1996 Stock Option Plan (the "Stock Option Plan"), which provides for the grant of incentive stock options and nonqualified stock options for the purchase of up to an aggregate of 1,000,000 shares of the Company's common stock by officers, employees and Directors of the Company. Under 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 become exercisable at such times and in such installments as determined by the Board of Directors.

Effective September 30, 1996, the Board of Directors approved the granting of 319,960 nonqualified stock options and committed to granting 189,348 of qualified incentive options under the Stock Option Plan to replace the phantom stock option plans. The employees and Directors were immediately vested in the nonqualified

options upon Reorganization. The qualified incentive options vest over a period of six years from the date of grant. The Company recognized a charge of \$1,378 in 1996 related to the termination of the phantom stock option plans.

A summary of the Company's stock option plan for each of the three years ended December 31, 1997 is summarized as follows:

| Price  | Number of Shares | Exercise Price Range | Weighted Average Exercise |
|--|------------------|----------------------|---------------------------|
| Under option, December 31, 1994 (141,758 shares exercisable) |                  |                      |                           |
|  | 141,758          | \$ .001-18.68        | \$ 1.55                   |
| Exercised  |                  |                      |                           |
|  | (99,756)         | \$ .001-18.68        | \$ 1.49                   |
| Under option, December 31, 1995 (42,002 shares exercisable)  |                  |                      |                           |
|  | 42,002           | \$ .001-18.68        | \$ 1.68                   |
| Granted  |                  |                      |                           |
|  | 319,960          | \$ 3.00- 5.05        | \$ 3.96                   |
| Exercised  |                  |                      |                           |
|  | (42,002)         | \$ .66-18.68         | \$ 1.68                   |
| Under option, December 31, 1996 (319,960 shares exercisable) |                  |                      |                           |
|  | 319,960          | \$ 3.00- 5.05        | \$ 3.91                   |
| Granted  |                  |                      |                           |
|  | 289,348          | \$ 9.50              | \$ 9.50                   |
| Exercised  |                  |                      |                           |
|  | (22,000)         | \$ 3.00- 3.47        | \$ 3.21                   |
| Under option, December 31, 1997 (356,660 shares exercisable) |                  |                      |                           |
|  | 587,308          | \$ 3.00- 9.50        | \$ 6.69                   |

A summary of outstanding and exercisable options at December 31, 1997 is summarized as follows:

| OPTIONS OUTSTANDING      |                  |   |                                 | OPTIONS EXERCISABLE |                                 |
|--------------------------|------------------|---|---------------------------------|---------------------|---------------------------------|
| Range of exercise prices | Number of shares | Weighted-average remaining contractual life | Weighted-average exercise price | Number of shares    | Weighted-average exercise price |
| \$ 3.00                  | 70,586           | 8.53  | \$3.00                          | 70,586              | \$3.00                          |
| 3.43-5.05                | 227,374          | 8.75  | 4.25                            | 227,374             | 4.25                            |
| 9.50                     | 289,348          | 8.97  | 9.50                            | 58,700              | 9.50                            |

**13. Stock Option Plans (Continued)**

The Company has adopted the disclosure-only provisions of SFAS No. 123. Accordingly, no compensation cost has been recognized for the stock option plans other than for nonqualified stock options. Had compensation costs for the stock option plans been determined based on the fair value at the grant date for awards in 1997 and 1996 consistent with the provisions of SFAS No. 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below:

| DECEMBER 31,                       | 1996    | 1997    |
|------------------------------------|---------|---------|
| Net income:                        |         |         |
| As reported                        | \$1,071 | \$4,710 |
| Pro forma                          | 989     | 4,394   |
| Basic earnings per common share:   |         |         |
| As reported                        | 0.27    | 0.75    |
| Pro forma                          | 0.25    | 0.70    |
| Diluted earnings per common share: |         |         |
| As reported                        | 0.26    | 0.73    |
| Pro forma                          | 0.24    | 0.68    |

There was no pro forma effect for 1995 as no options were vested or granted. These pro forma amounts may not be representative of future disclosures since the estimated fair value of stock options is amortized to expense over the vesting period and additional options may be granted in future years. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 1996 and 1997: cumulative volatility of 36.71% and 39.56% for 1996 and 1997, respectively; dividend yields of 1.35% and 1.68% for 1996 and 1997, respectively; risk-free interest rate of 6.60% and 5.72% for 1996 and 1997, respectively; and expected term of 5 years and 6.04 years for 1996 and 1997, respectively.

**14. Earnings per Common Share**

Presented below is basic and diluted EPS under SFAS 128 for the years ended December 31, 1995, 1996 and 1997:

|   | Income  | Shares    | Per Share amount |
|---|---------|-----------|------------------|
| <b>1995</b>                                       |         |           |                  |
| Earnings per share—common stock                   | \$8,861 | 3,877,836 | \$2.29           |
| Effect of dilutive securities:                    |         |           |                  |
| Stock options                                     |         | 245,036   |                  |
| Earnings per share—common stock assuming dilution | 8,861   | 4,122,872 | \$2.15           |
| <b>1996</b>                                       |         |           |                  |
| Earnings per share—common stock                   | 1,071   | 3,978,138 | \$ .27           |
| Effect of dilutive securities:                    |         |           |                  |
| Stock options                                     |         | 199,522   |                  |
| Earnings per share—common stock assuming dilution | 1,071   | 4,177,660 | \$ .26           |
| <b>1997</b>                                       |         |           |                  |
| Earnings per share—common stock                   | 4,710   | 6,307,899 | \$ .75           |
| Effect of dilutive securities:                    |         |           |                  |
| Stock options                                     |         | 191,356   |                  |
| Earnings per share—common stock assuming dilution | 4,710   | 6,499,255 | \$ .73           |

**15. Employee Benefits**

The Company has a defined contribution retirement plan covering substantially all of its eligible United States employees. Employer contributions under the retirement plan amounted to approximately \$901, \$586 and \$993 during 1995, 1996 and 1997, respectively.

During 1997, the Company terminated its medical benefit trust and established a new health care plan. These plans cover substantially all eligible United States employees. Employer contributions to the trust and health care plan amounted to approximately \$1,490, \$1,348 and \$1,954 during 1995, 1996 and 1997, respectively. Long-term disability and life insurance benefits are also provided to employees, the premiums for which are paid directly by Sun Hydraulics. Payments amounted to approximately \$132, \$157 and \$159 for 1995, 1996 and 1997, respectively.

The Company provides supplemental pension benefits to its employees of foreign operations in addition to mandatory benefits included in local country payroll tax statutes. These supplemental pension benefits amounted to approximately \$56, \$69 and \$81 during 1995, 1996 and 1997, respectively.

## 16. Information About the Company's Operations in Different Geographic Areas

The individual companies comprising the Company operate predominantly in a single industry as manufacturers and distributors of hydraulic components. The companies are multinational with operations in the United States, the United Kingdom and Germany. In computing earnings from operations for the foreign companies, no allocations of general corporate expenses, interest or income taxes have been made.

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

Total liabilities attributable to foreign operations were \$2,674, \$4,940 and \$3,867 at December 31, 1995, 1996 and 1997, respectively. Net foreign currency gains (losses) reflected in results of operations were \$10, (\$104) and (\$192) for the years ended 1995, 1996 and 1997, respectively. Operating profit is total sales and other operating income less operating expenses. In computing geographic operating profit, interest expense and net miscellaneous income (expense) have not been deducted (added).

Included in U.S. sales to unaffiliated customers were export sales, principally to Canada and Asia, of \$6,468, \$6,090 and \$7,431 during 1995, 1996 and 1997, respectively.

## 17. Commitments and Contingencies

The Company is not a part to any material 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 financial position of the Company.

In 1996, the Company was awarded a grant of \$424 by the German government, which helped to offset the cost of the German facility. This grant requires that the German operation employ 26 people by June 30, 1998. The Company anticipates that this headcount requirement will not be met until the first half of 1999. The Company believes that an extension may be obtained from the German authorities. If the Company fails to obtain an extension of time to meet the terms of the grant the \$424 will be repaid. This amount has been recorded as a deferred grant. The repayment of \$424 would affect cash and would have no effect on net income.

The Company has submitted a business interruption insurance claim of \$2,300 to its insurance carrier. The claim is related to a fire in the manifold plant in the United States which occurred while the plant was under construction. The Company believes that this fire delayed the opening of the new plant which in turn delayed the rearrangement of the cartridge operation and the creation of the cellular production for high volume models. The validity and amount of the claim is currently being evaluated by the Company's insurance carrier.

## GEOGRAPHIC INFORMATION

|                                 | United States | United Kingdom | Germany | Elimination | Consolidated |
|---------------------------------|---------------|----------------|---------|-------------|--------------|
| <b>1995</b>                     |               |                |         |             |              |
| Sales to unaffiliated customers | \$43,099      | \$ 8,300       | \$3,989 | \$ -        | \$55,388     |
| Intercompany sales              | 5,940         | 1,470          | -       | (7,410)     | -            |
| Operating profits               | 8,090         | 1,446          | 693     | -           | 10,229       |
| Identifiable assets             | 27,212        | 5,414          | 1,813   | (575)       | 33,864       |
| Depreciation expense            | 1,961         | 531            | 64      | -           | 2,556        |
| Capital expenditures            | 6,230         | 700            | 727     | -           | 7,657        |
| <b>1996</b>                     |               |                |         |             |              |
| Sales to unaffiliated customers | \$42,180      | \$ 8,866       | \$3,526 | \$ -        | \$54,572     |
| Intercompany sales              | 5,194         | 1,895          | -       | (7,089)     | -            |
| Operating profits               | 3,225         | 1,785          | 293     | (13)        | 5,290        |
| Identifiable assets             | 37,565        | 6,750          | 4,544   | (443)       | 48,416       |
| Depreciation expense            | 2,203         | 570            | 84      | -           | 2,857        |
| Capital expenditures            | 12,626        | 1,175          | 3,162   | -           | 16,963       |
| <b>1997</b>                     |               |                |         |             |              |
| Sales to unaffiliated customers | \$49,393      | \$10,779       | \$4,026 | \$ -        | \$64,198     |
| Intercompany sales              | 6,584         | 2,346          | 69      | (8,999)     | -            |
| Operating profits               | 5,717         | 2,410          | 149     | 26          | 8,302        |
| Identifiable assets             | 41,541        | 7,611          | 3,973   | 264         | 53,389       |
| Depreciation expense            | 2,840         | 634            | 232     | -           | 3,706        |
| Capital expenditures            | 5,972         | 617            | 286     | -           | 6,490        |



## Shareholder Information

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### Corporate Officers

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**Robert E. Koski**  
*Chairman of the Board*

**Clyde G. Nixon**  
*President, CEO*

**Richard J. Dobbyn**  
*Chief Financial Officer*

**Jeffrey Cooper**  
*Engineering Manager*  
Sun Hydraulics Corporation

**Peter G. Robson**  
*General Manager*  
Sun Hydraulics Limited

**Russell G. Copeman**  
*Manufacturing Manager*  
Sun Hydraulics Corporation

### Directors

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**Robert E. Koski**  
*Chairman of the Board,*  
Sun Hydraulics Corporation

**Clyde G. Nixon**  
*President, CEO*  
Sun Hydraulics Corporation

**Arthur B. Bodley**  
*President, CEO*  
Atlas Fluid Components Company

**James G. March, PhD**  
*Professor Emeritus*  
Stanford University

**Taco Van Tijn, Esquire**  
*Solicitor*

**David N. Wormley, PhD**  
*Dean, Engineering School*  
Pennsylvania State University

### Legal Counsel

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**Shumaker, Loop & Kendrick, LLP**  
Tampa, Florida

### Auditors

---

**Price Waterhouse LLP**  
Tampa, Florida

### Corporate Headquarters

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**Sun Hydraulics Corporation**  
1500 West University Parkway  
Sarasota, FL 34243  
Phone: 941-362-1200  
Fax: 941-355-4497

### Investor Relations

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If you wish to be placed on Sun Hydraulics' mailing list for periodic financial releases, or would like a copy, without charge, of the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission, please send your request to:

**Richard Arter**  
Investor Relations  
1500 West University Parkway  
Sarasota, FL 34243  
Phone: 941-362-1200  
Fax: 941-355-4497

### Transfer Agent

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**SunTrust Bank, Atlanta**  
Atlanta, Georgia

### Common Stock Information

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The Common Stock of Sun Hydraulics Corporation is traded on The NASDAQ National Market under the symbol SNHY.

As of March 25, 1998, there were 106 shareholders of record. The number of record holders was determined from the records of the Company's transfer agent and does not include beneficial owners of common stock whose shares are held in the name of various securities brokers, dealers and registered clearing agencies. The Company believes that there are approximately 2,000 beneficial owners of common stock.

As of March 25, 1998, the closing price per share of SNHY stock was \$13.125.

### Shareholders Annual Meeting

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The annual meeting of shareholders will be held Saturday, May 23, 1998, at 10:00 A.M. Eastern Standard Time at the Sun Hydraulics Manifold Operation, 701 Tallevast Road, Sarasota, Florida 34243.





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Cartridge Operations**

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**Sun Hydraulics Corporation  
Manifold Operations**

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