

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-K**

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

For the fiscal year ended January 2, 2010

Commission file number 0-21835

**SUN HYDRAULICS CORPORATION**

(Exact Name of Registration as Specified in its Charter)

**Florida**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**59-2754337**  
(I.R.S. Employer  
Identification No.)

**1500 West University Parkway**  
**Sarasota, Florida**  
(Address of Principal Executive Offices)

**34243**  
(Zip Code)

**941/362-1200**  
(Registrant's Telephone Number, Including Area Code)

**Securities registered pursuant to Section 12(b) of the Act**

| <u>Title of Each Class</u>    | <u>Name of each exchange on which registered</u> |
|-------------------------------|--|
| Common Stock \$.001 Par Value | NASDAQ Stock Market, LLC                         |

**Securities registered pursuant to Section 12(g) of the Act:**

| <u>Title of Each Class</u>    | <u>Name of each exchange on which registered</u> |
|-------------------------------|--|
| Common Stock \$.001 Par Value | NASDAQ Stock Market, LLC                         |

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes  No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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   
Non-accelerated filer  Smaller Reporting Company

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

The aggregate market value of the shares of voting common stock held by non-affiliates of the Registrant, computed by reference to the closing sales price of such shares on the Nasdaq Stock Market, LLC, as of the last business day of the Registrant's most recently completed second fiscal quarter was \$204,864,005.

As of February 26, 2010, there were 16,941,344 shares of common stock outstanding.

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**PART I**  
**ITEM 1. BUSINESS**

**Overview**

Sun Hydraulics (the “Company” or “We”) designs and manufactures screw-in hydraulic cartridge valves, manifolds and integrated packages for sale to international markets. These products are integral parts of hydraulic systems and are used by a variety of capital goods equipment manufacturers to control force, speed and motion.

The cartridge valves Sun Hydraulics produces are differentiated in the marketplace by their floating design. This design methodology provides benefits which include, but are not limited to, enhanced capacity, higher reliability, higher operating pressure capability, reduced size and greater installation flexibility. All of these benefits translate to the Company’s manifold and integrated package offerings.

The breadth and scope of Sun Hydraulics’ product offering is unparalleled in its industry. The Company believes this wide and diverse product offering acts as a barrier to entry for new competitors.

Sun Hydraulics’ products are used by a wide range of industries, most of which are considered capital goods producers. Product sales are broadly segmented by whether the product is used in a mobile or an industrial application. (see Products) Sun Hydraulics’ products are general purpose devices designed for use by a broad market. To a limited degree, the Company has designed specific products to a single customer’s specification.

The Company has operations in the United States, England, Germany, France, Korea, China and India (the Chinese operation is a joint venture and the Indian operation is a Liaison office). Products are sold primarily through independent authorized distributors who often act as system integrators by supplying complete hydraulic systems to OEMs. Sun Hydraulics’ foreign operations sometimes deal directly with customers in addition to managing independent distributors in their respective geographic regions.

In 2009, 46% of consolidated sales went to customers in the Americas, 33% to customers in Europe, the Middle East and Africa, and 20% to customers in the Asia/Pacific Region. In 2009, sales to any single customer or distributor did not exceed 6%.

Sun Hydraulics attributes its success to the innovative design and diversity of its products, the consistent high quality of its products and services, its ability to reliably deliver products on time, the breadth and diversity of its end markets, its geographic presence and the brand recognition of its products. The Company has been profitable every year since 1972 and has paid a dividend every quarter since going public in January 1997.

The Company was organized as a Florida corporation in 1986 to take over the operations of the business of the Company’s predecessor, Suninco, Inc. (f/k/a Sun Hydraulics Corporation). Suninco, Inc. was founded in 1970. The Company’s executive offices are located at 1500 West University Parkway, Sarasota, Florida 34243, and its telephone number is (941) 362-1200. The Company’s website is [www.sunhydraulics.com](http://www.sunhydraulics.com).

**Industry Background**

Sun Hydraulics is part of the hydraulics industry. Hydraulics is a form of fluid power that is used to achieve power transmission and motion control. Due to its mechanical advantage, hydraulics is widely employed to move and position materials, control machines, vehicles and equipment, and improve industrial efficiency and productivity. The primary products produced by this industry include; *pumps*, used to create the flow of fluids, *valves*, used to direct the flow and control pressure and the rate of flow, and *actuators*, which convert energy to work. The industry also produces other products including hose, fittings, sensors, accumulators, filters, regulators, lubricants, fluids and other items. The industry, in its present form, developed in the 1940s and 1950s.

Screw-in hydraulic cartridge valves provide a more desirable alternative to conventional forms of hydraulic valves. Conventional hydraulic valves are generally large, typically manufactured from iron castings,

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limited in their interface flexibility and usually designed to control a single task. Screw-in cartridge valves provide the same functional characteristics as conventional valves, but in a smaller size and often at a smaller cost. They are made from machined steel parts, are lighter-weight and more compact than conventional valves and provide significant advantages in interface flexibility.

These advantages help screw-in cartridge valves to displace conventional valves. Hydraulic system design engineers are able to develop complete control systems with multiple screw-in cartridge valves grouped together in a manifold to create an integrated package (i.e. a hydraulic control system functionally analogous to an electronic integrated circuit). Integrated packages optimize the control system, are proprietary to the customer, are compact and lightweight and significantly reduce assembly time and expense for OEMs.

## **Strategy**

Sun Hydraulics will continue to design, manufacture, market and support, on a worldwide basis, differentiated high-performance and high-quality products and systems. The Company believes this focus supports its business objectives of generating sustainable revenue growth that will consistently yield above-average returns on capital while achieving a high level of customer satisfaction. Key elements of the Company's strategy include the following:

*Deliver Value Through High-Quality, High-Performance Products.* The Company's products are designed with operating and performance characteristics that exceed those of many functionally similar products. The Company's products provide high value because they generally operate more reliably and at higher flow rates and pressures than competitive offerings of the same size.

*Achieve a High Level of Customer Satisfaction.* Sun Hydraulics schedules orders to the customer's request date. The Company believes that its long-term success is dependent upon its reputation in the marketplace, which in turn is a result of its ability to service its customers. The Company tests 100% of its screw-in cartridge valves to ensure the highest level of performance on a consistent basis.

*Offer a Wide Variety of Standard Products.* Sun Hydraulics offers the most comprehensive ranges of screw-in cartridge valves and manifolds in the world. The Company's products contain a high degree of common content to minimize work in process and maximize manufacturing efficiency. Products are designed for use by a broad base of industries to minimize the risk of dependence on any single market segment or customer.

*Expand the Product Line.* New products are designed to complement existing products, having a synergistic effect. Where possible, new products use existing parts and generally fit into existing cavities. The Company will continue to develop new non-electrical and electrically actuated cartridges, including solenoid and proportional valves. The Company believes its electrically-actuated cartridge valves help to increase sales of the Company's other cartridge valves and allow it to compete more effectively for integrated package business.

*Capitalize on Integrated Package Opportunities.* Sun Hydraulics designs and manufactures integrated packages which incorporate the Company's screw-in cartridge valves. To support this effort, the Company is able to design and manufacture manifolds at its operations in Sarasota, Florida, and Kansas City, Kansas, USA, Coventry, England, Erkelenz, Germany, Seoul, Korea and at its operation in Shanghai, China. Some of the Company's distributors also design and manufacture integrated packages which contain the Company's screw-in cartridge valves. Sun Hydraulics encourages competitive manifold manufacturers to utilize the Company's screw-in cartridge valves in their integrated package designs. The Company believes that customer requirements in the future will be for integrated packages more so than isolated components.

*Expand Global Presence.* Sun Hydraulics intends to continue to expand its global presence in the areas of distribution and international operations. The Company has strong distributor representation in most developed and developing markets, including North and South America, Western Europe, Asia, Australia, and South Africa. The Company will continue to expand its presence in key areas including, but not limited to, Eastern Europe, Russia, China and India. A strong local presence helps the Company compete for integrated package business, where proximity to the customer is beneficial.

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*Maintain a Horizontal Organization with Entrepreneurial Spirit.* Sun Hydraulics believes that maintaining its horizontal management structure is critical to retaining key personnel and an important factor in attracting top talent. The Company believes this culture encourages communication, creativity, entrepreneurial spirit, and individual responsibility among employees, and has a large impact on operating results.

*Leverage Manufacturing Capability and Know-how as Competitive Advantages.* Sun Hydraulics believes its process expertise is a competitive advantage. The Company's strong process capability is critical in achieving the high performance characteristics of its screw-in cartridge valves and integrated packages. The Company's in-house heat-treatment capability, somewhat unique in the industry, is critical to the durability and differentiation of the Company's cartridge valve products.

*Sell Through Distributors.* Due to the variety of potential customers and the Company's desire to avoid overhead costs, the sales function in North America is performed primarily by independent distributors. International Sun locations sell to both direct customers and through independent distributors. Many of the Company's distributors sell products manufactured by other companies and act as system integrators by providing complete hydraulic systems to customers.

*Develop Closer Relations with Key Customers.* The Company maintains close relationships with some OEMs and end users of its products. These relationships help the Company understand and predict future marketplace needs and provide a venue to test and refine new product offerings. The Company recognizes it may sometimes be required to enter into direct transactional relationships to gain business with certain large OEMs. The Company will be selective in developing these relationships to avoid unnecessary bureaucracy and cost.

*Form Strategic Relationships/Acquisitions.* When it is deemed to be of strategic benefit, Sun Hydraulics may enter into various relationships with other manufacturers including, but not limited to, marketing, brand labeling and other non-exclusive or exclusive agreements. In the future the Company expects to expand its internally developed products and capabilities via investments in outside firms. These investments could be full acquisitions, joint ventures, partial ownership investments or other agreements.

*Develop Complete Control System Solutions.* Historically, the Company's products have been purchased as components. Increasingly, the Company is engaged in developing complete integrated package system solutions that integrate more fully with OEMs' machinery and expects future customer requirements will be in this area.

## **Products**

### **Screw-in Hydraulic Cartridge Valves**

Sun Hydraulics' screw-in hydraulic cartridge valves are offered in five size ranges and include both electrically actuated and non-electrically actuated products. The floating construction pioneered by the Company results in a self alignment characteristic that provides performance and reliability advantages compared to most competitors' product offerings. This floating construction differentiates the Company's products from those of most of its competitors, who design and manufacture rigid screw-in cartridge valves that fit a common cavity. Some competitors manufacture certain products that fit the Company's cavity.

### **Standard Manifolds**

A manifold is a solid block of metal, usually aluminum or ductile iron, which is machined to create threaded cavities and channels into which screw-in cartridge valves can be installed and through which the hydraulic fluid flows.

The variety of standard manifolds offered by Sun Hydraulics is unmatched by any screw-in cartridge valve or manifold competitor. These products allow customers to easily integrate the Company's screw-in cartridge valves into their machinery and equipment. Once designed, standard manifolds require minimal, if any, maintenance engineering over the life of the product and can be manufactured at each of the Company's manufacturing operations.

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### **Integrated Packages (using custom designed manifolds)**

An integrated package consists of multiple cartridges assembled into a custom designed manifold for a specific customer to provide the specific operating characteristics of a customer's circuit.

The advantages of Sun Hydraulics screw-in cartridge valves translate to integrated packages designed by the Company and result in products that are smaller in size with enhanced operating performance. Due to the self-alignment characteristic, the Company's integrated packages do not routinely require testing once assembled, something often required when using competitive cartridge valves. Additionally, the Company has internally-developed, proprietary expert system software that it uses to manufacture custom manifolds efficiently in low volumes. Integrated packages provide many benefits to end users and equipment manufacturers, including reduced assembly time, order simplification, reduced leakage points, aesthetics, potentially fewer hose and fitting connections, and more control functions in a single location.

### **Engineering**

Sun Hydraulics' engineers play an important role in all aspects of the business, including design, manufacturing, sales, marketing and technical support. Engineers work within a disciplined set of design parameters that encourages the repeated incorporation of existing parts in new products. Engineers work closely with manufacturing personnel to define the processes required to manufacture products reliably and consistently.

### **Manufacturing**

The Company is a process intensive manufacturing operation that makes extensive use of automated handling and assembly technology (including robotics) where possible to perform repetitive tasks, thus promoting manufacturing efficiencies and workplace safety. The Company is somewhat vertically integrated and has the capability to manufacture many of the parts that go into its products.

At its two Sarasota, Florida, manufacturing plants, the Company has extensive testing facilities that allow it to test fully all cartridge valve products. A metallurgist and complete metallurgical laboratory support the Company's design engineers and in-house heat treatment.

The Company holds minimal finished goods inventory, typically at its overseas facilities, but relies on its distributors to purchase and maintain sufficient inventory to meet customers' demands. Most raw materials, including aluminum and steel, are delivered on a just-in-time basis. These and other raw materials are commercially available from multiple sources.

The Company controls most critical finishing processes in-house but relies on a small network of outside manufacturers to machine cartridge parts to varying degrees of completeness. Many high-volume machining operations are performed exclusively at outside suppliers. The Company is selective in establishing its supplier base and attempts to develop and maintain long-term relationships with suppliers.

The Company continually reviews all of its suppliers to improve the quality of incoming parts and to assess opportunities for better control of both price and quality. The Company's quality systems at the U.S. facilities are in compliance with ISO 9001:2008 for design and manufacture of steel cartridge valves, aluminum and ferrous manifolds for hydraulic systems. Those in the U.K. are certified to ISO 9001:2008 for the design and manufacture of aluminum and ferrous manifold bodies, hydraulic control valves and cartridge valves. Those in Germany are certified to ISO 9001:2000 for the design, distribution and manufacturing of hydraulic components for mobile and industrial applications. Those in Korea are certified to ISO 9001:2000 and 14001:2004 for the design, development, production servicing of hydraulic valves.

### **Sales and Marketing**

Sun Hydraulics products are sold globally, primarily through independent fluid power distributors. Technical support is provided by each of the Company's operations (Florida, Kansas, England, Germany, France, Korea, India and China).

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The Company currently has 88 distributors, 64 of which are located outside the United States and a majority of which have strong technical backgrounds or capabilities, which enable them to develop practical, efficient, and cost-effective fluid power systems for their customers. In 2009, sales to the Company's largest distributor represented less than 6% of net sales.

In addition to distributors, the Company sells directly to other companies within the hydraulic industry, including competitors, who incorporate the Company's products into their hydraulic products or systems. The Company believes making it easy for other manufacturers to buy its products often offers them better alternatives than developing similar products themselves.

The Company, to a limited degree, sells product directly to OEMs. Although the Company does not have any employee whose primary responsibility is direct sales, it may consider this in the future. The Company recognizes that to gain access to certain large OEM accounts it may have to deal directly with customers in the areas of sales and support.

The Company provides end users with technical information via its website and catalogues. This includes all information necessary to specify and obtain the Company's products. The Company believes this approach helps stimulate demand for the Company's products. The Company's website is complete and easy to use with product information available 24 hours a day, seven days a week around the world.

### **Customers**

Customers are broadly classified by being mobile or industrial.

Mobile applications involve equipment that generally is not fixed in place and is often operated in an uncontrolled environment, such as construction, agricultural, mining, and fire and rescue and other utility equipment. Mobile customers historically account for approximately two thirds of the Company's net sales.

Industrial applications involve equipment that generally is fixed in place in a controlled environment. Examples include automation machinery, presses, plastics machinery such as injection molding equipment, and machine tools. Industrial applications historically account for approximately one third of the Company's net sales.

In recent years, new applications have emerged that do not fit conveniently into the mobile or industrial categories, often blending requirements of each. Some of these applications include animatronics, wind power, wave power, solar power and amusement park rides. The Company expects its products to continue to be applied in areas outside of traditional mobile or industrial markets.

The Company does not warrant its products for use in any of the following applications, (i) any product that comes under the Federal Highway Safety Act, such as steering or braking systems for passenger-carrying vehicles or on-highway trucks, (ii) aircraft or space vehicles, (iii) ordnance equipment, (iv) life support equipment, and (v) any product that, when sold, would be subject to the rules and regulations of the United States Nuclear Regulatory Commission. These "application limitations" have alleviated the need for the Company to maintain the internal bureaucracy necessary to conduct business in these market segments.

### **Competition**

The Company's competitors include full-line producers and niche suppliers similar to the Company. Most competitors market globally. Full-line producers have the ability to provide total hydraulic systems to customers, including components functionally similar to those manufactured by Sun Hydraulics. The industry has experienced significant consolidation in recent years. Notably, large, full-line producers have acquired most of the independent screw-in hydraulic cartridge valve companies.

Most of the Company's competitors produce screw-in cartridge valves that fit an industry common cavity that sometimes allows their products to be interchangeable. The industry common cavity is not currently supported by any national or global standards organizations, although there is an ongoing effort to standardize a modified version of this cavity in the United States. The International Standards Organization (ISO) has a standard screw-in cartridge cavity that is different from the industry common cavity, but the Company is not aware of any major competitor that currently produces a full line of

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standard products conforming to the ISO standard. The Company does not manufacture a product that fits either the industry common or the ISO standard cavity. Some competitors manufacture selected screw-in cartridge valves that fit the Company's cavity. (see Risk Factors: The marketplace could adopt an industry standard cavity.)

A new class of competitors is emerging in low cost production areas (Asia, Eastern Europe). These competitors will typically copy both the Company's products and like products designed by competitors to fit industry common cavities. One of the barriers to these offshore competitors gaining a foothold in established markets are suitable channels or route to market. The Company recognizes this new class of competitor exists and will continue to monitor their growth and impact.

The Company believes that it competes based upon the quality, reliability, price, value, speed of delivery and technological characteristics of its products and services.

### **Employees**

As of January 2, 2010, Sun Hydraulics had 633 full-time employees in the United States, 70 in England, 32 in Germany, 3 in France and 32 in Korea. Over 90% of its employees are engaged in manufacturing, distribution, and engineering functions. No employees are represented by a union in any of the Company's operating units, and management believes that relations with its employees are good. Employees are paid either hourly or with an annual salary at rates that are competitive with other companies in the industry and geographic areas in which they operate. Management believes that Sun Hydraulics' culture, competitive salaries and wages, above average health and retirement plans, and a safe and pleasant working environment discourages employee turnover and encourages efficient, high-quality production. Nevertheless, due to the nature of the Company's manufacturing business, it is sometimes difficult to attract skilled personnel. (see Risk Factors: *Dependence on key employees and skilled personnel*)

### **Patents and Trademarks**

The Company believes that the growth of its business is dependent upon the quality and functional performance of its products and its relationship with the marketplace, rather than the extent of its patents and trademarks. The Company's principal trademark is registered internationally in the following countries: Argentina, Australia, Brazil, Canada, Chile, China, France, Germany, India, Italy, Japan, Korea, Mexico, Peru, Spain, Sweden, Switzerland, the United Kingdom and the United States. While the Company believes that its patents have significant value, the loss of any single patent would not have a material adverse effect on the Company.

### **Available Information**

The Company's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports, as well as its proxy statements and other materials which are filed with or furnished to the Securities and Exchange Commission ("SEC") are made available, free of charge, on or through the Sun Hydraulics website under the heading "Investor Relations - Reports - SEC Filings," as soon as reasonably practicable after they are filed with, or furnished to, the SEC.

## **ITEM 1A. - RISK FACTORS**

### **FACTORS INFLUENCING FUTURE RESULTS - FORWARD-LOOKING STATEMENTS**

This Annual Report contains "forward-looking statements" (within the meaning of the Private Securities Litigation Reform Act of 1995) that are based on current expectations, estimates, forecasts, and projections about us, our beliefs, and assumptions made by us, including (i) our strategies regarding growth, including our intention to develop new products; (ii) our financing plans; (iii) trends affecting our financial condition or results of operations; (iv) our ability to continue to control costs and to meet our liquidity and other financing needs; (v) the declaration and payment of dividends; and (vi) our ability to respond to changes in customer demand domestically and internationally, including as a result of standardization. In addition, we may make other written or oral statements, which constitute forward-looking statements, from time to time. Words such as "may," "expects," "projects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," variations of such words, and similar expressions are intended to

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identify such forward-looking statements. Similarly, statements that describe our future plans, objectives or goals also are forward-looking statements. These statements are not guarantees of future performance and are subject to a number of risks and uncertainties, including those discussed below and elsewhere in this report. Our actual results may differ materially from what is expressed or forecasted in such forward-looking statements, and undue reliance should not be placed on such statements. All forward-looking statements are made as of the date hereof, and we undertake no obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise.

Factors that could cause actual results to differ materially from what is expressed or forecasted in such forward-looking statements include, but are not limited to: (i) conditions in the capital markets, including the interest rate environment and the availability of capital; (ii) changes in the competitive marketplace that could affect our 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; (iii) new product introductions, product sales mix and the geographic mix of sales nationally and internationally; and the following risk factors:

**Sales in our industry are subject to economic cycles.** The capital goods industry in general, and the hydraulic industry in particular, are subject to economic cycles, which directly affect customer orders, lead times and sales volume. Economic downturns generally have a material adverse effect on our business and results of operations, as they did in 2009. Economic up cycles provide a context where demand for capital goods is stimulated, creating increased demand for the products we produce. In the future, continued weakening or improvement in the economy will directly affect orders and influence results of operations.

**We are subject to intense competition.** The hydraulic valve industry is intensely competitive, and competition comes from a large number of competitors, some of which are full-line producers and others that are niche suppliers like us. Full-line producers have the ability to provide total hydraulic systems to customers, including components functionally similar to those manufactured by us. We believe that we compete based upon quality, reliability, price, value, speed of delivery and technological characteristics. Many screw-in cartridge valve competitors are owned by corporations that are significantly larger and have greater financial resources than we have. We cannot assure that we will continue to be able to compete effectively with these companies.

Most competitors either manufacture manifolds or have sources that they use on a regular basis. In addition, there are many independent manifold suppliers that produce manifolds incorporating various manufacturers' screw-in cartridge valves, including those made by us. Finally, there are many small, independent machine shops that produce manifolds at very competitive prices. We believe that competition in the manifold and integrated package business is based upon quality, price, performance, proximity to the customer and speed of delivery. Many competitors have very low overhead structures and we cannot assure that we will be able to continue to compete effectively with these companies.

In addition, we compete in the sale of hydraulic valves, manifolds and integrated packages with certain of our customers, who also may be competitors. Generally, these customers purchase cartridge valves from us to meet a specific need in a system that cannot be filled by any valve they make themselves. To the extent that we introduce new products in the future that increase competition with such customers, it may have an adverse effect on our relationships with them.

**The marketplace could adopt an industry standard cavity that would not accommodate our products.** Our screw-in cartridge valves fit into a unique cavity for which, to date, few other manufacturers have designed products. Accordingly, our screw-in cartridge valves are not interchangeable with those of other manufacturers. Most competitive manufacturers produce screw-in cartridge valves that fit into an industry common cavity. There is an ongoing effort in the United States to produce a standard for screw-in hydraulic cartridge valve cavities based on the industry common cavity. Additionally, the International Standards Organization ("ISO") has an existing industry standard for screw-in hydraulic cartridge valve cavities, which is different from our cavity and the industry common cavity. In our view, the industry common cavity, as well as the suggested standardized form of this cavity, and the ISO standard cavity, fail to address critical functional requirements, which could result in performance and safety problems of significant magnitude for end users. To our knowledge, no major competitor has converted its standard product line to fit the ISO standard cavity. Any move by a substantial number of



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screw-in cartridge valve and manifold manufacturers toward the adoption of ISO standard or another standard, based on the existing industry common cavity, could have a material adverse effect on our business, financial condition and results of operation. See “Item 1. - Business — Competition.”

**We are subject to risks relating to international sales.** In 2009, approximately 59% of our net sales were outside of the United States. For the past ten years, international sales have continued to represent a greater proportion of our consolidated sales. We will continue to expand the scope of operations outside the United States, both through direct investment and distribution, and expect that international sales will continue to account for a substantial portion of net sales in future periods. International sales are subject to various risks, including unexpected changes in regulatory requirements and tariffs, longer payment cycles, difficulties in receivable collections, potentially adverse tax consequences, trade or currency restrictions, and, particularly in emerging economies, potential political and economic instability and regional conflicts. Furthermore, our international operations generate sales in a number of foreign currencies, particularly British pounds, the Euro, and the Korean Won. Therefore, our financial condition and results of operations can be affected by fluctuations in exchange rates between the United States dollar and these currencies. Any or all of these factors could have a material adverse effect on our business, financial condition and results of operations.

**We are subject to various risks relating to our growth strategy.** In pursuing our growth strategy, we intend to expand our presence in existing markets and enter new markets. In addition, we may pursue acquisitions and joint ventures to complement our business. Many of the expenses arising from expansion efforts may have a negative effect on operating results until such time, if at all, that these expenses are offset by increased revenues. We cannot assure that we will be able to improve our market share or profitability, recover our expenditures, or successfully implement our growth strategy. See “Item 1. - Business — Strategy.”

The expansion strategy also may require substantial capital investment for the construction of new facilities and their effective operation. We may finance the acquisition of additional assets using cash from operations, bank or institutional borrowings, or through the issuance of debt or equity securities. We cannot assure that we will be able to obtain financing from bank or institutional sources or through the equity or debt markets or that, if available, such financing will be on acceptable terms.

**We are dependent upon key employees and skilled personnel.** Our success depends, to some extent, upon a number of key individuals. The loss of the services of one or more of these individuals could have a material adverse effect on our business. Future operating results depend to a significant degree upon the continued contribution of key technical personnel and the skilled labor force. Competition for management and engineering personnel is intense and other employers may have greater financial and other resources to attract and retain these employees. We conduct a substantial part of our operations in Sarasota, Florida. Continued success is dependent on the Company’s ability to attract and retain a skilled labor force at this location. There are no assurances that we will continue to be successful in attracting and retaining the personnel required to develop, manufacture and market our products and expand our operations. See “Item 1. - Business — Employees.”

**We are subject to the risk of liability for defective products.** The application of many of our products entails an inherent risk of product liability. We cannot assure you that we will not face any material product liability claims in the future or that the product liability insurance we maintain at such time will be adequate to cover such claims.

**We are subject to fluctuations in the prices of raw materials.** The primary raw materials used in the manufacture of our products are aluminum, ductile iron and steel. We cannot assure you that prices for such materials will not increase or, if they do, that we will be able to increase the prices for our products to maintain our profit margins. If future price increases do not adequately cover material cost increases, our operating results may be adversely affected.

**We are dependent upon our parts suppliers.** Our largest expense in cost of sales is purchased cartridge valve parts. We cannot assure you that our manufacturing costs and output would not be materially and adversely affected by operational or financial difficulties experienced by one or more of our suppliers.

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**Hurricanes could cause a disruption in our operations which could adversely affect our business, results of operations, and financial condition.** A significant portion of our operations are located in Florida, a region that is susceptible to hurricanes. Such weather events can cause disruption to our operations and could have a material adverse effect on our overall results of operations. While we have property insurance to partially reimburse us for wind losses resulting from a named storm, such insurance would not cover all possible losses.

**We are subject to the cost of environmental compliance and the risk of failing to comply with environmental laws .** Our operations involve the handling and use of substances that are subject to federal, state and local environmental laws and regulations that impose limitations on the discharge of pollutants into the soil, air and water and establish standards for their storage and disposal. We believe that our current operations are in substantial compliance with applicable environmental laws and regulations, the violation of which could have a material adverse effect on our business, financial condition and results of operations. New laws and regulations, or stricter interpretations of existing laws or regulations, could have a material adverse affect on our business, financial condition and results of operations. We have not suffered any material adverse effects due to compliance with environmental laws and regulations in the past.

**Our board may decide to reduce or eliminate dividends.** Although we have paid a cash dividend each quarter since our common stock began publicly trading in 1997, we cannot assure that funds will be available for this purpose in the future. The declaration and payment of dividends is subject to the sole discretion of our board of directors and will depend upon our profitability, financial condition, capital needs, acquisition opportunities, future prospects and other factors deemed relevant by the board, and may be restricted by the terms of our credit facilities.

**Certain anti-takeover provisions may hinder or prevent a change in control.** Our Articles of Incorporation provide for a classified board of directors. In addition, the Articles give the board of directors the authority, without further action by the shareholders, to issue and fix the rights and preferences of a new class, or classes, of preferred stock. These and other provisions of the Articles and our Bylaws may deter or delay changes in control, including transactions in which shareholders might otherwise receive a premium for their shares over then current market prices. In addition, these provisions may limit the ability of shareholders to approve transactions that they may deem to be in their best interests.

**We are subject to control by certain shareholders and management.** Christine L. Koski, the daughter of the deceased founder of the Company, Robert E. Koski, is a member of the board of directors. She, along with other family members, own or control approximately 26% of the outstanding shares of our common stock. Accordingly, the members of the Koski family have the ability to influence significantly the election of our directors and the outcome of certain corporate actions requiring shareholder approval, and to influence our business. Such influence could preclude any acquisition of the Company and could adversely affect the price of our common stock. Our directors and executive officers as a group beneficially own or control approximately 24% of the outstanding shares of our common stock.

#### **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

#### **ITEM 2. PROPERTIES**

The Company owns major facilities in the United States, United Kingdom, Germany, and Korea, as set forth below.

The Company owns a 66,000 square foot facility in Sarasota, Florida, which houses manufacturing, design, marketing and other administrative functions. The Sarasota facility is well suited for the design, testing and manufacture of the Company's products.

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The Company also owns a 77,000 square foot manufacturing facility in Manatee County, Florida. The Manatee County facility, constructed in 1997, has a productive capacity similar to the Sarasota facility.

The close proximity of the Florida facilities allows for quick change and the ability to shift resources, including machinery and people, to effectively meet changing business requirements.

Both facilities in Florida are encumbered by a revolving line of credit, which matures on August 1, 2011. Monthly payment of interest only is due on the revolving line of credit, with a variable interest rate based upon the Company's leverage ratio. At January 2, 2010, there was no outstanding balance on the line of credit.

The Company also owns vacant land in Manatee County, Florida, for future expansion requirements. This land is adjacent to its existing facility. In total, the Company owns 27 acres of contiguous property. There is no mortgage on these properties and the Company believes the land to be well suited for additional manufacturing capacity.

The Company leases a 17,000 square foot manufacturing facility in Lenexa, Kansas, which is used to manufacture manifolds for the North American market.

The Company owns a 37,000 square foot facility in Coventry, England, free of any encumbrances. This operation, while primarily acting as a distributor, is also involved in manifold design and manufacturing.

The Company owns a 45,000 square foot distribution and manufacturing facility in Erkelenz, Germany, free of any encumbrances. This facility is well suited to house equipment used for manufacturing and testing of the Company's products. Currently, a small portion of the manufacturing area is utilized and the remainder is leased on an annual basis to an outside company.

The Company owns a 10,000 square foot distribution and manufacturing facility in Incheon, Korea, free of any encumbrances.

The Company believes that its properties have been adequately maintained, are generally in good condition, and are suitable and adequate for its business as presently conducted. The extent of utilization of the Company's properties varies from time to time and among its facilities.

### **ITEM 3. LEGAL PROCEEDINGS**

The Company from time to time is involved in routine litigation incidental to the conduct of its business. The Company does not believe that any pending litigation will have a material adverse effect on its consolidated financial position or results of operations.

### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

There were no matters submitted to a vote of the security holders of the Company through the solicitation of proxies or otherwise during the fourth quarter of the fiscal year ended January 2, 2010.

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## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

#### *Market Information*

The Common Stock of the Company has been trading publicly under the symbol SNHY on the Nasdaq Global Select Market since the Company's initial public offering on January 9, 1997. The following table sets forth the high and low closing sale prices of the Company's Common Stock as reported by the Nasdaq Global Select Market and the dividends declared for the periods indicated.

|                | <u>High</u> | <u>Low</u> | <u>Dividends<br/>declared</u> |
|----------------|-------------|------------|-------------------------------|
| <u>2009</u>    |             |            |                               |
| First quarter  | \$19.610    | \$10.590   | \$ 0.180                      |
| Second quarter | 19.000      | 13.930     | 0.090                         |
| Third quarter  | 22.170      | 15.050     | 0.090                         |
| Fourth quarter | 27.840      | 19.060     | 0.090                         |
| <u>2008</u>    |             |            |                               |
| First quarter  | \$30.620    | \$19.130   | \$ 0.090                      |
| Second quarter | 41.040      | 29.270     | 0.180                         |
| Third quarter  | 42.060      | 25.840     | 0.090                         |
| Fourth quarter | 26.040      | 11.460     | 0.090                         |

#### *Holdings*

There were 123 shareholders of record of Common Stock on February 26, 2010. The number of record holders was determined from the records of the Company's transfer agent and does not include beneficial owners of Common Stock whose shares are held in the names of securities brokers, dealers, and registered clearing agencies. The Company believes that there are approximately 12,000 beneficial owners of Common Stock.

#### *Dividends*

The Company declared quarterly dividends in 2009 that were paid on the 15th day of the month following the date of declaration. Additionally, the Company declared shared distribution cash dividends of \$0.09 per share in 2008 and 2009. The 2009 shared distribution cash dividend was paid on March 31, 2009 to shareholders of record as of March 15, 2009, and the 2008 shared distribution cash dividend was paid on May 30, 2008 to shareholders of record as of May 15, 2008. The Company's board of directors currently intends to continue to pay a quarterly dividend of at least \$0.09 per share during 2010. However, 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, acquisition opportunities, future prospects and other factors deemed pertinent by the board of directors.

#### *Stock Split*

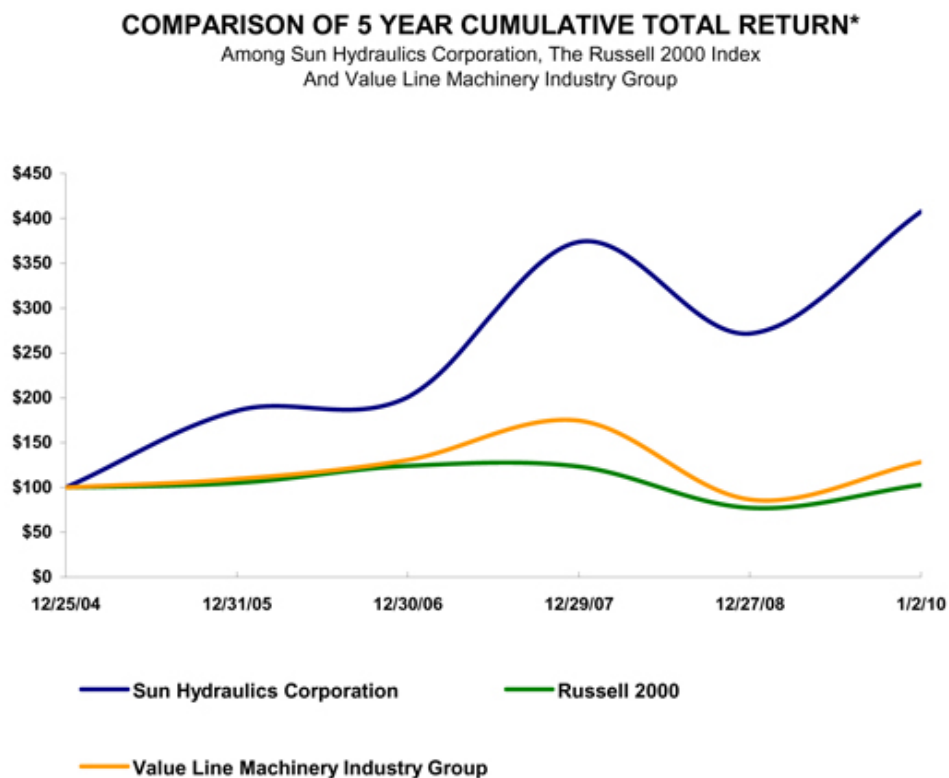
On June 19, 2007, the Company declared a three-for-two stock split, effected in the form of a 50% stock dividend, to shareholders of record on June 30, 2007, which was paid on July 15, 2007. The Company issued approximately 5,500,000 shares of common stock as a result of the stock split. The effect of the stock split on outstanding shares, earnings per share and dividends per share has been retroactively applied to all periods presented.

#### *Issuer Purchases of Equity Securities*

The Company did not repurchase any of its stock during the fourth quarter of 2009.

*Five-Year Stock Performance Graph*

The following graph compares cumulative total return among Sun Hydraulics Corporation, the Russell 2000 Index and the Value Line Machinery Industry Stock Index, from December 25, 2004, to January 2, 2010, assuming \$100 invested in each on December 25, 2004. Total return assumes reinvestment of any dividends for all companies considered within the comparison. The stock price performance shown in the graph is not necessarily indicative of future price performance.



|  | <u>12/25/04</u> | <u>12/31/05</u> | <u>12/30/06</u> | <u>12/29/07</u> | <u>12/27/08</u> | <u>1/2/10</u> |
|--|-----------------|-----------------|-----------------|-----------------|-----------------|---------------|
| <b>Sun Hydraulics Corporation</b>          | 100.00          | 185.52          | 200.76          | 373.94          | 271.51          | 407.62        |
| <b>Russell 2000</b>                        | 100.00          | 104.98          | 124.26          | 123.23          | 77.25           | 102.99        |
| <b>Value Line Machinery Industry Group</b> | 100.00          | 109.38          | 130.66          | 174.64          | 86.56           | 128.25        |

**ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA**

The following summary should be read in conjunction with the consolidated financial statements and related notes contained herein. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Item 1. Business.”

The Company reports on a fiscal year that ends on the Saturday closest to December 31st. Each quarter generally consists of thirteen weeks. As a result of the 2009 fiscal year ending January 2, 2010, the quarter ended January 2, 2010, consisted of fourteen weeks, resulting in a 53-week year. As a result of the 2005 fiscal year ending December 31, 2005, the quarter ended April 2, 2005, consisted of fourteen weeks, resulting in a 53-week year.

|                                      | Year Ended  |              |              |              |              |
|--------------------------------------|-------------|--------------|--------------|--------------|--------------|
|                                      | Jan 2, 2010 | Dec 27, 2008 | Dec 29, 2007 | Dec 30, 2006 | Dec 31, 2005 |
| (in thousands except per share data) |             |              |              |              |              |
| <b>Statement of Operations:</b>      |             |              |              |              |              |
| Net sales                            | \$ 97,393   | \$ 178,278   | \$ 167,374   | \$ 142,282   | \$ 116,757   |
| Gross profit                         | 21,957      | 59,117       | 54,850       | 43,932       | 36,918       |
| Operating income                     | 2,143       | 36,377       | 33,635       | 25,051       | 19,180       |
| Income before income taxes           | 2,017       | 37,729       | 34,371       | 24,903       | 19,137       |
| Net income                           | \$ 1,856    | \$ 25,735    | \$ 22,131    | \$ 16,223    | \$ 12,808    |
| Basic net income per common share    | \$ 0.11     | \$ 1.55      | \$ 1.35      | \$ 0.99      | \$ 0.79      |
| Diluted net income per common share  | \$ 0.11     | \$ 1.55      | \$ 1.34      | \$ 0.99      | \$ 0.78      |
| Dividends per common share           | \$ 0.45     | \$ 0.45      | \$ 0.34      | \$ 0.27      | \$ 0.20      |
| <b>Other Financial Data:</b>         |             |              |              |              |              |
| Depreciation and amortization        | \$ 6,968    | \$ 7,096     | \$ 6,341     | \$ 5,849     | \$ 5,604     |
| Capital expenditures                 | 5,096       | 10,874       | 12,591       | 9,525        | 8,813        |
| <b>Balance Sheet Data:</b>           |             |              |              |              |              |
| Cash and cash equivalents            | \$ 30,446   | \$ 35,303    | \$ 19,337    | \$ 9,497     | \$ 5,830     |
| Working capital                      | 53,454      | 50,217       | 36,198       | 24,015       | 16,391       |
| Total assets                         | 119,933     | 122,385      | 110,780      | 87,185       | 73,561       |
| Total debt                           | —           | 272          | 701          | 1,072        | 2,384        |
| Shareholders' equity                 | 107,614     | 106,556      | 91,882       | 70,800       | 56,440       |

Quarterly Results of Operations  
(unaudited, in thousands)

|                                     | <b>For the Quarter Ended</b> |                         |                         |                         |
|-------------------------------------|------------------------------|-------------------------|-------------------------|-------------------------|
|                                     | <b>Jan 2,<br/>2010</b>       | <b>Sep 26,<br/>2009</b> | <b>Jun 27,<br/>2009</b> | <b>Mar 28,<br/>2009</b> |
| Net sales                           | \$27,262                     | \$23,316                | \$21,607                | \$25,208                |
| Gross profit                        | 6,793                        | 5,351                   | 4,234                   | 5,579                   |
| Operating income                    | 1,549                        | 423                     | (633)                   | 804                     |
| Income before income taxes          | 1,626                        | 570                     | (901)                   | 722                     |
| Net income                          | <u>\$ 1,286</u>              | <u>\$ 554</u>           | <u>\$ (536)</u>         | <u>\$ 552</u>           |
| Basic net income per common share   | \$ 0.08                      | \$ 0.03                 | \$ (0.03)               | \$ 0.03                 |
| Diluted net income per common share | \$ 0.08                      | \$ 0.03                 | \$ (0.03)               | \$ 0.03                 |

|                                     | <b>For the Quarter Ended</b> |                         |                         |                         |
|-------------------------------------|------------------------------|-------------------------|-------------------------|-------------------------|
|                                     | <b>Dec 27,<br/>2008</b>      | <b>Sep 27,<br/>2008</b> | <b>Jun 28,<br/>2008</b> | <b>Mar 29,<br/>2008</b> |
| Net sales                           | \$32,936                     | \$44,771                | \$51,563                | \$49,008                |
| Gross profit                        | 8,210                        | 14,738                  | 19,075                  | 17,094                  |
| Operating income                    | 2,674                        | 9,281                   | 13,283                  | 11,139                  |
| Income before income taxes          | 3,154                        | 9,768                   | 13,341                  | 11,465                  |
| Net income                          | <u>\$ 2,480</u>              | <u>\$ 6,657</u>         | <u>\$ 8,908</u>         | <u>\$ 7,690</u>         |
| Basic net income per common share   | \$ 0.15                      | \$ 0.40                 | \$ 0.54                 | \$ 0.46                 |
| Diluted net income per common share | \$ 0.15                      | \$ 0.40                 | \$ 0.54                 | \$ 0.46                 |

|                                     | <b>For the Quarter Ended</b> |                         |                         |                         |
|-------------------------------------|------------------------------|-------------------------|-------------------------|-------------------------|
|                                     | <b>Dec 29,<br/>2007</b>      | <b>Sep 29,<br/>2007</b> | <b>Jun 30,<br/>2007</b> | <b>Mar 31,<br/>2007</b> |
| Net sales                           | \$41,289                     | \$41,809                | \$43,422                | \$40,854                |
| Gross profit                        | 13,346                       | 13,324                  | 14,297                  | 13,883                  |
| Operating income                    | 8,064                        | 8,045                   | 8,859                   | 8,667                   |
| Income before income taxes          | 8,198                        | 8,280                   | 9,045                   | 8,849                   |
| Net income                          | <u>\$ 5,127</u>              | <u>\$ 5,246</u>         | <u>\$ 5,952</u>         | <u>\$ 5,806</u>         |
| Basic net income per common share   | \$ 0.31                      | \$ 0.32                 | \$ 0.36                 | \$ 0.35                 |
| Diluted net income per common share | \$ 0.31                      | \$ 0.32                 | \$ 0.36                 | \$ 0.35                 |

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**ITEM 7. 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 January 2, 2010, were approximately 59% of total net sales.

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

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

***Industry Conditions***

Demand for the Company's products is dependent on demand for the capital goods into which the products are incorporated. The capital goods industries in general, and the fluid power industry specifically, are subject to economic cycles. According to the National Fluid Power Association (the fluid power industry's trade association in the United States), the United States index of shipments of hydraulic products decreased 40% in 2009 after increasing 8% and 1%, in 2008 and 2007, respectively.

The Company's order trend has historically tracked closely to the United States Purchasing Managers Index (PMI). The index increased to 54.9 in December 2009, from a low of 32.5 in December 2008. PMI increased throughout 2009 and moved above 50 in August, indicating an expanding economy. The index was 56.5 in February 2010, which was the seventh consecutive month with a PMI above 50. The portions of the index that represent new orders and production have shown growth for eight and nine consecutive months, respectively. Management believes these trends are a strong indication of growing demand.



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**Results for the 2009 fiscal year**

(Dollars in millions except net income per share)

|                            | <u>January 2,</u><br><u>2010</u> | <u>December 27,</u><br><u>2008</u> | <u>Decrease</u> |
|----------------------------|----------------------------------|------------------------------------|-----------------|
| <b>Twelve Months Ended</b> |                                  |                                    |                 |
| Net Sales                  | \$ 97.4                          | \$ 178.3                           | -45%            |
| Net Income                 | \$ 1.9                           | \$ 25.7                            | -93%            |
| Net Income per share:      |                                  |                                    |                 |
| Basic                      | \$ 0.11                          | \$ 1.55                            | -93%            |
| Diluted                    | \$ 0.11                          | \$ 1.55                            | -93%            |
| <b>Three Months Ended</b>  |                                  |                                    |                 |
| Net Sales                  | \$ 27.3                          | \$ 32.9                            | -17%            |
| Net Income                 | \$ 1.3                           | \$ 2.5                             | -48%            |
| Net Income per share:      |                                  |                                    |                 |
| Basic                      | \$ 0.08                          | \$ 0.15                            | -47%            |
| Diluted                    | \$ 0.08                          | \$ 0.15                            | -47%            |

The fourth quarter finished strong, resulting in sequential quarterly growth since the second quarter. Sun's order rates, capital goods inventory conditions, and indicators like PMI and Capacity Utilization are all improving. This leads management to believe that the worst of last year's recession is over and it expects that the first quarter will show continued improvement.

Management is pleased to have remained profitable for 2009, the 38<sup>th</sup> consecutive year of profitability, despite a drop in revenues of 45%. The Company did this without sacrificing its capacity or capabilities. The Company continued to make capital investments, develop and release new products, and, perhaps most critical, maintain workforce readiness. In June, Sun initiated rolling furloughs for the production workforce and a 3% salary reduction for non-production personnel. The furloughs allow the Company to balance its capacity with current business levels without compromising its ability to respond when demand increases. The furlough model, was designed so that it is relatively simple to return to normal work schedules as demand recovers. With the increased demand seen early in 2010, approximately 25% of production employees have been removed from the furloughs.

Throughout 2009, the Company experienced high levels of expedited order activity of approximately 16% of orders. Management is pleased to report that while expedited orders are still high, they are not as high as last year. That tells us that inventory has stabilized and things are coming into balance.

Management is encouraged by customer inquiries and the prototype activity that it experienced at all Sun locations. Some prototypes have led to production orders. Management is confident that its prototype activities will continue to drive new business.

Management believes market share gains are taken on the upturn of the cycle by those companies that are able to respond to the market demand and opportunities created. Sun's depth and breadth of products, its ability to provide complete systems solutions, and deliver reliably will allow it to gain share during this recovery.

Maintaining the Company's strong balance sheet and financial flexibility remains a key strategy. The Company ended 2009 with cash and investments of \$38.3 million, up \$3.0 million from the previous year, an unused line of credit of \$35.0 million, and zero dollars of long-term debt. The Company continued to invest in its business in 2009 with capital expenditures for the year of approximately \$5.1 million. The Company estimates capital expenditures in 2010 will be \$7.0 million. The Company has ample cash to do the things management believes are necessary to position the Company to take the next step in its growth.

## Dividends

The Company declared quarterly dividends of \$0.09 per share that were paid on the 15th day of the month following the date of declaration. Additionally, the Company declared a shared distribution cash dividend of \$0.09 per share that was paid on March 31, 2009 to shareholders of record as of March 15, 2009.

## Outlook

Weekly order rates in 2010 have increased compared to the fourth quarter of 2009. First quarter 2010 sales are expected to be approximately \$30 million, a 19% increase over the same period last year and 10% over the previous quarter. First quarter earnings per share are estimated to be between \$0.17 and \$0.19 per share, compared to \$0.03 per share in the first quarter last year and \$0.08 last quarter.

## Results of Operations

The following table sets forth, for the periods indicated, certain items in the Company's statements of operations as a percentage of net sales.

|                            | For the Year Ended |              |              |              |              |
|----------------------------|--------------------|--------------|--------------|--------------|--------------|
|                            | Jan 2, 2010        | Dec 27, 2008 | Dec 29, 2007 | Dec 30, 2006 | Dec 31, 2005 |
| Net sales                  | 100.0%             | 100.0%       | 100.0%       | 100.0%       | 100.0%       |
| Gross profit               | 22.5%              | 33.2%        | 32.8%        | 30.9%        | 31.6%        |
| Operating income           | 2.2%               | 20.4%        | 20.1%        | 17.6%        | 16.4%        |
| Income before income taxes | 2.1%               | 21.2%        | 20.5%        | 17.5%        | 16.4%        |

## Segment Information (in thousands)

|                                 | United States | Korea    | Germany  | United Kingdom | Elimination | Consolidated |
|---------------------------------|---------------|----------|----------|----------------|-------------|--------------|
| 2009                            |               |          |          |                |             |              |
| Sales to unaffiliated customers | \$ 59,278     | \$ 9,978 | \$14,654 | \$13,483       | \$ —        | \$ 97,393    |
| Intercompany sales              | 15,545        | —        | 139      | 1,101          | (16,785)    | —            |
| Operating income                | (2,110)       | 616      | 2,475    | 884            | 278         | 2,143        |
| Total assets                    | 85,338        | 8,191    | 12,447   | 15,923         | (1,966)     | 119,933      |
| Depreciation and amortization   | 5,335         | 104      | 502      | 1,027          | —           | 6,968        |
| Capital expenditures            | 4,758         | 41       | 30       | 267            | —           | 5,096        |
| 2008                            |               |          |          |                |             |              |
| Sales to unaffiliated customers | \$111,180     | \$17,455 | \$27,356 | \$22,287       | \$ —        | \$ 178,278   |
| Intercompany sales              | 28,656        | —        | 245      | 2,282          | (31,183)    | —            |
| Operating income                | 24,531        | 1,148    | 7,693    | 3,231          | (226)       | 36,377       |
| Total assets                    | 91,855        | 6,680    | 10,980   | 15,049         | (2,179)     | 122,385      |
| Depreciation and amortization   | 5,139         | 151      | 572      | 1,234          | —           | 7,096        |
| Capital expenditures            | 9,904         | 39       | 298      | 633            | —           | 10,874       |
| 2007                            |               |          |          |                |             |              |
| Sales to unaffiliated customers | \$ 99,516     | \$20,567 | \$24,164 | \$23,127       | \$ —        | \$ 167,374   |
| Intercompany sales              | 30,344        | —        | 142      | 2,621          | (33,107)    | —            |
| Operating income                | 22,408        | 2,103    | 5,955    | 3,205          | (36)        | 33,635       |
| Total assets                    | 74,026        | 9,067    | 12,710   | 17,079         | (2,102)     | 110,780      |
| Depreciation and amortization   | 4,488         | 178      | 556      | 1,119          | —           | 6,341        |
| Capital expenditures            | 9,339         | 284      | 125      | 2,843          | —           | 12,591       |

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## ***Comparison of Years Ended January 2, 2010 and December 27, 2008***

### ***Net Sales***

Net sales were \$97.4 million, a decrease of \$80.9 million, or 45.4%, compared to \$178.3 million in 2008. Net sales decreased 42.5% excluding the effect of exchange rates. The decrease in net sales was primarily driven by decreased demand in our end markets, which primarily include capital goods equipment. Price increases instituted in October 2008 accounted for approximately 1.5% of total sales. New product sales (defined as products introduced within the last five years) generally made up 10-15% of total sales in 2009.

North American sales decreased 46.5% or \$38.7 million, to \$44.5 million in 2009, Asian sales decreased 44.0% or \$13.6 million, to \$17.3 million in 2009, and European sales decreased 45.2% or \$26.8 million, to \$32.4 million in 2009.

The U.S. reporting segment had sales of \$59.3 million during 2009, down \$51.9 million or 46.7%, compared to sales of \$111.2 million during 2008. The decrease was driven by demand in our end markets and the general downturn in the global economy. International sales out of the U.S. were \$19.0 million during 2009, down 48.7% or \$18.0 million, compared to \$37.1 million during 2008. International sales out of the US include some sales to Europe, Africa and the Asia/Pacific region. Significant decreases in sales were noted in almost all geographic regions.

The Korean reporting segment had sales of \$10.0 million during 2009, down \$7.5 million or 42.8%, compared to sales of \$17.5 million during 2008. Currency effect reduced 2009 sales by approximately \$1.5 million. The remaining decrease was related to a slowdown in sales to four major Korean customers that are in the construction equipment industry. The Korean reporting segment was the first segment to be affected by the slowdown in the global economy. As expected by management, the Korean reporting segment was also the first segment to show quarterly year over year growth, which occurred in the fourth quarter of 2009 with sales increasing \$1.2 million, or 69.0% from the prior year. The Korean reporting segment had declining quarterly year over year sales since the second quarter of 2008. Efforts to expand and diversify its customer base, in addition to increased demand from existing customers, led to the increased sales.

The German reporting segment had sales of \$14.7 million during 2009, down \$12.7 million or 46.4%, compared to sales of \$27.4 million during 2008. Currency effect reduced 2009 sales by approximately \$1.0 million. The remaining decrease was primarily related to demand within Germany. However, sales were down in all geographic markets.

The U.K. reporting segment had sales of \$13.5 million during 2009, down \$8.8 million or 39.5%, compared to sales of \$22.3 million during 2008. Currency effect reduced 2009 sales by approximately \$1.4 million. The largest reduction of sales was to customers within the U.K. however, sales were down in almost all geographic markets.

### ***Gross Profit***

Gross profit decreased \$37.2 million or 62.9% to \$ 22.0 million in 2009, compared to \$59.1 million in 2008. Gross profit as a percentage of net sales decreased to 22.5% in 2009, compared to 33.2% in 2008. The Company experienced a sharp decline in sales during the fourth quarter of 2008, which resulted in gross profit margins of 24.9% in that period. Sales continued to decline during the first half of 2009, resulting in further reductions in the gross profit margin. Both sales and gross profit margins increased sequentially in the third and fourth quarters of 2009. The gross profit margin in the fourth quarter of 2009 was flat compared to the prior year with a margin of 24.9%, while sales decreased \$5.7 million for the same period. The 2008 fourth quarter results included additional retirement expense related to the shared distribution that was not included in the current year.

The 2009 gross profit decreases were primarily related to lower sales volume, which contributed \$26.8 million of the decrease. The remaining decreases in gross profit were attributed to productivity declines of approximately \$2.5 million, and increases in overhead expenses as a percentage of sales of approximately \$10.0 million, both of which occurred primarily in the U.S. In periods of sharp declining sales, the Company cannot reduce costs at the same pace. However, the decrease in gross profit was partially offset by lower material costs as a percent of sales of approximately \$2.1 million, primarily in the U.S.

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Additionally, the Company eliminated overtime premiums equal to approximately \$1.1 million, reduced retirement benefits, primarily related to the shared distribution, of approximately \$3.2 million that was included in the prior year results, and the Company had cost savings of approximately \$1.3 million resulting from the furloughs and salary reductions during the current year. These reductions were all primarily in the U.S.

### ***Selling, Engineering, and Administrative Expenses***

Selling, engineering and administrative expenses in 2009 were \$19.8 million, a \$2.9 million, or 12.8%, decrease, compared to \$22.7 million in 2008. The change was due to decreases in compensation of \$0.9 million, resulting primarily from salary freezes and reductions that began in January, fringe benefit costs of \$0.9 million, primarily related to retirement benefits associated with the shared distribution that was included in the prior year results, travel of \$0.4 million, and professional fees and outside services of \$0.4 million.

### ***Operating Income***

Operating income decreased \$34.2 million or 94.1% to \$2.1 million in 2009, compared to \$36.4 million in 2008, with operating margins of 2.2% and 20.4% for 2009 and 2008, respectively.

The U.S. reporting segment experienced an operating loss of \$2.1 million in 2009 compared to operating income of \$24.5 million during 2008, a decrease of \$26.7 million. The sharp decline in sales volume reduced operating income \$11.5 million. Additional decreases in operating income occurred from productivity declines as a result of keeping its workforce intact, and increased variable and fixed overhead costs as a percent of sales. Decreases in operating income were partially offset by decreases in material costs. Additionally, the Company had cost savings of approximately \$1.4 million in 2009, as a result of the furloughs and salary reductions.

The Korean reporting segment contributed \$0.6 million to our consolidated operating income during 2009 compared to \$1.1 million during 2008, a decrease of \$0.5 million. The decrease was almost entirely related to the reduction in sales volume.

The German reporting segment contributed \$2.5 million to our consolidated operating income during 2009 compared to \$7.7 million during 2008, a decrease of \$5.2 million. Reduction in sales volume resulted in a decrease of \$3.6 million to operating income. The remaining decrease was primarily related to increased fixed overhead costs as a percent of sales and increased material costs due to the strength of the U.S. Dollar against the Euro for material purchases made in U.S. Dollars.

The U.K. reporting segment contributed \$0.9 million to our consolidated operating income during 2009 compared to \$3.2 million during 2008, a decrease of \$2.3 million. The reduction in sales volume was responsible for \$1.3 million of the decrease in operating income. The remaining decrease was primarily related to increased fixed overhead costs as a percent of sales.

### ***Interest Income, Net***

Net Interest income for 2009 was \$0.6 million compared to net interest income of \$0.8 million for 2008. The Company paid off the remaining balance of its long-term debt in the first quarter of 2009, and had total average debt for 2008 of \$0.5 million. Total average cash and investments for 2009, was \$36.8 million compared to total average cash of \$27.3 million for 2008. Although total cash and investments increased in 2009, interest rates were at an all time low. In response to the decrease in interest rates in 2009, the Company invested in primarily corporate and municipal bonds to achieve an above average rate of return.

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**Foreign Currency Transaction (Gain) Loss, Net**

Net foreign currency transaction loss was \$0.3 million in 2009 compared to a gain of \$0.5 million in 2008. While the Euro, the Korean Won and the British Pound strengthened against the U.S. Dollar, the UK operations experienced losses related to sales conducted in U.S. dollars and from the revaluation of Sun Ltd. balance sheet items, which were held in U.S. dollars. The inverse was true of 2008.

**Miscellaneous (Income) Expense, Net**

Miscellaneous expense was \$0.4 million in 2009 compared to income of \$0.1 million in 2008. The decrease in income is primarily related to a reduction in equity method investment earnings from the prior year. The prior year income was primarily a result of proceeds from an insurance claim. This amount was partially offset by a loss on disposal of assets and charitable contributions.

**Income Taxes**

The provision for income taxes for the year ended January 2, 2010, was 8.0% of pretax income compared to a provision of 31.8% for the year ended December 27, 2008. The change was primarily due to the relative levels of income and different tax rates in effect among the countries in which the Company sells its products, particularly from the tax benefit recognized in the U.S.

**Comparison of Years Ended December 27, 2008 and December 29, 2007****Net Sales**

Net sales were \$178.3 million, an increase of \$10.9 million, or 6.5%, compared to \$167.4 million in 2007. Net sales increased 7.2% excluding the effect of exchange rates. The increase in net sales was primarily driven by increased demand in our end markets, which primarily include capital goods equipment. Price increases in 2008 accounted for approximately 1% of total sales. New product sales (defined as products introduced within the last five years) generally make up 15% of total sales.

North American sales increased 5.7% or \$4.5 million, to \$83.1 million in 2008, Asian sales increased 2.3% or \$0.7 million, to \$30.9 million in 2008, and European sales increased 9.2% or \$5.0 million, to \$59.3 million in 2008.

The U.S. reporting segment had sales of \$111.2 million during 2008, up \$11.7 million or 11.7%, compared to sales of \$99.5 million during 2007. The increase was driven by demand in our end markets. International sales out of the U.S. were \$37.1 million during 2008, up 26.6% or \$7.8 million, compared to \$29.3 million during 2007. Significant increases in sales were noted in Italy, China, and Australia.

The Korean reporting segment had sales of \$17.5 million during 2008, down \$3.1 million or 15.1%, compared to sales of \$20.6 million during 2007. Currency effect reduced 2008 sales by approximately \$2.0 million. The remaining decrease was related to a slowdown in sales to four major Korean customers that are in the construction equipment industry.

The German reporting segment had sales of \$27.4 million during 2008, up \$3.2 million or 13.2%, compared to sales of \$24.2 million during 2007. Currency effect contributed approximately \$2.1 million to sales in 2008. The remaining increase is primarily related to demand within Germany and in Austria.

The U.K. reporting segment had sales of \$22.3 million during 2008, down \$0.8 million or 3.6%, compared to sales of \$23.1 million during 2007. Currency effect reduced 2008 sales by approximately \$0.7 million, primarily related to sales in U.S. Dollars. The U.K. experienced reduced sales within the U.K. and in Ireland, while increasing sales to Netherlands, Norway, and United Arab Emirates.

**Gross Profit**

Gross profit increased \$4.3 million or 7.8% to \$ 59.1 million in 2008, compared to \$54.9 million in 2007. Gross profit as a percentage of net sales increased to 33.2% in 2008, compared to 32.8% in 2007. Margins were very strong in the first and second quarter of 2008, at 34.9% and 37.0%, respectively. The Company experienced some deterioration in the third quarter of 2008 when margins slipped to 32.9%.

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The sharp decline in 2008 fourth quarter sales resulted in gross margins of 24.9%. The Company has a large fixed cost base. This worked to its advantage over the last few years when the Company was able to leverage these fixed costs against consistently rising revenue. However, it has the opposite effect as the Company gets into periods of rapidly declining sales. The fixed costs remain, but cannot be absorbed as quickly by the lower revenue.

For 2008, the gross profit increases were primarily related to higher sales volume, which contributed \$3.6 million of the increase. The remaining gains in gross profit were attributed to productivity improvements of approximately \$0.8 million, primarily in the U.S. and U.K., and lower material costs of approximately \$0.4 million, primarily in the U.S. and Europe. Decreases in overhead expenses as a percent of sales of approximately \$1.2 million were offset by the increased retirement benefits primarily relating to the shared distributions of approximately \$1.7 million.

#### ***Selling, Engineering, and Administrative Expenses***

Selling, engineering and administrative expenses in 2008 were \$22.7 million, a \$1.5 million, or 7.2%, increase, compared to \$21.2 million in 2007. The change is primarily a result of increases in compensation of \$0.6 million, fringe benefit costs of \$0.7 million, and professional fees of \$0.2 million. The fringe benefits include an increase in retirement benefits primarily relating to the shared distributions of approximately \$0.8 million. The increase in professional fees is related to additional tax services for the R&D tax credit study.

#### ***Operating Income***

Operating income increased \$2.7 million or 8.2% to \$36.4 million in 2008, compared to \$33.6 million in 2007, with operating margins of 20.4% and 20.1% for 2008 and 2007, respectively.

The U.S. reporting segment contributed \$24.5 million to our consolidated operating income during 2008 compared to \$22.4 million during 2007, an increase of \$2.1 million. Record sales volume contributed \$2.6 million to operating income. Additional increases resulted from decreased material costs, relating to redesign and resourcing of products, and productivity improvements. Increases in operating income were partially offset by increases in retirement benefits primarily relating to the shared distributions of approximately \$1.8 million.

The Korean reporting segment contributed \$1.1 million to our consolidated operating income during 2008 compared to \$2.1 million during 2007, a decrease of \$1.0 million. Reduction in sales resulted in a \$0.3 million decrease in operating income. The remaining decrease resulted from increased material costs primarily related to the devaluation of the Korean Won against the U.S. Dollar for purchases made in U.S. Dollars.

The German reporting segment contributed \$7.7 million to our consolidated operating income during 2008 compared to \$6.0 million during 2007, an increase of \$1.7 million. Record sales volume contributed \$0.8 million to operating income. The remaining increase is primarily related to material costs due to the strength of the Euro against the U.S. Dollar for material purchases made in U.S. Dollars during the first nine months of the year. Increases in operating income were partially offset by the shared distributions of approximately \$0.2 million.

The U.K. reporting segment contributed \$3.2 million to our consolidated operating income during 2008 and 2007. The reduction in sales and shared distributions reduced operating income by approximately \$0.5 million. These decreases were offset by gains in productivity and a reduction in fixed costs.

#### ***Interest Income, Net***

Net Interest income for 2008 was \$0.8 million compared to net interest income of \$0.4 million for 2007. Total average debt for 2008, was \$0.5 million compared to \$0.9 million for 2007. Total average cash for 2008, was \$27.3 million compared to \$14.4 million for 2007. The Company did not have any outstanding variable debt during 2008.

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### ***Foreign Currency Transaction Gain, Net***

Net foreign currency transaction gain was \$0.5 million in 2008 compared to a minimal amount in 2007. While the Euro, the Korean Won and the British Pound weakened against the U.S. Dollar, the UK operations experienced gains related to sales conducted in U.S. dollars and from the revaluation of Sun Ltd. balance sheet items, which were held in U.S. dollars.

### ***Miscellaneous Income, Net***

Miscellaneous income was \$0.1 million in 2008 compared to \$0.3 million in 2007. The decrease is primarily related to a reduction in equity method investment earnings from the prior year. The current year income was primarily a result of proceeds from an insurance claim. This amount was partially offset by a loss on disposal of assets and charitable contributions.

### ***Income Taxes***

The provision for income taxes for the year ended December 27, 2008, was 31.8% of pretax income compared to 35.6% for the year ended December 29, 2007. The change was primarily due to the relative levels of income and different tax rates in effect among the countries in which the Company sells its products and the decrease in the German Statutory tax rate. The 2008 U.S. provision includes tax expense of \$0.8 million related to the repatriation of cash from the German subsidiary and a tax benefit of \$0.8 million for R&D tax credits for the years 2004 through 2007.

### ***Liquidity and Capital Resources***

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

Net cash flow from operations in 2009 was \$13.7 million, compared to \$38.5 million in 2008 and \$28.2 million in 2007. The \$24.9 million decrease in the Company's net cash flow from operations was due primarily to the decrease in net income of \$23.9 million. Cash on hand decreased \$5.0 million from \$35.3 million in 2008 to \$30.4 million in 2009. However, new in 2009, the Company had \$7.8 million invested in available for sale securities at January 2, 2010. Days sales outstanding increased to 42 in 2009 from 30 in 2008 and inventory turns decreased to 8.5 in 2009 from 11.1 in 2008. The increase in days sales outstanding is primarily attributed to the steep decline in sales during the first half of the year. The Company has not had, nor does it anticipate, any significant issues with collectability. With the increased demand in the fourth quarter, both days sales outstanding and inventory turns calculated on a quarterly basis have improved over the annual calculation. The \$10.3 million increase in the Company's net cash flow from operations in 2008 was due primarily to the increase in net income of \$3.6 million, and decreases in accounts receivable and inventory totaling \$6.0 million compared to increases in the prior year totaling \$4.5 million.

Total capital expenditures for 2009 were \$5.1 million. Capital expenditures, consisting primarily of purchases of machinery and equipment, were \$3.4 million in 2009, compared to \$8.4 million in 2008 and \$12.6 million in 2007. Also included in capital expenditures for the year ended January 2, 2010, and December 27, 2008, were land purchases equal to \$1.7 million and \$2.5 million, respectively. Capital expenditures in 2010 are projected to be \$7.0 million.

On August 11, 2005, the Company completed a refinancing of its existing debt in the U.S. with Fifth Third Bank (the "Bank"). The new financing consists of a secured revolving line of credit of \$35 million (the "Line of Credit"). The Line of Credit is secured by the Company's U.S. assets, including its manufacturing facilities, and requires monthly payments of interest. The Line of Credit has a floating interest rate based upon LIBOR plus 1.5% or the Bank's Base Rate, whichever is more advantageous. The Line of Credit is payable in full on August 1, 2011, but maturity may be accelerated by the Bank upon an Event of Default (as defined). Prepayment may be made without penalty or premium at any time upon the required notice to the Bank. At January 2, 2010, the Line of Credit had no outstanding balance.

The Line of Credit is subject to debt covenants including: 1) Debt (as defined) to Tangible Net Worth (as defined) ratio of not more than 1.5:1.0, 2) Funded Debt (as defined) to EBITDA (as defined) ratio of not more than 2.5:1.0, and 3) EBIT (as defined) to Interest Expense (as defined) 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 January 2, 2010, the Company was in compliance with all debt covenants.

The Company declared the following regular quarterly dividends to shareholders of record on the last day of the respective quarter:

|                | <u>2009</u> | <u>2008</u> | <u>2007</u> |
|----------------|-------------|-------------|-------------|
| First quarter  | \$0.090     | \$0.090     | \$0.067     |
| Second quarter | 0.090       | 0.090       | 0.090       |
| Third quarter  | 0.090       | 0.090       | 0.090       |
| Fourth quarter | 0.090       | 0.090       | 0.090       |

These dividends were paid on the 15<sup>th</sup> day of each month following the date of declaration. In addition, the Company declared shared distribution cash dividends of \$0.09 per share in 2008 and 2009. The 2009 dividend was paid on March 31, 2009, to shareholders of record as of March 15, 2009, and the 2008 dividend was paid on May 30, 2008, to shareholders of record as of May 15, 2008.

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, acquisition opportunities, 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 the 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.

OTHER MATERIAL COMMITMENTS. Our contractual obligations and debt obligations as of January 2, 2010, are summarized in the table below (in thousands):

|                                      | <u>Payments due by Period</u> |                             |                      |                      |                              |
|--------------------------------------|-------------------------------|-----------------------------|----------------------|----------------------|------------------------------|
|                                      | <u>TOTAL</u>                  | <u>LESS THAN<br/>1 YEAR</u> | <u>1-3<br/>YEARS</u> | <u>3-5<br/>YEARS</u> | <u>MORE THAN<br/>5 YEARS</u> |
| CONTRACTUAL OBLIGATIONS              |                               |                             |                      |                      |                              |
| Operating leases                     | \$ 37                         | 37                          | —                    | —                    | —                            |
| Other long term liabilities (1)      | <u>687</u>                    | <u>28</u>                   | <u>—</u>             | <u>—</u>             | <u>659</u>                   |
| <b>Total contractual obligations</b> | <b><u>\$ 724</u></b>          | <b><u>\$ 65</u></b>         | <b><u>\$ —</u></b>   | <b><u>\$ —</u></b>   | <b><u>\$ 659</u></b>         |

- (1) Other long term liabilities consist of deferred income of \$28 and deferred compensation of \$659. The deferred income is a result of a non-exclusive supply agreement with Bosch Rexroth, A.G., a German full-line hydraulic component and systems manufacturer, under which the Company will manufacture selected products carrying the Rexroth logo. In addition, the Company has a non-exclusive licensing agreement whereby Rexroth may manufacture some of the Company's products for use in its own fluid power systems. The licensing agreement was entered into in 1999 and will expire in 2010. Currently, Rexroth has elected not to manufacture any products under the licensing agreement, but



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continues to purchase these same products from the Company. The original amount received with regard to the licensing agreement was \$500,000, which is being recognized over the life of the agreement. Deferred compensation relates to Director compensation for attendance at Board meetings. Amounts will be paid upon an individual ceasing to be a Director of the Company or earlier dates selected by the Director as provided in the deferred compensation plan.

### ***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, accruals, stock based compensation, and income taxes. 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 related to product liabilities is provided for when they become known. The Company has not experienced any material product liabilities in the past.

#### *Impairment of Long-Lived Assets*

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 impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the asset exceeds its fair value.

#### *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 Consolidated Balance Sheets 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 to the Financial Statements 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 using a discounted cash flow method was performed at January 2, 2010, and December 27, 2008. 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 7 to the Financial Statements for goodwill amounts.

#### *Accruals*

The Company makes estimates related to certain employee benefits and miscellaneous accruals. Estimates for employee benefit accruals are based on management's assessment 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.

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The Company accrues for health care benefit costs under a self-funded plan. The Company purchases re-insurance for both specific and aggregate stop losses on claims that exceed \$115 thousand on an individual basis and approximately \$6.3 million on an aggregate basis.

#### *Stock-Based Compensation*

All share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense in earnings over the requisite service period. Benefits of tax deductions in excess of recognized compensation costs are reported as a financing cash inflow.

#### *Income Taxes*

The Company's income tax policy provides for a liability approach under which deferred income taxes are provided for based upon enacted tax laws and rates applicable to the periods in which the taxes become payable. These differences result from items reported differently for financial reporting and income tax purposes, primarily depreciation, accrued expenses and reserves.

#### *New Accounting Pronouncements*

In January 2010, the Financial Accounting Standards Board ("FASB") issued guidance amending the existing fair value measurements and disclosure guidance. The amendment requires new disclosures regarding the transfers in and out of level 1 and 2 fair value measurements and activity in level 3 fair value measurements. The amendment also clarifies existing disclosures regarding the level of disaggregated information as well as more disclosure around valuation techniques and inputs to fair value measurements. The guidance is effective for interim and annual reporting periods commencing after December 15, 2009, with a portion effective for fiscal years beginning after December 15, 2010. The adoption of this guidance is not expected to have a material impact on the Company's Consolidated Financial Statements.

In June 2009, the FASB issued new accounting guidance for determining whether an entity is a variable interest entity and requires an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. This guidance also requires an enterprise to assess whether it has an implicit financial responsibility to ensure that a variable interest entity operates as designed when determining whether it has power to direct the activities of the variable interest entity that most significantly impacts the entity's economic performance. This guidance also requires ongoing assessments of whether an enterprise is the primary beneficiary of a variable interest entity, requires enhanced disclosures and eliminates the scope exclusion for qualifying special-purpose entities. This guidance is effective for annual reporting periods beginning after November 15, 2009. The adoption of this guidance is not expected to have a material impact on the Company's Consolidated Financial Statements.

In June 2009, the FASB issued new accounting guidance to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. This guidance is effective for annual reporting periods beginning after November 15, 2009. The adoption of this guidance is not expected to have a material impact on the Company's Consolidated Financial Statements.

#### **Off Balance Sheet Arrangements**

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

The Company uses the equity method of accounting to account for its investments in Sun China, WhiteOak and High Country Tek. The Company does not have a majority ownership in or exercise control over any of the entities. These investments were not material to the financial statements of the Company at January 2, 2010.

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**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. However, due to the economic conditions of the past year, this pattern was not evident in 2009 and may not recur in 2010.

**Inflation**

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

**ITEM 7A. 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 has managed this risk by its ability to select the interest rate on its debt financing at LIBOR plus 1.5% or the Bank's Base Rate, whichever is more advantageous. The Company had no variable-rate debt outstanding at January 2, 2010, and December 27, 2008.

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 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Index to financial statements:

|   |    |
|---|----|
| <a href="#"><u>Report of Independent Registered Certified Public Accounting Firm</u></a>  | 28 |
| <a href="#"><u>Consolidated Balance Sheets as of January 2, 2010 and December 27, 2008</u></a>  | 29 |
| <a href="#"><u>Consolidated Statements of Operations for the years ended January 2, 2010, December 27, 2008, and December 29, 2007</u></a>                                    | 30 |
| <a href="#"><u>Consolidated Statements of Shareholders' Equity and Comprehensive Income for the years ended January 2, 2010, December 27, 2008, and December 29, 2007</u></a> | 31 |
| <a href="#"><u>Consolidated Statements of Cash Flows for the years ended January 2, 2010, December 27, 2008, and December 29, 2007</u></a>                                    | 32 |
| <a href="#"><u>Notes to the Consolidated Financial Statements</u></a>   | 33 |

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and  
Stockholders of Sun Hydraulics Corporation

We have audited the accompanying consolidated balance sheets of Sun Hydraulics Corporation (a Florida corporation) and subsidiaries (collectively, the Company) as of January 2, 2010 and December 27, 2008, and the related consolidated statements of operations, shareholders' equity and comprehensive income, and cash flows for each of the three years in the period ended January 2, 2010. We also have audited Sun Hydraulics Corporation and subsidiaries' internal control over financial reporting as of January 2, 2010, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Sun Hydraulics Corporation and subsidiaries as of January 2, 2010 and December 27, 2008, and the results of its operations and its cash flows for each of the three years in the period ended January 2, 2010, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, Sun Hydraulics Corporation and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of January 2, 2010, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

/s/ Kirkland, Russ, Murphy & Tapp, P.A.  
March 12, 2010  
Clearwater, Florida

**Sun Hydraulics Corporation**  
**Consolidated Balance Sheets**  
(in thousands, except for share information)

|   | <u>January 2, 2010</u> | <u>December 27, 2008</u> |
|---|------------------------|--------------------------|
| <b>Assets</b>   |                        |                          |
| Current assets:   |                        |                          |
| Cash and cash equivalents   | \$ 30,314              | \$ 35,176                |
| Restricted cash   | 132                    | 127                      |
| Accounts receivable, net of allowance for doubtful accounts of \$90 and \$92                                | 9,949                  | 12,502                   |
| Inventories   | 7,799                  | 9,960                    |
| Income taxes receivable   | 1,485                  | 1,353                    |
| Deferred income taxes   | 575                    | 259                      |
| Marketable Securities   | 7,844                  | —                        |
| Other current assets  | 1,797                  | 1,290                    |
| <b>Total current assets</b>   | <b>59,895</b>          | <b>60,667</b>            |
| Property, plant and equipment, net  | 56,633                 | 57,726                   |
| Other assets  | 3,405                  | 3,992                    |
| <b>Total assets</b>   | <b>\$ 119,933</b>      | <b>\$ 122,385</b>        |
| <b>Liabilities and shareholders' equity</b>   |                        |                          |
| Current liabilities:  |                        |                          |
| Accounts payable  | \$ 2,442               | \$ 3,258                 |
| Accrued expenses and other liabilities  | 2,475                  | 5,546                    |
| Long-term debt due within one year  | —                      | 147                      |
| Dividends payable   | 1,524                  | 1,499                    |
| <b>Total current liabilities</b>  | <b>6,441</b>           | <b>10,450</b>            |
| Long-term debt due after one year   | —                      | 125                      |
| Deferred income taxes   | 5,191                  | 4,871                    |
| Other noncurrent liabilities  | 687                    | 383                      |
| <b>Total liabilities</b>  | <b>12,319</b>          | <b>15,829</b>            |
| Commitments and contingencies (Note 17)   | —                      | —                        |
| 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, 16,933,168 and 16,658,271 shares outstanding | 17                     | 17                       |
| Capital in excess of par value  | 42,210                 | 38,042                   |
| Retained earnings   | 64,383                 | 70,099                   |
| Accumulated other comprehensive income  | 1,004                  | (1,602)                  |
| <b>Total shareholders' equity</b>   | <b>107,614</b>         | <b>106,556</b>           |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 119,933</b>      | <b>\$ 122,385</b>        |

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

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

|  | For the year ended     |                          |                          |
|--|------------------------|--------------------------|--------------------------|
|  | <u>January 2, 2010</u> | <u>December 27, 2008</u> | <u>December 29, 2007</u> |
| <b>Net sales</b>                                   | <b>\$ 97,393</b>       | <b>\$ 178,278</b>        | <b>\$ 167,374</b>        |
| Cost of sales                                      | <u>75,436</u>          | <u>119,161</u>           | <u>112,524</u>           |
| <b>Gross profit</b>                                | <b>21,957</b>          | <b>59,117</b>            | <b>54,850</b>            |
| Selling, engineering and administrative expenses   | <u>19,814</u>          | <u>22,740</u>            | <u>21,215</u>            |
| <b>Operating income</b>                            | <b>2,143</b>           | <b>36,377</b>            | <b>33,635</b>            |
| Interest (income), net                             | (562)                  | (793)                    | (411)                    |
| Foreign currency transaction (gain) loss, net      | 265                    | (467)                    | (42)                     |
| Miscellaneous (income)/expense, net                | <u>423</u>             | <u>(92)</u>              | <u>(283)</u>             |
| <b>Income before income taxes</b>                  | <b>2,017</b>           | <b>37,729</b>            | <b>34,371</b>            |
| Income tax provision                               | <u>161</u>             | <u>11,994</u>            | <u>12,240</u>            |
| <b>Net income</b>                                  | <b>\$ 1,856</b>        | <b>\$ 25,735</b>         | <b>\$ 22,131</b>         |
| <b>Basic net income per common share</b>           | <b>\$ 0.11</b>         | <b>\$ 1.55</b>           | <b>\$ 1.35</b>           |
| <b>Weighted average basic shares outstanding</b>   | <b>16,837</b>          | <b>16,603</b>            | <b>16,437</b>            |
| <b>Diluted net income per common share</b>         | <b>\$ 0.11</b>         | <b>\$ 1.55</b>           | <b>\$ 1.34</b>           |
| <b>Weighted average diluted shares outstanding</b> | <b>16,870</b>          | <b>16,634</b>            | <b>16,498</b>            |
| <b>Dividends declared per share</b>                | <b>\$ 0.450</b>        | <b>\$ 0.450</b>          | <b>\$ 0.337</b>          |

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

**Sun Hydraulics Corporation**  
**Consolidated Statement of Shareholders' Equity and Comprehensive Income**  
(in thousands)

|  | <u>Preferred<br/>Shares</u> | <u>Preferred<br/>Stock</u> | <u>Common<br/>Shares</u> | <u>Common<br/>stock</u> | <u>Capital in<br/>excess of<br/>par value</u> | <u>Retained<br/>earnings</u> | <u>Accumulated<br/>other<br/>comprehensive<br/>income</u> | <u>Total</u> |
|--|-----------------------------|----------------------------|--------------------------|-------------------------|---|------------------------------|---|--------------|
| Balance, December 30, 2006                       | —                           | \$ —                       | 16,274                   | \$ 16                   | \$30,962                                      | \$35,279                     | \$ 4,543  | \$ 70,800    |
| Forfeitures, restricted stock                    |                             |                            | (2)                      |                         |   |                              |   | —            |
| Shares issued, Restricted Stock                  |                             |                            | 27                       |                         |   |                              |   |              |
| Shares issued, Stock Options                     |                             |                            | 73                       |                         | 287   |                              |   | 287          |
| Shares issued, ESPP                              |                             |                            | 18                       |                         | 272   |                              |   | 272          |
| Shares issued, ESOP                              |                             |                            | 103                      |                         | 1,386   |                              |   | 1,386        |
| Stock-based compensation                         |                             |                            |                          |                         | 735   |                              |   | 735          |
| Tax benefit of stock-based compensation          |                             |                            |                          |                         | 748   |                              |   | 748          |
| Dividends issued                                 |                             |                            |                          |                         |   | (5,566)                      |   | (5,566)      |
| Comprehensive income:                            |                             |                            |                          |                         |   |                              |   | —            |
| Net income                                       |                             |                            |                          |                         |   | 22,131                       |   | 22,131       |
| Foreign currency translation adjustments         |                             |                            |                          |                         |   |                              | 1,089   | 1,089        |
| Comprehensive income:                            |                             |                            |                          |                         |   |                              |   | 23,220       |
| Balance, December 29, 2007                       | —                           | \$ —                       | 16,493                   | \$ 16                   | \$34,390                                      | \$51,844                     | \$ 5,632  | \$ 91,882    |
| Shares issued, Restricted Stock                  |                             |                            | 40                       | 1                       |   |                              |   | 1            |
| Shares issued, Other Comp                        |                             |                            | 3                        |                         |   |                              |   | —            |
| Shares issued, Stock Options                     |                             |                            | 17                       |                         | 87  |                              |   | 87           |
| Shares issued, ESPP                              |                             |                            | 16                       |                         | 359   |                              |   | 359          |
| Shares issued, ESOP                              |                             |                            | 89                       |                         | 2,255   |                              |   | 2,255        |
| Stock-based compensation                         |                             |                            |                          |                         | 896   |                              |   | 896          |
| Tax benefit of stock-based compensation          |                             |                            |                          |                         | 55  |                              |   | 55           |
| Dividends issued                                 |                             |                            |                          |                         |   | (7,480)                      |   | (7,480)      |
| Comprehensive income:                            |                             |                            |                          |                         |   |                              |   | —            |
| Net income                                       |                             |                            |                          |                         |   | 25,735                       |   | 25,735       |
| Foreign currency translation adjustments         |                             |                            |                          |                         |   |                              | (7,234)   | (7,234)      |
| Comprehensive income:                            |                             |                            |                          |                         |   |                              |   | 18,501       |
| Balance, December 27, 2008                       | —                           | \$ —                       | 16,658                   | \$ 17                   | \$38,042                                      | \$70,099                     | \$ (1,602)  | \$106,556    |
| Shares issued, Restricted Stock                  |                             |                            | 40                       |                         |   |                              |   | —            |
| Shares issued, Other Comp                        |                             |                            | 4                        |                         |   |                              |   | —            |
| Shares issued, Stock Options                     |                             |                            | 3                        |                         | 11  |                              |   | 11           |
| Shares issued, ESPP                              |                             |                            | 29                       |                         | 392   |                              |   | 392          |
| Shares issued, ESOP                              |                             |                            | 199                      |                         | 2,796   |                              |   | 2,796        |
| Stock-based compensation                         |                             |                            |                          |                         | 960   |                              |   | 960          |
| Tax benefit of stock-based compensation          |                             |                            |                          |                         | 9   |                              |   | 9            |
| Dividends issued                                 |                             |                            |                          |                         |   | (7,572)                      |   | (7,572)      |
| Comprehensive income:                            |                             |                            |                          |                         |   |                              |   | —            |
| Net income                                       |                             |                            |                          |                         |   | 1,856                        |   | 1,856        |
| Unrealized gain on available for sale securities |                             |                            |                          |                         |   |                              | 116   | 116          |
| Foreign currency translation adjustments         |                             |                            |                          |                         |   |                              | 2,490   | 2,490        |
| Comprehensive income:                            |                             |                            |                          |                         |   |                              |   | 4,462        |
| Balance, January 2, 2010                         | —                           | \$ —                       | 16,933                   | \$ 17                   | \$42,210                                      | \$64,383                     | \$ 1,004  | \$107,614    |

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

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

|   | For the year ended |                   |                   |
|---|--------------------|-------------------|-------------------|
|   | January 2, 2010    | December 27, 2008 | December 29, 2007 |
| <b>Cash flows from operating activities:</b>                                      |                    |                   |                   |
| Net income  | \$ 1,856           | \$ 25,735         | \$ 22,131         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                    |                   |                   |
| Depreciation and amortization   | 6,968              | 7,096             | 6,341             |
| (Gain) loss on disposal of assets   | 30                 | 138               | (74)              |
| Stock-based compensation expense  | 960                | 896               | 735               |
| Deferred director and phantom stock unit expense                                  | 398                | 56                | 694               |
| Stock options income tax benefit  | (9)                | (55)              | (748)             |
| Allowance for doubtful accounts   | (2)                | (123)             | 75                |
| Provision for slow moving inventory   | (41)               | 102               | 251               |
| Provision for deferred income taxes   | 4                  | (195)             | 575               |
| (Increase) decrease in:   |                    |                   |                   |
| Accounts receivable   | 2,555              | 4,650             | (3,187)           |
| Inventories   | 2,202              | 1,359             | (1,286)           |
| Income tax receivable   | (123)              | (1,353)           | —                 |
| Other current assets  | (507)              | (80)              | (224)             |
| Other assets, net   | 560                | 465               | (310)             |
| Increase (decrease) in:   |                    |                   |                   |
| Accounts payable  | (816)              | (2,410)           | 856               |
| Accrued expenses and other liabilities  | (672)              | 2,888             | 1,490             |
| Income taxes payable  | —                  | (619)             | 814               |
| Other noncurrent liabilities  | 304                | (23)              | 108               |
| Net cash from operating activities  | <u>13,667</u>      | <u>38,527</u>     | <u>28,241</u>     |
| <b>Cash flows from investing activities:</b>                                      |                    |                   |                   |
| Investment in High Country Tek  | —                  | —                 | (2,375)           |
| Capital expenditures  | (5,096)            | (10,874)          | (12,591)          |
| Proceeds from dispositions of equipment   | —                  | 99                | 192               |
| Purchases of Marketable Securities  | (10,600)           | —                 | —                 |
| Proceeds from Sale of Marketable Securities                                       | 2,863              | —                 | —                 |
| Net cash used in investing activities   | <u>(12,833)</u>    | <u>(10,775)</u>   | <u>(14,774)</u>   |
| <b>Cash flows from financing activities:</b>                                      |                    |                   |                   |
| Repayment of debt   | (261)              | (416)             | (371)             |
| Proceeds from exercise of stock options   | 11                 | 87                | 287               |
| Stock options income tax benefit  | 9                  | 55                | 748               |
| Proceeds from stock issued  | 392                | 359               | 272               |
| Dividends to shareholders   | (7,547)            | (7,465)           | (5,167)           |
| Net cash used in financing activities   | <u>(7,396)</u>     | <u>(7,380)</u>    | <u>(4,231)</u>    |
| Effect of exchange rate changes on cash and cash equivalents                      | <u>1,705</u>       | <u>(4,406)</u>    | <u>604</u>        |
| Net (decrease) increase in restricted cash  | 5                  | (19)              | 28                |
| Net (decrease) increase in cash and cash equivalents                              | <u>(4,862)</u>     | <u>15,985</u>     | <u>9,812</u>      |
| Cash and cash equivalents and restricted cash, beginning of period                | <u>35,303</u>      | <u>19,337</u>     | <u>9,497</u>      |
| Cash and cash equivalents and restricted cash, end of period                      | <u>\$ 30,446</u>   | <u>\$ 35,303</u>  | <u>\$ 19,337</u>  |
| <b>Supplemental disclosure of cash flow information:</b>                          |                    |                   |                   |
| Cash paid:  |                    |                   |                   |
| Interest  | \$ 9               | \$ 31             | \$ 51             |
| Income taxes  | \$ 289             | \$ 14,216         | \$ 11,599         |
| <b>Supplemental disclosure of noncash transactions:</b>                           |                    |                   |                   |
| Common stock issued to ESOP through accrued expenses and other liabilities        | \$ 2,796           | \$ 2,255          | \$ 1,386          |
| Unrealized gain on available for sale securities                                  | \$ 116             | \$ —              | \$ —              |

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



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**SUN HYDRAULICS CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
*(in thousands, except per share data)*

**1. 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 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. WhiteOak Controls, Inc. (“WhiteOak”), a 40% equity method investment, located in Mediapolis, Iowa, designs and produces complementary electronic control products. High Country Tek, Inc. (“HCT”), a 48% equity method investment, located in Nevada City, California, designs and manufactures ruggedized electronic/hydraulic control solutions for mobile equipment markets. Sun Hydraulics opened a Liaison office in Bangalore, India during 2007 to develop new business opportunities in the Indian market.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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

*Principles of Consolidation*

The consolidated financial statements include the accounts and operations of Sun Hydraulics and its direct and indirect subsidiaries. All significant intercompany accounts and transactions are eliminated in consolidation. The Company uses the equity method of accounting for its investments in Sun China, WhiteOak, and HCT. The Company does not have a majority ownership in or exercise control over these entities.

*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, accruals, stock based compensation, and income taxes. 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*

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 impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the asset exceeds its fair market value.

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### *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 the consolidated balance sheets 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 to the Financial Statements 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 using a discounted cash flow method was performed at January 2, 2010 and December 27, 2008. 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 7 to the Financial Statements for goodwill amounts.

### *Accruals*

The Company makes estimates related to certain employee benefits and miscellaneous accruals. Estimates for employee benefit accruals are based on management's assessment 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.

The Company accrues for health care benefit costs under a self-funded plan. The Company purchases re-insurance for both specific and aggregate stop losses on claims that exceed \$115 on an individual basis and approximately \$6,300 on an aggregate basis.

### *52-53 Week Fiscal Year*

The Company reports on a fiscal year that ends on the Saturday closest to December 31st. Each quarter generally consists of thirteen weeks. As a result of the 2009 fiscal year ending January 2, 2010, the quarter ended January 2, 2010, consisted of fourteen weeks, resulting in a 53-week year.

### **Reclassification**

Certain amounts shown in the 2008 and 2007 consolidated financial statements and notes to the consolidated financial statements have been reclassified to conform to the 2009 presentation.

### **Management Estimates and Assumptions**

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

### **Cash and Cash Equivalents**

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

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## Inventories

Inventories are valued at the lower of cost or market, cost being determined on a first-in, first-out basis. Obsolete and slow moving inventory is evaluated and reserves are established based on specific criteria determined by management.

## Property, Plant and Equipment

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

|                                 | <u>Years</u> |
|---------------------------------|--------------|
| Computer equipment              | 3 - 5        |
| Machinery and equipment         | 4 - 12       |
| Furniture and fixtures          | 4 - 10       |
| Leasehold and land improvements | 5 - 15       |
| Buildings                       | 40           |

Gains or losses on the retirement, sale, or disposition of property, plant, and equipment are reflected in the Consolidated Statement of Operations in the period in which the assets are taken out of service.

## Valuation Assessment of Long-Lived Assets

Management periodically evaluates long-lived assets for potential impairment and will provide for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be fully recoverable. Assets are reviewed for utilization on a monthly basis by management in conjunction with employees who work directly with the assets.

## Goodwill

Goodwill, which represents the excess of the purchase price of acquisition over the fair value of the net assets acquired and other acquisition costs, is carried at cost. Goodwill is not amortized by the Company. Instead, goodwill is reviewed for impairment on an annual basis, or more frequently if events or circumstances indicate possible impairment.

## Other Assets

Other assets consist of equity investments in the Company's joint ventures in Sun China, WhiteOak and HCT. The equity investments were recorded at cost and have been adjusted for investment income or loss and dividend distributions for each quarterly period since their origin.

## Revenue Recognition

Sales are recognized when products are shipped and title to the products is passed to the customer. Sales incentives are granted to customers based upon the volume of purchases. These sales incentives are recorded at the time of sales as a reduction of gross sales.

## Shipping and Handling Costs

Shipping and handling costs billed to distributors and customers are recorded in revenue. Shipping costs incurred by the Company are recorded in cost of goods sold.

## Foreign Currency Translation and Transactions

The Pound Sterling is the functional currency of Sun Ltd. The Euro is the functional currency of Sun GmbH. The South Korean Won is the functional currency of Sun Korea. The U.S. Dollar is the functional currency for Sun Hydraulics and the reporting currency for the consolidated group. The assets and liabilities of Sun Ltd., Sun GmbH, and Sun Korea are translated at the exchange rate in effect at the balance sheet date, and income and expense items are translated at the average annual rate of exchange for the period. The resulting unrealized translation gains and losses are included as a component of shareholders' equity designated as "accumulated other comprehensive income." Realized gains and losses from foreign currency transactions are included in the Consolidated Statement of Operations.

## Income Taxes

The Company's income tax policy provides for a liability approach under which deferred income taxes are provided for based upon enacted tax laws and rates applicable to the periods in which the taxes become payable. These differences result from items reported differently for financial reporting and income tax purposes, primarily depreciation, accrued expenses and reserves.

## Stock-Based Compensation

All share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense in earnings over the requisite service period. Benefits of tax deductions in excess of recognized compensation costs are reported as a financing cash inflow.

### 3. FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company uses the three-tier fair value hierarchy which prioritizes the inputs used in measuring fair value as follows:

*Level 1.* Observable inputs such as quoted prices in active markets;

*Level 2.* Inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and

*Level 3.* Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

At January 2, 2010, the Company held available-for-sale securities with an aggregate fair value of \$7,844. The Company, on a recurring basis, measures available-for-sale securities at fair value using quoted prices in active markets. The majority of these available for sale securities were previously classified as held to maturity. In the fourth quarter of 2009, the Company changed the classification and accounting to provide greater flexibility in the management of these investments. The net unrealized holding gain on available for sale securities amounted to \$116 at January 2, 2010. In addition, the Company reports deferred director stock units and phantom stock units as a liability. These liabilities, on a recurring basis, are measured at fair value using quoted prices in the active market. The Company recognized a net loss related to those liabilities of \$398 and \$56 for the years ended January 2, 2010 and December 27, 2008, respectively.

The Company did not have any fair value adjustments for assets and liabilities measured at fair value on a nonrecurring basis during the period ended January 2, 2010 and December 27, 2008.

Assets measured at fair value on a recurring basis include the following as of January 2, 2010:

| <u>Description</u>            | <u>January 2, 2010</u> | <u>Fair Value Measurements at Reporting Date Using</u> |  |  |
|-------------------------------|------------------------|--|--|--|
|                               |                        | <u>Quoted Prices in Active Markets (Level 1)</u>       | <u>Significant Other Observable Inputs (Level 2)</u> | <u>Significant Unobservable Inputs (Level 3)</u> |
| Available-for-sale securities | \$ 7,844               | \$ 7,844   | \$ —   | \$ —   |

Liabilities measured at fair value on a recurring basis include the following as of January 2, 2010:

| <u>Description</u>            | <u>January 2, 2010</u> | <u>Fair Value Measurements at Reporting Date Using</u> |  |  |
|-------------------------------|------------------------|--|--|--|
|                               |                        | <u>Quoted Prices in Active Markets (Level 1)</u>       | <u>Significant Other Observable Inputs (Level 2)</u> | <u>Significant Unobservable Inputs (Level 3)</u> |
| Deferred director stock units | \$ 659                 | \$ 659   | \$ —   | \$ —   |
| Phantom stock units           | 19                     | 19   | —  | —  |
| Total                         | \$ 678                 | \$ 678   | \$ —   | \$ —   |

The carrying amounts of cash and cash equivalents, restricted cash, accounts receivable, other current assets, accounts payable, accrued expenses and other liabilities approximate fair value based on their short-term status.

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

#### 4. RESTRICTED CASH

On January 2, 2010 and December 27, 2008, the Company had restricted cash of \$132 and \$127, respectively. \$48 and \$44 of the 2009 and 2008 restricted cash balance, respectively, consisted of reserves for customs and excise taxes in the U.K. operation. The restricted amount was calculated as an estimate of two months of customs and excise taxes for items coming into the Company's U.K. operations and was held with Lloyd's TSB in the U.K. The remaining 2009 and 2008 amounts relate to a guarantee of VAT in our France operation. The guarantee is held with Cr dit Agricole Bank in France.

#### 5. INVENTORIES

|                                     | <u>January 2, 2010</u> | <u>December 27, 2008</u> |
|-------------------------------------|------------------------|--------------------------|
| Raw materials                       | \$ 3,186               | \$ 4,428                 |
| Work in process                     | 2,420                  | 2,757                    |
| Finished goods                      | 2,900                  | 3,523                    |
| Provision for slow moving inventory | <u>(707)</u>           | <u>(748)</u>             |
| Total                               | <u>\$ 7,799</u>        | <u>\$ 9,960</u>          |

#### 6. PROPERTY, PLANT, AND EQUIPMENT

|                                 | <u>January 2, 2010</u> | <u>December 27, 2008</u> |
|---------------------------------|------------------------|--------------------------|
| Machinery and equipment         | \$ 75,487              | \$ 69,337                |
| Office furniture and equipment  | 10,509                 | 9,712                    |
| Buildings                       | 25,650                 | 25,025                   |
| Leasehold and land improvements | 2,723                  | 2,599                    |
| Land                            | <u>7,065</u>           | <u>5,334</u>             |
|                                 | \$ 121,434             | \$ 112,007               |
| Less: Accumulated depreciation  | <u>(66,715)</u>        | <u>(59,217)</u>          |
| Construction in progress        | <u>1,914</u>           | <u>4,936</u>             |
| Total                           | <u>\$ 56,633</u>       | <u>\$ 57,726</u>         |

Depreciation expense for the years ended January 2, 2010, December 27, 2008, and December 29, 2007 totaled \$6,932, \$7,069, and \$6,314, respectively.

#### 7. GOODWILL

On January 2, 2010 and December 27, 2008, the Company had \$715 of goodwill related to its acquisition of Sun Korea.

Valuation models reflecting the expected future cash flow projections were used to value Sun Korea at January 2, 2010 and December 27, 2008. The analysis indicated that there was no impairment of the carrying value of the goodwill.

## 8. OTHER ASSETS

|   | <u>January 2, 2010</u> | <u>December 27, 2008</u> |
|---|------------------------|--------------------------|
| Goodwill  | \$ 715                 | \$ 715                   |
| Equity investment in joint venture                            |                        |                          |
| Sun China   | 1,214                  | 1,081                    |
| WhiteOak Controls, Inc.                                       | 157                    | 209                      |
| High Country Tek, Inc.  | 1,042                  | 1,744                    |
| Loan acquisition costs, net of amortization of \$123 and \$94 | 47                     | 76                       |
| Deposits with suppliers                                       | 130                    | 143                      |
| Other   | 100                    | 24                       |
| Total   | <u>\$ 3,405</u>        | <u>\$ 3,992</u>          |

## 9. ACCRUED EXPENSES AND OTHER LIABILITIES

|                           | <u>January 2, 2010</u> | <u>December 27, 2008</u> |
|---------------------------|------------------------|--------------------------|
| Compensation and benefits | \$ 1,660               | \$ 4,277                 |
| Insurance                 | 456                    | 723                      |
| Other                     | 359                    | 546                      |
| Total                     | <u>\$ 2,475</u>        | <u>\$ 5,546</u>          |

## 10. LONG-TERM DEBT

|   | <u>January 2, 2010</u> | <u>December 27, 2008</u> |
|---|------------------------|--------------------------|
| \$35,000 revolving line of credit, collateralized by U.S. assets, interest rate Libor + 1.5% or Bank's Base Rate at Company's discretion (1.731% at January 2, 2010), due August 1, 2011. | \$ —                   | \$ —                     |
| 10-year notes, fixed interest rates ranging from 3.5-5.1%, collateralized by equipment in Germany, due between 2009 and 2011.   | —                      | 272                      |
|   | —                      | 272                      |
| Less amounts due within one year  | —                      | (147)                    |
| Total   | <u>\$ —</u>            | <u>\$ 125</u>            |

The are no remaining principal payments due at January 2, 2010.

On August 11, 2005, the Company completed a refinancing of its existing debt in the U.S. with Fifth Third Bank (the "Bank"). The financing consists of a secured revolving line of credit of \$35 million (the "Line of Credit"). The Line of Credit is secured by the Company's U.S. assets, including its manufacturing facilities, and requires monthly payments of interest. The Line of Credit has a floating interest rate based on LIBOR plus 1.5% or the Bank's Base Rate, whichever is more advantageous. The Line of Credit is payable in full on August 1, 2011, but maturity may be accelerated by the Bank upon an Event of Default (as defined). Prepayment may be made without penalty or premium at any time upon the required notice to the Bank. At January 2, 2010, there was no outstanding balance on the Line of Credit.

The Line of Credit is subject to debt covenants including: 1) Debt (as defined) to Tangible Net Worth (as defined) ratio of not more than 1.5:1.0, 2) Funded Debt (as defined) to EBITDA (as defined) ratio of not more than 2.5:1.0, and 3) EBIT (as defined) to Interest Expense (as defined) 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 January 2, 2010, the Company was in compliance with all debt covenants.

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## 11. DIVIDENDS TO SHAREHOLDERS

The Company declared dividends of \$7,572, \$7,480, and \$5,566 to shareholders in 2009, 2008, and 2007, respectively.

The Company declared the following regular quarterly dividends to shareholders of record on the last day of the respective quarter:

|                | <u>2009</u> | <u>2008</u> | <u>2007</u> |
|----------------|-------------|-------------|-------------|
| First quarter  | \$0.090     | \$0.090     | \$0.067     |
| Second quarter | 0.090       | 0.090       | 0.090       |
| Third quarter  | 0.090       | 0.090       | 0.090       |
| Fourth quarter | 0.090       | 0.090       | 0.090       |

These dividends were paid on the 15<sup>th</sup> day of each month following the date of declaration. In addition, the Company declared shared distribution cash dividends of \$0.09 per share in 2008 and 2009. The 2009 dividend was paid on March 31, 2009 to shareholders of record as of March 15, 2009, and the 2008 dividend was paid on May 30, 2008 to shareholders of record as of May 15, 2008.

## 12. INCOME TAXES

Deferred income tax assets and liabilities are provided to reflect the future tax consequences of differences between the tax basis of assets and liabilities and their reported amounts in the financial statements.

For financial reporting purposes, income before income taxes includes the following components:

|               | For the year ended |                      |                      |
|---------------|--------------------|----------------------|----------------------|
|               | January 2,<br>2010 | December 27,<br>2008 | December 29,<br>2007 |
| United States | \$ (1,934)         | \$ 24,820            | \$ 22,789            |
| Foreign       | 3,951              | 12,909               | 11,582               |
| <b>Total</b>  | <b>\$ 2,017</b>    | <b>\$ 37,729</b>     | <b>\$ 34,371</b>     |

The components of the income tax provision (benefit) are as follows:

|                                   | For the year ended |                      |                      |
|-----------------------------------|--------------------|----------------------|----------------------|
|                                   | January 2,<br>2010 | December 27,<br>2008 | December 29,<br>2007 |
| Current tax expense:              |                    |                      |                      |
| United States                     | \$ (773)           | \$ 7,711             | \$ 7,853             |
| State and local                   | (46)               | 503                  | 464                  |
| Foreign                           | 976                | 3,975                | 3,348                |
| <b>Total current</b>              | <b>157</b>         | <b>12,189</b>        | <b>11,665</b>        |
| Deferred tax expense (benefit):   |                    |                      |                      |
| United States                     | 14                 | 42                   | 217                  |
| State and local                   | 6                  | 13                   | (4)                  |
| Foreign                           | (16)               | (250)                | 362                  |
| <b>Total deferred</b>             | <b>4</b>           | <b>(195)</b>         | <b>575</b>           |
| <b>Total income tax provision</b> | <b>\$ 161</b>      | <b>\$ 11,994</b>     | <b>\$ 12,240</b>     |

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

|   | For the year ended |                      |                      |
|---|--------------------|----------------------|----------------------|
|   | January 2,<br>2010 | December 27,<br>2008 | December 29,<br>2007 |
| U.S. federal taxes at statutory rate                  | \$ 706             | \$ 13,205            | \$ 12,043            |
| Increase(decrease)                                    |                    |                      |                      |
| Net residual tax on foreign distributions             | —                  | 827                  | —                    |
| Foreign tax credit                                    | —                  | —                    | (27)                 |
| Domestic production activity deduction                | —                  | (519)                | (381)                |
| Research and Development Tax Credit - Current<br>Year | (200)              | (241)                | —                    |
| Research and Development Tax Credit - Prior Years     | —                  | (849)                | —                    |
| Foreign income taxed at lower rate                    | (424)              | (793)                | (344)                |
| Nondeductible items                                   | 67                 | 94                   | 116                  |
| Effect of federal rate change                         | —                  | —                    | 106                  |
| State and local taxes, net                            | (40)               | 516                  | 460                  |
| Change in reserve                                     | 124                | 2                    | (174)                |
| Korea withholding tax                                 | —                  | —                    | 107                  |
| Other   | (72)               | (248)                | 334                  |
| <b>Income tax provision</b>                           | <b>\$ 161</b>      | <b>\$ 11,994</b>     | <b>\$ 12,240</b>     |



Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income taxes. The temporary differences that give rise to significant portions of the deferred tax assets and liabilities as of January 2, 2010 and December 27, 2008 are presented below:

|   | January 2,<br>2010 | December 27,<br>2008 |
|---|--------------------|----------------------|
| <b>Deferred tax assets:</b>               |                    |                      |
| Current:                                  |                    |                      |
| Accrued expenses and other                | \$ 575             | \$ 259               |
| Total current deferred tax assets         | <u>575</u>         | <u>259</u>           |
| Noncurrent:                               |                    |                      |
| Accrued expenses and other                | 626                | 387                  |
| Deferred royalty income                   | <u>10</u>          | <u>29</u>            |
| Total noncurrent deferred tax assets      | <u>636</u>         | <u>416</u>           |
| <b>Deferred tax liabilities:</b>          |                    |                      |
| Noncurrent:                               |                    |                      |
| Depreciation                              | (5,827)            | (5,287)              |
| Other                                     | <u>—</u>           | <u>—</u>             |
| Total noncurrent deferred tax liabilities | <u>(5,827)</u>     | <u>(5,287)</u>       |
| Net noncurrent deferred tax liability     | <u>\$ (5,191)</u>  | <u>\$ (4,871)</u>    |

A valuation allowance to reduce the deferred tax assets reported is required if, based on the weight of the evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. For the fiscal years ended 2009 and 2008, management has determined that a valuation allowance is not required.

The Company intends and has the ability to indefinitely reinvest the earnings of its non-U.S. subsidiaries, which reflect full provision for non-U.S. income taxes, to expand its international operations. These earnings relate to ongoing operations and, at January 2, 2010, cumulative earnings were approximately \$31 million. Accordingly, no provision has been made for U.S. income taxes that might be payable upon repatriation of such earnings. In the event any earnings of non-U.S. subsidiaries are repatriated, the Company will provide U.S. income taxes upon repatriation of such earnings, which will be offset by applicable foreign tax credits, subject to certain limitations. Due to specific circumstances, during the year ended December 27, 2008, the Company repatriated \$6,000 from its foreign subsidiaries. U.S. income taxes due based on the repatriations have been provided for in the above income tax provisions.

The Company prescribes a recognition threshold and measurement attribute for an uncertain tax position taken or expected to be taken in a tax return.

The following is a roll-forward of the Company's unrecognized tax benefits:

|   |              |
|---|--------------|
| Unrecognized tax benefits - January 1, 2007         | \$ 208       |
| Increases from positions taken during prior periods | 34           |
| Lapse of statute of limitations                     | <u>(208)</u> |
| Unrecognized tax benefits - December 29, 2007       | \$ 34        |
| Increases from positions taken during prior periods | 2            |
| Lapse of statute of limitations                     | <u>—</u>     |
| Unrecognized tax benefits - December 27, 2008       | \$ 36        |
| Increases from positions taken during prior periods | 124          |
| Lapse of statute of limitations                     | <u>—</u>     |
| Unrecognized tax benefits - January 2, 2010         | \$ 160       |

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As of January 1, 2007, the Company had an unrecognized tax benefit of \$208 including accrued interest. During 2007, the Company recognized the tax benefit of \$208, which had a favorable effect on the effective tax rate for the period ended December 29, 2007.

At January 2, 2010, the Company had an unrecognized tax benefit of \$160 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 related to the unrecognized tax benefit has been recognized and included in income tax expense. Interest accrued as of January 2, 2010, is not considered material to the Company's Consolidated Financial Statements.

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

The Company's federal returns are currently under examination by the Internal Revenue Service (IRS) in the United States for the periods 2004 through 2007. The IRS proposed a significant adjustment to the Company's research and development tax credit position. Management has disagreed with the proposed adjustment and believes sufficient evidence is available to defend the position. To date, there have not been any other significant proposed adjustments.

Audit outcomes and the timing of audit settlements are subject to significant uncertainty. It is reasonably possible that within the next twelve months the Company will resolve some or all of the matters presently under consideration for 2004 through 2007 with the IRS, and that there could be significant increases or decreases to unrecognized tax benefits.

### **13. STOCK OPTION PLANS**

During 1996, the Company adopted the 1996 Stock Option Plan (the "Stock Option Plan"), which provides for the grant of incentive stock options and nonqualified stock options for the purchase of up to an aggregate of 2,250,000 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 the Company's stock option plan for the years ended January 2, 2010, December 27, 2008, and December 29, 2007 is summarized as follows:

|  | <u>Number<br/>of shares</u> | <u>Exercise<br/>price<br/>range</u> | <u>Weighted<br/>average<br/>exercise price</u> |
|--|-----------------------------|-------------------------------------|--|
|  |                             | (share amounts are in thousands)    |  |
| Under option, December 30, 2006<br>(84 shares exercisable) | 113                         | \$3.00 - 12.27                      | \$ 4.47  |
| Granted  | —                           | \$ — - —                            | \$ —   |
| Exercised  | (72)                        | \$3.00 - 12.27                      | \$ 3.97  |
| Forfeitures  | (5)                         | \$ 3.11 - 5.49                      | \$ 3.39  |
| Under option, December 29, 2007<br>(32 shares exercisable) | <u>36</u>                   | <u>\$3.00 - 12.27</u>               | <u>\$ 5.62</u>                                 |
| Granted  | —                           | \$ — - —                            | \$ —   |
| Exercised  | (17)                        | \$3.00 - 12.27                      | \$ 5.23  |
| Forfeitures  | —                           | \$ — - —                            | \$ —   |
| Under option, December 27, 2008<br>(16 shares exercisable) | <u>19</u>                   | <u>\$3.00 - 12.27</u>               | <u>\$ 5.95</u>                                 |
| Granted  | —                           | \$ — - —                            | \$ —   |
| Exercised  | (3)                         | \$ 3.00 - 5.49                      | \$ 3.66  |
| Forfeitures  | —                           | \$ — - —                            | \$ —   |
| Under option, January 2, 2010<br>(15 shares exercisable)   | <u>16</u>                   | <u>\$3.00 - 12.27</u>               | <u>\$ 6.39</u>                                 |

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 January 2, 2010, and December 27, 2008, was \$6.

A summary of outstanding and exercisable options at January 2, 2010 is summarized as follows:

| <u>Options Outstanding</u>          |                             |                                       |                           | <u>Options Exercisable</u>  |  |
|-------------------------------------|-----------------------------|---------------------------------------|---------------------------|-----------------------------|--|
| <u>Range of<br/>exercise prices</u> | <u>Number of<br/>shares</u> | <u>Weighted-average</u>               |                           | <u>Number of<br/>shares</u> | <u>Weighted<br/>average<br/>exercise price</u> |
|                                     |                             | <u>Remaining<br/>contractual life</u> | <u>Exercise<br/>price</u> |                             |  |
| \$ 3.00                             | 2                           | 0.83                                  | 3.00                      | 2                           | 3.00   |
| 3.11                                | 1                           | 1.83                                  | 3.11                      | 1                           | 3.11   |
| 3.15                                | 2                           | 0.75                                  | 3.15                      | 2                           | 3.15   |
| 5.49                                | 7                           | 1.75                                  | 5.49                      | 7                           | 5.49   |
| 12.27                               | 4                           | 2.92                                  | 12.27                     | 3                           | 12.27  |

There were no stock options granted during 2009, 2008 and 2007.

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 750,000 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.

During 2001, the Company adopted the 2001 Restricted Stock Plan, which provides for the grant of restricted stock of up to an aggregate of 618,750 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. Compensation cost has been 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 years ended January 2, 2010, December 27, 2008, and December 29, 2007 totaled \$794, \$722, and \$507, respectively. At January 2, 2010, 87,111 shares remained available to be issued through the Restricted Stock Plan.

A summary of the Company's restricted stock plan for the years ended January 2, 2010, December 27, 2008, and December 29, 2007 is summarized as follows:

|  | <u>Number<br/>of shares</u> | <u>Weighted<br/>average<br/>grant-date<br/>fair value</u> |
|--|-----------------------------|---|
| Nonvested balance at December 30, 2006 | 92                          | \$ 11.14  |
| Granted                                | 27                          | 33.75   |
| Vested                                 | (49)                        | 9.40  |
| Forfeitures                            | <u>(2)</u>                  | <u>12.90</u>  |
| Nonvested balance at December 29, 2007 | 68                          | \$ 21.22  |
| Granted                                | 40                          | 18.90   |
| Vested                                 | (35)                        | 18.24   |
| Forfeitures                            | <u>—</u>                    | <u>—</u>  |
| Nonvested balance at December 27, 2008 | 73                          | \$ 21.45  |
| Granted                                | 40                          | 20.97   |
| Vested                                 | (37)                        | 22.86   |
| Forfeitures                            | <u>(1)</u>                  | <u>22.82</u>  |
| Nonvested balance at January 2, 2010   | <u>75</u>                   | <u>\$ 21.78</u>   |

The Company has \$1,350 of total unrecognized compensation cost related to restricted stock awards granted under the Plan as of January 2, 2010. That cost is expected to be recognized over a weighted average period of 1.65 years.

The Company maintains an Employee Stock Purchase Plan ("ESPP"), in which most employees are eligible to participate. Employees in the United States who choose to participate are granted an opportunity to purchase common stock at 85 percent of market value on the first or last day of the quarterly purchase period, whichever is lower. Employees in the United Kingdom are granted an opportunity to purchase common stock at market value, on the first or last day of the quarterly purchase period, whichever is lower, with the Company issuing one additional free share of common stock for each six shares purchased by the employee under the ESPP. The ESPP authorizes the issuance, and the purchase by employees, of up to 731,250 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 their annual salary in any year. Employees purchased 28,065 shares at a weighted average price of \$13.96, and 15,971 shares at a weighted average price of \$22.50, under the ESPP during 2009 and 2008, respectively. The Company recognized \$95 and \$92 of compensation expense during 2009 and 2008, respectively. At January 2, 2010, 539,706 shares remained available to be issued through the ESPP.

The Company has a Nonemployee Director Equity and Deferred Compensation Plan (the "Plan"), which originally was adopted by the Board of Directors and approved by the shareholders in 2004. The Plan was amended on March 1, 2008 and was approved by the shareholders at the 2008 Annual Meeting. Under the Plan, Directors who are not officers of the Company are paid 250 shares of Company common stock and \$3 in fees 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. Additionally, the Board of Directors has the authority to increase from time to time, as it deems desirable or appropriate, the number of shares of stock awarded to all or any one or more of the Nonemployee Directors. No more than 25,000 shares of stock, in the aggregate, may be issued under the Plan during any single calendar year. Committee Chairmen currently receive additional fees equal to 25% of normal compensation and the Chairman of the Board is paid twice the amount of normal compensation, with such additional compensation payable in Company common stock. Previously under the Plan, Nonemployee Directors were paid \$5 of which half was paid in Company common stock.

Directors may elect under the Plan to receive all or part of their cash fees in Company stock and to defer receipt of their fees until a subsequent year. The Plan authorizes the issuance of up to 180,000 shares of common stock.

Directors were granted 10,601 and 7,961 shares during 2009 and 2008, respectively. At January 2, 2010, there were 25,109 deferred stock units outstanding. Deferred stock units are treated as liabilities. The Company recognized director stock compensation expense of \$390 and \$79, for 2009 and 2008, respectively. At January 2, 2010, 143,052 shares remained available to be issued through the Plan.

#### 14. EARNINGS PER SHARE

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

|  | January 2,<br>2010 | December 27,<br>2008 | December 29,<br>2007 |
|--|--------------------|----------------------|----------------------|
| <b>Net income</b>  | <b>\$ 1,856</b>    | <b>\$ 25,735</b>     | <b>\$ 22,131</b>     |
| Basic weighted average number of common shares outstanding         | 16,837             | 16,603               | 16,437               |
| <b>Basic net income per common share</b>                           | <b>\$ 0.11</b>     | <b>\$ 1.55</b>       | <b>\$ 1.35</b>       |
| Effect of dilutive stock options and deferred director stock units | 33                 | 31                   | 61                   |
| Diluted weighted average number of common shares outstanding       | 16,870             | 16,634               | 16,498               |
| <b>Diluted net income per common share</b>                         | <b>\$ 0.11</b>     | <b>\$ 1.55</b>       | <b>\$ 1.34</b>       |

#### 15. EMPLOYEE BENEFITS

The Company has a defined contribution retirement plan covering substantially all of its eligible United States employees. Employer contributions under the retirement plan amounted to approximately \$880, \$4,333, and \$2,573 during 2009, 2008, and 2007, respectively.

The Company provides supplemental pension benefits to its employees of foreign operations in addition to mandatory benefits included in local country payroll tax statutes. These supplemental pension benefits amounted to approximately \$280, \$256, and \$348 during 2009, 2008, and 2007, respectively.

The Company uses an Employee Stock Ownership Plan ("ESOP") as the discretionary match portion of its 401(k) retirement plan. The Company contributes to the ESOP for all eligible United States employees. Under the ESOP, which is 100% company funded, the Company allocates common stock to each participant's account. The allocation is generally a percentage of a participant's compensation as determined by the Board of Directors on an annual basis.

The Company made an annual contribution to the ESOP of 69,311 shares in January of 2008, related to fiscal year 2007. Contributions were based on annual compensation. All shares receive regular quarterly dividends payable to the ESOP to cover plan expenses.

In May 2008, the Board introduced the concept of a shared distribution dividend. The shared distribution dividend rewards the majority of employees through a contribution into their retirement accounts and concurrently rewards shareholders with a special cash dividend. As a result of the shared distribution, the Company contributed 176,827 and 20,185 shares into the ESOP in March 2009 and May 2008, respectively.

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The Company incurred retirement benefit expense under the ESOP of approximately zero, \$3,221 and \$1,498 during 2009, 2008 and 2007, respectively. The 2008 amount includes both the 3% and 9% shared distributions announced in May 2008, and March 2009, respectively. These amounts are included in the total employer contributions to the retirement plan noted above.

There are no restrictions on the shares contributed to the ESOP. This allows participants to sell their shares to enable diversification within their individual 401(k) accounts. The Company does not have any repurchase obligations under the ESOP.

During 2008, the Company developed plans for international employees to participate in the shared distributions. Three percent of 2008 wages was accrued for international employees throughout the year. Additionally 9% of 2008 wages was accrued in accordance with the shared distribution announced in March 2009. The Company's foreign operations recognized total expense of approximately \$753 in 2008. The Company's U.K. employees received 23,246 shares in March 2009, into a share incentive plan, while employees in the remaining locations received their shared distribution in the form of cash. In Korea the cash was deposited into a Company retirement plan.

The Company awards deferred cash bonuses to key employees of its foreign operations. The deferred cash bonuses are similar to phantom stock units, in that such bonuses are tied to the value of the Company's common stock. Awards are recognized over the deferral period as variable plan awards. The Company recognized approximately \$54, \$35 and \$539 of compensation expense in 2009, 2008 and 2007, respectively, related to the awards.

## **16. 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.

Total 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 |
|---------------------------------|---------------|----------|----------|----------------|-------------|--------------|
| <b>2009</b>                     |               |          |          |                |             |              |
| Sales to unaffiliated customers | \$ 59,278     | \$ 9,978 | \$14,654 | \$13,483       | \$ —        | \$ 97,393    |
| Intercompany sales              | 15,545        | —        | 139      | 1,101          | (16,785)    | —            |
| Operating income                | (2,110)       | 616      | 2,475    | 884            | 278         | 2,143        |
| Total assets                    | 85,338        | 8,191    | 12,447   | 15,923         | (1,966)     | 119,933      |
| Depreciation and amortization   | 5,335         | 104      | 502      | 1,027          |             | 6,968        |
| Capital expenditures            | 4,758         | 41       | 30       | 267            |             | 5,096        |
| <b>2008</b>                     |               |          |          |                |             |              |
| Sales to unaffiliated customers | \$111,180     | \$17,455 | \$27,356 | \$22,287       | \$ —        | \$ 178,278   |
| Intercompany sales              | 28,656        | —        | 245      | 2,282          | (31,183)    | —            |
| Operating income                | 24,531        | 1,148    | 7,693    | 3,231          | (226)       | 36,377       |
| Total assets                    | 91,855        | 6,680    | 10,980   | 15,049         | (2,179)     | 122,385      |
| Depreciation and amortization   | 5,139         | 151      | 572      | 1,234          |             | 7,096        |
| Capital expenditures            | 9,904         | 39       | 298      | 633            |             | 10,874       |
| <b>2007</b>                     |               |          |          |                |             |              |
| Sales to unaffiliated customers | \$ 99,516     | \$20,567 | \$24,164 | \$23,127       | \$ —        | \$ 167,374   |
| Intercompany sales              | 30,344        | —        | 142      | 2,621          | (33,107)    | —            |
| Operating income                | 22,408        | 2,103    | 5,955    | 3,205          | (36)        | 33,635       |
| Total assets                    | 74,026        | 9,067    | 12,710   | 17,079         | (2,102)     | 110,780      |
| Depreciation and amortization   | 4,488         | 178      | 556      | 1,119          |             | 6,341        |
| Capital expenditures            | 9,339         | 284      | 125      | 2,843          |             | 12,591       |

Sales to unaffiliated customers represent sales from each of the individual subsidiaries. For information on sales to geographic locations, see the Comparisons of the Years Ended January 2, 2010, and December 27, 2008, in Management's Discussion and Analysis of Financial Condition and Results. Operating income is total sales and other operating income less operating expenses. Segment operating income does not include interest income/expense, foreign currency transaction gain/loss, and net miscellaneous income/expense.

Included in U.S. sales to unaffiliated customers were export sales of \$19,031, \$37,073, and \$29,283, during 2009, 2008, and 2007, respectively. Export sales to Canada and Asia/Pacific totaling, \$12,918, \$24,824, and \$19,981, during 2009, 2008, and 2007, respectively, make up the majority of these export sales. Additionally, export sales to Europe were \$4,916, \$10,708 and \$8,027 during 2009, 2008, and 2007, respectively.

## 17. 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.

**OPERATING LEASES** — The Company leases a manufacturing facility in Lenexa, Kansas and production support facilities in Sarasota, Florida under operating leases having initial terms expiring in 2010. The lease for the manufacturing facility in Kansas is currently on a month to month basis, and represents approximately 17,000 square feet of space. The lease for the production support facilities in Florida is expiring in April, 2010, and represents approximately 10,000 square feet. Total rental expense for the years ended 2009, 2008 and 2007 was approximately \$221, \$236 and \$221, respectively.

Future minimum lease payments on operating leases are as follows:

| 2010                         | <u>37</u>   |
|------------------------------|-------------|
| Total minimum lease payments | <u>\$37</u> |

**INSURANCE** — The Company accrues for health care benefit costs under a self-funded plan. The Company purchases re-insurance for both specific and aggregate stop losses on claims that exceed \$115 on an individual basis and approximately \$6,300 on an aggregate basis. The Company records a liability for all unresolved claims at the anticipated cost to the Company at the end of the period based on management's assessment. The Company believes it has adequate reserves for all self-insurance claims.

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## 18. NEW ACCOUNTING PRONOUNCEMENTS

In January 2010, the Financial Accounting Standards Board (“FASB”) issued guidance amending the existing fair value measurements and disclosures guidance. The amendment requires new disclosures regarding the transfers in and out of level 1 and 2 fair value measurements and activity in level 3 fair value measurements. The amendment also clarifies existing disclosures regarding the level of disaggregated information as well as more disclosure around valuation techniques and inputs to fair value measurements. The guidance is effective for interim and annual reporting periods commencing after December 15, 2009, with a portion effective for fiscal years beginning after December 15, 2010. The adoption of this guidance is not expected to have a material impact on the Company’s Consolidated Financial Statements.

In June 2009, the FASB issued new accounting guidance for determining whether an entity is a variable interest entity and requires an enterprise to perform an analysis to determine whether the enterprise’s variable interest or interests give it a controlling financial interest in a variable interest entity. This guidance also requires an enterprise to assess whether it has an implicit financial responsibility to ensure that a variable interest entity operates as designed when determining whether it has power to direct the activities of the variable interest entity that most significantly impacts the entity’s economic performance. This guidance also requires ongoing assessments of whether an enterprise is the primary beneficiary of a variable interest entity, requires enhanced disclosures and eliminates the scope exclusion for qualifying special-purpose entities. This guidance is effective for annual reporting periods beginning after November 15, 2009. The adoption of this guidance is not expected to have a material impact on the Company’s Consolidated Financial Statements.

In June 2009, the FASB issued new accounting guidance to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor’s continuing involvement, if any, in transferred financial assets. Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. This guidance is effective for annual reporting periods beginning after November 15, 2009. The adoption of this guidance is not expected to have a material impact on the Company’s Consolidated Financial Statements.



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**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH  
ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**ITEM 9A. CONTROLS AND PROCEDURES**

**Controls and Procedures**

The Company's management, with the participation of the Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of the Company's "disclosure controls and procedures" (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report, have concluded that our disclosure controls and procedures are effective and are designed to ensure that the information we are required to disclose is recorded, processed, summarized and reported within the necessary time periods. Our disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in reports that we file or submit pursuant to the Securities Exchange Act of 1934, as amended, are accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

**Internal Control Over Financial Reporting**

Management is responsible for establishing and maintaining adequate internal control over financial reporting.

There were no changes in the Company's internal control over financial reporting during the quarter ended January 2, 2010, that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Management's Report on Internal Control over Financial Reporting**

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;
- provide reasonable assurance that transactions are recorded, as necessary, to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Management, with the participation of the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the Company's internal control over financial reporting based on the criteria set forth in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation under the Internal Control - Integrated Framework, management, with the participation of the Chief Executive Officer and Chief Financial Officer, concluded that the internal control over financial reporting was effective as of January 2, 2010.

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The effectiveness of the Company's internal control over financial reporting as of January 2, 2010 has been audited by Kirkland, Russ, Murphy and Tapp, P.A., an independent registered certified public accounting firm, as stated in their report.

**ITEM 9B. OTHER INFORMATION**

None.

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**PART III.**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS OF THE REGISTRANT AND CORPORATE GOVERNANCE MATTERS**

**Executive Officers**

The information required by this item with respect to our executive officers is set forth in our 2010 Proxy Statement under the caption “Governance of the Company” and is incorporated herein by reference.

**Directors**

The information required by this item with respect to our board of directors and committees thereof is set forth in our 2010 Proxy Statement under the caption “Governance of the Company” and is incorporated herein by reference.

**Section 16(a) Beneficial Ownership Reporting Compliance**

The information required by this item with respect to Section 16(a) beneficial ownership reporting compliance is set forth in our 2010 Proxy Statement under the caption “Compliance with Section 16(a) of the Securities Exchange Act of 1934” and is incorporated herein by reference.

**Code of Business Conduct and Ethics**

The information required by this item with respect to our Code of Business Conduct and Ethics is set forth in our 2010 Proxy Statement under the caption “Governance of the Company” and is incorporated herein by reference.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by this item is set forth under the caption “Executive Compensation” in our 2010 Proxy Statement and is incorporated herein by reference.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information required by this item with respect to equity compensation plans is set forth under the caption “Equity Compensation Plan Information” in our 2010 Proxy Statement and with respect to security ownership of certain beneficial owners, directors and executive officers is set forth under the caption “Security Ownership of Certain Beneficial Owners and Management” in our 2010 Proxy Statement and is incorporated herein by reference.

**ITEM 13. CERTAIN RELATIONSHIPS, RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE**

The information required by this item is set forth under the captions “Compensation Committee Interlocks and Insider Participation,” “Certain Relationships and Related Transactions” and “Independence and Committees of the Board of Directors” in our 2010 Proxy Statement and is incorporated herein by reference.

**ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

The information required by this item is set forth under the caption “Independent Registered Public Accounting Firm” in our 2010 Proxy Statement and is incorporated herein by reference.

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**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

1. The following financial statements are included in Part II, Item 8:

|   |    |
|---|----|
| <a href="#"><u>Report of Independent Registered Certified Public Accounting Firm</u></a>  | 28 |
| <a href="#"><u>Consolidated Balance Sheets as of January 2, 2010 and December 27, 2008</u></a>  | 29 |
| <a href="#"><u>Consolidated Statements of Operations for the years ended January 2, 2010, December 27, 2008, and December 29, 2007</u></a>                                    | 30 |
| <a href="#"><u>Consolidated Statements of Shareholders' Equity and Comprehensive Income for the years ended January 2, 2010, December 27, 2008, and December 29, 2007</u></a> | 31 |
| <a href="#"><u>Consolidated Statements of Cash Flows for the years ended January 2, 2010, December 27, 2008, and December 29, 2007</u></a>                                    | 32 |
| <a href="#"><u>Notes to the Consolidated Financial Statements</u></a>   | 33 |

All other schedules are omitted as the required information is inapplicable or the information is presented in the consolidated financial statements and notes thereto in Item 8 above.

2. Exhibits:

| <u>Exhibit Number</u> | <u>Exhibit Description</u>   |
|-----------------------|--|
| 3.1                   | Amended and Restated Articles of Incorporation of the Company (previously filed as Exhibit 3.1 in the Pre-Effective Amendment No. 4 to the Company's Registration Statement on Form S-1 filed on December 19, 1996 (File No. 333-14183) and incorporated herein by reference). |
| 3.2                   | Amended and Restated Bylaws of the Company (previously filed as Exhibit 3.2 in the Company's Quarterly report on Form 10-Q for the quarter ended October 2, 1999 and incorporated herein by reference).  |
| 3.2.1                 | Certificate of Amendment to Amended and Restated Bylaws of the Company (previously filed as Exhibit 3.2.1 in the Company's Quarterly report on Form 10-Q for the quarter ended March 27, 2004 and incorporated herein by reference).   |
| 3.2.2                 | Certificate of Amendment of Bylaws of the Company (previously filed as Exhibit 3.1 in the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2007 and incorporated herein by reference).  |
| 10.1+                 | Form of Indemnification Agreement (previously filed as Exhibit 10.4 in the Pre-Effective Amendment No. 4 to the Company's Registration Statement on Form S-1 filed on December 19, 1996 (File No. 333-14183) and incorporated herein by reference).                            |
| 10.2                  | Form of Distributor Agreement (Domestic) (previously filed as Exhibit 10.1 in the Company's Registration Statement on Form S-1 filed on October 15, 1996 (File No. 333-14183) and incorporated herein by reference).   |

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- 10.3 Form of Distributor Agreement (International) (previously filed as Exhibit 10.2 in the Company's Registration Statement on Form S-1 filed on October 15, 1996 (File No. 333-14183) and incorporated herein by reference).
- 10.4 Mortgage, dated April 11, 1996, between Sun Hydraulik GmbH and Dresdner Bank (previously filed as Exhibit 4.19 in the Company's Registration Statement on Form S-1 filed on October 15, 1996 (File No. 333-14183) and incorporated herein by reference).
- 10.5 Credit and Security Agreement dated August 11, 2005, between the Company, as Borrower, and Fifth Third Bank, as Lender (previously filed as Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended October 1, 2005 and incorporated herein by reference).
- 10.6 Renewal and Future Advance Revolving Line of Credit Promissory Note dated August 11, 2005, between the Company, as Borrower, and Fifth Third Bank, as Lender (previously filed as Exhibit 4.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended October 1, 2005 and incorporated herein by reference).
- 10.7 Renewed, Amended and Restated Mortgage and Security Agreement dated August 11, 2005, between the Company, as Mortgagor, and Fifth Third Bank, as Mortgagee (previously filed as Exhibit 4.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended October 1, 2005 and incorporated herein by reference).
- 10.8+ 1996 Sun Hydraulics Corporation Stock Option Plan (previously filed as Exhibit 10.3 in the Pre-Effective Amendment No. 4 to the Company's Registration Statement on Form S-1 filed on December 19, 1996 (File No. 333-14183) and incorporated herein by reference).
- 10.9+ Amendment No. 1 to 1996 Stock Option Plan (previously filed as Exhibit 10.4 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1997 and incorporated herein by reference).
- 10.10+ Forms of agreement for grants under the Sun Hydraulics Corporation 1996 Stock Option Plan (previously filed as Exhibit 10.12+ to the Company's Quarterly Report on Form 10-Q for the quarter ended September 25, 2004 and incorporated herein by reference).
- 10.11+ Sun Hydraulics Corporation 2006 Stock Option Plan (previously filed as Exhibit 99.2 to the Company's Form 8-K filed on September 14, 2006 and incorporated herein by reference).
- 10.12+ Sun Hydraulics Corporation Employee Stock Award Program (previously filed as Exhibit 4 to the Company's registration statement on Form S-8 filed on July 20, 1999, and incorporated herein by reference).
- 10.13+ 2001 Sun Hydraulics Corporation Restricted Stock Plan (previously filed as Exhibit 4 to the Company's registration statement on Form S-8 filed on June 12, 2001 (file No. 333-62816), and incorporated herein by reference).
- 10.14+ Form of agreement for grants of restricted shares under the Sun Hydraulics Corporation Restricted Stock Plan.
- 10.15+ Sun Hydraulics Corporation Employee Stock Purchase Plan (previously filed as Exhibit 4 to the Company's registration statement on Form S-8 filed on July 27, 2001 (file No. 333-66008), and incorporated herein by reference).

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- 10.16+ Sun Hydraulics Corporation 2004 Nonemployee Director Equity and Deferred Compensation Plan (As Amended and Restated Effective March 1, 2008) (previously filed as Appendix A to the Company's Proxy Statement for the 2008 Annual Meeting of Shareholders filed with the Commission on April 25, 2008 and incorporated herein by reference).
  - 10.17+ Form of Performance Share Agreement (previously filed as Exhibit 99.1 to the Company's Form 8-K filed on December 16, 2004 and incorporated herein by reference).
  - 10.18+ The Sun Hydraulics Corporation 401(k) and ESOP Retirement Plan dated December 12, 2007 (previously filed as Exhibit 10.17 to the Company's Form 10-K filed on March 11, 2009 and incorporated herein by reference).
  - 10.19+ First Amendment to Sun Hydraulics Corporation 401(K) and ESOP Retirement Plan dated September 22, 2008 (previously filed as Exhibit 10.18 to the Company's Form 10-K filed on March 11, 2009 and incorporated herein by reference).
  - 10.20+ Second Amendment to Sun Hydraulics Corporation 401(K) and ESOP Retirement Plan dated December 16, 2008 (previously filed as Exhibit 10.19 to the Company's Form 10-K filed on March 11, 2009 and incorporated herein by reference).
  - 10.21+ Sun Hydraulics Limited Share Incentive Plan (previously filed as Exhibit 4 to the Company's Registration Statement on Form S-8 filed on March 27, 2009 (File Number 333158245) and incorporated herein by reference).
  - 10.22+ Peter Robson Employment Agreement dated April 22, 1981 (previously filed as Exhibit 10.1+ to the Company's Quarterly Report on Form 10-Q filed on May 6, 2009 and incorporated herein by reference).
  - 10.23+ Executive Continuity Agreement, dated December 7, 2009, between Sun Hydraulics Corporation and Allen J. Carlson (previously filed as Exhibit 99.1 to the Company's Form 8-K filed on December 11, 2009 and incorporated herein by reference).
  - 10.24+ Executive Continuity Agreement, dated December 7, 2009, between Sun Hydraulics Corporation and Tricia L. Fulton (previously filed as Exhibit 99.2 to the Company's Form 8-K filed on December 11, 2009 and incorporated herein by reference).
  - 10.25 Securities Purchase Agreement between Sun Hydraulics Corporation and High Country Tek, Inc., dated November 30, 2007 (previously filed as Exhibit 99.1 in the Company's Form 8-K filed on November 30, 2007 and incorporated herein by reference).
  - 14 Code of Ethics (previously filed as Exhibit 14 in the Company's Annual report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference).
  - 21 Subsidiaries of the Registrant (previously filed as Exhibit 21 in the Company's Annual report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference).
  - 23.1 Kirkland, Russ, Murphy and Tapp, P.A. Consent of Independent Registered Certified Public Accounting Firm.
  - 31.1 CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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- 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.
- + Executive management contract or compensatory plan or arrangement.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Sarasota, State of Florida on March 15, 2010.

SUN HYDRAULICS CORPORATION

By: /s/ Allen J. Carlson

Allen J. Carlson, President and  
Chief Executive Officer

Pursuant to requirements of the Securities Exchange Act of 1934, this Report has been signed by the following persons on behalf of the Registrant and in the capacities indicated as of March 15, 2010.

| <u>Signature</u>  | <u>Title</u>  |
|---|---|
| <u>/s/ Allen J. Carlson</u><br>Allen J. Carlson           | President, Chief Executive Officer<br>and Director                      |
| <u>/s/ Tricia L. Fulton</u><br>Tricia L. Fulton           | Chief Financial Officer (Principal<br>Financial and Accounting Officer) |
| <u>/s/ Marc Bertoneche</u><br>Marc Bertoneche             | Director  |
| <u>/s/ John S. Kahler</u><br>John S. Kahler               | Director  |
| <u>/s/ Christine L. Koski</u><br>Christine L. Koski       | Director  |
| <u>/s/ Philippe Lemaitre</u><br>Philippe Lemaitre         | Director  |
| <u>/s/ Ferdinand E. Megerlin</u><br>Ferdinand E. Megerlin | Director, Chairman of the Board of Directors                            |
| <u>/s/ David N. Wormley</u><br>David N. Wormley           | Director  |



## RESTRICTED SHARE AGREEMENT

**THIS RESTRICTED SHARE AGREEMENT** (the “Agreement”), made effective as of \_\_\_\_\_, 20\_\_\_\_, between SUN HYDRAULICS CORPORATION, a Florida corporation (the “Corporation”), and \_\_\_\_\_ (“Participant”).

**WITNESSETH:**

**WHEREAS**, Participant is an employee of the Corporation and/or a subsidiary of the Corporation (“Subsidiary”);

**WHEREAS**, the Corporation has adopted the Sun Hydraulics Corporation 2001 Restricted Stock Plan (the “Plan”) in order to provide its officers, employees, consultants and directors with incentives to achieve long-term corporate objectives;

**WHEREAS**, the Compensation Committee of the Corporation’s Board of Directors has granted an award of Restricted Shares (as defined below in Section 1) under the Plan to the Participant on the terms and conditions set forth below;

**NOW, THEREFORE**, in consideration of the various covenants and agreements herein contained, and intending to be legally bound hereby, the parties hereto agree as follows:

1. Grant of Restricted Shares.

The Corporation hereby grants to Participant a total of \_\_\_\_\_ ( \_\_\_\_\_ ) shares of the common stock, \$.001 par value per share, of the Corporation (the “Restricted Shares”), subject to the transfer restrictions and other conditions set forth in this Agreement.

The Corporation shall cause the Restricted Shares to be issued and a stock certificate or certificates representing the Restricted Shares to be registered in the name of Participant promptly upon execution of this Agreement, but the stock certificate or certificates shall be delivered to, and held in custody by, the Corporation until the applicable restrictions lapse at the times specified in Section 3 below. On or before the date of execution of this Agreement, Participant shall deliver to the Corporation one or more stock powers endorsed in blank relating to the Restricted Shares, which will permit transfer to the Corporation of all or any portion of the Restricted Shares and any securities constituting Retained Distributions (as defined below in Section 2(a)(ii)) that shall be forfeited or that shall not become vested in accordance with this Agreement.

2. Restrictions.

(a) Participant shall have all rights and privileges of a shareholder of the Corporation with respect to the Restricted Shares, including voting rights and the right to receive dividends paid with respect to such shares, except that the following restrictions shall apply, until such time or times as restrictions lapse under Section 3 of this Agreement:

(i) Participant shall not be entitled to delivery of the certificate or certificates for any of the Restricted Shares until the restrictions imposed by this Agreement have lapsed with respect to those Restricted Shares, at the times defined in Section 3;

(ii) other than regular cash dividends and such other distributions as the Board of Directors may in its sole discretion designate, the Corporation will retain custody of all distributions (“Retained Distributions”) made or declared with respect to the Restricted Shares (and such Retained Distributions will be subject to the same restrictions, terms and conditions as are applicable to the Restricted Shares) until such time, if ever, as the Restricted Shares with respect to which such Retained Distributions shall have been made, paid or declared shall have become vested, and such Retained Distributions shall not bear interest or be segregated in separate accounts;

(iii) the Restricted Shares may not be sold, transferred, assigned, pledged or otherwise encumbered or disposed of by Participant before these restrictions have lapsed pursuant to Section 3, except with the consent of the Corporation; and

(iv) the Restricted Shares and Retained Distributions shall be subject to forfeiture upon termination of Participant’s employment with the Corporation to the extent set forth in Section 6 below and upon the breach of any restrictions, terms or conditions of this Agreement.

Once any portion of Participant’s Restricted Share award has become vested under Section 3, the newly vested shares shall no longer be subject to the preceding restrictions, and shall no longer be considered to be Restricted Shares.

(b) Any attempt to dispose of Restricted Shares in a manner contrary to the restrictions set forth in this Agreement shall be ineffective.

**3. When Restrictions Lapse.**

The Restricted Shares shall vest and the restrictions set forth in this Agreement shall lapse with respect to such vested shares as follows:

|                        | <u>Date of Occurrence of Participant’s<br/>Termination of Employment</u> | <u>Shares of Stock<br/>Subject to Divestiture</u> |
|------------------------|--|---|
| Prior to and including | , 20   | _____   |
| From                   | , 20 , to and including , 20   | _____   |
| From                   | , 20 , to and including , 20   | _____   |

provided that Participant is employed by the Corporation or a Subsidiary on such date. The foregoing notwithstanding, in the event of a pending or threatened change in control, in connection with any merger, consolidation, acquisition, separation, reorganization, liquidation or like occurrence in which the Corporation is involved, the Board of Directors may, in its sole discretion, take such actions as permitted under the Plan.

**4. Issuance of Stock Certificates for Shares.**

The stock certificate or certificates representing the Restricted Shares shall be issued promptly following the execution of this Agreement, and shall be delivered to the Corporate Secretary or such other custodian as may be designated by the Corporation, to be held until the restrictions have lapsed under Section 3. Such stock certificate or certificates shall bear the following legend:

The transferability of this certificate and the shares of stock represented hereby are subject to the terms and conditions (including forfeiture) of a Restricted Share Agreement entered into between the registered owner and Sun Hydraulics Corporation. A copy of such Agreement is on file in the offices of, and will be made available for a proper purpose by, the Corporate Secretary of Sun Hydraulics Corporation.

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Once the restrictions imposed by this Agreement have lapsed with respect to any portion of the Restricted Shares, upon the written request of Participant, a stock certificate or certificates for such portion of the Restricted Shares shall be returned and exchanged for new stock certificates without the foregoing legend for the newly vested portion of the Restricted Shares. Upon the written request of Participant, the certificates representing the newly vested shares shall be delivered to Participant (or to the person to whom the rights of Participant shall have passed by will or the laws of descent and distribution) promptly after the date on which the restrictions imposed on such shares by this Agreement have lapsed, but not before Participant has made any tax payment to the Corporation or made other arrangements for tax withholding, as required by Section 5. Once the restrictions imposed by this Agreement have lapsed with respect to all of the Restricted Shares, all certificates held by the Corporation representing the vested shares shall be delivered promptly to Participant (or to the person to whom the rights of Participant shall have passed by will or the laws of descent and distribution), provided that Participant has made any tax payment to the Corporation or made other arrangements for tax withholding, as required by Section 5.

5. Tax Withholding.

Whenever the restrictions on Participant's rights to some or all of the Restricted Shares lapse under Section 3 of this Agreement or upon Participant's filing an election with the Internal Revenue Service pursuant to Section 83(b) of the Internal Revenue Code of 1986, as amended, the Corporation shall notify Participant of the amount of tax which must be withheld by the Corporation under all applicable federal, state and local tax laws. Participant agrees to make arrangements with the Corporation to (a) remit a cash payment of the required amount to the Corporation, (b) to authorize the deduction of such amounts from Participant's compensation or (c) to otherwise satisfy the applicable tax withholding requirement in a manner satisfactory to the Corporation.

6. Forfeiture On Termination of Employment.

If the Participant's employment with the Corporation or Subsidiary is terminated for any reason, either by the Corporation or Participant, during the term of this Agreement, any Restricted Shares remaining subject to the restrictions imposed by this Agreement shall be forfeited; provided, however, that in the event of termination by reason of death, permanent total disability, or retirement at or after normal retirement age, any remaining restrictions automatically shall lapse.

7. Restricted Shares Not to Affect Employment.

Neither this Agreement nor the Restricted Shares granted hereunder shall confer upon Participant any right to continued employment with the Corporation or any Subsidiary, and shall not in any way modify or restrict the Corporation's or such Subsidiary's right to terminate such employment.

8. Agreement Subject to the Plan. This Agreement and the rights and obligations of the parties hereto are subject to and governed by the terms of the Plan as the same may be amended from time to time, the provisions of which are incorporated by reference into this Agreement.

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9. Miscellaneous.

(a) This Agreement may be executed in one or more counterparts, all of which taken together will constitute one and the same instrument.

(b) The terms of this Agreement may only be amended, modified or waived by a written agreement executed by both of the parties hereto.

(c) The validity, performance, construction and effect of this Agreement shall be governed by the laws of the State of Florida, without giving effect to principles of conflicts of law.

(d) This Agreement constitutes the entire agreement between the parties hereto with respect to the transactions contemplated herein.

(e) Except as otherwise herein provided, this Agreement shall be binding upon and shall inure to the benefit of the Corporation, its successors and assigns, and of Participant and Participant's personal representatives.

**IN WITNESS WHEREOF**, the parties have executed this Restricted Share Agreement as of the day and year first above written.

ATTEST:

\_\_\_\_\_  
Secretary

Witness:  
\_\_\_\_\_

**SUN HYDRAULICS CORPORATION**

By: \_\_\_\_\_  
President

**PARTICIPANT**

\_\_\_\_\_

**CONSENT OF INDEPENDENT REGISTERED CERTIFIED PUBLIC ACCOUNTING FIRM**

We have issued our report dated March 12, 2010, accompanying the consolidated financial statements included in the Annual Report of Sun Hydraulics Corporation on Form 10-K for the years ended January 2, 2010 and December 27, 2008. We hereby consent to the incorporation by reference of said report in the Registration Statements of Sun Hydraulics Corporation on Forms S-8 (File No. 333-30801, effective July 3, 1997, File No. 333-83269, effective July 20, 1999, File No. 333-62816, effective June 12, 2001, File No. 333-66008 effective July 27, 2001, File No. 333-119367, effective September 29, 2004, and File No. 333-124174, effective April 19, 2005, File No. 333-158245, March 27, 2009).

/s/ Kirkland, Russ, Murphy & Tapp, P.A.

March 12, 2010

Clearwater, Florida

## CERTIFICATION

I, Allen J. Carlson, certify that:

1. I have reviewed this Annual Report on Form 10-K for the year ended January 2, 2010, of Sun Hydraulics Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 15, 2009

/s/ Allen J. Carlson

Allen J. Carlson  
President, Chief Executive Officer

## CERTIFICATION

I, Tricia L. Fulton, certify that:

1. I have reviewed this Annual Report on Form 10-K for the year ended January 2, 2010, of Sun Hydraulics Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 15, 2009

/s/ Tricia L. Fulton

Tricia L. Fulton  
Chief Financial Officer

**CERTIFICATION PURSUANT TO 18 U.S.C. § 1350**

I, Allen J. Carlson, the Chief Executive Officer of Sun Hydraulics Corporation (the "Company"), certify that (i) the Annual Report on Form 10-K for the Company for the year ended January 2, 2010 (the "Report"), fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Allen J. Carlson  
Chief Executive Officer  
March 15, 2009



**CERTIFICATION PURSUANT TO 18 U.S.C. § 1350**

I, Tricia L. Fulton, the Chief Financial Officer of Sun Hydraulics Corporation (the “Company”), certify that (i) the Annual Report on Form 10-K for the Company for the year ended January 2, 2010 (the “Report”), fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Tricia L. Fulton  
\_\_\_\_\_  
Chief Financial Officer  
March 15, 2009