UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

# FORM 10-Q

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

For the quarterly period ended September 25, 2004 — Commission file number 0-21835

# SUN HYDRAULICS CORPORATION

(Exact Name of Registration as Specified in its Charter)

| | |
|---|---|
| FLORIDA | 59-2754337 |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |
| 1500 WEST UNIVERSITY PARKWAY<br>SARASOTA, FLORIDA | 34243 |
| (Address of Principal Executive Offices) | (Zip Code) |

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes [ ] No [ X ]

The Registrant had 6,930,446 shares of common stock, par value $.001, outstanding as of October 26, 2004.

Sun Hydraulics Corporation
INDEX
For the quarter ended September 25, 2004


| | Page |
|---|---|
| PART I.FINANCIAL INFORMATION | |
| Item 1. Financial Statements | |
| Consolidated Balance Sheets as of September 25, 2004 (unaudited) and December 27, 2003 | 3 |
| Consolidated Statements of Operations for the Three Months Ended September 25, 2004 (unaudited) and September 27, 2003 (unaudited) | 4 |
| Consolidated Statements of Operations for the Nine Months Ended September 25, 2004 (unaudited) and September 27, 2003 (unaudited) | 5 |
| Consolidated Statements of Changes in Shareholders' Equity and Comprehensive Income for the Nine Months Ended September 25, 2004 (unaudited) | 6 |
| Consolidated Statements of Cash Flows for the Nine Months Ended September 25, 2004 (unaudited) and September 27, 2003 (unaudited) | 7 |
| Notes to Consolidated Financial Statements | 8 |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations | 14 |
| Forward Looking Information | 19 |
| Item 3. Quantitative and Qualitative Disclosure About Market Risk | 20 |
| Item 4. Controls and Procedures | 20 |
| PART II. OTHER INFORMATION | 21 |
| Item 1. Legal Proceedings | |
| Item 2. Changes in Securities | |
| Item 3. Defaults Upon Senior Securities | |
| Item 4. Submission of Matters to a Vote of Security Holders | |
| Item 5. Other Information | |
| Item 6. Exhibits and Reports on Form 8-K | |
| Ex-10.12 Forms of Agreement For Grants | |
| Ex-31.1 Section 302 CEO Certification | |
| Ex-31.2 Section 302 CFO Certification | |
| Ex-32.1 Section 906 CEO Certification | |
| Ex-32.2 Section 906 CFO Certification | |

PART I: FINANCIAL INFORMATION

Item 1.

**Sun Hydraulics Corporation**

**Consolidated Balance Sheets**
**(in thousands, except share data)**

| | September 25, 2004 | | December 27, 2003 | |
|---|---|---|---|---|
| | (unaudited) | | | |
| **Assets** | | | | |
| Current assets: | | | | |
| Cash and cash equivalents | $ | 7,199 | $ | 4,794 |
| Restricted cash | | 433 | | 425 |
| Accounts receivable, net of allowance for doubtful accounts of $193 and $187 | | 8,420 | | 6,215 |
| Inventories | | 6,794 | | 6,621 |
| Other current assets | | 580 | | 524 |
| Total current assets | | 23,426 | | 18,579 |
| Property, plant and equipment, net | | 42,539 | | 42,829 |
| Other assets | | 1,593 | | 1,624 |
| **Total assets** | **$** | **67,558** | **$** | **63,032** |
| **Liabilities and Shareholders' Equity** | | | | |
| Current liabilities: | | | | |
| Accounts payable | $ | 2,214 | $ | 2,440 |
| Accrued expenses and other liabilities | | 3,750 | | 2,217 |
| Long-term debt due within one year | | 991 | | 937 |
| Dividends payable | | 345 | | 270 |
| Taxes payable | | 2,101 | | 51 |
| Total current liabilities | | 9,401 | | 5,915 |
| Long-term debt due after one year | | 11,379 | | 17,270 |
| Deferred income taxes | | 4,363 | | 4,456 |
| Other noncurrent liabilities | | 305 | | 328 |
| Total liabilities | | 25,448 | | 27,969 |
| 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 $0.001<br>6,906,214 shares outstanding, September 25, 2004<br>6,757,941 shares outstanding, December 27, 2003 | | 7 | | 7 |
| Capital in excess of par value | | 27,796 | | 26,478 |
| Unearned compensation related to outstanding restricted stock | | (415) | | (601) |
| Retained earnings | | 12,391 | | 7,522 |
| Accumulated other comprehensive income | | 2,331 | | 1,657 |
| Total shareholders' equity | | 42,110 | | 35,063 |
| **Total liabilities and shareholders' equity** | **$** | **67,558** | **$** | **63,032** |

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)**

| | Three months ended | |
|---|---|---|
| | September 25, 2004 | September 27, 2003 |
| | (unaudited) | (unaudited) |
| **Net sales** | **$ 23,164** | **$ 17,851** |
| Cost of sales | 16,117 | 13,328 |
| **Gross profit** | **7,047** | **4,523** |
| Selling, engineering and administrative expenses | 4,002 | 3,604 |
| **Operating income** | **3,045** | **919** |
| Interest expense | 123 | 137 |
| Foreign currency transaction (gain)/loss | (43) | (1) |
| Miscellaneous (income)/expense, net | (7) | (1) |
| **Income before income taxes** | **2,972** | **784** |
| Income tax provision | 1,092 | 275 |
| **Net income** | **$ 1,880** | **$ 509** |
| **Basic net income per common share** | **$ 0.27** | **$ 0.08** |
| **Weighted average basic shares outstanding** | 6,895 | 6,591 |
| **Diluted net income per common share** | **$ 0.27** | **$ 0.08** |
| **Weighted average diluted shares outstanding** | 6,972 | 6,635 |
| **Dividends declared per share** | **$ 0.05** | **$ 0.04** |

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

Table of Contents

**Sun Hydraulics Corporation**

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

| | Nine months ended | |
|---|---|---|
| | September 25, 2004 | September 27, 2003 |
| | (unaudited) | (unaudited) |
| **Net sales** | **$ 71,077** | **$ 53,188** |
| Cost of sales | 49,338 | 39,059 |
| **Gross profit** | **21,739** | **14,129** |
| Selling, engineering and administrative expenses | 12,262 | 11,491 |
| **Operating income** | **9,477** | **2,638** |
| Interest expense | 405 | 415 |
| Foreign currency transaction (gain)/loss | (75) | (190) |
| Miscellaneous (income)/expense, net | (25) | (24) |
| **Income before income taxes** | **9,172** | **2,437** |
| Income tax provision | 3,343 | 857 |
| **Net income** | **$ 5,829** | **$ 1,580** |
| **Basic net income per common share** | **$ 0.86** | **$ 0.24** |
| **Weighted average basic shares outstanding** | 6,811 | 6,491 |
| **Diluted net income per common share** | **$ 0.85** | **$ 0.24** |
| **Weighted average diluted shares outstanding** | 6,869 | 6,535 |
| **Dividends declared per share** | **$ 0.14** | **$ 0.12** |

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

**Sun Hydraulics Corporation**

**Consolidated Statements of Changes in Shareholders’ Equity and Comprehensive Income (unaudited)**

**(in thousands)**

| | Shares | Preferre stock | Common stock | Capital in excess of par value | Unearned compensation related to restricted stock | Retained earnings | Accumulated other comprehensive income | Treasury Stock | Total |
|---|---|---|---|---|---|---|---|---|---|
| Balance, December 27, 2003 | 6,759 | $ — | $ 7 | $26,478 | $ (601) | $ 7,522 | $ 1,657 | $ — | $35,063 |
| Shares issued, restricted stock | | | | | 186 | | | | 186 |
| Shares issued, ESPP | | | | (68) | | | | | (68) |
| Shares issued, option exercises | 147 | | | 1,386 | | | | | 1,386 |
| Treasury stock (32 Shares at cost) | | | | | | | | (513) | — |
| Treasury stock (transferred to ESOP) | | | | | | | | 513 | — |
| Dividends declared | | | | | | (960) | | | (960) |
| Comprehensive income: | | | | | | | | | |
| Net income | | | | | | 5,829 | | | 5,829 |
| Foreign currency translation adjustments | | | | | | | 674 | | 674 |
| Comprehensive income | | | | | | | | | 6,503 |
| Balance, September 25, 2004 | 6,906 | $ — | $ 7 | $27,796 | $ (415) | $12,391 | $ 2,331 | $ — | $42,110 |

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)**

| | Nine Months ended | |
|---|---|---|
| | September 25, 2004 | September 27, 2003 |
| | (unaudited) | (unaudited) |
| **Cash flows from operating activities:** | | |
| Net income | $ 5,829 | $ 1,580 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 4,073 | 3,907 |
| Loss on disposal of assets | 43 | 367 |
| Deferred income taxes | (93) | (1) |
| Allowance for doubtful accounts | 6 | 35 |
| Amortization of compensation expense | 186 | 116 |
| (Increase) decrease in: | | |
| Accounts receivable | (2,211) | (2,219) |
| Inventories | (173) | 34 |
| Taxes receivable | — | — |
| Other current assets | (56) | 612 |
| Other assets | 31 | (516) |
| Increase (decrease) in: | | |
| Accounts payable | (226) | 474 |
| Accrued expenses and other liabilities | 1,533 | 1,941 |
| Dividends payable | 75 | 11 |
| Taxes payable | 2,050 | 684 |
| Other liabilities | (23) | (38) |
| Net cash provided by operating activities | 11,044 | 6,987 |
| **Cash flows from investing activities:** | | |
| Capital expenditures | (3,531) | (3,090) |
| Proceeds from dispositions of equipment | 19 | 11 |
| Net cash used in investing activities | (3,512) | (3,079) |
| **Cash flows from financing activities:** | | |
| Proceeds from debt | — | 18,850 |
| Repayment of debt | (5,837) | (8,411) |
| Proceeds from stock issuance | 1,319 | 956 |
| Dividends to shareholders | (960) | (14,133) |
| Net cash used in financing activities | (5,478) | (2,738) |
| Effect of exchange rate changes on cash and cash equivalents | 359 | (58) |
| Net increase in cash and cash equivalents | 2,413 | 1,112 |
| Cash and cash equivalents, beginning of period | **5,219** | **3,958** |
| Cash and cash equivalents, end of period | **$ 7,632** | **$ 5,070** |
| Supplemental disclosure of cash flow information: | | |
| Cash paid/(received): | | |
| Interest | $ 405 | $ 415 |
| Income taxes | $ 1,386 | $ 174 |

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

SUN HYDRAULICS CORPORATION

NOTES TO THE CONSOLIDATED, UNAUDITED FINANCIAL STATEMENTS
(Dollars in thousands except per share data)

1. BASIS OF PRESENTATION AND SUMARY OF BUSINESS

Sun Hydraulics Corporation and its wholly-owned subsidiaries design, manufacture, and sell screw-in cartridge valves and manifolds used in hydraulic systems. The Company has facilities in the United States, the United Kingdom, Germany, Korea, 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 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.

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission for reporting on Form 10-Q. Accordingly, certain information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements are not included herein. The financial statements are prepared on a consistent basis (including normal recurring adjustments) and should be read in conjunction with the consolidated financial statements and related notes contained in the Annual Report on Form 10-K for the fiscal year ended December 27, 2003, filed by Sun Hydraulics Corporation (together with its subsidiaries, the "Company") with the Securities and Exchange Commission on March 26, 2004. In Management's opinion, all adjustments necessary for a fair presentation of the Company's financial statements are reflected in the interim periods presented. Operating results for the three and nine month periods ended September 25, 2004, are not necessarily indicative of the results that may be expected for the period ending December 25, 2004.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Stock-Based Compensation

The Company has adopted the disclosure only provisions of Statements of Financial Accounting Standards (FAS) No. 148, Accounting for Stock-Based Compensation – Transition and Disclosure, an amendment to FAS 123, Accounting for Stock-Based Compensation, and has elected to follow Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees and related interpretations in accounting for its employee stock options. Under APB 25, because the exercise price of employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recorded. If the Company had elected to recognize compensation expense for stock options based on the fair value at grant date, consistent with the method prescribed by FAS 123, net income and earnings per share would have been reduced to the pro forma amounts below. The pro forma amounts were determined using the Black-Scholes valuation model with weighted average assumptions as set forth below.

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | September 25, 2004 | September 27, 2003 | September 25, 2004 | September 27, 2003 |
| Net Income as Reported | $ 1,880 | $ 509 | $ 5,829 | $ 1,580 |
| Stock-based compensation reported in net income, net of related taxes | 35 | 32 | 117 | 73 |
| Stock compensation expense calculated under FAS 123, net of related taxes | (49) | (55) | (159) | (141) |
| Pro Forma Net Income | $ 1,866 | $ 486 | $ 5,787 | $ 1,512 |
| Basic earnings per common share: | | | | |
| As reported | $ 0.27 | $ 0.08 | $ 0.86 | $ 0.24 |
| Pro forma | $ 0.27 | $ 0.07 | $ 0.85 | $ 0.23 |
| Diluted earnings per common share: | | | | |
| As reported | $ 0.27 | $ 0.08 | $ 0.85 | $ 0.24 |
| Pro forma | $ 0.27 | $ 0.07 | $ 0.84 | $ 0.23 |
| Assumptions | | | | |
| Risk-free interest rate | 4.03% | 4.02% | 4.03% | 4.02% |
| Expected lives (in years) | 6.5 | 6.5 | 6.5 | 6.5 |
| Expected volatility | 40.00% | 18.00% | 40.00% | 18.00% |
| Dividend yield | 1.53% | 2.00% | 1.53% | 2.00% |

Earnings per share

The following table represents the computation of basic and diluted earnings per common share as required by SFAS No. 128 “Earnings Per Share” (in thousands, except per share data):

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | September 25, 2004 | September 27, 2003 | September 25, 2004 | September 27, 2003 |
| **Net income** | **$ 1,880** | **$ 509** | **$ 5,829** | **$ 1,580** |
| Basic weighted average number of common shares outstanding | 6,895 | 6,591 | 6,811 | 6,491 |
| **Basic earnings per common share** | **$ 0.27** | **$ 0.08** | **$ 0.86** | **$ 0.24** |
| Effect of dilutive stock options | 77 | 44 | 58 | 43 |
| Diluted weighted average number of common shares outstanding | 6,972 | 6,635 | 6,869 | 6,535 |
| **Diluted earnings per common share** | **$ 0.27** | **$ 0.08** | **$ 0.85** | **$ 0.24** |

Diluted earnings per common share excludes antidilutive stock options of approximately 45,000 for each period ended September 25, 2004, and 276,000 for each period ended September 27, 2003.

3. RESTRICTED CASH

The restricted cash balance at September 25, 2004, consisted of $433 in reserves as a required deferment 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.

4. INVENTORIES

| | September 25, 2004 | December 27, 2003 |
|---|---|---|
| Raw materials | $ 2,577 | $ 2,120 |
| Work in process | 2,309 | 2,390 |
| Finished goods | 2,163 | 2,308 |
| Provision for slow moving inventory | (255) | (197) |
| Total | $ 6,794 | $ 6,621 |

5. GOODWILL

On September 25, 2004, the Company had $715 of goodwill, related to its acquisition of Sun Korea. Goodwill is held in other assets on the balance sheet. Valuation models reflecting the expected future cash flow projections were used to value Sun Korea at December 27, 2003. The analysis indicated that there was no impairment on the carrying value of the goodwill. As of September 25, 2004, no factors were identified that indicated impairment on the carrying value of the goodwill.

## 6. LONG-TERM DEBT

| | September 25, 2004 | December 27, 2003 |
|---|---|---|
| $11,000 five-year note, collateralized by U.S. real estate and equipment and a 65% stock pledge in the foreign subsidiaries, interest rate Libor + 1.9% or prime rate at Company’s discretion, due July 23, 2008. | $ 10,358 | $ 10,770 |
| $12,000 revolving line of credit, collateralized by U.S. real estate and equipment and a 65% stock pledge in the foreign subsidiaries, interest rate Libor + 1.9% or prime rate at Company’s discretion, due July 23, 2006. | — | 5,150 |
| $2,400 12-year mortgage note on the German facility, fixed interest rate of 6.05%, due September 30, 2008. | 930 | 1,086 |
| 10-year notes, fixed interest rates ranging from 3.5-5.1%, collateralized by equipment in Germany, due between 2009 and 2011. | 1,000 | 1,103 |
| Other | 82 | 98 |
| | 12,370 | 18,207 |
| Less amounts due within one year | (991) | (937) |
| Total | $ 11,379 | $ 17,270 |

Certain of these debt instruments are subject to debt covenants including 1) Fixed Charges Coverage Ratio (as defined) of 2.0 to 1.0, determined quarterly on a rolling four quarters basis, 2) Debt (as defined) to Tangible Net Worth (as defined) of not more than 1.5 to 1.0, determined quarterly, 3) Current Ratio of 1.5 to 1.0, determined quarterly, 4) Funded Debt (as defined) to EBITDA of less than 3.25 to 1.0, determined quarterly on a rolling four quarters basis, and 5) the Company’s primary domestic depository accounts shall be with SouthTrust Bank. As of September 25, 2004, the Company was in compliance with all debt covenants.

## 7. 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, and Korea. In computing operating profit for the foreign subsidiaries, no allocations of general corporate expenses have been made. Management bases its financial decisions by the geographical location of its operations.

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

Table of Contents

Segment information is as follows:

| | United States | Korea | Germany | United Kingdom | Elimination | Consolidated |
|---|---|---|---|---|---|---|
| **Three Months Ended September 25, 2004** | | | | | | |
| Sales to unaffiliated customers | $14,676 | $1,900 | $ 3,390 | $ 3,198 | $ — | $ 23,164 |
| Intercompany sales | 4,112 | — | 19 | 465 | (4,596) | — |
| Operating income/(loss) | 1,921 | 201 | 791 | 135 | (3) | 3,045 |
| Depreciation | 960 | 34 | 132 | 259 | — | 1,385 |
| Capital expenditures | 883 | 32 | 38 | 99 | — | 1,052 |
| **Three Months Ended September 27, 2003** | | | | | | |
| Sales to unaffiliated customers | $11,208 | $1,630 | $ 2,316 | $ 2,697 | $ — | $ 17,851 |
| Intercompany sales | 2,918 | — | 9 | 323 | (3,250) | — |
| Operating income/(loss) | 508 | 187 | 432 | (190) | (18) | 919 |
| Depreciation | 900 | 32 | 94 | 235 | — | 1,261 |
| Capital expenditures | 757 | 386 | 111 | 466 | — | 1,720 |
| **Nine Months Ended September 25, 2004** | | | | | | |
| Sales to unaffiliated customers | $44,566 | $6,744 | $ 9,860 | $ 9,907 | $ — | $ 71,077 |
| Intercompany sales | 12,029 | — | 52 | 1,301 | (13,382) | — |
| Operating income/(loss) | 6,361 | 776 | 2,013 | 338 | (11) | 9,477 |
| Depreciation | 2,835 | 102 | 341 | 795 | — | 4,073 |
| Capital expenditures | 2,921 | 40 | 105 | 465 | — | 3,531 |
| **Nine Months Ended September 27, 2003** | | | | | | |
| Sales to unaffiliated customers | $32,473 | $5,175 | $ 6,951 | $ 8,589 | $ — | $ 53,188 |
| Intercompany sales | 9,794 | — | 33 | 1,032 | (10,859) | — |
| Operating income/(loss) | 1,806 | 541 | 925 | (655) | 21 | 2,638 |
| Depreciation | 2,752 | 89 | 285 | 781 | — | 3,907 |
| Capital expenditures | 1,688 | 418 | 203 | 781 | — | 3,090 |

Operating income is total sales and other operating income less operating expenses. In computing segment operating income/(loss), interest expense and net miscellaneous income (expense) have not been deducted (added).

Included in U.S. sales to unaffiliated customers were export sales, principally to Canada and Asia, of $7,655 and $5,830 during the nine months ended September 25, 2004, and September 27, 2003, respectively.

8. NEW ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued FASB Interpretation No. 46 (FIN 46), *Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51* (ARB 51). FIN 46 provides guidance in determining (1) whether consolidation is required under the "controlling financial interest" model of ARB 51 or (2) whether the variable interest model under FIN 46 should be used to account for existing and new entities. In December 2003, the FASB released a revised version of FIN 46 (FIN 46A) clarifying certain aspects of FIN 46 and providing certain entities with exemptions from its requirements. The Company uses the equity method of accounting to account for investments in its joint venture in China in which it does not have a majority ownership or exercise control. The Company adopted FIN 46 as of January 1, 2004, and does not believe that its investment in the China Joint Venture is a Variable Interest Entity within the scope of FASB Interpretation (FIN) No. 46, *Consolidation of Variable Interest Entities, an interpretation of ARB No. 5,* nor is it material to the financial statements of the Company at September 25, 2004.

9. COMMITMENTS AND CONTINGENCIES

The Company is not a party to any legal proceedings other than routine litigation incidental to its business. In the opinion of management, the amount of ultimate liability with respect to these actions will not materially affect the results of operations, financial position or cash flows of the Company.

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

### OVERVIEW

Sun Hydraulics Corporation is a leading designer and manufacturer of high-performance screw-in hydraulic cartridge valves and manifolds, which control force, speed and motion as integral components in fluid power systems. The Company sells its products globally through wholly owned companies and independent distributors with some direct accounts. Sales outside the United States for the quarter ended September 25, 2004, were 49% of total net sales.

Approximately 66% of product sales are used by the mobile market, which is characterized by applications where the equipment is not fixed in place, the operating environment is often unpredictable, and duty cycles are generally moderate to low. Some examples of mobile equipment include off-road construction equipment, fire and rescue equipment and mining machinery.

The remaining 34% of sales are used by industrial markets, which are characterized by equipment that is fixed in place, typically in a controlled environment, and which operates at higher pressures and duty cycles. Automation machinery, metal cutting machine tools and plastics machinery are some examples of industrial equipment. The Company sells to both markets with a single product line.

*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), United States shipments of hydraulic products declined during the past three years, decreasing -16%, -3% and -2% in 2001, 2002 and 2003, respectively. The declining trend has reversed as the United States hydraulics industry has expanded significantly in the first nine months of 2004.

The Company's order trend has historically tracked closely to the United States Purchasing Managers Index (PMI). The index was 58.5 at the end of September 2004 compared to 53.7 at the end of September 2003. When PMI is over 50, it indicates economic expansion.

Table of Contents

*Results for the third quarter*

(Dollars in millions except net income per share)

| | September 25, 2004 | September 27, 2003 | Increase |
|---|---|---|---|
| Three Months Ended | | | |
| Net Sales | $ 23.2 | $ 17.9 | 30% |
| Net Income | $ 1.9 | $ 0.5 | 280% |
| Net Income per share: | | | |
| Basic | $ 0.27 | $ 0.08 | 238% |
| Fully Diluted | $ 0.27 | $ 0.08 | 238% |
| Nine Months Ended | | | |
| Net Sales | $ 71.1 | $ 53.2 | 34% |
| Net Income | $ 5.8 | $ 1.6 | 263% |
| Net Income per share: | | | |
| Basic | $ 0.86 | $ 0.24 | 258% |
| Fully Diluted | $ 0.85 | $ 0.24 | 254% |

Sales increases by business segment were as follows:

| | 3rd Quarter | Year-to-date |
|---|---|---|
| United States | 31% | 37% |
| United Kingdom | 19% | 15% |
| Germany | 46% | 42% |
| Korea | 17% | 30% |

The first half of the year surge in orders continued into the third quarter with a 33% increase over last year. The Company believes its flexible production capability and its responsive supplier base continues to provide excellent delivery performance to its customers.

Gross profit increased 56% compared to the same quarter last year. Gross profit as a percentage of net sales increased to 30% from 25% last year. Sales volume and productivity increases more than offset increased material costs.

The Company is sharing in the raw material cost increases experienced by its suppliers; however, direct production unit costs are unchanged. To further combat the continuing rise in material costs, the Company has announced a modest price increase on selected products effective the beginning of next year.

**Outlook**

The order rate for October 2004, the first month of the fourth quarter, showed a substantial increase over the third quarter.

Fourth quarter shipments are estimated to be $22.0 million, which would be a 25% increase over the same quarter last year. The majority of this increase is projected to be in the U.S. operation as the rate of growth internationally is projected to slow.

Net income per share on sales of $22.0 million should yield approximately $0.15, which would bring net income per share for the year to $1.00.

## COMPARISON OF THREE MONTHS ENDED SEPTEMBER 25, 2004 AND SEPTEMBER 27, 2003

***Net Sales***

Net sales were $23.2 million, an increase of $5.3 million, or 29.8%. Third party sales in the United States operation increased 30.9% with an increase of 5.6% to Asia, a 35.4% increase to Canada and a 34.7% increase to United States distributors.

Net sales in the Korean operation increased 16.6%. The demand for construction equipment in China is driving a significant portion of the increased sales in Korea as well as Japan and other Asian markets.

Net sales in the United Kingdom operation increased 18.6%. Domestic UK sales increased 17.4% and sales to Scandinavia increased 20.2%.

Net sales in the German operation increased 46.3%. Sales within Germany increased 31.0% and sales in Italy and Austria increased 87.5%.

***Gross Profit***

Gross profit increased 55.8%, or $2.5 million. Gross profit as a percentage of net sales increased to 30.4% from 25.3% last year. The increase in gross profit as a percentage of sales was due to the favorable effects of increased sales volume, exchange rates and productivity increases. These were partially offset by increased material and employee benefit costs.

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

Selling, engineering and administrative expenses increased 11%, or $0.4 million, to $4.0 million compared to $3.6 million the same quarter last year. The increase was primarily due to higher employee wages and benefit costs, outside services including website development, and higher than usual travel and meetings expenses.

***Interest Expense***

Interest expense for the quarter ended September 25, 2004, remained flat at $0.1 million compared to the quarter ended September 27, 2003. Total average debt for the quarter ended September 25, 2004, was $13.6 million compared to $14.6 million for the quarter ended September 27, 2003.

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

There was minimal impact to net income in the quarters ended September 25, 2004 and September 27, 2003, as a result of foreign currency transactions.

***Income Taxes***

The provision for income taxes for the quarter ended September 25, 2004, was 36.7% of pretax income compared to 35.1% for the quarter ended September 27, 2003. The change was due to the relative mix of income and different tax rates in effect among the countries in which the Company sells its products.

## COMPARISON OF THE NINE MONTHS ENDED SEPTEMBER 25, 2004 AND SEPTEMBER 27, 2003

***Net Sales***

Net sales were $71.1 million, an increase of $17.9 million, or 33.6%. This increase reflected the recovery of the capital goods market in the United States, demand for construction equipment in China and strong demand in Central Europe.

### *Gross Profit*

Gross profit increased 53.9%, or $7.6 million. Gross profit as a percentage of net sales increased to 30.6% from 26.6% last year. The increase in gross profit as a percentage of sales was due to the favorable effects of increased sales volume, exchange rates and productivity increases. These were partially offset by increased material and employee benefit costs.

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

Selling, engineering and administrative expenses increased 6.7%, or $0.8 million, to $12.3 million compared to last year. The second quarter of last year included a non-recurring write-off of software in the U.K. operating segment. Excluding the non-recurring item last year, selling, engineering and administrative expenses increased 10.2% or $1.2 million. The increase was primarily due to higher professional fees, outside services, and wage and benefit related expenses including the establishment of an Employee Stock Ownership Plan (ESOP).

### *Interest Expense*

Interest expense for the nine months ended September 25, 2004, remained flat at $0.4 million compared to the nine months ended September 27, 2003. Total average debt for the period ended September 25, 2004, was $15.3 million compared to $14.8 million for the period ended September 27, 2003.

### *Foreign Currency Transaction (Gain) Loss*

Foreign currency transaction gains of $0.1 million for the nine months ended September 25, 2004, was due to the gains of the Euro and Won in the German and Korean operations, and the loss of the Pound in the U.K. operations, against the U. S. Dollar. Foreign currency transaction gain of $0.2 million in the nine months ended September 27, 2003, was due primarily to the gain of the Euro against the U. S. Dollar in the German operation.

### *Income Taxes*

The provision for income taxes for the nine months ended September 25, 2004, was 36.4% of pretax income compared to 35.2% for the nine months ended September 27, 2003. The change was due to the relative mix of income and different tax rates in effect among the countries in which the Company sells its products.

## LIQUIDITY AND CAPITAL RESOURCES

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

Cash from operations for the nine months ended September 25, 2004, was $11.0 million, compared to $7.0 million for the nine months ended September 27, 2003. The $4.0 million increase in cash from operations was due primarily to the $4.2 million increase in net income, offset by working capital changes. Days sales outstanding (DSO) were 33 and 40 at September 25, 2004, and September 27, 2003, respectively. Inventory turns improved to 9.5 at September 25, 2004, compared with 8.0 at September 27, 2003. Inventory levels were unchanged.

Capital expenditures, consisting primarily of purchases of machinery and equipment, were $3.5 million for the nine months ended September 25, 2004, compared to $3.1 million for the nine months ended September 27, 2003. Capital expenditures for the year are projected to be approximately $5.0 million.

The Company declared quarterly dividends of $0.05 per share to shareholders of record September 30, 2004, payable on October 15, 2004. The declaration and payment of future dividends is subject to the sole discretion of the Board of Directors, and any determination as to the payment of future dividends will depend upon the Company’s profitability, financial condition, capital needs, future prospects and other factors deemed pertinent by the Board of Directors.

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

***Off Balance Sheet Arrangements***

The Company uses the equity method of accounting to account for investments in its joint venture in China in which it does not have a majority ownership or exercise control. The Company does not believe that its investment in the China Joint Venture is a Variable Interest Entity and within the scope of FASB Interpretation (FIN) No. 46, *Consolidation of Variable Interest Entities, an interpretation of ARB No. 5,* nor is it material to the financial statements of the Company at September 25, 2004.

***Seasonality***

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

***Inflation***

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

***Critical Accounting Policies and Estimates***

The Company currently only applies judgment and estimates, which may have a material effect on the eventual outcome of assets, liabilities, revenues and expenses, for impairment of long-lived assets, accounts receivable, inventory, goodwill and accruals. The following explains the basis and the procedure for each account where judgment and estimates are applied.

*Revenue Recognition*

It is the Company's accounting policy to report revenues when title passes and risk of loss transfers to the customer. The effect of material non-recurring events is provided for when they become known.

*Impairment of Long-Lived Assets*

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

The Company assesses the recoverability of goodwill and intangible assets not subject to amortization under SFAS 142. See Goodwill below.

*Accounts Receivable*

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

*Inventory*

The Company offers a wide variety of standard products and as a matter of policy does not discontinue products. On an ongoing basis, component parts found to be obsolete through design or process changes are disposed of and charged to material cost. The Company reviews on-hand balances of products and component parts against specific criteria. Products and component parts without usage or that have excess quantities on hand are evaluated. An inventory reserve is then established for the full inventory carrying value of those products and component parts deemed to be obsolete or slow moving. See Note 4 for inventory reserve amounts.

*Goodwill*

The Company acquired its Korean operations in September 1998 using the purchase method. As a result, goodwill is reflected on the consolidated balance sheet. A valuation based on the cash flow method was performed at December 27, 2003, and 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 for goodwill amounts.

*Accruals*

The Company makes estimates related to certain employee benefits and miscellaneous accruals. Estimates for employee benefit accruals are based on information received from plan administrators in conjunction with management's assessments of estimated liabilities related to workers' compensation, the 401(k) plan discretionary match, and health care benefits. Estimates for miscellaneous accruals are based on management's assessment of estimated liabilities for costs incurred.

**FORWARD-LOOKING INFORMATION**

*Certain oral statements made by management from time to time and certain statements contained herein that are not historical facts are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934 and, because such statements involve risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Forward-looking statements, including those in Management's Discussion and Analysis of Financial Condition and Results of Operations are statements regarding the intent, belief or current expectations, estimates or projections of the Company, its Directors or its Officers about the Company and the industry in which it operates, and assumptions made by management, and include among other items, (i) the Company's strategies regarding growth, including its intention to develop new products; (ii) the Company's financing plans; (iii) trends affecting the Company's financial condition or results of operations; (iv) the Company's ability to continue to control costs and to meet its liquidity and other financing needs; (v) the declaration and payment of dividends; and (vi) the Company's ability to respond to changes in customer demand domestically and internationally, including as a result of standardization. Although the Company believes that its expectations are based on reasonable assumptions, it can give no assurance that the anticipated results will occur.*

*Important factors that could cause the actual results to differ materially from those in the forward-looking statements include, among other items, (i) the economic cyclicality of the capital goods industry in general and the hydraulic valve and manifold industry in particular, which directly affect customer orders, lead times and sales volume; (ii) conditions in the capital markets, including the interest rate environment and the availability of capital; (iii) changes in the competitive marketplace that could affect the Company's revenue and/or cost bases, such as increased competition, lack of qualified engineering, marketing, management or other personnel, and increased labor and raw materials costs; (iv) changes in technology or customer requirements, such as standardization of the cavity into which screw-in cartridge valves must fit, which could render the Company's products or technologies noncompetitive or obsolete; (v) new product introductions, product sales mix and the geographic mix of sales nationally and internationally; and (vi) changes relating to the Company's international sales, including changes in regulatory requirements or tariffs, trade or currency restrictions, fluctuations in exchange rates, and tax and collection issues. Further information relating to factors that could cause actual results to differ from those anticipated is included but not limited to information under the headings "Business" (including under the subheading "Business Risk Factors") in the Company's*

*Form 10-K for the year ended December 27, 2003, and "Management's Discussion and Analysis of Financial Conditions and Results of Operations" in this Form 10-Q for the quarter ended September 25, 2004. The Company disclaims any intention or obligation to update or revise forward-looking statements, whether as a result of new information, future events or otherwise.*

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company is exposed to market risk from changes in interest rates on borrowed funds, which could affect its results of operations and financial condition. The Company had approximately $10.4 million in variable-rate debt outstanding at September 25, 2004. The Company has managed this risk by its ability to select the interest rate on its debt financing at Libor plus 1.9% or its lender's prime rate, whichever is more advantageous. Beginning in July 2004, the interest rate on its debt financing remained variable based upon the Company's leverage ratio. At September 25, 2004, a 1% change in interest rates up or down would affect the Company's income statement on an annual basis by approximately $104,000 at the current, variable-rate outstanding debt level. At September 27, 2003, the Company had $17.8 million in variable-rate debt outstanding and, as such, a 1% change in interest rates up or down would have affected the Company's income statement on an annual basis by approximately $178,000.

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

**Item 4. CONTROLS AND PROCEDURES**

As of September 25, 2004, the Company's management, under the direction of its Chief Executive Officer and the Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of the disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Company's Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of September 25, 2004, in timely alerting them to material information required to be included in the Company's periodic SEC filings.

There were no significant changes in the Company's internal controls over financial reporting during the quarter ended September 25, 2004, that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

PART II

OTHER INFORMATION

Item 1. Legal Proceedings.

None.

Item 2. Changes in Securities, Use of Proceeds and Issuer Repurchases of Equity Securities.

None.

Item 3. Defaults upon Senior Securities.

None.

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

None.

Item 5. Other Information.

The Company has established the date for its next Annual Meeting of Shareholders, which will be held on June 11, 2005, in Sarasota, Florida.

Item 6. Exhibits and Reports on Form 8-K.

Exhibits:

| Exhibit Number | Exhibit Description |
|---|---|
| 10.12+ | Forms of agreement for grants under the Sun Hydraulics Corporation 1996 Stock Option Plan |
| 31.1 | CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | CEO Certification pursuant to 18 U.S.C. § 1350. |
| 32.2 | CFO Certification pursuant to 18 U.S.C. § 1350. |

(b) Reports on Form 8-K

1. Report on Form 8-K (dated August 2, 2004) filed August 2, 2004, announcing the financial results for the second quarter of 2004 and establishment of an Employee Stock Ownership Plan.

2. Report on Form 8-K (dated August 2, 2004) filed August 6, 2004, announcing a copy of the transcript of the conference call held on August 2, 2004.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Sarasota, State of Florida on November 5, 2004.

SUN HYDRAULICS CORPORATION

By: /s/ Richard J. Dobbyn

Richard J. Dobbyn
Chief Financial Officer (Principal
Financial and Accounting Officer)

Exhibit 10.12

FORM OF
STOCK OPTION AGREEMENT

This Stock Option Agreement, is entered into as of the ____ day of _________________, 200__, between SUN HYDRAULICS CORPORATION, a Florida corporation (the "Corporation"), and ____________________________ (the "Participant").

W I T N E S S E T H

WHEREAS, the Participant is an officer and/or key employee of Sun Hydraulics Corporation; and

WHEREAS, effective September 30, 1996, the Corporation adopted the Sun Hydraulics Corporation 1996 Stock Option Plan, as amended effective as of February 24, 1997 (the "Plan") in order to provide officers and key employees of the Corporation and its affiliated companies with an opportunity to acquire an equity interest in the Corporation; and

WHEREAS, the Corporation has determined that it is in the best interests of the Corporation to grant Participant the option to purchase shares of common stock of the Corporation under the Plan.

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

1. Grant of Options. Subject to the terms and conditions of this Agreement, the Corporation hereby grants to the Participant the right and option to purchase up to a total of ___________________________ (_______) shares of the common stock, $0.001 par value, of the Corporation (the "Common Stock"), at a purchase price of $___________ per share.

2. Period of Exercise. The Options shall become vested and exercisable in three (3) installments. At any time during the term of the Options, the maximum number of shares of Common Stock the Participant may purchase by exercising the Options shall be limited as specified in the following schedule:

<TABLE>
<CAPTION>

| PERIOD | MAXIMUM NUMBER OF SHARES WHICH CAN BE PURCHASED |
|---|---|
| <S> | <C> |
| After [date] | Up to ________ shares |
| From [date] to [date] | Up to ________ shares (less any shares previously purchased through Option exercises) |
| After [date] | Up to ________ shares (less any shares previously purchased through Option exercises) |

</TABLE>

3. Termination Date of Options. The Options granted hereunder shall terminate on __________________, 20___. The Participant shall have no right to exercise the Options at any time after this date.

4. Manner of Exercise. When the Participant elects to exercise the Options to purchase shares of Common Stock, he shall give written notice of such exercise to the Secretary of the Corporation. The notice of exercise shall state the number of shares of Common Stock as to which the Options are being exercised.

The Participant may exercise the Options to purchase all, or any lesser whole number, of the number of shares of Common Stock which he is then permitted to purchase under Paragraph 2.

5. Payment for Shares. Full payment of the option price for the shares of Common Stock purchased by exercising the Options shall be due at the time the notice of exercise is delivered pursuant to Paragraph 4. Such payment may be

made (i) in cash, (ii) by delivery of shares of Common Stock already owned by the Participant for at least six months, with a fair market value equal to the option price, (iii) with the approval of the Compensation Committee (the "Committee") of the Board of Directors of the Corporation, in cash at the time of exercise to the extent of the par value of such shares of Common Stock with the balance of the Purchase Price paid pursuant to a promissory note on terms satisfactory to the Committee delivered at the time of exercise, or (iv) in any other form acceptable to the Committee.

Alternatively, the Participant may exercise his Options by delivering a signed, irrevocable notice of exercise, accompanied by payment in full of the option price by the Participant's stockbroker and an irrevocable instruction to the Corporation to deliver the shares of Common Stock issuable upon exercise of the Options promptly to the Participant's stockbroker for the Participant's account.

6. Issuance of Stock Certificates for Shares. The stock certificates for any shares of Common Stock issuable to the Participant upon exercise of the Options shall be delivered to the Participant (or to the person to whom the rights of the Participant shall have passed by will or the laws of descent and distribution) as promptly after the date of exercise as is feasible, but not before the Participant has paid the option price for such shares. The Corporation shall place such legends on the stock certificates, and such other notations on its stock transfer records, as may be necessary to identify such shares as shares issued pursuant to the exercise of incentive stock options.

7. Termination. If the Participant's employment with the Corporation terminates during the term of the Options, the Participant shall have the right to exercise the Options during a period of ninety (90) days following the termination of employment, but in no event later than __________________, 20____. The maximum number of shares the Participant may purchase by exercising the Options during this ninety day period shall not exceed the number of shares which could be purchased by the Participant immediately prior to the date of termination pursuant to Paragraph 2.

8. Effect of Death or Disability. If the Participant dies before the Options expire or have been exercised with respect to all of the shares of Common Stock subject to the Options,



the Participant's executor, administrator, or any person to whom the Options may be transferred by his will or by the laws of descent, shall have the right to exercise the Options, to the extent not previously exercised, at any time prior to the first anniversary of the date of death, but in no event later than __________________, 20____. For this purpose, the terms of this Agreement shall be deemed to apply to such person as if he or she were the Participant.

In the event of the disability of Participant while employed by the Corporation, the Options may be exercised, to the extent not previously exercised, by Participant at any time prior to the first anniversary of the date of disability, but in no event later than __________________, 20____. The determination as to whether Participant's employment is terminated due to "disability" shall be vested solely in the Committee and its determination shall be final and conclusive on all parties.

9. Adjustments in the Shares. Notwithstanding anything contained herein to the contrary, in the event of any changes in the Common Stock of the Corporation prior to the purchase thereof by Participant by reason of a share dividend, split-up, reclassification, recapitalization, subdivision, combination, exchange of shares, merger, consolidation or liquidation by or of the Corporation, the aggregate number and class of shares available under this Agreement to be purchased by Participant and the purchase price therefor shall be correspondingly adjusted by the Committee; provided, however, that no such adjustment shall be made as a result of any public offering of shares of the Corporation's Common Stock.

10. Non-Transferability of Options. The Participant's rights under the Options may not be assigned or transferred by the Participant other than by will or the laws of descent and distribution.

11. Securities Laws. The Corporation may from time to time impose any

conditions on the exercise of the Options as it deems necessary or advisable to ensure that the Options granted hereunder, and each exercise thereof, satisfy the requirements of applicable securities and other laws. Such conditions to satisfy applicable securities and other laws may include, without limitation, the partial or complete suspension of the right to exercise the Options until the offering of the shares covered by the Options have been registered under the Securities Act of 1933, or the printing of legends on all stock certificates issued to the Participant referring to the restrictions on the transferability of such shares.

12. Rights Prior to Issuance of Certificates. Neither the Participant nor any person to whom the rights of the Participant shall have passed by will or the laws of descent and distribution shall have any of the rights of a stockholder with respect to any shares of Common Stock until the date of the issuance to him of certificates for such Common Stock as provided in Paragraph 6 above.

13. Agreement Subject to Option 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.



14. Withholding. The Company's obligation to deliver all or any of the Shares upon the exercise of the Option shall be subject to the applicable tax withholding requirements of the United States and any political subdivision thereof. Withholding tax due upon the exercise of any Option may be paid using the Shares upon such terms and conditions as the Board shall determine; provided, however, that the Board in its sole discretion may disapprove such form of payment and require that such taxes be paid in cash.

15. 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 the Participant and the Corporation.

(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.

IN WITNESS WHEREOF, the parties have executed this Agreement effective the date and year first above written.

ATTEST: SUN HYDRAULICS CORPORATION

_______________________________________ By: ________________________________

Secretary President

"PARTICIPANT"

_____________________________________



FORM OF
INCENTIVE STOCK OPTION AGREEMENT

This Incentive Stock Option Agreement, is entered into as of the ____ day of _________________, 200__, between SUN HYDRAULICS CORPORATION, a Florida corporation (the "Corporation"), and ____________________________ (the "Participant").

W I T N E S S E T H

WHEREAS, the Participant is an officer and/or key employee of Sun Hydraulics Corporation; and

WHEREAS, effective September 30, 1996, the Corporation adopted the Sun Hydraulics Corporation 1996 Stock Option Plan, as amended effective as of February 24, 1997 (the "Plan") in order to provide officers and key employees of the Corporation and its affiliated companies with an opportunity to acquire an equity interest in the Corporation; and

WHEREAS, the Corporation has determined that it is in the best interests of the Corporation to grant Participant the option to purchase shares of common stock of the Corporation under the Plan.

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

1. Grant of Options. Subject to the terms and conditions of this Agreement, the Corporation hereby grants to the Participant the right and option to purchase up to a total of ___________________________ (_______) shares of the common stock, $0.001 par value, of the Corporation (the "Common Stock"), at a purchase price of $___________ per share.

The options to purchase up to _____________ shares of Common Stock granted under this Agreement (the "Options") are intended to qualify as "incentive stock options" within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended.

2. Period of Exercise. The Options shall become vested and exercisable in three (3) installments. At any time during the term of the Options, the maximum number of shares of Common Stock the Participant may purchase by exercising the Options shall be limited as specified in the following schedule:

<TABLE>
<CAPTION>

| PERIOD | MAXIMUM NUMBER OF SHARES WHICH CAN BE PURCHASED |
|---|---|
| <S> | <C> |
| After [date] | Up to ________ shares |
| From [date] to [date] | Up to ________ shares (less any shares previously purchased through Option exercises) |
| After [date] | Up to ________ shares (less any shares previously purchased through Option exercises) |

</TABLE>

3. Termination Date of Options. The Options granted hereunder shall terminate on __________________, 20___. The Participant shall have no right to exercise the Options at any time after this date.

4. Manner of Exercise. When the Participant elects to exercise the Options to purchase shares of Common Stock, he shall give written notice of such exercise to the Secretary of the Corporation. The notice of exercise shall state the number of shares of Common Stock as to which the Options are being exercised.

The Participant may exercise the Options to purchase all, or any lesser whole number, of the number of shares of Common Stock which he is then permitted to purchase under Paragraph 2.

5. Payment for Shares. Full payment of the option price for the shares of Common Stock purchased by exercising the Options shall be due at the time the notice of exercise is delivered pursuant to Paragraph 4. Such payment may be made (i) in cash, (ii) by delivery of shares of Common Stock already owned by the Participant for at least six months, with a fair market value equal to the option price, (iii) with the approval of the Compensation Committee (the "Committee") of the Board of Directors of the Corporation, in cash at the time of exercise to the extent of the par value of such shares of Common Stock with the balance of the Purchase Price paid pursuant to a promissory note on terms satisfactory to the Committee delivered at the time of exercise, or (iv) in any other form acceptable to the Committee.

Alternatively, the Participant may exercise his Options by delivering a signed, irrevocable notice of exercise, accompanied by payment in full of the option price by the Participant's stockbroker and an irrevocable instruction to the Corporation to deliver the shares of Common Stock issuable upon exercise of the Options promptly to the Participant's stockbroker for the Participant's account.

6. Issuance of Stock Certificates for Shares. The stock certificates for any shares of Common Stock issuable to the Participant upon exercise of the Options shall be delivered to the Participant (or to the person to whom the rights of the Participant shall have passed by will or the laws of descent and distribution) as promptly after the date of exercise as is feasible, but not before the Participant has paid the option price for such shares. The Corporation shall place such legends on the stock certificates, and such other notations on its stock transfer records, as may be necessary to identify such shares as shares issued pursuant to the exercise of incentive stock options.

7. Termination. If the Participant's employment with the Corporation terminates during the term of the Options, the Participant shall have the right to exercise the Options during a period of ninety (90) days following the termination of employment, but in no event later than __________________, 20____. The maximum number of shares the Participant may purchase by exercising the Options during this ninety day period shall not exceed the number of shares which could be purchased by the Participant immediately prior to the date of termination pursuant to Paragraph 2.



8. Effect of Death or Disability. If the Participant dies before the Options expire or have been exercised with respect to all of the shares of Common Stock subject to the Options, the Participant's executor, administrator, or any person to whom the Options may be transferred by his will or by the laws of descent, shall have the right to exercise the Options, to the extent not previously exercised, at any time prior to the first anniversary of the date of death, but in no event later than __________________, 20____. For this purpose, the terms of this Agreement shall be deemed to apply to such person as if he or she were the Participant.

In the event of the disability of Participant while employed by the Corporation, the Options may be exercised, to the extent not previously exercised, by Participant at any time prior to the first anniversary of the date of disability, but in no event later than __________________, 20____. The determination as to whether Participant's employment is terminated due to "disability" shall be vested solely in the Committee and its determination shall be final and conclusive on all parties.

9. Adjustments in the Shares. Notwithstanding anything contained herein to the contrary, in the event of any changes in the Common Stock of the Corporation prior to the purchase thereof by Participant by reason of a share dividend, split-up, reclassification, recapitalization, subdivision, combination, exchange of shares, merger, consolidation or liquidation by or of the Corporation, the aggregate number and class of shares available under this Agreement to be purchased by Participant and the purchase price therefor shall be correspondingly adjusted by the Committee; provided, however, that no such adjustment shall be made as a result of any public offering of shares of the Corporation's Common Stock.

10. Non-Transferability of Options. The Participant's rights under the Options may not be assigned or transferred by the Participant other than by will or the laws of descent and distribution.

11. Securities Laws. The Corporation may from time to time impose any conditions on the exercise of the Options as it deems necessary or advisable to ensure that the Options granted hereunder, and each exercise thereof, satisfy the applicable requirements of federal and state securities laws. Such conditions to satisfy applicable federal and state securities laws may include, without limitation, the partial or complete suspension of the right to exercise the Options until the offering of the shares covered by the Options have been registered under the Securities Act of 1933, or the printing of legends on all stock certificates issued to the Participant referring to the restrictions on the transferability of such shares.

12. Rights Prior to Issuance of Certificates. Neither the Participant

nor any person to whom the rights of the Participant shall have passed by will or the laws of descent and distribution shall have any of the rights of a stockholder with respect to any shares of Common Stock until the date of the issuance to him of certificates for such Common Stock as provided in Paragraph 6 above.

13. Agreement Subject to Option 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.

14. Withholding. The Company's obligation to deliver all or any of the Shares upon the exercise of the Option shall be subject to the applicable tax withholding requirements of the United States and any political subdivision thereof. Withholding tax due upon the exercise of any Option may be paid using the Shares upon such terms and conditions as the Board shall determine; provided, however, that the Board in its sole discretion may disapprove such form of payment and require that such taxes be paid in cash.

15. 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 the Participant and the Corporation.

(c) To the extent that any of the provisions of this Agreement are inconsistent with the provisions of Section 422 of the Internal Revenue Code and such inconsistency would cause any Options granted hereunder not to be treated as incentive stock options for federal income tax purposes, the provisions of this Agreement and of the Options granted hereunder shall be deemed to be amended in a manner to comply with the provisions of Section 422 of the Internal Revenue Code, as the case may be.

(d) 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.

IN WITNESS WHEREOF, the parties have executed this Agreement effective the date and year first above written.

ATTEST: SUN HYDRAULICS CORPORATION

_______________________________________ By:_________________________________
Secretary President

"PARTICIPANT"

_____________________________________

Exhibit 31.1

CERTIFICATION

I, Allen J. Carlson, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the quarter ended September 25, 2004, 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 Rule 13a-15(e)) 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) 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

(c) 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: November 5, 2004

/s/ Allen J. Carlson

- ----------------------------------------

Allen J. Carlson
President, Chief Executive Officer

Exhibit 31.2

CERTIFICATION

I, Richard J. Dobbyn, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the quarter ended September 25, 2004, 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 Rule 13a-15(e)) 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) 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

(c) 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: November 5, 2004

/s/ Richard J. Dobbyn

\- ------------------------------------

Richard J. Dobbyn
Chief Financial Officer

EXHIBIT 32.1

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350

I, Allen Carlson, the Chief Executive Officer of Sun Hydraulics Corporation (the "Company"), certify that (i) the Quarterly Report on Form 10-Q for the Company for the quarter ended September 25, 2004 (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 Carlson
--------------------------------
Chief Executive Officer
November 5, 2004

EXHIBIT 32.2

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350

I, Richard J. Dobbyn, the Chief Financial Officer of Sun Hydraulics Corporation (the "Company"), certify that (i) the Quarterly Report on Form 10-Q for the Company for the quarter ended September 25, 2004 (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/ Richard J. Dobbyn
--------------------------------
Chief Financial Officer
November 5, 2004