

SUN HYDRAULICS CORP
Form 10-Q
August 08, 2017

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 July 1, 2017 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)

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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, smaller reporting company or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller Reporting Company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 27,058,651 shares of common stock, par value \$.001, outstanding as of July 28, 2017.

Sun Hydraulics Corporation

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July 1, 2017

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PART I: FINANCIAL INFORMATION

Item 1.

Sun Hydraulics Corporation

Consolidated Balance Sheets

(in thousands, except share data)

	July 1, 2017 (unaudited)	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	\$ 78,673	\$ 74,221
Restricted cash	126	37
Accounts receivable, net of allowance for doubtful accounts of \$313 and \$101	40,214	25,730
Inventories, net	38,482	30,000
Income taxes receivable	—	512
Short-term investments	3,846	6,825
Other current assets	4,291	3,943
Total current assets	165,632	141,268
Property, plant and equipment, net	78,250	80,515
Deferred income taxes	4,050	3,705
Goodwill	110,477	103,583
Other intangibles, net	108,206	112,565
Other assets	2,678	3,141
Total assets	\$ 469,293	\$ 444,777
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable	\$ 16,032	\$ 10,166
Accrued expenses and other liabilities	8,563	7,456
Current portion of contingent consideration	16,890	10,765
Dividends payable	2,435	2,424
Income taxes payable	1,495	265
Total current liabilities	45,415	31,076
Revolving line of credit	124,000	140,000
Contingent consideration, less current portion	32,692	24,312
Deferred income taxes	6,654	9,501
Other noncurrent liabilities	3,786	3,491
Total liabilities	212,547	208,380
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, 27,050,779 and 26,936,021 shares outstanding	27	27
Capital in excess of par value	92,659	89,718

Retained earnings	174,580	162,485
Accumulated other comprehensive loss	(10,520)	(15,833)
Total shareholders' equity	256,746	236,397
Total liabilities and shareholders' equity	\$ 469,293	\$ 444,777

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

Sun Hydraulics Corporation

Consolidated Statements of Operations

(in thousands, except per share data)

	Three months ended	
	July 1, 2017	July 2, 2016
	(unaudited)	(unaudited)
Net sales	\$89,335	\$ 50,809
Cost of sales	50,752	31,856
Gross profit	38,583	18,953
Selling, engineering and administrative expenses	15,843	8,394
Amortization of intangible assets	2,039	115
Operating income	20,701	10,444
Interest expense (income), net	964	(386)
Foreign currency transaction loss (gain), net	7	(151)
Miscellaneous expense, net	635	387
Change in fair value of contingent consideration	8,191	—
Income before income taxes	10,904	10,594
Income tax provision	3,620	3,604
Net income	\$7,284	\$ 6,990
Basic and diluted net income per common share	\$0.27	\$ 0.26
Basic and diluted weighted average shares outstanding	27,046	26,908
Dividends declared per share	\$0.09	\$ 0.09

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

Sun Hydraulics Corporation

Consolidated Statements of Operations

(in thousands, except per share data)

	Six months ended	
	July 1,	July 2,
	2017	2016
	(unaudited)	(unaudited)
Net sales	\$ 170,688	\$ 101,837
Cost of sales	99,311	63,343
Gross profit	71,377	38,494
Selling, engineering and administrative expenses	30,544	15,862
Amortization of intangible assets	4,348	302
Operating income	36,485	22,330
Interest expense (income), net	1,589	(758)
Foreign currency transaction gain, net	(40)	(265)
Miscellaneous expense, net	702	564
Change in fair value of contingent consideration	8,191	—
Income before income taxes	26,043	22,789
Income tax provision	8,548	7,591
Net income	\$ 17,495	\$ 15,198
Basic and diluted net income per common share	\$0.65	\$ 0.57
Basic and diluted weighted average shares outstanding	26,996	26,857
Dividends declared per share	\$0.20	\$ 0.22

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

Sun Hydraulics Corporation

Consolidated Statements of Comprehensive Income (unaudited)

(in thousands)

	Three months ended		Six months ended	
	July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Net income	\$7,284	\$ 6,990	\$17,495	\$ 15,198
Other comprehensive income (loss)				
Foreign currency translation adjustments, net of tax	3,240	(2,510)	5,191	(2,192)
Unrealized (loss) gain on available-for-sale securities, net of tax	(7)	457	122	653
Total other comprehensive income (loss)	3,233	(2,053)	5,313	(1,539)
Comprehensive income	\$10,517	\$ 4,937	\$22,808	\$ 13,659

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 (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, December 31, 2016	-	\$ -	26,936	\$ 27	\$ 89,718	\$ 162,485	\$ (15,833)	\$ 236,397
Shares issued, Restricted Stock			71					-
Shares issued, other compensation			13					-
Shares issued, ESPP			14		465			465
Shares issued, shared distribution			17		628			628
Stock-based compensation					1,848			1,848
Dividends declared						(5,400)		(5,400)
Net income						17,495		17,495
Other comprehensive income							5,313	5,313
Balance, July 1, 2017	-	\$ -	27,051	\$ 27	\$ 92,659	\$ 174,580	\$ (10,520)	\$ 256,746

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

Sun Hydraulics Corporation

Consolidated Statements of Cash Flows

(in thousands)

	Six months ended	
	July 1, 2017 (unaudited)	July 2, 2016 (unaudited)
Cash flows from operating activities:		
Net income	\$17,495	\$ 15,198
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,855	5,034
Loss on disposal of assets	692	316
Stock-based compensation expense	2,038	2,884
Amortization of debt issuance costs	202	—
Allowance for doubtful accounts	119	34
Provision for slow moving inventory	108	—
Benefit for deferred income taxes	(3,229)	(131)
Amortization of acquisition related inventory step-up	1,774	—
Change in fair value of contingent consideration	8,191	—
(Increase) decrease in:		
Accounts receivable	(14,191)	(6,254)
Inventories	(10,120)	737
Income taxes receivable	512	123
Other current assets	(303)	249
Other assets	98	(55)
Increase (decrease) in:		
Accounts payable	5,796	1,035
Accrued expenses and other liabilities	1,145	1,399
Income taxes payable	1,207	1,634
Other noncurrent liabilities	295	(260)
Net cash provided by operating activities	21,684	21,943
Cash flows from investing activities:		
Investment in licensed technology	—	(850)
Capital expenditures	(3,305)	(2,557)
Proceeds from dispositions of equipment	18	2
Purchases of short-term investments	—	(9,637)
Proceeds from sale of short-term investments	2,938	15,803
Net cash (used in) provided by investing activities	(349)	2,761
Cash flows from financing activities:		
Repayment of borrowings on revolving line of credit	(16,000)	—
Proceeds from stock issued	465	418
Dividends to shareholders	(5,390)	(5,900)
Change in restricted cash	—	4
Net cash used in financing activities	(20,925)	(5,478)
Effect of exchange rate changes on cash and cash equivalents	4,042	(1,529)
Net increase in cash and cash equivalents	4,452	17,697
Cash and cash equivalents, beginning of period	74,221	81,932
Cash and cash equivalents, end of period	\$78,673	\$ 99,629

Supplemental disclosure of cash flow information:

Cash paid:

Income taxes	\$9,506	\$ 5,582
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Interest	\$1,926	\$ —
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Supplemental disclosure of noncash transactions:

Common stock issued for shared distribution through accrued expenses and other

liabilities	\$628	\$ 1,679
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Unrealized gain on available for sales securities	\$122	\$ 653
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Measurement period adjustment to goodwill and contingent consideration	\$6,314	\$ —
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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

(In thousands except share and per share data)

1. COMPANY BACKGROUND

Sun Hydraulics Corporation (“Sun”, “we”, “our”, “us” or the “Company”), together with its wholly-owned subsidiaries, is an industrial technology leader that develops and manufactures solutions for both the hydraulics and electronics markets. Sun operates in two business segments: Hydraulics and Electronics. The Hydraulics segment consists of all of the global, historical Sun Hydraulics companies and serves the hydraulics market as a leading manufacturer of high-performance screw-in hydraulic cartridge valves, electro-hydraulics, manifolds, and integrated package solutions for the worldwide industrial and mobile hydraulics markets. The Electronics segment is served by two of Sun’s wholly-owned subsidiaries: Enovation Controls, LLC, (“Enovation Controls”) and High Country Tek (“HCT”). Enovation Controls is a global provider of innovative electronic control, display and instrumentation solutions for both recreational and off-highway vehicles, as well as stationary and power generation equipment. HCT is an independent designer and producer of modular, robust, reliable digital and analog electronic controller products for the fluid power industry.

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 31, 2016, filed by Sun Hydraulics Corporation with the Securities and Exchange Commission on February 28, 2017. 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 1, 2017, are not necessarily indicative of the results that may be expected for the period ending December 30, 2017.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reclassifications

Certain reclassifications have been made to the prior period consolidated financial statements to conform to the current period presentation.

Recently Adopted Accounting Standards

In July 2015, the FASB issued ASU 2015-11, Inventory: Simplifying the Measurement of Inventory. ASU 2015-11 requires that 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 became effective, and was adopted prospectively, for the first quarter of fiscal year 2017. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation: Improvements to Employee Shared-Based Payment Accounting. ASU 2016-09 is intended to simplify several aspects of accounting for share-based payment awards. The new guidance became effective and was adopted for the first quarter of fiscal year 2017. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

Recently Issued Accounting Standard

In March 2017, the FASB issued ASU 2017-08, Receivables – Nonrefundable Fees and Other Costs. ASU 2017-08 shortens the amortization period for certain callable debt securities held at a premium, requiring the premium to be amortized to the earliest call date. The standard is effective for annual and interim periods beginning after December 15, 2018. The Company does not expect the adoption of this guidance to have a material impact on the consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, Intangibles – Goodwill and Other: Simplifying the Test for Goodwill Impairment. ASU 2017-04 eliminates the second step in the goodwill impairment test which requires an entity to determine the implied fair value of the reporting unit's goodwill. Instead, an entity should recognize an impairment loss if the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, with the impairment loss not to exceed the amount of goodwill allocated to the reporting unit. The standard is effective for annual and interim goodwill impairment tests conducted in fiscal years beginning after December 15, 2019, with early adoption permitted. The Company does not expect the adoption of this guidance to have a material impact on the consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments. The guidance is effective for annual and interim periods beginning after December 15, 2017. Early adoption is permitted. The Company does not expect the adoption of this guidance to have a material impact on the consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses: Measurement of credit losses on Financial Instruments. 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 years 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 February 2016, the FASB issued ASU 2016-02, Leases. ASU 2016-02 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 ASU 2016-01, Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01 primarily affects equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. Among other things, this new guidance requires certain equity investments to be measured at fair value with changes in fair value recognized in net income. 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 May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers. Subsequent updates to the guidance were issued in 2016. 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 is effective for annual and interim periods beginning on or after December 15, 2017.

The guidance permits two methods of adoption: retrospectively to each prior reporting period presented (full retrospective method), or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application (the cumulative catch-up transition method). The Company currently anticipates adopting the standard for the annual and interim periods beginning on December 31, 2017, using the cumulative catch-up transition method. Management's evaluation of the directional impacts of adopting the new standard on the timing of revenue recognition is in progress, and is expected to be complete during the quarter ended September 30, 2017. The detailed analysis of the impact on the timing of revenue recognition and the cumulative catch-up adjustment will be completed prior to the end of the 2017 fiscal year.

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		Six Months Ended	
	Ended July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
Net income	\$7,284	\$6,990	\$17,495	\$15,198
Basic and diluted weighted average shares outstanding	27,046	26,908	26,996	26,857
Basic and diluted net income per common share	\$0.27	\$0.26	\$0.65	\$0.57

3. BUSINESS ACQUISITION

On December 5, 2016 (the “Acquisition Date”), the Company completed the acquisition of Enovation Controls, LLC, a global provider of electronic control, display and instrumentation solutions. Historically Enovation Controls sold products to four customer markets: natural gas production controls (NGPC), engine controls and fuel systems (ECFS), power controls (PC) and vehicle technologies (VT). Prior to the closing date, and pursuant to an Asset Transfer Agreement, Enovation Controls transferred the assets and liabilities of their lines of business associated with the NGPC and ECFS customer markets to a separate legal entity, leaving Enovation Controls with only the lines of business associated with the PC and VT customer markets and the related agreed upon assets and liabilities to be acquired by Sun.

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Pursuant to a Unit Purchase Agreement, Sun acquired all of the outstanding membership units of Enovation Controls for initial cash consideration of \$201,020 and additional cash earn-out potential of \$50,000. Total consideration for the acquisition was subject to a post-closing adjustment for working capital in accordance with the terms of the Purchase Agreement. During the first quarter of 2017 the Company recognized an additional \$500 of consideration for the post-closing working capital adjustment.

The contingent consideration arrangement requires the Company to pay up to \$50,000 of additional consideration to Enovation Controls' former owners based on defined revenue and EBITDA targets. The potential payments are due in three installments, to be paid during the 9, 18 and 27 month periods after closing. See Note 4 to the Financial Statements for a summary of the changes in estimated fair value of the contingent consideration liability.

The purchase price was allocated to tangible and intangible assets acquired and liabilities assumed based on their estimated fair values. The fair value of identifiable intangible assets acquired was based on estimates and assumptions made by management at the time of the acquisition. Management is currently awaiting additional information to complete the valuation of identified intangible assets and related deferred income taxes. As additional information, as of the acquisition date, becomes available and as management completes its evaluation, the preliminary purchase price allocation may be revised during the remainder of the measurement period (which will not exceed 12 months from the Acquisition Date). Any such revisions or changes may be material as the fair values are finalized.

The fair value of total purchase consideration consisted of the following:

Cash	\$201,020
Fair value of contingent consideration	41,391
Post closing adjustment for working capital	500
Total purchase consideration	242,911
Less: cash acquired	(964)
Total purchase consideration, net of cash acquired	\$241,947

The preliminary allocation of the total purchase price, net of cash acquired, is as follows:

Accounts receivable	\$9,502
Inventories	16,979
Other current assets	176
Property, plant and equipment	10,546
Goodwill	105,481
Intangible assets	108,070
Other assets	8
Total assets acquired	250,762
Accounts payable	(3,260)
Accrued expenses and other liabilities	(3,745)
Deferred income taxes	(1,810)
Total liabilities assumed	(8,815)
Fair value of net assets acquired	\$241,947

Unaudited Pro Forma Information

The following unaudited pro forma financial information presents combined results of operations for each of the periods presented, as if Enovation Controls had been acquired as of the beginning of 2016. The financial results of Enovation Controls included in the pro forma information provided below reflect net sales and direct costs and

operating expenses related to the acquired lines of business only.

The PC and VT lines of business were not separate legal entities and were never operated as stand-alone businesses, divisions or subsidiaries and Enovation Controls had never maintained the distinct and separate accounts necessary to prepare full carve out financial statements. Due to the impracticability of obtaining full financial information for the carve-out operations, certain costs of Enovation Controls, primarily related to corporate overhead, foreign currency translation gains and losses and interest expense are not included in the pro forma results prior to the Acquisition Date.

The pro forma information includes adjustments to interest expense, income tax provision, amortization and depreciation for intangible assets and property, plant and equipment acquired and net sales and cost of sales for the effects of the supply agreement entered into at the Acquisition Date. The pro forma information does not reflect any operating efficiencies or potential cost savings that may result from the acquisition. Accordingly, the pro forma information is for illustrative purposes only and is not intended to present or be indicative of the actual results of operations of the combined company that may have been achieved had the acquisition actually occurred at the beginning of 2016, nor is it intended to represent or be indicative of future results of operations of the combined business. Consequently, actual results will differ from the unaudited pro forma information presented below:

	Three months ended July 2, 2016	Six months ended July 2, 2016
Net sales	\$70,499	\$141,354
Operating income	12,732	26,497
Net income	7,973	17,078
Basic and diluted net income per common share	0.30	0.64

4. 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 were derived from quoted prices in active markets for identical assets or liabilities. Contingent consideration and newly acquired intangible assets are measured at fair value using level 3 inputs. 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. The Company's short-term investments are carried at fair value, with the unrealized gains and losses, net of tax, reported as a component of shareholder's equity. Realized gains and losses on sales of short-term investments are generally determined using the specific identification method, and are included in miscellaneous expense, net 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 1, 2017 and December 31, 2016. The fair value of cash and cash equivalents, accounts receivable, other current assets, accounts payable and accrued expenses and other liabilities approximates their carrying value, due to their short-term nature.

July 1, 2017				
	Adjusted Cost	Unrealized Gains	Unrealized Losses	Fair Value
Assets				
Level 1:				
Equity securities	\$—	\$ 21	\$ —	\$ 21
Mutual funds	1,483	—	(149)	1,334
Subtotal	1,483	21	(149)	1,355
Level 2:				
Corporate fixed income	1,455	2	(228)	1,229
Municipal bonds	1,336	\$ —	(74)	1,262
Subtotal	2,791	2	(302)	2,491
Total	\$4,274	\$ 23	\$ (451)	\$ 3,846
Liabilities				
Level 3:				
Contingent consideration				\$ 49,582
Total				\$ 49,582

December 31, 2016				
	Adjusted Cost	Unrealized Gains	Unrealized Losses	Fair Value
Assets				
Level 1:				
Equity securities	\$—	\$ 31	\$ —	\$ 31
Mutual funds	1,483	\$ —	(159)	1,324
Subtotal	1,483	31	(159)	1,355
Level 2:				
Corporate fixed income	4,288	9	(408)	3,889
Municipal bonds	1,675	\$ —	(94)	1,581
Subtotal	5,963	9	(502)	5,470
Total	\$7,446	\$ 40	\$ (661)	\$ 6,825
Liabilities				
Level 3:				
Contingent consideration				\$ 35,077
Total				\$ 35,077

The Company recognized a net realized loss on investments during the six months ended July 1, 2017 of \$259 and a net realized loss of \$309 during the six months ended July 2, 2016. As of July 1, 2017, 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 1, 2017 and July 2, 2016, the

Company recognized impairment charges of \$220 and \$276, respectively, which are included in the net realized losses for the period.

Maturities of investments at July 1, 2017 are as follows:

	Adjusted Cost	Fair Value
Due in less than one year	\$ 401	\$ 278
Due after one year but within five years	1,214	1,169
Due after five years but within ten years	469	394
Due after ten years	707	650
Total	\$ 2,791	\$ 2,491

A summary of the changes in the estimated fair value of contingent consideration at July 1, 2017 is as follows:

Balance at December 31, 2016	\$35,077
Measurement period adjustment	6,314
Change in estimated fair value	7,563
Accretion in value	628
Balance at July 1, 2017	\$49,582

The fair value of the contingent consideration arrangement was estimated using a risk-adjusted probability analysis. During the second quarter of 2017 management completed the valuation of the acquisition date fair value of contingent consideration resulting in a measurement period adjustment which increased the fair value of the liability and goodwill by \$6,314. Also during the second quarter of 2017, an adjustment to the fair value of contingent consideration was recorded based on Enovation Controls' results of operations during the period and managements revision of revenue and EBITDA forecasts. The adjustment was not considered a measurement period adjustment and was therefore recognized in current period earnings.

5. INVENTORIES

	July 1, 2017	December 31, 2016
Raw materials	\$24,242	\$ 16,864
Work in process	6,035	5,641
Finished goods	9,323	8,069
Provision for slow moving inventory	(1,118)	(574)
Total	\$38,482	\$ 30,000

6. GOODWILL AND INTANGIBLE ASSETS

A summary of changes in goodwill at July 1, 2017 is as follows:

	Hydraulics	Electronics	Total
Balance at December 31, 2016	\$ 2,214	\$ 101,369	\$ 103,583
Working capital adjustment	—	500	500
Measurement period adjustment	—	6,314	6,314
Currency translation	80	—	80
Balance at July 1, 2017	\$ 2,294	\$ 108,183	\$ 110,477

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As of July 1, 2017, no factors were identified that indicated impairment of the carrying value of the Company's goodwill.

At July 1, 2017 and December 31, 2016, intangible assets consisted of the following:

	July 1, 2017			December 31, 2016		
	Gross carrying amount	Accumulated amortization	Net carrying amount	Gross carrying amount	Accumulated amortization	Net carrying amount
Definite-lived intangibles:						
Trade Name and Brands	\$30,774	\$ (1,330)	\$ 29,444	\$30,774	\$ (541)	\$ 30,233
Non-compete Agreements	950	(111)	839	950	(16)	934
Technology	18,435	(1,645)	16,790	18,435	(620)	17,815
Supply Agreement	21,000	(1,225)	19,775	21,000	(175)	20,825
Sales Order Backlog	620	(620)	—	620	(347)	273
Customer Relationships	39,751	(1,610)	38,141	39,751	(614)	39,137
Licensing Agreement	3,727	(510)	3,217	3,727	(379)	3,348
	\$115,257	\$ (7,051)	\$ 108,206	\$115,257	\$ (2,692)	\$ 112,565

Amortization expense of intangible assets for the six months ended July 1, 2017, and July 2, 2016 was approximately \$4,348 and \$302, respectively. Total estimated amortization expense of intangible assets for the years 2018 through 2022 is presented below. The remaining amortization for 2017 is approximately \$4,074.

Year:	
2018	\$8,148
2019	8,148
2020	8,148
2021	8,117
2022	7,839
Total	\$40,400

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 1, 2017.

7. LONG-TERM DEBT

The Company has a revolving line of credit that provides for up to \$300,000 of available credit, available through November 22, 2021. At July 1, 2017 and December 31, 2016, the balance on the revolving line was \$124,000 and \$140,000, respectively, with \$176,000 and \$160,000 of additional credit available, respectively, subject to pro forma compliance with debt covenants. The interest rate in effect at July 1, 2017 was 2.92%. Interest expense recognized during the six months ended July 1, 2017 totaled \$1,778. As of the date of this filing, the Company was in compliance with all debt covenants related to the credit agreement.

8. INCOME TAXES

At July 1, 2017, the Company had an unrecognized tax benefit of \$3,786 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 1, 2017, 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 2007 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 2007 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 2007 through 2012 with the IRS and that there could be significant increases or decreases to unrecognized tax benefits.

9. STOCK-BASED COMPENSATION

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 1, 2017, 453,737 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 1, 2017 and July 2, 2016, totaled \$1,397 and \$2,316, respectively.

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The following table summarizes restricted stock activity from December 31, 2016, through July 1, 2017:

	Number of shares (in thousands)	Weighted average grant-date fair value
Nonvested balance at December 31, 2016	104	\$ 32.42
Granted	74	35.45
Vested	(35)	33.75
Forfeitures	(2)	31.85
Nonvested balance at July 1, 2017	141	\$ 33.81

The Company had \$3,102 of total unrecognized compensation cost related to restricted stock awards granted under the 2011 Plan as of July 1, 2017. That cost is expected to be recognized over a weighted average period of 1.15 years.

The Company maintains an Employee Stock Purchase Plan (“ESPP”) in which only Sun Hydraulics US 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 the Company’s 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 plan. The ESPP and U.K. plans authorize 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 15,090 shares at a weighted average price of \$30.90, and 25,896 shares at a weighted average price of \$25.89, under the ESPP and U.K. plans during the six months ended July 1, 2017 and July 2, 2016, respectively. The Company recognized \$131 and \$137 of compensation expense during the six months ended July 1, 2017 and July 2, 2016, respectively. At July 1, 2017, 563,202 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, Nonemployee Directors are compensated for their Board service solely in shares of Common Stock. 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 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 under the 2012 Directors Plan, 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 1, 2017, 162,124 shares remained available for issuance under the 2012 Directors Plan. Directors were granted 12,750 shares for the six months ended July 1, 2017 and July 2, 2016, respectively. The Company recognized director stock compensation expense of \$501 and \$407 for the six months ended July 1, 2017 and July 2, 2016, respectively.

10. ACCUMULATED OTHER COMPREHENSIVE LOSS

Changes in Accumulated Other Comprehensive Loss by Component

Six Months Ended July 1, 2017

	Unrealized		
	Gains and		
	Losses on		
	Available-for-	Foreign	
	Sale	Currency	
	Securities	Items	Total
Balance at December 31, 2016	\$ (391)	\$(15,442)	\$(15,833)
Other comprehensive (loss) income before reclassifications	(41)	5,191	5,150
Amounts reclassified from accumulated other comprehensive loss	163	—	163
Net current period other comprehensive income	122	5,191	5,313
Balance at July 1, 2017	\$ (269)	\$(10,251)	\$(10,520)

Reclassifications out of Accumulated Other Comprehensive Loss

Six Months Ended July 1, 2017

Details about Accumulated Other	Six	
Comprehensive Income Components	Months	
	Ended	Affected Line Item in the
	July 1,	Consolidated Statement of Operations
	2017	
Unrealized gains and losses on available-for-sale securities		
Realized gain/(loss) on sale of securities	\$ (39)	Miscellaneous expense, net
Other than temporary impairment	(220)	Miscellaneous expense, net
	(259)	Total before tax
	96	Tax benefit
	(163)	Net of tax
Total reclassifications for the period	\$ (163)	

11. SEGMENT REPORTING

For the six months ended July 2, 2016, the Company's individual subsidiaries operated 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 was managed, the Company determined that it had only one operating and reporting segment for both internal and external reporting purposes. With the acquisition of Enovation Controls on December 5, 2016, the Company re-evaluated the reportable operating segment presentation. As of the date of the acquisition, the Company has two reportable segments: Hydraulics and Electronics. These segments are organized primarily based on the similar nature of products offered for sale, the types of customers served and the methods of distribution and are consistent with how the segments are managed, how resources are allocated and how information is used by the chief operating decision makers. As a result of the re-evaluation of reportable operating segments, financial information for HCT is presented in the Electronics segment as of the beginning of the 2016 fiscal year.

The Company evaluates performance and allocates resources based primarily on segment operating income. Certain costs were not allocated to the business segments as they are not used in evaluating the results of, or in allocating resources to, Sun's segments. These costs are presented in the Corporate and other line item below. For the six months ended July 1, 2017, the unallocated costs included certain corporate costs not deemed to be allocable to all segments of \$300 and acquisition-related costs including charges related to inventory step-up to fair value of \$1,774 and amortization of acquisition-related intangible assets of \$4,227. The accounting policies of Sun's operating segments are the same as those used to prepare the accompanying consolidated financial statements.

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The following table presents financial information by reportable segment:

	Three months ended		Six months ended	
	July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
Net sales				
Hydraulics	\$60,818	\$49,915	\$114,940	\$100,098
Electronics	28,517	894	55,748	1,739
	\$89,335	\$50,809	\$170,688	\$101,837
Operating Income:				
Hydraulics	\$16,359	\$10,642	\$30,131	\$22,568
Electronics	6,419	(198)	12,655	(238)
Corporate and other	(2,077)	—	(6,301)	—
	\$20,701	\$10,444	\$36,485	\$22,330
Depreciation and Amortization:				
Hydraulics	\$2,241	\$2,386	\$4,529	\$4,780
Electronics	2,523	121	5,326	254
	\$4,764	\$2,507	\$9,855	\$5,034
Capital Expenditures:				
Hydraulics	\$1,465	\$1,493	\$2,076	\$2,435
Electronics	1,082	65	1,229	122
	\$2,547	\$1,558	\$3,305	\$2,557

	July 1, 2017	December 31, 2016
Total Assets:		
Hydraulics	\$198,887	\$193,722
Electronics	270,406	251,055
Total	\$469,293	\$444,777

Geographic Region Information

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

	Three months ended		Six months ended	
	July 1, 2017	July 2, 2016	July 1, 2017	July 2, 2016
Net sales				
Americas	\$52,705	\$23,402	\$99,993	\$48,117
Europe/Middle East/Africa	19,229	15,803	39,329	31,480
Asia/Pacific	17,401	11,604	31,366	22,240
Total	\$89,335	\$50,809	\$170,688	\$101,837

	July 1, 2017	December 31, 2016
Tangible long-lived assets		
Americas	\$69,007	\$71,802
Europe/Middle East/Africa	7,340	7,116
Asia/Pacific	1,903	1,597
Total	\$78,250	\$80,515

12. RELATED PARTY TRANSACTIONS

Enovation Controls purchases and sells inventory to an entity partially owned by one of its officers. For the six months ended July 1, 2017, sales to, and purchases from, the entity for inventory totaled \$1,299 and \$5,805, respectively. At July 1, 2017, amounts due from, and due to, the entity for inventory sales and purchases totaled \$548 and \$723, respectively.

In addition to these inventory transactions, Enovation Controls entered into a transition services agreement with the related party to provide, and receive, certain transition services for a period of up to one year for specified services. For the six months ended July 1, 2017, sales and cost of sales recognized by Enovation Controls under the agreement totaled \$1,217 and \$968, respectively, and are included in miscellaneous expense, net in the Consolidated Statement of Operations. For the six months ended July 1, 2017, purchases from the related party under the agreement totaled \$856. At July 1, 2017, amounts due from, and due to, the related party under the transition services agreement totaled \$238 and \$192, respectively.

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.

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

This report on Form 10-Q contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. The words "expects," "anticipates," "believes," "intends," "plans" and similar expressions identify forward-looking statements. In addition, any statements which refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. We undertake no obligation to publicly disclose any revisions to these forward-looking statements to reflect events or circumstances occurring subsequent to filing this Form 10-Q with the Securities and Exchange Commission. These forward-looking statements are subject to risks and uncertainties, including, without limitation, those discussed in this section and those identified in Item 1A, "Risk Factors" included in our 2016 Annual Report on Form 10-K. In addition, new risks emerge from time to time and it is not possible for management to predict all such risk factors or to assess the impact of such risk factors on our business. Accordingly, our future results may differ materially from historical results or from those discussed or implied by these forward-looking statements. Given these risks and uncertainties, the reader should not place undue reliance on these forward-looking statements.

OVERVIEW

We are an industrial technology leader that develops and manufactures solutions for both the hydraulics and electronics markets, each of which serve as reportable segments. The Hydraulics segment, which consists of the historical Sun Hydraulics companies, 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 Electronics segment, which consists primarily of Enovation Controls, is a global provider of innovative electronic control, display and instrumentation solutions for both recreational and off-highway vehicles, as well as stationary and power generation equipment.

Enovation Controls was acquired on December 5, 2016. Our consolidated operating results for the six months ended July 1, 2017 include the results of Enovation Controls, while our consolidated operating results for the six months ended July 2, 2016 do not. For comparability, see unaudited pro forma information included in Note 3 to the Financial Statements.

The operating results of the Hydraulics and Electronics segments included in MD&A are presented on a basis consistent with our internal management reporting. Segment information included in Note 11 to the Financial Statements is also presented on this basis. All differences between our internal management reporting basis and accounting principles generally accepted in the United States ("U.S. GAAP"), specifically the allocation of certain corporate and acquisition-related costs, are included in Corporate and Other.

Vision 2025

In 2016 we introduced our vision for the Company for the next decade. We believe it is important to reach a critical mass of \$1 billion in sales by 2025 while remaining a technology leader in the industrial goods sector. To achieve our target, we anticipate organic sales of our pre-Enovation Controls historic business will reach up to \$500 million and acquisitions (including Enovation Controls) will add another \$500 million in revenue. Through this growth, our decision-making process will consider our desire to maintain superior profitability and financial strength.

The acquisition of Enovation Controls was the first step to realizing our vision. Enovation Controls improves and expands our technology offering, allows us to market integrated solutions of electronics and hydraulics, and, most importantly, advances our electrification and digitization initiatives across our product portfolio. The acquisition brings Sun new end markets, diversification of our technology platform, and provides entry into highly sophisticated, specialized markets. Enovation Controls provides us with a large team of over 100 electronic and software engineers with a track record of new product development and technical innovation. In addition, the sales team has developed

strong customer relationships from which market insight can be drawn.

Product development is a key factor to organic growth in both the Hydraulics and Electronics segments, as well as joint development between the two segments. In the Hydraulics segment, our most recent new product introductions have been electrically actuated valves. We expect the trend for development of similar types of products to continue as capital goods markets move toward further electrification and digitalization of machines. Product development in the Electronics segment is generally completed in conjunction with the customer, specifically in the Vehicle Technologies (“VT”) line of business. The technology is then transferred to Power Controls (“PC”) products after implementation in VT.

Mergers and acquisitions of companies that advance our technology capabilities will be critical to achieving our 2025 Vision. Cultivating target lists and relationships with potential M&A targets can often be a lengthy process, but we believe it is key to creating successful acquisitions with sustainable business results. We have an established list of potential targets at any given time and entertain reviewing other opportunities for acquisition as they become known to us.

Management utilizes financial and operational results by segment and at the consolidated level for decision-making purposes as well as evaluation. Within each segment, global leaders are responsible for the coordination of their functional area as well as cross-functional initiatives. Small teams have been identified to work across both segments in areas of product management, sales, operations and finance. Key performance indicators are utilized by each global functional area, segment and at the consolidated level.

Industry conditions

Demand for our products is dependent on demand for the industrial goods markets into which the products are incorporated. The capital goods industries in general, and the Hydraulics and Electronics segments 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 6.2% during the first half of 2017 after decreasing 9% in 2016, and decreasing 16% in 2015. The Institute of Printed Circuits Association reports that North American electronics business indicators suggest the likelihood of continued sales growth in the industry this year, but with some volatility. Electronics manufacturing services (EMS) and semiconductor sales saw strong growth in the first half of 2017, while printed circuit board (PCB) sales saw some growth as well.

We utilize industry trend reports from various sources, as well as feedback from customers and distributors, to evaluate economic trends. We also rely on global government statistics such as Gross Domestic Product and Purchasing Managers Index to understand higher level economic conditions.

Results for the second quarter

(in millions except net income per share)

	Three Months Ended				
	July 1,	July 2,	%		
	2017	2016	Change		
Net sales	\$89.3	\$50.8	76	%	
Net income	\$7.3	\$7.0	4	%	
Net income per share:					
Basic and diluted	\$0.27	\$0.26	4	%	

	Six Months Ended				
	July 1,	July 2,	%		
	2017	2016	Change		
Net sales	\$170.7	\$101.8	68	%	
Net income	\$17.5	\$15.2	15	%	
Net income per share:					
Basic and diluted	\$0.65	\$0.57	14	%	

Second quarter sales, in both the Hydraulics and Electronics segments, exceeded expectations. Consolidated Q2 sales increased 76% over the prior year. Our Hydraulics segment sales were up \$10.9 million, 21.8%, and our Electronics segment sales were up \$27.6 million, primarily attributable to Enovation Controls, acquired in December 2016. We continue to see an increase in global demand driving the growth in sales in all of our geographic regions. Additionally, we are starting to realize returns on investments made in global sales and marketing initiatives. A strong U.S dollar adversely affected sales and EPS during the second quarter by \$0.9 million and \$0.03, respectively.

Enovation Controls' sales and operating results have exceeded our year-to-date forecast, and projections for the remainder of 2017 have improved. This strong performance was driven by higher demand in the power controls and recreational vehicle end markets and led to an increase in the fair value of the acquisition-related contingent consideration liability during Q2. The contingent consideration is based on defined revenue and EBITDA targets through early 2019. The change in fair value during Q2, in excess of the acquisition date fair value, was recognized in earnings and negatively impacted Q2 and year-to-date net income and EPS, net of tax, by \$5.3 million and \$0.19, respectively.

2017 Outlook

Consolidated revenue for the 2017 year is expected to be between \$315 million and \$330 million, with the Hydraulics segment contributing between \$215 million and \$225 million and the Electronics segment contributing between \$100 million and \$105 million. Consolidated operating margin, prior to acquisition-related amortization expense, is expected to be 22% to 24% for the 2017 year. Consolidated interest expense is expected to be between \$4.2 million and \$4.4 million, prior to considering the offsetting interest income. The full year tax effective rate is anticipated to be 32% to 34%. Capital expenditures are estimated to be between \$20 million

and \$25 million. Depreciation and amortization are estimated to be between \$12 million to \$13 million and between \$8 million and \$9 million, respectively.

SEGMENT RESULTS

Hydraulics

The Hydraulics segment provides the global capital goods industries with hydraulic components and systems used to transmit power and control force, speed and motion. On a component level, the Hydraulics segment designs and manufactures screw-in hydraulic cartridge valves, manifolds, and integrated fluid power packages and subsystems used in hydraulic systems. The following table sets forth the results of operations for the Hydraulics segment (in millions):

	Three months ended			% Change
	July 1, 2017	July 2, 2016		
	Net sales	\$60.8	\$49.9	
Gross profit	\$25.6	\$18.6	37.6	
Gross profit %	42.1 %	37.3 %		
Operating income	\$16.4	\$10.6	54.7	
Operating income %	27.0 %	21.2 %		

	Six months ended			% Change
	July 1, 2017	July 2, 2016		
	Net sales	\$114.9	\$100.1	
Gross profit	\$47.6	\$37.9	25.6	
Gross profit %	41.4 %	37.9 %		
Operating income	\$30.1	\$22.6	33.2	
Operating income %	26.2 %	22.6 %		

Second quarter net sales for the Hydraulics segment totaled \$60.8 million, representing growth of \$10.9 million, 21.8%, over the prior-year period. Year-to-date net sales for the Hydraulics segment totaled \$114.9 million, representing growth of \$14.8 million, 14.8%, over the prior-year period. The growth was driven by increased demand in all geographic and end markets and was also impacted by global sales and marketing initiatives. Changes in exchange rates had a negative impact on sales of \$0.5 million for the second quarter and \$0.9 million year to date.

The following table presents net sales based on the geographic region of the sale for the Hydraulics segment (in millions):

	Three months ended			% Change
	July 1, 2017	July 2, 2016		
	Americas	\$28.2	\$22.5	
Europe/Middle East/Africa	16.6	15.8	5.1	

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Asia/Pacific	16.0	11.6	37.9	%
Total	\$60.8	\$49.9		

	Six months ended			
	July 1, 2017	July 2, 2016	Change	%
Americas	\$52.8	\$46.4	13.8	%
Europe/Middle East/Africa	33.7	31.5	7.0	%
Asia/Pacific	28.4	22.2	27.9	%
Total	\$114.9	\$100.1		

Increased demand in the U.S. and Canada resulted in sales to the Americas growing by \$5.7 million, 25.3%, in the second quarter of 2017 and \$6.4 million, 13.8%, year to date.

Sales to Europe, the Middle East and Africa (“EMEA”) went up \$0.8 million, 5.1%, in the second quarter of 2017 and \$2.2 million, 7.0%, year to date. Increased demand, primarily in the United Kingdom, Germany and Spain led to the growth. Exchange rates had a negative impact on sales to EMEA of approximately \$0.6 million in the second quarter of 2017 and \$1.1 million year to date.

Sales to the Asia/Pacific region went up \$4.4 million, 37.9%, in the second quarter of 2017 and \$6.2 million, 27.9%, year to date. Increased demand in China and South Korea and sales and marketing initiatives in the region led to the growth. Exchange rates had a \$0.1 million positive impact on Asia/Pacific sales in the second quarter of 2017 and \$0.2 million year to date.

Second quarter gross profit grew \$7.0 million, 37.6%, compared to the second quarter of the prior year, and gross profit as a percentage of net sales improved to 42.1% for the second quarter of 2017. Increased sales volume impacted gross profit by approximately \$4.0 million during Q2. Year-to-date gross profit grew \$9.7 million, 25.6%, compared to 2016, and gross profit as a percentage of net sales improved to 41.4%. Increased sales volume impacted gross profit year to date by approximately \$5.6 million. The remainder of the growth in gross profit was a result of our ability to leverage our fixed costs, combined with cost reduction efforts during the year.

Second quarter operating income grew \$5.8 million, 54.7%, compared to the second quarter of the prior year, and operating income as a percentage of net sales improved to 27.0% for the second quarter of 2017. Year-to-date operating income grew \$7.5 million, 33.2%, and year-to-date operating income as a percentage of net sales improved to 26.2%. The improvement in operating income during 2017 was primarily due to sales volume and improved gross profit. Second quarter growth in operating income was also related to a reduction in selling, engineering and administrative costs as a percentage of sales, 15.2% in Q2 2017 compared to 16.2% in Q2 2016.

Selling, engineering and administrative expenses (“SEA”) grew \$1.1 million, or 13.6%, to \$9.2 million in the second quarter of 2017, compared to \$8.1 million in the second quarter of the prior year. Year-to-date SEA costs grew \$2.2 million, or 14.5%, to \$17.4 million, compared to \$15.2 million in the prior year. The fluctuations were due to the following: increased compensation costs, primarily related to investments in strong talent necessary to support our initiatives to drive future profitability, increased professional fees for legal and advisory services related to special projects, increased insurance costs for an extraordinary claim that occurred during the second quarter of 2017 and lower CEO transition costs in 2017 compared to year to date 2016.

Electronics

The Electronics segment designs and manufactures electronic control, display and instrumentation solutions for recreational and off-highway vehicles and stationary and power generation equipment. End markets within the Electronics segment are divided into two lines of business: Power Controls and Vehicle Technologies. Power Controls serves a variety of end markets with products such as displays, panels, gauges, controllers, battery chargers and various end devices. Vehicle Technologies serves the recreational vehicles end market with products such as electronic controls, displays and instrumentation. The following table sets forth the results of operations for the Electronics segment (in millions):

	Three months ended July 1, 2017	Six months ended July 1, 2017
Net sales	\$ 28.5	\$ 55.8
Gross profit	\$ 13.0	\$ 25.6
Gross profit %	45.6 %	45.9 %
Operating income	\$ 6.4	\$ 12.7
Operating income %	22.5 %	22.8 %

Net sales for our Electronics segment totaled \$28.5 million for the second quarter of 2017, \$27.8 million of which were contributed by Enovation Controls. This represented an \$8.4 million, 44%, increase in the net sales of the PC and

VT lines of business of Enovation Controls during the second quarter of 2016, which was prior to our acquisition of Enovation Controls in the fourth quarter of 2016. Year-to-date net sales for our Electronics segment totaled \$55.8 million, of which \$54.3 million were contributed by Enovation Controls, representing a \$15.5 million, 40%, increase over the net sales of the PC and VT lines of business of Enovation Controls during the same period of 2016, which was prior to our acquisition of Enovation Controls in the fourth quarter of 2016.

The sales growth was driven by demand in the power controls and recreational vehicle end markets and our proactive sales initiatives as well as increased demand for new products developed in the past year. Changes in exchange rates had a negative impact on Q2 sales of approximately \$0.4 million and year to date of \$1.0 million.

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The following table presents net sales based on the geographic region of the sale for the Electronics segment (in millions):

	Three months ended July 1, 2017	Six months ended July 1, 2017
Americas	\$ 24.5	\$ 47.2
Europe/Middle East/Africa	2.6	5.6
Asia/Pacific	1.4	3.0
Total	\$ 28.5	\$ 55.8

Sales to the Americas totaled \$24.5 million during Q2 and \$47.2 million year to date. Sales to the EMEA region totaled \$2.6 million during Q2 and \$5.6 million year to date. Exchange rates had a negative impact on sales to EMEA of approximately \$0.4 million in the second quarter of 2017 and \$0.9 million year to date. Sales to the Asia/Pacific region totaled \$1.4 million for Q2 and \$3.0 million year to date. Exchange rates had a minimal impact on Asia/Pacific sales during 2017.

For the second quarter of 2017, gross profit totaled \$13.0 million, and gross profit as a percentage of net sales totaled 45.6%. Selling, engineering and administrative expenses totaled \$6.6 million for the second quarter of 2017 and operating income for the Electronics segment totaled \$6.4 million, with an operating margin of 22.5%. Year-to-date gross profit totaled \$25.6 million, and gross profit as a percentage of net sales totaled 45.9%. Selling, engineering and administrative expenses totaled \$12.8 million year to date 2017 and operating income for the Electronics segment totaled \$12.7 million, with an operating margin of 22.8%.

Corporate and Other

Certain costs are excluded from segment results as they are not used in evaluating the results of, or in allocating resources to, our operating segments. For the three months ended July 1, 2017, these costs included corporate costs not deemed to be allocable to either operating segment of \$0.1 million and amortization of acquisition-related intangible assets of \$2.0 million. Year to date 2017, these costs included corporate costs not deemed to be allocable to all segments of \$0.3 million, acquisition-related costs including charges related to inventory step-up to fair value of \$1.8 million and amortization of acquisition-related intangible assets of \$4.2 million.

Interest Expense, net

Net interest expense was \$1.0 million for the second quarter of 2017 compared to net interest income of \$0.4 million for the prior-year quarter. Interest expense for the second quarter of 2017 totaled \$1.1 million compared to minimal interest expense for the second quarter of 2016. Year-to-date net interest expense was \$1.6 million compared to net interest income of \$0.8 million for 2016. Year-to-date interest expense was \$1.8 million compared to minimal interest expense for the same period of 2016.

Total average cash and investments for the quarter ended July 1, 2017, totaled \$78.9 million compared to \$134.9 million for the quarter ended July 2, 2016. Total average cash and investments year to date 2017 totaled \$81.7 million compared to \$132.0 million for the same period of 2016. The funding of the acquisition of Enovation Controls during the fourth quarter of 2016 was the driver for the increases in interest expense and decreases in average cash and short-term investments.

Change in Fair Value of Contingent Consideration

The fair value of our acquisition-related contingent consideration liability is revalued each quarter to its estimated fair value, and changes are recorded in earnings of the period. Changes in fair value are primarily a result of actual sales volume and EBITDA results of Enovation Controls for the period as well as changes in the probabilities of estimated future sales volume and EBITDA results of Enovation Controls. During the second quarter of 2017 the fair value of the liability increased by \$8.2 million over the final acquisition date fair value estimate of \$41.4 million, to \$49.6 million.

Income Taxes

The provision for income taxes for the quarter ended July 1, 2017, was 33.2% of pretax income compared to 34.0% for the quarter ended July 2, 2016. The year-to-date provision for income taxes was 32.8% of pretax income compared to 33.3% for the same period of 2016. These effective rates relate to the relative levels of income and different tax rates in effect among the countries in which we sell our products.

LIQUIDITY AND CAPITAL RESOURCES

Historically, our primary source of capital has been cash generated from operations, although funding of acquisition activity in 2016 and short-term fluctuations in working capital requirements have been met through borrowings under revolving lines of credit as needed. Our principal uses of cash have been paying operating expenses, paying dividends to shareholders, making capital expenditures, and servicing debt.

The following tables summarizes our cash flows for the periods (in millions):

	Six months ended		
	July		\$
	July 1, 2017	July 2, 2016	Change
Net cash provided by operating activities	\$21.7	\$21.9	\$(0.2)
Net cash provided by investing activities	(0.3)	2.8	(3.1)
Net cash used in financing activities	(20.9)	(5.5)	(15.4)
Effect of exchange rates on cash	4.0	(1.5)	5.5
Net increase in cash and cash equivalents	\$4.5	\$17.7	\$(13.2)

Cash on hand grew \$4.5 million from \$74.2 million at the end of 2016 to \$78.7 million at July 1, 2017.

Cash from operations decreased \$0.2 million, 1%, compared to the prior-year period. Net income for 2017 increased approximately \$2.3 million compared to the same period of 2016. The non-cash change in fair value of the acquisition-related contingent consideration liability during the second quarter of 2017 reduced net income by \$5.3 million, net of tax. Changes in inventory and accounts receivable reduced cash by \$24.3 million in 2017 compared to a use of cash of \$5.5 million during the same period of 2016. Days sales outstanding went up to 41 days as of July 1, 2017 compared to 35 days as of July 2, 2016. Days of inventory on hand went up to 63 as of July 1, 2017 from 36 as of July 2, 2016. These increases were primarily related to the addition of Enovation Controls during the fourth quarter of 2016 and business model differences compared with our historical operations. Accounts receivable, net balances grew \$14.5 million as of July 1, 2017 compared to December 31, 2016, which is a direct result of the improvement in net sales during 2017 compared to 2016.

Capital expenditures were \$3.3 million for the six months ended July 1, 2017, primarily made up of purchases of machinery and equipment. Capital expenditures for 2017 are estimated to be between \$20 million and \$25 million, primarily consisting of purchases of machinery and equipment, the purchase of Enovation Controls' manufacturing facility and corporate offices in Tulsa Oklahoma, which are currently being rented, and the construction of a new production facility for our South Korean subsidiary, which will be completed in 2018.

We expect to pay \$16.7 million, plus accrued interest, in connection with the first payment due on the contingent consideration liability during the fourth quarter of 2017.

In 2016 we entered into a credit agreement with PNC Bank, National Association, as administrative agent, and the lenders party thereto. The credit agreement provides us with a revolving line of credit of up to \$300 million that is available through November 22, 2021. The credit agreement includes an accordion feature to increase the line of credit by up to an additional \$100 million in the form of additional revolving credit loans or in the form of term loans. The loans under the line of credit will bear interest at the Euro Rate (as defined) or the Base Rate (as defined), at our option, plus the Applicable Margin (as defined) based on the Borrower's Leverage Ratio (as defined). The Applicable Margin ranges from 1.25% to 2.25% for the Euro Rate and ranges from 0.25% to 1.25% 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 (as defined), prepayment may be made without penalty or premium at any time upon the required notice to the Bank.

During the fourth quarter of 2016, we paid cash of approximately \$61 million and borrowed \$140 million on the line of credit to complete the acquisition of Enovation Controls. During the first half of 2017 we repaid \$16 million of the borrowings.

During the second quarter of 2017, we declared a quarterly cash dividend of \$0.09 per share payable on July 15, 2017, to shareholders of record as of June 30, 2017. 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 our profitability, financial condition, capital needs, future prospects and other factors deemed pertinent by the Board of Directors.

We believe that cash generated from operations and our borrowing availability under the revolving line of credit will be sufficient to satisfy our 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, we 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

We do not engage in any off balance sheet financing arrangements. In particular, we do not have any material interest in variable interest entities, which include special purpose entities and structured finance entities.

Inflation

The impact of inflation on our operating results has been moderate in recent years, reflecting generally lower rates of inflation in the economy. While inflation has not had, and we do not expect that it will have, a material impact upon operating results, there is no assurance that our business will not be affected by inflation in the future.

Critical Accounting Policies and Estimates

We currently apply 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, income taxes and fair value of short-term investments. Our critical accounting policies and estimates are included in our Annual Report on Form 10-K for the year ended December 31, 2016, and did not change during the second quarter of 2017.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

See “Item 7A – Quantitative and Qualitative Disclosures about Market Risk,” in our 2016 Annual Report on Form 10-K filed on February 28, 2017. There were no material changes during the six months ended July 1, 2017.

Item 4. CONTROLS AND PROCEDURES

As of July 1, 2017, 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). 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 July 1, 2017, 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 1, 2017, 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 31, 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 1, 2017.

Period	Total Number of Shares Purchased	Average Price Paid per Share	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
April 2 through April 29	—			
April 30 through May 27	—			
May 28 through July 1	225	\$43.14		

(1) In connection with an award of 750 shares to one of the Company's directors as Board fees under the 2012 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.

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

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 8, 2017.

SUN HYDRAULICS CORPORATION

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

(Principal Financial and Accounting Officer)