

**Operator:** Greetings, and welcome to the Sun Hydraulics Corporation First Quarter 2017 Financial Results conference call. At this time, all participants are on a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

It is now my pleasure to turn the call over to your host, Karen Howard, Investor Relations for Sun Hydraulics. Thank you, you may begin.

**Karen Howard:** Thank you, Rob, and good morning, everyone. We certainly appreciate your time today for our first quarter 2017 financial results conference call. On the line with me are Wolfgang Dangel, our President and Chief Executive Officer, and Tricia Fulton, our Chief Financial Officer. Wolfgang and Tricia will be reviewing the results that were published in the press release distributed after yesterday's market close. If you don't have that release, it is available on our website at [www.sunhydraulics.com](http://www.sunhydraulics.com). You will also find the slides there that will accompany our discussion today.

If you look to the slide deck, on Slide 2 you'll find our safe harbor statement. As you may be aware, we will make some forward-looking statements during this presentation and also during the Q&A. These statements apply to future events that are subject to risks and uncertainties as well as other factors that could cause actual results to differ materially from where we are today. These risks and uncertainties and other factors are provided in the earnings release as well as other documents filed by the Company with the Securities and Exchange Commission. These documents can be found at our website or at [www.sec.gov](http://www.sec.gov).

I also want to point out that during today's call, we will discuss some non-GAAP financial measures, which we believe are useful in evaluating our performance. You should not consider the presentation of this additional information in isolation or as a substitute for results compared in accordance with GAAP. We have provided reconciliations of comparable GAAP to non-GAAP measures in the tables that accompany today's earnings release as well as in the slides.

Wolfgang will get started with some highlights for the quarter and discuss the Enovation Controls integration. Tricia will go through the detail of the financial results. Then, we'll turn it back to Wolfgang for his perspective on our outlook before we open up the line for questions and answers.

So with that, it is now my pleasure to introduce Wolfgang.

**Wolfgang H. Dangel:** Thank you, Karen, and good morning, everyone. Please turn to Slide 3. We are pleased with the start to 2017. This is an especially exciting time. We're experiencing growing economic conditions as well as a lot of energy within our organization, as our teams coordinate to execute the integration plan of our Enovation Controls acquisition. But first, I'll start with summarizing the results for the quarter.

Sales grew 59%, reaching a record \$81.4 million. Sales in all of our markets around the globe grew organically, and we also benefited from the Enovation Controls acquisition, which closed in early December 2016.

For each quarter throughout this year, we will isolate the Enovation Controls revenue, so you have a basis for the organic comparison. In the first quarter, Enovation Controls contributed \$26.6 million, reflecting 36% growth over its sales in the first quarter of last year. This growth is driven by strong demand in the recreational vehicle market, specifically all-terrain vehicles, as well as rebounding end markets for construction and energy.

The core Sun business grew 7%, driven by market expansion as well as our penetration of new markets, particularly in Asia. Both of our businesses realized progressive growth as we moved through the quarter, and that trend continued through April.

Earnings per share grew 24% to \$0.38. Enovation Controls was accretive by \$0.04, which is net of acquisition-related amortization of \$0.10 per share and incremental interest expense of \$0.02 per share. On an operational basis, excluding the amortization and interest expense, Enovation Controls contributed \$0.17 per share.

You may know that the Sun business has been known for strong cash flows. Our consolidated cash flow in the quarter enabled us to repay \$16 million of the debt we incurred in December for the acquisition, leaving us with a \$124 million balance outstanding.

We are pleased with the progress we are making on the integration of Enovation Controls acquisition. Please turn to Slide 4 and I will touch on that in some more detail.

During our due diligence of the Enovation Controls acquisition, we developed a multi-phased integration plan. Phase I of that plan consists of 4 major goals:

- First and foremost is to achieve the 2017 financial forecast. We realized a solid start to the year, and we are currently on plan to attain that goal.
- Second is to leverage knowledge of market intelligence between our businesses. This impacts our sales, engineering and purchasing groups where we share information to better service our customers and provide solutions to their needs.
- Third, we have targeted revenue and cost synergies to attain by 2020. Phase I has us establishing a process to develop a concrete path to achieve them. This process is already underway, realizing it takes time to cultivate relationships among the appropriate internal and external people, to develop the plans to realize the potential opportunities.
- Finally, our engineering teams are exchanging technology know-how to drive new product development ideas. We're particularly interested in furthering electrification and digitalization of our product offering, expertise that Enovation Controls brings to Sun.

The Enovation Controls acquisition was the first step in the acquisition portion of our Vision 2025, whereby we plan to reach \$1 billion in revenue while maintaining superior profitability and financial strength.

With that overview of the quarter and integration plan, I will now turn the call over to Tricia to review the financial results for the quarter in a bit more detail.

**Tricia L. Fulton:** Thank you, Wolfgang, and good morning, everyone. I'm starting on Slide 6. First quarter sales were \$81.4 million, up 59% compared to last year's quarter. This includes \$26.6 million for the Enovation Controls business, indicating that the organic business grew approximately \$3.8 million or 7%. We did not have any price increases in 2016, so pricing did not affect the comparability. Foreign currency translation had an unfavorable \$1 million impact for the quarter, compared with last year's quarter.

I will now touch on sales by region, which are designated here in the sales bar charts. We inserted a chart in the back of the press release and the supplemental slides, summarizing this information. Since September we have been experiencing progressive improvement in all of our geographic markets. We realized year-over-year first quarter growth in each market.

In the Americas, sales grew 91% to \$47.3 million, driven by the Enovation Controls business as well as organic growth. The Enovation Controls business is heavily weighted to the U.S., driving our sales to the Americas markets up to 58% of the consolidated total. EMEA realized 28% growth to \$20.1 million and the Asia Pacific region was up 32%, to \$14 million. Our organic business grew 2%, 9% and 16% in the Americas, EMEA and APAC, respectively. We are especially pleased to see that the investments we're making in China, Korea and India are proving fruitful.

Turning to the bottom line, earnings per share were \$0.38, up from \$0.31 last year. The current quarter results included several acquisition-related items as follows:

- \$4 million of amortization expense related to acquisition items, which amounts to approximately \$0.10 per share. Of that \$4 million, nearly \$1.8 million of it is in cost of goods sold and \$2.3 million is in selling, engineering and administrative, or SEA expense.
- We realized \$1 million of incremental net interest expense, primarily due to the cash and debt used to fund the acquisition. This amounts to approximately \$0.02 per share.

Please turn to Slide 7 for review of our first quarter operating results. Gross profit grew by \$13.3 million on the higher sales, driving gross margin up to 40.3%. This improvement is net of the \$1.8 million of acquisition-related amortization I mentioned previously. This amortization was completed during the first quarter as the related inventory turns, so it will not recur in the future quarters.

SEA expenses increased by \$7.2 million to \$14.7 million. The majority of the increase was \$5.8 million due to the addition of the Enovation Controls business. Additionally, we incurred approximately \$700,000 of incremental CEO transition costs and professional fees, both of which we expect are now complete.

We incurred approximately \$2.1 million of higher amortization of intangible assets related to the Enovation Controls acquisition. We expect this will continue at least for the remainder of this year and then the amounts will vary next year due to the differing amortization periods of the assets.

Our EBITDA for the quarter grew by \$8.2 million, resulting in an EBITDA margin of 27.8% compared to 28.1% in last year's quarter. As summarized in the chart at the back of the slides and press release, it excludes the amortization that I mentioned a moment ago. But it is negatively impacted by the incremental CEO transition costs and professional fees incurred this quarter.

Please turn to Slide 8 for review of our cash flows and capital structure. During the first quarter of 2017, we generated \$12.4 million of cash from operating activities, a 19% increase over the first quarter of 2016. We used \$16 million and started repaying the debt we incurred for the Enovation Controls acquisition. We finished the quarter with \$75.1 million of cash and short-term investments and \$124 million of debt, or \$48.9 million of net debt. Our net debt to net capitalization was down to 16.5%.

At the end of 2016, we had \$81 million in cash and short-term investments and \$140 million of debt, or \$59 million of net debt. That had our net debt to net capitalization at 20%.

Continuing our practice of returning some of our cash to shareholders, in March our Board of Directors approved a \$0.09 per share regular dividend, which was paid in April. As a reminder, this is an addition to the \$0.02 per share special dividend for 2016 that we announced in February and was paid during March.

Wolfgang, I would like to turn it back to you for your perspective on outlook before we open the line for Q&A.

**Wolfgang H. Dangel:** Thanks, Tricia. Please turn to Slide 10. As Tricia indicated, we've seen improvement in all of our global regions since September. This continued through April and gives us confidence in the guidance we provided for 2017. As noted, leading indicators are pointing to a 2017 business cycle rise in the U.S. market and most global markets. It is believed that the U.S. economy is currently in the early stages of a new business cycle rising trend. Most economies in the rest of the world are similarly poised for new business cycle growth. In particular, rising trends are anticipated in Europe, China, Japan and Brazil.

Considering the industry sectors that are most relevant to Sun, the construction industry is accelerating in 2017, supported by strong recovery in industrial energy producer prices and recent investments in new energy projects. Further, the housing market is on the cusp of transitioning to accelerating growth.

More broadly, the manufacturing sector is accelerating mildly, driving the overall recovery in the industrial economy. Growth in general commodity prices and increasing global demand will contribute to upward momentum in prices and input costs.

Specific to our Electronics segment, the Institute of Printed Circuits Association reports that North American electronics business indicators are strengthening. All of these factors bode well for Sun for the remainder of 2017.

Please turn to Slide 11 for additional thoughts regarding our outlook. As I've noted previously, the growth trends cited on the prior slide do not consider changes in economic policy that might be implemented by the U.S. administration, which remain uncertain. Reflecting on recent presidential elections in Europe, there has certainly been a lot of tension and anxiety over the potential impact of nationalist and populist movements. But the elections held in Austria and most recently in France this past weekend indicated strong support for the ongoing viability of the European Union, which I expect will be positive for the global economy.

Germany has a major election later this year, which we will be watching closely. Additionally, we are cautious about other geopolitical risks that can potentially impact global trade such as those in Turkey, Syria, Ukraine, Russia and North Korea.

Please proceed to Slide 12, where we summarized our guidance for 2017. It remains unchanged from what we presented to you in February. We want to caution you that, while we are very bullish with respect to the start of our year and the economic outlook, it is normal for the first half year to outpace the second half as a result of purchasing patterns in our industry. Accordingly, we believe that our guidance numbers reflect our current outlook for the remainder of the year.

So with that, let's open up the line for questions and answers.

**Operator:** Thank you. At this time, we will be conducting a question and answer session. If you would like to ask a question please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick-up your handset before pressing the star keys. One moment please while we poll for questions. As a reminder, we can take any questions submitted over the webcast as well.

Our first question comes from Mircea (Mig) Dobre with Robert W. Baird. Please proceed with your question.

**Mircea Dobre:** Good morning everyone.

**Tricia L. Fulton:** Morning, Mig.

**Mircea Dobre:** I have multiple questions. I want to start with Enovation Controls. This business is performing better than my expectations. How is it performing vis-a-vis yours? What were you thinking when you initially bought the business? Can you help us understand what drives outperformance or underperformance versus what you expected? Was there something special in the first quarter that drove the 36% growth that you talked about?

**Wolfgang H. Dangel:** Sure, Mig. We bought Enovation Controls because we believed in the business model and the competence of the entire organization. The first quarter has been positive

and exceeded expectations. Nevertheless, we could realize that 2017 was shaping up well for Enovation Controls for various reasons. The end markets they are serving are doing well.

We have two lines of businesses there, one is the Power Controls business, which is tied to a lot of the off-highway vehicles and industrial stationary equipment. These markets have significantly recovered. It's not a complete surprise that we see a significant increase in business in those end markets.

The second line of business is the Vehicle Technology business line. I'm not surprised with this business line either. If you look at the key end markets and the key segments they are serving, it's all-terrain vehicle, recreational vehicles and marine. Those end markets have been doing well. I think it's due to the efforts that have been made on the Enovation Controls side over the last two years in terms of product development and project work with those specific end customers in each of those segments. All of this reflects in the Q1 performance at Enovation Controls. It's a seasonal business, the first half of the year is historically stronger than the second half of the year. Therefore, Q1 is not truly representative. You should not expect a 36% growth rate on a quarterly basis.

**Mircea Dobre:** Can you help us get a sense for the seasonality of this business? What happens in the front half versus the back half, either as a percentage of full year revenues or however you want to discuss it?

**Wolfgang H. Dangel:** Sun's core business is the hydraulics business line. Enovation Controls compares reasonably well to the historic Sun business cycle and the curves that you have been seeing on the hydraulics side. As I pointed out, the only distinction is in Vehicle Technologies. It has a project-driven approach that makes you depend a little bit more on the performance of the individual OEMs you're working with. Again, I think, due to the technology competence Enovation Controls has, they have been doing well with their target OEMs. So, that contributed definitely on top of the normal seasonality that you would see in their business during Q1.

**Mircea Dobre:** Sorry to keep pushing you on this, but I think it's an important topic. Your Electronics business did north of \$27 million of revenue, approximately \$26 million was from Enovation Controls. If I look at your guidance for the full year, in terms of what you expect for the Electronics business, then the remaining three quarters are basically guided for revenue that's below \$22 million. Is there conservatism built into your guidance? Should we anticipate in the back half of the year sequentially that revenues need to drop to the tune of 20% versus what we have seen in the front half because of seasonality?

**Wolfgang H. Dangel:** Yes, I can't tell you if it will drop to the level of \$22 million, but I can tell you we have limited visibility of the second half of this year. However, we have to be honest. We have literally zero visibility for the fourth quarter of this year. Now we have strong indications of what will happen in the third quarter. Historically, we know that the second half of the year is lower in revenue. Whether we will drop down to \$22 million, I can't tell you today. That would be sheer speculation and I don't want to do that at this stage.

**Mircea Dobre:** You have a forecast out for the full year in terms of revenue. What's embedded in the initial forecast and how did you think about it? How has the first quarter trended versus your initial forecast, which to me would look like the first quarter trended above what you were thinking initially when you issued the guidance?

**Wolfgang H. Dangel:** Yes, that's correct. The first quarter was stronger, as I said, given the reasons I stated. First quarter was stronger-than-expected, but having no visibility of the fourth quarter, I think it would be sheer speculation here to sit and throw out the numbers. I don't want to do that. We gave you guidance in February, and we feel pretty confident based on everything we

see and looking at historic business curves and business data at Enovation Controls that we will be within that guidance.

**Mircea Dobre:** Okay, Wolfgang, fair enough. Can you help us understand how you think about incremental margins for this business? We can talk about it on an adjusted basis, excluding amortization, just to keep things simple. An extra, call it, dollar or a million dollars of sales, what sort of incremental profit pull-through would Enovation Controls be posting normally?

**Tricia L. Fulton:** Their incremental revenue dropped very similarly to what you have historically seen in the Sun business, which has been a 40% to 50% drop on incremental revenue. They have a fairly high fixed cost base that gets absorbed quickly with incremental revenue. Whereas, Sun tends to get strong leverage at the gross margin level, where the fixed costs are. Enovation Controls tends to have more fixed costs in the SEA section.

**Mircea Dobre:** Can you clarify the run rate for SEA going forward? You've done a little higher at \$14.7 million. But as I understand, roughly \$700,000 of that is going to be going away. Is it fair to think of about \$14 million as a run rate going forward, or is there something that could potentially be added to that number as the year progresses?

**Tricia L. Fulton:** It's a pretty good estimate for where we are right now. But that being said, we are continuing to make investments similar to the investments that we made last year when we added the regional application specialists, and we are continuing to expand sales and marketing efforts in Asia as well. We will let you know when those things are happening, but given everything that's in place right now, I think your \$14 million number is pretty good. But, realize that we are going to continue to make investments going forward as required for what we see in the marketplaces in this region.

**Mircea Dobre:** Sure, fair enough. Is there a way to parse out the impact of new product introductions? I remember you talking about this being a growth driver when you announced the acquisition. So, when we're looking at this, call it, 30-plus-percent growth. How many points of that would you say are owed to this new product initiative really?

**Wolfgang H. Dangel:** Well, it depends on the definition of new products, because the life cycle of products on the Electronics side is obviously significantly shorter than on the Hydraulics side. I think if you look at new products, and you would look at a three-year time frame, my guesstimate would be that probably 70% to 80% is new products. So, revenue that you see today is probably two-thirds to three-quarters due to new products that have been developed over the last three years, and one third is probably based on legacy products carried forward.

**Mircea Dobre:** We can follow up off-line for more there. Moving on to the Hydraulics business, historically, you and I have usually talked about seasonality in this business on these calls. I recall that normal seasonality in your core business would have your revenues up to the tune of 7% sequentially in the second quarter from the first. I'm trying to understand if that's still an appropriate way to think about it, particularly given Wolfgang's comments vis-a-vis demand continuing to improve through the quarter and into April?

**Tricia L. Fulton:** I think it's a fairly good assumption on the Hydraulics side that we would see a bump in Q2 over Q1. We have historically talked about that being a normal seasonal pattern. As you'll recall from our script, we were seeing growth in all of the regions, but the Americas was, by far, the weakest of all of those. We are seeing a lot more growth in Europe and Asia than we are in the Americas. So, I think there's still probably some opportunity for more growth in the Americas as we roll through into Q2.

We're seeing some recovery in the end markets, and we're getting good information about a positive marketplace from the distributors that we have in the North American markets, but it certainly is not

at the level yet that we are seeing in the rest of the regions. So, I would expect that we will see some bump in Q2 related to normal economic growth.

**Mircea Dobre:** Okay. Regarding distributors, I'm trying to get a sense of what you're hearing from distributors in terms of stocking levels and if there is a need for a restock in North America. Can you parse out OEM demand versus distributors? Does it appear to be more driven by just pure OEMs or is it distributors?

**Wolfgang H. Dangel:** To answer the first question, we pull inventory levels from the channel on a quarterly basis. Inventory has come a little bit down in the channel, not significantly. The second question, whether it's more OEM driven versus distribution business driven, I would say it's across-the-board and it depends on the end market specific OEMs are operating in. I think oil and gas has recovered, but is not as strong as the construction industry. It depends on the OEM you're dealing with. It's growth with small, medium and large OEMs and some of the resellers.

**Mircea Dobre:** I see. I know that you did not put through a price increase this year. What are your views for price increases on a longer-term basis versus what you are able to do historically from a competitive dynamic aspect? Do you feel as if you are still able to capture your typical price increases in the Hydraulics business compared to what are you seeing on the raw materials front? Are you getting any pressure there? Is there really any way to offset it, given that you haven't increased prices in Hydraulics?

**Wolfgang H. Dangel:** That's correct, Mig. We are going into the third consecutive year without price increases. We feel comfortable maintaining this attitude for the time being. I don't want to speak about 2018. With regard to suppliers, we have seen minimal pressure for price increases so far. Based on the conversations we are having with some of our suppliers, we expect them to do exactly the same thing we are doing. We are launching continuous improvement initiatives to make up any potential cost increases through productivity and efficiency improvements. We launched a major lean initiative a year ago. I feel comfortable that we still have a lot of room for improvement as far as cost is concerned. I don't see an immediate need with regard to price increases to customers nor to absorb any price increases from suppliers, because we would expect they will align themselves with our way of thinking.

**Mircea Dobre:** What is the optimal capital structure for the Company? How are you thinking about leverage? Obviously, you are paying down the debt related to the acquisition. You have aggressive goals, as you look out to 2025 in terms of growing revenue. What is your tolerance for leverage at the high end? How do you think about average leverage through the cycle?

**Tricia L. Fulton:** We have availability on our credit facility to go out much higher than we are currently. If an opportunity were there, we wouldn't have trouble utilizing that, and that's why we put that facility in place. But certainly, as you've seen our goal is to pay down the debt as quickly as we can so that we can lower leverage. There are other ways for us to pay for acquisitions as well, such as issuing stock. That has been a consideration in deals that we've looked at in the past and certainly not ruled out by any stretch. We understand that we do have debt available as needed to pay for an acquisition that could come up that would potentially be very accretive to the business and also create the cash flow that would help us pay down the debt as quickly as we could.

**Mircea Dobre:** Sure. I appreciate that.

**Wolfgang H. Dangel:** We have substantial opportunities here to create free cash flow, as you can see from those numbers. As stated during earlier calls, the intention is to repay debt as quickly as possible. Other tools could come into consideration as we move forward from here. Generally, the guideline is to generate free cash flow to repay the debt as quickly as possible. I think we've made big strides in the first quarter of this year. From a balance sheet perspective we are sitting on a

tremendous amount of cash, particularly overseas. If legislation changes down the road, that would provide ample opportunities to deal with the debt situation.

**Mircea Dobre:** I appreciate all of that. Do you define leverage as debt-to-EBITDA? Are you comfortable with your business' cyclicalities? Do you see yourself at a position where you could take leverage three or four times debt-to-EBITDA in order to do a deal? Do you think you have that kind of an appetite? Is there a specific threshold from that leverage standpoint where an equity issuance or other alternatives come into play?

**Tricia L. Fulton:** Under our current debt agreement, we are allowed to lever up to 3.75 times with an acquisition. We wouldn't have put that in place if we weren't comfortable with utilizing it, depending on where we are in the business cycle. If an opportunity comes up we prefer to stay below that. But, we do have the opportunity to utilize that as we would see fit under our agreement.

**Mircea Dobre:** All right, I appreciate all the color. Thank you.

**Operator:** As a reminder, if you would like to ask a question, please press star, one on your telephone keypad. One moment please while we pull for questions. We do have a question from the webcast; Karen please proceed with the question.

**Karen Howard:** Thanks, Rob. Yes, we have a question submitted on the webcast from Kevin Sonnett with RK Capital. It's in regard to Enovation Controls. He says, "Please discuss the mix of the end markets and both product lines a little more. Specifically, such as the breakdown of the mobile, off-highway, construction, equipment, etc., and the overlap with Sun Hydraulics. What are the biggest end market products in this part of Enovation Controls? The other part, the recreation end market, what are the biggest end markets such as ATVs, marine and so forth, like boats, yachts. With ATVs, I believe OEMs have struggled here, too much inventory, low-priced, Asian competition, driving prices lower."

**Wolfgang H. Dangel:** Let's start with the Enovation Controls Power Controls business line. Within the key end markets there are off-highway vehicles and industrial stationary equipment. When we refer to off-highway vehicles, about 40% is in construction. A small portion is in agricultural, a significant portion is in utility vehicles. If we look at Vehicle Technologies, all-terrain vehicles and recreational vehicles, that's about 40% of the business and 60% of the business is marine. If we look at Hydraulics, about a quarter of our business is in material handling, a third of our business is in construction and mining and the rest is equally split over other industrial applications. There is a bit of agriculture and forestry in there as well.

The latter part of the question was about how OEMs having struggled. There is too much inventory of low-priced Asian competition. Historically, we are not competing with those type of people. They are trying to enter the customers and end markets we are operating in. But historically, Sun and Enovation Controls have premium products for very sophisticated applications. So, we see less competition with low-priced Asian competitors across the board.

**Operator:** Ladies and gentlemen, we have reached the end of the question-and-answer session. I'd like to turn the call back to Management for closing comments.

**Wolfgang H. Dangel:** Thank you, again, for your participation this morning. Thank you to all of the hard-working Sun employees who are driving our results. We look forward to updating you on our second quarter progress in early August. Have a great day.

**Operator:** This concludes today's teleconference. You may disconnect your lines at this time. We thank you for your participation. Have a great day.