

SUN HYDRAULICS CORP

Form 10-Q

November 05, 2013

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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FORM 10-Q

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QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 28, 2013

Commission file number 0-21835

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SUN HYDRAULICS CORPORATION

(Exact Name of Registration as Specified in its Charter)

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FLORIDA

(State or Other Jurisdiction of  
Incorporation or Organization)

59-2754337

(I.R.S. Employer  
Identification No.)

1500 WEST UNIVERSITY PARKWAY  
SARASOTA, FLORIDA

(Address of Principal Executive Offices)

34243

(Zip Code)

941/362-1200

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

☐

Accelerated filer

☒

Non-accelerated filer

☐

Smaller Reporting Company

☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

The Registrant had 26,348,192 shares of common stock, par value \$.001, outstanding as of October 25, 2013.



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Sun Hydraulics Corporation

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## PART I: FINANCIAL INFORMATION

## Item 1.

## Sun Hydraulics Corporation

## Consolidated Balance Sheets

(in thousands, except share data)

|   | September 28,<br>2013<br>(unaudited) | December 29,<br>2012 |
|---|--------------------------------------|----------------------|
| Assets  |                                      |                      |
| Current assets:   |                                      |                      |
| Cash and cash equivalents   | \$46,490                             | \$34,478             |
| Restricted cash   | 328                                  | 329                  |
| Accounts receivable, net of allowance for doubtful accounts of \$132 and \$124                              | 18,273                               | 13,754               |
| Inventories   | 12,778                               | 12,559               |
| Income taxes receivable   | —                                    | 728                  |
| Deferred income taxes   | 440                                  | 248                  |
| Short-term investments  | 40,644                               | 37,700               |
| Other current assets  | 3,174                                | 2,649                |
| Total current assets  | 122,127                              | 102,445              |
| Property, plant and equipment, net  | 74,105                               | 64,672               |
| Goodwill  | 5,188                                | 4,472                |
| Other assets  | 3,602                                | 3,532                |
| Total assets  | \$205,022                            | \$175,121            |
| Liabilities and shareholders' equity  |                                      |                      |
| Current liabilities:  |                                      |                      |
| Accounts payable  | \$5,721                              | \$4,606              |
| Accrued expenses and other liabilities  | 6,067                                | 7,641                |
| Income taxes payable  | 679                                  | —                    |
| Dividends payable   | 2,363                                | —                    |
| Total current liabilities   | 14,830                               | 12,247               |
| Deferred income taxes   | 7,399                                | 7,230                |
| Other noncurrent liabilities  | 392                                  | 371                  |
| Total liabilities   | 22,621                               | 19,848               |
| Commitments and contingencies   | —                                    | —                    |
| Shareholders' equity:   |                                      |                      |
| Preferred stock, 2,000,000 shares authorized, par value \$0.001, no shares outstanding                      | —                                    | —                    |
| Common stock, 40,000,000 shares authorized, par value \$0.001, 26,250,999 and 26,094,580 shares outstanding | 26                                   | 26                   |
| Capital in excess of par value  | 63,956                               | 57,402               |
| Retained earnings   | 117,447                              | 97,242               |
| Accumulated other comprehensive income (loss)   | 972                                  | 603                  |
| Total shareholders' equity  | 182,401                              | 155,273              |
| Total liabilities and shareholders' equity  | \$205,022                            | \$175,121            |

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



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Sun Hydraulics Corporation  
Consolidated Statements of Operations  
(in thousands, except per share data)

|  | Three months ended                   |                                      |
|--|--------------------------------------|--------------------------------------|
|  | September 28,<br>2013<br>(unaudited) | September 29,<br>2012<br>(unaudited) |
| Net sales  | \$49,369                             | \$48,825                             |
| Cost of sales                                    | 29,755                               | 29,428                               |
| Gross profit                                     | 19,614                               | 19,397                               |
| Selling, engineering and administrative expenses | 6,540                                | 6,202                                |
| Operating income                                 | 13,074                               | 13,195                               |
| Interest (income) expense, net                   | (272                                 | ) (406                               |
| Foreign currency transaction (gain) loss, net    | 82                                   | 2                                    |
| Miscellaneous (income) expense, net              | 470                                  | 6                                    |
| Income before income taxes                       | 12,794                               | 13,593                               |
| Income tax provision                             | 4,519                                | 4,758                                |
| Net income                                       | \$8,275                              | \$8,835                              |
| Basic net income per common share                | \$0.32                               | \$0.34                               |
| Weighted average basic shares outstanding        | 26,247                               | 25,989                               |
| Diluted net income per common share              | \$0.32                               | \$0.34                               |
| Weighted average diluted shares outstanding      | 26,247                               | 25,999                               |
| Dividends declared per share                     | \$0.090                              | \$0.090                              |

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

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Sun Hydraulics Corporation  
Consolidated Statements of Operations  
(in thousands, except per share data)

|  | Nine months<br>ended September<br>28, 2013 | Nine Months<br>Ended September<br>29, 2012 |
|--|--|--|
|  | (unaudited)                                | (unaudited)                                |
| Net sales  | \$156,218                                  | \$161,131                                  |
| Cost of sales                                    | 92,699                                     | 96,546                                     |
| Gross profit                                     | 63,519                                     | 64,585                                     |
| Selling, engineering and administrative expenses | 19,752                                     | 19,662                                     |
| Operating income                                 | 43,767                                     | 44,923                                     |
| Interest (income) expense, net                   | (709)                                      | ) (1,041 )                                 |
| Foreign currency transaction (gain) loss, net    | (68)                                       | ) (75 )                                    |
| Miscellaneous (income) expense, net              | 80   | (158 )                                     |
| Income before income taxes                       | 44,464                                     | 46,197                                     |
| Income tax provision                             | 14,824                                     | 15,493                                     |
| Net income                                       | \$29,640                                   | \$30,704                                   |
| Basic net income per common share                | \$1.13                                     | \$1.19                                     |
| Weighted average basic shares outstanding        | 26,206                                     | 25,904                                     |
| Diluted net income per common share              | \$1.13                                     | \$1.18                                     |
| Weighted average diluted shares outstanding      | 26,206                                     | 25,937                                     |
| Dividends declared per share                     | \$0.360                                    | \$0.390                                    |

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



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## Sun Hydraulics Corporation

## Consolidated Statements of Comprehensive Income (Loss) (unaudited)

(in thousands)

|   | Three months ended |               | Nine months ended |               |
|---|--------------------|---------------|-------------------|---------------|
|   | September 28,      | September 29, | September 28,     | September 29, |
|   | 2013               | 2012          | 2013              | 2012          |
|   | (unaudited)        | (unaudited)   | (unaudited)       | (unaudited)   |
| Net income  | \$8,275            | \$8,835       | \$29,640          | \$30,704      |
| Other comprehensive income (loss)                       |                    |               |                   |               |
| Foreign currency translation adjustments                | 3,092              | 1,364         | 562               | 1,032         |
| Unrealized gain (loss) on available-for-sale securities | 31                 | 200           | (193              | ) 317         |
| Total other comprehensive income (loss)                 | 3,123              | 1,564         | 369               | 1,349         |
| Comprehensive income                                    | \$11,398           | \$10,399      | \$30,009          | \$32,053      |

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

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## Sun Hydraulics Corporation

## Consolidated Statement of Changes in Shareholders' Equity (unaudited)

(in thousands)

|                                       | Preferred<br>shares | Preferred<br>stock | Common<br>shares | Common<br>stock | Capital in<br>excess of<br>par value | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>income | Total     |
|---------------------------------------|---------------------|--------------------|------------------|-----------------|--------------------------------------|----------------------|---|-----------|
| Balance, December 29,<br>2012         | —                   | \$—                | 26,095           | \$26            | \$57,402                             | \$97,242             | \$ 603  | \$155,273 |
| Shares issued, other<br>comp          |                     |                    | 23               |                 |                                      |                      |   | —         |
| Shares issued, ESPP                   |                     |                    | 27               |                 | 651                                  |                      |   | 651       |
| Shares issued, shared<br>distribution |                     |                    | 106              |                 | 3,486                                |                      |   | 3,486     |
| Stock-based<br>compensation           |                     |                    |                  |                 | 2,417                                |                      |   | 2,417     |
| Dividends declared                    |                     |                    |                  |                 |                                      | (9,435 )             |   | (9,435 )  |
| Net income                            |                     |                    |                  |                 |                                      | 29,640               |   | 29,640    |
| Other comprehensive<br>income (loss)  |                     |                    |                  |                 |                                      |                      | 369   | 369       |
| Balance, September 28,<br>2013        | —                   | \$—                | 26,251           | \$26            | \$63,956                             | \$117,447            | \$ 972  | \$182,401 |

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

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Sun Hydraulics Corporation  
Consolidated Statements of Cash Flows  
(in thousands)

|   | Nine months ended  |                    |
|---|--------------------|--------------------|
|   | September 28, 2013 | September 29, 2012 |
|   | (unaudited)        | (unaudited)        |
| Cash flows from operating activities:   |                    |                    |
| Net income  | \$29,640           | \$30,704           |
| Adjustments to reconcile net income to net cash provided by operating activities: |                    |                    |
| Depreciation and amortization   | 5,393              | 5,353              |
| (Gain)Loss on disposal of assets  | 324                | 84                 |
| Gain on investment in business  | (528)              | ) —                |
| Provision for deferred income taxes   | (23)               | ) 4                |
| Allowance for doubtful accounts   | 8                  | 44                 |
| Stock-based compensation expense  | 2,124              | 1,639              |
| (Increase) decrease in, net of assets acquired:                                   |                    |                    |
| Accounts receivable   | (4,514)            | ) (2,119)          |
| Inventories   | (151)              | ) (147)            |
| Income taxes receivable   | 728                | 120                |
| Other current assets  | (525)              | ) (104)            |
| Other assets  | 284                | (92)               |
| Increase (decrease) in, net of liabilities assumed:                               |                    |                    |
| Accounts payable  | 1,115              | 65                 |
| Accrued expenses and other liabilities  | 2,206              | 3,722              |
| Income taxes payable  | 679                | 1,047              |
| Other noncurrent liabilities  | 21                 | (219)              |
| Net cash provided by operating activities   | 36,781             | 40,101             |
| Cash flows from investing activities:   |                    |                    |
| Investment in business, net of cash acquired                                      | (923)              | ) —                |
| Capital expenditures  | (14,569)           | ) (6,703)          |
| Proceeds from dispositions of equipment   | 70                 | 56                 |
| Purchases of short-term investments   | (22,945)           | ) (25,774)         |
| Proceeds from sale of short-term investments                                      | 19,327             | 6,821              |
| Net cash used in investing activities   | (19,040)           | ) (25,600)         |
| Cash flows from financing activities:   |                    |                    |
| Proceeds from stock issued  | 651                | 506                |
| Dividends to shareholders   | (7,072)            | ) (10,107)         |
| Change in restricted cash   | 1                  | 3                  |
| Net cash used in financing activities   | (6,420)            | ) (9,598)          |
| Effect of exchange rate changes on cash and cash equivalents                      | 691                | 759                |
| Net increase (decrease) in cash and cash equivalents                              | 12,012             | 5,662              |
| Cash and cash equivalents, beginning of period                                    | 34,478             | 45,080             |
| Cash and cash equivalents, end of period  | \$46,490           | \$50,742           |
| Supplemental disclosure of cash flow information:                                 |                    |                    |
| Cash paid:  |                    |                    |
| Income taxes  | \$13,440           | \$14,323           |
| Supplemental disclosure of noncash transactions:                                  |                    |                    |
|   | \$3,486            | \$4,407            |

Common stock issued for shared distribution through accrued expenses and other liabilities

|   |       |       |
|---|-------|-------|
| Common stock issued for deferred director's compensation through other noncurrent liabilities | \$294 | \$930 |
|---|-------|-------|

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

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## SUN HYDRAULICS CORPORATION

## NOTES TO THE CONSOLIDATED, UNAUDITED FINANCIAL STATEMENTS

(Dollars in thousands except per share data)

## 1. BASIS OF PRESENTATION AND SUMMARY OF BUSINESS

Sun Hydraulics Corporation, and its wholly-owned subsidiaries, 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, Korea, France, China, and India. Sun Hydraulics Corporation (“Sun Hydraulics”), with its main offices located in Sarasota, Florida, designs, manufactures, and sells its products primarily through distributors. Sun Hydraulik Holdings Limited (“Sun Holdings”), a wholly-owned subsidiary of Sun Hydraulics, was formed to provide a holding company for the European market operations; its wholly-owned subsidiaries are Sun Hydraulics Limited (a British corporation, “Sun Ltd.”) and Sun Hydraulik GmbH (a German corporation, “Sun GmbH”). Sun Ltd. operates a manufacturing and distribution facility located in Coventry, England, and Sun GmbH operates a manufacturing and distribution facility located in Erkelenz, Germany. Sun Hydraulics Korea Corporation (“Sun Korea”), a wholly-owned subsidiary of Sun Hydraulics, located in Incheon, South Korea, operates a manufacturing and distribution facility. In 2012, Sun Korea acquired Seungwon Solutions Corporation (“Seungwon”), also located in Incheon, South Korea, a component supplier to Sun Korea and third parties. Sun Hydraulics, SARL (“Sun France”), a wholly-owned subsidiary of Sun Hydraulics was dissolved in November 2011. Concurrently, Sun Hydraulics opened a liaison office in Bordeaux, France to service the French market. Sun Hydraulics established Sun Hydraulics China Co. Ltd, a representative office in Shanghai in January 2011, to develop new business opportunities in the Chinese market. Sun Hydraulics (India) a liaison office in Bangalore, India is used to develop new business opportunities in the Indian market. On September 27, 2011, Sun Hydraulics purchased the outstanding shares of High Country Tek, Inc. (“HCT”) it did not already own. HCT, now a wholly-owned subsidiary of Sun Hydraulics, is located in Nevada City, California, and designs and manufactures ruggedized electronic/hydraulic control solutions for mobile equipment markets. WhiteOak Controls, Inc. (“WhiteOak”), a 40% equity method investment, located in Mediapolis, Iowa, designs and produces complementary electronic control products. On April 1, 2013, Sun Hydraulics purchased the remaining 60% of WhiteOak, which was merged into HCT (see note 7).

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission for reporting on Form 10-Q. Accordingly, certain information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements are not included herein. The financial statements are prepared on a consistent basis (including normal recurring adjustments) and should be read in conjunction with the consolidated financial statements and related notes contained in the Annual Report on Form 10-K for the fiscal year ended December 29, 2012, filed by Sun Hydraulics Corporation (together with its subsidiaries, the “Company”) with the Securities and Exchange Commission on March 12, 2013. In Management’s opinion, all adjustments necessary for a fair presentation of the Company’s financial statements are reflected in the interim periods presented. Operating results for the nine month period ended September 28, 2013, are not necessarily indicative of the results that may be expected for the period ending December 28, 2013.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

## Earnings per share

The following table represents the computation of basic and diluted earnings per common share (in thousands, except per share data):

|   | Three Months Ended    |                       | Nine Months Ended     |                       |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
|   | September 28,<br>2013 | September 29,<br>2012 | September 28,<br>2013 | September 29,<br>2012 |
| Net income                                | \$8,275               | \$8,835               | \$29,640              | \$30,704              |
| Weighted average basic shares outstanding | 26,247                | 25,989                | 26,206                | 25,904                |

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|   |        |        |        |        |
|---|--------|--------|--------|--------|
| Basic net income per common share           | \$0.32 | \$0.34 | \$1.13 | \$1.19 |
| Effect of dilutive stock options            | —      | 10     | —      | 32     |
| Weighted average diluted shares outstanding | 26,247 | 25,999 | 26,206 | 25,937 |
| Diluted net income per common share         | \$0.32 | \$0.34 | \$1.13 | \$1.18 |

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## Reclassification

Certificates of deposit classified as cash in the prior period were reclassified to marketable securities to conform to the current year presentation. Non-trade receivables classified as accounts receivable in the prior period were reclassified to other current assets to conform to the current year presentation.

## 3. STOCK-BASED COMPENSATION

The Company's 2006 Stock Option Plan ("2006 Plan") provides for the grant of incentive stock options and nonqualified stock options for the purchase of up to an aggregate of 1,125,000 shares of the Company's common stock by officers, employees and directors of the Company. Under the terms of the plan, incentive stock options may be granted to employees at an exercise price per share of not less than the fair value per common share on the date of the grant (not less than 110% of the fair value in the case of holders of more than 10% of the Company's voting stock). Nonqualified stock options may be granted at the discretion of the Company's Board of Directors. The maximum term of an option may not exceed 10 years, and options become exercisable at such times and in such installments as determined by the Board of Directors. No awards have been granted under the 2006 Plan.

The Company's 2001 Restricted Stock Plan provides for the grant of restricted stock of up to an aggregate of 928,125 shares of the Company's common stock to officers, employees, consultants and directors of the Company. Under the terms of the plan, the minimum period before any shares become non-forfeitable may not be less than six months. The 2001 Restricted Stock Plan expired in 2011 and was replaced in September 2011 with the 2011 Equity Incentive Plan ("2011 Plan"). The 2011 Plan provides for the grant of up to an aggregate of 1,000,000 shares of restricted stock, restricted share units, stock appreciation rights, dividend or dividend equivalent rights, stock awards and other awards valued in whole or in part by reference to or otherwise based on the Company's common stock, to officers, employees and directors of the Company. The 2011 Plan was approved by the Company's shareholders at the 2012 Annual Meeting. At September 28, 2013, 823,212 shares remained available to be issued through the 2011 Plan.

Compensation cost is measured at the date of the grant and is recognized in earnings over the period in which the shares vest. Restricted stock expense for the nine months ended September 28, 2013, and September 29, 2012, totaled \$1,557 and \$1,176 respectively.

The following table summarizes restricted stock activity from December 29, 2012, through September 28, 2013:

|   | Number<br>of shares | Weighted<br>average<br>grant-date<br>fair value |
|---|---------------------|---|
| Nonvested balance at December 29, 2012  | 169                 | 25.81   |
| Granted                                 | —                   | —   |
| Vested                                  | —                   | —   |
| Forfeitures                             | —                   | —   |
| Nonvested balance at September 28, 2013 | 169                 | —   |

The Company has \$2,094 of total unrecognized compensation cost related to restricted stock awards granted under the two plans as of September 28, 2013. That cost is expected to be recognized over a weighted average period of 0.89 years.

The Company maintains an Employee Stock Purchase Plan ("ESPP"), in which most employees are eligible to participate. Employees in the United States who choose to participate are granted an opportunity to purchase common stock at 85 percent of market value on the first or last day of the quarterly purchase period, whichever is lower. Employees in the United Kingdom, under a separate plan, are granted an opportunity to purchase common stock at market value, on the first or last day of the quarterly purchase period, whichever is lower, with the Company issuing one additional free share of common stock for each six shares purchased by the employee under the ESPP. The ESPP authorizes the issuance, and the purchase by employees, of up to 1,096,875 shares of common stock through payroll deductions. No U.S. employee is allowed to buy more than \$25 of common stock in any year, based on the market

value of the common stock at the beginning of the purchase period, and no U.K. employee is allowed to buy more than the lesser of £1.5 or 10% of his or her annual salary in any year. Employees purchased 27,060 shares at a weighted average price of \$24.05, and 25,882 shares at a weighted average price of \$19.55, under the ESPP during the nine months ended September 28, 2013, and September 29, 2012, respectively. The Company recognized \$142 and \$129 of compensation expense during the nine months ended September 28, 2013 and September 29, 2012, respectively. At September 28, 2013, 686,224 shares remained available to be issued through the ESPP and the U.K. plan.



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The Nonemployee Director Equity and Deferred Compensation Plan (the “Plan”) originally was adopted by the Board of Directors and approved by the shareholders in 2004, and amended in 2008. Under the Plan, Directors who were not officers of the Company were paid 375 shares of Company common stock and \$3 in cash fees for attendance at each meeting of the Board of Directors, as well as each meeting of each Board Committee on which they served when the committee meeting was not held within one day of a meeting of the Board of Directors. Committee Chairmen received additional fees equal to 25% of normal compensation and the Chairman of the Board was paid twice the amount of normal compensation, with such additional compensation payable in Company common stock. Prior to June 7, 2011, Directors were able to elect under the Plan to receive all or part of their cash fees in Company stock and to defer receipt of their fees until a subsequent year. When so deferred, the shares of stock were converted to deferred stock units. Deferred stock units are treated as liabilities. At September 28, 2013, there were zero deferred stock units outstanding. The Plan has now been terminated, and no further issuance of shares will be made under the Plan.

In March 2012, the Board reviewed its non-employee director compensation policy and determined that compensating Directors solely in Company stock would further align the interests of the Board and the shareholders. Accordingly, the Board of Directors adopted the Sun Hydraulics Corporation 2012 Nonemployee Director Fees Plan (the “2012 Directors Plan”), which was approved by the shareholders of the Company at its 2012 annual meeting.

Under the 2012 Directors Plan, as compensation for attendance at each Board meeting and each meeting of each committee of the Board on which he or she serves when the committee meeting is not held within one day of a meeting of the Board, each Nonemployee Director will be paid 500 shares of Common Stock. The Chairman’s fee is twice that of a regular director, and the fee for the chairs of each Board committee is 125% that of a regular director. The Board has the authority to change from time to time, in any manner it deems desirable or appropriate, the share compensation to be awarded to all or any one or more Nonemployee Directors, provided that, with limited exceptions, such changes are subject to prior shareholder approval. The aggregate number of Shares which may be issued during any single calendar year is limited to 25,000 Shares. The 2012 Directors Plan authorizes the issuance of up to 270,000 shares of common stock. At September 28, 2013, 244,249 shares remained available for issuance under the 2012 Directors Plan.

Directors were granted 12,500 and 12,676 shares for the nine months ended September 28, 2013, and September 29, 2012, respectively. The Company recognized director stock compensation expense of \$432 and \$349 for the nine months ended September 28, 2013, and September 29, 2012, respectively.

#### 4. RESTRICTED CASH

On September 28, 2013, the Company had restricted cash of \$328. A restricted cash reserve for customs and excise taxes in the U.K. operation was \$48 at September 28, 2013. The restricted amount was calculated as an estimate of two months of customs and excise taxes for items coming into the Company’s U.K. operations and is held with Lloyds TSB in the U.K. Restricted cash of \$280 at September 28, 2013, represents the holdback of the purchase price associated with the acquisition of Seungwon on October 18, 2012.

#### 5. INVENTORIES

|                                     | September 28,<br>2013 | December 29,<br>2012 |
|-------------------------------------|-----------------------|----------------------|
| Raw materials                       | \$6,275               | \$5,564              |
| Work in process                     | 3,767                 | 3,695                |
| Finished goods                      | 3,419                 | 3,980                |
| Provision for slow moving inventory | (683)                 | (680)                |
| Total                               | \$12,778              | \$12,559             |

#### 6. GOODWILL AND INTANGIBLE ASSETS

A summary of changes in goodwill at September 28, 2013 is as follows:

|                            |         |
|----------------------------|---------|
| Balance, December 29, 2012 | \$4,472 |
| Acquisitions               | 726     |

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|                             |         |   |
|-----------------------------|---------|---|
| Currency translation        | (10     | ) |
| Balance, September 28, 2013 | \$5,188 |   |

Goodwill is made up of amounts relating to the acquisitions of Sun Korea, HCT, Seungwon, and WhiteOak. Valuation models reflecting the expected future cash flow projections are used to value reporting units. A valuation of the reporting unit at

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December 29, 2012, indicated that there was no impairment of the carrying value of the goodwill at Sun Korea. As of September 28, 2013, no factors were identified that indicated impairment of the carrying value of goodwill. A valuation of the reporting unit at September 28, 2013 indicated that there was no impairment of the carrying value of the goodwill at HCT.

The Company recognized \$2,658 and \$746 in identifiable intangible assets as a result of the acquisitions of HCT and WhiteOak, respectively. Intangible assets are held in other assets on the balance sheet. At September 28, 2013, and December 29, 2012, intangible assets consisted of the following:

|                             | September 28, 2013    |                          |                     | December 29, 2012     |                          |                     |
|-----------------------------|-----------------------|--------------------------|---------------------|-----------------------|--------------------------|---------------------|
|                             | Gross carrying amount | Accumulated amortization | Net carrying amount | Gross carrying amount | Accumulated amortization | Net carrying amount |
| Definite-lived intangibles: |                       |                          |                     |                       |                          |                     |
| Trade Name                  | \$ 774                | \$(161 )                 | \$ 613              | \$ 756                | \$(95 )                  | \$ 661              |
| Non-compete agreement       | 11                    | (3 )                     | 8                   | —                     | —                        | —                   |
| Technology                  | 868                   | (108 )                   | 760                 | 697                   | (256 )                   | 441                 |
| Customer Relationships      | 1,751                 | (155 )                   | 1,596               | 1,475                 | (92 )                    | 1,383               |
|                             | \$ 3,404              | \$(427 )                 | \$ 2,977            | \$ 2,928              | \$(443 )                 | \$ 2,485            |

Technology associated with our original equity method investment in WhiteOak is included in the prior year numbers above. As a result of the acquisition, our original investment is eliminated upon consolidation. This includes gross technology of \$270 and \$209 of accumulated amortization through March 30, 2013.

Total estimated amortization expense for the years 2014 through 2018 is presented below. The remaining amortization for 2013 is approximately \$70.

|       |          |
|-------|----------|
| Year: |          |
| 2014  | 264      |
| 2015  | 256      |
| 2016  | 255      |
| 2017  | 255      |
| 2018  | 255      |
| Total | \$ 1,285 |

Intangible assets are evaluated for impairment whenever events or circumstances indicate that the undiscounted net cash flows to be generated by their use over their expected useful lives and eventual disposition may be less than their net carrying value. No such events or circumstances occurred during the nine months ended September 28, 2013.

## 7. ACQUISITIONS

On April 1, 2013, the Company acquired the remaining 60% of the capital stock of WhiteOak that it did not already own for \$1,000. WhiteOak has been merged into HCT and relocated to HCT's facility in California. HCT will manufacture, market, sell and have design control for all current WhiteOak products. The combination of HCT and WhiteOak gives Sun full ownership of the technology to develop the next generation of Sun's electronic control products.

The Company recorded approximately \$726 in goodwill, \$746 in definite lived intangible assets, and \$12 in transaction costs related to the acquisition. Of the \$746 of acquired intangible assets, \$18 was assigned to the WhiteOak trade name (1 year useful life), \$11 was assigned to non-compete agreements (2 year useful life), \$276 was assigned to customer relationships (15 year useful life), and \$441 was assigned to technology (10 year useful life). Additionally, the Company recorded a gain of \$528 as a result of remeasuring to fair value its 40% equity interest in WhiteOak held before the business combination.

On October 18, 2012, the Company, through Sun Korea, purchased all of the outstanding stock of Seungwon Solutions Corporation ("Seungwon") for approximately \$1,458. Seungwon is a component supplier, and approximately 80% of its sales are to Sun Korea.

The Company recorded approximately \$1,731 in goodwill and approximately \$80 in transaction costs related to the acquisition.

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The results of operations of WhiteOak and Seungwon have been included in the Company's consolidated results since the dates of acquisition. Supplemental pro forma information and disclosure of acquired assets and liabilities have not been provided as these acquisitions did not have a material impact on the consolidated financial statements individually or in the aggregate.

**8. LONG-TERM DEBT**

Effective August 1, 2011, the Company completed a credit and security agreement in the U.S. with Fifth Third Bank (the "Bank"). The agreement provides for three separate credit facilities totaling \$50,000.

Facility A is a \$15,000 unsecured revolving line of credit and requires monthly payments of interest. Facility A has a floating interest rate of 1.45% over the 30-day LIBOR Rate (as defined).

Facility B is an accordion feature to increase the revolving line of credit to a \$35,000 secured revolving line of credit. Facility B will be secured by the Company's U.S. assets, including its manufacturing facilities, and requires monthly payments of interest. Facility B will bear interest at the 30-day LIBOR Rate or the Bank's Base Rate (as defined), at the Company's discretion, plus a margin based on the Borrower's Funded Debt to EBITDA Leverage Ratio (as defined). The LIBOR Margin ranges from 1.45% to 2.25% and the Bank's Base Rate ranges from (0.25)% to 0.00%. Facility C is a \$15,000 construction and term loan. Facility C requires monthly payments of interest for the first 24 months and monthly payments of principal plus accrued interest for 60 months based upon a 15 year amortization schedule. The Construction Loan bears interest at the 30-day LIBOR Rate or the Bank's Base Rate, at the Company's discretion, plus a margin based on the Borrower's Funded Debt to EBITDA Leverage Ratio. The LIBOR Margin ranges from 1.65% to 2.45% and the Bank's Base Rate ranges from (0.05)% to 0.20%.

Facility A or Facility B (if activated) is payable in full on August 1, 2016. Facility C (if activated) is payable seven years after the closing of the facility. Maturity may be accelerated by the Bank upon an Event of Default (as defined). Prepayment may be made without penalty or premium at any time upon the required notice to the Bank.

Facility A is subject to debt covenants (capitalized terms are defined therein) including: 1) Minimum Tangible Net Worth of not less than \$92,000, increased annually by 50% of Net Income, and 2) Minimum EBITDA of not less than \$5,000; and requires the Company to maintain its primary domestic deposit accounts with the bank. At September 28, 2013, the Company was in compliance with all debt covenants related to Facility A as follows:

| Covenant                   | Required Ratio/Amount     | Actual Ratio/Amount |
|----------------------------|---------------------------|---------------------|
| Minimum Tangible Net Worth | \$144,358                 | \$174,236           |
| Minimum EBITDA             | Not less than \$5 million | \$59,566            |

If Facility B or Facility C are activated, covenant 2 above will automatically terminate and two additional covenants will be required: 1) Funded Debt to EBITDA ratio equal to or less than 3.0:1.0, and 2) EBIT to Interest Expense ratio of not less than 2.5:1.0. As of December 29, 2012, the Company had not activated Facility B or Facility C.

The Company did not have any amounts drawn on Facilities A, B, or C for the periods ended September 28, 2013, and September 29, 2012.

**9. INCOME TAXES**

At September 28, 2013, the Company had an unrecognized tax benefit of \$1,268 including accrued interest. If recognized, the unrecognized tax benefit would have a favorable effect on the effective tax rate in future periods. The Company recognizes interest and penalties related to income tax matters in income tax expense. Interest accrued as of September 28, 2013, is not considered material to the Company's consolidated financial statements.

The Company files U.S. federal income tax returns as well as income tax returns in various states and foreign jurisdictions. The Company is no longer subject to income tax examinations by tax authorities for years prior to 2004 for the majority of tax jurisdictions.

The Company's federal returns are currently under examination by the Internal Revenue Service (IRS) in the United States for the periods 2004 through 2011. To date, there have not been any significant proposed adjustments that have not been accounted for in the Company's consolidated financial statements.

Audit outcomes and the timing of audit settlements are subject to significant uncertainty. It is reasonably possible that within the next twelve months the Company will resolve some or all of the matters presently under consideration for

2004 through 2011 with the IRS and that there could be significant increases or decreases to unrecognized tax benefits.

Table of Contents**10. SEGMENT REPORTING**

Historically, the Company had four operating and reportable segments, which were based on the geographic location of its subsidiaries. In 2012, the Company re-evaluated its operating and reportable segments, resulting in a change to a single reportable segment in manufacturing, marketing, selling and distributing its products worldwide. This change was made because, increasingly, the Company is shipping products directly from the factory of origin to end-customers worldwide. Management believes the discrete financial information of the Company's individual foreign subsidiaries is no longer representative of the business level in those locations, and management no longer makes decisions or assesses performance based on this information. Management believes the investment community will have a better understanding, with less confusion, when reviewing our results as one operating segment. The additional information related to the region to which our products are sold, as opposed to the region where the sale was recorded, is more aligned with managerial decision-making and will best inform all interested parties.

The individual subsidiaries comprising the Company operate predominantly in a single industry as manufacturers and distributors of hydraulic components. Given the similar nature of products offered for sale, the type of customers, the methods of distribution and how the Company is managed, the Company determined that it now has only one operating and reporting segment for both internal and external reporting purposes. Prior period financial information included herein has been restated to reflect the financial position and results of operations as one segment.

**Geographic Region Information:**

Net sales are measured based on the geographic destination of sales. Total and long-lived assets are shown based on the physical location of the assets. Long-lived assets primarily include net property, plant and equipment:

|                   | Three Months<br>Ended<br>September<br>28, 2013 | Three Months<br>Ended<br>September<br>29, 2012 | Nine months<br>ended<br>September<br>28, 2013 | Nine Months<br>Ended<br>September<br>29, 2012 |
|-------------------|--|--|---|---|
| Net sales         |  |  |   |   |
| Americas          | 24,943   | 26,145   | 76,925  | 81,544  |
| Europe/Africa/ME  | 14,807   | 14,061   | 46,669  | 47,564  |
| Asia/Pacific      | 9,619  | 8,619  | 32,624  | 32,023  |
| Total             | 49,369   | 48,825   | 156,218                                       | 161,131                                       |
|                   |  |  | September 28,<br>2013                         | December 29,<br>2012                          |
| Total assets      |  |  |   |   |
| Americas          |  |  | 134,476                                       | 110,392                                       |
| Europe/Africa/ME  |  |  | 53,799  | 50,054  |
| Asia/Pacific      |  |  | 16,747  | 14,675  |
| Total             |  |  | 205,022                                       | 175,121                                       |
| Long-lived assets |  |  |   |   |
| Americas          |  |  | 69,730  | 60,240  |
| Europe/Africa/ME  |  |  | 9,033   | 8,085   |
| Asia/Pacific      |  |  | 4,132   | 4,351   |
| Total             |  |  | 82,895  | 72,676  |

**11. FAIR VALUE OF FINANCIAL INSTRUMENTS**

The Company applies fair value accounting guidelines for all financial assets and liabilities and non-financial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Under these guidelines, fair value is defined as the price that would be received for the sale of an asset or

paid to transfer a liability (i.e. an exit price) in an orderly transaction between market participants at the measurement date. The guidance establishes a three-tier fair value hierarchy which prioritizes the inputs used in measuring fair value as follows:

Level 1 - Quoted prices in active markets for identical assets or liabilities.



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Level 2 - Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets or quoted prices for identical assets or liabilities in inactive markets.

Level 3 - Unobservable inputs that are supported by little, infrequent, or no market activity and reflect the Company's own assumptions about inputs used in pricing the asset or liability.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The Company's valuation techniques used to measure the fair value of marketable equity securities, mutual funds, and phantom stock units were derived from quoted prices in active markets for identical assets or liabilities. The valuation techniques used to measure the fair value of all other financial instruments were valued based on quoted market prices or model driven valuations using significant inputs derived from or corroborated by observable market data.

The Company's investments have been classified and accounted for as available-for-sale. Management determines the appropriate classification of its investments at the time of purchase and reevaluates the designation at each balance sheet date. The Company may or may not hold securities with stated maturities greater than 12 months until maturity. As management views these securities as available to support current operations, the Company classifies securities with maturities beyond 12 months as current assets under the caption short-term investments in the accompanying Consolidated Balance Sheets. These investments are carried at fair value, with the unrealized gains and losses reported as a component of shareholder's equity. Realized gains and losses on sales of investments are generally determined using the specific identification method, and are included in miscellaneous (income) expense in the Consolidated Statements of Operations.

The following tables provide information regarding the Company's assets and liabilities measured at fair value on a recurring basis at September 28, 2013, and December 29, 2012.

|   | September 28, 2013 |                  |                   |            |
|---|--------------------|------------------|-------------------|------------|
|   | Adjusted Cost      | Unrealized Gains | Unrealized Losses | Fair Value |
| <b>Assets</b>                             |                    |                  |                   |            |
| <b>Level 1:</b>                           |                    |                  |                   |            |
| Equity securities                         | 1,363              | 68               | (84)              | ) 1,347    |
| Mutual funds                              | 3,537              | 3                | (24)              | ) 3,516    |
| Subtotal                                  | 4,900              | 71               | (108)             | ) 4,863    |
| <b>Level 2:</b>                           |                    |                  |                   |            |
| Corporate fixed income                    | 23,705             | 86               | (299)             | ) 23,492   |
| Municipal bonds                           | 3,989              | 2                | (27)              | ) 3,964    |
| Certificates of deposit and time deposits | 7,403              | 1                | —                 | ) 7,404    |
| Asset backed securities                   | 1,006              | —                | (85)              | ) 921      |
| Subtotal                                  | 36,103             | 89               | (411)             | ) 35,781   |
| Total                                     | 41,003             | 160              | (519)             | ) 40,644   |
| <b>Liabilities</b>                        |                    |                  |                   |            |
| <b>Level 1:</b>                           |                    |                  |                   |            |
| Phantom stock units                       | 79                 | —                | —                 | ) 79       |
| Total                                     | 79                 | —                | —                 | ) 79       |

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| December 29, 2012                         |               |                  |                   |            |
|---|---------------|------------------|-------------------|------------|
|   | Adjusted Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Assets                                    |               |                  |                   |            |
| Level 1:                                  |               |                  |                   |            |
| Equity securities                         | 602           | 6                | (86)              | ) 522      |
| Mutual funds                              | 1,936         | —                | (28)              | ) 1,908    |
| Subtotal                                  | 2,538         | 6                | (114)             | ) 2,430    |
| Level 2:                                  |               |                  |                   |            |
| Corporate fixed income                    | 18,270        | 48               | (105)             | ) 18,213   |
| Government securities                     | 195           | 14               | —                 | ) 209      |
| Municipal bonds                           | 4,525         | 4                | (15)              | ) 4,514    |
| Certificates of deposit and time deposits | 10,891        | 1                | —                 | ) 10,892   |
| Asset backed securities                   | 1,447         | —                | (5)               | ) 1,442    |
| Subtotal                                  | 35,328        | 67               | (125)             | ) 35,270   |
| Total                                     | 37,866        | 73               | (239)             | ) 37,700   |
| Liabilities                               |               |                  |                   |            |
| Level 1:                                  |               |                  |                   |            |
| Deferred director stock units             | 263           | —                | —                 | ) 263      |
| Phantom stock units                       | 30            | —                | —                 | ) 30       |
| Total                                     | 293           | —                | —                 | ) 293      |

The Company recognized a net realized loss on investments during the nine months ended September 28, 2013 of \$7 and a net realized gain of \$27 during the nine months ended September 29, 2012. As of September 28, 2013, gross unrealized losses related to individual securities that had been in a continuous loss position for 12 months or longer were not significant. The Company considers these unrealized losses in market value of its investments to be temporary in nature. When evaluating an investment for other-than-temporary impairment, the Company reviews factors such as the length of time and extent to which fair value has been below its cost basis, the financial condition of the issuer and any changes thereto, and the Company's intent to sell, or whether it is more likely than not it will be required to sell, the investment before recovery of the investment's cost basis. During the nine months ended September 28, 2013, the Company recognized an impairment charge of \$61, which is included in the net realized loss for the period. This resulted from the deterioration of the financial condition of an issuer of a corporate bond security. Maturities of investments at September 28, 2013 are as follows:

|   | Adjusted Cost | Fair Value |
|---|---------------|------------|
| Due in less than one year                 | \$18,686      | \$18,644   |
| Due after one year but within five years  | 10,440        | 10,286     |
| Due after five years but within ten years | 3,476         | 3,474      |
| Due after ten years                       | 3,501         | 3,377      |
| Equity securities                         | 1,363         | 1,347      |
| Mutual Funds                              | 3,537         | 3,516      |
| Total                                     | \$41,003      | \$40,644   |

The Company reports deferred director stock units and phantom stock units as a liability. All remaining deferred stock units were issued in 2013. The Company recognized expense relating to these liabilities of \$50 and \$74, for the periods ended September 28, 2013, and September 29, 2012. Phantom stock units vest over a period of three years. The Company did not have any fair value adjustments for assets and liabilities measured at fair value on a nonrecurring basis during the period ended September 28, 2013.

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## 12. ACCUMULATED OTHER COMPREHENSIVE INCOME

Changes in Accumulated Other Comprehensive Income by Component

Nine Months Ended September 28, 2013

|  | Unrealized<br>Gains and<br>Losses on<br>Available-for-<br>Sale<br>Securities | Foreign<br>Currency<br>Items | Total |
|--|--|------------------------------|-------|
| Balance at December 29, 2012                                     | \$(166   | ) \$769                      | \$603 |
| Other comprehensive income (loss) before reclassifications       | (198   | ) 562                        | 364   |
| Amounts reclassified from accumulated other comprehensive income | 5  | —                            | 5     |
| Net current period other comprehensive income (loss)             | (193   | ) 562                        | 369   |
| Balance at September 28, 2013                                    | \$(359   | ) \$1,331                    | \$972 |
| Reclassifications out of Accumulated Other Comprehensive Income  |  |                              |       |
| Nine Months Ended September 28, 2013                             |  |                              |       |

| Details about Accumulated Other<br>Comprehensive Income<br>Components | Amount<br>Reclassified<br>from AOCI | Three Months<br>Ended September<br>28, 2013 | Nine months ended<br>September 28, 2013 | Affected Line<br>Item in the<br>Consolidated<br>Statements of Operations |
|---|-------------------------------------|---|---|--|
| Unrealized gains and losses on<br>available-for-sale securities       |                                     |   |   |  |
| Realized gain/(loss) on sale of<br>securities                         | \$(2                                | )   | \$54                                    | Miscellaneous (income) expense, net                                      |
| Other than temporary impairment                                       | —                                   | (61   | )                                       | Miscellaneous (income) expense, net                                      |
|   | (2                                  | )   | (7                                      | ) Total before tax   |
|   | 1                                   | 2   |   | Tax benefit  |
|   | \$(1                                | )   | \$(5                                    | ) Net of tax   |
| Total reclassifications for the<br>period                             | \$(1                                | )   | \$(5                                    | )  |

## 13. NEW ACCOUNTING PRONOUNCEMENTS

In July 2013, the FASB issued guidance on the Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. Under the guidance, an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, noting several exceptions. This guidance is effective for fiscal and interim reporting periods beginning after December 15, 2013. The Company has determined that this new guidance will not have a material impact on its consolidated financial statements.

In February 2013, the FASB issued guidance on the Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income. The guidance requires that companies present either in a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source (e.g., the release due to cash flow hedges from interest rate contracts)

and the income statement line items affected by the reclassification (e.g., interest income or interest expense). If a component is not required to be reclassified to net income in its entirety (e.g., the net periodic pension cost), companies would instead cross reference to the related footnote for additional information (e.g., the pension footnote). This guidance is effective for fiscal and

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interim reporting periods beginning after December 15, 2012. The Company adopted this guidance in the first quarter of 2013. There was no material impact as a result of this.

## 14. 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 results of operations, financial position or cash flows of the Company.

## Item 2. 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 wholly-owned subsidiaries and independent distributors. Sales outside the United States for the year ended December 29, 2012, were approximately 60% of total net sales.

Approximately two-thirds of Sun's products are used by the mobile market, which is characterized by applications where the equipment is not fixed in place, the operating environment is often unpredictable, and duty cycles are generally moderate to low. Some examples of the mobile market include equipment used in off-road construction, agriculture, fire and rescue, utilities, oil fields, and mining.

The remaining one-third of products sold are used by industrial markets, which are characterized by equipment that is fixed in place, typically in a controlled environment, and which operates at higher pressures and duty cycles. Power units, automation machinery, metal cutting machine tools and plastics machinery are some examples of industrial equipment. The Company sells to both markets with a single product line.

## Industry conditions

Demand for the Company's products is dependent on demand for the capital goods into which the products are incorporated. The capital goods industries in general, and the fluid power industry specifically, are subject to economic cycles. According to the National Fluid Power Association (the fluid power industry's trade association in the United States), the United States index of shipments of hydraulic products increased 1% and 24% in 2012 and 2011. The index of shipments of hydraulic products decreased 2% for the three-month period ending September 28, 2013, compared to the same period of the prior year.

The Company's order trend has historically tracked closely to the United States Purchasing Managers Index (PMI). When PMI is over 50, it indicates economic expansion in the manufacturing sector; when it is below 50, it indicates contraction. The index increased to 56.2 in September 2013 compared to 51.6 in September 2012. The U.S. PMI index registered 56.4 for October, the fifth consecutive month that PMI has indicated expansion in the manufacturing sector.

## Results for the third quarter

(in millions except net income per share)

|                       | September 28,<br>2013 | September 29,<br>2012 | Increase/(Decrease) |    |
|-----------------------|-----------------------|-----------------------|---------------------|----|
| Three Months Ended    |                       |                       |                     |    |
| Net sales             | \$49.4                | \$48.8                | 1                   | %  |
| Net income            | \$8.3                 | \$8.8                 | (6                  | )% |
| Net income per share: |                       |                       |                     |    |
| Basic                 | \$0.32                | \$0.34                | (6                  | )% |
| Diluted               | \$0.32                | \$0.34                | (6                  | )% |
| Nine months ended     |                       |                       |                     |    |
| Net sales             | \$156.2               | \$161.1               | (3                  | )% |
| Net income            | \$29.6                | \$30.7                | (3                  | )% |
| Net income per share: |                       |                       |                     |    |
| Basic                 | \$1.13                | \$1.19                | (5                  | )% |

|         |        |        |    |    |
|---------|--------|--------|----|----|
| Diluted | \$1.13 | \$1.18 | (4 | )% |
| 18      |        |        |    |    |

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Third quarter sales were consistent with the Company's forecast, with demonstrated strength in international markets. Asia/Pacific sales were up nearly 12% and Europe sales were up almost 5%. Earnings came in at the lower end of the forecast range due to higher than expected taxes of approximately \$0.01 per share.

While North American sales were down 5% for the quarter, longer-term indicators - specifically U.S. and global PMI numbers - are pointing to a more favorable macro environment. Management believes these indicators should positively impact demand for Sun's products throughout the fourth quarter and into 2014.

The Company's third factory in Sarasota is open and producing products. The relocation of machinery and employees from the Company's Kansas location is now complete. This allows the Company to consolidate important functions, including manifold design and manufacturing, shipping, and its integrated package business. Management expects these changes will generate efficiencies and allow the Company to better serve its customers. Management believes the new factory will provide the capacity necessary to meet demand through the next growth cycle.

Management expects the fourth quarter to be a great ending to another profitable and successful year. As signals indicate, the global economy is improving and management expects to head into the new year with momentum. Management believes the Company is poised and ready to capitalize on early-cycle opportunities. As in past cycles, the Company's efforts will remain on satisfying customer demand, growing market share, and delivering strong financial results.

### Outlook

Fourth quarter 2013 revenues are expected to be approximately \$48 million, up approximately 11% from the fourth quarter of 2012. Earnings per share are estimated to be \$0.31 to \$0.33 compared to \$0.26 in the same period a year ago. The earnings estimate is negatively impacted by approximately \$0.01 per share due to the completion of the relocation of the Company's Kansas operations to Sarasota.

Management estimates year-end 2013 sales to be approximately \$204 million, equal to 2012 sales. Earnings per share for 2012 are estimated to be \$1.44 to \$1.46, compared to \$1.43 in 2012.

### COMPARISON OF THE THREE MONTHS ENDED SEPTEMBER 28, 2013 AND SEPTEMBER 29, 2012

Historically the Company had four operating and reportable segments, which were based on the geographic location of its subsidiaries. In 2012, the Company re-evaluated its operating and reportable segments, resulting in a change to a single reportable segment in manufacturing, marketing, selling and distributing its products worldwide. Prior period financial information included herein has been restated to reflect the financial position and results of operations as one segment.

#### Net Sales

Net sales were \$49.4 million, an increase of \$0.5 million, or 1.1%, compared to \$48.8 million in 2012. The increase in net sales was driven by stronger demand in our international end markets, which primarily includes capital goods equipment. Changes in exchange rates had a positive impact on sales of approximately \$0.3 million. New product sales (defined as products introduced within the last five years) continue to make up 10 - 15% of total sales.

Sales to the Americas decreased 4.6% or \$1.2 million, to \$24.9 million in the third quarter of 2013, driven by weaker North American demand. Asian/Pacific sales increased 11.6% or \$1.0 million, to \$9.6 million in the third quarter of 2013, primarily related to demand from Korea and China. This was partially offset by weaker demand in Australia. Exchange rates had a \$0.1 million positive impact on Asia/Pacific sales in the third quarter of 2013. EAME sales increased 5.3% or \$0.7 million, to \$14.8 million in the third quarter of 2013, primarily related to demand in Germany. Sales to Europe improved during the third quarter, after a general economic downturn experienced in this region over the past year. Exchange rates had a positive impact on sales to EAME of approximately \$0.2 million in the third quarter of 2013.

Gross Profit

Gross profit increased \$0.2 million or 1.1% to \$19.6 million in the third quarter of 2013, compared to \$19.4 million in the third quarter last year. Gross profit as a percentage of net sales remained constant at 39.7% in the third quarter of 2013. The increase in gross profit was primarily attributable to increased sales volume in the current quarter.

Selling, Engineering and Administrative Expenses



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Selling, engineering and administrative expenses increased 5.4%, or \$0.3 million, to \$6.5 million in the third quarter of 2013, compared to \$6.2 million last year. The change for the third quarter is related to increases in compensation of approximately \$0.2 million, due to stock compensation and currency effects. The current period also includes costs associated with Seungwon of approximately \$0.1 million, which were not present in the prior year.

### Operating Income

Operating income decreased \$0.1 million or 0.9% to \$13.1 million in the third quarter of 2013, compared to \$13.2 million in the third quarter last year, with operating margins of 26.5% and 27.0% for the third quarters of 2013 and 2012, respectively. This decrease was primarily related to the increased selling, engineering and administration costs, which were partially offset by income due to the higher sales volume.

### Interest Income, Net

Net interest income was \$0.3 million for the quarter ended September 28, 2013, compared to \$0.4 million for the quarter ended September 29, 2012. The Company currently has no outstanding debt. Total average cash and investments for the quarter ended September 28, 2013, was \$83.1 million compared to \$87.8 million for the quarter ended September 29, 2012.

### Miscellaneous (Income) Expense, Net

There was net miscellaneous loss of \$0.5 million for the quarter ended September 28, 2013, compared to a minimal amount for the quarter ended September 29, 2012. The current period amount is primarily related to losses on the disposal of assets associated with the relocation of our Kansas facility to Sarasota.

### Income Taxes

The provision for income taxes for the quarter ended September 28, 2013, was 35.3% of pretax income compared to 35.0% for the quarter ended September 29, 2012. For the current period, taxes include discrete items of approximately 1.9% of pretax income related reserves for uncertain tax positions and provision to return true-ups. The prior year period included discrete items of approximately 1.5% of pretax income.

## COMPARISON OF THE NINE MONTHS ENDED SEPTEMBER 28, 2013 AND SEPTEMBER 29, 2012

### Net Sales

Net sales were \$156.2 million in 2013, a decrease of \$4.9 million, or 3.0%, compared to \$161.1 million in 2012. The decrease in net sales was primarily driven by weaker demand in our North American and European end markets, which primarily include capital goods equipment. A price increase, effective July 1, 2012, contributed approximately 2%, or \$3.3 million to sales. Changes in exchange rates had a positive impact on sales of approximately \$0.7 million. New product sales (defined as products introduced within the last five years) continue to make up 10 - 15% of total sales.

Sales to the Americas decreased 5.7% or \$4.6 million, to \$76.9 million in 2013, driven by weaker North American demand. Asian/Pacific sales increased 1.9% or \$0.6 million, to \$32.6 million in 2013, primarily related to demand from Korea and China. For the year, sales to China are up 10.8%. These increases were partially offset by reduced demand in Australia. Exchange rates had a \$0.5 million positive impact on Asia/Pacific sales in 2013. EAME sales decreased 1.9% or \$0.9 million, to \$46.7 million in 2013, resulting from the general economic slowdown in Europe. However, this decline was mostly attributable to the first quarter. Second quarter sales improved sequentially and were essentially level with the comparable period last year, while third quarter sales improved 5.3% compared to the prior year period. There was a positive impact from currency to EAME sales in 2013 of approximately \$0.2 million.

### Gross Profit

Gross profit decreased \$1.1 million or 1.7% to \$63.5 million in 2013, compared to \$64.6 million last year. Gross profit as a percentage of net sales increased to 40.7% in 2013, compared to 40.1% last year.

Lower sales volume reduced gross profit by approximately \$3.3 million. Increases in labor as a percent of sales reduced gross profit by approximately \$0.7 related primarily to the addition of Seungwon. Overhead expenses as a percent of sales decreased gross profit by approximately \$0.4 million. These decreases in gross profit were partially offset by a price increase in July 2012 of approximately \$3.3 million.

Selling, Engineering and Administrative Expenses

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Selling, engineering and administrative expenses increased 0.5%, or \$0.1 million, to \$19.8 million in 2013, compared to \$19.7 million last year. The change for 2013 was related to increases in compensation of approximately \$0.4 million, due to stock compensation and currency effects. The current period also includes costs associated with Seungwon of approximately \$0.3 million, which were not present in the prior year. These increases were partially offset by reduced benefit costs and professional fees each equal to approximately \$0.2 million.

### Operating Income

Operating income decreased \$1.2 million or 2.6% to \$43.8 million in 2013, compared to \$44.9 million last year, with operating margins of 28.0% and 27.9% for 2013 and 2012, respectively. This decrease was primarily related to the reduced sales volume in the current year.

### Interest Income, Net

Net interest income was \$0.7 million in 2013, compared to \$1.0 million in 2012. The Company currently has no outstanding debt. Total average cash and investments for the nine months ended September 28, 2013, was \$80.0 million compared to \$82.2 million for the nine months ended September 29, 2012.

### Miscellaneous (Income) Expense, Net

There was net miscellaneous loss of \$0.1 million in 2013, compared to net miscellaneous income of \$0.2 million in 2012. The current period amount is primarily related to losses on the disposal of assets associated with the relocation of our Kansas facility to Sarasota. These charges were partially offset by a gain of \$0.5 million as a result of remeasuring to fair value our 40% equity interest in WhiteOak Controls held before the business combination. The prior period includes an incentive received for our thermal storage energy building.

### Income Taxes

The provision for income taxes for the nine months ended September 28, 2013, was 33.3% of pretax income compared to 33.5% for the nine months ended September 29, 2012. The change was primarily due to the relative levels of income and different tax rates in effect among the countries in which the Company sells its products. For both periods, taxes include discrete items of approximately 0.5% of pretax income. The current period related to reserves for uncertain tax positions and provision to return true-ups. The prior year period related to reserves for uncertain tax positions, which were partially offset by provision to return true-ups.

## LIQUIDITY AND CAPITAL RESOURCES

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

Cash from operations for the nine months ended September 28, 2013, was \$36.8 million, a decrease of \$3.3 million, compared to \$40.1 million for the nine months ended September 29, 2012. Net income was down approximately \$1.1 million from the prior period. Changes in working capital relating to increases in accounts receivable were \$4.5 million during 2013, compared to \$2.1 million during 2012. Increases in inventory were \$0.2 million during 2013, compared to \$0.1 million during 2012. Increases in accounts payable and accruals were \$3.3 million during 2013, compared to \$3.8 million during 2012. These working capital changes are typical of improved business conditions in 2013 compared to those experienced in the Company's fourth quarter of 2012. Cash on hand increased \$12.0 million from \$34.5 million at the end of 2012 to \$46.5 million at September 28, 2013. Days sales outstanding (DSO) were 34 at September 28, 2013, and September 29, 2012. Inventory turns were 9.3 as of September 28, 2013, and 9.1 as of September 29, 2012.

In 2012, the Company began construction on a third facility in Sarasota, Florida. The new facility has 58,000 square feet of manufacturing and 17,000 square feet of office space. The total investment is approximately \$17.0 million. The Company began moving manufacturing operations into the facility during the third quarter of 2013 and expects to occupy the office space in the fourth quarter. As part of this transition, the Company has announced that it will close its Kansas location and move those operations to this new facility. Total one-time costs to relocate this operation are estimated to be \$0.7 million, half of which were incurred in the third quarter and the remainder will be incurred in the fourth quarter. Fixed costs associated with the new facility, net of the savings realized from relocating the Kansas

facility, are estimated to be \$1.0 million annually.

Capital expenditures were \$14.6 million for the nine months ended September 28, 2013. Approximately \$9.2 million related to the Company's new facility in Sarasota, Florida, and \$1.1 million related to the renovation of its UK facility. The remainder is

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made up primarily of purchases of machinery and equipment. Capital expenditures, consisting primarily of machinery and equipment, were \$6.7 million for the nine months ended September 29, 2012. Capital expenditures for the current year are projected to be approximately \$17.0 million, which includes approximately \$10.0 million related to the new facility.

The Company declared a quarterly cash dividend of \$0.09 per share payable on October 15, 2013, to shareholders of record as of September 30, 2013. The declaration and payment of future dividends is subject to the sole discretion of the Board of Directors, and any determination as to the payment of future dividends will depend upon the Company's profitability, financial condition, capital needs, future prospects and other factors deemed pertinent by the Board of Directors.

The Company believes that cash generated from operations and its borrowing availability under its revolving line of credit will be sufficient to satisfy the Company's operating expenses and capital expenditures for the foreseeable future. In the event that economic conditions were to severely worsen for a protracted period of time, the Company would have several options available to ensure liquidity in addition to increased borrowing. Capital expenditures could be postponed since they primarily pertain to long-term improvements in operations. Additional operating expense reductions also could be made. Finally, the dividend to shareholders could be reduced or suspended.

### Off Balance Sheet Arrangements

The Company does not engage in any off balance sheet financing arrangements. In particular, the Company does not have any material interest in variable interest entities, which include special purpose entities and structured finance entities.

Through the first quarter, the Company used the equity method of accounting to account for its investment in WhiteOak. The Company did not have a majority ownership in or exercise control over the entity. The investment was not material to the financial statements of the Company at March 30, 2013. On April 1, 2013, Sun Hydraulics purchased the remaining 60% of WhiteOak (see note 7).

### Seasonality

The Company generally has experienced increased sales during the second quarter of the year, largely as a result of the order patterns of our customers. The Company's second quarter net sales, income from operations and net income historically are the highest 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. 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.

### Critical Accounting Policies and Estimates

The Company currently applies judgment and estimates which may have a material effect on the eventual outcome of assets, liabilities, revenues and expenses for impairment of long-lived assets, inventory, goodwill, accruals, and income taxes. The Company's critical accounting policies and estimates are included in its Annual Report on Form 10-K for the year ended December 29, 2012, and did not change during the first nine months of 2013.

### FORWARD-LOOKING INFORMATION

Certain oral statements made by management from time to time and certain statements contained herein that are not historical facts are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934 and, because such statements involve risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Forward-looking statements, including those in Management's Discussion and Analysis of Financial Condition and Results of Operations, are statements regarding the intent, belief or current expectations, estimates or projections of the Company, its Directors or its Officers about the Company and the industry in which it operates, and assumptions made by management, and include among other items, (i) the Company's strategies regarding growth, including its intention to develop new products; (ii) the Company's financing plans; (iii) trends affecting the Company's financial condition or results of operations; (iv) the Company's ability to continue to control costs and to meet its liquidity and other financing needs; (v) the declaration

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

Important factors that could cause the actual results to differ materially from those in the forward-looking statements include, among other items, (i) the economic cyclicity of the capital goods industry in general and the hydraulic valve and manifold

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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 costs, such as increased competition, lack of qualified engineering, marketing, management or other personnel, and increased labor and raw materials costs; (iv) changes in technology or customer requirements, such as standardization of the cavity into which screw-in cartridge valves must fit, which could render the Company's products or technologies noncompetitive or obsolete; (v) new product introductions, product sales mix and the geographic mix of sales nationally and internationally; and (vi) changes relating to the Company's international sales, including changes in regulatory requirements or tariffs, trade or currency restrictions, fluctuations in exchange rates, and tax and collection issues. Further information relating to factors that could cause actual results to differ from those anticipated is included but not limited to information under the headings Item 1. "Business," and Item 1A. "Risk Factors" in the Company's Form 10-K for the year ended December 29, 2012, and "Management's Discussion and Analysis of Financial Conditions and Results of Operations" in this Form 10-Q for the quarter ended September 28, 2013. 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.

### Item 3. 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. The Company's interest rate on its debt financing remains variable based upon the Company's leverage ratio. The Company had no variable-rate debt outstanding at September 28, 2013. Therefore, a 1% change in interest rates up or down would not have a material effect on the Company's income statement on an annual basis.

The Company's exposure to foreign currency exchange fluctuations relates primarily to the direct investment in its facilities in the United Kingdom, Germany and Korea. The Company does not use financial instruments to hedge foreign currency exchange rate changes.

### Item 4. CONTROLS AND PROCEDURES

As of September 28, 2013, the Company's management, under the direction of its Chief Executive Officer and the Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Our disclosure controls and procedures are designed to provide reasonable assurance that the information required to be disclosed in our SEC reports is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms, and is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Based upon that evaluation, the Company's Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level as of September 28, 2013, in timely alerting them to material information required to be included in the Company's periodic SEC filings.

There were no changes in the Company's internal controls over financial reporting during the period ended September 28, 2013, that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II  
OTHER INFORMATION

Item 1. Legal Proceedings.

None.

Item 1A. Risk Factors.

For information regarding risk factors, please refer to Part I, Item 1A in the Company's Annual Report on Form 10-K for the year ended December 29, 2012.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosure

Not applicable.

Item 5. Other Information.

None.



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Item 6. Exhibits.

Exhibits:

| Exhibit<br>Number | Exhibit Description  |
|-------------------|--|
| 31.1              | CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2              | CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1              | CEO Certification pursuant to 18 U.S.C. § 1350.                              |
| 32.2              | CFO Certification pursuant to 18 U.S.C. § 1350.                              |
| 10.1              | Amended and Restated Credit and Security Agreement                           |
| Exhibit 101.1     | Interactive Data File  |
| 101.INS           | XBRL Instance Document   |
| 101.SCH           | XBRL Schema Document   |
| 101.CAL           | XBRL Calculation Linkbase Document   |
| 101.DEF           | XBRL Definition Linkbase Document  |
| 101.LAB           | XBRL Label Linkbase Document   |
| 101.PRE           | XBRL Presentation Linkbase Document  |

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Sarasota, State of Florida on November 5, 2013.

SUN HYDRAULICS CORPORATION

By: /s/ Tricia L. Fulton  
Tricia L. Fulton  
Chief Financial Officer (Principal Financial and Accounting Officer)