



Sun Hydraulics Corporation 1999 Annual Report

About Sun Hydraulics

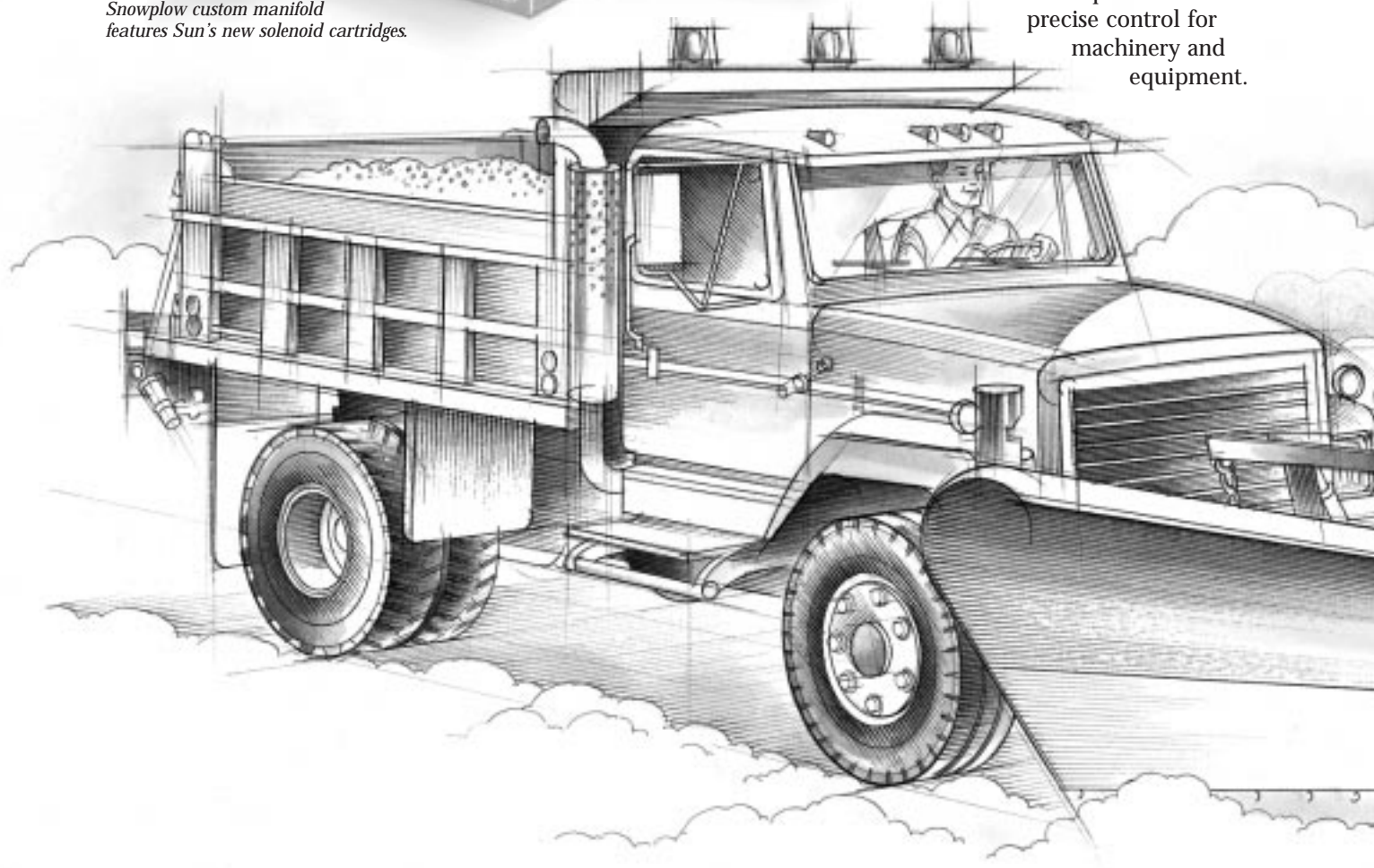
Snowplows use hydraulics to move and position plow blades. The blades, which typically have a carbide edge to help cut through ice and snow, often weigh 4,000 pounds or more! Edge wear from the friction of being in constant contact with the road surface usually means blades have to be replaced many times during the plowing season. In addition to these expensive maintenance costs, when the blade is resting on the road surface as the truck plows, valuable horsepower is consumed making for less than optimum driving conditions.

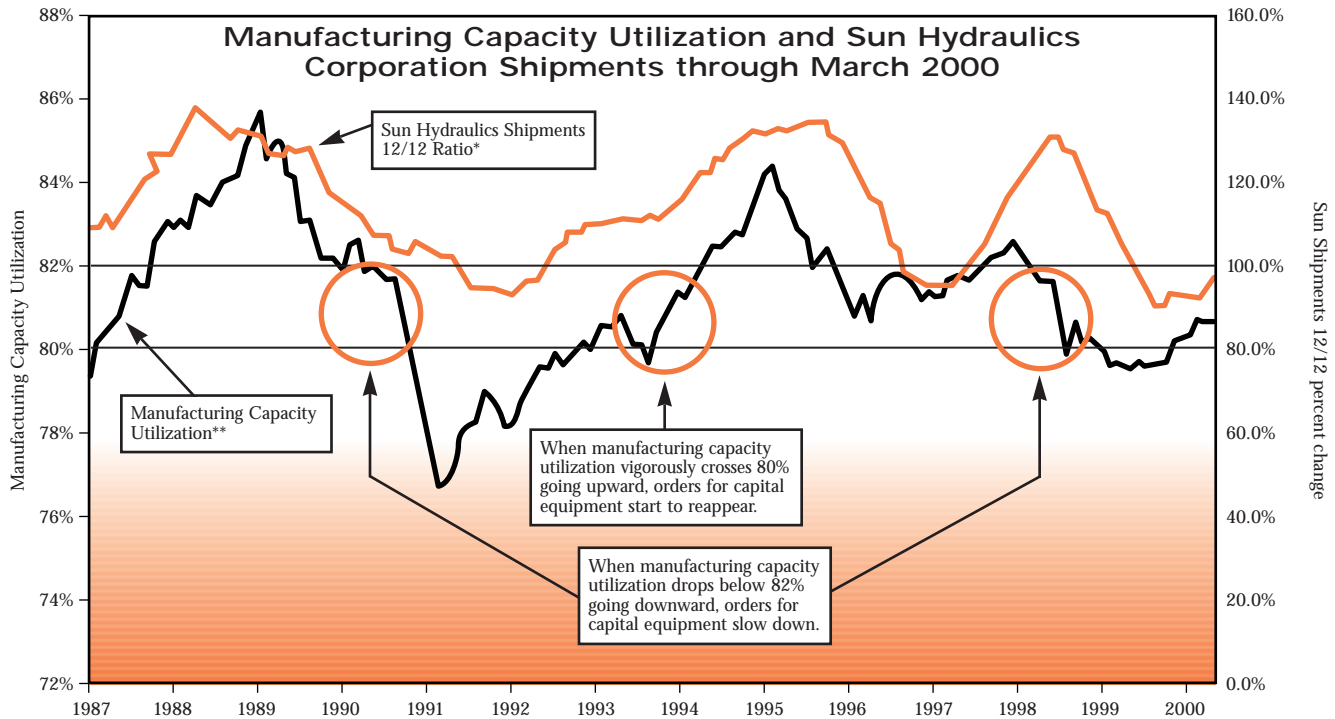
A new plow balance system designed by one of Sun Hydraulics' distributors helps to hydraulically control the amount of weight the plow cutting edge bears on the road surface. The manifold (designed and manufactured by Sun Hydraulics) incorporates five different Sun cartridge valves. Benefits of this control package include extended edge life (up to 10 times more), reduced

scraping noise in the truck, reduced damage to road surfaces and more available horsepower for the driver. Sun Hydraulics cartridge valves and manifolds are the choice of machine designers when the requirement is for precise control for machinery and equipment.



Snowplow custom manifold features Sun's new solenoid cartridges.





*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.

Some of Our End Product Uses

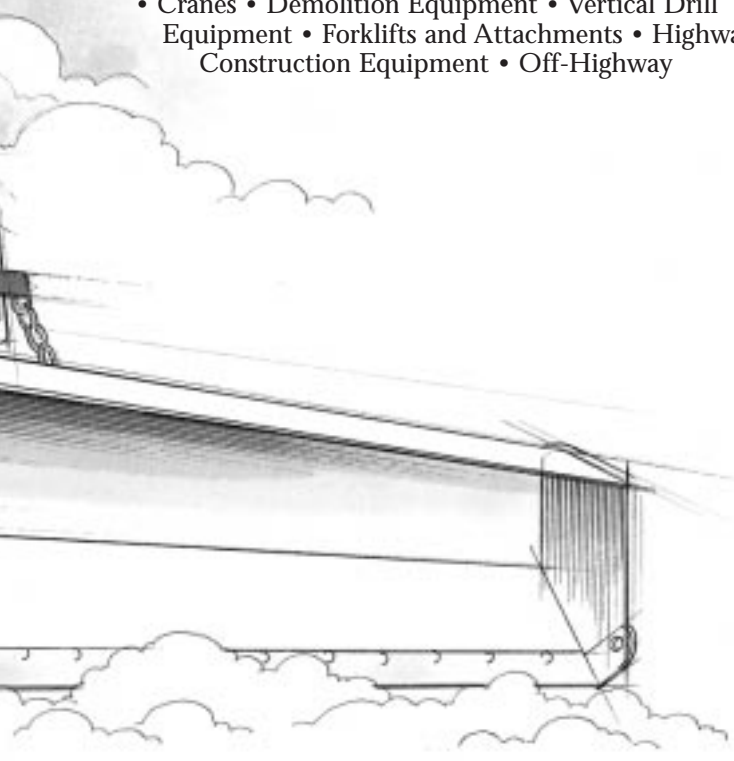
Mobile Products

- 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



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



Selected Consolidated Financial Data

(in thousands except per share data)

YEARS ENDED	Jan. 1	December 31,			
	2000	1998	1997	1996 (4)	1995 (4)
Statement of Income Data:					
Net sales	\$69,652	\$71,881	\$64,198	\$54,572	\$55,388
Cost of sales	53,107	52,537	44,621	37,185	34,581
Gross profit	16,545	19,344	19,577	17,387	20,807
Selling, engineering and administrative expenses	12,507	11,656	11,275	12,097 (1)	10,578
Operating income	4,038	7,688	8,302	5,290	10,229
Interest expense	954	837	905	823	814
Miscellaneous (income) expense	420	(1,669)	133	267	(79)
Income before income taxes	2,664	8,520	7,264	4,200	9,494
Deferred tax provision (2)	-	-	-	2,425	-
Income tax provision (benefit) (3)	833	2,873	2,554	704	633
Net income	\$ 1,831	\$ 5,647	\$ 4,710	\$ 1,071	\$ 8,861
Basic net income per common share	\$ 0.29	\$ 0.89	\$ 0.75	\$ 0.27	\$ 2.29
Weighted average shares outstanding	6,380	6,345	6,308	3,978	3,878
Diluted net income per common share	\$ 0.28	\$ 0.87	\$ 0.73	\$ 0.26	\$ 2.15
Weighted average diluted shares outstanding	6,569	6,531	6,499	4,178	4,123
Other Financial Data:					
Depreciation and amortization	\$ 5,043	\$ 4,387	\$ 3,706	\$ 2,857	\$ 2,556
Capital expenditures	7,897	8,137	6,490	16,963	7,657
Balance Sheet Data:					
Cash and cash equivalents	\$ 1,122	\$ 1,592	\$ 1,249	\$ 1,038	\$ 2,434
Working capital	8,717	5,629	6,100	958	4,326
Total assets	64,074	61,019	53,389	48,416	33,864
Total debt	14,342	11,907	9,564	17,218	6,186
Shareholders' equity	41,176	40,015	35,000	22,397	21,529

- (1) Includes a non-recurring, non-cash compensation expense of \$1.4 million related to the termination of employee phantom stock compensation agreements and the issuance of options to Directors. 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, 1995 and December 31, 1996 represents primarily foreign taxes.
- (4) Pro forma 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. Unaudited pro forma net income was \$2,617 and \$5,883 for the years ended December 31, 1996 and 1995, respectively. 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. Unaudited diluted pro forma net income per share was \$0.40 and \$0.92 for the years ended December 31, 1996 and 1995, respectively.

As of January 1, 1999, the Company changed from a calendar reporting year ending on December 31st to a fiscal year which will end on the Saturday closest to December 31st. Each quarter consists of two 4-week periods and one 5-week period.

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

Overview

Sun Hydraulics Corporation is a leading designer and manufacturer of high-performance screw-in hydraulic cartridge valves and manifolds, which control force, speed and motion as integral components in fluid power systems. The Company sells its products globally, primarily through independent distributors. Approximately 66% of product sales are used by the mobile market, characterized by applications where the equipment is not fixed in place, the operating environment is often unpredictable, and duty cycles are generally moderate to low. The remaining 34% of sales are used by industrial markets, which are characterized by equipment that is fixed in place, typically in a controlled environment, with higher pressures and duty cycles. The Company sells to both markets with a single product line. In 1999, the Company generated approximately 37% of its net sales outside of the United States, and its single largest end-user customer represented less than 3% of net sales.

Demand for the Company's products is dependent on demand for the capital goods into which the products are incorporated. The capital goods industries in general, and the fluid power industry specifically, are subject to economic cycles. In the last half of 1998, and throughout 1999, the Company experienced little or negative growth due to a slowdown in many of the capital goods industries that use the Company's products. According to the National Fluid Power Association (the fluid power industry's trade association in the United States), United States orders for mobile hydraulic products were down 5.2% in 1999 compared to 1998, and orders of industrial hydraulic products were down 3.5% for the same time period. Shipments of mobile hydraulic products were down 6.7% in 1999, compared to 1998, and shipments of industrial hydraulic products were down 10.3% for the same time period.

The Company's orders decreased 1.1% in 1999, compared to 1998, which management believes is largely attributable to the aforementioned slowdown in the capital goods industries. For the first three quarters of 1999, orders decreased 5.8%, compared to the first three quarters of 1998, with the decrease evident in all major markets with the exception of Asia. During the fourth quarter of 1999, orders increased 13.1% compared to the fourth quarter of 1998, with increases evident in all major markets. Management believes that the order

increase is indicative of an upturn in the business cycle of the capital goods industries.

The Company's net sales decreased 3.1% in 1999, compared to 1998. North American distributor inventories of Sun products decreased approximately 5.7% from December 1998 to December 1999, consistent with the slowdown in the capital goods industries. Net sales and operating profits were adversely affected in the United States operation, primarily in the second quarter, and the United Kingdom operation in the fourth quarter, due to the implementation of new, fully-integrated manufacturing software systems. Decreases seen in all major markets except Germany were partially offset by the incremental net sales gain related to acquisition of the Korean subsidiary in the fourth quarter of 1998. On the positive side, the supplier initiative begun during the fourth quarter of 1998 contributed favorably to operating profits, especially in the second half of 1999.

For the past two years, the Company has focused its efforts on increasing its productive capacity in anticipation of a business cycle upturn. Capacity expansion plans are substantially complete and management believes the Company has the necessary capacity to meet the expected increase in demand for its products.

Geographic Highlights

In 1999, the Company continued to expand its geographic presence and to concentrate on capacity expansion programs:

United States: In late 1999, the high-volume production cell was relocated from the Company's Sarasota facility to its Manatee facility and a new heat treat operation was installed at that site. The move was completed with minimal disruption to production. The space vacated by the move of the cell is being reconfigured with a focus on improving the manufacturing, assembly and testing processes used for products that are required in lower volumes and the processes used in new product development. With these arrangements, the Company believes it has the productive capacity to respond to market demands for the foreseeable future.

England: The plans to expand the facility in England are still under review but may be partially implemented in 2000.



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

(Continued)

Germany: The German facility began production of limited quantities of manifolds for local customers and continued design work on new cartridge valves. It is anticipated that this facility will begin assembling and testing cartridge valves for the European market in 2000, including the Company's new electrically actuated (solenoid) cartridge valves.

Korea: The business climate in Korea has improved and the Company's Korean subsidiary has seen increased sales. To date, no cash flow problems have been evident relating to the financial restructuring at Daewoo Group, the largest Korean customer. The Company is currently reviewing the assembly of some of its cartridge valves at its Korean facility for sale in the Korean market.

China: The joint venture in China has begun production of manifold products and had a minimal amount of sales in 1999. The Company expects sales from the joint venture to increase in 2000, but not to the extent that they will have a material effect on profit.

Orders for the Company's series '0' products continued to increase in 1999. Orders for the Company's electrically actuated (solenoid) products, introduced in Europe in April 1999 and to North American distributors in September 1999, are not yet significant. Management believes the demand for these products will build slowly as distributors and customers evaluate product performance and begin to build stock. It is expected that the availability of solenoid cartridges will have a long-term positive effect on demand for manifolds and the Company's non-solenoid cartridge valves.

The Company has always encouraged the hydraulics industry to recognize the benefits associated with the cavity structure and design ideas utilized in its products. Management believes the adoption by other companies of the cavity structure utilized by the Company will increase its total market opportunities. As part of its efforts to encourage the use of its cavity structure and cartridge design in the marketplace, the Company is in the process of finalizing a non-exclusive manufacturing license agreement with Mannesmann Rexroth, A.G. The agreement allows the licensee to manufacture specified products under its own label. Additionally, Mannesmann Rexroth will brand label some products manufactured by the Company and utilize other of the Company's products in systems that Rexroth produces. The Company believes the endorsement evidenced by Mannesmann Rexroth's

adoption of its cavity structure and cartridge valve design will further expand the market opportunities for its products. The Company anticipates it will evaluate similar agreements with other manufacturers of fluid power components when it would be of strategic benefit. Utilization of the Company's unique design by other cartridge valve manufacturers offers an opportunity for the Company's cavity to be recognized as an industry standard.

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.

Years ended	Jan. 1 2000	Dec. 31 1998	Dec. 31 1997	Dec. 31 1996 ⁽⁴⁾
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	76.2%	73.1	69.5	68.1
Gross profit	23.8	26.9	30.5	31.9
Selling, engineering and administrative expenses	18.0	16.2	17.6	22.2
Operating income	5.8	10.7	12.9	9.7
Interest expense	1.4	1.2	1.4	1.5
Miscellaneous (income) expense	0.6	(2.3)	0.2	0.5
Income before income taxes	3.8%	11.8%	11.3%	7.7%

Comparison of Years Ended January 1, 2000 and December 31, 1998

Net sales decreased 3.1%, or \$2.2 million, to \$69.7 million in fiscal 1999, compared to \$71.9 million in 1998. Excluding the Korean operation, acquired in September 1998, net sales decreased approximately 6.2%, or \$4.4 million. This decrease was due primarily to a slowdown in the capital goods industry, and thus, the fluid power industry. Many agricultural, mining, paper and machine tool equipment makers saw significant volume declines in 1999. Domestic net sales decreased \$4.9 million, European net sales decreased \$0.6 million, and Asian net sales, excluding Korea, were flat for the

year with a large increase in the fourth quarter of 1999 over the fourth quarter of 1998.

Gross profit decreased to \$16.5 million in fiscal 1999, compared to \$19.3 million in 1998. Gross profit as a percentage of net sales decreased to 23.8% in 1999, from 26.9% in 1998. The decrease in gross profit as a percent of sales was due primarily to lower net sales spread over a higher fixed cost base. Also, productivity in the United States and United Kingdom operations were adversely affected by the implementation of new, fully integrated manufacturing systems. The resultant increases in direct labor and related expenses were partially offset by reduced material costs related to the Company's supplier initiative program.

Selling, engineering and administrative expenses increased \$0.9 million, or 7.3%, to \$12.5 million in 1999, compared to \$11.7 million in 1998. Approximately, \$0.3 million of the increase was due to the Korean operation acquired in September 1998. The balance of the increase represents higher wages, increased advertising, and one time system implementation costs offset by lower pension costs.

Interest expense was \$1.0 million and \$0.8 million in 1999 and 1998, respectively. The interest expense related to long-term mortgages and related party debt decreased while interest on the unsecured and secured lines of credit in the United States increased \$0.2 million. The new secured line of credit was used to facilitate cash flow related to specific capital acquisitions over a four-year term.

Miscellaneous (income) expense was \$0.4 million in 1999 compared to \$1.7 million of income in 1998. In 1998, the Company received a \$1.7 million payment in settlement of a business-interruption insurance claim. This claim was related to a fire in September 1996, at the Manatee County facility while it was under construction, and delayed the opening of operations. Other expenses increased primarily as the result of the disposal of certain equipment in the United States operation no longer used in production, equity losses on the joint venture in China, and foreign currency exchange transactions.

The income tax provision for the year ended January 1, 2000, was 31.3% of pretax income compared to 33.7% for the year ended December 31, 1998. Excluding income from the Korean operation, the provision for income taxes in the twelve months ended January 1, 2000, was 32.5%, compared to 33.2% in

1998. Tax savings were realized in the United States from the Sun Hydraulics Foreign Sales Corporation and in Korea from provisions of local law.

Comparison of Years Ended December 31, 1998 and 1997

Net sales increased 12.0%, or \$7.7 million, to \$71.9 million in 1998, compared to \$64.2 million in 1997. Domestic net sales increased 15.6%, or \$6.6 million, to a total of \$48.5 million in 1998, compared to \$42.0 million in 1997. Domestic orders were flat year to year and the increase in domestic net sales was due primarily to an equivalent backlog reduction as a result of improved product delivery lead times. International net sales increased 5.0%, or \$1.1 million, to \$23.4 million in 1998, compared to \$22.2 million in 1997. European net sales increased \$1.6 million, or 10.7% in 1998 compared to 1997. Asian net sales decreased \$1.2 million or 29.8% in 1998 compared to 1997.

Gross profit decreased slightly to \$19.3 in 1998, compared to \$19.6 in 1997. Gross profit as a percentage of net sales decreased to 26.9% in 1998 from 30.5% in 1997. The decrease in gross profit as a percent of sales was due primarily to increased manufacturing prime costs in the United States operation. Material costs increased as a percentage of net sales due to a full year effect of increases incurred primarily in the second half of 1997. These increases in 1997 related to parts cost increases primarily for engineering design changes and the outsourcing of parts. Direct labor and related direct expenses did not decrease appreciably as a percentage of net sales due to inefficiencies incurred to improve product delivery lead times.

Selling, engineering and administrative expenses increased \$0.4 or 3.4% to \$11.7 million in 1998, compared to \$11.3 million in 1997. Increases in compensation, travel and meetings were offset by decreases in trade show, catalogue and general business expenses. The acquisition of Sun Korea contributed approximately \$0.2 million to selling, engineering and administrative expenses. These expenses as a percentage of net sales decreased to 16.2% in 1998 from 17.6% in 1997.

Interest expense was \$0.8 million and \$0.9 million in 1998 and 1997, respectively. The interest expense related to long-term mortgages and related party debt decreased; however, this was offset by increased interest on the unsecured line of credit.



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

(Continued)

Miscellaneous income was \$1.7 million in 1998 compared to miscellaneous expense of \$0.1 million in 1997. In 1998, the Company received a \$1.7 million payment in settlement of a business-interruption insurance claim. This claim was related to a fire in September 1996, at the Manatee County facility while it was under construction, and delayed the opening of operations.

The income tax provision for the year ended December 31, 1998 was 33.7% of pretax income compared to 35.2% for the year ended December 31, 1997. The decrease in the effective tax rate from 1997 to 1998, was due primarily to the mix

of pretax income between the Company's operating segments and the resolution of tax audits.

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.

Quarterly Results of Operations

(in thousands)

Quarter Ended	Jan. 1 2000	Sept. 30 1999	June 30 1999	March 31 1999	Dec. 31 1998	Sept. 30 1998	June 30 1998	March 31 1998
Net sales	\$17,602	\$17,664	\$15,921	\$18,465	\$17,500	\$17,664	\$17,584	\$19,133
Cost of sales	13,007	13,174	12,982	13,945	13,459	13,132	12,599	13,347
Gross profit	4,595	4,490	2,939	4,520	4,041	4,532	4,985	5,786
Selling, engineering and administrative expenses	3,191	3,157	3,068	3,092	2,745	2,864	3,033	3,014
Operating income	1,404	1,333	(129)	1,428	1,296	1,668	1,952	2,772
Interest expense	261	264	176	253	130	216	231	260
Miscellaneous (income) expense	108	178	36	97	(81)	(1,586) (1)	(45)	43
Income before income taxes	1,035	891	(341)	1,078	1,247	3,038	1,766	2,469
Tax provision	300	303	(125)	355	443	1,015	586	829
Net income	\$ 735	\$ 588	\$ (216)	\$ 723	\$ 804	\$ 2,023	\$ 1,180	\$ 1,640

(1) Includes a business-interruption insurance claim of \$1,661, net of expenses.

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, dividends to shareholders, to make capital expenditures, and to service debt.

At January 1, 2000, the Company had working capital of \$8.7 million. Cash flow from operations in

1999 was \$5.6 million, compared to \$8.6 million in 1998 and \$6.5 million in 1997. The decrease in the Company's cash flow from operations in 1999 compared to 1998 was due primarily to a decrease in net income of \$3.8 million offset by an increase in depreciation and amortization of \$0.7 million. The increase in the Company's cash flow from operations in 1998 compared to 1997 was due primarily to an increase in net income of \$0.9 million and an increase in depreciation of \$0.7 million.

Capital expenditures were \$7.9 million in 1999 compared to \$8.1 million in 1998, and \$6.5 million in 1997. In 1999, \$6.0 million was spent in the United States operations, \$1.3 million was spent in the United Kingdom, \$0.5 was spent in Germany, and \$0.1 million was spent in Korea. In 1998, \$6.1 million was spent in the United States operations, \$1.2 million was spent in the United Kingdom, and \$0.8 million was spent in Germany.

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. The grant required that the German operation employ 26 people by June 30, 1998. This deadline has been extended and negotiations to determine the amount of the grant that may have to be repaid are in progress. This amount has been recorded as a deferred grant. Any repayment would only affect cash and would have no effect on net income.

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.

On July 23, 1999, the Company replaced its \$10.0 million unsecured revolving credit facility with a five year, secured, revolving credit facility of \$7.5 million, and a one year unsecured, revolving credit facility of \$5.0 million. The \$7.5 million credit facility has an interest rate equal to the bank lender's prime rate less 1% for the first year, and the treasury bill rate plus 1.75% for the remaining four years. The \$5.0 million credit facility has 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. At January 1, 2000, the interest rates were both 7.50% and the balances were \$4.6 million and \$2.2 million, respectively.

A 10-year mortgage loan of \$6.2 million was obtained in May 1996 at a fixed interest rate of 8.25% for construction of the Manatee County facility. Terms on the construction note were interest-only on the balance drawn down through the completion of construction and then conversion to a 10-year mortgage note with a 15-year amortization schedule. In April 1999, this mortgage note was renegotiated to an interest rate of 7.375%. Terms are monthly principal and interest payments with remaining principal due July 1, 2006. At January 1, 2000, \$4.7 million was outstanding on this facility.

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. This loan had a term of 12 years with variable interest of 6.47%. During 1999, the Company renegotiated this loan with a mortgage note, bearing fixed interest at 6.05% and a maturity date of September 30, 2008. At January 1, 2000, \$1.4 million was outstanding under this mortgage note.

In February 1999, the Company negotiated three loans in Germany secured by equipment, a ten year 5.1% fixed interest rate loan for approximately \$0.3 million, a ten year 5.1% fixed interest rate loan for approximately \$0.1 million, and a ten year 3.5% fixed interest rate loan for approximately \$0.8 million. At January 1, 2000, the outstanding balance on these facilities was approximately \$0.9 million.

The Company believes that cash generated from operations and its borrowing availability under its revolving lines of credit will be sufficient to satisfy the Company's operating expenses and capital expenditures for the foreseeable future.

The Company declared quarterly dividends of \$0.04 per share to shareholders of record on the last day of each quarter in 1999 and 1998. These dividends were paid on the 15th day of each month following the date of declaration.

YEAR 2000 READINESS DISCLOSURE

The following is a summary of actions taken by the Company during the years preceding January 1, 2000 in anticipation of the year 2000 transition and the potential problems that computer systems and embedded technology could experience handling dates beyond the year 1999.

In order to address potential computer problems arising in connection with the year 2000, the Company devised the following four-phased approach: (1) assessment, (2) testing, (3) renovation and (4) validation. With regard to its internal operations, the assessment phase consisted of the inventory of all systems, including hardware, software and embedded systems (such as the Company's CNC equipment) in all of Company's locations, the identification of all critical applications, and the collection of all internal source codes. The testing phase included the testing of the Company's critical applications for year 2000 readiness. The Company defined "year 2000 ready" to mean that neither the performance nor functionality of any of its critical systems, including both information technology



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

(Continued)

and non-information technology systems, would be materially affected by dates prior to, during and after the year 2000. The renovation phase involved the replacement of all non-compliant systems with year 2000 compliant systems. The validation phase involved the re-testing of all upgraded systems.

As of January 1, 2000, all material aspects of the Company's internal year 2000 plan had been completed. As a result of its assessment and testing phases, the Company identified and modified certain software subsystems and routines that required modification to be fully year 2000 compliant. In addition, the Company replaced the computer operating systems in its United States Sarasota facility and in its United Kingdom facility with "enterprise-wide manufacturing systems" that are year 2000 ready.

The Company also has assessed the year 2000 readiness of its key suppliers by inquiring about their year 2000 readiness and, whenever possible, obtaining year 2000 readiness warranties or statements as to their readiness. No major vendor issues were reported over the year 2000 transition.

The Company estimates that, as of January 1, 2000, the cost of remediating/replacing its internal systems was approximately \$1.3 million. The Company funded this effort through operating cash flows. This estimate includes remediation of key information technology and non-information technology systems, but does not include the potential costs related to any customer or other claims and the costs of any disruptions caused by suppliers not being year 2000 ready. This estimate is based on a current assessment of the year 2000 project and is subject to change.

Because the Company experienced no major year 2000-related issues internally or externally over the year 2000 transition, it does not currently believe that it will incur material costs or experience material disruptions in its business associated with the year 2000. However, there can be no assurance that year 2000 issues will not be uncovered in the future or that the costs of any such year 2000 issues will not have a material impact on the Company's business, operations or financial condition in future periods.

Seasonality

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 are the lowest of any quarter during the year. However, during fiscal 1999, due to the Company's poor second quarter results, this was not the case.

Inflation

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. 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.

Euro

On January 1, 1999, eleven member countries of the European Union established fixed conversion rates between their national currencies and the "euro," which will ultimately result in the replacement of the currencies of these participating countries with the euro (the "Euro Conversion"). The Company has assessed the potential impact of the Euro Conversion and has initiated an internal analysis to plan for the conversion and implement remediation measures. The Company's German operation converted its functional currency to the euro in January 2000. Costs associated with the Euro Conversion are being expensed by the Company during the period in which they are incurred and are not currently anticipated to be material. The Company presently believes that, with remediation measures, any material risks associated with the Euro Conversion can be mitigated.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to market risk from changes in interest rates on borrowed funds, which could affect its results of operations and financial condition. At January 1, 2000, the Company had approximately \$6.8 million in variable-rate debt outstanding and, as such, the market risk is immaterial based upon a 10%

increase or decrease in interest rates. The Company manages this risk by selecting unsecured debt financing at its lenders' prime rate less 1%, or the LIBOR rate plus 1.9%, whichever is the more advantageous.

FORWARD-LOOKING INFORMATION

Certain oral statements made by management from time to time and certain statements contained herein that are not historical facts are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934 and, because such statements involve risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Forward-looking statements, including those in Management's Discussion and Analysis of Financial Condition and Results of Operations are statements regarding the intent, belief or current expectations, estimates or projections of the Company, its Directors or its Officers about the Company and the industry in which it operates, and assumptions made by management, and include among other items, (i) the Company's strategies regarding growth, including its intention to develop new products; (ii) the Company's financing plans; (iii) trends affecting the Company's financial condition or results of operations; (iv) the Company's ability to continue to control costs and to meet its liquidity and other financing needs; (v) the declaration and payment of dividends; and (vi) the Company's ability to respond to changes in customer demand domestically and internationally, including as a result of standardization. Although the Company believes that its expectations are based on reasonable assumptions, it can give no assurance that the anticipated results will occur.

Important factors that could cause the actual results to differ materially from those in the forward-looking statements include, among other items, (i) the economic cyclicalities of the capital goods industry in general and the hydraulic valve and manifold industry in particular, which directly affect customer orders, lead times and sales volume; (ii) conditions in the capital markets, including the interest rate environment and the availability of capital; (iii) changes in the competitive marketplace that could affect the Company's revenue and/or cost bases, such as increased competition, lack of qualified engineering, marketing, management or other personnel, and increased labor and raw materials costs; (iv) changes in technology or customer requirements, such as standardization of the cavity into

which screw-in cartridge valves must fit, which could render the Company's products or technologies noncompetitive or obsolete; (v) new product introductions, product sales mix and the geographic mix of sales nationally and internationally; and (vi) changes relating to the Company's international sales, including changes in regulatory requirements or tariffs, trade or currency restrictions, fluctuations in exchange rates, and tax and collection issues. Further information relating to factors that could cause actual results to differ from those anticipated is included but not limited to information under the headings "Business," particularly under the subheading, "Business Risk Factors" and "Management's Discussion and Analysis of Financial Conditions and Results of Operations" in Form 10-K for the year ended January 1, 2000. The Company disclaims any intention or obligation to update or revise forward-looking statements, whether as a result of new information, future events or otherwise.



Report of Independent Certified Public Accountants

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 comprehensive income, and of cash flows present fairly, in all material respects, the financial position of Sun Hydraulics Corporation and its subsidiaries at January 1, 2000 and December 31, 1998, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States. 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 auditing standards generally accepted in the United States, 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.

A handwritten signature in cursive script that reads "PricewaterhouseCoopers LLP".

PricewaterhouseCoopers LLP
Tampa, Florida
March 6, 2000



Consolidated Balance Sheets

(in thousands)

FOR THE YEAR ENDED	Jan. 1, 2000	Dec. 31, 1998
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 1,122	\$ 1,592
Accounts receivable, net of allowance for doubtful accounts of \$196 and \$169	6,260	5,342
Inventories	8,131	8,125
Taxes receivable	455	-
Other current assets	591	891
TOTAL CURRENT ASSETS	16,559	15,950
Property, Plant and Equipment, Net	46,529	44,003
Other Assets	986	1,066
TOTAL ASSETS	\$64,074	\$61,019
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	\$ 2,712	\$ 2,877
Accrued expenses and other liabilities	1,464	2,065
Long-term debt due within one year	3,033	4,302
Notes payable to related parties due within one year	378	578
Dividends payable	255	254
Income taxes payable	-	245
TOTAL CURRENT LIABILITIES	7,842	10,321
Long-Term Debt Due After One Year	10,830	6,461
Notes Payable to Related Parties Due After One Year	101	566
Deferred Income Taxes	4,125	3,656
TOTAL LIABILITIES	22,898	21,004
Commitments & Contingencies (Note 17)		
Shareholders' Equity:		
Preferred stock	-	-
Common stock	6	6
Capital in excess of par value	24,486	24,386
Retained earnings	16,173	15,363
Accumulated other comprehensive income	511	260
TOTAL SHAREHOLDERS' EQUITY	41,176	40,015
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$64,074	\$61,019

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)

FOR THE YEAR ENDED	Jan. 1, 2000	Dec. 31, 1998	Dec. 31, 1997
Net sales	\$69,652	71,881	\$64,198
Cost of sales	53,107	52,537	44,621
Gross profit	16,545	19,344	19,577
Selling, engineering and administrative expenses	12,507	11,656	11,275
Operating income	4,038	7,688	8,302
Interest expense	954	837	905
Other miscellaneous (income) expense	420	(1,669)	133
Income before income taxes	2,664	8,520	7,264
Income tax provision	833	2,873	2,554
Net income	\$ 1,831	\$ 5,647	\$ 4,710
Basic net income per common share	\$ 0.29	\$ 0.89	\$ 0.75
Weighted average shares outstanding	6,380	6,345	6,308
Diluted net income per common share	\$ 0.28	\$ 0.87	\$ 0.73
Weighted average diluted shares outstanding	6,569	6,531	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 and Comprehensive Income

(in thousands)

	Shares	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, December 31, 1996	4,000	2,179	2,719	17,450	49	22,397
Net proceeds from stock offering	2,300	2	19,250			19,252
Distributions to shareholders				(10,545)		(10,545)
Dividends declared				(883)		(883)
Merger with Sun Holdings (Note 2)		(2,175)	2,123			(52)
Exercise of stock options	22		71			71
Comprehensive income:						
Net income				4,710		4,710
Foreign currency translation adjustments					50	50
Comprehensive income						4,760
Balance, December 31, 1997	6,322	6	24,163	10,732	99	35,000
Dividends declared				(1,016)		(1,016)
Exercise of stock options	39		223			223
Comprehensive income:						
Net income				5,647		5,647
Foreign currency translation adjustments					161	161
Comprehensive income						5,808
Balance, December 31, 1998	6,361	6	24,386	15,363	260	40,015
Dividends declared				(1,021)		(1,021)
Exercise of stock options	22		75			75
Comprehensive income:						
Issue of stock	2		13			13
Tax effect of non-qualified stock options			12			12
Comprehensive income:						
Net income				1,831		1,831
Foreign currency translation adjustments					251	251
Comprehensive income						2,082
Balance, January 1, 2000	6,385	\$ 6	\$24,486	\$16,173	\$ 511	\$41,176

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

Consolidated Statements of Cash Flows

(in thousands)

FOR THE YEAR ENDED	Jan. 1, 2000	Dec. 31, 1998	Dec. 31, 1997
Cash Flows From Operating Activities:			
Net income	\$ 1,831	\$ 5,647	\$ 4,710
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	5,043	4,387	3,706
(Gain)/Loss on disposal of assets	281	-	-
Compensation expense of stock options	13	-	-
Provision for deferred income taxes	481	453	625
(Increase) decrease in:			
Accounts receivable	(945)	(665)	(1,070)
Allowance for doubtful accounts	27	122	47
Inventories	(6)	(877)	(2,324)
Income tax receivable, net	(700)	-	-
Other current assets	300	38	200
Other assets	30	86	962
Increase (decrease) in:			
Accounts payable	(165)	(167)	(426)
Accrued expenses and other liabilities	(601)	(279)	213
Income taxes payable, net	-	(135)	(81)
Other liabilities	-	-	(20)
Net cash provided by operating activities	<u>5,589</u>	<u>8,610</u>	<u>6,542</u>
Cash Flows From Investing Activities:			
Investment in acquisition and joint venture		(1,110)	-
Capital expenditures	(7,897)	(8,137)	(6,490)
Proceeds from dispositions of equipment	96	143	207
Net cash used in investing activities	<u>(7,801)</u>	<u>(9,104)</u>	<u>(6,283)</u>
Cash Flows From Financing Activities:			
Proceeds from debt	13,206	9,323	5,580
Repayment of debt	(10,106)	(7,039)	(12,579)
Repayment of notes payable to related parties	(663)	(765)	(655)
Proceeds from exercise of stock options	75	223	71
Net proceeds from stock offering	-	-	19,252
Cash paid for Sun Holdings merger (Note 2)	-	-	(52)
Dividends to shareholders	(1,021)	(983)	(663)
Distributions to shareholders	-	-	(11,052)
Net cash provided by (used in) financing activities	<u>1,491</u>	<u>759</u>	<u>(98)</u>
Adjustment for Other Comprehensive Income	251	78	50
Net Increase (Decrease) in Cash and Cash Equivalents	(470)	343	211
Cash and Cash Equivalents, Beginning of Period	1,592	1,249	1,038
Cash and Cash Equivalents, End of Period	<u>\$ 1,122</u>	<u>\$ 1,592</u>	<u>\$ 1,249</u>
Supplemental Disclosure of Cash Flow Information:			
Cash paid for:			
Interest	<u>\$ 1,002</u>	<u>\$ 954</u>	<u>\$ 1,206</u>
Income taxes	<u>\$ 1,052</u>	<u>\$ 2,555</u>	<u>\$ 2,010</u>

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

Notes to Consolidated Financial Statements

1. Business

Sun Hydraulics Corporation and its wholly-owned subsidiaries (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, Germany, and Korea. Sun Hydraulics Corporation ("Sun Hydraulics"), with its main offices located in Sarasota, Florida, designs, manufactures and sells through independent distributors in the United States. Sun Hydraulik Holdings Limited ("Sun Holdings"), a wholly-owned subsidiary of Sun Hydraulics, 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, "Sun GmbH"). Sun Ltd. operates a manufacturing and distribution facility located in Coventry, England, and Sun GmbH, located in Erkelenz, Germany, designs, manufactures and markets the Company's products in German-speaking European markets. Sun Hydraulics Korea Corporation ("Sun Korea"), a wholly-owned subsidiary of Sun Hydraulics, was acquired September 28, 1998 (see Note 2). Sun Korea, located in Incheon, South Korea, operates a manufacturing and distribution facility.

2. Reorganization and Initial Public Offering

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 interests 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.

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 and comprehensive income.

The \$19,252 of net proceeds from the IPO were used as follows: an S Corporation distribution of \$9,446, representing 90% of the total distribution of \$10,545 was

made, \$7,676 was paid to extinguish debt, \$1,000 was paid to reduce the mortgage on the United States construction loan, and \$1,130 was retained as working capital.

The Company has 20,000,000 authorized shares of common stock, par value \$0.001, with 6,384,948 shares outstanding at January 1, 2000. The Company also has 2,000,000 authorized shares of preferred stock, par value \$0.001, with no shares outstanding.

3. Acquisition and Joint Venture

On September 28, 1998, Sun Hydraulics acquired 100% of the equity shares of Korea Fluid Power Co. Ltd., which had been the Company's exclusive distributor in South Korea since 1988. This wholly-owned subsidiary's name was changed to Sun Hydraulics Korea Corporation in January 1999. The acquisition price paid by the Company was \$860. The amounts paid in excess of the net book value have been capitalized as goodwill, and are amortized over a period of 15 years. Goodwill is recorded under other assets in the Company's financial statements, and was \$520, net of amortization as of January 1, 2000.

On November 1, 1998, Sun Hydraulics entered into a 50/50 joint venture agreement ("joint venture") with Links Lin, the owner of Sun Hydraulics Corporation's Taiwanese distributor. This agreement provides for an initial capital contribution of \$250, which is recorded in Investment in joint venture in the Company's financial statements.

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 Consolidation

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.

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.

52 Week Fiscal Year

Commencing in 1999, the Company implemented a fiscal year which ends on the Saturday nearest to the end of the month of December. Each quarter consists of two 4-week periods and one 5-week period.

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:

	YEARS
Software and computer equipment	3-5
Machinery and equipment	4-12
Furniture and fixtures	4-10
Leasehold and land improvements	5-15
Buildings	40

Capitalized Software Costs

Capitalized software costs are accounted for under "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" ("SOP 98-1") and are recorded at cost less accumulated depreciation. Software is capitalized upon the successful testing of the system. Depreciation is charged to income over the estimated useful life of the software. The amount recorded under SOP 98-1 during 1999, was \$528, and was capitalized upon completion.

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 January 1, 2000, management does not believe that an impairment reserve is required.

Other Assets

Other assets include goodwill and other acquisition costs of \$817, net of amortization, related to the acquisition of Sun Korea, and an equity investment in the Company's joint venture of \$146, which are discussed further in Note 2. Goodwill, which represents the excess of purchase price of acquisitions over the fair value of the net assets acquired, is carried at cost, net of accumulated amortization and amortized on a straight-line basis over fifteen years. Other acquisition costs are carried at cost, net of accumulated amortization and amortized on a straight-line basis over fifteen years. The equity investment is established at cost and adjusted for investment income or loss and dividend distributions for each period.

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 \$50, \$466, and \$630 for the years ended January 1, 2000, December 31, 1998, and December 31, 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 \$728, \$262, and \$719 for the years ended January 1, 2000, December 31, 1998 and December 31, 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 was the functional currency of GmbH during fiscal 1999, and will be changed to the Euro for fiscal 2000. The South Korean Won is the functional currency of Sun Korea. The U.S. Dollar is the functional currency for Sun Hydraulics and the reporting currency for the consolidated group. The monetary assets and liabilities of Sun Ltd., GmbH, and Sun Korea are translated at the exchange

(in thousands except per share data)

rate in effect at the balance sheet date, while all other assets, liabilities, and shareholders' equity, 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 as "accumulated comprehensive income." 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.

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. Such reclassifications had no effect on total assets, equity, net income, or total cash flows.

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 due to the nature of their short maturities.

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 \$495, and \$1,133 at January 1, 2000, and December 31, 1998, respectively.

6. Inventories

	Jan. 1, 2000	Dec. 31, 1998
Raw materials	\$ 2,602	\$ 2,462
Work in process	3,452	2,864
Finished goods	2,077	2,799
	<u>\$ 8,131</u>	<u>\$ 8,125</u>

7. Property, Plant and Equipment

	Jan. 1, 2000	Dec. 31, 1998
Machinery and equipment	\$37,065	\$33,736
Office Furniture and EDP equipment	8,124	6,736
Buildings	18,518	18,408
Leasehold and land improvements	881	557
Construction in progress	3,518	2,005
Land	2,481	2,099
	<u>70,587</u>	<u>63,541</u>
Less: Accumulated depreciation	(24,058)	(19,538)
	<u>\$46,529</u>	<u>\$44,003</u>

Depreciation expense for the years ended January 1, 2000, December 31, 1998, and December 31, 1997 were \$4,993, \$4,387, and \$3,706, respectively.

8. Accrued Expenses and Other Liabilities

	Jan. 1, 2000	Dec. 31, 1998
Compensation and benefits	\$ 677	\$ 951
Deferred grant	424	424
Sales taxes payable	5	20
Insurance	177	-
Warranty expense	25	130
Other accrued expenses	156	157
Due to joint venture	-	245
Advertising	-	20
Professional Fees	-	78
	<u>\$ 1,464</u>	<u>\$ 2,065</u>

Notes to Consolidated Financial Statements

(Continued)

9. Long-Term Debt

	Jan. 1, 2000	Dec. 31, 1998
Lines of credit agreements- unsecured	\$ 2,215	\$ 3,974
Lines of credit agreements- secured	4,616	-
Mortgage note payable- U.S. Manatee County facility	4,725	4,864
Mortgage note payable- German facility	1,352	1,748
Secured notes payable- German equipment	933	-
Secured notes payable-Korea	22	177
	<u>13,863</u>	<u>10,763</u>
Less amounts due within one year	<u>(3,033)</u>	<u>(4,302)</u>
	<u>\$10,830</u>	<u>\$ 6,461</u>

The remaining principal payments are due as follows: 2001 - \$1,482; 2002 - \$1,598; 2003 - \$1,723; 2004 - \$1,278; and 2005 thereafter - \$4,749.

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.

On July 23, 1999, the Company replaced its \$10,000 unsecured revolving credit facility with a five year, secured, revolving credit facility of \$7,500, and a one-year unsecured, revolving credit facility of \$5,000. The \$7,500 credit facility has an interest rate equal to the bank lender's prime rate less 1% for the first year, and the treasury bill rate plus 1.75% for the remaining four years. This credit facility is collateralized with machinery and equipment. The \$5,000 credit facility has 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. At January 1, 2000, the interest rate for both the secured and unsecured facilities was 7.5%, and the balances outstanding were \$4,616 and \$2,215, respectively. Both credit facilities are subject to certain debt covenants.

A 10-year mortgage loan of \$6,187 was obtained, at a fixed interest rate of 8.25%, for construction of the Manatee County facility. Terms on the construction note were interest-only on the balance drawn down through the completion of construction and then conversion to a 10-year mortgage note with a 15-year amortization schedule. In April 1999, this mortgage note was renegotiated to an interest rate of 7.375%. Terms are monthly principal and interest payments with remaining principal due July 1, 2006. At January 1, 2000, \$4,725 was outstanding under this mortgage loan.

In May 1996, the Company obtained a mortgage loan of approximately \$2,400, denominated in German marks, for the new facility in Erkelenz, Germany. This loan had a term of 12 years with variable interest of 6.47%. During 1999, the Company renegotiated this loan with a mortgage note, bearing fixed interest at 6.05%, with monthly payments of approximately \$24, and a maturity date of September 30, 2008. At January 1, 2000, \$1,352 was outstanding under this mortgage note.

In February 1999, the Company negotiated three loans in Germany secured by equipment, a ten year 5.1% fixed interest rate loan for approximately \$300, a ten year 5.1% fixed interest rate loan for approximately \$100, and a ten year 3.5% fixed interest rate loan for approximately \$800. At January 1, 2000, the outstanding balances on these facilities were \$237, \$0, and \$696, respectively.

In England, the Company has a \$1,200 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 payable on demand. At January 1, 2000, there was no balance outstanding on this credit facility.

Sun Korea has a secured note denominated in Korean Won, with interest payable at a fixed rate of 6%, with a maturity date of June 25, 2001. At January 1, 2000, \$22 was outstanding under this credit facility.

Capitalized interest was \$0, \$90, and \$160, for the years ended January 1, 2000, December 31, 1998 and December 31, 1997, respectively.

10. Related Parties

Notes payable to related parties include the following:

	Jan. 1, 2000	Dec. 31, 1998
15% unsecured note payable for repurchase and retirement of stock, quarterly principal and interest installments ranging from \$1 to \$20 through January 1, 2001.	\$ 145	\$ 950
10% unsecured notes payable for phantom compensation, quarterly principal and interest payments of \$14 payable through January 1, 2003.	<u>334</u>	<u>194</u>
	479	1,144
Less amounts due within one year	<u>(378)</u>	<u>(578)</u>
	<u>\$ 101</u>	<u>\$ 566</u>

The remaining principal payments are due as follows: 2001 - \$35; 2002 - \$52; 2003 - \$14

(in thousands except per share data)

The 15% notes payable represent the repurchase and retirement of stock to former employees for the years 1989 to 1993. These notes represent the repurchase of shares of common stock from five former employees. These agreements contain a provision disallowing prepayment.

During 1995, Sun Hydraulics entered into a 35-month agreement with SunOpTech, Ltd. ("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 the general partner of SunOpTech. In exchange for the development of computer software and computer support, Sun Hydraulics paid approximately \$1,000 over the three-year period. Fees paid in 1998 for the final year of this agreement were \$33. For the years ended December 31, 1998, and 1997, Sun Hydraulics paid SunOpTech expenses of \$45, 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.

11. Distributions and Dividends to Shareholders

The Company declared distributions of \$1,021, \$1,016, and \$10,545 to shareholders in 1999, 1998, and 1997, respectively. 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 a cash dividend of \$.04 per share on February 25, 2000, to shareholders of record on March 31, 2000, payable on April 15, 2000. The Company declared quarterly dividends of \$0.04 per share to shareholders of record on the last day of each quarter in 1999 and 1998. These dividends were paid on the 15th day of each month following the date of declaration.

12. Income Taxes

Pretax income is taxed under the following jurisdictions:

FOR THE YEAR ENDED	Jan. 1, 2000	Dec. 31, 1998	Dec. 31, 1997
United States	\$1,439	\$6,854	\$4,962
Foreign	1,325	1,666	2,302
Total	<u>\$2,764</u>	<u>\$8,520</u>	<u>\$7,264</u>

The income tax provision consists of the following:

FOR THE YEAR ENDED	Jan. 1, 2000	Dec. 31, 1998	Dec. 31, 1997
Current tax expense:			
United States	\$ 38	\$1,662	\$1,157
State and local	1	159	75
Foreign	326	600	697
Total current	<u>365</u>	<u>2,421</u>	<u>1,929</u>
Deferred tax expense (benefit):			
United States	573	411	615
State and local	51	36	14
Foreign	(156)	5	(4)
Total deferred	<u>468</u>	<u>452</u>	<u>625</u>
Total income tax provision	<u>\$ 833</u>	<u>\$2,873</u>	<u>\$2,554</u>

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

FOR THE YEAR ENDED	Jan. 1, 2000	Dec. 31, 1998	Dec. 31, 1997
U.S. federal taxes at statutory rate	\$ 940	\$2,897	\$2,461
Increase (decrease)			
Benefit of foreign sales corporation	(59)	(60)	-
Foreign income taxed at higher rate	(104)	(59)	(80)
Nondeductible items	27	(42)	35
State and local taxes, net	29	137	138
Income tax provision	<u>\$ 833</u>	<u>\$2,873</u>	<u>\$2,554</u>

Deferred tax assets and liabilities at fiscal year end are as follows:

	Jan. 1, 2000	Dec. 31, 1998
Deferred taxes, non-current:		
Assets		
Accrued expenses and reserves not currently deductible	\$ 109	\$ 132
Compensation expense recognized for book, not yet deductible for tax	329	388
Deferred tax asset, non-current	438	520
Liabilities		
Depreciation	(4,562)	4,176
Net deferred tax liability, non-current	<u>\$4,124</u>	<u>\$3,656</u>

13. Stock Option Plans

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 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 options become exercisable at such times and in such installments as determined by the Board of Directors.

A summary of the Company's stock option plan for each of the three years ended January 1, 2000, is summarized as follows:

(share amounts in thousands)

	Number of Shares	Exercise Price Range	Weighted Average Exercise Price
Under option, December 31, 1996 (320 shares exercisable)	320	\$ 3.00- 5.05	\$ 3.91
Granted	289	\$ 9.50	\$ 9.50
Exercised	(22)	\$ 3.00- 3.47	\$ 3.21
Under option, December 31, 1997 (357 shares exercisable)	587	\$ 3.00- 9.50	\$ 6.69
Granted	220	\$10.00-16.75	\$15.22
Exercised	(39)	\$ 3.00- 9.50	\$ 5.75
Under option, December 31, 1998 (385 shares exercisable)	768	\$ 3.00-16.75	\$ 9.18
Granted	-	\$ -	\$ -
Exercised	(22)	\$ 3.00- 3.47	\$ 3.39
Forfeitures	(80)	\$ 9.50	\$ 9.50
Under option, January 1, 2000 (453 shares exercisable)	666	\$ 3.00-16.75	\$ 9.19

A summary of outstanding and exercisable options at January 1, 2000 is summarized as follows:

OPTIONS OUTSTANDING

Range of exercise prices	Number of shares	Weighted-average contractual life	Weighted-average exercise price
\$ 3.00	62,746	4.08	\$ 3.00
3.43-5.05	189,068	6.75	4.41
9.50	194,385	6.35	9.50
10.00	50,000	8.92	10.00
16.75	170,000	8.36	16.75

OPTIONS EXERCISABLE

Range of exercise prices	Number of shares	Weighted-average exercise price
\$ 3.00	62,746	\$ 3.00
3.43-5.05	189,068	4.41
9.50	112,944	9.50
10.00	50,000	10.00
16.75	38,000	16.75

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 1998 and 1997 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:

FOR THE YEAR ENDED	Jan. 1, 2000	Dec. 31, 1998	Dec. 31, 1997
Net income:			
As reported	\$1,831	\$5,647	\$4,710
Pro forma	1,404	5,188	4,394
Basic earnings per common share:			
As reported	0.29	0.89	0.75
Pro forma	0.22	0.82	0.70
Diluted earnings per common share:			
As reported	0.28	0.87	0.73
Pro forma	0.21	0.79	0.68

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 1998 and 1997: cumulative volatility of 43.09%, and 39.56% for 1998 and 1997, respectively; dividend yields of 1.68%, and 1.68%, for 1998 and 1997, respectively; risk-free interest rate of 5.57%, and 5.72%, for 1998 and 1997, respectively; and expected term of 6.59 years, and 6.04 years for 1998 and 1997, respectively.

14. Earnings per Common Share

The Company calculates its earnings per share ("EPS") using Statement of Financial Accounting Standards No. 128, "Earnings per Share" ("SFAS 128").

Basic EPS is calculated as net income divided by the weighted average number of shares of common stock outstanding.

Diluted EPS is calculated using the treasury stock method under which net income is divided by the weighted average number of common and common equivalent shares outstanding during the year. Common stock equivalents consist of options.

Presented below is basic and diluted EPS under SFAS 128 for the years ended January 1, 2000, December 31, 1998 and 1997:

	Income	Weighted Average Shares Outstanding	Per Share amount
1999			
Earnings per share— common stock	\$1,831	6,380	\$0.29
Effect of dilutive securities: Stock options		164	
Earnings per share— common stock assuming dilution	\$1,831	6,544	\$0.28
1998			
Earnings per share— common stock	\$5,647	6,345	\$0.89
Effect of dilutive securities: Stock options		186	
Earnings per share— common stock assuming dilution	\$5,647	6,531	\$0.87
1997			
Earnings per share— common stock	\$4,710	6,308	\$0.75
Effect of dilutive securities: Stock options		191	
Earnings per share— common stock assuming dilution	\$4,710	6,499	\$0.73

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 \$702, \$982, and \$993 during 1999, 1998 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 health care plan and the trust amounted to approximately \$2,265, \$2,569, and \$1,954, during 1999, 1998 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 \$144, \$166, and \$159, for fiscal 1999, 1998 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 \$124, \$93, and \$81, during 1999, 1998 and 1997, respectively.

16. Segment Reporting

In 1998, the Company adopted Statement of Accounting Standards No. 131, "Disclosures about Segments of Enterprise and Related Information" ("SFAS 131"). SFAS 131 supercedes SFAS 14, "Financial Reporting for Segments of a Business Enterprise," replacing the "industry segment" approach with the "management" approach of determining reportable segments of an organization. The management approach designates the internal organization that is used by management for making operation decisions and addressing performance as the source of determining the Company's reportable segments. Management bases its financial decisions by the geographical location of its operations.

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

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

16. Segment Reporting (Continued)

Segment information is as follows:

SEGMENT INFORMATION

	United States	Korea	United Kingdom	Germany	Elimination	Consolidated
1999						
Sales to unaffiliated customers	\$49,630	\$4,202	\$10,758	\$5,062	\$ -	\$69,652
Intercompany sales	8,354	-	2,016	43	(10,413)	-
Operating profits	2,492	81	1,059	354	52	4,038
Identifiable assets	49,539	857	8,044	5,902	(268)	64,074
Depreciation and amortization	3,802	112	827	302	-	5,043
Capital expenditures	5,953	119	1,323	502	-	7,897
1998						
Sales to unaffiliated customers	\$54,940	\$ 556	\$11,708	\$4,677	\$ -	\$71,881
Intercompany sales	8,340	-	2,281	40	(10,661)	-
Operating profits	5,902	(169)	1,937	190	(172)	7,688
Identifiable assets	47,850	329	8,882	4,032	(74)	61,019
Depreciation and amortization	3,434	-	732	221	-	4,387
Capital expenditures	6,105	(26)	1,254	805	-	8,137
1997						
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 and amortization	2,840	-	634	232	-	3,706
Capital expenditures	5,972	-	617	286	-	6,490

Total liabilities attributable to foreign operations were \$4,198, \$4,182, and \$3,867, at January 1, 2000, December 31, 1998, and December 31, 1997, respectively. Net foreign currency gains (losses) reflected in results of operations were (\$168), (\$35), and (\$192), for the years ended 1999, 1998 and 1997, respectively. Operating profit is total sales and other operating income less operating expenses. In computing segment 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 \$6,056, \$6,415, and \$7,431, during 1999, 1998 and 1997, respectively.

18. Commitments and Contingencies

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

In 1996, the Company was awarded a grant of 711 Deutsche Marks (approximately \$424), by the German government, which helped to offset the cost of the German facility. This grant required that the German operation employ 26 people by June 30, 1998. The

Company did not meet this headcount requirement and was granted an extension. If the Company fails to meet the terms of the grant, approximately 50% of the grant will be repaid. This amount has been recorded as a deferred grant. The repayment would affect cash and would have no effect on net income.

The Company received a business interruption insurance claim of \$1,821 (\$1,661, net of expenses), from its insurance carrier in 1998 and is recorded in miscellaneous income. The claim was related to a fire in the Manatee County facility 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.



Shareholder Information

Corporate Officers

Robert E. Koski
Chairman of the Board

Clyde G. Nixon
President, CEO

Richard J. Dobbyn
Chief Financial Officer

Allen J. Carlson
Vice President
Sun Hydraulics Corporation

Jeffrey Cooper
Engineering Manager
Sun Hydraulics Corporation

Peter G. Robson
General Manager
Sun Hydraulics Limited

Directors

Robert E. Koski
Chairman of the Board
Sun Hydraulics Corporation

Clyde G. Nixon
President, CEO
Sun Hydraulics Corporation

James G. March, PhD
Professor Emeritus
Stanford University

Taco Van Tijn, Esquire
Solicitor

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

John S. Kahler
President, CEO
Cincinnati Incorporated

Ferdinand E. Megerlin, Dr.-Ing
Chairman, Joint Managing Director
Linde AG, Industrial Trucks
and Hydraulics Division

Legal Counsel

Shumaker, Loop & Kendrick, LLP
Tampa, Florida

Auditors

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Tampa, Florida

Corporate Headquarters

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Investor Relations

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:

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Sarasota, FL 34243
Phone: 941-362-1200
Fax: 941-355-4497

Transfer Agent

SunTrust Bank, Atlanta
Atlanta, Georgia

Common Stock Information

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

As of March 31, 2000, there were 101 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 31, 2000, the closing price per share of SNHY stock was \$8.81 and there were 6,384,948 shares outstanding.

Shareholders Annual Meeting

The annual meeting of shareholders will be held Saturday, May 13, 2000, at 10:00 A.M. Eastern Standard Time at Sun Hydraulics Corporation, 701 Tallevest Road, Sarasota, Florida 34243.



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