

DEAR STAKEHOLDERS,

Many good things happened at our company in 2012. Annual sales reached a new high (\$204.4 million) and gross margin remained strong (39%). Earnings per share (\$1.44), while a bit off from the prior year, were solid. We began construction of our third Sarasota factory, and we added new customers at a rapid rate in Asia and Europe. Additionally, we returned more than \$29 million to shareholders and employees via a shared distribution in March and a special one-time, \$1.00-per-share dividend in late December. With approximately \$72 million in cash and investments remaining on our balance sheet, and no debt, we ended the year well positioned to take advantage of new opportunities.

Even with all the positive news, 2012 was a tumultuous period, full of volatility and uncertainty. After a strong start, business conditions deteriorated as the year progressed. An expected second-half reacceleration of China's growth never materialized, Europe continued to be mired in recession, and the U.S. economy contracted in the fourth quarter. Our company felt the impact, posting lower sales and net income in the second half of the year. As we spoke with people, many sought absolute answers about the short-term future. Was the sales decline seasonal? Was it cyclical? Was it related to elections in the U.S. or government changes elsewhere? Many in the investment community wanted concrete answers where none were to be found.

Amidst all the dialogue, a general idea emerged of a slower growth macro economy as the "new normal." But even if that should prove to be the case, our company will still be in a strong position. Sun has consistently grown, on average, at about four times the rate of U.S. GDP growth; the result has been a doubling in our size about every five years. The hydraulics industry has grown at the same rate as GDP, which historically has been 3%–4%. The cartridge valve industry has grown at twice that rate as cartridges have replaced older, more cumbersome types of hydraulic valves. Sun is able to grow faster than the cartridge valve industry, faster than the hydraulics industry, and faster than the economy, because it has embraced five principles:

- Offer better, more reliable products,
- Develop smaller and more innovative integrated packages,

- Provide superior service, notably reliable delivery,
- Offer global factory support, and
- Deliver full and transparent information to all stakeholders.

These tenets, while not new, are fundamental to Sun and its success. We have mentioned them often, though we sometimes expect readers are looking for something more glamorous and exciting. Yet these five principles are what differentiate us, what propel us to outperform the economy and our competition. This has been true historically, and we believe it will continue to hold true in the future.

But there is something even more foundational than the five tenets listed above, something antecedent—namely, the corporate values we embrace. These values guide our corporate behavior and ultimately determine the results we achieve. And of the values we embrace, *trust* may be the most important. That's why we've put the word on the cover of this report.

Sun Hydraulics, from its inception, has believed that establishing trust is necessary for delivering sustainable results. Being honest and fair in all our relationships develops trust. Behaving consistently and ethically develops trust. Honoring our commitments and being an active participant in our community and industry develop trust. Not too long ago, Dr. Eric Schmidt, Executive Chairman of Google, Inc., said, "In a networked world, trust is the most important currency." Bingo.

Trust allows for the formation of deep and lasting relationships. Trust drives behavior. Behavior builds reputation. Reputation gains you employees, suppliers, distributors, customers, shareholders and friends. Trust keeps them.

In many ways, it appears that short-termism's grip on the collective consciousness is becoming ever more firm. Many seem to mistakenly regard the business cycle as being synonymous with the long term. At times like this, it is important to recognize what really matters. . . and what ultimately drives results.



Allen J. Carlson
President and CEO

With **Outstanding** PERFORMANCE.

Dear Shareholders,

What makes a company stand out, and why is it important to do so? By successfully differentiating itself in all spheres of activity—from product design and service delivery, to choice of suppliers and employees, to acquisition and retention of customers and shareholders—the company builds a foundation for consistently delivering sustainably better financial results.

The actions we took in 2011 will enable us to continue differentiating our company, fueling our future growth and success. We added more than 100 people to our global workforce, including talented young design and manufacturing engineers. We also added 1,800 square feet of office space at our Florida headquarters to accommodate our growing engineering community and provide some breathing room for the rest of us. We believe that to attract the best workforce, it is essential to provide a safe and comfortable working environment.

Wages and benefits also distinguish our company. Sun offers a total employment package that is sought after by employee prospects and envied by other employers. One component of the package is a distribution of profits to employees from time to time. First added to the benefit mix four years ago, the shared distribution is awarded at the discretion of the Board of Directors, and is guided by Sun's performance. And with 2011 proving to be a record year at Sun for both revenues and earnings, our Board recently announced a shared distribution of profits to employees and shareholders totaling \$7.7 million. So not only do our policies and actions attract the best employees, they attract the best shareholders as well—those who trust in the Company, its philosophical underpinnings and its ability to generate consistently better returns.

In the third quarter of 2011, we completed the acquisition of High Country Tek (HCT), a process that began in 2007 with a minority equity investment by us. This relationship has brought critical capabilities and

expertise in electronic controls to Sun's product and service portfolio. Many of the electrically actuated products Sun has brought to market over the past five years require electronic control drivers. With HCT now fully owned by Sun, we have further augmented our ability to provide unique and superior solutions, with 100% Sun content, to existing and potential customers.

Last fall, we talked about our development of a new valve that complements our best-in-class load-holding products. The product is so intriguing, Sun has applied for patent protection, not something we routinely do. The new valve, which we have just released to the market this spring, provides significant energy savings for mobile customers. While there may be one or two similar products in the marketplace, we don't believe any of them offer the same level of performance, reliability and capacity.

Early in 2012, we announced that we had applied for permits to build a third factory in Florida, adjacent to one of our existing facilities. The permitting process can sometimes be full of unexpected twists and turns. Taking care of this activity now will allow us to commence construction when we are ready, with no delay. The new permit applications herald another growth phase for the Company, sustaining a trajectory that has been consistent for more than 40 years.

Each of the activities I describe above demonstrates how Sun is different. Each is grounded in the recognition that what drives value and makes a company stand apart from the crowd is the attention it pays to all of its stakeholders, its development of expertise and superior products, and its focus on the long term.



Allen J. Carlson
President and CEO

Dear Shareholders:

In 2010, we began to reap the rewards of the disciplined actions we took during the recession. Though we had to make difficult decisions, we never compromised our principles or strategic vision. We continued to invest in our people during 2009 and to develop more efficient processes. Our suppliers continued to invest in their capabilities to make sure we could meet our delivery requirements. And our distribution channels continued to find new business. The result was a 55% increase in sales for 2010 and earnings per share improved to \$1.26 compared to \$0.11 in 2009.

The uptick in 2010 was quick and steep. After gradually increasing in the second half of 2009, orders accelerated throughout 2010. In fact, fourth-quarter sales were 10% higher than third-quarter sales, contradicting historical patterns and setting the stage for 2011's fast start. Because we kept our workforce intact during the downturn, we were easily able to handle the rapid rise in business and maintain the delivery performance our customers have come to expect. As we have said over and over, delivery performance early in the cycle translates into lasting market share gains.

At this point in 2011, we are optimistic about the prospects for growth. We continue to fine-tune our position in the hydraulics industry by adding capabilities and delivering system solutions to take advantage of market opportunities. Our operational efficiency is superior to that achieved in the last cycle, as evidenced by our strong margin performance. Gross margin for 2010 was 34.7% compared with 33.2% for 2008, the peak year of the last cycle. Our balance sheet continues to be exemplary, with \$66.2 million in working capital, providing adequate financial resources to fund our growth.

Part of that growth will come from product development. Anticipating market needs, we provide enhanced value for customers through product line extension and expansion. Our development efforts focus on such product characteristics as higher pressures and flow rates, greater durability and more reliable performance, and smaller, lighter and more innovative solutions. Products with these features deliver greater value to the customer and provide a lower life cycle cost. This sets Sun apart.

Another part of our growth will come from market positioning. We have been adding system integrators to our distribution channels to complement our independent distributors and enhance market coverage. Through our German operation, we are beginning to explore the Russian market. In India, we have broadened our coverage by adding four new distributors. And in China, we have opened a new representative office which we believe will help us further penetrate the Chinese market by adding distributors and integrators and identifying key customers. Concurrently, we have sold our interest in our Chinese joint venture, Sun Hydraulics Systems (Shanghai) Co., to our partner, the Lin family. The former joint venture has become Sun's first authorized distributor in the country. Our relationship with the Lin family, which also owns our Taiwanese distributor, goes back 25 years.

Adhering to Basic Principles

We believe that success comes from a combination of tangible actions and intangible qualities. Our success—in the form of strong financial results and rising shareholder value—has come from having a sound vision and doing the right things for the right reasons. From its inception, Sun has been committed to being the leader in its field. We offer products that advance our customers' business, improving the safety and performance of the machinery in which they are used. We invest in equipment and processes to ensure our operations are efficient and profitable. We provide a safe and pleasant working environment for our employees, because it allows them to be more productive and helps them achieve life satisfaction. We keep the explicit and implicit promises we make to our customers, so they will remain our customers. Our brand and our reputation, we know, are products of our behavior.

We are committed to building our brand and burnishing our reputation by staying true to our principles. We thank all of our stakeholders for their support of Sun Hydraulics.



Allen J. Carlson
President and CEO

Dear Sun Community:

The global recession made 2009 one of the most difficult years in Sun's history. Tough market conditions challenged our employees—along with our customers, distributors and suppliers—in ways most had never experienced. Our financial results for the year tell the story: Revenues declined by 45% to \$97 million, while net income fell by 93% to \$1.9 million.

Our response to the downturn was to continue investing in our company and manage the business prudently, but without compromising our future success. Not only did we *not* reduce our dividends, we actually paid out an additional dividend in the form of a shared distribution last March. And despite all the turmoil, we earned 11 cents per share, making 2009 our 38th consecutive year of profitability. As a result of the actions taken last year, we believe our company in 2010 is stronger than ever.

Knowing 2009 would be difficult, Sun's leadership in late 2008 began planning for tougher times. Our concerns were to:

- Figure out how to downsize our workforce to match the weakened economic environment, while simultaneously keeping the headcount at full strength so that we can quickly respond as the economy improves.
- Maintain self-funded, world-class benefits, which help Sun attract and retain the best employees around the world.
- Prioritize capital investments needed to ensure Sun's competitive advantage.
- Identify non-critical expenses that we could delay without compromising long-term goals.
- Continue being creative and strategic in product development, focusing on bringing products quickly to market.
- Being in position to capitalize on personnel, channel and acquisition opportunities.

WORKFORCE READINESS, MAINTENANCE OF BENEFITS

We knew at the end of 2008 that our workforce would be too big for 2009 business levels, but we did not want to undermine our readiness for the future. Our solution was to divide all of our U.S. production employees into three like groups and rotate them in the production schedule. Each group worked two weeks and then took a one-week furlough without pay. In this way we reduced expenses while ensuring we always had production workers on hand to meet demand. Salaried employees had their pay reduced by three percent. Neither production workers nor salaried employees had their benefits reduced. In April 2010, we ended the employee furlough program and restored the three percent salary decrease for all U.S. employees.

About 18% of Sun's employees are located outside of the U.S. Around the world, Sun companies are or have been engaged in similar creative programs that keep our workforce intact while reducing expenses in the short term.

PRIORITIZING INVESTMENTS AND EXPENSES

Sun made capital investments of \$5.1 million in 2009, about 47% of the level last year. We bought more property adjacent to one of our Florida factories, expanding our future expansion options and we purchased new machine tools with which we are able to more efficiently machine parts to our demanding tolerances. Upgrading our heat-treating capability helped increase capacity and productivity in this crucial area. We also invested in our employees by providing tuition assistance and access to third-party manufacturing education programs. These investments should make us more productive and strengthen the foundation for our future growth.

To reduce costs, we constrained travel expenses and closely monitored professional fees for non-essential services we routinely outsource. As promised in last year's report, every Sun employee exercised prudence when making a spending decision. This wasn't just because the economy had weakened, but because respect for judiciousness is built into our culture.

PRODUCT DEVELOPMENT

We moved production of our stainless steel cartridge products to the U.S. from England. These products were redesigned with new materials, helping to increase their corrosion resistance and improve manufacturability. A new, more competitive pricing structure was put in place and the entire product line was re-introduced to the market.

We began expanding the flow capacities of some of our cartridges, working closely with a key customer. The new versions of these products will be marketable to other customers in other industries like mining, marine and energy, presenting new opportunities for growth.

Some of our most important development work involved electrically-actuated and ancillary products. Sun engineers added several new cartridge products that will help maintain and enhance Sun's position as an industry leader in high-performance control solutions. Some of these products are cost-effective alternatives to pricey competitive industrial products.

Rather than be sold as individual components, many of these new products will be combined with other cartridges and electronics, usually in a custom designed manifold. The result will be an integrated package that communicates with other machine elements. The ability to integrate our products into a complete machine control system will be critical to Sun's future success.

OPPORTUNITIES

We engaged in strategic discussions with a number of parties during 2009, including High Country Tek. (We had previously made an investment in that company in 2007.) Some of these discussions have continued into 2010. As we have frequently stated, if the right strategic opportunity presents itself, we are ready to do a deal.

Last fall, we changed our approach to the Indian market to better penetrate and better serve it. Since beginning to explore this market with a direct presence in 2008, we have added numerous new distributors and customers. India was one of the very few regions in which we experienced sales growth in 2009.

Late last year, we hired a sales and marketing leader to augment our efforts in China. This individual has significant industry and in-country experience and will help us chart a course to expand our presence in this critically important market. India and China are important to recognizing our goal of the Asia/Pacific region generating one third of Sun's net sales.

2010 AND BEYOND

As I mentioned earlier, I believe Sun entered 2010 as a stronger company. Our products, capabilities and services are aligned with the needs of the marketplace. Our balance sheet is sound and we remain debt-free. Upstream and downstream, our suppliers and distributors continue to invest in their companies and collaborate with us to help make Sun one of the most responsive companies in the hydraulics industry.

We believe 2010 will offer a better economic climate than last year. Compared to 2009, almost every measurement will show improvement. Margin improvement may be erratic, though, since it will be influenced by the number of people brought back from furlough in a given period. Until our full workforce is re-engaged, there will be minor fluctuations in margins, but the trend will be positive as long as sales increase.

We are confident that productivity will improve due to actions taken in the past year. Over the short term, we cannot predict how much our capital investments will improve throughput and what impact new products and services will have. We do know, however, that such initiatives will have a positive effect on Sun's results over the long term.

In closing, I want to thank everyone who has continued to be a Sun stakeholder and supporter. Everyone at Sun profoundly appreciates the trust you place in us to be stewards of our company.



Allen J. Carlson
President and CEO

Letter to Shareholders

Dear Sun Community:

Last year was our best year ever, despite the economic contraction that set in toward the end of it. Sales for 2008 grew by 7%, to \$178.3 million, and earnings expanded by 16%, to \$25.7 million. To enable our stakeholders to share in Sun's success even more, we initiated a method to make discretionary distributions of stock to our employees and cash dividends to our shareholders. We also were pleased to be recognized once again by major financial and business publications for our growth and financial performance.

There was a sad note to the year, however. Sun's founder, Bob Koski, died at his home on October 11, 2008. With his passing, the hydraulics industry lost one of its most vocal supporters and a recognized leader. Bob was a visionary and pioneer in the areas of hydraulic cartridge valves as well as horizontal management. His work laid the foundation for Sun's leadership position in the industry and for the field of organizational philosophy. We remain committed to maintaining our leadership role and to embodying Bob's high ethical standards.

Striking contrasts

The year started with a roar but finished with a whimper. Through the first half of 2008, Sun continued the explosive growth it had achieved in prior years. Sales rose 20% in the first quarter and 19% in the second, while net income soared 32% and 50%, respectively. The second quarter, in fact, marked our 20th consecutive quarter of double-digit sales growth and our 18th consecutive quarter of double-digit earnings growth. The \$51.6 million of sales and \$8.9 million of net income posted in the second quarter were record numbers for Sun.

The reasons for the great results remained unchanged:

- Outstanding product and delivery performance,
- New offerings of electrically actuated cartridges, enabling us to expand our sales opportunities,

- An aggressive posture in the area of integrated packages,
- A strong global presence, with distribution partners strategically located around the world, and
- The wide reach of our website, www.sunhydraulics.com, which allows customers around the world to explore our product offering 24 hours a day/seven days a week.

More than 800 Sun employees worldwide, working with a small group of committed suppliers, made it all possible.

Obscured by the lofty first-half results, though, were indications of a troublesome second half. While both international and North American sales were robust in the second quarter, material costs started to rise and the order rate began to weaken. We announced a price increase to cover escalating costs, expected some softening in certain market segments (notably those related to construction) and paid close attention to orders.

Third-quarter earnings growth was very good (29%), but on modest sales gains (of 7%). At Sun, incremental sales increases drop quickly to the bottom line once we cover our fixed costs. The third quarter perfectly demonstrated this earnings leverage.

Despite the strong earnings, we knew business was slowing. In October, the wheels came off! The slowdown in orders was drastic, and fourth-quarter sales came in at only \$32.9 million, a drop of 20% from a year earlier. Sun's quarterly sales hadn't been that low since the fourth quarter of 2005.

All indicators were pointing to a protracted and possibly severe slowdown. The Purchasing Managers Index was plummeting, credit markets had collapsed, the financial industry was a mess and the government was committing hundreds of billions of dollars to bolster the economy. Some customers virtually stopped production for the remainder of 2008.

This wasn't the first time Sun was facing a cyclical downturn, of course. Using knowledge gleaned from history, in November and December we began planning for a difficult period. We knew we would have to watch spending and keep a careful eye on work schedules. We eliminated overtime, idled our factories during the holidays and froze salaries at 2008 levels for key leaders.

In mid-November, we gave a presentation at the annual Robert W. Baird & Co. Industrial Conference, one of the largest investment conferences focused on industrial companies. The title of one of our slides was "Lessons Learned." Our narrative noted that our business is cyclical, that descent and ascent are rapid, that new product development must continue, and that remaining in front of the customer is vital. Most important, we talked about the key obligation of a company's leadership—anticipation and preparation.

At Sun, we know that our success is a result of anticipating what may come and preparing for it accordingly. We certainly recognize the need to be prudent during those times when the economy is contracting.

But we also believe it is critical to continue investing in our company in anticipation of better times. Those who are best prepared to respond to rising demand in the early stages of a cyclical upturn achieve the reward of increased market share. Sun's strong balance sheet will allow us to continue making those investments that will ensure our future success.

What's ahead?

Sun will not mortgage its future at the expense of some ephemeral profit. (We consider the word "mortgage" to be apt.) We will be cautious and mindful. We may elect to delay spending on projects or machinery not critical to our growth objectives. But we remain committed to keeping our workforce intact, because that is a key component of being able to respond to increases in demand when the economy improves.

Over the next year, Sun engineering will continue to develop products our customers need. Manufacturing will implement additional productivity measures and get to some of those housekeeping things that are difficult to attend to when you are growing at double-digit rates (redesigning production work areas to improve work flows, installing new machinery and cross-training employees). We will continue to monitor our capacity situation and, if appropriate, invest to augment it. Our marketing group will continue to enhance our website and provide technical education and materials for our distribution partners; we will stay in front of the customer. We will keep improving our facilities, honing our processes and sharpening our competitive edge. We also will look for investment opportunities that could help to strengthen our competitive position. And we'll be willing to pull the trigger on the right deals.

You have our promise that every Sun employee will exercise care in his or her decision making—that is how we do things, regardless of whether the economy is expanding or contracting. Our focus will continue to be on the future, doing those things necessary to allow us to continue to grow.



Allen J. Carlson

President & CEO

Dear Shareholders:

As I look back on the past year, I do so with bittersweet emotions.

While Sun continued to prosper, we lost an extraordinary individual in 2007. Clyde Nixon, Sun's Chairman until his death, passed away last April. Clyde was Sun's second CEO and president, taking over the reins of the Company in 1988. He held those positions until May 2000. Among the notable accomplishments during that period was the Company's IPO in 1997. Throughout his tenure, Clyde was instrumental in establishing Sun's international presence and strong reputation. An outspoken advocate for education and a leader in our industry and community, Clyde will be sorely missed, and never forgotten.

The sweet part of the bittersweet emotions came from the Company's strong performance in 2007.

Complete system solutions

Both sales and earnings continued to increase at double-digit rates, going up 17.6% and 36.4%, respectively. Return on Capital Employed continued to strengthen as well, reaching 30% for the year. We enhanced our abilities to provide complete system solutions with an investment in a complementary company. Internationally, we established a sales operation in India to get traction

in a key potential market. And we continued to fuel our organic growth with new products.

Among these new offerings were more electrically actuated products that were introduced in the spring. Some of these products included technology acquired through our June 2005 investment in WhiteOak Controls. Specifically, we embedded WhiteOak's digital electronics directly into our electrically actuated valves to create a group of innovative products that are unique in our industry. Market reaction to our new products has been very favorable.

In November 2007, we invested in High Country Tek (HCT), a provider of electronic hardware and software solutions for mobile hydraulic applications. HCT's products dovetail nicely with our own electro-hydraulic efforts, further expanding our capabilities in this area. In addition, with its small, dedicated sales force, HCT will help us get closer to key customers to better understand their requirements.

Operationally, we continued to invest in all of our manufacturing locations. We added new machinery to enhance our capacity and delivery reliability. Our ability to ship on time isn't due to just hardware, though. Our workforce is agile and determined to satisfy our customers. Our employees are self-managed, know what is required, and do whatever is necessary to produce and deliver the products our customers need.

Products that are unique

On the international front, we opened a sales office in Bangalore, India. In the short term, this will help us better understand the Indian marketplace. Longer term, we believe a direct presence in this key market will help us gain market share. Since 2000, sales from our Korean operation have increased 275%. Since opening a sales operation in France in 2003, we have seen sales to that market double. Eventually, we hope our efforts in India will follow the same trajectory as our other international expansions.

What's ahead?

While there are some economic uncertainties in the short term, long-term we expect to continue outgrowing the industry and gaining market share. Our customers recognize the performance and reliability advantages of our products, and every day they are learning more about our growing ability to provide integrated, multi-function solutions as well as components. We will stay focused on organic growth, but at the same time will take advantage of acquisition opportunities that are strategic and complementary.

We will again invest to improve our productive infrastructure. New machinery adds capability and capacity while improving productivity. We will also challenge our suppliers to make similar investments to keep pace with technological advancements and improve their productivity.

In closing...

Sun has been profitable every year since 1972. We have accomplished this by paying close attention to:

- **Developing new products,**
- **Nurturing an educated and agile workforce,**
- **Expanding capacity to manufacture our products when our customers need them, and**
- **Achieving the best global delivery system possible.**

Continuing to profitably grow and gain market share is ultimately the best way to serve our shareholders. We believe that over time, sound fundamentals result in increased share price.

We have the people, the products and the solutions to satisfy our customers—and the strategies to provide above-average returns to our shareholders. We intend to sustain the strong momentum these assets have given us.



Allen J. Carlson
President & CEO

DEAR SHAREHOLDERS

Sun Hydraulics Corporation

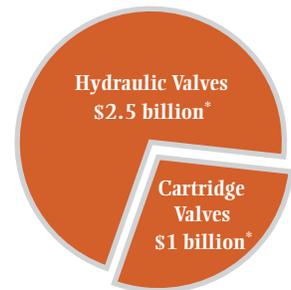
For those interested in last year's results, they are well documented inside of this annual report. Instead of reflecting on what happened in 2006, I am using this opportunity to address some fundamental, long-term ideas.

Last November, while visiting investors in the Midwest, an interesting question was posed: Why does Sun continue to grow faster than the industry and what is Sun's future opportunity? We have detailed the answer to the first part of the question numerous times, most recently on the inside cover of this report.

Regarding the second part of the question, I will explain why I believe there continues to be substantial opportunity for Sun, for many, many years, to continue to grow organically.

Over time, the **hydraulic industry** grows at about the rate of US GDP. In the short term, there are periods of faster growth and periods of slower growth. The valve segment of the industry—the types of products we produce at Sun—represent the brains of a hydraulic system. They control the pressures and flows, direct traffic, issue instructions and regulate the system.

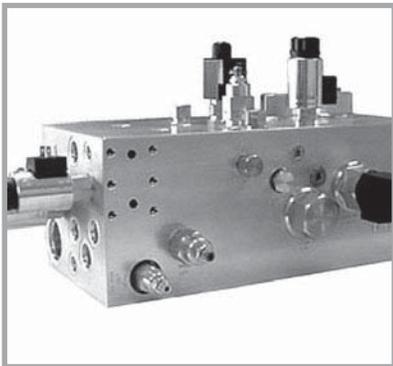
Cartridge valves are a superior form of hydraulic valves. At present, they represent approximately 1/3 of the world's valve production. Due to their superiority, cartridge valves continue to gain market share relative to other forms of valves. In our estimation, the cartridge valve industry grows at twice the rate of the overall valve industry and will continue to do so.



*Company estimates

THE FASTER PACE OF CARTRIDGE VALVE PENETRATION IS FUNDAMENTAL TO SUN'S CONTINUING OPPORTUNITY.

A primary reason for cartridge valve popularity is the ability to combine many standard cartridge functions in a single manifold. The result, sometimes called a hydraulic integrated circuit or integrated package, is analogous to an electronic integrated circuit or circuit board. The cartridge valves can be likened to transistors, resistors and capacitors in the electric analogy. A custom-designed manifold is the equivalent of the board the components are placed on.



Because conventional valves only control a single function, many valves and connections are required in application. However, a single hydraulic integrated circuit can be a complete control system for a machine!

Sun's design approach is the foundation of what sets us apart from other cartridge valve companies. Our valves are physically smaller and operate at higher levels of performance and reliability. This results in our integrated packages being more compact and flexible.

Sun's product line breadth and depth are wider and deeper. We offer more functions, in more sizes and capacities than anyone else. In any specific functional area, Sun offers multiple products. This allows machine designers to select the product that best optimizes the performance of their control system.

There are multiple benefits that accrue from Sun's design approach, too many to list here. One of the most interesting, though, is that our design philosophy allows our products to be used in an expansive and diverse range of machinery and equipment.

You have probably heard us talk about mobile and industrial markets and how each has different operating characteristics and requirements. We've told you that we supply the same product to both market segments. Perhaps a closer look at a specific segment will help explain the myriad ways Sun's products can penetrate a given market.

LET'S LOOK AT THE ENERGY INDUSTRY.

Sun's cartridges, manifolds and integrated packages are used across the entire spectrum of this industry. Our products are found on equipment that extracts natural resources like coal and oil. They are installed in machines that harvest corn and sugar cane used for ethanol, and timber, where the byproducts become woody bio-pulp, an exciting new alternative energy source.



In electricity generation, you will find Sun products in conventional, alternative and new and emerging applications. Sun's cartridges have long been used in giant turbines that power the electrical grid. On solar farms, Sun's valves help to move and position photovoltaic panels. Ours are the valves of choice for windmills, where maintenance is difficult and reliability of absolute importance. Most recently, Sun has been working with OPD, a company in the U.K. that has developed a fascinating technology that produces electricity from wave energy in the ocean.

After the extraction of resources and the production of useable energy, you will find Sun's products used on equipment that helps to deliver energy. Trucks that erect power lines and machines that dig trenches are full of Sun products. We have integrated packages that unload an entire train car full of natural resources by tipping the car onto its side—while it is still moving!



This widespread use of Sun products is repeated in just about all of the industries we serve. While there are sometimes applications with limited future potential (ask me some time about the Amish farmer's use of a Sun product to help him plow his field), suffice it to say that Sun cartridges, manifolds and integrated packages can be used **wherever the control of motion is required.**

I hope this gives you a sense of why everyone here is so optimistic about our future. The market opportunities are widespread and our design efforts continue to yield products the marketplace requires.

Historically, Sun has grown at about twice the rate of the cartridge valve industry. That means Sun grows about 10–15 percent annually, over long-term periods. In fact, dating back to 1972, Sun's compound annual growth rate is 23%! And this has been done almost exclusively through **organic growth.**

To complement our organic growth, we have taken advantage of certain synergistic opportunities. In 1998, we purchased our Korean distributor for \$800 thousand. Later the same year, we made an initial investment of \$250 thousand to start a joint-venture company in Shanghai, China. In 2005, we made a \$400 thousand equity investment in WhiteOak Controls.

While we can't guarantee we will continue to grow at our historical pace, we embrace that past as a laudable goal for our future.



A handwritten signature in orange ink that reads "Allen".

Allen Carlson
President & CEO

>>> **Dear Shareholders**

In 2005, Sun was nationally recognized by the financial media, including both *Fortune* and *Forbes* magazines. Additionally, our 2004 and 2005 financial performance resulted in our inclusion in the 2005 Russell 2000® Index. As a result of these events, Sun received increased exposure in the financial markets.

Amidst this new found notoriety, we were frequently asked a number of questions by members of the investing community, including:

- **How will you sustain your growth?**
- **How much capacity do you have?**
- **Why has your stock price appreciated so rapidly? or,**
- **Why has your stock price declined so rapidly?**

We are somewhat chagrined when asked the last two questions because the price of Sun's stock is a result of several factors, many of which are outside of our control. For things within our control... product design and manufacture, delivery accuracy, earnings and dividends...we are extremely proud of our performance. So, while we can't control or explain short-term fluctuations, we believe that, over the long run, Sun's commitment to product differentiation, quality and customer service will continue to be reflected in an increasing stock price.

The questions regarding sustained growth and capacity are legitimate and interesting. The majority of Sun's sales growth has been, and continues to be, organic. Last year we took an equity position in a small start-up company called WhiteOak Controls. This joint venture is part of Sun's long-term product strategy and we look forward to reaping the future benefits. We investigated a number of other external opportunities last year and will continue to do so, looking for any opportunities that may help contribute to our long term growth.

In 2005, we continued to design and release new products, invest in activities to market those products, focus on delivering products to customers' request date and package unique solutions using standard cartridges and custom designed manifolds. We don't expect our focus to deviate from these things in the future and anticipate they will continue to foster growth.

The capacity question is more difficult for us to respond to. At Sun, we continually monitor the ebb and flow of materials throughout the supply chain. If we spot bottlenecks or constrictions, we alleviate them, always with an eye upstream and downstream for ways to improve overall productivity. If needed, we add new machinery and design new processes. Some people refer to this as management by constraints.

Another aspect of capacity is bricks and mortar. Sun has factories in Kansas and Florida, in England and Germany, and in Korea and China. In those facilities, we employ approximately 750 people. We believe this mix of buildings and people is well suited to meet our future growth goals.

2005 was an exciting year in almost all respects. We participated in major trade shows in the U.S., Europe and China, introducing new electro-hydraulic and corrosion resistant valves. Sales and earnings grew in double digits for the third year in a row. In July, we delivered a 50% stock dividend and in October doubled the quarterly dividend to 10 cents/share. Every Sun operation around the world and every Sun distributor contributed to Sun's growth. Our suppliers continued to invest in their businesses to keep pace with our growth.

We believe we gained market share in 2005...and 2006 has once again started off with a bang. Our enthusiasm continues as we look forward to another prosperous year.



Allen Carlson
President & CEO



Sun Hydraulics Corporation
1500 West University Parkway
Sarasota, FL 34243 USA
Phone: 941-362-1200 Fax: 941-355-4497
www.sunhydraulics.com

April 5, 2005
Re: Annual Report

Dear Shareholders,

We all understand the importance of having balance in our personal lives. At Sun, we believe balance is also a part of a successful business.

We have stated in past reports that it is important to balance the short term with the long term. We are in a cyclical business. When you are at the bottom of a cycle, the temptation is to focus on the short term. In the last recession we maintained and improved our workforce and kept investing in new equipment and improving our processes. We continued to be profitable through three difficult years while strengthening Sun to take advantage of the upturn. The decisions Sun made during slow times were instrumental in our performance in 2004 and early 2005.

Growth, profitability and the overall quality of Sun depend on balancing engineering, manufacturing and marketing. We do this by having employees work across the organization, not within departments. This creates a well-trained, motivated and agile workforce. Engineers work closely with manufacturing to devise processes that reliably replicate designs. In a period of rapidly expanding markets, we are focusing efforts on sales and marketing programs to globally promote our products. We believe this focus will continue to improve Sun's performance during the next business cycle.

To continue to expand our international presence, we are hard at work in the Americas, Europe and Asia/Pacific. In 1997, we invested in a new facility in Germany; in 1998, we acquired a company in Korea and formed a joint venture in China; in 2002, we doubled the size of our UK facility; and, in 2003, we opened a sales/marketing office in France and a new production facility for iron manifolds in the U.S. Last year, every one of these initiatives contributed to Sun's growth and profitability.

This annual report includes many measures of past financial performance, including a balance sheet that measures tangible assets. However, we also recognize certain intangible assets are equally important. Intangible assets include our human and intellectual capital, our distribution network, our supplier base, satisfied customers, our reputation and our brand.

Sun's intangible assets are a product of the corporate values listed in this report, unchanged since our formation in 1970. Patterning our individual and corporate behavior in accordance with these values has enabled Sun to achieve the balance we have tried to explain in this letter. Achieving and sustaining that balance is what best serves our customers, shareholders, suppliers, distributors, and employees.

A handwritten signature in black ink, appearing to read "Allen".

Allen Carlson
President & CEO

A handwritten signature in black ink, appearing to read "Clyde".

Clyde G. Nixon
Chairman



1500 West University Parkway
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www.sunhydraulics.com

Letters to Shareholders

Dear Shareholders,

As 2003 ends and 2004 begins, Sun Hydraulics remains committed to being the global leader in hydraulic cartridge valve and manifold technology. We have never wavered from this goal. To maintain and enhance this position, we believe there are three critical areas that we must keep in the forefront. They are:

- Differentiated quality products
- Operational effectiveness
- Developing and maintaining close distributor & customer relationships

The most critical time to remain focused on these areas is when the economy is not expanding. While it often *seems* easier to curtail activities to reduce costs, successful companies take this time to invest and improve themselves. Sun Hydraulics has done just that! We believe we have continued to gain market share in the downturn and are poised for continued growth.

Differentiated quality products enable our distributors and customers to design and produce hydraulic systems with greater performance and reliability. In 2003, we continued to expand our electro-hydraulic product line. These new products have been well received in the marketplace and enable us to expand our "packaged" system business. Sun's long-term product strategy is to develop new cartridge valves that complement existing valves. Customers can develop *unique* solutions by combining new and existing cartridges in custom designed manifolds (packages). This allows Sun to recognize new opportunities and address new markets.

Operational effectiveness requires a simultaneous focus on quality, productivity and "on-time" shipments to customer demand. Our employees make this happen. We continued to maintain our workforce in 2003 and engaged in cross training to increase our capability and capacity. Being an agile organization is the best way for Sun Hydraulics to provide products and services that are responsive to customer needs.

Developing and maintaining **close distributor and customer relationships** is critical to our growth and *our ability to identify new product opportunities*. During 2003, we intensified our customer focus, working closely with a number of small, medium and large international OEMs to provide systems that greatly improve machine performance and efficiency. Many of these systems incorporate Sun's new proportional valves as well as other new enabling products introduced in recent years. The solutions are typically housed in custom manifolds designed and manufactured by Sun.

Sun will continue to focus on its core competencies, improving our agility and identifying and eliminating constraints. I want to thank our shareholders, distributors, employees, customers and suppliers for your support and hard work to make Sun an even better company.

A handwritten signature in black ink, appearing to read "Allen Carlson".

Allen Carlson
President & CEO

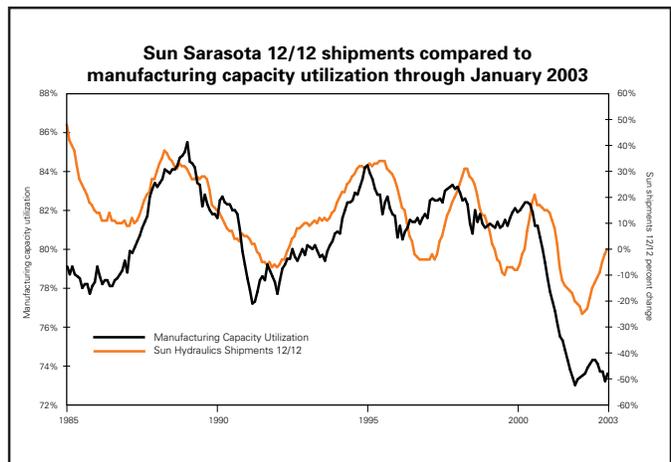
letter to shareholders >

Dear Shareholders

The Past Year >

Sun once again was profitable in 2002. We delivered \$0.27 per share in earnings, paid out \$0.16 per share in dividends, and generated \$7.5 million in cash. All of this was accomplished even though sales were slightly lower than the previous year and global economic conditions continued to be challenging. We maintained our production workforce and continued to invest in capacity and process developments, all of which deliver productivity improvements.

Sun's global market penetration continued to grow, even though consolidated sales were flat. Our German and Korean companies made significant contributions and helped offset subdued activity in our United States and United Kingdom operations. Domestic capital goods spending remained depressed with excess capacity throughout the U.S. manufacturing sector, as evidenced by the Federal Reserve's measure of manufacturing capacity utilization (see graph). However, the weakened U.S. dollar helped to make our products more competitive in overseas markets and, again in 2002, the dollar value of Sun's shipments outside of the United States topped 45%!



Productivity Improvements >

- Assembly automation
- Aqueous parts cleaning
- Product redesign
- Process improvements
- Freight cost reduction
- Heat treatment/coating improvements
- Parts outsourcing

Sales of "enabler products" (lower volume, unique, problem-solving cartridge valves and manifolds) held their own in 2002, even increasing in some product types, while higher volume product sales were down due to market conditions. Mature volumes for many enabler products will often be relatively low, but these items are important to the overall mix of products that Sun offers to the marketplace. The uniqueness of enabler products generates relatively steady demand even in difficult economic conditions.



Engineered valve packages provide benefits to OEMs and users.

Throughout 2002, we continued to invest time and effort in our website, www.sunhydraulics.com. This global medium allows us to present more of our products, to more of the marketplace, than at any time in our history. In 2002, we added many new products and features to the website to aid our customers. We encourage all of our shareholders to visit www.sunhydraulics.com and learn more about Sun Hydraulics and our products.

In 2002, we kept operating expenses in line with lower business levels while we continued to make prudent investments for our future. We implemented many productivity improvements in our U.S. operations and completed our capacity expansion in the U.K. We maintained our investment in people and saw the productive capacity of our workforce increase significantly. Shipments in 2002 were achieved with a significantly reduced number of working hours while we continued to offer a high level of customer service.

In our 3rd quarter 2002 conference call last November, we said, "Due to the great uncertainties in the world economies, we are reluctant, and in fact unable, to forecast beyond the next quarter." Though the global economy remains a great uncertainty as of this writing, we are optimistic about 2003 and the longer term future.

Moving Forward >

Our investments and actions of the past few years have given us the capacity and capability to respond rapidly to increased demand. With our United Kingdom expansion completed, we have the infrastructure and production workforce in place to easily meet multiple years of double-digit growth. To help stimulate demand, we have a number of exciting initiatives planned for 2003.

New Products >

In January, we released the first of our electro-proportional cartridge valves. These new products address a growing segment of the hydraulic market where hydraulic components are controlled electrically. Initial product offerings include a variety of pressure controls and flow controls that complement our existing cartridge valves. Our electro-proportional products deliver a very high level of performance for their price and early reports indicate that they will be well received in the marketplace.

What is a Proportional Valve?

Proportional valves respond to an electrical signal to regulate the hydraulic system. They can be compared to a dimmer switch that regulates the intensity of household lights.

In 2002...we implemented many productivity improvements...completed capacity expansion...maintained our investment in people...and saw the productive capacity of our workforce increase significantly.

U.S. Expansion >

In February, we announced the start-up of an operation in Kansas City that will help us increase our market share in the engineered valve package business. In addition to having factory personnel in the area to support distributors' efforts, we will have a local source for manufacturing larger and ductile iron manifolds in the United States.

This added capability, together with our growing line of electro-hydraulic products, allows us to aggressively pursue the engineered valve package segment of the market. Combining many standard cartridges in a single custom-designed manifold offers significant benefits to both OEMs and users. While Sun has always competed for this business, in 2003 we will become much more active in pursuing this segment of the market.

European Expansion >

In April, we announced the formation of a new Sun marketing and technical support company in France. While we have had past success in the French market, our customer base has been limited and we found it difficult to retain business over the long term. We will build the company in France following a formula that has been successful for us in the past. In the formative stages, we begin by hiring a strong national manager who is familiar with the market, the customs and the language while being technically competent and knowledgeable about our products.

letter to shareholders *(continued)* >

2003—What's going to happen? >

Sun has never pretended to be able to predict the unpredictable. We take a long-term approach to our business, knowing that over time, if we stay the course and do the right things, the market will reward us. As of the writing of this letter, great uncertainties remain in the global economy; it is not necessary to repeat here what you read and hear every day.

We have the infrastructure and production workforce in place to easily meet multiple years of double-digit growth.

Sun Hydraulics is conscious of our obligations to all of our stakeholders—shareholders, employees, customers, suppliers and our community. To best serve all constituents, our focus will remain on improving our market orientation and operational effectiveness to grow the business.



Clyde G. Nixon
Chairman of the Board



Allen J. Carlson
President and Chief Executive Officer



Sun's new proportional valves deliver high performance.



When this Ferris wheel in Shanghai, China had operational problems, Sun Hydraulics valves were employed to correct the problem.

Observations from Clyde Nixon, Allen Carlson and Bob Koski

I'm sure recent media attention has caused all top managers to step back and examine the way they run their businesses. When Sun went public in 1997, we told the investment community, and everyone else who would listen, that we planned to continue to manage the business as we had as a private company. Taking a long-term approach always had been successful, and we believed that quarterly results should be kept in context.

Sun continues to follow this philosophy. Unlike our direct competitors we not only own our own property, we also are highly vertically integrated. Sun keeps a higher proportion of manufacturing in-house than other companies in the cartridge valve industry. This allows us to maintain quality, to refine our processes, and to differentiate ourselves in terms of product performance and customer service. In short, we control our own destiny. Yet, people continue to point out how we can make a few more dollars by leveraging our assets through all sorts of creative financial arrangements.

In recent years Sun has watched as some of the leading companies in our industry have self-destructed chasing quarterly results and other short-term financial goals. At Sun, we try to focus our efforts on making money by designing, manufacturing and selling superior quality hydraulic valves and packages, and by developing

As we entered 2001, the economy was soft but we fully expected to see the beginning of a recovery in the later half of the year. We kept our workforce intact and prepared for the expected upturn in business. We were on track and ready...until September.

After the tragedy of September 11, we reassessed the situation and knew a late year economic recovery was unlikely. That a recovery would occur was never in doubt; the timing though, was suddenly not clear. Despite the uncertainties, we decided to stay the course, with a few modifications.

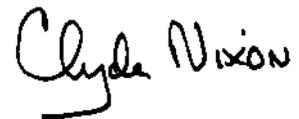
In the U.S. operations, we continued to postpone all discretionary expenses. Many employees took voluntary time off without pay. Hourly overtime was cut to the bone and all salaried employees took a pay cut. As we entered 2002, these actions remained in place. Wage increases for all U.S. employees have been postponed until the business climate improves. Non-U.S. operations have taken similar belt-tightening measures.

However, we have continued to invest in equipment and people on behalf of our shareholders.

new products, new markets and improved processes. And you don't need a PhD to understand our financial statements: what you see is what you get.

Because we have continued to invest in our company as we have grown, including bricks and mortar and innovative processes, we enjoy a very strong cash flow. This enables us to remain a leading-edge company, even in difficult economic times. We have just finished a most challenging year, but remained profitable, maintained our workforce, made prudent capital investments for future growth—and, at the same time, generated sufficient funds to pay dividends and reduce debt.

We believe we continue to move in the right direction—with no need for footnotes.



Some of last year's investments include:

- Cross "learning"
- Aqueous-based parts cleaning
- Upgrade of website
- European expansion (facilities, equipment and distribution)
- Strengthening of Asian marketing and distribution

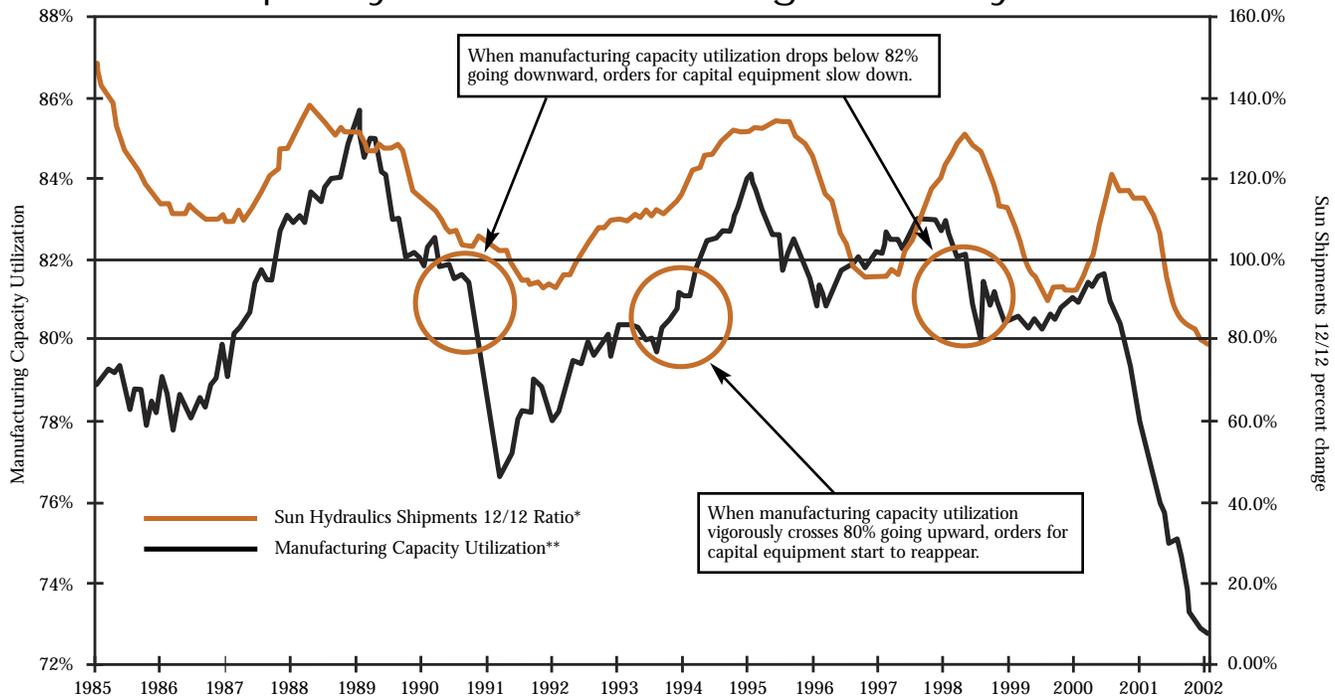
I am extremely proud of our nearly 700 employees worldwide for these and other accomplishments.

In 2001, we endured the worst manufacturing recession since 1978. The United States hydraulics industry experienced a 16.4% decline in shipments as capital goods spending ground to a halt. Yet, without compromising our ability to respond when conditions do improve, Sun remained profitable with very strong cash flow.

We thank our shareholders for their encouragement and continued investment in Sun Hydraulics. We are confident that your loyalty will be rewarded.



Sun Sarasota 12/12 Shipments Compared to Manufacturing Capacity Utilization Through January 2002



*Sun shipments are U.S. shipments only (not consolidated) and are shown as a 12/12 ratio. This compares the shipments for the current 12 month period to the 12 month period ended one year earlier, and is stated as a percent change.

**Capacity utilization is shown as the actual percentage reported each month by the Federal Reserve Board.

The Enron story brings back memories. While going public in late 1996, I was asked many times by analysts why Sun Hydraulics owned its factories. After all, Sun **could** leverage RONA (return on net assets) and **would** look more attractive to investors without these “non-performing” assets. I answered that while these assets did not make money, they did save money through the avoidance of sales tax on rent and that by controlling its assets Sun could comfortably survive when business conditions turned south (and maybe even gain market share). They rolled their eyes at this old fashioned idea.

Sun’s first factory was owned by the Koski family. When we built a new, much larger plant in 1980, bankers advised that they would be glad to use the equity in the old factory as a down payment, and the Koski family could continue to be the landlord. In 15 or 20 years, the Koskis would own the building and land outright using a standard triple-net lease. They were astonished when I declined by saying that if Sun was going to pay for it, Sun should own it. They said “You’re giving up a lot of money,” and I said, “Yes, but Sun will have a strong balance sheet. The equity will come in handy on rainy days.”

How analysts can hype stocks of companies with phantom assets as being worth high multiples of earnings speaks of gambling, not investing. They, and accounting firms, have refused to recognize that without substance, bubbles tend to burst. They even act surprised when they do!

To compound the problem, banks tend to act in lockstep. They fell all over themselves to loan money to these shells. Now, they refuse to loan money for new ventures backed by solid assets. I have to wonder what they teach at business schools. (Remember the 1980s, when banks loaned money to third world countries at 15% interest. They then made further loans to pay that interest and kept these loans as “assets” on their books... until the bubble burst. The recession of the early 1990s followed as banks wrote off these bad loans.)

While the Fed is lowering interest rates to make money available, belt-tightening banks are keeping “the spread” to cover bad debt exposure while good companies go bankrupt because they can’t borrow money for operations. Dumb! Will any of this help the nation recover? Not in my book!

Bob Koski

Observations from Clyde Nixon, Allen Carlson and Bob Koski

Sun serves the capital goods markets and we are keenly aware that our business is cyclical. There are times of rapid growth, often in excess of 20% a year, followed by decline. Our objective is to sustain growth throughout the business cycle. We recognize there will be times when annual or semi-annual growth may be flat, or for a brief period negative, but that demand will return as the next cycle begins.

It is important to be in a position to be able to respond rapidly to demand, which often increases sharply as the business cycle turns up. To do this, the investment in processes, capacity, and people cannot fluctuate even though shipments have slowed. After three years of rapid growth in the mid-90's, Sun's shipments had increased more than 95% and we encountered capacity problems. Over the past four years, Sun has invested more than \$25 million in capital equipment to avoid this problem in the future.

In recent months the papers have been full of corporate layoffs and "restructuring", as public companies respond to short-term earnings pressures resulting from the slowdown in the economy. If the persons laid-off had learned to contribute significantly, you have to wonder how prepared such companies will be when their business improves. The loss will be felt.

For the past three years, Sun has invested significant capital and energy to improve our processes, strengthen our workforce and increase our capacity to better serve our customers and provide improved returns to our shareholders. The benefits of these investments and initiatives are evident in our 2000 financial results.

Demand for hydraulic products boomed in the first six months of 2000, before falling off significantly in the second half of the year. We are proud that we were able to maintain growth throughout the year, finishing the year with shipments 13.6% higher than the prior year. Sun's export business continued to grow with 40% of sales outside of the United States, remarkable for a company of Sun's size.

Despite the slow second half, our gross profit as a percent of sales held up well, thanks to the efforts of Sun's production personnel. Even with lower shipping volumes in the second half of the year, we were able to maintain our manufacturing profit margins and at the same time improve our customer service. For the year, gross profit as a percent of sales improved to 26.8%, compared to 23.3% in 1999. We expect gross profit to continue to improve with increasing shipment volume.

Since 1975, Sun has not had a workforce reduction. Even in the recessions of the early 80's and 90's, we were able to maintain our workforce in difficult times. Hours were fewer, shop and office pay was reduced, but when the business cycle improved, Sun was able to grow.

The best way to avoid overstaffing is to keep a healthy balance between direct labor employees (*value adders*) and overhead employees (*cost adders*). Sun maintains this balance through good years and bad. We give our direct labor workers the freedom to make decisions and be proactive. As a result, we are more productive than companies with large bureaucracies.

Maintaining a lean workforce has numerous advantages beyond a lower cost structure. Excess levels of overhead not only inflate costs, but also stifle initiative. A lean organization tends to be more efficient and agile and more adaptive to change. Our challenge is to anticipate and develop the resources our workforce needs to satisfy our customers.

We're where we want to be – bring on the recovery.



The indices we use to track manufacturing activity in the United States indicate continued weakness. However, orders in the first two months of 2001 were strong and we project first quarter shipments will be about 9% higher than the fourth quarter of 2000. Sun is prepared to react to further increases in demand. Even with temporary uncertainties in capital goods markets, we will continue to invest and add capacity to meet future growth.

Manufacturing capacity and quality, new product development, and communicating and maintaining strong routes to market remain our focus. We will continue to strengthen our personnel around the world and strive to reduce the time it takes to get new products to market. All of these efforts will contribute to further strengthening the Sun brand and providing value to our shareholders.



Observations from Bob Koski and Clyde Nixon

During my first 15 years of gainful employment, I had the opportunity to observe how dysfunctional large companies typically were and how difficult it was for small companies to grow gracefully. I watched the bad effects of “politics” in both cases and saw how hard this was to control. “Rumors” were regularly crafted and floated to test reality. Rationalizations were wondrous and the action took place at all levels – from officers and managers to factory floor supervisors to rank and file workers. Problems became serious when politics and personal egos transcended company needs. “Jockeying for position” consumed time and intellect. “Who you knew” was often perceived as more important than “what you knew” – or even “what you did.”

Starting Sun with three employees (John Allen, my wife Beverly and me) and believing that the company would grow to employ several hundred people, I thought we had a golden opportunity to minimize the destructive effects of politics and egos. I studied other organizations looking for good examples.

One very interesting and successful organization during the 1920s and 1930s was the DuPont Chemical Company. What caught my attention most was the way DuPont ran its highly productive laboratories at a time when there was a severe shortage of trained scientists who had also, on occasion, to act like managers (often with little formal management training). DuPont developed what I call “shared offices.” Two scientists would co-manage projects, one “senior” to the other but both with equal authority. The “senior” scientist/manager would mentor the junior. Both would confer regularly

to agree on required actions. Either could make spot decisions (although this was to be avoided, if at all possible, and these decisions, with their rationale, had to be communicated to the other partner as soon as possible). Benefits of shared offices included:

1. Either partner could be moved to another project or promoted without jeopardizing the original project.
2. Either partner could be sick, traveling or on vacation without jeopardizing the project.
3. High quality decisions were made and quickly implemented. Bad ideas were quickly identified and dropped. Quality products and processes resulted.
4. Partners and others had good feelings about each other. Workers felt that decisions were not arbitrary. They could share their views with either partner and felt someone was there to listen to them.

The DuPont Chemical Company prospered. DuPont’s talent pool was highly regarded. DuPont’s position in the chemical world grew rapidly.

I thought Sun Hydraulics could adopt this idea. By not having formal organization charts, and titles, two (or more) people could share leadership roles at many levels. We could develop products and processes and supervise the shop floor. We could develop and deploy talent as we grew. And to a large extent, this might diffuse the debilitating political process and allow people to concentrate on the work at hand.

This system generally works, to the surprise of many.

When Clyde Nixon was named President (law requires that a president and certain other officers be named – but we are not required to use these titles), I shared the President’s office with Clyde and gradually backed away from certain presidential responsibilities. During the last three years we have also been sharing the duties of Chairman. Clyde is expected to be appointed as Chairman of Sun at the May 12th Board of Directors Meeting. I expect to continue to share some of these duties with Clyde, but without an official title. At the same time, Allen Carlson is expected to be appointed President and CEO of Sun by the Board. Clyde has already been sharing/mentoring this office with Allen and will continue to have significant executive duties. I doubt that anyone will notice a change at Sun and I’m confident that the momentum and direction of the Company will not change. That this process is considered abnormal is astonishing to me. The basic rule is simple – “No Surprises.” Surprised?

Bob Koski

In 1999, Sun had the breathing space necessary to address the programs and processes that have plagued us in recent years. The following major accomplishments have prepared us for the upturn in business that started in the fourth quarter of 1999:

- *New computer systems in our U.S. and U.K. facilities.* These implementations were accomplished with considerable disruption, especially in the second quarter of 1999.

- *Increased capacity for high volume products.* We moved our high volume product cell operations to the Manatee plant. New automated assembly equipment has significantly increased our production capacity for these products, while freeing space in our Sarasota plant for production of new products.

- *Redundancy in critical operations.* With the installation of a second heat treat furnace, we addressed a capacity bottleneck and developed redundancy for a process that is critical to the quality of our products.

- *Rationalizations to our vendor base.* Our supplier initiative has resulted in improved quality of incoming parts, reduced costs for some purchased components and increased capacity for many outsourced parts.

- *A broad based increase in our manufacturing capacity worldwide.* We are aggressively adding the personnel needed to respond to the rapid growth that traditionally takes place in a market recovery.

While it is usually difficult to remain profitable while making major capital investments, we are proud that we did so during the past two years. With capacity now in place, we expect to respond effectively with increased shipments to the recovering capital goods market. More importantly, we will also be able to aggressively promote newly developed products that have been held back due to capacity constraints.

Expansion programs have not been limited to the U.S. We have continued to invest in international operations. Particularly pleasing, our Korean company rebounded in 1999 and made a significant contribution to our consolidated results. Overall, in 1999 Sun's sales to the Far East were approximately 10% of total shipments.

Although the European market has suffered a capital goods slowdown similar to the U.S., our plants in



England and Germany are currently seeing improved business. Europe remains our strongest export market, accounting for 23% of worldwide shipments.

During the past year, a number of fluid power companies made decisions to utilize both our cavity and screw-in hydraulic cartridge valves in products that they manufacture and sell. By promoting the Sun cavity, these new programs will substantially increase market opportunities.

Capital improvements would be meaningless without the people necessary to move forward. Last year, we continued to strengthen Sun's depth in many important areas. The increased involvement of Allen Carlson is just one example.

Clyde Nixon

Which comes first: the chicken or the egg?
Do you need customers before you develop products?

In a previous life, I worked for a company that would develop new products only with a customer in-hand. But over time, as additional customers were sought, design modifications were required to suit each new customer's particular needs. Design variations were the norm, not the exception, and this developed into a manufacturing nightmare.

Starting Sun Hydraulics with a clean piece of paper was fun. John Allen and I laid out a matrix of valve functions, having common flow paths and ports, against a range of sizes, all serviceable at pressures up to 5000 psi. To keep the number of sizes to a practical minimum, we used a Robert's progression of two; each larger size would have twice the flow (horsepower) capacity of the next smaller size (e.g. 1, 2, 4, 8, 16, etc.). This arrangement provided group technology in manufacturing (common material size, operations and, ultimately, many common parts). We could have enormous flexibility with a minimum inventory. We refined the various cartridge cavities to assure that aluminum manifolds (with cartridges installed) would stand 3000 psi in fatigue and identical nodular iron manifolds would be suitable for 5000 psi. Neat!

Building the matrix was exciting, but created many interesting problems. It was not easy, for instance, to design direct acting and pilot operated relief valves with the same flow path...but we did. Today, these products are world class performers. The *floating construction* we insisted on using produced great performance, but many critical parts were much more difficult to make. Cartridges with floating construction are, however, far more forgiving when installed in less than perfect cavities. Performance wise, we could leave the competition behind!

The big question was, would anybody buy these valves? Our first prospective customer insisted that we redesign a load holding cartridge to fit a cartridge cavity they were currently using! This was character building time...we refused. But because that customer could not find any other load holding valve that consistently worked, they eventually agreed to adopt Sun's valve and cavity. Sun Hydraulics was off and running.

Sun has continued to develop new products in laboratory environments with no specific customers in mind, attempting to anticipate market needs rather than responding to customer requests. Because multiple design iterations are normally needed to develop a new product, ingenious engineers often explore odd product ideas along with standard product ideas. Some of these look like they could be useful in strange circuits. We collect these as *circuit savers* and include a few in our catalog as "teasers."

As bright customers learn that Sun has a circuit saver goody-box, the phone rings, we meet new engineers and Sun's camel nose is inside a customer's tent, usually to stay. Life can be very interesting.

Bob Koski



Bob has finally written a letter that I do not feel I have to explain or qualify. Sun has always planned its growth around the introduction of new products, and, unlike many in our industry, Sun's product designs are aimed at developing new markets and applications, rather than replacing existing products.

Virtually all of the products ever sold by Sun are still being sold today. Improvements have been incorporated over time, but the products still fit the same cavity and carry the same model codes. Following this approach, product obsolescence has never been a factor at Sun.

Sun now has product families in five different sizes. Providing products with generally equal performance characteristics in five flow capacities, while not easy, is one of the attributes that differentiates Sun from its competition. The broad range of flow capacities allows us to sell our products to a divergent group of customers and markets, helping to mitigate the cyclical nature of our business.

Our product development program continues to add functions that we believe will help to improve hydraulic systems performance. Sun refers to many of these products as *enablers* or circuit savers. We also are developing products to compete in established markets. Our new electrically actuated (solenoid) cartridge valves give Sun entry into a large potential market where we previously had limited product offerings. With these products, we will increase our ability to solve more of our customer's application problems. All of these new solenoid valves feature our floating construction and fit into existing Sun cavities.

Sun's cavity remains a critical feature in the successful high-performance operation of our products. We were delighted in April when Mannesmann Rexroth, the world-wide performance leader in hydraulic valves and pumps, announced that Sun cavities will be used for its new cartridge valve program. The decision by Rexroth to use the Sun family of cavities is based on technical advantages compared to ISO standard and de facto industry standard cavities. This will raise the bar to a new level for our industry.

Product development at Sun is a disciplined undertaking that forces our design engineers to work within a somewhat rigid framework. However, the product synergy that results from adhering to these principles consistently yields rewards for our customers, employees and shareholders.

Clyde Nixon

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



Observations from Bob Koski and Clyde Nixon

Number One

A most useful way for shareholders to evaluate the quality of longer-term investments in companies like Sun Hydraulics is to gather clues about how a company tends to think and behave. Most people start learning about a company through management reports.

Personally, I learn much more about companies when I can freely communicate with a broad spectrum of employees. It's sort of like listening to taxicab drivers when you want to learn about what is really happening in the local politics of a large city.

Somehow, the printed information in most annual reports does not give me much comfort that I really understand a company. I do not believe that the hard "numbers" really explain a company's potential value. Additionally, I often feel that "management remarks" do not reconcile with how companies are likely to think and behave.

Consequently, if you are, or, might wish to be, a serious "investor" in Sun Hydraulics, come to Sarasota, Florida, Coventry, England or Erkelenz, Germany and meet your investment: the people that are the heart and soul of our company. We enjoy meeting with our customers, suppliers and investors, along with their families. With or without an appointment, come and meet Sun. I know you will be welcome; I think you will be impressed.

Bob Koski

On behalf of Sun Hydraulics, I would like to welcome our many new shareholders. Since our public offering in January, we have seen our shareholder base grow from 23 investors to more than 2,200 at the end of the first quarter. Many of our new shareholders are familiar with the company. About 25% of our world-wide work force purchased shares, as have a large number of suppliers, distributors, customers and colleagues from within our industry. While we appreciate the confidence of these many friends of Sun Hydraulics, I want to extend a special thank you to the investors who have joined us for the first time.

We experienced a very frustrating year in 1996. Our fiscal performance was not what we would have liked, due in large part to capacity constraints at our Sarasota cartridge facility. While we did initiate expansion programs in the U.S. and Europe, we have experienced some shipment disruptions as we bring our new facilities on-line. We are working to eliminate these disruptions to take maximum advantage of the strong demand levels that began to appear in late 1996. Our newest products, Series 0 cartridges, have been well-received in the marketplace and we expect a bright future for these miniature cartridge valves.

In our first 27 years, Sun Hydraulics' success can be attributed largely to our total commitment to a long-term perspective throughout our operations. By taking our time, as Bob Koski is fond of saying, we have been able to "do the right things for the right reasons."

As we discussed our IPO with potential investors, we were frequently asked if we could maintain a long-term focus as a public company. We believe we can, and we believe we should.

Clyde Nixon