



Sun Hydraulics Corporation 1996 Annual Report



Sun Hydraulics' counterbalance valves and manifolds.

About Sun Hydraulics

Manlifts, scissor lifts and other aerial devices use motion and control (counterbalance) valves to put the operator in the position he desires. These valves must then hold him in position until he wants to move. From the operator's perspective, it is important that all motions are smooth, speeds controlled, and positioning precise. From the designer's perspective, motion and control valves are a critical element of the overall machine design.

Sun Hydraulics has more than 25 years experience designing and manufacturing motion and control valves. We offer a great variety of different valve configurations that enable machine designers to empirically optimize their machine design. The uncompromising requirement for reliable operation and precise control has helped build Sun Hydraulics' world-wide reputation as a supplier of high-quality screw-in hydraulic cartridge valves and manifolds.

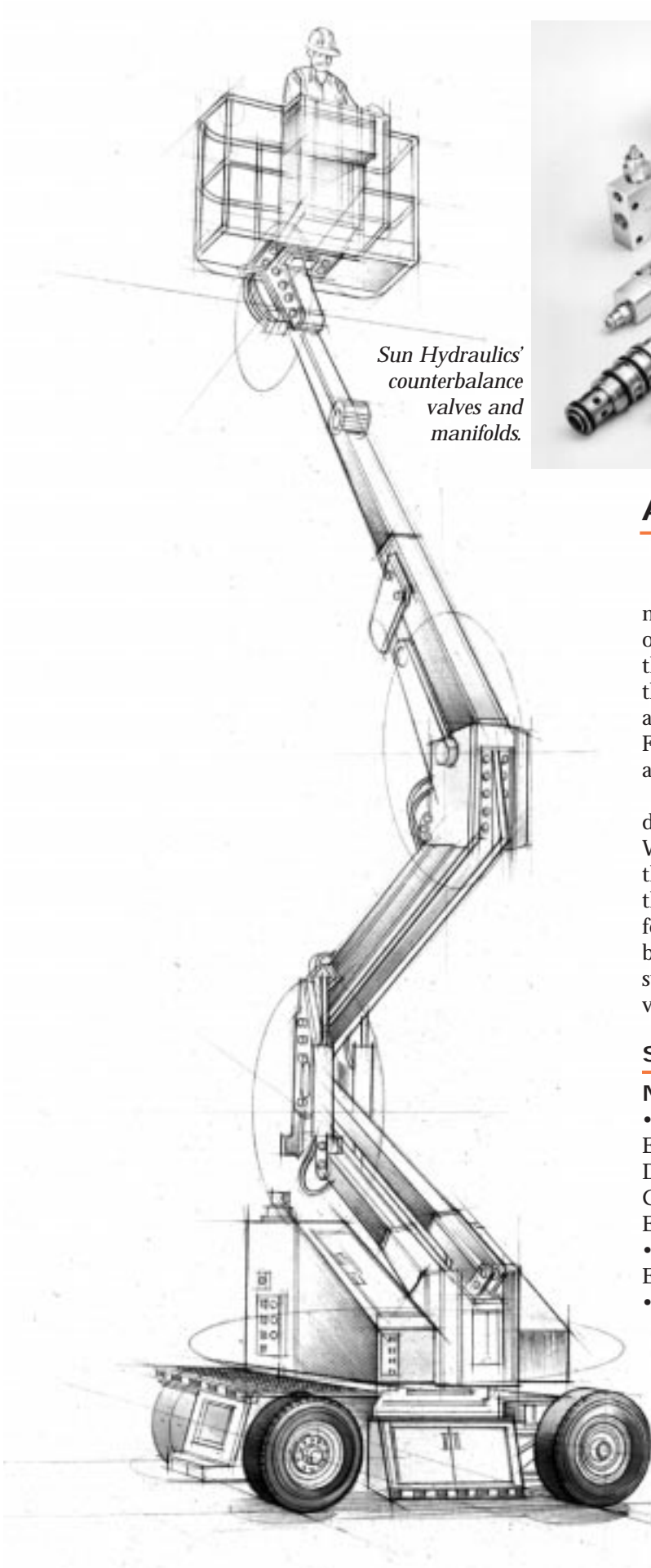
Some of Our End Product Uses

Mobile Products

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

Industrial Products

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





Observations from Bob Koski and Clyde Nixon

Number One

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

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

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

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

Bob Koski

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

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

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

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

Clyde Nixon



Selected Financial Data

(in thousands except per share data)

YEARS ENDED DECEMBER 31,	1992	1993	1994	1995	1996	1996
Statement of Income Data:						Pro Forma
Net sales	\$28,331	\$ 32,431	\$ 42,853	\$ 55,388	\$ 54,572	
Cost of sales	17,946	21,971	27,512	34,581	37,185	
Gross profit	10,385	10,460	15,341	20,807	17,387	
Selling, engineering and administrative expenses	7,826	7,346	8,605	10,578	12,097 (1)	
Operating income	2,559	3,114	6,736	10,229	5,290	
Interest expense	997	931	859	814	823	
Miscellaneous (income) expense	(252)	249	66	(79)	267	
Income before income taxes	1,814	1,934	5,811	9,494	4,200	
Deferred tax provision (2)					2,425	
Income tax provision (benefit) (3)	(201)	(148)	408	633	704	
Net income	<u>\$ 2,015</u>	<u>\$ 2,082</u>	<u>\$ 5,403</u>	<u>\$ 8,861</u>	<u>\$ 1,071</u>	
Pro Forma Statement of Income Data:						
Pro forma income before income taxes	\$ 1,814	\$ 1,934	\$ 5,811	\$ 9,494	\$ 4,200	
Pro forma income tax provision	580	604	2,738	3,611	1,583	
Pro forma net income (4)	<u>\$ 1,234</u>	<u>\$ 1,330</u>	<u>\$ 3,073</u>	<u>\$ 5,883</u>	<u>\$ 2,617</u>	
Pro forma net income per common share (5)				\$.92	\$.40	
Supplemental pro forma net income (4)					<u>\$ 2,870</u>	
Supplemental pro forma net income per share (5)					<u>\$.44</u>	
Weighted average shares outstanding (5)				6,424	6,509	
Balance Sheet and Other Financial Data:						
Cash and cash equivalents	\$ 1,128	\$ 1,883	\$ 2,371	\$ 2,434	\$ 1,038	\$ 4,774
Working capital	3,396	4,557	5,085	4,326	958	6,147
Total assets	20,411	22,674	27,868	33,864	48,416	51,104
Total debt	7,637	8,184	8,025	6,186	17,218	11,065
Shareholders' equity	10,805	12,051	15,624	21,529	22,397	31,238
Depreciation	1,971	2,112	2,197	2,556	2,857	
Capital expenditures	1,987	3,005	5,130	7,657	16,963	

(1) Includes a non-recurring, non-cash compensation expense of approximately \$1.5 million related to the termination of phantom stock compensation agreements and the issuance of options to Directors. See Note 13 of the Notes to Combined 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 represents primarily foreign taxes.

(4) The 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, 3 and 12 of the Notes to Combined Financial Statements. The supplemental pro forma net income reflects reduced interest expense related to the paydown of debt upon receipt of proceeds from the initial public offering.

(5) The pro forma net income per share and the supplemental pro forma net income per share are based on estimated weighted average number of shares outstanding during the period, after giving effect to the reorganization and the initial public offering.

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

Overview

The Company is a leading designer and manufacturer of high-performance, screw-in hydraulic cartridge valves and manifolds which control force, speed and motion as integral components in fluid power systems. The Company's innovative product design, consistent high quality and superior product performance have allowed it to generate a profit in every year since 1972. Net sales were down approximately 1.5% for fiscal year 1996 compared to fiscal year 1995. In recent years, the Company's sales have been comprised of approximately 75% screw-in cartridge valves and approximately 25% manifolds, and the Company expects that relationship to remain relatively constant. The Company sells its products globally through independent distributors. In 1996, the Company generated approximately 34% of its net sales outside the United States, and the Company's single largest end user customer represented less than 3% of net sales.

The Company experienced significant growth in net sales and improvements in profitability in 1994 and 1995. Management believes that the Company's growth was due primarily to the increasing awareness of the quality, reliability and design flexibility of the Company's products and its increased presence in international markets, as well as the growth of the hydraulics market in general. The fluid power industry peaked in mid-1995 and was generally flat in 1996, with shipments up 0.3% for the year, according to reports by the National Fluid Power Association.

In the twelve months ended December 31, 1996, the Company experienced a decline in net sales that was consistent with industry business levels. In addition to industry flatness, the Company attributes the decline in sales to inventory reductions in its United States distribution channel and significant slowdowns in Canadian and German sales. The Company's gross margin deteriorated due to the inefficiencies at the Company's existing plant in Sarasota, Florida which was operating near capacity. The Company believes that the new facility in Sarasota, Florida that opened in March 1997, will address the current capacity constraints.

The capital goods industry in general, and the hydraulic valve and manifold industry in particular, is subject to economic cycles. Historically, the Company has managed to mitigate negative consequences of

cyclical downturns with new product introductions and geographic and end user market diversity. The demand for the Company's products is dependent upon demand for the capital goods in which the Company's products are incorporated.

The Company maintains facilities in the United States, the United Kingdom and Germany. The United States plant manufactures screw-in cartridge valves and manifolds, and supplies the United Kingdom plant with finished products and some cartridge valve components for final assembly and test. The United Kingdom operation also manufactures manifolds and supplies a portion to the United States plant. Both the United States and United Kingdom operations supply technical support and finished product to the German distribution facility. During 1996 new facilities in the United States and Germany were under construction; both commenced operations in March 1997. The new plant in the United States will be used for the production of manifolds, and the original plant will be dedicated to the production of cartridge valves. The German facility will continue as a distribution operation and will be used for future manufacturing needs. The United States dollar is the functional currency for all intercompany sales, and international sales are made in a number of foreign currencies, particularly British pounds and German marks. Currency fluctuations have not been material to date, but could become more important as the Company's international sales grow in the future.

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

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. Results for any one or more periods are not necessarily indicative of annual results or continuing trends.

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

(Continued)

Results of Operations (Continued)

	1994	1995	1996
Net sales	100.0%	100.0%	100.0%
Cost of sales	64.2	62.4	68.1
Gross profit	35.8	37.6	31.9
Selling, engineering and administrative expenses	20.1	19.1	22.2
Operating income	15.7	18.5	9.7
Interest expense	2.0	1.5	1.5
Miscellaneous (income) expense	0.1	(0.1)	0.5
Income before income taxes	13.6%	17.1%	7.7%

Comparison of Years Ended December 31, 1996 and 1995

Net sales decreased 1.5%, or \$0.8 million, to \$54.6 million in the twelve month period ended December 31, 1996, compared to \$55.4 million in the twelve month period ended December 31, 1995. Domestic net sales decreased 1.9%, or \$0.7 million to \$35.9 million in the twelve month period ended December 31, 1996. The decline primarily was due to a general decrease in fluid power industry shipments for the first three quarters of the year, United States distributor inventory corrections in the first half of the year and capacity constraints throughout the year. International net sales decreased 1.5%, or \$0.3 million, to \$18.5 million in the twelve month period ended December 31, 1996. United Kingdom, Pacific Rim and other foreign net sales increased 8.1%, offset by net sales decreases in Germany and Canada of 11.2% and 26.2%, respectively.

Gross profit decreased 16.4%, or \$3.4 million, to \$17.4 million in the twelve month period ended December 31, 1996, compared to \$20.8 million in the twelve month period ended December 31, 1995. Gross profit as a percentage of net sales decreased to 31.9% for the twelve month period ended December 31, 1996, from 37.6% for the twelve month period ended December 31, 1995. The decrease in gross profit was primarily due to increased costs in the United States plant as new machinery for future growth was installed

in severely restricted space, creating excess down time and start-up costs. In addition, material cost increases also were experienced due to an increase in outsourcing necessitated because the United States plant was operating near capacity.

Selling, engineering and administrative expenses increased 14.4% or \$1.5 million, to \$12.1 million in the twelve month period ended December 31, 1996, compared to \$10.6 million in the twelve month period ended December 31, 1995. These expenses as a percentage of net sales increased to 22.2% for the twelve month period ended December 31, 1996, from 19.1% for the twelve month period ended December 31, 1995. The increase in selling, engineering and administrative expenses primarily was due to a non-recurring, non-cash compensation expense of \$1.5 million related to the issuance of stock options and the cancellation of phantom stock compensation agreements. Excluding the \$1.5 million compensation expense, selling, engineering and administrative expenses as a percentage of sales would have been 19.4% for the twelve month period ended December 31, 1996, compared to 19.1% for the twelve month period ended December 31, 1995.

Comparison of Years Ended December 31, 1995 and 1994

Net sales increased 29.3%, or \$12.5 million, to \$55.4 million in 1995, compared to \$42.9 million in 1994. Domestic net sales increased 27.7%, or \$7.9 million, to a total of \$36.6 million in 1995, compared to \$28.7 million in 1994. International net sales increased 32.5%, or \$4.6 million, to \$18.8 million in 1995, compared to \$14.2 million in 1994. The international net sales increase was due primarily to increased volume across all major geographic areas led by the Pacific Rim and Canada.

Gross profit increased 35.6%, or \$5.5 million, to \$20.8 million in 1995, compared to \$15.3 million in 1994. Gross profit as a percentage of net sales increased to 37.6% in 1995 from 35.8% in 1994. The improvement in gross margin was generally due to allocating fixed costs over a greater sales base.

Selling, engineering and administrative expenses increased 22.9%, or \$2.0 million, to \$10.6 million in 1995, compared to \$8.6 million in 1994. The increase in

selling, engineering and administrative expenses was primarily due to increased customer support staffing, research and development expenses and professional fees. These expenses as a percentage of net sales decreased to 19.1% in 1995 from 20.1% in 1994. The decrease in these expenses as a percentage of net sales resulted from allocating these higher expenses over greater net sales.

Quarterly Results of Operations

The following tables set forth certain quarterly financial information for each of the Company's last eight quarters. The Company believes that this information includes all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of such quarterly information when read in conjunction with the Financial Statements and the Notes thereto included elsewhere herein. The pro forma income tax provision and pro forma net income are presented as if the Company were a C Corporation in the periods presented. The operating results for any quarter are not necessarily indicative of the results for any future period or for the entire year.

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, make distributions to shareholders, repurchase shares of the Company's Common Stock and service debt.

At December 31, 1996, the Company had working capital of approximately \$1.0 million. Cash generated from operations in 1996 was \$7.0 million, compared to \$12.7 million in 1995 and \$7.3 million in 1994. The decrease in the Company's cash generated from operations reflects a \$7.8 million decrease in net income and approximately \$0.8 million expended for public offering expense.

Capital expenditures in 1996 were \$17.0 million, compared to \$7.7 million in 1995 and \$5.1 million in 1994. In 1996, \$12.6 million was spent for the new manufacturing plants in the United States and Germany, both of which commenced operations in March 1997.

Quarterly Results of Operations

(in thousands)

Quarter Ended	March 31 1995	June 30 1995	Sept. 30 1995	Dec. 31 1995	March 31 1996	June 30 1996	Sept. 30 1996	Dec. 31 1996
Net sales	\$13,632	\$14,288	\$14,798	\$12,670	\$13,806	\$13,831	\$13,596	\$13,339
Cost of sales	8,185	8,901	9,275	8,220	9,491	9,125	9,287	9,282
Gross profit	5,447	5,387	5,523	4,450	4,315	4,706	4,309	4,057
Selling, engineering and administrative expenses	2,486	2,549	2,617	2,926	2,665	2,929	3,694 ⁽¹⁾	2,809
Operating income	2,961	2,838	2,906	1,524	1,650	1,777	615	1,248
Interest expense	212	220	180	202	205	218	255	145
Miscellaneous (income) expense	(16)	5	(70)	2	53	(63)	117	160
Income before income taxes	2,765	2,613	2,796	1,320	1,392	1,622	243	943
Pro forma tax provision	987	933	1,149	542	554	646	55	328
Pro forma net income	\$ 1,778	\$ 1,680	\$ 1,647	\$ 778	\$ 838	\$ 976	\$ 188	\$ 615
Supplemental pro forma net income					\$ 918	\$ 1,061	\$ 201	\$ 690

(1) Includes non-recurring compensation expense of \$1.5 million.



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

(Continued)

Liquidity and Capital Resources (Continued)

In 1996, the Company was awarded a grant of \$0.5 million by the German government, which helped to offset the cost of the German facility. Also included in 1996 capital expenditures was \$4.4 million for machinery and equipment. Capital expenditures in 1995 included \$0.9 million for land and land improvements for the United States and German facilities.

At December 31, 1996, the Company had a \$1.7 million line of credit, secured by all inventory and accounts receivable. In February, 1997, this was replaced by a \$10.0 million unsecured revolving credit facility with a term of one year and an interest rate equal to the bank lender's prime rate.

In 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 May, 1996, the Company converted its existing \$0.8 million line of credit for capital equipment to a term loan, borrowing an additional \$2.3 million for a total loan amount of approximately \$3.1 million at December 31, 1996. The converted loan had an interest rate of 8.25% and a maturity date of May 1, 2003. The loan is secured by the equipment purchased with the loan proceeds. Concurrently, the Company obtained a ten-year mortgage loan for \$6.2 million at an interest rate of 8.25% for the new facility in Florida. This loan matures on July 1, 2006. At December 31, 1996, the existing Florida facility had a \$2.4 million mortgage loan with an interest rate of 8.25% and a maturity date of April 1, 2006. In England, the Company has a \$1.2 million line of credit, denominated in British pounds, which bears interest at a floating rate (8.25% at December 31, 1996) equal to 2.25% over the bank's base rate. None of these arrangements contain pre-payment penalties. In addition, the Company has \$2.1 million in notes payable to former stockholders, which bear interest at a weighted rate of 15%, and which have terms ranging from three to five years. These notes were issued by the Company in connection with the repurchase of shares of Common Stock from the former shareholders, and do not allow for prepayment by the Company.

In January, 1997, the Company received \$20.3 million of proceeds from its initial public offering of common stock. Net proceeds after expenses were

approximately \$19.3 million. In January, 1997, \$9.5 million of the S Corporation distribution was paid out representing 90% of the total distribution of \$10.4 million. Also in January, the capital equipment loan balance of \$2.9 million and the mortgage balance of \$2.4 million on the original United States facility were paid off in full. In February, \$0.9 million was paid on the revolving line of credit in the United States.

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.

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.

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 and relative stability in the Company's cost of sales. While inflation has not had, and the Company does not expect that it will have, a material impact upon operating results, there is no assurance that the Company's business will not be affected by inflation in the future.

FORWARD-LOOKING INFORMATION

Certain oral statements made by management from time to time and certain statements contained herein that are not historical facts are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934 and because such statements involve risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Forward-looking statements, including those in Management's Discussion and Analysis of Financial Condition and Results of Operations and Observations from Bob Koski and Clyde Nixon are statements regarding the intent, belief or current expectations, estimates or projections of the Company, its Directors or its

Report of Independent Certified Public Accountants

FORWARD-LOOKING INFORMATION (Cont.)

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 financial needs; (v) the declaration and payment of dividends; and (vi) the Company's ability to respond to changes in customer demand domestically and internationally, including as a result of standardization. Although the Company believes that its expectations are based on reasonable assumptions, it can give no assurance that the anticipated results will occur.

Important factors that could cause the actual results to differ materially from those in the forward-looking statements include, among other items, (i) the economic 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 the Company's products or technologies noncompetitive or obsolete; (v) new product introductions, product sales mix and geographic mix of sales nationally and internationally; and (vi) changes relating to the Company's international sales, including changes in regulatory requirements or tariffs, trade or currency restrictions, fluctuations in exchange rates, and tax and collection issues. Further information relating to factors that could cause actual results to differ from those anticipated is included but not limited to information under the heading "Risk Factors" in the Form S-1 Registration Statement and Prospectus for the Company's initial public offering, effective January 9, 1997 (SEC File No. 333-14183), and "Business" in the Company's Form 10-K for the year ended December 31, 1996, and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's Form 10-Q for the quarter ended March 31, 1997.

To the Board of Directors and Shareholders of Sun Hydraulics Corporation and Sun Hydraulik Holdings Limited (collectively "Sun Hydraulics Corporation")

In our opinion, the accompanying combined balance sheets and the related combined statements of income, of changes in shareholders' equity and of cash flows present fairly, in all material respects, the financial position of Sun Hydraulics Corporation (the "Company") at December 31, 1996 and 1995, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1996, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

Price Waterhouse LLP
Tampa, Florida
March 26, 1997



Combined Balance Sheets

(in thousands)

YEARS ENDED DECEMBER 31,	1995	1996	Pro Forma 1996
ASSETS			(Unaudited) (Note 2)
Current Assets:			
Cash and cash equivalents	\$ 2,434	\$ 1,038	\$ 4,774
Accounts receivable, net of allowance for doubtful accounts of \$40, \$62 and \$62	3,574	3,535	3,535
Inventories	4,478	4,451	4,451
Other current assets	222	1,132	1,132
TOTAL CURRENT ASSETS	10,708	10,156	13,892
Property, Plant and Equipment, Net	23,129	37,212	37,212
Other Assets	27	1,048	—
	<u>\$33,864</u>	<u>\$48,416</u>	<u>\$51,104</u>
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current Liabilities:			
Accounts payable	\$ 2,992	\$ 3,273	\$ 3,273
Accrued expenses and other liabilities	1,188	1,961	1,961
Long-term debt due within one year	495	2,340	887
Notes payable to related parties due within one year	574	655	655
Accrued distributions to shareholders	643	508	508
Income taxes payable net	490	461	461
TOTAL CURRENT LIABILITIES	6,382	9,198	7,745
Long-Term Debt Due After One Year	2,553	12,314	7,614
Notes Payable to Related Parties			
Due After One Year	2,564	1,909	1,909
Deferred Income Taxes	84	2,578	2,578
Other Liabilities	752	20	20
TOTAL LIABILITIES	<u>12,335</u>	<u>26,019</u>	<u>19,866</u>
Commitments & Contingencies (Notes 10 and 16)			
Shareholders' Equity:			
Capital stock	2,181	2,179	6
Capital in excess of par value	997	2,719	24,165
Retained earnings	18,676	17,450	7,018
Equity adjustments for foreign currency translation	(325)	49	49
TOTAL SHAREHOLDERS' EQUITY	<u>21,529</u>	<u>22,397</u>	<u>31,238</u>
	<u>\$33,864</u>	<u>\$48,416</u>	<u>\$51,104</u>

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



Combined Statements of Income

(in thousands except per share data)

YEARS ENDED DECEMBER 31,	1994	1995	1996
Net sales	\$42,853	\$55,388	\$54,572
Cost of sales	27,512	34,581	37,185
Gross profit	15,341	20,807	17,387
Selling, engineering and administrative expenses	8,605	10,578	12,097
Operating income	6,736	10,229	5,290
Interest expense	859	814	823
Miscellaneous (income) expense	66	(79)	267
Income before income taxes	5,811	9,494	4,200
Income tax provision	408	633	3,129
Net income	\$ 5,403	\$ 8,861	\$ 1,071
Pro Forma Income Data (Note 2): (Unaudited)			
Pro forma income before income taxes		\$ 9,494	\$ 4,200
Pro forma income tax provision		3,611	1,583
Pro forma net income		\$ 5,883	\$ 2,617
Pro forma net income per share		\$ 0.92	\$ 0.40
Supplemental pro forma net income			\$ 2,870
Supplemental pro forma net income per share			\$ 0.44
Pro forma average shares outstanding		6,424	6,509

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



Combined Statements of Changes in Shareholders' Equity

(in thousands)

	Capital Stock	Capital in Excess of Par Value	Retained Earnings	Equity Adjustment For Foreign Currency Translation	Total
Balance, December 31, 1993	\$ 2,181	\$ 472	\$10,080	\$ (682)	\$12,051
Exercise of stock options		105			105
Adjustment for foreign currency translation				308	308
Net income			5,403		5,403
Distributions to shareholders			(2,514)		(2,514)
Realized tax benefit on debt exchange (see Note 10)		271			271
Balance, December 31, 1994	2,181	848	12,969	(374)	15,624
Exercise of stock options		149			149
Adjustment for foreign currency translation				49	49
Net income			8,861		8,861
Distributions to shareholders			(3,154)		(3,154)
Balance, December 31, 1995	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		70			70
Repurchase and retirement of shares		(41)			(41)
Exchange of shares in merger (Note 2)	(2)	(602)	604		—
Adjustment for foreign currency translation				374	374
Net income			1,071		1,071
Distributions to shareholders			(2,901)		(2,901)
Balance, December 31, 1996	2,179	2,719	17,450	49	22,397
Pro Forma (unaudited) (Note 2):					
Issuance of stock in connection with initial public offering	2	(2)			—
Proceeds from initial public offering		20,321			20,321
S Corporation distribution			(10,432)		(10,432)
Deferred costs related to initial public offering		(1,048)			(1,048)
Exchange of shares in merger (Note 2)	(2,175)	2,175			—
Pro forma balance, December 31, 1996	<u>\$ 6</u>	<u>\$24,165</u>	<u>\$ 7,018</u>	<u>\$ 49</u>	<u>\$31,238</u>

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



Combined Statements of Cash Flows

(in thousands)

YEARS ENDED DECEMBER 31,	1994	1995	1996
Cash Flows From Operating Activities:			
Net income	\$ 5,403	\$ 8,861	\$ 1,071
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	2,197	2,556	2,857
Compensation expense of stock options	—	—	2,110
(Benefit from)/provision for deferred income taxes	328	(110)	—
(Increase) decrease in:			
Accounts receivable	(937)	(479)	39
Inventories	(765)	(679)	27
Other current assets	(60)	307	(910)
Other assets	(11)	(4)	(1,021)
Increase (decrease) in:			
Accounts payable	1,014	1,146	281
Accrued expenses and other liabilities	(5)	280	773
Income taxes payable, net	—	490	2,465
Other liabilities	100	369	(732)
Net cash provided by operating activities	<u>7,264</u>	<u>12,737</u>	<u>6,960</u>
Cash Flows From Investing Activities:			
Capital expenditures	(5,130)	(7,657)	(16,963)
Proceeds from dispositions of equipment	—	23	23
Net cash used in investing activities	<u>(5,130)</u>	<u>(7,634)</u>	<u>(16,940)</u>
Cash Flows From Financing Activities:			
Proceeds from long-term debt	1,850	3,337	16,502
Repayment of long-term debt	(1,563)	(4,661)	(4,896)
Proceeds from notes payable to related parties	1,940	—	—
Repayment of notes payable to related parties	(2,386)	(515)	(574)
Purchase accounting-Suninco	—	—	185
Proceeds from exercise of stock options	105	149	70
Repurchase of shares	—	—	(41)
Distributions to shareholders	(1,900)	(3,399)	(3,036)
Net cash provided by (used in) financing activities	<u>(1,954)</u>	<u>(5,089)</u>	<u>8,210</u>
Foreign Currency Translation Adjustment	<u>308</u>	<u>49</u>	<u>374</u>
Net Increase (Decrease) in Cash and Cash Equivalents	<u>488</u>	<u>63</u>	<u>(1,396)</u>
Cash and Cash Equivalents, Beginning of Year	<u>1,883</u>	<u>2,371</u>	<u>2,434</u>
Cash and Cash Equivalents, End of Year	<u>\$ 2,371</u>	<u>\$ 2,434</u>	<u>\$ 1,038</u>
Supplemental Disclosure of Cash Flow Information:			
Cash paid (received) during the year for:			
Interest (net of amounts capitalized)	<u>\$ 875</u>	<u>\$ 815</u>	<u>\$ 324</u>
Income taxes	<u>\$ (223)</u>	<u>\$ 109</u>	<u>\$ 587</u>
Increase in assets associated with purchase of minority interest shares (Note 2)			<u>\$ 283</u>

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

Notes to Combined Financial Statements

1. Business

Sun Hydraulics Corporation and its subsidiaries (the "Company") design, manufacture and sell screw-in cartridge valves and manifolds used in hydraulic systems, and has facilities in the United States, the United Kingdom and Germany. Sun Hydraulics Corporation ("Sun Hydraulics"), located in Sarasota, Florida, designs, manufactures and sells through independent distributors in the United States. Sun Hydraulik Holdings Limited ("Sun Holdings") was formed to provide a holding company vehicle for the European market operations. Its subsidiaries are Sun Hydraulics Limited (a British corporation, "Sun Ltd.") and Sun Hydraulik GmbH (a German corporation, "GmbH"). Sun Ltd. was originally formed in 1985, and operates a manufacturing and distribution facility located in Coventry, England. GmbH was incorporated on January 1, 1991, as a wholly-owned subsidiary of Sun Holdings to market the Company's products in German-speaking European markets.

2. Reorganization and Initial Public Offering

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

Subsequent to year end, Sun Hydraulics effected a 9 to 1 stock split. Also subsequent to year end, Sun Hydraulics issued 374,811 shares of common stock 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.

Upon Reorganization, the Company had 20,000,000 authorized shares of common stock, par value \$0.001, with 4,000,002 shares outstanding. The Company also had 2,000,000 authorized shares of preferred stock, par value \$0.001, with no shares outstanding.

In conjunction with the Reorganization, the Company's Board of Directors approved an initial public offering (the "IPO") of the Company's common stock. The Company filed a Registration Statement on Form S-1 with the Securities and Exchange Commission effective January 9, 1997. The effects of the Reorganization, the S Corporation distribution (see Note 11), a charge to recognize deferred income taxes (see Note 12) and the use of proceeds from the IPO are reflected in the pro forma balance sheet as of December 31, 1996.

Pro Forma Balance Sheet and Changes in Shareholders' Equity.

The effects of the Reorganization, a charge associated with the provision for deferred income taxes of \$2,425 which the Company recognized upon its termination of S Corporation status (see Note 11) and the use of net proceeds of \$19,273 from the IPO are reflected in the pro forma balance sheet as of December 31, 1996. The use of proceeds reflects distribution of previously taxed S Corporation retained earnings of \$10,432 and repayment of debt approximating \$6,153.

Pro Forma Net Income

Pro forma net income reflects a provision for income taxes as if Sun Hydraulics had been a C Corporation for all periods presented.

The computation of pro forma earnings per share is based on the weighted average number of outstanding common shares, on a pro forma basis, during the period plus common stock equivalents, if dilutive, consisting of certain shares subject to stock options, after giving effect to the Reorganization (see Note 2) and the initial public offering. The assumed exercise of dilutive stock options less the number of treasury shares assumed to be purchased from the proceeds were calculated using the book value of the Company prior to 1994 and the appraised fair market value of the Company from 1995 forward.

Supplemental Pro Forma Net Income

The computation of supplemental pro forma earnings is calculated as above, but gives effect to the repayment of debt, including interest expense and related tax effect, as of the beginning of the year from the proceeds of the IPO.

3. Summary of Significant Accounting Policies

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

Principles of Combination

The combined financial statements include the accounts and operations of Sun Hydraulics and Sun

Holdings and its subsidiaries. All significant intercompany accounts and transactions are eliminated in combination.

Management Estimates and Assumptions

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

Cash and Cash Equivalents

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

Inventories

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

Property, Plant and Equipment

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

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

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

During 1995, the Company adopted Statement of Financial Accounting Standards No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of. 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, 1996, management does not believe that an impairment reserve is required.

Other Assets

Other assets consist primarily of deferred costs associated with the IPO. Such costs have been charged against proceeds of the IPO in the accompanying pro forma balance sheet.

Other Liabilities

At December 31, 1995 other liabilities consisted of accrued compensation earned under the Company's phantom stock option plans (the "Plans"). Compensation cost was measured as the amount by which the market value, as defined in the Plans, 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 Plans as the higher of: the last arms 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.

Effective September 30, 1996, the Board of Directors of the Company approved a stock option plan to replace the phantom stock agreements by issuing 305,260 nonqualified stock options and 189,348 incentive stock options. Exercise prices of the nonqualified options range from \$3.00 to \$5.05. The employees were immediately vested in their non-qualified options upon issuance. The incentive stock options will vest over periods up to seven years. The Company recognized a charge during 1996 related to termination of the phantom stock agreements of approximately \$1,378.

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 of the Company's manufacturing processes and related software which approximated \$1,276, \$1,337 and \$1,007 for the years ended December 31, 1994, 1995 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 \$791, \$792 and \$641 for the years ended December 31, 1994, 1995 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 U.S. Dollar is the functional currency for Sun Hydraulics and the reporting currency for the combined group. The assets and liabilities of Sun Ltd. and GmbH are translated at the exchange rate in effect at the balance sheet date, while income and expense items are translated at the average annual rate of exchange for the period. The resulting unrealized translation gains and losses are included in the component of shareholders' equity designated "equity adjustment for foreign currency translation". Realized gains and losses from foreign currency transactions are included in other non-operating income.

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 phantom stock compensation.

Sun Hydraulics elected to be taxed under the S Corporation provisions of the Internal Revenue Code. Historically, the shareholders of Sun Hydraulics included their pro rata share of income or loss in their individual returns. A portion of the distributions to shareholders was related to their individual income tax liabilities, resulting from S Corporation taxable earnings (see Note 12). Effective December 31, 1996, Sun Hydraulics converted to C Corporation status and Sun Hydraulics' subsequent earnings are subject to corporate income taxes. Accordingly, for informational purposes, the statement of income reflects a 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 will disclose the effects of adopting this pronouncement in the Notes to Combined Financial Statements (see Note 13).

4. Fair Value of Investments

In 1995, the Company adopted Statement of Financial Accounting Standards No. 107, Disclosures about the Fair Value of Financial Instruments, which requires disclosure of information about the fair value of certain financial instruments for which it is practicable to estimate that value. For purposes of the following disclosure, the fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation. The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

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

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

The fair value of the notes payable to related parties is estimated based on the current rates offered to the Company for similar debt. The estimated fair value of the Company's related party debt is \$3,572 and \$2,645 at December 31, 1995 and 1996, respectively.

5. Inventories

The components of inventory are summarized as follows:

DECEMBER 31,	1995	1996
Raw materials	\$ 127	\$ 147
Work in process	3,236	2,758
Finished goods	1,115	1,546
	<u>\$4,478</u>	<u>\$ 4,451</u>

6. Property, Plant and Equipment

The components of property, plant and equipment are summarized as follows:

DECEMBER 31,	1995	1996
Machinery and equipment	\$20,666	\$24,930
Furniture and fixtures	4,221	4,938
Buildings	4,861	5,071
Land and leasehold improvements	532	586
	<u>30,280</u>	<u>35,525</u>
Less-accumulated depreciation	(11,684)	(14,281)
	<u>18,596</u>	<u>21,244</u>
Construction in progress	3,414	14,558
Land	1,119	1,410
	<u>\$23,129</u>	<u>\$37,212</u>

(in thousands except share and per share data)

As a result of the merger of Sun Hydraulics and Suninco in June 1996 (see Note 2), a portion of which was accounted for under the purchase method of accounting, land and buildings were increased \$38 and \$245, respectively.

During 1995, the Company purchased land for \$461 and began construction of a new production facility in Sarasota, Florida. The aggregate cost incurred as of year end of the new production facility was \$10,185 with an anticipated \$460 cost to complete and the facility was placed in service during March 1997.

Also during 1995, the Company purchased land in Erkelenz, Germany for approximately \$429 for construction of a new production and distribution facility. The aggregate cost of the facility was \$3,596 and the facility was placed in service March 1997.

7. Accrued Expenses and Other Liabilities

The components of accrued expenses and other liabilities are summarized as follows:

DECEMBER 31,	1995	1996
Compensation and benefits	\$ 863	\$1,161
Deferred revenue	—	462
Taxes	—	112
Interest	111	93
Warranty expense	—	44
Other accrued expenses	214	89
	<u>\$1,188</u>	<u>\$1,961</u>

8. Long-Term Debt

The components of long-term debt are summarized as follows:

DECEMBER 31,	1995	1996	Pro Forma (unaudited) (note 2) 1996
Lines of credit agreements, interest payable at lender's prime rate (8.50% and 8.25% at December 31, 1995 and 1996)	\$ 38	\$ 1,512	\$ 588
Secured equipment loan, interest only payable monthly at 10.25% in 1995 and 8.25% in 1996	443	2,874	—
8.25% mortgage note payable secured by real property due in monthly principal and interest installments of \$20	1,714	2,355	—
Variable rate mortgage note (13.0% at December 31, 1995 and 1996) secured by real property, principal and interest payable in monthly installments of \$8 through 2007	511	—	—
Notes payable secured by equipment, payable in monthly principal and interest installments with interest rates varying from 4.90% to 5.60% with maturity dates from March 1996 to June 1998	277	46	46
Construction lines of credit at 8.25% and 6.47% to be converted to mortgage notes payable at 8.25% and 6.47% between 12 and 15 years	—	7,867	7,867
Capital lease obligations at varying interest rates from 8.45% to 12.45% through 1999	65	—	—
	<u>3,048</u>	<u>14,654</u>	<u>8,501</u>
Less amounts due within one year	(495)	(2,340)	(887)
	<u>\$2,553</u>	<u>\$12,314</u>	<u>\$7,614</u>

The remaining principal payments are due as follows: 1998-\$835; 1999-\$955; 2000-\$1,035; 2001-\$1,122; 2002 and thereafter \$8,367.

8. Long-Term Debt (Continued)

The Company had a \$1,700 revolving credit agreement, secured by all inventory and accounts, bearing interest at the lender's prime rate with a maturity date of March 1, 1997. At December 31, 1996, \$775 of this amount was available to the Company. The agreement required Sun Hydraulics to maintain certain financial ratios and places certain limitations on fixed asset expenditures. A waiver of this limitation was obtained as of September 30, 1996, for the remainder of fiscal 1996 from the bank.

Subsequent to December 31, 1996, the Company negotiated a one year, unsecured revolving credit facility. The agreement provides for a maximum availability of \$10,000, payable on demand at the lender's prime rate of interest.

In January 1995, the Company obtained the secured equipment loan for capital equipment expenditures at a fixed interest rate, with interest only for the first year, converting to a five year amortization with monthly principal and interest payments of \$13. In May 1996, the loan was converted to a seven-year term loan and additional funds were advanced. As of December 31, 1995 and 1996, the Company had drawn \$443 and \$2,874, respectively, on this equipment line of credit.

During 1996, the mortgage note was increased by approximately \$794 and the interest rate reduced from

Notes to Combined Financial Statements

(Continued)

8. Long-Term Debt (Continued)

9% to 8.25%. Also, a 10-year mortgage note of \$6,187 was obtained at a fixed interest rate of 8.25%. Terms on the new mortgage note are 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.

9. Capital Stock

At December 31, 1995 and 1996, prior to effects of the Reorganization (see Note 2), the combined par value of common stock consisted of the following:

DECEMBER 31,	1995	1996
Sun Hydraulics Corporation	\$ 3	\$ 4
Suninco, Inc.	3	—
Sun Hydraulik Holdings Limited	2,175	2,175
	<u>\$2,181</u>	<u>\$2,179</u>

Other information by entity, prior to the effects of Reorganization, is as follows:

DECEMBER 31,	1995	1996
Sun Hydraulics Corporation		
Par value per share	\$ 0.01	\$ 0.01
Shares authorized	1,000,000	1,000,000
Shares issued and outstanding	342,815	366,043
Suninco, Inc.		
Par value per share	\$ 0.01	\$ —
Shares authorized	1,000,000	—
Shares issued and outstanding	302,735	—
Sun Hydraulik Holdings Limited		
Par value per share	\$ 6.81	\$ 6.81
Shares authorized	421,052	421,052
Shares issued and outstanding	319,315	320,315

10. Related Parties

Notes payable to related parties include the following:

DECEMBER 31,	1995	1996
15% unsecured notes payable for repurchase and retirement of stock, quarterly principal and interest installments ranging from \$43 to \$142 through 2001	\$2,849	\$2,303
10% unsecured notes payable for phantom compensation, quarterly principal and interest payments of \$14 payable through 2002	289	261
	<u>3,138</u>	<u>2,564</u>
Less amounts due within one year	(574)	(655)
	<u>\$2,564</u>	<u>\$1,909</u>

The remaining principal payments are due as follows: 1998-\$757; 1999-\$586; 2000-\$365; 2001-\$135; 2002 and thereafter-\$66.

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

During 1995, Sun Hydraulics entered into a 35 month agreement with SunOpTech ("SunOpTech"), a limited partnership formed to further development of manufacturing software used in the Company's production process. In exchange for the development of computer software and computer support, Sun Hydraulics will pay approximately \$955 over the three year period and reimburse SunOpTech for reasonable expenses related to the software development. During 1995 and 1996, \$90 and \$555, respectively were paid to SunOpTech under the agreement. Future payments are scheduled as follows: 1997-\$325 and 1998-\$30. For the years ended December 31, 1995 and 1996, Sun Hydraulics years ended December 31, 1995 and 1996, Sun Hydraulics paid expenses of SunOpTech of \$25 and \$203, respectively. Additionally, Sun Hydraulics provided certain administrative support and office space to SunOpTech at no charge. These expenses are included in selling, engineering and administrative expenses.

A Director of the Company is the President, Chief

(in thousands except share and per share data)

Executive Officer and controlling stockholder of a fluid power distributorship that purchases and sells the Company's products pursuant to one of the Company's standard distributor agreements. This distributorship purchased approximately \$1,250, \$1,310 and \$1,104 of products from the Company in fiscal 1994, 1995 and 1996, respectively.

Effective July 1, 1994, Sun Hydraulics and Suninco agreed to an exchange of debt instruments. The realized tax benefit on the transaction of \$271 was treated for financial statement purposes as a capital contribution, resulting in an increase to capital in excess of par value.

11. Distributions to Shareholders

The Company declared distributions of \$2,514, \$3,154 and \$2,901 to shareholders in 1994, 1995 and 1996, respectively, a portion of which was to fund shareholders' individual income tax liabilities related to the S Corporation taxable earnings.

Approximately half of the distributions in 1996 have been to fund shareholders' individual income tax liabilities related to the S Corporation taxable earnings.

Subsequent to year end the Company will distribute all of Sun Hydraulics' previously undistributed retained earnings totaling \$10,432 related to the S Corporation. A distribution of \$9,446 representing 90% of the total undistributed retained earnings was paid in January 1997.

12. Income Taxes

Pretax income from continuing operations for the years ended December 31, is taxed under the following jurisdictions:

DECEMBER 31,	1994	1995	1996
United States	\$4,914	\$7,489	\$2,190
Foreign	897	2,005	2,010
Total	<u>\$5,811</u>	<u>\$9,494</u>	<u>\$4,200</u>

The income tax provision consists of the following:

DECEMBER 31,	1994	1995	1996
Current tax expense (benefit):			
United States	\$197	\$ (3)	\$ 7
State and local	—	—	—
Foreign	154	746	621
Total current	<u>351</u>	<u>743</u>	<u>628</u>
Deferred tax expense (benefit):			
United States	(82)	(88)	2,170
State and local	(37)	(16)	255
Foreign	176	(6)	76
Total deferred	<u>57</u>	<u>(110)</u>	<u>2,501</u>
Total income tax provision	<u>\$408</u>	<u>\$ 633</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,	1994	1995	1996
U.S. federal taxes at statutory rate	\$ 1,976	\$ 3,228	\$ 1,428
Increase (decrease):			
Foreign income taxed at higher rates	12	28	14
Book/tax basis differences on disposed equipment	131	—	—
Taxable gain eliminated from book income	127	—	—
Conversion of S Corporation to C Corporation	—	—	2,354
S Corporation income	(1,839)	(2,684)	(724)
Nondeductible items	45	46	57
State and local taxes, net	(37)	(16)	—
Other	(7)	31	—
Income tax provision	<u>\$ 408</u>	<u>\$ 633</u>	<u>\$ 3,129</u>

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

DECEMBER 31,	1995	1996
Deferred taxes, non-current:		
Assets		
Accrued expenses and reserves not currently deductible	\$ —	\$ 182
Phantom stock compensation	218	558
Florida NOL carry forward	15	18
Deferred tax asset, non-current	<u>\$233</u>	<u>\$ 758</u>
Liabilities		
Depreciation differences	\$317	\$3,336
Deferred tax liability, non-current	<u>\$317</u>	<u>\$3,336</u>
Net deferred tax liability, non-current	<u>\$ 84</u>	<u>\$2,578</u>

At December 31, 1996, the Company has a Florida income tax net operating loss carry forward of approximately \$328 available to offset future taxable income. These carry forwards expire through 2010. Utilization of these carry forwards may be limited in the event of certain ownership changes.

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

12. Income Taxes (Continued)
Pro Forma Taxes (unaudited)

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

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

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

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

13. Stock Option Plans

Under stock option plans which have expired, the Company had granted incentive stock options to certain employees which were exercisable at a price equal to the fair market value on the date of grant. No shares were available for granting at December 31, 1994, 1995

13. Stock Option Plans (Continued)

or 1996. The Company had stock option activity related to these plans for the three years ended December 31, 1996 as shown in the table below.

During 1996, the Company adopted the 1996 Stock Option Plan (the "Stock Option Plan"), which provides for the grant of incentive stock options and nonqualified stock options for the purchase of up to an aggregate of 1,000,000 shares of the Company's common stock by officers, employees and directors of the Company. Under terms of the plan, incentive stock options may be granted to employees at an exercise price per share of not less than the fair value per common share on the date of the grant (not less than 110% of the fair value in the case of holders of more than 10% of the Company's voting stock). Nonqualified stock options may be granted at the discretion of the Company's Board of Directors.

Effective September 30, 1996, the Board of Directors of the Company approved a plan to replace previously granted phantom stock agreements by issuing 305,260 nonqualified stock options on September 30, 1996, and committing to issue 189,348 qualified incentive stock options upon Reorganization. Exercise prices of the nonqualified options range from \$3.00 to \$5.05. The employees were immediately vested in the nonqualified options upon Reorganization. The qualified options will vest over periods up to seven years. The Company recognized a charge in 1996 related to the termination of the phantom stock agreements of approximately \$1,378.

Also effective September 30, 1996, the Company granted 14,700 nonqualified stock options to four Directors. These options have an exercise price of \$3.00 per share, a term of 10 years and are exercisable upon Reorganization. The Company recognized a charge during 1996 of approximately \$110 in connection with the issuance of these options.

Options granted under the Stock Option Plan expire seven and ten years from the date of the grant.

DECEMBER 31,	1994		1995		1996	
	Weighted Average Exercise		Weighted Average Exercise		Weighted Average Exercise	
	Shares	Price	Shares	Price	Shares	Price
Outstanding at 12/31/94	44,000	\$7.37	27,000	\$8.12	8,000	\$8.83
Exercised	(17,000)	6.17	(19,000)	7.83	(8,000)	8.83
Outstanding at 12/31/95	<u>27,000</u>	<u>\$8.12</u>	<u>8,000</u>	<u>\$8.83</u>	<u>0</u>	<u>\$ —</u>
Options exercisable at 12/31/96	13,000		2,000		0	

(in thousands except share and per share data)

A summary of the Stock Option Plan as of December 31, 1996, and changes during the years ending on those dates is presented below:

DECEMBER 31, 1996

	Weighted Average Exercise	
	Shares	Price
Outstanding at 12/31/95	—	\$ —
Granted	319,960	3.91
Exercised	—	—
Outstanding at 12/31/96	<u>319,960</u>	<u>\$3.91</u>
Options exercisable at 12/31/96	—	—

OPTIONS OUTSTANDING AND EXERCISABLE

Range of Exercise Prices	Number Outstanding at Dec. 31, 1996	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
\$ 3.00	14,700	9.75	\$3.00
3.00-5.50	<u>305,260</u>	9.73	3.95
	<u>319,960</u>		3.91

Fair Value Disclosures

Had compensation cost for the Company's stock option grants been determined based on the fair value of the stock options at the grant dates as prescribed in FAS 123, the Company's net income and net income per share would not have changed during 1995 as no options were granted during that year. The Company would have recorded additional expense (after tax effect) during 1996 of approximately \$82, resulting in adjusted net income of \$989 and adjusted pro forma net income of \$2,535 for the year. Pro forma net income per share, adjusted for the additional compensation cost, would have been \$0.39 per share.

The fair value of each option grant is estimated on the date of grant using the fair market value method with the following assumptions used for grants during the applicable period: cumulative volatility of 82%; dividend yield of 1.38%; risk-free interest rate of 6.60% for options granted during the year ended December 31, 1996; and an estimated weighted average expected option term of 5 years.

14. 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 \$796, \$901 and \$586 during 1994, 1995 and 1996, respectively.

The Company has a medical benefit trust to provide for health care coverage to substantially all eligible United States employees. Employer contributions to the trust amounted to approximately \$1,242, \$1,490 and \$1,348 during 1994, 1995 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 \$110, \$132 and \$157 for 1994, 1995 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 \$43, \$56 and \$69 during 1994, 1995 and 1996, respectively.

The Company had phantom stock agreements with certain employees. Under these agreements, 92,801 phantom options were deemed vested, as defined in the agreements, at various dates from October 1, 1987 to July 1, 2005. At December 31, 1995, all phantom options remained outstanding and 60,951 phantom options were deemed vested at prices ranging from \$2.35 to \$24.72 per share. Approximately \$379 and \$732 is included in other liabilities under these agreements at December 31, 1994 and 1995, respectively. Compensation expense related to these phantom options of \$105 and \$353 is included in selling, engineering and administrative expenses in 1994 and 1995, respectively. Effective September 30, 1996 the Board of Directors of the Company approved a plan to replace the phantom stock agreements.

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

The individual companies comprising the Company operate predominantly in a single industry as manufacturers and distributors of hydraulic components. The companies are multinational with operations in the United States, the United Kingdom and Germany. Intercompany

(losses) reflected in results of operations were (\$19), \$10 and \$117 for the years ended 1994, 1995 and 1996, respectively. Operating income is total sales and other operating income less operating expenses. In computing geographic operating income, interest expense and net miscellaneous income (expense) have not been deducted (added).

GEOGRAPHIC INFORMATION

	United States	United Kingdom	Germany	Elimination	Combined
1994					
Sales to unaffiliated customers	\$33,284	\$6,590	\$2,979	—	\$42,853
Intercompany sales	5,297	1,119	—	\$(6,416)	—
Operating profits	5,753	676	307	—	6,736
Identifiable assets	22,486	4,828	1,036	(482)	27,868
Depreciation expense	1,746	406	45	—	2,197
Capital expenditures	4,355	739	36	—	5,130
1995					
Sales to unaffiliated customers	\$43,099	\$8,300	\$3,989	—	\$55,388
Intercompany sales	5,940	1,470	—	\$(7,410)	—
Operating profits	8,090	1,446	693	—	10,229
Identifiable assets	27,212	5,414	1,813	(575)	33,864
Depreciation expense	1,961	531	64	—	2,556
Capital expenditures	6,230	700	727	—	7,657
1996					
Sales to unaffiliated customers	\$42,180	\$8,866	\$3,526	—	\$54,572
Intercompany sales	5,194	1,895	—	\$(7,089)	—
Operating profits	14,765	3,108	1,262	(1,748)	17,387
Identifiable assets	37,565	6,750	4,544	(443)	48,416
Depreciation expense	2,203	570	84	—	2,857
Capital expenditures	12,626	3,162	1,175	—	16,963

transfers between geographic areas are accounted for based on sales prices that approximate those to third parties. In computing earnings from operations for the foreign companies, no allocations of general corporate expenses, interest or income taxes have been made.

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

Total liabilities attributable to foreign operations were \$2,493, \$2,674 and \$4,940 at December 31, 1994, 1995 and 1996, respectively. Net foreign currency gains

Included in U.S. sales to unaffiliated customers were export sales, principally to Canada and Asia, of \$4,589, \$6,468 and \$6,090 during 1994, 1995 and 1996, respectively.

16. Commitments and Contingencies

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



Shareholder Information

Corporate Officers

Robert E. Koski
Chairman of the Board

Clyde G. Nixon
President, CEO

Robert J. Devereaux
Vice President

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

Arthur B. Bodley
President, CEO
Atlas Fluid Components Company

James G. March, PhD
Professor Emeritus
Stanford University

Taco Van Tijn, Esquire
Solicitor

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

Legal Counsel

Shumaker, Loop & Kendrick, LLP
Tampa, Florida

Auditors

Price Waterhouse LLP
Tampa, Florida

Corporate Headquarters

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Fax: 941-355-4497

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:

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

Transfer Agent

SunTrust Bank, Atlanta
Atlanta, Georgia

Common Stock Information

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

As of May 1, 1997, there were 98 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 2,300 beneficial owners of common stock.

As of May 1, 1997, the closing price per share of SNHY stock was \$10.75.

Shareholders Annual Meeting

The annual meeting of shareholders will be held Saturday, June 21, 1997, at 10:00 A.M. Eastern Standard Time at the Sun Hydraulics Manifold Operation, 701 Tallevast Road, Sarasota, Florida 34243.



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Cartridge Operations**

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