

SUN HYDRAULICS CORP

Form 10-Q

August 04, 2016

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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 July 2, 2016 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

59-2754337

(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)

1500 WEST UNIVERSITY PARKWAY 34243  
SARASOTA, FLORIDA

(Address of Principal Executive Offices) (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 26,922,090 shares of common stock, par value \$.001, outstanding as of July 29, 2016.



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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)

	July 2, 2016 (unaudited)	January 2, 2016
Assets		
Current assets:		
Cash and cash equivalents	\$ 99,629	\$ 81,932
Restricted cash	40	44
Accounts receivable, net of allowance for doubtful accounts of \$218 and \$184	19,751	13,531
Inventories	12,310	13,047
Income taxes receivable	—	123
Deferred income taxes	462	460
Short-term investments	38,234	44,174
Other current assets	3,458	3,707
Total current assets	173,884	157,018
Property, plant and equipment, net	71,573	74,121
Goodwill	4,852	4,988
Other assets	6,355	5,413
Total assets	\$ 256,664	\$ 241,540
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable	\$ 5,457	\$ 4,422
Accrued expenses and other liabilities	4,569	4,849
Income taxes payable	1,634	—
Dividends payable	2,422	2,411
Total current liabilities	14,082	11,682
Deferred income taxes	7,665	7,411
Other noncurrent liabilities	—	260
Total liabilities	21,747	19,353
Commitments and contingencies	—	—
Shareholders' equity:		
Preferred stock, 2,000,000 shares authorized, par value \$0.001, no shares outstanding	—	—
Common stock, 50,000,000 shares authorized, par value \$0.001, 26,921,211 and 26,786,518 shares outstanding	27	27
Capital in excess of par value	87,246	82,265
Retained earnings	159,226	149,938
Accumulated other comprehensive income (loss)	(11,582 )	(10,043 )
Total shareholders' equity	234,917	222,187
Total liabilities and shareholders' equity	\$ 256,664	\$ 241,540

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	
	July 2, 2016	June 27, 2015
	(unaudited)	(unaudited)
Net sales	\$50,809	\$ 54,016
Cost of sales	31,856	32,612
Gross profit	18,953	21,404
Selling, engineering and administrative expenses	8,509	7,329
Operating income	10,444	14,075
Interest (income) expense, net	(386 )	(344 )
Foreign currency transaction (gain) loss, net	(151 )	260
Miscellaneous (income) expense, net	387	185
Income before income taxes	10,594	13,974
Income tax provision	3,604	4,726
Net income	\$6,990	\$ 9,248
Basic net income per common share	\$0.26	\$ 0.35
Weighted average basic shares outstanding	26,908	26,684
Diluted net income per common share	\$0.26	\$ 0.35
Weighted average diluted shares outstanding	26,908	26,684
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)

	Six months ended	
	July 2, 2016	June 27, 2015
	(unaudited)	(unaudited)
Net sales	\$101,837	\$108,402
Cost of sales	63,343	65,603
Gross profit	38,494	42,799
Selling, engineering and administrative expenses	16,164	14,615
Operating income	22,330	28,184
Interest (income) expense, net	(758)	) (661 )
Foreign currency transaction (gain) loss, net	(265)	) (699 )
Miscellaneous (income) expense, net	564	212
Income before income taxes	22,789	29,332
Income tax provision	7,591	9,707
Net income	\$15,198	\$19,625
Basic net income per common share	\$0.57	\$0.74
Weighted average basic shares outstanding	26,857	26,645
Diluted net income per common share	\$0.57	\$0.74
Weighted average diluted shares outstanding	26,857	26,645
Dividends declared per share	\$0.270	\$0.270

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		Six months ended	
	July 2,	June 27,	July 2,	June 27,
	2016	2015	2016	2015
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Net income	\$6,990	\$ 9,248	\$15,198	\$ 19,625
Other comprehensive income (loss)				
Foreign currency translation adjustments, net of tax	(2,510 )	2,165	(2,192 )	(2,359 )
Unrealized gain (loss) on available-for-sale securities, net of tax	457	(236 )	653	(148 )
Total other comprehensive income (loss)	(2,053 )	1,929	(1,539 )	(2,507 )
Comprehensive income	\$4,937	\$ 11,177	\$13,659	\$ 17,118

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 shares	Preferred stock	Common shares	Common stock	Capital in excess of par value	Retained earnings	Accumulated other comprehensive income (loss)	Total
Balance, January 2, 2016	—	\$	—26,786	\$ 27	\$ 82,265	\$ 149,938	\$ (10,043 )	\$ 222,187
Shares Issued, Restricted Stock			45					—
Shares issued, other compensation			13					—
Shares issued, ESPP			26		418			418
Shares issued, shared distribution			51		1,679			1,679
Stock-based compensation					2,884			2,884
Dividends declared						(5,910 )		(5,910 )
Net income						15,198		15,198
Other comprehensive income (loss)							(1,539 )	(1,539 )
Balance, July 2, 2016	—	\$	—26,921	\$ 27	\$ 87,246	\$ 159,226	\$ (11,582 )	\$ 234,917

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)

	Six months ended		
	July 2, 2016	June 27, 2015	
	(unaudited)	(unaudited)	
Cash flows from operating activities:			
Net income	\$15,198	\$ 19,625	
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	5,034	4,572	
(Gain)Loss on disposal of assets	316	94	
Provision (benefit) for deferred income taxes	(131	) 98	
Allowance for doubtful accounts	34	(29	)
Stock-based compensation expense	2,884	1,959	
(Increase) decrease in:			
Accounts receivable	(6,254	) (1,992	)
Inventories	737	1,668	
Income taxes receivable	123	—	
Other current assets	249	(37	)
Other assets	(55	) 373	
Increase (decrease) in:			
Accounts payable	1,035	765	
Accrued expenses and other liabilities	1,399	1,050	
Income taxes payable	1,634	327	
Other noncurrent liabilities	(260	) (3	)
Net cash provided by operating activities	21,943	28,470	
Cash flows from investing activities:			
Investment in licensed technology	(850	) (575	)
Capital expenditures	(2,557	) (3,079	)
Proceeds from dispositions of equipment	2	—	
Purchases of short-term investments	(9,637	) (12,025	)
Proceeds from sale of short-term investments	15,803	10,611	
Net cash provided by (used in) investing activities	2,761	(5,068	)
Cash flows from financing activities:			
Proceeds from stock issued	418	550	
Dividends to shareholders	(5,900	) (7,194	)
Change in restricted cash	4	3	
Net cash used in financing activities	(5,478	) (6,641	)
Effect of exchange rate changes on cash and cash equivalents	(1,529	) (1,937	)
Net increase (decrease) in cash and cash equivalents	17,697	14,824	
Cash and cash equivalents, beginning of period	81,932	56,843	
Cash and cash equivalents, end of period	\$99,629	\$ 71,667	
Supplemental disclosure of cash flow information:			
Cash paid:			
Income taxes	\$5,582	\$ 9,369	
Supplemental disclosure of noncash transactions:			
Common stock issued for shared distribution through accrued expenses and other liabilities	\$1,679	\$ 3,535	

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, South 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 (France) (“Sun France”), a liaison office located in Bordeaux, France, is used 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. In 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. In 2013, Sun Hydraulics purchased the remaining 60% of WhiteOak Inc., which was merged into HCT. WhiteOak, designs and produces complementary electronic control products.

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 January 2, 2016, filed by Sun Hydraulics Corporation (together with its subsidiaries, the “Company”) with the Securities and Exchange Commission on March 1, 2016. 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 six month period ended July 2, 2016, are not necessarily indicative of the results that may be expected for the period ending December 31, 2016.

## 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		Six Months Ended	
	July 2, 2016	June 27, 2015	July 2, 2016	June 27, 2015
Net income	\$6,990	\$9,248	\$15,198	\$19,625
Weighted average basic shares outstanding	26,908	26,684	26,857	26,645

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Basic net income per common share	\$0.26	\$0.35	\$0.57	\$0.74
Effect of dilutive stock options	—	—	—	—
Weighted average diluted shares outstanding	26,908	26,684	26,857	26,645
Diluted net income per common share	\$0.26	\$0.35	\$0.57	\$0.74

Table of Contents**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 2011 Equity Incentive Plan ("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 July 2, 2016, 520,612 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 six months ended July 2, 2016 and June 27, 2015, totaled \$2,316 and \$1,402, respectively.

The following table summarizes restricted stock activity from January 2, 2016, through July 2, 2016:

	Number of shares (in thousands)	Weighted average grant-date fair value
Nonvested balance at January 2, 2016	161	33.54
Granted	45	33.22
Vested	(16 )	36.41
Forfeitures	—	—
Nonvested balance at July 2, 2016	190	33.21

The Company had \$3,567 of total unrecognized compensation cost related to restricted stock awards granted under the 2011 Plan as of July 2, 2016. That cost is expected to be recognized over a weighted average period of 0.92 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 25,896 shares at a weighted average price of \$25.89, and 16,866 shares at a weighted average price of \$32.63, under the ESPP during the six months ended July 2, 2016 and June 27, 2015, respectively. The Company recognized \$137 and \$124 of compensation expense during the six months ended July 2, 2016 and June 27, 2015, respectively. At July 2, 2016, 593,444 shares remained available to be issued through the ESPP and the U.K. plan.

In March 2012, 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 initially adopted, 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 was paid 500 shares of Common Stock. The Chairman's fee was twice that of a regular director, and the fee for the chairs of each Board Committee was 125% that of a regular director. In February 2015, the Board adopted amendments to the 2012 Directors Plan which revised the compensation for Nonemployee Directors. Each Nonemployee Director now receives an annual retainer of 2,000 shares of Common Stock. The Chairman's retainer is twice that of a regular director, and the retainer for the chairs of each Board Committee is 150% that of a regular director. In addition, each Nonemployee Director receives 250 shares of Common Stock for attendance at each Board meeting and each meeting of each

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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. In June 2015, the Company's shareholders approved the amendments to the 2012 Directors Plan.

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 35,000 shares. The 2012 Directors Plan authorizes the issuance of up to 270,000 shares of common stock. At July 2, 2016, 186,624 shares remained available for issuance under the 2012 Directors Plan. Directors were granted 12,750 and 10,625 shares for the six months ended July 2, 2016 and June 27, 2015, respectively. The Company recognized director stock compensation expense of \$407 and \$409 for the six months ended July 2, 2016 and June 27, 2015, respectively.

#### 4. RESTRICTED CASH

On July 2, 2016, the Company had restricted cash of \$40. A restricted cash reserve for customs and excise taxes in the U.K. operation was \$40 at July 2, 2016. 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.

#### 5. INVENTORIES

	July 2, 2016	January 2, 2016
Raw materials	\$5,404	\$5,555
Work in process	4,269	4,478
Finished goods	3,121	3,464
Provision for slow moving inventory	(484 )	(450 )
Total	\$12,310	\$13,047

#### 6. GOODWILL AND INTANGIBLE ASSETS

A summary of changes in goodwill at July 2, 2016 is as follows:

Balance, January 2, 2016	\$4,988
Acquisitions	—
Currency translation	(136 )
Balance, July 2, 2016	\$4,852

Valuation models reflecting the expected future cash flow projections are used to value reporting units. A valuation of the reporting unit at January 2, 2016 indicated that there was no impairment of the carrying value of the goodwill at Sun Korea. A valuation of the reporting unit at September 26, 2015 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. In 2014, the Company entered into a licensing agreement with Sturman Industries, Inc., recognizing intangible assets of \$1,075 in 2014 and \$1,425 in 2015, and \$850 in the six months ending July 2, 2016. The agreement is for licensed technology to be used with the Company's electrically actuated hydraulic cartridge valves. Royalties will be paid from the date of the first commercial sale and continue for fifteen years thereafter, or until the last related licensed patent expires, whichever is the later date. At July 2, 2016 and January 2, 2016, intangible assets consisted of the following:





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	July 2, 2016			January 2, 2016		
	Gross carrying amount	Accumulated amortization	Net carrying amount	Gross carrying amount	Accumulated amortization	Net carrying amount
Definite-lived intangibles:						
Trade Name	\$774	\$ (378)	) \$ 396	\$774	\$ (340)	) \$ 434
Non-compete agreement	11	(11)	) —	11	(11)	) —
Technology	935	(405)	) 530	935	(304)	) 631
Customer relationships	1,751	(410)	) 1,341	1,751	(363)	) 1,388
Licensing agreement	3,350	(256)	) 3,094	2,500	(140)	) 2,360
	\$6,821	\$ (1,460)	) \$ 5,361	\$5,971	\$ (1,158)	) \$ 4,813

Total estimated amortization expense for the years 2017 through 2021 is presented below. The remaining amortization for 2016 is approximately \$236.

Year:

2017 486

2018 486

2019 486

2020 486

2021 486

Total \$2,430

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 six months ended July 2, 2016.

## 7. LONG-TERM DEBT

Effective August 1, 2011, the Company entered into a credit and security agreement in the U.S. with Fifth Third Bank (the “Bank”). The agreement initially provided for three separate credit facilities totaling \$50,000. As noted below, at July 2, 2016, two of the original facilities remained available.

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. The Company did not activate Facility C for the construction of its new Sarasota factory and access to this facility has expired.

Facility A or Facility B (if activated) is payable in full on August 1, 2016. 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 July 2, 2016, the Company was in compliance with all debt covenants related to Facility A as follows:

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Covenant	Required Ratio/Amount	Actual Ratio/Amount
Minimum Tangible Net Worth	\$194,585	\$224,704
Minimum EBITDA	Not less than \$5 million	\$51,695

If Facility B is 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 July 2, 2016, the Company had not activated Facility B.

The Company did not have any amounts drawn on Facilities A, B, or C for the periods ended July 2, 2016, and June 27, 2015. See Note 14, Subsequent Event, for additional information.

**8. INCOME TAXES**

At July 2, 2016, the Company had an unrecognized tax benefit of \$2,142 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 July 2, 2016, 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 2005 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 2005 through 2012. 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 2005 through 2012 with the IRS and that there could be significant increases or decreases to unrecognized tax benefits.

**9. SEGMENT REPORTING**

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 has only one operating and reporting segment for both internal and external reporting purposes.

**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 Ended July 2, 2016	Three Months Ended June 27, 2015	Six months ended July 2, 2016	Six months ended June 27, 2015
Net sales				
Americas	\$23,402	\$25,940	\$48,117	\$51,829
Europe/Africa/ME	15,803	16,302	31,480	32,916
Asia/Pacific	11,604	11,774	22,240	23,657
Total	\$50,809	\$54,016	\$101,837	\$108,402

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	July 2, 2016	January 2, 2016
Total assets		
Americas	\$184,356	\$168,662
Europe/Africa/ME	55,988	56,720
Asia/Pacific	16,320	16,158
Total	\$256,664	\$241,540
Long-lived assets		
Americas	\$71,518	\$72,529
Europe/Africa/ME	6,939	7,923
Asia/Pacific	4,323	4,070
Total	\$82,780	\$84,522

**10. 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.

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 and mutual funds 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 short-term 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.

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The following tables provide information regarding the Company's assets and liabilities measured at fair value on a recurring basis at July 2, 2016 and January 2, 2016.

	July 2, 2016				
	Adjusted Cost	Unrealized Gains	Unrealized Losses	Fair Value	
Assets					
Level 1:					
Equity securities	\$638	\$ 12	\$ (35 )	\$ 615	
Mutual funds	2,209	36	(267 )	1,978	
Subtotal	\$2,847	\$ 48	\$ (302 )	\$ 2,593	
Level 2:					
Corporate fixed income	\$31,649	\$ 121	\$ (803 )	\$ 30,967	
Municipal bonds	2,979	9	(41 )	2,947	
Certificates of deposit and time deposits	1,324	—	—	1,324	
Asset backed securities	402	2	(1 )	403	
Subtotal	\$36,354	\$ 132	\$ (845 )	\$ 35,641	
Total	\$39,201	\$ 180	\$ (1,147 )	\$ 38,234	
Liabilities					
Level 2:					
Phantom stock units	\$21	\$ —	\$ —	\$ 21	
Total	\$21	\$ —	\$ —	\$ 21	

	January 2, 2016				
	Adjusted Cost	Unrealized Gains	Unrealized Losses	Fair Value	
Assets					
Level 1:					
Equity securities	\$1,318	\$ 28	\$ (36 )	\$ 1,310	
Mutual funds	2,611	1	(238 )	2,374	
Subtotal	\$3,929	\$ 29	\$ (274 )	\$ 3,684	
Level 2:					
Corporate fixed income	\$35,936	\$ 8	\$ (1,682 )	\$ 34,262	
Municipal bonds	2,897	—	(94 )	2,803	
Certificates of deposit and time deposits	2,947	—	—	2,947	
Asset backed securities	498	—	(20 )	478	
Subtotal	\$42,278	\$ 8	\$ (1,796 )	\$ 40,490	
Total	\$46,207	\$ 37	\$ (2,070 )	\$ 44,174	
Liabilities					
Level 2:					
Phantom stock units	\$17	\$ —	\$ —	\$ 17	
Total	\$17	\$ —	\$ —	\$ 17	

The Company recognized a net realized loss on investments during the six months ended July 2, 2016 of \$309 and a net realized loss of \$117 during the six months ended June 27, 2015. As of July 2, 2016, 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 six months ended July 2, 2016, the Company recognized an impairment charge of \$276, which is included in the net realized loss for the period. There were no

other-than-temporary impairments during the six month periods ended June 27, 2015.

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Maturities of investments at July 2, 2016 are as follows:

	Adjusted Cost	Fair Value
Due in less than one year	\$ 10,758	\$ 10,699
Due after one year but within five years	16,658	16,218
Due after five years but within ten years	5,030	4,954
Due after ten years	3,908	3,770
Total	\$ 36,354	\$ 35,641

The Company reports phantom stock units as a liability. The Company recognized expense relating to this liability of \$4 and \$17, for the six month periods ended July 2, 2016 and June 27, 2015, respectively. 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 July 2, 2016.

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## Changes in Accumulated Other Comprehensive Income by Component

Six Months Ended July 2, 2016

	Unrealized Gains and Losses on Available-for- Sale Securities	Foreign Currency Items	Total
Balance at January 2, 2016	\$ (1,262 )	\$(8,781 )	\$(10,043)
Other comprehensive income (loss) before reclassifications	458	(2,192 )	(1,734 )
Amounts reclassified from accumulated other comprehensive income	195	—	195
Net current period other comprehensive income (loss)	653	(2,192 )	(1,539 )
Balance, July 2, 2016	\$ (609 )	\$(10,973 )	\$(11,582)
Reclassifications out of Accumulated Other Comprehensive Income			
Six Months Ended July 2, 2016			

Details about Accumulated Other Comprehensive Income Components	Six Months Ended July 2, 2016	Affected Line Item in the Consolidated Statements of Operations
Unrealized gains and losses on available-for-sale securities		
Realized gain/(loss) on sale of securities	\$ (33 )	Miscellaneous (income) expense, net
Other than temporary impairment	(276 )	Miscellaneous (income) expense, net
	(309 )	Total before tax
	114	Tax benefit
	\$(195 )	Net of tax
Total reclassifications for the period	\$(195 )	

**12. NEW ACCOUNTING PRONOUNCEMENTS**

In June 2016, the FASB issued guidance on a new credit loss standard that replaces the incurred loss impairment methodology in current GAAP. The new impairment model requires immediate recognition of estimated credit losses expected to occur for most financial assets and certain other instruments. For available-for-sale debt securities with unrealized losses, the losses will be recognized as allowances rather than reductions in the amortized cost of the securities. It is effective for annual reporting periods beginning after December 15, 2019 and interim periods within those annual periods. Early adoption for fiscal year beginning after December 15, 2018 is permitted. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first effective reporting period. The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements.

In March 2016, the FASB issued guidance on Compensation-Stock Compensation, Improvements to Employee Share-Based Payment Accounting, which is intended to simplify several aspects of accounting for share-based payment awards. The effective date will be the first quarter of fiscal year 2017, with early adoption permitted. The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated



financial statements.

In March 2016, the FASB issued guidance on Investments-Equity Method and Joint Ventures which eliminates the retroactive adjustments to an investment qualifying for the equity method of accounting as a result of an increase in the level of ownership

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interest or degree of influence by the investor. The effective date will be the first quarter of fiscal year 2017. The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements.

In March 2016, the FASB issued guidance on Derivatives and Hedging which simplifies the embedded derivative analysis for debt instruments containing contingent call or put options by clarifying that an exercise contingency does not need to be evaluated to determine whether it relates to interest rates and credit risk in an embedded derivative analysis. The effective date will be the first quarter of fiscal year 2017, with early adoption permitted. The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements.

In February 2016, the FASB issued guidance on Accounting for Leases, which requires an entity to recognize both assets and liabilities arising from financing and operating leases, along with additional qualitative and quantitative disclosures. The guidance is effective for reporting periods beginning after December 15, 2018 with early adoption permitted. The Company is currently evaluating the effects, if any, adoption of this guidance will have on the Company's consolidated financial statements.

In January 2016, the FASB issued guidance on changes to the accounting for financial instruments that primarily affect equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. This standard is effective in 2018 with certain provisions allowing for early adoption. The Company is currently evaluating the effects, if any, adoption of this guidance will have on the Company's consolidated financial statements.

In November 2015, the FASB issued guidance that requires all deferred tax assets and liabilities, along with any related valuation allowance, to be classified as noncurrent on the Consolidated Statement of Financial Position. Previous guidance requires the deferred taxes for each jurisdiction to be presented as a net current asset or liability and net noncurrent asset or liability. As a result of the new guidance, each jurisdiction will now only have one net noncurrent deferred tax asset or liability. The new guidance does not change the existing requirement that only permits offsetting deferred tax assets and liabilities within a single jurisdiction. The new guidance is effective January 1, 2017, with early adoption permitted. The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements.

In July 2015, the FASB issued guidance on Simplifying the Measurement of Inventory. The guidance requires inventory be measured at the lower of cost and net realizable value. Additionally, the guidance defines net realizable value as estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The guidance is effective for reporting periods beginning after December 15, 2016 and interim periods within those fiscal years with early adoption permitted. The guidance should be applied prospectively. The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements.

In August 2014, the FASB issued guidance on Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern. The guidance requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued and provides guidance on determining when and how to disclose going concern uncertainties in the financial statements. Certain disclosures will be required if conditions give rise to substantial doubt about an entity's ability to continue as a going concern. The guidance applies to all entities and is effective for annual and interim reporting periods ending after December 15, 2016, with early adoption permitted. The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements.

In May 2014, the FASB issued guidance on Revenue from Contracts with Customers, to clarify the principles used to recognize revenue for all entities. The core principle of the new guidance is that an entity will recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. The standard provides a five-step analysis of

transactions to determine when and how revenue is recognized. Additionally, the guidance requires disaggregated disclosures related to the nature, amount, timing, and uncertainty of revenue that is recognized. The guidance was originally to be effective for annual and interim periods beginning after December 15, 2016. The FASB has subsequently delayed this standard by one year. Early adoption is permitted as of the original effective date. The Company is currently evaluating the effects, if any, adoption of this guidance will have on the Company's consolidated financial statements.

### 13. 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.

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14. SUBSEQUENT EVENT

On July 29, 2016 the Company entered into a new credit agreement (the “2016 Credit Agreement”), with PNC Bank, National Association (the “Bank”), as administrative agent, and the lenders party thereto.

The 2016 Credit Agreement provides the Company with a revolving line of credit (“the Facility”) of up to \$100 million that is available through July 29, 2021. The 2016 Credit Agreement includes an accordion feature to increase the revolving line of credit by up to an additional \$75 million. Interest is payable quarterly for loans under the Base Rate Option (as defined), and interest is payable on the last day of the applicable Interest Period (as defined) (and, if such Interest Period is longer than three (3) Months, interest is also payable on the 90th day of such Interest Period) for loans under the Euro Rate Option (as defined). The loans under the facility will bear interest at the Euro Rate (as defined) or the Base Rate (as defined), at the Company’s option, plus the Applicable Margin (as defined) based on the Borrower’s Leverage Ratio (as defined). The Applicable Margin ranges from 1.25% to 2.00% for the Euro Rate and ranges from 0.25% to 1.00% for the Base Rate. Subject to customary breakage fees for loans under the Euro Rate Option that are prepaid on a day other than the last day of the applicable Interest Period, prepayment may be made without penalty or premium at any time upon the required notice to the Bank.

The 2016 Credit Agreement requires the Company (together with its subsidiaries) to comply with certain financial tests, including a minimum Interest Coverage Ratio (as defined) of 3.0 to 1.0 and a maximum Leverage Ratio (as defined) of 3.5 to 1.0. As of the date of this filing, the Company was in compliance with all debt covenants related to the Facility.

The 2016 Credit Agreement also requires the Company to comply with a number of restrictive covenants. These covenants limit, in certain circumstances, the Company’s ability to take a variety of actions, including but not limited to: incur indebtedness; create or maintain liens on its property or assets; make investments, loans and advances; repurchase shares of its Common Stock; engage in acquisitions, mergers, joint ventures, consolidations and asset sales; and pay dividends and distributions.

The 2016 Credit Agreement contains customary default provisions and has various non-financial covenants, both requiring the Company to refrain from taking certain future actions (as described above) and requiring the Company to take certain affirmative actions, such as maintaining its corporate existence, paying liabilities timely, maintaining insurance, and providing its bank lending group with financial information on a timely basis. Maturity of the Credit Facility may be accelerated by the Bank upon an Event of Default (as defined).

The Company and certain of its subsidiaries agreed to take certain actions to secure borrowings under the 2016 Credit Agreement. As a result, (i) the Company entered into a Pledge Agreement with the Bank, for the benefit of the lenders, granting a security interest in certain equity ownership in certain of its subsidiaries to secure amounts borrowed under the 2016 Credit Agreement and (ii) the Company’s domestic subsidiary entered into a Guaranty Agreement guarantying payment and performance of the Company’s obligations under the 2016 Credit Agreement.

The 2016 Credit Agreement incorporates sub-facilities for swing loans up to \$15 million and issuance of letters of credit up to \$5 million. Swing loans and letters of credit issued under the 2016 Credit Agreement decrease availability under the \$100 million revolving line of credit.

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Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
OVERVIEW

Sun 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 January 2, 2016, were approximately 58% of total net sales.

Approximately two-thirds of product sales 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 sales 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.

In recent periods, the Company's products have been used by emerging markets that have characteristics of both the mobile and industrial markets and do not conveniently fit either classification exclusively. These markets include alternative energy equipment including wind, wave and solar equipment, animatronics and staging for theater and cinema. The Company sells to these markets the same products used in its traditional markets.

Management and Operations Philosophy

Since its inception, Sun has operated as an entrepreneurial enterprise, with an emphasis on individual employee empowerment and a disinclination to create bureaucracy, a formal management structure or administrative impediments to innovation, efficiency and customer service. Accordingly, the Company's organization, management structure, and reporting and decision-making systems are highly unified and unlayered.

In addition to representative and sales offices located throughout the world, Sun has three subsidiaries outside the United States (in the U.K., Germany and Korea) and one U.S. subsidiary. These entity distinctions arose out of historical considerations or as the result of acquisitions. Nevertheless, and increasingly as it has developed into a global enterprise, the Company is operated and managed on a consolidated basis. Much of the Company's primary financial and operations data is reported from Sun's various legal entities, which are separate taxpayers and, in many cases, subject to statutory audits in the countries in which they are organized. This information from Sun locations around the world is then compiled and aggregated, with appropriate consolidating entries, on a monthly basis. However, Sun does not manage or make decisions based on the individual legal entity information. Instead, this is done on the basis of the consolidated information.

Sun has always employed a leadership model in which all management personnel have line responsibilities and participate across functional lines and in multiple areas, including geographical areas. Through a common vision, shared values and networks of informal, overlapping relationships, the Company has emphasized a unified approach. The CEO oversees the Company with a constant focus on consolidated results.

With oversight from its Board of Directors and an emphasis on transparent communication across the entire Company, Sun's operating strategy and business is based upon the creation and manufacture of a comprehensive line of functional

products which are sold, through distribution and directly, worldwide for use in a host of mobile and industrial applications. This unified focus places a premium on the delivery of Sun products for fluid power solutions anywhere in the world in the most efficient manner, with little regard for traditional geographic or entity differentiation. Instead, Sun's management looks at where products are sold - the Americas, Europe (which includes the Middle East and Africa), and Asia/Pacific. Decisions as to resource allocation, expansion of facilities and personnel, and capital investment are all made based on information on "sales to" customers, not information about "sales from" Sun subsidiary entities. This reflects the fact that sales are routinely specified, originated or sold beyond and regardless of entity or geographic boundaries. In particular, many of the sales in Europe and Asia come directly from the U.S. and never pass through one of Sun's subsidiary entities in those regions.

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Management's focus is on overall Company performance and the evaluation of opportunities for additional "sales to" customers. Sun's CEO truly acts as the chief executive for the entire business; he and the other management leaders oversee operations worldwide, without an intermediate reporting bureaucracy in each location in which Sun has a legal entity. Using "shared offices," leadership responsibilities are disbursed throughout the Company, with minimal formal reporting relationships and maximum collaboration among employees worldwide. By focusing on total net orders and total net sales, not individual legal entity performance, Sun is able to better serve its customers. This philosophy permeates not only the management approach to decision-making, but also the Company's compensation system, which is based on company-wide performance, and not individual or entity-level management-by-objective criteria.

**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 decreased 16% in 2015 after increasing 6% in 2014. The index of shipments of hydraulic products decreased 11% for the six month period ending June 30, 2016.

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 decreased to 53.2 in June 2016 compared to 53.5 in June 2015. The U.S. PMI index registered 52.6 for July 2016.

**Results for the second quarter**

(in millions except net income per share)

	July 2, 2016	June 27, 2015	Increase/(Decrease)	
Three Months Ended				
Net sales	\$50.8	\$ 54.0	(6	)%
Net income	\$7.0	\$ 9.2	(24	)%
Net income per share:				
Basic	\$0.26	\$ 0.35	(26	)%
Diluted	\$0.26	\$ 0.35	(26	)%
Six Months Ended				
Net sales	\$101.8	\$108.4	(6	)%
Net income	\$15.2	\$19.6	(22	)%
Net income per share:				
Basic	\$0.57	\$ 0.74	(23	)%
Diluted	\$0.57	\$ 0.74	(23	)%

Sales for the second quarter of 2016 were slightly above expectations. Year-over-year, global demand weakened by 6% as end market headwinds continued to influence results. The Americas experienced a 10% decline, primarily due to the continued impact of lower oil prices and lack of investment in the mining sector. The European and Asian Pacific regions were down only marginally, at 3% and 1% respectively. Profitability was in line with projections as currency impacted EPS by less than \$0.01 over last year.

Demand in Sun's various end markets remains sluggish, but management is encouraged by increased sales in selected markets throughout Asia Pacific which is directly attributable to increased marketing efforts in the region. Sun believes that continued investment is a necessary component to drive long-term results. The Company is accelerating lean manufacturing efforts, expanding our electronic and digital capabilities, acquiring talent to complement current

competencies, and acting on opportunities where Sun can grow in both new and existing geographic regions.

#### Outlook

Third quarter 2016 revenues are expected to be approximately \$46 million, down 4% from the third quarter of 2015. Earnings per share are estimated to be \$0.19 to \$0.21, compared to \$0.32 in the same period a year ago. The 2015 earnings include a



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one-time gain on the sale of the building in Korea of approximately \$0.04. The 2016 estimate includes additional expenses incurred for growth initiatives and related compensation of approximately \$0.04. Additionally, CEO transition expenses will negatively impact EPS by approximately \$0.01. The transition costs will continue to reduce earnings through the first quarter of 2017. The remainder of the expected decline is attributable to decreased volume. Currency is not expected to have a substantial impact on earnings per share in third quarter estimates.

### COMPARISON OF THE THREE MONTHS ENDED JULY 2, 2016 AND JUNE 27, 2015

#### Net Sales

Net sales were \$50.8 million, a decrease of \$3.2 million, or 5.9%, compared to \$54.0 million in the second quarter of 2015. The decrease in net sales was driven by weaker demand in all markets. Changes in exchange rates had a negative impact on sales of approximately \$0.5 million. New product sales (defined as products introduced within the last five years) continue to make up 10 - 12% of total sales.

Asia/Pacific sales decreased 1.4% or \$0.2 million, to \$11.6 million in the second quarter of 2016, primarily related to decreased demand from Korea. Exchange rates had a \$0.2 million negative impact on Asia/Pacific sales in the second quarter of 2016. EAME sales decreased 3.1% or \$0.5 million, to \$15.8 million in the second quarter of 2016, primarily related to decreased demand in the United Kingdom, Finland and Norway. Exchange rates had a negative impact on sales to EAME of approximately \$0.2 million in the second quarter of 2016. Sales to the Americas decreased 9.8% or \$2.5 million, to \$23.4 million in the second quarter of 2016, primarily related to decreased demand in the U.S.

#### Gross Profit

Gross profit decreased \$2.5 million or 11.5%, to \$19.0 million in the second quarter of 2016, compared to \$21.4 million in the second quarter of last year. Gross profit as a percentage of net sales decreased to 37.3% in the second quarter of 2016, compared to 39.6% in the second quarter of last year. Lower sales volume reduced gross profit by approximately \$1.3 million. The remainder of the decrease resulted from higher costs as a percent of sales, including overhead costs of \$1.2 million.

#### Selling, Engineering and Administrative Expenses

Selling, engineering and administrative expenses increased \$1.2 million or 16.1%, to \$8.5 million in the second quarter of 2016, compared to \$7.3 million in the second quarter of last year. The increase relates primarily to the CEO transition.

#### Operating Income

Operating income decreased \$3.6 million or 25.8%, to \$10.4 million in the second quarter of 2016, compared to \$14.1 million in the second quarter last year, with operating margins of 20.6% and 26.1% for the second quarters of 2016 and 2015, respectively.

The Company derives its operating income based on the consolidated results of its legal entities. The Company has made the decision to consolidate engineering and manufacturing for the most part in the U.S. The Company's foreign subsidiaries primarily act as part of our sales and distribution channel. This structure results in different operating margins among the legal entities due to the mix of products, channels to market, and industries present in different geographic regions.

Products manufactured in the U.S. are sold worldwide. Pricing, operations and cost structure are the primary reasons that operating income in the U.S. is higher than foreign subsidiary operating income, which we expect will continue. Our German and U.K. entities act as value add distributors. These entities sell to both end use customers in their respective regions, as well as to third party distributors in certain parts of Europe. U.K. margins have historically been lower than in Germany. This is due to the fact that, in the U.K., we manufacture iron manifolds for the European market. This results in higher overhead costs primarily related to machinery and equipment, and the employment of nearly twice as many people as in Germany. Margins are lowest in our Korean entity. Korea, more than any other subsidiary, sells direct to large OEM customers where pricing pressure is most pronounced.

The U.S. legal entity contributed \$9.4 million to our consolidated operating income in the second quarter 2016, compared to \$12.5 million in the second quarter of 2015, a decrease of \$3.1 million. The decrease is primarily related to volume. The U.S. legal entity ships products directly to customers around the world. Third party export sales from the U.S. were \$17.4 million in the second quarter of 2016 compared to \$15.9 million in the second quarter of 2015. As demand strengthens internationally, the U.S. legal entity will benefit from these direct export sales.

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Our Korean subsidiary experienced an operating loss of \$0.1 million in the second quarter of 2016 compared to minimal impact on our consolidated operating income in the second quarter of 2015.

Our German subsidiary contributed \$0.6 million to our consolidated operating income in the second quarter of 2016 compared to operating income of \$1.0 million during the second quarter of 2015, a decrease of \$0.4 million.

Our U.K. subsidiary contributed \$0.5 million to our consolidated operating income in the second quarter of 2016 compared to \$0.6 million in the second quarter of 2015.

### Interest Income, Net

Net interest income was \$0.4 million for the quarter ended July 2, 2016 and \$0.3 million for the quarter ended June 27, 2015. The Company currently has no outstanding debt. Total average cash and investments for the quarter ended July 2, 2016, was \$134.9 million compared to \$111.1 million for the quarter ended June 27, 2015.

### Miscellaneous (Income) Expense, Net

Net miscellaneous expense was \$0.4 million for the quarter ended July 2, 2016, compared to net miscellaneous expense of \$0.2 million for the quarter ended June 27, 2015.

### Income Taxes

The provision for income taxes for the quarter ended July 2, 2016, was 34.0% of pretax income compared to 33.8% for the quarter ended June 27, 2015. This effective rate relates to the relative levels of income and different tax rates in effect among the countries in which the Company sells its products.

## COMPARISON OF THE SIX MONTHS ENDED JULY 2, 2016 AND JUNE 27, 2015

### Net Sales

Net sales were \$101.8 million, a decrease of \$6.6 million, or 6.1%, compared to \$108.4 million in 2015. The decrease in net sales was driven by weaker demand in all markets. Changes in exchange rates had a negative impact on sales of approximately \$1.1 million. New product sales (defined as products introduced within the last five years) continue to make up 10 - 12% of total sales.

Asia/Pacific sales decreased 6.0% or \$1.4 million, to \$22.2 million in 2016, primarily related to decreased demand from Korea. Exchange rates had a \$0.6 million negative impact on Asia/Pacific sales in 2016. EAME sales decreased 4.4% or \$1.4 million, to \$31.5 million in 2016, primarily related to decreased demand in Germany, the United Kingdom, and Norway. Exchange rates had a negative impact on sales to EAME of approximately \$0.5 million in 2016. Sales to the Americas decreased 7.2% or \$3.7 million, to \$48.1 million in 2016, primarily related to decreased demand in the U.S.

### Gross Profit

Gross profit decreased \$4.3 million or 10.1%, to \$38.5 million in 2016, compared to \$42.8 million in 2015. Gross profit as a percentage of net sales decreased to 37.8% in 2016, compared to 39.5% last year. Lower sales volume reduced gross profit by approximately \$2.6 million. The remainder of the decrease resulted from higher costs as a percent of sales, including material costs of \$0.4 million, and overhead costs of \$1.4 million.

### Selling, Engineering and Administrative Expenses

Selling, engineering and administrative expenses increased \$1.5 million or 10.6%, to \$16.2 million in 2016, compared to \$14.6 million last year. The increase relates primarily to the CEO transition.

### Operating Income

Operating income decreased \$5.9 million or 20.8%, to \$22.3 million in 2016, compared to \$28.2 million last year, with operating margins of 21.9% and 26.0% for 2016 and 2015, respectively.

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The Company derives its operating income based on the consolidated results of its legal entities. The Company has made the decision to consolidate engineering and manufacturing for the most part in the U.S. The Company's foreign subsidiaries primarily act as part of our sales and distribution channel. This structure results in different operating margins among the legal entities due to the mix of products, channels to market, and industries present in different geographic regions.

Products manufactured in the U.S. are sold worldwide. Pricing, operations and cost structure are the primary reasons that operating income in the U.S. is higher than foreign subsidiary operating income, which we expect will continue. Our German and U.K. entities act as value add distributors. These entities sell to both end use customers in their respective regions, as well as to third party distributors in certain parts of Europe. U.K. margins have historically been lower than in Germany. This is due to the fact that, in the U.K., we manufacture iron manifolds for the European market. This results in higher overhead costs primarily related to machinery and equipment, and the employment of nearly twice as many people as in Germany. Margins are lowest in our Korean entity. Korea, more than any other subsidiary, sells direct to large OEM customers where pricing pressure is most pronounced.

The U.S. legal entity contributed \$19.7 million to our consolidated operating income in 2016, compared to \$24.5 million in 2015, a decrease of \$4.8 million. The decrease is primarily related to volume. The U.S. legal entity ships products directly to customers around the world. Third party export sales from the U.S. were \$32.8 million in 2016 compared to \$31.2 million in 2015. As demand strengthens internationally, the U.S. legal entity will benefit from these direct export sales.

Our Korean subsidiary contributed minimal impact to our consolidated operating income in 2016 compared to \$0.1 million in 2015.

Our German subsidiary contributed \$1.5 million to our consolidated operating income in 2016 compared to operating income of \$2.2 million in 2015, a decrease of \$0.7 million.

Our U.K. subsidiary contributed \$1.1 million to our consolidated operating income in 2016 compared to \$1.5 million in 2015.

### Interest Income, Net

Net interest income was \$0.8 million in 2016 and \$0.7 million in 2015. The Company currently has no outstanding debt. Total average cash and investments for the six months ended July 2, 2016, was \$132.0 million compared to \$108.1 million for the six months ended June 27, 2015.

### Miscellaneous (Income) Expense, Net

Net miscellaneous expense was \$0.6 million in 2016, compared to net miscellaneous expense of \$0.2 million in 2015.

### Income Taxes

The provision for income taxes for the six months ended July 2, 2016, was 33.3% of pretax income compared to 33.1% for the six months ended June 27, 2015. This effective rate relates to the relative levels of income and different tax rates in effect among the countries in which the Company sells its products.

## 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 six months ended July 2, 2016, was \$21.9 million, a decrease of \$6.5 million, compared to \$28.5 million for the six months ended June 27, 2015. Net income was down approximately \$4.4 million from the prior year period. Changes in working capital related to increases in accounts receivable of \$6.3 million during 2016,

compared to increases of \$2.0 million during 2015. Decreases in inventory were \$0.7 million during 2016, compared to a decrease of \$1.7 million during 2015. Increases in accounts payable and accruals were \$2.4 million during 2016, compared to \$1.8 million during 2015. Cash on hand increased \$17.7 million from \$81.9 million at the end of 2015 to \$99.6 million at July 2, 2016. Days sales outstanding (DSO) were 35 at July 2, 2016, and 33 at June 27, 2015. Inventory turns were 10.4 as of July 2, 2016, and 10.6 as of June 27, 2015.

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Capital expenditures were \$2.6 million for the six months ended July 2, 2016, primarily made up of purchases of machinery and equipment. Capital expenditures for 2016 are estimated to be \$6.0 million, primarily related to purchases of machinery and equipment.

The Company declared a quarterly cash dividend of \$0.09 per share payable on July 15, 2016, to shareholders of record as of June 30, 2016. 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. Please refer to Note 14 Subsequent Event for additional information. 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 interest in variable interest entities, which include special purpose entities and structured finance entities.

### 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 January 2, 2016, and did not change during the first six months of 2016.

### 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 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 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

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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 January 2, 2016, and “Management’s Discussion and Analysis of Financial Conditions and Results of Operations” in this Form 10-Q for the quarter ended July 2, 2016. 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 July 2, 2016. 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 July 2, 2016, 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(f). The Company’s 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 July 2, 2016, 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 July 2, 2016, 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 January 2, 2016.

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

Below is a summary of stock repurchases for the three months ended July 2, 2016.

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
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April 3  
through April —  
30

May 1  
through May —  
28

May 29  
through July 225 \$ 33.91  
2

In connection with an award of 750 shares to one of the Company's directors as Board fees under the 2012 (1)Nonemployee Director Fees Plan, the Company withheld 225 shares to satisfy federal tax withholding obligations on the award.

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 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.
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 August 4, 2016.

SUN HYDRAULICS CORPORATION

By: /s/ Tricia L. Fulton

Tricia L. Fulton

Chief Financial Officer (Principal Financial and Accounting Officer)