SUN HYDRAULICS CORP
Form 10-Q
May 09, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2007

Commission file number 0-21835

SUN HYDRAULICS CORPORATION

(Exact Name of Registration as Specified in its Charter)

FLORIDA	**59-2754337**
(State or Other Jurisdiction of	**(I.R.S. Employer**
Incorporation or Organization)	**Identification No.)**
1500 WEST UNIVERSITY PARKWAY	
SARASOTA, FLORIDA	**34243**
(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 x No ¨

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

The Registrant had 10,934,574 shares of common stock, par value $.001, outstanding as of April 27, 2007.

Sun Hydraulics Corporation

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For the quarter ended March 31, 2007

PART I: FINANCIAL INFORMATION

Item 1.

Sun Hydraulics Corporation

Consolidated Balance Sheets

(in thousands, except share data)

	March 31, 2007 (unaudited)	December 30, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 12,562	$ 9,379
Restricted cash	59	118
Accounts receivable, net of allowance for doubtful accounts of $110 and $140	17,182	13,917
Inventories	11,768	10,386
Deferred income taxes	219	219
Other current assets	1,350	986
Total current assets	43,140	35,005
Property, plant and equipment, net	51,995	50,355
Other assets	1,880	1,825
Total assets	**$ 97,015**	**$ 87,185**
Liabilities and shareholders equity		
Current liabilities:		
Accounts payable	$ 6,245	$ 4,812
Accrued expenses and other liabilities	3,286	4,059
Long-term debt due within one year	430	426
Dividends payable	1,093	1,085
Income taxes payable	3,324	608
Total current liabilities	14,378	10,990
Long-term debt due after one year	489	646
Deferred income taxes	4,527	4,451
Other noncurrent liabilities	335	298
Total liabilities	19,729	16,385
Commitments and contingencies		
Shareholders equity:		
Preferred stock, 2,000,000 shares authorized, par value $0.001, no shares outstanding		
Common stock, 20,000,000 shares authorized, par value $0.001, 10,932,224 and 10,849,316 shares outstanding	11	11
Capital in excess of par value	32,642	30,962
Retained earnings	39,995	35,284
Accumulated other comprehensive income	4,638	4,543
Total shareholders equity	77,286	70,800
Total liabilities and shareholders equity	**$ 97,015**	**$ 87,185**

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 March 31, 2007 (unaudited)	Three months ended April 1, 2006 (unaudited)
Net sales	**$ 40,854**	**$ 34,185**
Cost of sales	26,971	23,204
Gross profit	**13,883**	**10,981**
Selling, engineering and administrative expenses	5,216	4,671
Operating income	**8,667**	**6,310**
Interest expense	1	70
Foreign currency transaction gain	(26)	(41)
Miscellaneous (income)/expense, net	(157)	28
Income before income taxes	**8,849**	**6,253**
Income tax provision	3,043	2,073
Net income	**$ 5,806**	**$ 4,180**
Basic net income per common share	**$ 0.53**	**$ 0.38**
Weighted average basic shares outstanding	10,918	10,932
Diluted net income per common share	**$ 0.53**	**$ 0.38**
Weighted average diluted shares outstanding	10,974	11,001
Dividends declared per share	**$ 0.100**	**$ 0.100**

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

Sun Hydraulics Corporation

Consolidated Statement of Changes in Shareholders Equity and Comprehensive Income (unaudited)

(in thousands)

	Preferred shares	Preferred stock	Common shares	Common stock	Capital in excess of par value	Retained earnings	Accumulated other comprehensive income	Total
Balance, December 30, 2006		$	10,849	$ 11	$ 30,962	$ 35,284	$ 4,543	$ 70,800
Shares issued, stock options			11		54			54
Shares issued, ESPP			3		59			59
Shares issued, ESOP			69		1,386			1,386
Stock-based compensation					150			150
Stock option income tax benefit					31			31
Dividends declared						(1,095)		(1,095)
Comprehensive income:								
Net income						5,806		5,806
Foreign currency translation adjustments							95	95
Comprehensive income								5,901
Balance, March 31, 2007		$	10,932	$ 11	$ 32,642	$ 39,995	$ 4,638	$ 77,286

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

Sun Hydraulics Corporation

Consolidated Statements of Cash Flows

(in thousands)

	Three months ended	
	March 31, 2007 (unaudited)	**April 1, 2006 (unaudited)**
Cash flows from operating activities:		
Net income	$ 5,806	$ 4,180
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,500	1,437
(Gain)/Loss on disposal of assets	(20)	26
Provision for deferred income taxes	76	(1)
Allowance for doubtful accounts	(30)	(12)
Stock-based compensation expense	150	152
Stock options income tax benefit	(31)	(31)
(Increase) decrease in:		
Accounts receivable	(3,235)	(2,642)
Inventories	(1,382)	(722)
Income taxes receivable		236
Other current assets	(364)	(201)
Other assets	(62)	(16)
Increase (decrease) in:		
Accounts payable	1,433	(1,185)
Accrued expenses and other liabilities	613	760
Taxes payable	2,747	1,393
Other noncurrent liabilities	37	(4)
Net cash provided by operating activities	7,238	3,370
Cash flows from investing activities:		
Capital expenditures	(3,203)	(1,965)
Proceeds from dispositions of equipment	31	2
Net cash used in investing activities	(3,172)	(1,963)
Cash flows from financing activities:		
Proceeds from debt		1,500
Repayment of debt	(153)	(145)
Proceeds from exercise of stock options	54	49
Proceeds from stock issued	59	50
Payments for purchase of treasury stock		(244)
Dividends to shareholders	(1,087)	(1,089)
Stock options income tax benefit	31	31
Net cash (used in) provided by financing activities	(1,096)	152
Effect of exchange rate changes on cash and cash equivalents	154	4
Net increase in cash and cash equivalents	3,124	1,563
Cash and cash equivalents, beginning of period	**9,497**	**5,830**
Cash and cash equivalents, end of period	**$ 12,621**	**$ 7,393**
Supplemental disclosure of cash flow information:		
Cash paid:		

Interest	$ 1	$ 70
Income taxes	$ 470	$ 476
Supplemental disclosure of noncash transactions:		
Common stock issued to ESOP through accrued expenses and other liabilities	$ 1,386	$ 1,180

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

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 and joint ventures, 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, and China. 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 Inchon, South Korea, operates a manufacturing and distribution facility. Sun Hydraulics, SARL (Sun France), a wholly-owned subsidiary of Sun Hydraulics, located in Bordeaux, France, operates a sales and engineering support facility. Sun Hydraulics Systems (Shanghai) Co., Ltd. (Sun China), a 50/50 joint venture between Sun Hydraulics and Links Lin, the owner of Sun Hydraulics Taiwanese distributor, is located in Shanghai, China, and operates a manufacturing and distribution facility. Sun Hydraulics acquired a 40% equity method investment in WhiteOak Controls, Inc. (WhiteOak), on June 28, 2005. WhiteOak, located in Mediapolis, Iowa, 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 December 30, 2006, filed by Sun Hydraulics Corporation (together with its subsidiaries, the Company) with the Securities and Exchange Commission on March 14, 2007. 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 three month period ended March 31, 2007, are not necessarily indicative of the results that may be expected for the period ending December 29, 2007.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
Earnings per share

The following table represents the computation of basic and diluted earnings per common share as required by Statement of Financial Accounting Standard (FAS) No. 128, *Earnings Per Share* (in thousands, except per share data):

	Three Months Ended	
	March 31, 2007	April 1, 2006
Net income	**$ 5,806**	**$ 4,180**
Weighted average basic shares outstanding	10,918	10,932
Basic net income per common share	**$ 0.53**	**$ 0.38**
Effect of dilutive stock options	56	69
Weighted average diluted shares outstanding	10,974	11,001
Diluted net income per common share	**$ 0.53**	**$ 0.38**

3. STOCK-BASED COMPENSATION
Effective January 1, 2006, the Company adopted the provisions of FAS No. 123R, *Share-Based Payment*, (FAS 123R) for its share-based compensation plans, using the modified prospective method.

During 1996, the Company adopted the 1996 Stock Option Plan (1996 Plan), which provides for the grant of incentive stock options and nonqualified stock options for the purchase of up to an aggregate of 1,500,000 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.

A summary of activity under the 1996 Plan for the three months ended March 31, 2007 is as follows:

	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Options outstanding as of December 30, 2006	75	$ 6.70		
Granted				
Exercised	(10)	$ 5.23		
Forfeitures				
Options outstanding as of March 31, 2007	65	$ 6.92	4.26	$ 1,282
Options exercisable as of March 31, 2007	46	$ 5.84	4.01	$ 952

All options listed above vest over three to five years with a maximum term of seven to ten years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model using weighted average assumptions. Stock option compensation expense for the periods ended March 31, 2007 and April 1, 2006, was $10 and $19, respectively. There were no options granted during these periods.

In September 2006, the Company adopted the 2006 Stock Option Plan (2006 Plan), which provides for the grant of incentive stock options and nonqualified stock options for the purchase of up to an aggregate of 500,000 shares of the Company s common stock by officers, employees and directors of the Company. The Company adopted the 2006 Plan due to the expiration of the Company s 1996 Stock Option Plan in

2006. 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, and any awards granted prior to the 2007 Annual Meeting will be conditioned upon shareholder approval of the 2006 Plan at such meeting.

During 2001, the Company adopted the 2001 Restricted Stock Plan, which provides for the grant of restricted stock of up to an aggregate of 412,500 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. Restricted stock granted prior to January 1, 2006, was accounted for using the measurement and recognition principles of APB 25. Accordingly, compensation cost was 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 three months ended March 31, 2007, and April 1, 2006, totaled $117 and $115, respectively.

The following table summarizes restricted stock activity from December 30, 2006, through March 31, 2007:

	Number of shares	**Weighted average grant-date fair value**
Nonvested balance at December 30, 2006	62	16.71
Granted		
Vested		
Forfeitures		
Nonvested balance at March 31, 2007	62	16.71

The Company has $797 of total unrecognized compensation cost related to restricted stock awards granted under the Plan as of March 31, 2007. That cost is expected to be recognized over a weighted average period of 1.70 years.

During 2001, the Company adopted the Employee Stock Purchase Plan (ESPP), which became effective August 1, 2001. Most employees are eligible to participate. Employees 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. The ESPP authorizes the issuance, and the purchase by employees, of up to 487,500 shares of common stock through payroll deductions. No employee is allowed to buy more than $25,000 of common stock in any year, based on the market value of the common stock at the beginning of the purchase period. Employees purchased 3,368 shares at a weighted average price of $17.43 and 3,010 shares at a weighted average price of $16.43, under the ESPP during the three months ended March 31, 2007, and April 1, 2006, respectively. In accordance with FAS 123R, the Company recognized $10 and $9 of compensation expense during the periods ended March 31, 2007 and April 1, 2006, respectively. At March 31, 2007, 397,784 shares remained available to be issued through the ESPP.

During 2004, the Board of Directors adopted and the shareholders approved the Nonemployee Director Equity and Deferred Compensation Plan (the Plan). Directors who are not officers of the Company are paid $4,000 for attendance at each meeting of the Board of Directors, as well as each meeting of each Board Committee on which they serve when the committee meeting is not held within one day of a meeting of the Board of Directors. Directors receive $1,500 of the $4,000 Director fee in shares of Company stock under the Plan. Directors also may elect under the Plan to receive all or part of the remainder of their fees in Company stock and to defer receipt of their fees until a subsequent year. The Plan authorizes the issuance of up to 120,000 shares of common stock.

On September 9, 2006, the Board approved an increase in the total amount paid for each such meeting to $5,000, and also amended the 2004 Plan to make $2,500 of the $5,000 fee payable in shares of the Company s common stock. The amendment to the 2004 Plan is subject to approval by the Company s shareholders at the 2007 Annual Meeting. If shareholder approval is not obtained at the 2007 Annual Meeting, the additional $1,000 will be paid in cash instead of shares, and the amendment to the 2004 Plan will automatically terminate.

Directors were granted 956 and 529 shares for the periods ended March 31, 2007, and April 1, 2006, respectively. Of the shares granted in 2007, 176 shares are subject to shareholder approval. At March 31, 2007, there were 6,343 deferred stock units outstanding. Deferred stock units are treated as liabilities in accordance with FAS 123R. The Company recognized director compensation expense of $59 and $13, for the periods ended March 31, 2007 and April 1, 2006, respectively. At March 31, 2007, 109,356 shares remained available to be issued through the Plan

4. RESTRICTED CASH

The restricted cash balance at March 31, 2007, consisted of $59 in reserves as a required deferment for customs in the U.K. operation. The restricted amount was calculated as an estimate of two months of customs for items coming into the Company s U.K. operations and is held with Lloyd s TSB in the U.K.

5. INVENTORIES

	March 31, 2007	December 30, 2006
Raw materials	$ 4,164	$ 3,585
Work in process	4,594	3,481
Finished goods	3,453	3,715
Provision for slow moving inventory	(443)	(395)
Total	$ 11,768	$ 10,386

6. GOODWILL

On March 31, 2007, the Company had $715 of goodwill, related to its acquisition of Sun Korea. Goodwill is held in other assets on the balance sheet. Valuation models reflecting the expected future cash flow projections were used to value Sun Korea at December 30, 2006. The analysis indicated that there was no impairment of the carrying value of the goodwill. As of March 31, 2007, no factors were identified that indicated impairment of the carrying value of the goodwill.

7. LONG-TERM DEBT

	March 31, 2007	December 30, 2006
$35,000 revolving line of credit, collateralized by U.S. assets, interest rate variable based upon the Company s leverage ratio, due August 1, 2011.	$	$
$2,400 12-year mortgage note on the German facility, fixed interest rate of 6.05%, due September 30, 2008.	411	464
10-year notes, fixed interest rates ranging from 3.5-5.1%, collateralized by equipment in Germany, due between 2009 and 2011.	508	593
Other		15
	919	1,072
Less amounts due within one year	(430)	(426)
Total	$ 489	$ 646

The revolving line of credit is subject to debt covenants (capitalized terms are defined therein) including: 1) Debt to Tangible Net Worth ratio of not more than 1.5:1.0, 2) Funded Debt to EBITDA ratio of not more than 2.5:1.0, and 3) EBIT to Interest Expense ratio of not less than 1.1:1.0; and requires the Company to maintain its primary domestic deposit accounts with the Bank. As of March 31, 2007, the Company was in compliance with all debt covenants.

8. INCOME TAXES

In July 2006, the FASB issued FIN 48, *Accounting for Uncertainty in Income Taxes, and Related Implementation Issues* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a Company s financial statements in accordance with FASB No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Company adopted FIN 48 effective January 1, 2007. The adoption of FIN 48 did not have a material effect on the Company s Consolidated Financial Statements.

As of January 1, 2007, the Company had an unrecognized tax benefit of $208 including accrued interest. There has been no significant change in the unrecognized tax benefit during the first quarter ending March 31, 2007. 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 related to the unrecognized tax benefit has been recognized and included in income tax expense. Interest accrued as of March 31, 2007 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 before 2003 for the majority of tax jurisdictions.

9. SEGMENT REPORTING

The individual subsidiaries comprising the Company operate predominantly in a single industry as manufacturers and distributors of hydraulic components. The Company is multinational with operations in the United States, and subsidiaries in the United Kingdom, Germany, Korea, and France. Amounts for

France, due to their immateriality, are included with the U.S. In computing operating profit for the foreign subsidiaries, no allocations of general corporate expenses have been made. Management bases its financial decisions by the geographical location of its operations.

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

Segment information is as follows:

	United States	Korea	Germany	United Kingdom	Elimination	Consolidated
Three Months						
Ended March 31, 2007						
Sales to unaffiliated customers	$ 23,769	$ 4,957	$ 6,591	$ 5,537	$	$ 40,854
Intercompany sales	8,169		30	883	(9,082)	
Operating income	5,743	510	1,644	835	(65)	8,667
Depreciation	1,061	40	136	256		1,493
Capital expenditures	2,742	57	26	378		3,203
Three Months						
Ended April 1, 2006						
Sales to unaffiliated customers	$ 20,861	$ 4,090	$ 4,577	$ 4,657	$	$ 34,185
Intercompany sales	6,677		36	786	(7,499)	
Operating income	4,058	607	940	739	(34)	6,310
Depreciation	1,031	37	119	243		1,430
Capital expenditures	1,873	3	13	76		1,965

Operating income is total sales and other operating income less operating expenses. Segment operating income does not include interest expense and net miscellaneous income/expense.

10. NEW ACCOUNTING PRONOUNCEMENTS

In February 2007, the Financial Accounting Standards Board (FASB) issued FAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159), which gives entities the option to measure eligible financial assets, and financial liabilities at fair value on an instrument by instrument basis, that are otherwise not permitted to be accounted for at fair value under other accounting standards. The election to use the fair value option is available when an entity first recognizes a financial asset or financial liability. Subsequent changes in fair value must be recorded in earnings. This statement is effective as of the beginning of a company s first fiscal year after November 15, 2007. The Company is currently evaluating the impact of adopting this Statement.

In September 2006, the FASB issued FAS No. 157, *Fair Value Measurements* (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. FAS 157 is effective for fiscal years beginning after November 15, 2007. The adoption of this Statement is not expected to have a material effect on the Company s Consolidated Financial Statements.

11. 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 30, 2006, were approximately 53% of total net sales.

Approximately 66% 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 mobile equipment include off-road construction equipment, fire and rescue equipment and mining machinery.

The remaining 34% of sales are used by industrial markets, which are characterized by equipment that is fixed in place, typically in a controlled environment, and which operates at higher pressures and duty cycles. 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.

Company Focus

In recent years, the Company has realized robust growth in all areas of the world. Management believes there are five key reasons why:

Delivery performance,

New products, especially electro-hydraulic products,

Integrated packages,

Our geographic presence, and

Our website.

The Company is continuously engaged in efforts to improve productivity to enhance productive capacity and be in the best position to be able to respond to marketplace demand. Company engineering and manufacturing personnel redesign existing products, where necessary, to improve manufacturability. New product design efforts include personnel from engineering, manufacturing and marketing to help reduce the time and effort required to release products to the market. These on-going activities enable the Company to maintain a level of delivery performance and shipping reliability that it believes differentiates it from its competitors.

The Company continues to add to its electro-hydraulic valve offerings with many new products, including different types of solenoid and proportional valves. Electrically actuated cartridges help create new system opportunities as they enable the Company to offer complete integrated valve packages which could not be offered previously. The addition of electro-hydraulic products allows integrated packages to be designed with 100% Sun content. Integrated packages, standard cartridges housed in a custom designed manifold, have been one of the Company s fastest growing areas.

The Company has wholly-owned companies in North America, Europe and the Far East, augmented by what management believes to be the finest distribution network in the fluid power industry. The Company s distributors are particularly skilled in applying products and developing integrated solutions for the local market. Through its wholly-owned companies and global distribution network, the Company is able to service all major industrialized market areas.

The Company s major marketing tool is its website, www.sunhydraulics.com. The Company s website is developed for serious design engineers. It provides all the detailed technical information and specifications to select, apply and obtain Sun products, 24 hours a day, seven days a week. The website continues to evolve by adding greater levels of detail in technical information and new configuration capability.

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 9% and 13% in 2006 and 2005, respectively. The index of shipments continued to show growth through March 2007, increasing 5%.

The Company s order trend has historically tracked closely to the United States Purchasing Managers Index (PMI). The index decreased to 50.9 at the end of March 2007 compared to 55.2 at the end of March 2006. In April of 2007, the index rose to 54.7. When PMI is over 50, it indicates economic expansion; when it is below 50, it indicates contraction in the economy.

Results for the first quarter

(Dollars in millions except net income per share)

	March 31, 2007	April 1, 2006	Increase
Three Months Ended			
Net Sales	$ 40.9	$ 34.2	20%
Net Income	$ 5.8	$ 4.2	38%
Net Income per share:			
Basic	$ 0.53	$ 0.38	39%
Diluted	$ 0.53	$ 0.38	39%

The brisk conditions the Company experienced across all geographic areas in the first quarter have continued through April. While all business segments grew significantly, European and Asian sales were especially strong. Management is confident that its international efforts are succeeding. Nearly 54% of total sales for the quarter were generated outside of North America. Last month, the Company introduced several new electro-hydraulic products at the Hannover Fair in Germany, which the Company believes were well received.

The Company was extremely pleased with its earnings on this level of sales especially after experiencing margin erosion over several quarters last year. Gross profit improved this quarter and led to incremental bottom-line increases.

Throughout this capital goods cycle, management believes that Sun continues to gain market share as it outgrows the industry. Management believes the Company s growth continues to be fueled by attending to basics: having the right products for the marketplace, providing detailed product information on demand, and delivering products when and where the customer wants.

Outlook

Second quarter 2007 sales are estimated to be approximately $41 million and earnings per share are estimated to be in the range of $0.52 to $0.54. This would represent an increase of approximately 11% in sales and 36% in earnings per share over last year.

COMPARISON OF THE THREE MONTHS ENDED MARCH 31, 2007 AND APRIL 1, 2006

Net Sales

Net sales were $40.9 million, an increase of $6.7 million, or 19.5%, compared to $34.2 million in 2006. The increase was due in large part to the continued growth of international sales, particularly in Europe where sales increased 34.3%, or $3.6 million, to $14.1 million. Sales to France increased 39.3%, to Germany 43.3%, and to the U.K. 29.2%. Significant increases were also noted in Finland, Italy, and Sweden.

Asian sales continued to grow, increasing 24.9%, or $1.4 million, to $7.0 million. Domestic sales in Korea increased 21.2%, sales to Japan increased 25.1%, and sales to China 45.0%.

North American sales increased 9.2%, or $1.6 million, to $19.0 million.

Gross Profit

Gross profit increased $2.9 million, or 26.4%, to $13.9 million. Gross profit as a percentage of net sales increased to 34.0% in the first quarter of 2007, compared to 32.1% in the first quarter last year. Increases in gross profit were due to fixed cost absorption from higher sales volume, and a sales price increase that occurred in July 2006.

Selling, Engineering and Administrative Expenses

Selling, engineering and administrative expenses increased 11.7%, or $0.5 million, to $5.2 million compared to the same quarter last year. The change is primarily a result of increased compensation costs, engineering and marketing expenses, and professional fees.

Interest Expense

Interest expense for the quarter ended March 31, 2007, was minimal compared to $0.1 million in the quarter ended April 1, 2006. Total average debt for the quarter ended March 31, 2007, was $1.0 million compared to $2.7 million for the quarter ended April 1, 2006. The Company did not have any outstanding variable debt during the period ended March 31, 2007.

Foreign Currency Transaction Gain

There was minimal impact to net income in the quarters ended March 31, 2007, and April 1, 2006, as a result of foreign currency transactions.

Miscellaneous (Income)/Expense, Net

Miscellaneous income was $0.2 for the quarter ended March 31, 2007 compared to a minimal miscellaneous expense in the quarter ended April 1, 2006. The increase was primarily a result of earnings from joint ventures and interest income.

Income Taxes

The provision for income taxes for the quarter ended March 31, 2007, was 34.4% of pretax income compared to 33.2% for the quarter ended April 1, 2006. The increase was due to a change in 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, repurchase Company common stock and service debt.

Cash from operations for the three months ended March 31, 2007, was $7.2 million, compared to $3.4 million for the three months ended April 1, 2006. The $3.8 million increase in the Company s net cash flow from operations during the period was due primarily to the increase in net income, taxes payable, accounts payable, and accrued expenses. These amounts were partially offset by the increases in accounts receivable and inventory balances. Days sales outstanding (DSO) were 38 and 36 at March 31, 2007, and April 1, 2006, respectively. Inventory turns decreased from 10.8 as of April 1, 2006 to 9.2 as of March 31, 2007. The increase in DSO and the decrease in inventory turns were both partially caused by increasing foreign demand.

Capital expenditures, consisting primarily of purchases of machinery and equipment, were $3.2 million for the three months ended March 31, 2007, compared to $2.0 million for the three months ended April 1, 2006. Capital expenditures for the year are projected to be approximately $10.0 million.

The Company declared quarterly dividends of $0.10 per share to shareholders of record March 31, 2007, payable on April 15, 2007. 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 uses the equity method of accounting to account for its investments in Sun China and WhiteOak. The Company does not have a majority ownership in or exercise control over either of the entities. The Company does not believe that its investments in Sun China or WhiteOak qualify as Variable Interest Entities, within the scope of FASB Interpretation (FIN) No. 46, *Consolidation of Variable Interest Entities, an interpretation of ARB No. 5,* nor are they material to the financial statements of the Company at March 31, 2007.

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. As a result, 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. 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 only 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, accounts receivable, inventory, goodwill and accruals. The following explains the basis and the procedure for each account where judgment and estimates are applied.

Revenue Recognition

The Company reports revenues, net of sales incentives, when title passes and risk of loss transfers to the customer. The effect of material non-recurring events is provided for when they become known.

Impairment of Long-Lived Assets

In accordance with Statement of Financial Accounting Standards (FAS) No. 144, *Accounting for Impairment or Disposal of Long-lived Assets* (FAS 144), long-lived assets, such as property and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the asset is measured by comparison of its carrying amount to future net cash flows the asset is expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the asset exceeds its fair market value.

The Company assesses the recoverability of goodwill and intangible assets not subject to amortization under FAS No. 142, *Goodwill and Other Intangible Assets* (FAS 142). See Goodwill below.

Accounts Receivable

The Company sells to most of its customers on a recurring basis, primarily through distributors with which the Company maintains long-term relationships. As a result, bad debt experience has not been material. The allowance for doubtful accounts is determined on a specific identification basis by a review of those accounts that are significantly in arrears. There can be no assurance that a distributor or a large direct sale customer with overdue accounts receivable balances will not develop financial difficulties and default on payment. See balance sheet for allowance amounts.

Inventory

The Company offers a wide variety of standard products and as a matter of policy does not discontinue products. On an ongoing basis, component parts found to be obsolete through design or process changes are disposed of and charged to material cost. The Company reviews on-hand balances of products and component parts against specific criteria. Products and component parts without usage or that have excess quantities on hand are evaluated. An inventory reserve is then established for the full inventory carrying value of those products and component parts deemed to be obsolete or slow moving. See Note 5 for inventory reserve amounts.

Goodwill

The Company acquired its Korean operations in September 1998 using the purchase method. As a result, goodwill is reflected on the consolidated balance sheet. A valuation based on the cash flow method was performed at December 30, 2006. It was determined that the value of the goodwill was not impaired. There is no assurance that the value of the acquired company will not decrease in the future due to changing business conditions. See Note 6 for goodwill amounts.

Accruals

The Company makes estimates related to certain employee benefits and miscellaneous accruals. Estimates for employee benefit accruals are based on information received from plan administrators in conjunction with management s assessments of estimated liabilities related to workers compensation, health care benefits and annual contributions to an employee stock ownership plan (ESOP), established in 2004 as part of the Company s retirement plan. Estimates for miscellaneous accruals are based on management s assessment of estimated liabilities for costs incurred.

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 cost bases, such as increased competition, lack of qualified engineering, marketing, management or other personnel, and increased labor and raw materials costs; (iv) changes in technology or customer requirements, such as standardization of the cavity into which screw-in cartridge valves must fit, which could render the Company s products or technologies noncompetitive or obsolete; (v) new product introductions, product sales mix and the geographic mix of sales nationally and internationally; and (vi) changes relating to the Company s international sales, including changes in regulatory requirements or tariffs, trade or currency restrictions, fluctuations in exchange rates, and tax and collection issues. Further information relating to factors that could cause actual results to differ from those anticipated is included but not limited to information under the headings Item 1. Business, and Item 1A. Risk Factors in the Company s Form 10-K for the year ended December 30, 2006, and Management s Discussion and Analysis of Financial Conditions and Results of Operations in this Form 10-Q for the quarter ended March 31, 2007. 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 March 31, 2007.

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 March 31, 2007, 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 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 March 31, 2007, in timely alerting them to material information required to be included in the Company s periodic SEC filings.

There were no significant changes in the Company s internal controls over financial reporting during the period ended March 31, 2007, that materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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 30, 2006.

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

None.

Item 3. Defaults upon Senior Securities.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

Exhibits:

Exhibit Number	**Exhibit Description**
3.1	Certificate of Amendment of Bylaws of Sun Hydraulics Corporation dated May 2, 2007.
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.

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 May 8, 2007.

SUN HYDRAULICS CORPORATION

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

Financial and Accounting Officer)