

## INVESTMENT LETTER

### SUN HYDRAULICS CORPORATION (NASDAQ: SNHY)



Closing price as of November 26, 2008 (the date of the INVESTMENT LETTER): \$15.13

A money manager attempts multitasking at the **Lone Star Steakhouse & Saloon** as he studies **Sun Hydraulics (NASDAQ:SNHY)** and is reminded why owning a piece of **Sun Hydraulics** gives him a big lift.

#### **Sunday, November 15, 2008, Tulsa, Oklahoma**

I was sitting at my favorite booth at the **Lone Star Steakhouse & Saloon** on fifty first Street in Tulsa, drinking coffee, munching peanuts, and keeping my eyes and ears open so I could get a taste and a feel for the ambience and the style of a restaurant that I frequent.

I was waiting for my friend, **Gary Garner**, to join me. It was 11:35 A.M. and **Gary** was not due until noon so I had ample time to relax, look around the restaurant, listen to the plaintive sounds of the country and western music, take note of the cacti set above the ledges of the dining tables, observe the Texas license plates hanging from the walls, and to study the murals of mean-looking longhorns staring with menace at cowboys who seemed to be composed even in the midst of **steerious** danger. I also had time to look at one of the restaurant's three televisions, all of which were silently broadcasting the day's first round of the American version of the gladiator wars: the National Football League games.

And without being obvious I had a few moments to study my fellow diners, to guess what they did for a living, the hobbies they enjoyed, and how often they came to the **Lone Star Steakhouse & Saloon**.

My agenda was to study what was going on at **Lone Star**, but more importantly to read the 2007 10-K that **Sun Hydraulics (NASDAQ:SNHY)** had filed with the Securities and Exchange Commission in Washington on March 12, 2008.

The 10-K, the document that every publicly traded company must file every year with the Securities and Exchange Commission, contains a wealth of information: a summary of the company's business, five years of financials: balance sheets, income statements by quarter and by year and a cash flow analysis; discussion of options (granted, forfeited, and exercised); an analysis of pension obligations; and an exhaustive discussion of every conceivable significant risk that the company faces.

The 10-K document also includes a report by the independent registered certified public accounting firm indicating whether the CPA firm found the financials that it had audited satisfactory in what the accounting profession terms "...material respects." (What material means is enough of a subject for another letter.)

Looking up from the 10-K, I recalled a visit to the [Lone Star](#) web site, where I had discovered the meaning of what the company calls the [Lone Star](#) difference or what I call the [Lone Star](#) state of mind.

The [Lone Star](#) state of mind, I learned, has nothing to do with reaching a state of tranquility, enjoying intense intellectual absorption, or with being at peace with oneself. The [Lone Star](#) state of mind has little to do with karma or the wonderful feeling you get after exercise or yoga.

The [Lone Star](#) state of mind, instead, is an appetite and a stomach, primed, conditioned, and trained to consume, in one meal, an obscene number of calories, a number of calories that would even challenge a two hundred and ninety pound [Oklahoma Sooner](#) lineman, at least in one sitting. Understanding the [Lone Star](#) mind depends on understanding the [Lone Star](#) difference.

To understand the [Lone Star](#) difference and to consider the company's strategy to encourage gross consumption, let's look at the [Lone Star](#) web site:

[Lone Star](#) restaurants embrace an authentic roadhouse theme and serve mesquite-grilled steaks, which are hand-cut fresh daily at each restaurant. The menu includes "Texas-sized" portions of food, and the meal starts with a Texas Rose (a hand-battered, whole cut onion with special seasoned sauce, enough for two); signature lettuce wedge and chicken pot pie soup. (*[Lone Star web site](#)*)

Now, you are finished with the appetizers and you are ready to see whether you really are a man and can continue to consume calories at a feverish pace. So, it is now time for the real business at hand:

A hand-cut mesquite grilled steak and a Texas side, that is: your choice of baked potato, twice baked potato, homemade chili, or some steak fries. (*[Lone Star web site](#)*)

Let us assume that you had a one hour rest period after the above main course. You should now be ready to enjoy the Homemade Apple Cobbler topped with vanilla bean ice cream, a dish that the [Lone Star](#) claims is better than what Mom makes. (Obviously the menu writers at [Lone Star](#) did not know my mom who would have severely reprimanded me for even considering a trip to [Lone Star](#).)

Hunger was now interfering with my concentration and I was now more interested in steak than in the 10-K document. Nevertheless, I plodded on with the 10-K, reminding myself that such reading was requisite for a thorough understanding of a company and as important as the pre-flight check that pilots go through before take-off.

A few moments later, I noticed the hostess escorting three burly men, each wearing a cowboy hat, to the table in front of me. Two of these men sat down with their backs to me, and the other one sat facing me.

As soon as they sat down they engaged in animated, earnest conversation about the college football games which they had evidently watched the day before, dissecting the performances of the coaches and the players as thoroughly as [The New York Times](#) theatre critics, Ben Brantley and Charles Isherwood, would critique the performance of the key actors in a Broadway musical, or as meticulously as Joe Morgenstern of [The Wall Street Journal](#) would critique the latest movie release.

**INVESTMENT THESIS**  
**SUN HYDRAULICS CORPORATION (NASDAQ: SNHY)**

Thousands of industrial applications require hydraulics, and hence hydraulic systems are ubiquitous.

**Sun Hydraulics** is a specialist in the world of hydraulics, making screw-in cartridge valves and manifolds that are essential parts of every hydraulic system, a package which often contains hundreds or even thousands of parts.

“Screw-in cartridge valves have significant marketplace acceptance because hydraulic system design engineers are easily able to develop multiple function control systems. A number of screw-in cartridge valves can be grouped together in a manifold, creating a hydraulic control system that is functionally analogous to an electronic integrated circuit. End users can utilize screw-in cartridge valves and custom manifolds to design an optimum solution for control of their fluid power systems that significantly reduces assembly time and response.”

*Sun Hydraulics Corporation, 10-K, for the year ended December 31, 2007, page two*

Unlike the conventional cartridge valve, a screw-in cartridge valve means that you can take one valve and replace it with a more powerful, or less powerful, valve, and screw in the new valve (smaller or larger) into a manifold depending on whether you want greater or lesser pumping power, giving the hydraulic mechanism greater versatility than the conventional approach, giving more or less pumping power as desired.

Within the hydraulics world, **Sun Hydraulics** enjoys these competitive advantages:

**Sun** has the broadest offering of cartridge valves and manifolds in the industry. **Sun’s** screw-in valves come in five size ranges, suitable for flows from one to four hundred gallons per minute, covering hydraulic needs from small to big jobs.

These products allow customers to easily integrate the company’s screw-in cartridge valves into their systems in many different ways. Once designed, standard manifolds require minimal, if any, maintenance and engineering over the life of the product and can be readily manufactured at all of the company’s operations.”

*Sun Hydraulics Corporation, 10-K, for the year ended December 31, 2007, page five*

**Sun** enjoys great geographical diversification, with plants in the United States, the United Kingdom, Germany, China and Korea.

***The screw-in cartridge valve business is growing at twice the rate of the conventional cartridge valve business and Sun is growing at twice the rate of the screw-in cartridge valve business, a growth that reflects the company’s competitive advantages.***

These men, I guessed, considering their size and the content of their conversation, may well have played football in college. In any case they certainly did not look or act like the effete eastern intellectuals that walked the campus of **Swarthmore College**, where the author did his undergraduate

work. [Spiro Agnew](#), a Governor of Maryland and subsequently Vice-President under [Richard Nixon](#), loved the term effete eastern intellectuals.

The three men looked, instead, as if they were used to heavy outdoor labor, heavy lifting. I realize that I may be guilty of stereotyping, but it appeared highly unlikely that they would spend Sunday afternoon reading [Bertrand Russell's A History of Western Philosophy](#), the [Gregg Reference Manual](#), or [The New York Times Manual of Style and Usage](#). Instead they would be very likely to spend Sunday afternoons viewing successive professional football games, drinking a few Buds, and absorbing two hours of commercials, as they would probably do this day.

Soon a waitress approached their table, welcomed them to the [Lone Star](#), asked them what they wanted to drink, and then quickly, as she was trained to do, asked ...”could I start you off with some cheese fries or some spinach and artichoke dip?”

My hunger was now becoming acute, and I was tempted to look up at the waitress, and say, “ Yes I’ll have some cheese fries...” but I decided that such a move would not be prudent, as it could antagonize the three guests, who might very well conclude that I had rudely interrupted their exchange with the waitress. After all, these gentlemen, who were in their forties or fifties, obviously were enjoying the attention from the young waitress and would not look favorably, I feared, at any development that would compromise that attention.

Any idea of saying something spontaneous, and risking resentment from the table next to me was squelched, when I observed the words printed on the shirt that one of the men was wearing. The message read “[Real Men Eat Red Meat](#).” My appetite for danger and excitement was quickly satisfied and I put my head down and returned to the [Sun](#) 10-K in front of me. The waitress was attractive--- and I usually do not surrender any opportunity to flirt---- and cheese fries sounded great, but it was a wiser decision to continue reading about [Sun](#).

As I continued to study, I thought about hydraulics, the science of harnessing and exploiting fluid power, applying force and motion to push, pull, rotate, regulate, and to move sideways a wide range of objects.

Hydraulics is based on the Greek word for water, and originally covered the study of physical behavior of water at rest. Today hydraulics study covers the flow and movement of all liquids.

The ancients were familiar with many hydraulic principles. The Egyptians and the people of Persia, India, and China conveyed water along channels for irrigation and domestic purposes, using dams and sluice gates to control the flow. The Romans constructed aqueducts to carry water to their cities.

There are thousands of applications for hydraulic systems, making these systems important mechanisms in agriculture, heavy machinery, forestry, oil and gas drilling, and in other industries. Whenever there is a need to move something, it is likely that hydraulic systems will be out in force. (Get it?)

Hydraulics can help with light loads using little force, but also can develop enormous force to move and position materials and equipment that weigh many tons. A winch might be used to lift a sailboat on Grand Lake out of the water and onto the dock. This is a heavy lifting job and the winch might well be equipped with hydraulic valves working at four hundred gallons per minute or five thousand pounds per square inch. A different hydraulics system, in contrast, might be used as a sound deadener, positioned at the top of the door, so the door, when shut, will not slam shut, but will close slowly, and not bang into the wall. In the latter case, the hydraulic function is less demanding.

When [Helmerich & Payne \(NYSE:HP\)](#), an operator of onshore and offshore drilling rigs, domestic and foreign, wishes to lower or raise drilling pipe, the company will use a hydraulic system to do so. This is heavy lifting. Light lifting or a small hydraulics challenge would be raising the ladder on a fire truck or raising a man or a woman on a platform used by personnel at Utica Square in Tulsa to prune trees.

Amusement parks rely on hydraulics especially for the most dangerous rides, such as the roller coaster, and for some of their terrifying and exciting water rides, such as Six Flag's Roaring Rapids, in Arlington, Texas, a favorite ride of Meredith Bohot.

Hydraulic systems are used to lift plows, to change the position of components, such as a combine header or bulldozer blade, and to operate remote motors as well as to assist steering and braking on a combine.

With hydraulics a dump truck can be turned with the push of a finger if the truck is equipped with a hydraulically operated open-box bed hinged at the rear, the front of which can be lifted up to allow the contents to be deposited on the ground behind the truck at the delivery site.

Perhaps it is with the power steering in our car or in our sports utility vehicle (suv) that we meet the power of hydraulics frequently and intimately.

When I was growing up, and learning how to drive on Long Island in the summer, I can remember that turning the wheels of the 1952 Pontiac required great triceps effort. My driving instructor seemed to enjoy the expression on my face (fear and loathing) when he asked me to parallel park the Pontiac, a car which was not equipped with power steering. When I had pulled into a parking spot, my shirt was usually drenched with sweat.

Today, when drivers in Tulsa maneuver their suvs around town, they use little muscle to steer safely, expecting power steering powered by hydraulic systems so that they can drive their tanks with little triceps effort.

Today steering wheel hydraulics have gone from plain hydraulic power steering systems to electro-hydraulic power steering systems which use the same hydraulic assist technology as standard systems but whose pumps are powered by an electric motor. (In a pure power steering exercise, a belt driven by the engine would power the pump.) Ford, Volkswagen, Audi, Mazda, Toyota, and Suzuki use the hybrid electro-hydraulic system.

In the last seven years [Sun](#) has made two acquisitions that give it presence in the field of electronically activated cartridge valves. In 2005 Sun took a forty per cent equity interest in [White Oak](#) controls, a maker of digital amplifiers. Sun bought [High Country Tek](#) in 2007 to enhance its electric-hydraulic efforts. Like the computer chip in a car that precisely regulates the mixture of fuel and air, the electronic component in the valve brings more efficiency to the valve, enabling [Sun](#) to get better margins.

In other words, moving to the electrical standard is similar to switching from analog to digital when tuning a radio or television. Consider the steering wheel and separate throttle mechanically activated or controlled by a boat operator. By replacing the mechanical linkage with an electronically activated hydraulic manifold, the steering wheel and throttle are replaced by an electronic joystick that is similar to what you would encounter if you were operating a gaming console.

With a little energy from your fingers, you can control the speed and direction of a boat. The electronically activated joystick can be linked to a global positioning system so that when you enter

your destination on the dashboard your speed, and your direction, are calculated instantaneously for you.

### **A Few Comments about Sun's Future, the Capital Gains Potential of a Sun Investment, and a Consideration of Sun as a Take over Candidate**

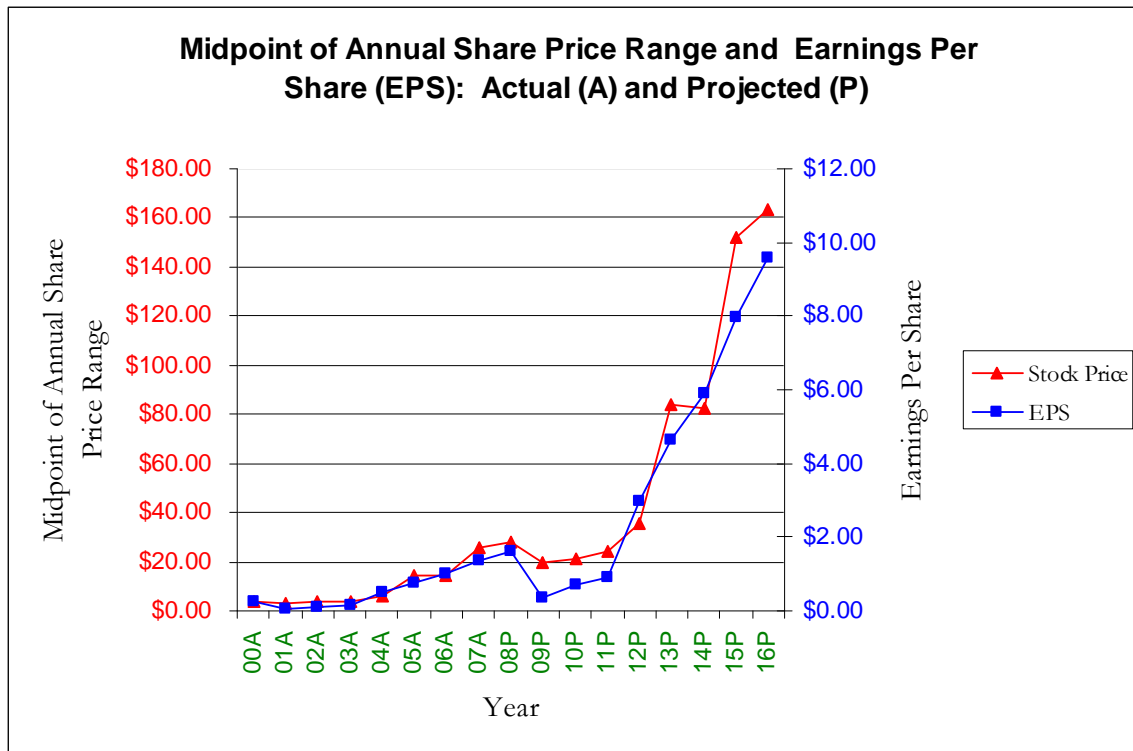
In the last fifteen years conglomerates such as [Eaton Corporation \(NYSE: ETN\)](#) and [Parker Hannifin \(NYSE: PHI\)](#) have gobbled up many hydraulics companies, making the acquisition targets part of a much larger company. Fifteen years ago, thirty companies in the United States produced cartridge valves. Today there are six stand alone companies making cartridge valves.

Once the hydraulics company is absorbed it often loses much of its focus and its entrepreneurial character, and most obviously it loses much of its competitive ferocity.

Assumption is a favorite word of business school professors and bureaucrats. So it is a suspect word. Nevertheless, if we assume that the company's competitive position remains as strong in the next seven years as it is now, and that the world economy comes out of the current recession by the end of 2009, I believe that there are substantial rewards----annual double digit gains far exceeding the rate of inflation---that we will enjoy as [Sun](#) shareholders.

The chart on page seven shows the possibility of [Sun's](#) capital gain reward, a reward that does not include a rising dividend. Remember that all systems must be go to achieve the kind of reward outlined. Nevertheless whatever happens by 2016 will in all probability be good for us. (Note: from 2000 through 2008 [Sun's dividend rose at an annual compound rate of twenty three per cent and its earnings rose at an annual compound rate of twenty five per cent.](#))

**SUN HYDRAULICS (NASDAQ: SNHY)**



Year	Earnings Per Share	Share Midpoint
00A	\$ 0.27	\$ 4.0
01A	\$ 0.06	\$ 3.3
02A	\$ 0.12	\$ 3.6
03A	\$ 0.15	\$ 4.0
04A	\$ 0.50	\$ 5.8
05A	\$ 0.78	\$ 14.2
06A	\$ 0.99	\$ 14.3
07A	\$ 1.34	\$ 25.6
08P	\$ 1.61	\$ 27.7
09P	\$ 0.36	\$ 19.7
10P	\$ 0.72	\$ 21.5
11P	\$ 0.89	\$ 24.2
12P	\$ 2.98	\$ 35.8
13P	\$ 4.65	\$ 83.7
14P	\$ 5.90	\$ 82.7
15P	\$ 7.99	\$ 151.8
16P	\$ 9.60	\$ 163.2

Chart and table compiled by Jim Carnett

The chart and table on page seven assume the following:

- 1) Earnings for the period 2009-2016 grow at same rate for Sun as they did for the 2000-2008 period.
- 2) The market awards Sun the same price-earnings per share ratio for the period 2009-2016 as it did for the 2000-2008 period.
- 3) Earnings per share for 2009 are expected to decline to \$.36 as the recession takes hold, but the recession ends at the end of 2009. (Likewise, earnings per share fell from \$.27 to \$.06 in 2001).

If the earnings recovery from 2010-2016 enjoys the same percentage gains as the years 2002-2008, we could see Sun's earnings rise to nearly \$10 per share in 2016, a recovery that would lead to a sharp stock price appreciation for Sun, or a 2016 midpoint share price of \$163.20.

Of course projections and assumptions often take a different path from reality. Nevertheless, we believe Sun is a fierce competitor and that its competitive position was good in 2001 and is probably much better today. As 2008 draws to a close Sun has \$33 million in cash versus \$2.7 million in 2000. Sun has less than \$0.5 million in debt versus \$10 million in 2000. Sun has much stronger profit margins and a lower break-even point than it did in 2000.

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Clients, officers, shareholders, and employees of the Fredric E. Russell Investment Management Co. have a position in Sun Hydraulics Corporation, a position of 118,593 shares (16,575 are held by Fredric E. Russell).

We may liquidate, decrease, or increase these positions at any time, without notice before or after we do so.

The writer of this report, Fredric E. Russell, lists his academic and professional background as follows: B.A., Swarthmore College, Swarthmore, PA; M.B.A. and M.A., Washington University, St. Louis, MO. He also holds the CPA certificate, and has taught accounting at the university level. He believes his love for writing and his usually correct grammar come from spending four years learning the English language at Deerfield Academy in Deerfield, MA, and from reading everything well written he can find.

You may read more about us, find other investment letters and the details of our record on our website: [www.fredricerussell.com](http://www.fredricerussell.com).

Having waded through a long letter, you deserve a few puns:

- 1) As one Sun engineer, advising the other on a personal problem, said, "... Just go with the flow."
- 2) In the hydraulics industry, most engineers have forceful personalities.
- 3) At a Sun party, the engineers were out in force.

