

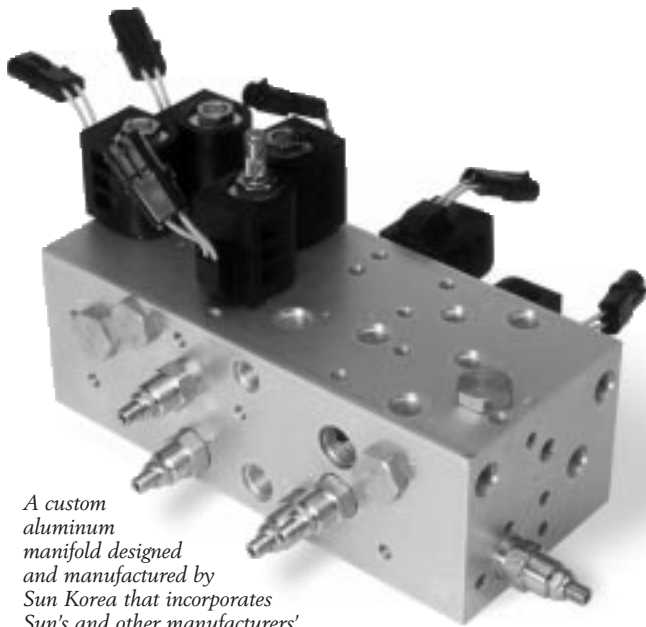


Sun Hydraulics Corporation 1998 Annual Report

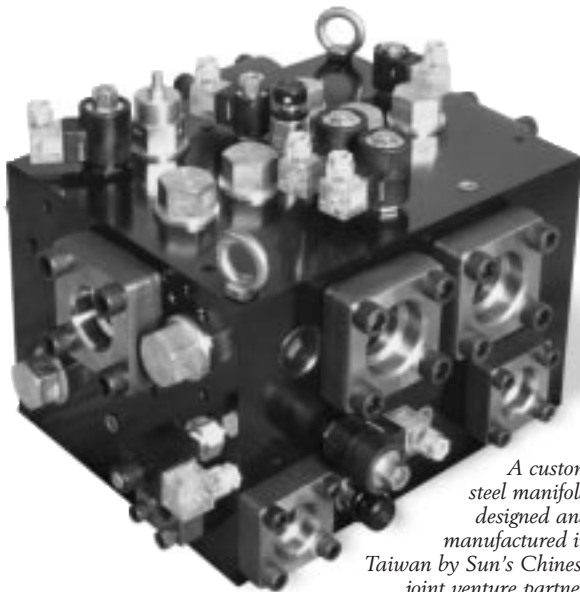
Growing International Markets and Global Customers

Equipment manufacturers are establishing design and manufacturing facilities in strategic geographic locations to better service customers and improve profitability. In many of these locations, new manufacturers are emerging. Often, countries have local content requirements for products and systems sold into its markets. In 1998, Sun Hydraulics strengthened its ability to replicate high-level hydraulic technology solutions in remote locations while satisfying many local content requirements.

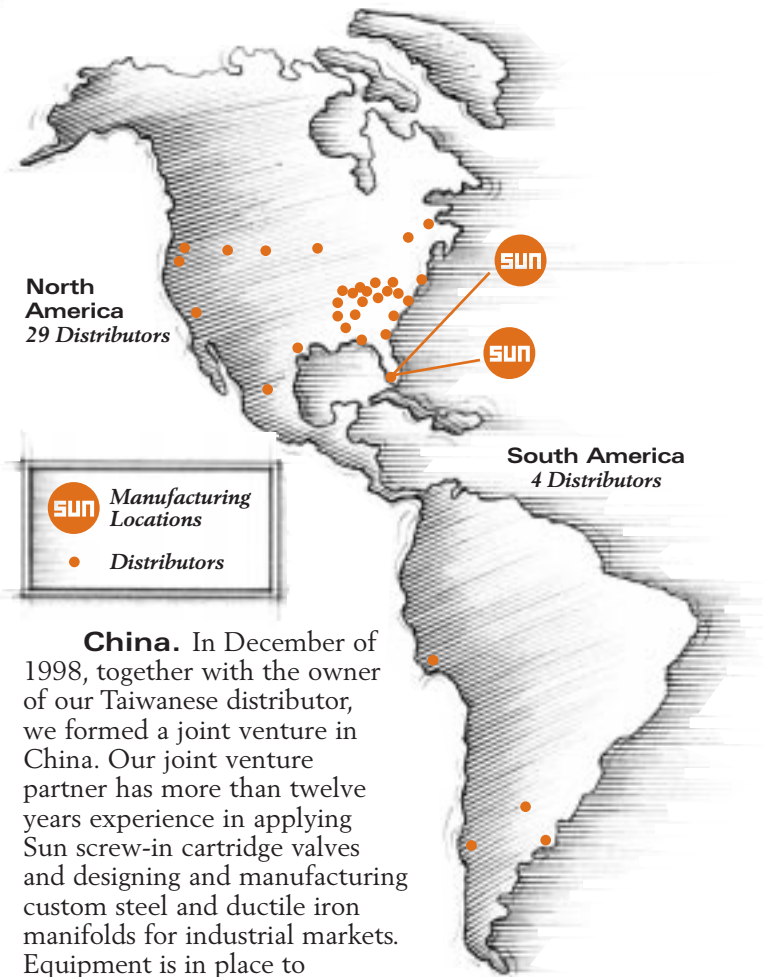
Korea. In August of 1998, we acquired Korea Fluid Power, Ltd., our exclusive distributor in Korea for more than ten years. With this acquisition, we have added a team of people with a high level of technical understanding of Sun products who have developed an expertise in designing and manufacturing standard and custom aluminum manifolds that incorporate our screw-in cartridge valves.



A custom aluminum manifold designed and manufactured by Sun Korea that incorporates Sun's and other manufacturers' screw-in cartridge valves.



A custom steel manifold designed and manufactured in Taiwan by Sun's Chinese joint venture partner.



China. In December of 1998, together with the owner of our Taiwanese distributor, we formed a joint venture in China. Our joint venture partner has more than twelve years experience in applying Sun screw-in cartridge valves and designing and manufacturing custom steel and ductile iron manifolds for industrial markets. Equipment is in place to manufacture manifolds that incorporate our screw-in cartridge valves, and we will continue to build a technical team similar to that in Korea.

Europe. Our facility in Coventry, England, has been designing and manufacturing manifolds for more than ten years and we are poised to increase our capacity at this location. In Germany, we continue to

expand our operation in Erkelenz and now have equipment in place to manufacture prototype custom aluminum manifolds for the German market.

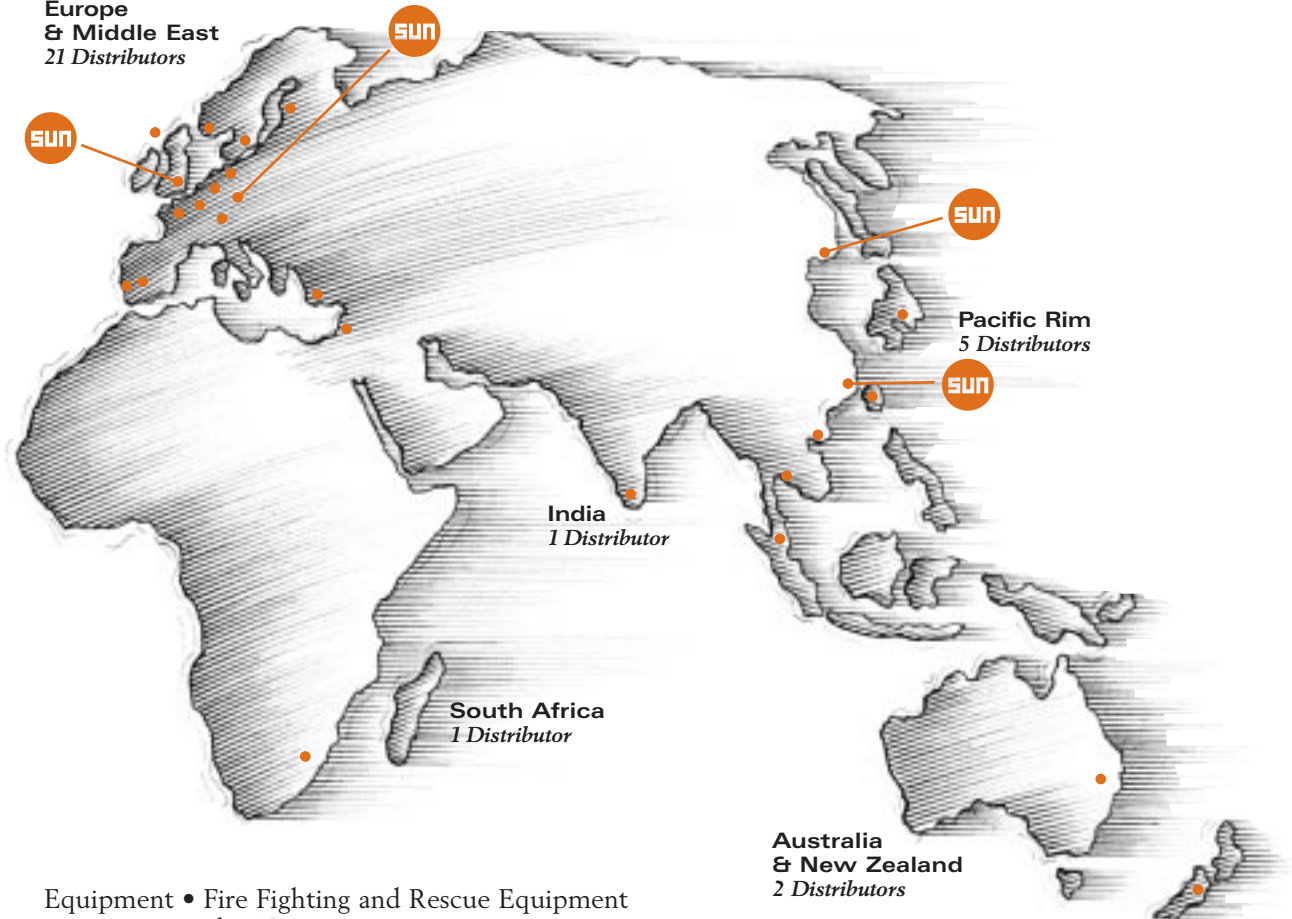
Together with our manufacturing locations in the United States and our global distribution network, Sun Hydraulics is ready to meet the growing international demand for screw-in hydraulic cartridge valve and manifold system solutions.

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

**Europe
& Middle East**
21 Distributors



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

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



Selected Consolidated Financial Data

(in thousands except per share data)

YEARS ENDED DECEMBER 31,	1998	1997	1996 ⁽⁴⁾	1995 ⁽⁴⁾	1994
Statement of Income Data:					
Net sales	\$71,881	\$64,198	\$54,572	\$55,388	\$42,853
Cost of sales	<u>52,537</u>	<u>44,621</u>	<u>37,185</u>	<u>34,581</u>	<u>27,512</u>
Gross profit	19,344	19,577	17,387	20,807	15,341
Selling, engineering and administrative expenses	<u>11,656</u>	<u>11,275</u>	<u>12,097⁽¹⁾</u>	<u>10,578</u>	<u>8,605</u>
Operating income	7,688	8,302	5,290	10,229	6,736
Interest expense	837	905	823	814	859
Miscellaneous (income) expense	<u>(1,669)</u>	<u>133</u>	<u>267</u>	<u>(79)</u>	<u>66</u>
Income before income taxes	8,520	7,264	4,200	9,494	5,811
Deferred tax provision ⁽²⁾	-	-	2,425	-	-
Income tax provision (benefit) ⁽³⁾	2,873	2,554	704	633	408
Net income	<u>\$ 5,647</u>	<u>\$ 4,710</u>	<u>\$ 1,071</u>	<u>\$ 8,861</u>	<u>\$ 5,403</u>
Basic net income per common share	\$ 0.89	\$ 0.75	\$ 0.27	\$ 2.29	\$ 1.41
Weighted average shares outstanding	6,345	6,308	3,978	3,878	3,825
Diluted net income per common share	\$ 0.87	\$ 0.73	\$ 0.26	\$ 2.15	\$ 1.30
Weighted average diluted shares outstanding	6,531	6,499	4,178	4,123	4,156
Other Financial Data:					
Depreciation	\$ 4,387	\$ 3,706	\$ 2,857	\$ 2,556	\$ 2,197
Capital expenditures	8,137	6,490	16,963	7,657	5,130
Balance Sheet Data:					
Cash and cash equivalents	\$ 1,592	\$ 1,249	\$ 1,038	\$ 2,434	\$ 2,371
Working capital	5,629	6,100	958	4,326	5,085
Total assets	61,019	53,389	48,416	33,864	27,868
Total debt	11,907	9,564	17,218	6,186	8,025
Shareholders' equity	40,015	35,000	22,397	21,529	15,624

(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. See Note 14 of the Notes to Financial Statements. Excluding such expense, pro forma net income for the twelve months ended December 31, 1996 would have been approximately \$3.8 million.

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

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

(4) 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. See Notes 2 and 13 of the Notes to the Consolidated Financial Statements. 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 net income per share was \$0.40 and \$0.92 for the years ended December 31, 1996 and 1995, respectively.

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

Overview

Sun Hydraulics Corporation is a leading designer and manufacturer of high-performance, screw-in hydraulic cartridge valves and manifolds which control force, speed and motion as integral components in fluid power systems. The Company sells its products globally through independent distributors. Approximately 66% of product sales are used by the mobile equipment market and 34% are used by the industrial equipment market. In 1998, the Company generated approximately 32.5% of its net sales outside the United States, and the Company's single largest end-user customer represented less than 3% of net sales.

Demand for the Company's products is dependent upon demand for the capital goods into which the Company's products are incorporated. The capital goods industry in general, and the fluid power industry in particular, is subject to economic cycles. According to the National Fluid Power Association, United States mobile hydraulic shipments were up 2.8% in 1998, from 1997 and industrial hydraulic shipments were up 7.4%; however, industry orders were down 4.7% in 1998, compared to 1997. North American distributor inventories of Sun products increased approximately 42% from December 1997 to December 1998. During the fourth quarter of 1998, the Company improved its product delivery times and significantly reduced its past due backlog. These improvements, coupled with distributor inventory increases during 1998 and the slowdown of business, could adversely affect orders, and thus, shipments, in the near term.

Net sales increased 12.0% in 1998 compared to 1997. Orders for 1998 were 1.5% below 1997. During 1998, product delivery times improved and past due backlog was significantly reduced. This was due to the capacity expansion of the United States manufacturing operation completed during the first half of 1997, a company-wide initiative to reduce production lead times, and the fact that demand leveled off. Plans for additional capacity are in process, which the Company anticipates will be put in place during 1999. The high-volume cartridge production cell will be moved from the Sarasota plant to the new Manatee County plant that was completed in 1997. An automated assembly machine and additional equipment will be added to the cell and a heat treat operation will be installed by the

end of the year. The Sarasota plant will be rearranged to take advantage of the additional space created by the movement of the cell and will manufacture new products and products required in lower volumes. The expansion of the United Kingdom production facility has been postponed until a significant increase in customer demand is foreseen. The plant in Germany is proceeding with the start-up of prototype manifold production. Assembly of the Company's new electrically actuated product line (solenoid) is also anticipated to be performed in Germany for European customers.

Operating profits were adversely affected in 1998 due to increases in manufacturing prime costs. This was a result of continued emphasis on improving customer delivery times and product quality. Material costs were particularly affected by outsourcing and increased costs of purchased parts. The Company has developed a procurement strategy and instituted an ongoing program to source quality parts more cost effectively. Management believes that the initiatives to increase capacity and productivity and decrease prime costs will start to have positive effects on operating profit by the second half of 1999.

The new Series '0' product line sales were less than 1% of total net sales in 1998. There was little promotion of this product line due to production capacity constraints and long lead times for existing product lines. Marketing efforts will increase in 1999 as confidence is gained that customer delivery requirements can be satisfactorily met.

An electrically actuated cartridge valve (solenoid) has been designed and is undergoing "beta" testing at several customer sites. A multi-year contract has been entered into with a supplier to provide the electrical assembly. Production is planned for the second quarter of this year. This is a new addressable market, which the Company believes is larger than the market for non-solenoid cartridge valves. Most of the Company's competitors offer solenoid cartridge valves as well as non-solenoid cartridge valves.

Historically, new product line volume builds slowly and initially generates low margins. Margins improve as volume increases and the design and manufacturing processes mature. During 1999, profit should be positively affected by the series '0' and solenoid cartridge valve shipments; however, the percentage of cost of sales to sales will be adversely affected.



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

(Continued)

On September 30, 1998, the Company purchased Korea Fluid Power, Ltd. ("KFP"), which formerly acted as the Company's Korean distributor, and had net sales in 1998 of approximately \$2.5 million. In January 1999, the new subsidiary's name was changed to Sun Hydraulics Korea Corporation ("Sun Korea"). Sun Korea sells primarily to OEMs in the Korean mobile market and also manufactures aluminum manifolds that incorporate the Company's and other manufacturers screw-in cartridge valves.

On November 1, 1998, the Company entered into a joint venture with its distributor for Taiwan to establish a distributorship and manifold manufacturing operation in mainland China. The Company has invested \$0.3 million and has 50% ownership. A building has been leased in Shanghai, and start-up of operations is underway. Sales of the joint venture are not expected to be significant in 1999.

Most of the Company's screw-in cartridge valve competitors produce screw-in cartridge valves that fit an industry common cavity that allows their products sometimes to be interchangeable. The industry common cavity is not supported by any national or global standards organizations. The International Standards Organization (ISO) recently developed a standard screw-in cartridge cavity that is different from the industry common cavity. The Company does not manufacture a product that fits either the industry common or the ISO standard cavity. Currently, the Company is not aware of any major competitor that produces a full line of standard products conforming to the ISO standard. The Company is aware that several competitors are designing, and some are producing, cartridge valves that are interchangeable with the Company's cartridge valves. The Company has long encouraged the hydraulics industry to recognize the benefits of the Company's cavity structure, which utilizes its unique cartridge valve designs, and is hopeful that the recent action by competition is an endorsement to that end. The Company believes the adoption by others of the cavity structure utilized by the Company will increase its total market opportunities.

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 December 31,	1998	1997	1996
Net sales	100.0%	100.0%	100.0%
Cost of sales	<u>73.1</u>	<u>69.5</u>	<u>68.1</u>
Gross profit	26.9	30.5	31.9
Selling, engineering and administrative expenses	<u>16.2</u>	<u>17.6</u>	<u>22.2</u>
Operating income	10.7	12.9	9.7
Interest expense	1.2	1.4	1.5
Miscellaneous (income) expense	<u>(2.3)</u>	<u>0.2</u>	<u>0.5</u>
Income before income taxes	<u>11.8%</u>	<u>11.3%</u>	<u>7.7%</u>

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.

Miscellaneous income was \$1.7 million in 1998 compared to \$0.1 million of expense 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.

Comparison of Years Ended December 31, 1997 and 1996

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

Gross profit increased 12.6%, or \$2.2 million, to \$19.6 million in 1997, compared to \$17.4 million in

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

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

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

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

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



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

(Continued)

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	Dec. 31 1998	Sept. 30 1998	June 30 1998	March 31 1998	Dec. 31 1997	Sept. 30 1997	June 30 1997	March 31 1997
Net sales	\$17,500	\$17,664	\$17,584	\$19,133	\$17,022	\$17,301	\$15,276	\$14,599
Cost of sales	13,459	13,132	12,599	13,347	12,133	11,842	10,444	10,202
Gross profit	4,041	4,532	4,985	5,786	4,889	5,459	4,832	4,397
Selling, engineering and administrative expenses	2,745	2,864	3,033	3,014	2,691	3,018	2,849	2,717
Operating income	1,296	1,668	1,952	2,772	2,198	2,441	1,983	1,680
Interest expense	130	216	231	260	252	285	216	152
Miscellaneous (income) expense	(81)	(1,586) ⁽¹⁾	(45)	43	92	27	72	(58)
Income before income taxes	1,247	3,038	1,766	2,469	1,854	2,129	1,695	1,586
Tax provision	443	1,015	586	829	593	777	616	568
Net income	<u>\$ 804</u>	<u>\$ 2,023</u>	<u>\$ 1,180</u>	<u>\$ 1,640</u>	<u>\$ 1,261</u>	<u>\$ 1,352</u>	<u>\$ 1,079</u>	<u>\$ 1,018</u>

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

At December 31, 1998, the Company had working capital of \$5.6 million. Cash flow from operations in 1998 was \$8.6 million, compared to \$6.5 million in 1997 and \$7.0 million in 1996. 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. The decrease in the Company's cash flow from operations in 1997 compared to 1996 was due primarily to increased inventory levels in the plants in the United

States and increased accounts receivable related to increased sales volume, offset partially by increases in net income and depreciation.

Capital expenditures were \$8.1 million in 1998 compared to \$6.5 million in 1997, and \$17.0 million in 1996. In 1998, \$6.1 million was spent in the United States operations, \$1.2 million was spent in the United Kingdom, and \$0.8 was spent in Germany. In 1997, \$1.1 million was spent to complete the new facilities in the United States and Germany and the balance of \$5.4 million for machinery and equipment. Capital expenditures in 1996 included \$12.6 million for buildings and land improvements for the United States and German facilities and \$4.4 million for machinery and equipment.

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 now been extended until September 30, 1999, and if the requirement is not met, 50% of the grant plus interest will have to be repaid. This amount has been recorded as a deferred grant. The repayment of the \$0.2 million 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 contains prepayment penalties.

In February 1997, the Company negotiated a one-year, unsecured revolving credit facility in the United States. The new credit facility provided for a maximum availability of \$10.0 million, payable on demand at the lender's prime rate of interest, and contained no debt covenants. At December 31, 1998, \$3.9 million was outstanding under this credit facility. In February 1998, the Company renegotiated this unsecured credit facility for a term of one year and an interest rate equal to the bank lender's prime rate less 1%, or LIBOR plus 1.9% for predetermined periods of time at the Company's option.

In England, the Company has a \$1.2 million line of credit, denominated in British pounds, which bears interest at a floating rate equal to 2.25% over the bank's base rate and is payable on demand. At December 31, 1998, there was no balance outstanding on this credit facility.

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

A 10-year mortgage note of \$6.1 million was obtained in May 1996, at a fixed interest rate of 8.25% for construction of the Manatee county facility. Terms on the new mortgage note were interest-only on the balance drawn down through the completion of construction and then conversion to a 10-year note with a 15-year amortization schedule. In March 1998, this mortgage note was renegotiated to an interest rate of 7.875%. In March 1999, this mortgage note was renegotiated to an interest rate of 7.375%. New terms are monthly principal and interest payments with remaining principal due July 1, 2006.

In May 1996, the Company obtained a mortgage loan of approximately \$2.4 million, denominated in German marks, for the new facility in Erkelenz, Germany. The loan has a term of 12 years and bears interest at 6.47%. In February 1999, the Company

secured three loans in Germany, 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.

In addition, the Company has \$1.1 million in notes payable to former shareholders, which bear interest at a weighted rate of 15%, with terms expiring in one to four years. These notes were issued by the Company in connection with the repurchase of shares of common stock from former shareholders, and do not allow for prepayment by the Company.

On September 30, 1998, the Company acquired its distributor in Korea for \$0.8 million. The Korean Company had approximately \$0.8 million of loans outstanding with interest rates from 6.0% to 15.0%. In December 1998, the Company paid \$0.6 million to pay off the higher interest rate loans. At December 31, 1998, the outstanding balance of these loans was \$0.2 million.

In January 1997, the Company received \$20.3 million of proceeds from its initial public offering of 2,300,000 shares of common stock. Net proceeds after expenses were approximately \$19.3 million of which \$10.5 million was distributed to shareholders of record as of December 31, 1996; \$2.9 million was used to repay an equipment note; \$2.4 million was used to repay the mortgage on the Sarasota facility; \$1.0 million was paid on the mortgage on the Manatee facility; \$1.4 million was paid on the United States revolving line of credit; and the remaining \$1.1 million was used for working capital.

The Company received payment of \$1.8 million (or \$1.7 million, net of expenses) related to a business-interruption insurance claim in September 1998. The claim was related to a fire in the Manatee plant in the United States, which occurred while the plant was under construction. This fire delayed the opening of the new plant which, in turn, delayed the rearrangement of the cartridge operation and the creation of the cellular production for high volume models.

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

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

(Continued)

YEAR 2000 READINESS DISCLOSURE

Management continues to evaluate the issues associated with the year 2000 in an effort to minimize the impact of the millennium date change on its business operations, information technology systems, and production infrastructure. In general, these issues arise from the fact that many existing computer systems, including hardware, software and embedded technology, only use the last two digits to refer to a year. Accordingly, many of these computer systems will not properly recognize a year that begins with "20" instead of the familiar "19." If not corrected, these computer systems could fail or create erroneous results.

The Company has established the following four-phased approach to address the year 2000 issue: (1) assessment, (2) testing, (3) renovation and (4) validation. With regard to its internal operations, the assessment phase consist of (i) the inventory of all systems, including hardware, software and embedded systems (such as the Company's CNC equipment) in all of Company's locations, (ii) the identification of all critical applications, and (iii) the collection of all internal source codes. Other than with regard to its embedded systems, this phase is now substantially completed. The Company anticipates full completion, including assessment of its embedded systems, by the end of the second quarter of 1999.

With regard to its external relationships, the assessment phase includes surveying the Company's material suppliers, distributors, and customers to determine the potential exposure to the Company if such parties fail to correct their year 2000 issues in a timely manner. The Company has now received responses to approximately fifty percent of its third party questionnaires. The Company anticipates the completion of this external assessment by the end of the fourth quarter of 1999.

The Company is currently testing all critical applications for year 2000 readiness and anticipates completion of this testing by the second quarter of 1999. The Company defines "year 2000 ready" to mean that neither the performance nor functionality of any of its critical systems, including both information technology and non-information technology systems, will be materially affected by dates prior to, during and after the year 2000. While testing continues, the Company has entered its renovation phase by commencing the replacement of the computer systems in two of its five locations (the

United States Sarasota facility and the United Kingdom operation) with "enterprise manufacturing systems" that, according to representations made by the systems' manufacturers, are currently year 2000 ready. The final phase of the Company's year 2000 readiness plan is a validation phase, during which upgraded systems will be re-tested.

The Company anticipates all phases of its year 2000 readiness plan, including the validation phase, to be completed by the end of the fourth quarter of 1999. There can, however, be no assurance that these deadlines will be met or precisely when the Company will be year 2000 ready.

The Company has not yet obtained information sufficient to quantify the potential effects of possible internal and external year 2000 non-compliance so as to determine the likely worst-case scenarios or to develop contingency plans to deal with such scenarios. A significant interruption in the Company's business due to a year 2000 non-compliance issue, however, could have a material adverse effect on the Company's financial position, operations, and liquidity. Also, there can be no assurance that the systems of other companies on which the Company relies will be timely converted or that any such failure to convert by another company will not have an adverse effect on the Company's operations. While the Company intends to develop appropriate contingency plans prior to the end of the fourth quarter of 1999, there can be no assurances that the Company's contingency plans, once developed, will substantially reduce the risk of year 2000 non-compliance.

The Company estimates that the total costs of its year 2000 project will be approximately \$0.9 million, including costs totaling \$0.7 million incurred through December 31, 1998. These expenditures are being funded through operating cash flows. Although there can be no assurances thereof, the estimated costs of the year 2000 project are not expected to 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 have

been the lowest of any quarter during the year. This was not true in 1997 because of the ramp-up in production related to the increased capacity in the United States operations.

Inflation

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 is currently assessing 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 analysis will encompass the costs and consequences of incomplete or untimely resolution of any required systems modifications, various technical and operational challenges and other risks including possible effects on the Company's financial position and results of operations. 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 December 31, 1998, the Company had approximately \$4.0 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 debt financing at the bank's prime rate less 1%, or the LIBOR rate plus 1.9%, whichever is the most 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; (vi) the Company's Year 2000 readiness plans and costs; and (vii) 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 cyclicality 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

Report of Independent Certified Public Accountants

FORWARD-LOOKING INFORMATION (Cont.)

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; (vi) the Company's ability timely to become Year 2000 ready, including the Company's ability to identify all critical systems that will be impacted by the Year 2000, the Company's ability, in a cost-efficient manner, to correct, upgrade or replace such systems, and the Year 2000 readiness of third parties with which the Company has material relationships; and (vii) 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 "Risk Factors" in the Form S-1 Registration Statement and Prospectus for the Company's initial public offering, and "Business" and "Management's Discussion and Analysis of Financial Conditions and Results of Operations" in this Form 10-K for the year ended December 31, 1998. 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.

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 (the "Company") at December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

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

PricewaterhouseCoopers LLP
Tampa, Florida
March 5, 1999



Consolidated Balance Sheets

(in thousands)

YEARS ENDED DECEMBER 31,	1998	1997
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 1,592	\$ 1,249
Accounts receivable, net of allowance for doubtful accounts of \$169 and \$47	5,342	4,558
Inventories	8,125	6,775
Other current assets	891	932
TOTAL CURRENT ASSETS	15,950	13,514
Property, Plant and Equipment, Net	44,003	39,789
Other Assets	1,066	86
TOTAL ASSETS	<u>\$61,019</u>	<u>\$53,389</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	\$ 2,877	\$ 2,847
Accrued expenses and other liabilities	2,065	2,174
Long-term debt due within one year	4,302	1,035
Notes payable to related parties due within one year	578	757
Dividends payable	254	221
Income taxes payable	245	380
TOTAL CURRENT LIABILITIES	10,321	7,414
Long-Term Debt Due After One Year	6,461	6,620
Notes Payable to Related Parties Due After One Year	566	1,152
Deferred Income Taxes	3,656	3,203
TOTAL LIABILITIES	<u>21,004</u>	<u>18,389</u>
Commitments & Contingencies (Note 18)		
Shareholders' Equity:		
Preferred stock	—	—
Common stock	6	6
Capital in excess of par value	24,386	24,163
Retained earnings	15,363	10,732
Accumulated other comprehensive income	260	99
TOTAL SHAREHOLDERS' EQUITY	<u>40,015</u>	<u>35,000</u>
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	<u>\$61,019</u>	<u>\$53,389</u>

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



Consolidated Statements of Income

(in thousands except per share data)

YEARS ENDED DECEMBER 31,	1998	1997	1996
Net sales	\$71,881	\$64,198	\$54,572
Cost of sales	52,537	44,621	37,185
Gross profit	19,344	19,577	17,387
Selling, engineering and administrative expenses	11,656	11,275	12,097
Operating income	7,688	8,302	5,290
Interest expense	837	905	823
Other miscellaneous (income) expense	(1,669)	133	267
Income before income taxes	8,520	7,264	4,200
Income tax provision	2,873	2,554	3,129
Net income	\$ 5,647	\$ 4,710	\$ 1,071
Basic net income per common share	\$ 0.89	\$ 0.75	\$ 0.27
Weighted average shares outstanding	6,345	6,308	3,978
Diluted net income per common share	\$ 0.87	\$ 0.73	\$ 0.26
Weighted average diluted shares outstanding	6,531	6,499	4,178

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, 1995	3,958	\$ 2,181	\$ 997	\$18,676	\$ (325)	\$21,529
Issuance of stock options			2,110			2,110
Suninco step-up for purchase accounting			185			185
Exercise of stock options	42		70			70
Repurchase and retirement of shares			(41)			(41)
Exchange of shares in merger		(2)	(602)	604		-
Distributions to shareholders				(2,901)		(2,901)
Comprehensive income:						
Net income				1,071		1,071
Other comprehensive income:						
Foreign currency translation adjustments					374	374
Comprehensive income						1,445
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
Other comprehensive income:						
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
Other comprehensive income:						
Foreign currency translation adjustments					161	161
Comprehensive income						5,808
Balance, December 31, 1998	6,361	\$ 6	\$24,386	\$15,363	\$ 260	\$40,015

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



Consolidated Statements of Cash Flows

(in thousands)

YEARS ENDED DECEMBER 31,	1998	1997	1996
Cash Flows From Operating Activities:			
Net income	\$ 5,647	\$ 4,710	\$ 1,071
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	4,387	3,706	2,857
Compensation expense of stock options	–	–	2,110
Provision for deferred income taxes	453	625	2,494
(Increase) decrease in:			
Accounts receivable	(543)	(1,023)	39
Inventories	(877)	(2,324)	27
Other current assets	38	200	(910)
Other assets	86	962	(1,021)
Increase (decrease) in:			
Accounts payable	(167)	(426)	281
Accrued expenses and other liabilities	(279)	213	773
Income taxes payable, net	(135)	(81)	(29)
Other liabilities	–	(20)	(732)
Net cash provided by operating activities	<u>8,610</u>	<u>6,542</u>	<u>6,960</u>
Cash Flows From Investing Activities:			
Investment in acquisition and joint venture	(1,110)	–	–
Capital expenditures	(8,137)	(6,490)	(16,963)
Proceeds from dispositions of equipment	143	207	23
Net cash used in investing activities	<u>(9,104)</u>	<u>(6,283)</u>	<u>(16,940)</u>
Cash Flows From Financing Activities:			
Proceeds from debt	9,323	5,580	16,502
Repayment of debt	(7,039)	(12,579)	(4,896)
Repayment of notes payable to related parties	(765)	(655)	(574)
Purchase accounting-Suninco	–	–	185
Proceeds from exercise of stock options	223	71	70
Repurchase of shares	–	–	(41)
Net proceeds from stock offering	–	19,252	–
Cash paid for Sun Holdings merger (Note 2)	–	(52)	–
Dividends to shareholders	(983)	(663)	–
Distributions to shareholders	–	(11,052)	(3,036)
Net cash provided by (used in) financing activities	<u>759</u>	<u>(98)</u>	<u>8,210</u>
Adjustment for Other Comprehensive Income	<u>78</u>	<u>50</u>	<u>374</u>
Net Increase (Decrease) in Cash and Cash Equivalents	<u>343</u>	<u>211</u>	<u>(1,396)</u>
Cash and Cash Equivalents, Beginning of Period	<u>1,249</u>	<u>1,038</u>	<u>2,434</u>
Cash and Cash Equivalents, End of Period	<u>\$ 1,592</u>	<u>\$ 1,249</u>	<u>\$ 1,038</u>
Supplemental Disclosure of Cash Flow Information:			
Cash paid for:			
Interest	\$ 954	\$ 1,206	\$ 324
Income taxes	\$ 2,555	\$ 2,010	\$ 587

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 the Company, was formed to provide a holding company vehicle for the European market operations; its wholly-owned subsidiaries are Sun Hydraulics Limited (a British corporation, "Sun Ltd.") and Sun Hydraulik GmbH (a German corporation, "GmbH"). Sun Ltd. operates a manufacturing and distribution facility located in Coventry, England and GmbH, located in Erkelenz, Germany, markets the Company's products in German-speaking European markets. Sun Hydraulics Korea Corporation ("Sun Korea"), a wholly-owned subsidiary of the Company, was acquired September 24, 1998, (see Note 4). Sun Korea, located in Incheon, South Korea, operates a manufacturing and distribution facility.

2. Reorganization and Initial Public Offering

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

In January 1997, Sun Hydraulics effected a 9.90372627 for 1 stock split. All prior year share amounts reflected in the financial statements include the effect of the stock split. Additionally, Sun Hydraulics issued 374,811 shares of common stock and made a nominal cash payment of \$52 in exchange for all of the issued and outstanding stock of Sun Holdings (the "Reorganization"). The Reorganization was accounted for in a manner similar to a pooling of 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.

Prior to December 31, 1996, Sun Hydraulics had elected to be taxed under the S Corporation provisions of the Internal Revenue Code. Effective December 31, 1996, Sun Hydraulics converted to C Corporation status and Sun Hydraulics' subsequent earnings are subject to corporate income taxes.

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 6,360,922 shares outstanding at December 31, 1998. 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 30, 1998, Sun Hydraulics acquired 100% of the equity shares of Korea Fluid Power Co. Ltd. ("KFP"), 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 \$558 as of December 31, 1998.

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 other assets in the Company's financial statements.

4. Recent Accounting Pronouncements

In June 1998, the American Institute of Certified Public Accountants (“AICPA”) issued Statement of Position 98-5, “Reporting on the Costs of Start-up Activities” (“SOP 98-5”). SOP 98-5 requires that all costs incurred in start-up activities be expensed as incurred. Start-up activities include the costs associated with one-time activities related to opening a new facility, introducing a new product or service, conducting business with a new class of customer or initiating a new process in an existing facility. SOP 98-5 is effective for financial statements for fiscal years beginning after December 15, 1998. The Company’s organization cost of \$41 related to the acquisition of Sun Korea is required to be written off as a change in accounting policy in fiscal 1999.

5. 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. As a result of the Reorganization in 1997 (See Note 2), financial statements for 1998 and 1997 are on a consolidated basis and financial statements for 1996 are on a combined basis.

Management Estimates and Assumptions

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

52 Week Fiscal Year

Commencing in fiscal year 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
Land and leasehold improvements	5-15
Buildings	40

Capitalized interest was \$90, \$160, and \$293, for the years ended December 31, 1998, 1997 and 1996, respectively.

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 as of December 31, 1998, was \$681, is recorded as Project in Process, and will be capitalized upon completion. Since the systems are still in process, no depreciation expense related to capitalized software has been recorded as of December 31, 1998.

Valuation Assessment of Long-Lived Assets

Management periodically evaluates long-lived assets for potential impairment and will reserve for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be fully recoverable. As of December 31, 1998, management does not believe that an impairment reserve is required.

Other Assets

Other assets include goodwill of \$558 and other acquisition costs of \$144 related to the acquisition of Sun Korea, and an equity investment in the Company’s joint venture of \$247, which are discussed further in Note 3. 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 \$466, \$630, and \$1,007 for the years ended December 31, 1998, 1997 and 1996, 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 \$262, \$719, and \$641 for the years ended December 31, 1998, 1997 and 1996, respectively.

Foreign Currency Translation and Transactions

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

Prior to December 31, 1996, Sun Hydraulics had elected to be taxed under the S Corporation provisions of the Internal Revenue Code. Historically, the shareholders of Sun Hydraulics included their pro rata share of income or loss in their individual returns. A portion of the distributions to shareholders was related to their individual income tax liabilities, resulting from S Corporation taxable earnings (see Note 13). Effective December 31, 1996, Sun Hydraulics converted to C Corporation status and Sun Hydraulics' subsequent earnings are subject to corporate income taxes. Accordingly, for informational purposes, the December 31, 1996 statement of income reflects an unaudited pro forma income tax provision which would have been recorded if Sun Hydraulics had been a C Corporation, based on the tax laws in effect during those periods.

Stock-Based Compensation

The Company adopted Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("FAS 123") during 1996. Upon adoption, the Company retained the intrinsic value method of accounting for stock-based compensation and has disclosed the effects of adopting this pronouncement in the notes to the financial statements (see Note 14).

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.

6. 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.

Notes to Consolidated Financial Statements

(Continued)

6. Fair Value of Investments (Continued)

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 \$1,133, and \$1,630 at December 31, 1998 and 1997, respectively.

7. Inventories

DECEMBER 31,	1998	1997
Raw materials	\$ 575	\$ 214
Work in process	4,751	4,348
Finished goods	2,799	2,213
	<u>\$ 8,125</u>	<u>\$ 6,775</u>

8. Property, Plant and Equipment

DECEMBER 31,	1998	1997
Machinery and equipment	\$33,736	\$28,165
Office Furniture and EDP equipment	6,736	5,880
Buildings	18,408	17,663
Leasehold and land improvements	557	760
Construction in progress	2,005	838
Land	2,099	1,581
	<u>63,541</u>	<u>54,887</u>
Less: Accumulated depreciation	<u>(19,538)</u>	<u>(15,098)</u>
	<u>\$44,003</u>	<u>\$39,789</u>

9. Accrued Expenses and Other Liabilities

DECEMBER 31,	1998	1997
Compensation and benefits	\$ 951	\$ 1,348
Deferred grant	424	424
Taxes	20	117
Interest	40	75
Warranty expense	130	30
Other accrued expenses	157	180
Due to joint venture	245	-
Advertising	20	-
Professional Fees	78	-
	<u>\$ 2,065</u>	<u>\$ 2,174</u>

10. Long-Term Debt

DECEMBER 31,	1998	1997
Lines of credit agreements	\$3,974	\$ 666
Secured notes payable-Korea	177	-
Mortgage note payable- U.S. Manatee County facility	4,864	4,990
Mortgage note payable- German facility	1,748	1,999
	<u>10,763</u>	<u>7,655</u>
Less amounts due within one year	<u>(4,302)</u>	<u>(1,035)</u>
	<u>\$6,461</u>	<u>\$6,620</u>

The remaining principal payments are due as follows: 2000-\$338; 2001-\$351; 2002-\$365; 2003-\$379; and 2004 thereafter-\$5,028.

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

The United States had a \$1,700 revolving credit agreement, secured by all inventory and accounts receivable, bearing interest at the lender's prime rate with a maturity date of March 1, 1997. In February 1997, the Company negotiated a one-year, unsecured revolving credit facility to replace the \$1,700 revolving credit agreement. This credit facility provided for a maximum availability of \$10,000, payable on demand at the lender's prime rate of interest, and contained no debt covenants. In February 1998, the Company renegotiated this unsecured credit facility for an additional one year term and an interest rate equal to the bank lender's prime rate less 1%, or LIBOR plus 1.9% for predetermined periods of time at the Company's option. At December 31, 1998, the interest rate was 6.75%, and \$3,940 was outstanding under this credit facility.

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 December 31, 1998, there was no balance outstanding on this credit facility.

The German line of credit is a demand note denominated in German marks with interest payable at the lender's prime rate. At December 31, 1998, the interest rate was 8.5%, and \$34 was outstanding under this credit facility.

In February 1999, the Company secured three loans in Germany, a ten year 5.1% fixed interest rate loan for approximately \$300, a ten year 5.1% fixed interest rate loan for approximately \$1,000, and a ten year 3.5% fixed interest rate loan for approximately \$800.

Sun Korea has various notes denominated in Korean Won, and secured by property, plant and equipment, with interest payable at fixed rates ranging from 6% to 7.5% and maturities ranging from February 1999 to March 2005. At December 31, 1998, \$177 was outstanding under these credit facilities.

A 10-year mortgage loan of \$6,187 was obtained at a fixed interest rate of 8.25% for construction of the Manatee 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. The Company applied \$1,000 of the IPO proceeds toward repayment of this note. In February 1998, this mortgage note was renegotiated to an interest rate of 7.875%. Effective April 1999, this mortgage note will have an interest rate of 7.375%. Terms are monthly principal and interest payments of \$43 for 8.25 years with remaining principal due July 1, 2006. At December 31, 1998, \$4,864 was outstanding under this mortgage note.

In May 1996, the Company obtained a mortgage loan of approximately \$2,400, denominated in German marks, for the new facility in Erkelenz, Germany. The loan has a term of 12 years and bears interest at 6.47%. At December 31, 1998, \$1,748 was outstanding under this mortgage note.

11. Related Parties

Notes payable to related parties include the following:

DECEMBER 31,	1998	1997
15% unsecured note payable for repurchase and retirement of stock, quarterly principal and interest installments ranging from \$1 to \$70 through 2001.	\$ 950	\$1,680
10% unsecured notes payable for phantom compensation, quarterly principal and interest payments of \$14 payable through 2002.	194	229
	1,144	1,909
Less amounts due within one year	(578)	(757)
	<u>\$ 566</u>	<u>\$1,152</u>

The remaining principal payments are due as follows: 2000-\$365; 2001-\$135; 2002-\$52; and 2003-\$14.

The 15% notes payable represent the repurchase and retirement of stock to related parties for the years 1989 to 1993. These notes represent the repurchase of shares of common stock from four retiring employees, one employee of retirement age who was still employed by the Company at the time the shares were repurchased,

and former shareholders related to the principal shareholder of the Company. These agreements contain a provision disallowing prepayment.

During 1995, Sun Hydraulics entered into a 35-month agreement with SunOpTech, 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 under this agreement for the year ended December 31, 1998 were \$33. For the years ended December 31, 1998, 1997 and 1996, Sun Hydraulics paid SunOpTech's expenses of \$45, \$291, and \$203, 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.

12. Distributions and Dividends to Shareholders

The Company declared distributions of \$1,016, \$10,545 and \$2,901 to shareholders in 1998, 1997 and 1996, respectively. A portion of the 1996 distributions were to fund shareholders' individual income tax liabilities related to the S Corporation taxable earnings.

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

The Company declared a cash dividend of \$.04 per share on February 26, 1999, to shareholders of record on March 31, 1999, payable on April 15, 1999. The Company declared quarterly cash dividends of \$.04 per share, to shareholders of record on December 31, 1998, September 30, 1998, June 30, 1998 and March 31, 1998. These dividends were paid on January 15, 1999, October 15, 1998, July 15, 1998 and April 15, 1998, respectively. The Company declared quarterly cash dividends of \$.035 per share, to shareholders of record on December 31, 1997, October 1, 1997, July 3, 1997 and, March 31, 1997. These dividends were paid on January 15, 1998, October 15, 1997, July 15, 1997 and April 15, 1997, respectively.

Notes to Consolidated Financial Statements

(Continued)

13. Income Taxes

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

DECEMBER 31,	1998	1997	1996
United States	\$6,854	\$4,962	\$2,190
Foreign	1,666	2,302	2,010
Total	<u>\$8,520</u>	<u>\$7,264</u>	<u>\$4,200</u>

The income tax provision consists of the following:

DECEMBER 31,	1998	1997	1996
Current tax expense:			
United States	\$1,662	\$1,157	\$ 7
State and local	159	75	–
Foreign	600	697	621
Total current	<u>2,421</u>	<u>1,929</u>	<u>628</u>
Deferred tax expense (benefit):			
United States	411	615	2,170
State and local	36	14	255
Foreign	5	(4)	76
Total deferred	<u>452</u>	<u>625</u>	<u>2,501</u>
Total income tax provision	<u>\$2,873</u>	<u>\$2,554</u>	<u>\$3,129</u>

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

DECEMBER 31,	1998	1997	1996
U.S. federal taxes			
at statutory rate	\$2,897	\$2,461	\$1,428
Increase (decrease)			
Benefit of foreign sales corporation	(60)	–	–
Foreign income taxed at higher rate	(59)	(80)	14
Conversion of S to C Corporation	–	–	2,354
S Corporation income	–	–	(724)
Nondeductible items	41	39	57
State and local taxes, net	137	138	–
Other	(83)	(4)	–
Income tax provision	<u>\$2,873</u>	<u>\$2,554</u>	<u>\$3,129</u>

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

DECEMBER 31,	1998	1997
Deferred taxes, non-current:		
Assets		
Accrued expenses and reserves not currently deductible	\$ 132	\$ 139
Compensation expense recognized for book, not yet deductible for tax	388	451
Florida NOL carry forward	–	–
Deferred tax asset, non-current	<u>520</u>	<u>590</u>
Liabilities		
Depreciation	4,176	3,793
Net deferred tax liability, non-current	<u>\$3,656</u>	<u>\$3,203</u>

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

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

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

(in thousands except per share data)

14. Stock Option Plans

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

During 1996, the Company adopted the 1996 Stock Option Plan (the "Stock Option Plan"), which provides for the grant of incentive stock options and nonqualified stock options for the purchase of up to an aggregate of 1,000 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). Non-qualified 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.

In February 1997, the FASB issued Statement of Financial Accounting Standards No. 128, "Earnings per Share" (SFAS 128). SFAS 128 establishes new standards for computing and presenting earnings per share (EPS). Specifically, SFAS 128 replaces the presentation of primary EPS with a presentation of basic EPS, requires

dual presentation of basic and diluted EPS on the face of the income statement, and requires a reconciliation of the basic EPS computation to the diluted EPS computation.

A summary of the Company's stock option plan for each of the three years ended December 31, 1998, is summarized as follows:

	Number of Shares	Exercise Price Range	Weighted Average Exercise Price
Under option, December 31, 1995 (42 shares exercisable)	42	\$.001-18.68	\$ 1.68
Granted	320	\$ 3.00- 5.05	\$ 3.96
Exercised	(42)	\$.66-18.68	\$ 1.68
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

A summary of outstanding and exercisable options at December 31, 1998 is summarized as follows:

OPTIONS OUTSTANDING				OPTIONS EXERCISABLE	
Range of exercise prices	Number of shares	Weighted-average remaining contractual life	Weighted-average exercise price	Number of shares	Weighted-average exercise price
\$ 3.00	66,666	5.24	\$ 3.00	66,666	\$ 3.00
3.43-5.05	207,374	7.75	4.33	207,374	4.33
9.50	274,348	7.54	9.50	111,311	9.50
10.00	50,000	9.92	10.00	-	10.00
16.75	170,000	9.33	16.75	-	16.75

14. Stock Option Plans (Continued)

The Company has adopted the disclosure-only provisions of SFAS No. 123. Accordingly, no compensation cost has been recognized for the stock option plans other than for nonqualified stock options. Had compensation costs for the stock option plans been determined based on the fair value at the grant date for awards in 1998, 1997 and 1996 consistent with the provisions of SFAS No. 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below:

DECEMBER 31,	1998	1997	1996
Net income:			
As reported	\$5,647	\$4,710	\$1,071
Pro forma	5,188	4,394	989
Basic earnings per common share:			
As reported	0.89	0.75	0.27
Pro forma	0.82	0.70	0.25
Diluted earnings per common share:			
As reported	0.87	0.73	0.26
Pro forma	0.79	0.68	0.24

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, 1997 and 1996: cumulative volatility of 43.09%, 39.56%, and 36.71% for 1998, 1997 and 1996, respectively; dividend yields of 1.68%, 1.68%, and 1.35% for 1998, 1997 and 1996, respectively; risk-free interest rate of 5.57%, 5.72%, and 6.60% for 1998, 1997 and 1996, respectively; and expected term of 6.59 years, 6.04 and 5.0 years for 1998, 1997 and 1996, respectively.

15. Earnings per Common Share

In February 1997, the FASB issued Statement of Financial Accounting Standards No. 128, "Earnings per Share" ("SFAS 128"). SFAS 128 establishes new standards for computing and presenting earnings per share ("EPS"). Specifically, SFAS 128 replaces the presentation of primary EPS with a presentation of basic EPS, requires dual presentation of basic and diluted EPS computation on the face of the income statement, and requires a reconciliation of the basic EPS computation to the diluted EPS computation.

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 December 31, 1996, 1997 and 1998:

	Income	Weighted Average Shares Outstanding	Per Share amount
1996			
Earnings per share—common stock	\$1,071	3,978	\$.27
Effect of dilutive securities:			
Stock options		200	
Earnings per share—common stock assuming dilution	\$1,071	4,178	\$.26
1997			
Earnings per share—common stock	\$4,710	6,308	\$.75
Effect of dilutive securities:			
Stock options		191	
Earnings per share—common stock assuming dilution	\$4,710	6,499	\$.73
1998			
Earnings per share—common stock	\$5,647	6,345	\$.89
Effect of dilutive securities:			
Stock options		186	
Earnings per share—common stock assuming dilution	\$5,647	6,531	\$.87

16. 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 \$982, \$993 and \$586 during 1998, 1997 and 1996, 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 \$2,569, \$1,954 and \$1,348 during 1998, 1997 and 1996, 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 \$166, \$159 and \$157 for 1998, 1997 and 1996, 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 \$93, \$81 and \$69 during 1998, 1997 and 1996, respectively.

17. 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.

Total liabilities attributable to foreign operations were \$4,182, \$3,867, and \$4,940 at December 31, 1998, 1997 and 1996, respectively. Net foreign currency gains (losses) reflected in results of operations were (\$35), (\$192) and (\$104) for the years ended 1998, 1997 and 1996, 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 \$6,415, \$7,431, and \$6,090 during 1998, 1997 and 1996, 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 \$426), 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 to September 30, 1999. 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. 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.

SEGMENT INFORMATION

	United States	Korea	United Kingdom	Germany	Elimination	Consolidated
1996						
Sales to unaffiliated customers	\$42,180	\$ -	\$ 8,866	\$3,526	\$ -	\$54,572
Intercompany sales	5,194	-	1,895	-	(7,089)	-
Operating profits	3,225	-	1,785	293	(13)	5,290
Identifiable assets	37,565	-	6,750	4,544	(443)	48,416
Depreciation expense	2,203	-	570	84	-	2,857
Capital expenditures	12,626	-	1,175	3,162	-	16,963
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 expense	2,840	-	634	232	-	3,706
Capital expenditures	5,972	-	617	286	-	6,490
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 expense	3,434	-	732	221	-	4,387
Capital expenditures	6,105	(26)	1,254	805	-	8,137

Shareholder Information

Corporate Officers

Robert E. Koski
Chairman of the Board

Clyde G. Nixon
President, CEO

Richard J. Dobbyn
Chief Financial Officer

Jeffrey Cooper
Engineering Manager
Sun Hydraulics Corporation

Peter G. Robson
General Manager
Sun Hydraulics Limited

Russell G. Copeman
Manufacturing Manager
Sun Hydraulics Corporation

Directors

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

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Auditors

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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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Investor Relations
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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 18, 1999, there were 115 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 23, 1999, the closing price per share of SNHY stock was \$7.00 and there were 6,383,148 shares outstanding.

Shareholders Annual Meeting

The annual meeting of shareholders will be held Saturday, May 22, 1999, at 10:00 A.M. Eastern Standard Time at Sun Hydraulics Corporation, 1500 West University Parkway, Sarasota, Florida 34243.





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