Sauer.

Sauer Inc. NINETEEN NINETY EIGHT Annual Report

98

Sauer is a global leader in the design, manufacture and sales of highly engineered hydraulic systems and components for leading manufacturers of off-highway mobile equipment used in construction, road building, agriculture, turf care and specialty vehicles.

Contents:

Product lines

Total system capabilities

Sauer products are components and integrated hydraulic systems that generate, transmit and control fluid power in off-highway mobile equipment. Original equipment manufacturers (OEMs) use our hydrostatic transmissions, gear pumps and motors, microprocessor controls and electrohydraulics to provide the hydraulic power for the propel, work and control functions of their vehicles.

Corporate headquarters

Ames, Iowa U.S.A.
Neumünster, Germany

Plants

Ames, Iowa U.S.A.
Freeport, Illinois U.S.A.
LaSalle, Illinois U.S.A.
Lawrence, Kansas U.S.A.
Minneapolis, Minnesota U.S.A.
Newtown, Pennsylvania U.S.A.
Sullivan, Illinois U.S.A.
West Branch, Iowa U.S.A.
Bologna, Italy
Dubnica, Slovakia
Neumünster, Germany
Povazska Bystrica, Slovakia
Swindon, England
Shanghai, People’s Republic of China

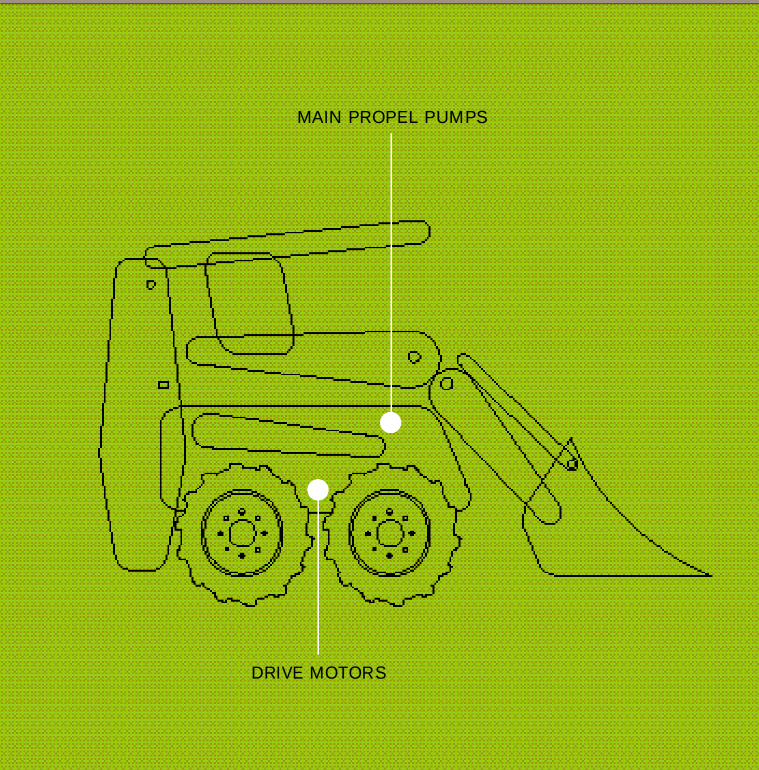
Key markets

Construction
Road building
Agriculture
Turf care
Speciality vehicles

SAUER INC. IS A HOLDING COMPANY THAT CONDUCTS ITS BUSINESS GLOBALLY UNDER THE SAUER-SUNDSTRAND NAME.

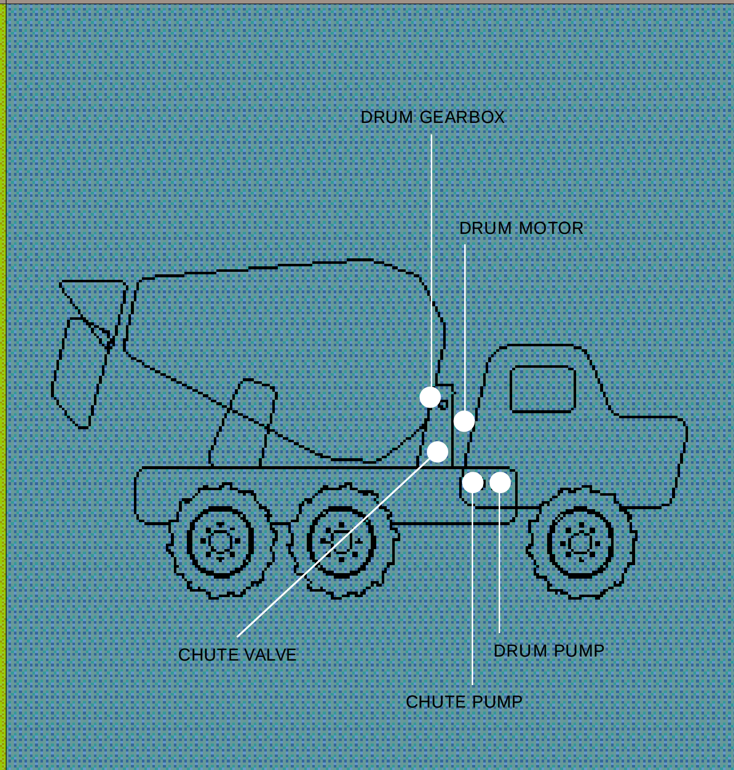
1 Propel function

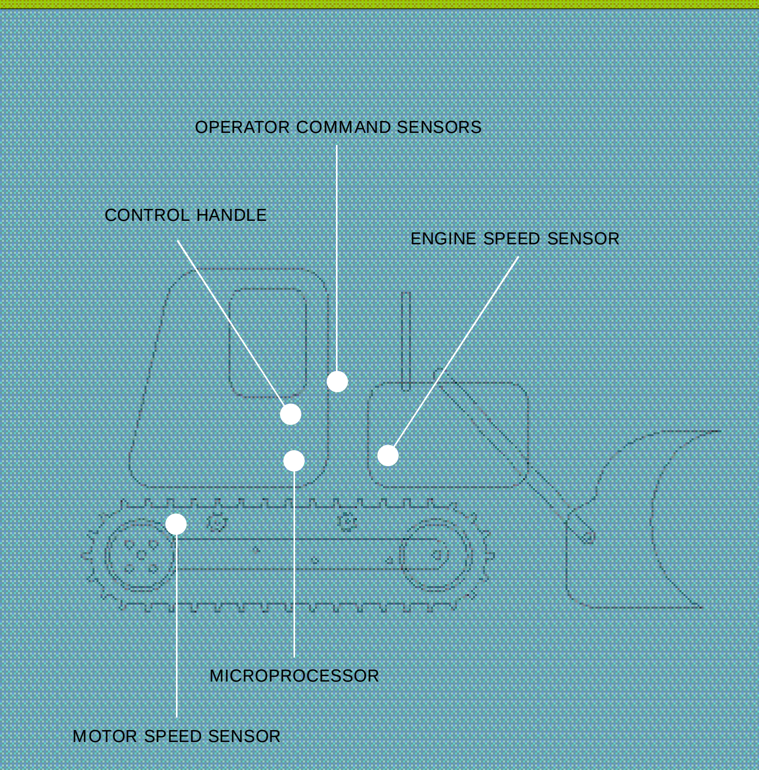
Most of Sauer's revenues come from products that transmit engine power to the wheels or tracks of a vehicle. Providing efficiency, reliability and installation flexibility, these products include hydrostatic transmissions, gear reducers and integrated hydrostatic transaxles.



2 Work function

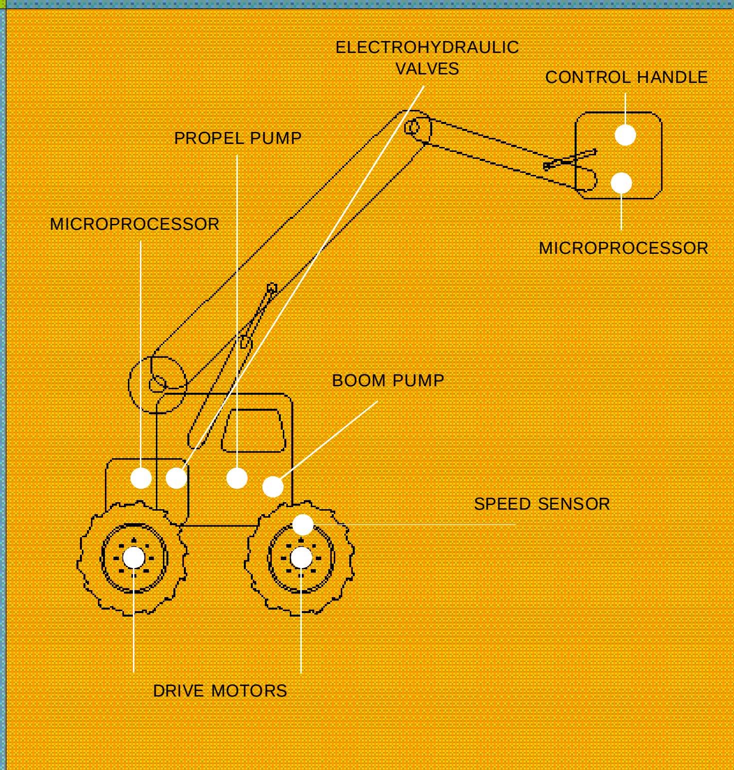
Sauer manufactures products that transmit power from a vehicle's engine to perform various work functions. These products include gear pumps and motors; multi-pump assemblies; open circuit piston pumps; and gearboxes.





3 Control function

Microprocessor electronic controls provide smart interfaces, which make equipment easy to operate and precise in function. Sauer controls include microcontrollers; grade and slope sensors and controllers;joysticks; speed and position sensors; and solenoid-operated valves.

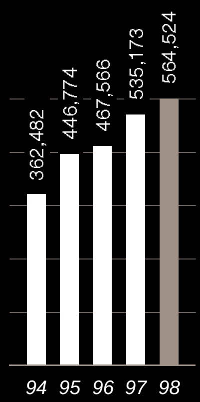


4 Integrated vehicle systems

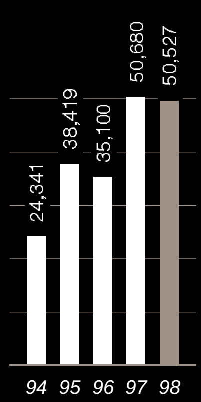
OEMs are producing more productive and complex machines that benefit from totally integrated systems provided by a single-source supplier. Sauer systems effectively power and control a vehicle's propel, work, fuel management, safety, cooling, braking and steering functions.

Financial summary

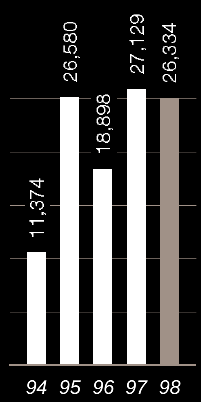
Dollars in thousands except per share amounts	*1994*	*1995*	*1996*	*1997*	*1998*
Operating Data:					
Net sales	$362,482	$446,774	$467,566	$535,173	$564,524
Earnings before interest and taxes	$ 24,341	$ 38,419	$ 35,100	$ 50,680	$ 50,527
Net income	$ 11,374	$ 26,580	$ 18,898	$ 27,129	$ 26,334
Per Share Data:					
Diluted earnings per share	$ 0.47	$ 1.10	$ 0.78	$ 1.12	$ 1.01
Dividends per share	$ 0.08	$ 0.32	$ 0.32	$ 0.32	$ 0.29
Book value per share	$ 1.58	$ 2.46	$ 2.93	$ 3.52	$ 5.69
Ratios:					
Return on sales	7.9%	10.0%	8.9%	11.1%	10.6%
Return on average net assets	25.2%	30.6%	22.2%	25.8%	20.3%
Debt to debt-equity	56.7%	53.6%	53.1%	53.6%	45.0%
Other:					
Backlog (at year end)	$187,400	$235,600	$227,000	$277,500	$261,700
Capital expenditures	$ 21,350	$ 45,689	$ 56,284	$ 66,750	$ 98,582
Number of employees (at year end)	2,628	2,899	3,055	3,751	3,710
Sales / total compensation expense	3.15x	3.37x	3.46x	3.66x	3.68x



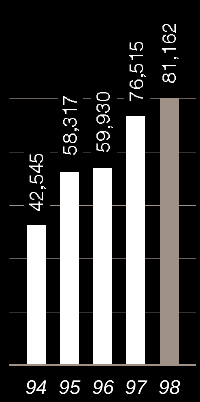
Net Sales
($ in thousands)



EBIT
($ in thousands)



Net Income
($ in thousands)



EBITDA*
($ in thousands)

** EBITDA – represents net income, plus provision for income taxes and net interest expense, plus depreciation and amortization.*

A message to our stockholders

Sauer met the challenges of 1998 by outpacing the industry and securing our market and technology leadership. After a strong first half and the excitement of our initial public offering in May, the year ended with some market downturns that adversely affected our financial performance. Yet, while some of our markets experienced cyclical sales, we recorded another year of sales growth, technology innovations and customer program wins that will ensure our profitable growth and keep Sauer the preferred hydrostatic and hydraulic system supplier in the years to come.

Our net sales for 1998 were up 5.5% to $564.5 million, despite soft market conditions during the second half of the year. Our net income for the year was $26.3 million or $1.01 earnings per share, compared to $27.1 million or $1.12 per share in 1997. Our financial results were affected by the higher costs associated with ongoing investment for long-term growth, coupled with the slowing sales growth. Our OEM customers' sales slowed in the fourth quarter due to a significant downturn in the agricultural market in North America and Europe,as well as the economic uncertainties in Brazil and Southeast Asia.

Our company was founded 12 years ago, and our roots in the off-highway mobile equipment industry go back more than 30 years. We have grown accustomed to weathering market ups and downs and meeting the changing needs of customers, who range from small distributors to large multinational original equipment manufacturers of off-road mobile equipment. Our strong commitment to maintaining our leadership position is demonstrated in our ongoing capital investment, which was $99 million in 1998 and is expected to be about $70 million for each of the next several years.

Among the highlights of 1998 was our initial public offering of company stock, which strengthened our balance sheet and provided the resources we need to grow along with our customers, who expect an increasingly high level of performance in products and services. Most importantly, we were able to offer our 3,700 employees the opportunity to be owners of the company. We encourage a culture of teamwork and excellence that will be enriched by direct employee ownership. Sauer has a reputation for employing the best and the brightest in our industry. We believe our status as a public company will give us an even higher profile, allowing us to attract and retain talented and highly motivated individuals.

In operations, we secured four major customer program wins for new vehicle applications, representing more than $50 million in new business. While these programs will be in development for some time, all four call for fully integrated, advanced-control systems that support new vehicle applications of major OEM customers. We have developed close, long-term relationships with major off-highway equipment manufacturers, who rely on Sauer to provide a significant amount of component content for their vehicles. Working together, we are setting the industry standard for quality and technology.

We secured this new business on the strength of our proven abilities. Sauer is widely recognized as the technology leader in high-efficiency hydrostatic transmissions, high-performance hydraulics, and advanced microprocessor controls, which are used separately or as part of an integrated system that powers and controls a vehicle's propulsion and work functions. In addition, customers depend on our global service network and responsive organization, which is linked worldwide by electronic communications, including one of the most advanced CAD-CAM systems. Our skilled workforce includes more than 200 engineers who are technology experts committed to understanding and meeting customer needs.

(L–R)

Tonio P. Barlage President and Chief Operating Officer

Klaus H. Murmann Chairman and Chief Executive Officer

David L. Pfeifle Executive Vice President

During the past two years, we started up five manufacturing plants, including facilities in Slovakia, China, and the newest one in Lawrence, Kansas. During this period of plant and equipment upgrades, we have effectively increased our production capacity by 25%. We also have expanded our geographic reach by moving further into the Asian and Latin American markets. To be a global leader and serve our customers, we believe we must focus our efforts on the key markets of Europe, Asia and the Americas.

Our core product lines performed well during the year, and our Turf Care products had an especially strong showing. Sauer is the leading provider of hydrostatic transmissions to manufacturers of consumer and commercial lawn and garden vehicles. In just eight years, this primarily U.S.-based business has grown from $20 million to $120 million, and we expect continued strong growth for the foreseeable future.

There is no question that our first year as a public company was a challenging one. We enter 1999 with a cautious outlook, confident in the knowledge that we are continuing to win new customer product programs.

Our strategy for continuing profitable growth is based on five objectives: 1) expand our per-vehicle content by providing more components and integrated systems; 2) gain market share through new applications such as aerial lifts; 3) expand our global reach; 4) make acquisitions that fit well with our strategy and culture; and 5) improve our operating margins through greater internal efficiencies.

We are making significant strides in achieving these key objectives, which will be the focus of our efforts in 1999 and beyond. While we expect soft markets to continue in agriculture, we will outpace the market by following this growth strategy. We can offset market downturns and increase the value we add by expanding the functions we provide for each customer's vehicle.

We are grateful to our customers for their continuing support and business. They provide us with ongoing challenges that satisfy our spirit of creativity and development. By providing them with specialized products and services, we free them to focus on what they do best. And, together, we are providing the market with smarter, more efficient and easier to operate vehicles.

Our organization is united in its commitment to quality, service and progress. Since long before it was in vogue, we have provided value, integrity, responsive service and reliable products. While many companies talk about how they make a difference, our employees prove it every day. We appreciate their hard work, dedication and unfailing willingness to drive change. We are most grateful for our stockholder's ongoing support that allows us to grow and be successful. The outlook for Sauer is bright as we gain market share and expand our global business.

Klaus Murmann

Klaus H. Murmann
Chairman and Chief Executive Officer

Tonio P. Barlage
President and Chief Operating Officer

David L. Pfeifle
Executive Vice President

Sauer is dedicated to being the hydraulics technology leader, quality leader and market leader in five key markets: construction, road building, agriculture, turf care and specialty vehicles.

14 manufacturing facilities 3,700 customer-focused employees

Construction and Road Building

Through its global manufacturing operations, Sauer designs, manufactures, and sells a broad range of high-power, high-performance hydrostatic transmissions, which have become the dominant type of propulsion drive train for off-highway mobile equipment. With more than 30 years of experience, Sauer is the market and technology leader in several diversified global markets, foremost of which are construction and road building. Our customers are primarily large multinational original equipment manufacturers (OEMs) that produce earthmoving machinery, all types of concrete transportation and pumping equipment, compactors, concrete and asphalt pavers and skid steer loaders.

Because the vehicles in this market are some of the most technologically demanding, Sauer develops customized components specifically configured for individual customer applications. As a result, we have cultivated long-term customer relationships in which our engineers work closely with customers to design to the highest performance standards during program development, a cycle that can take as long as six years for a major new machine. Once a successful new vehicle application hits the market, it often sets an industry standard, and other OEMs look to us for similar systems. Our components can greatly increase a vehicle's productivity and ease of operation by integrating propel and work functions into an efficient machine management system. They also increase the Sauer content per machine, which is one of our key growth strategies.

National infrastructure development and private-sector construction drive market demand, which is steady despite the fact that some U.S. and European OEMs have experienced slowing export sales to Asia and Latin America.Sauer's recent developments for this market include a new medium-power series of hydrostatic transmissions; high-torque, low-speed motors; and advanced microprocessor controls. In addition, our worldwide service and support network and strong customer relationships have earned us a reputation for quality, innovation and being easy to work with.

equipment

“We look for total mobile equipment solutions.”

Frank Ramm
Engineering
Neumünster, Germany

Marina Athanasiu
Quality Control
Neumünster, Germany

Frank and Marina are part of the Sauer team that is leading developments in integrated vehicle systems for construction and road-building equipment. "We listen to our customers so we can determine the best solution and help them produce the most efficient vehicle," says Marina. Around the heart of the Sauer system, the hydrostatic transmission, they have integrated dedicated components and controls into a system that optimizes performance, space, noise and cost. "Vehicle manufacturers require innovative and intelligent applications of electrohydraulics for their off-highway vehicles to make them more productive as well as environmentally sound," adds Frank. "We keep our eyes and ears fixed on the market so we can respond to our customers' changing needs."

Major applications

Chip spreaders

Concrete pumps

Concrete saws

Crawler dozers

Crawler loaders

Ditchers/trenchers

Excavators

Grinders

Landfill compactors

Oil distributors

Pavers

Planers

Rollers

Skid steer loaders

Transit mixers

Utility tractors

Wheel loaders

70% of sales to OEMs 35% total market share

Agriculture

Of the five major markets Sauer serves, the agriculture equipment sector offers some of the most promising long-term opportunities despite the current soft market. While sales are down due to pressures on commodity prices worldwide, major manufacturers of tractors and combines, in partnership with Sauer, are making strategic investments in innovative machine designs that will reap gains for years to come. Sauer's technology leadership and proven ability to work in tandem with customers is giving us a clear competitive advantage.

At the forefront of this market's innovative applications is the hydromechanical transmission (HMT) for medium and large tractors. HMT tractors, developed jointly with Sauer, have received very positive initial response. Our trusted expertise in hydromechanical design, high-efficiency hydrostatic transmissions and advanced microprocessor controls has earned us the leading position in HMT design. Expectations are that during the next five years all major OEMs will begin to convert from mechanical transmissions to hydromechanical designs that offer infinitely variable speeds with better fuel economy and tractor productivity. While volume production is several years away, a number of major OEMs have committed to using Sauer's advanced designs for products in development.

In addition to price constraints, OEMs in this market are under pressure to improve equipment productivity, maximize harvest yields, and reduce the application requirements of costly and environmentally harmful fertilizers and pesticides. Our advanced hydraulic systems can make these enhancements while reducing vehicle costs. Since many agricultural tasks have to be done within a limited, seasonal time frame, equipment reliability and service support are critical success factors. Augmenting our widely recognized leadership in reliability, Sauer's worldwide service network and quick-response parts delivery are a valued asset for customers.

While soft commodity pricing and intense competition will characterize this market for the near future, we are confident that Sauer will continue to be a valued partner and market leader in this dynamic industry.

"Sauer hydromechanical transmissions are revolutionizing tractor performance."

Dave Eastwood
Marketing
Swindon, England

"We help our customers manufacture the mobile equipment that produces the world's food supply. This is an important job and our task is to improve the equipment's performance in an increasingly efficient and environmentally sound way. I am fortunate to have talented and enthusiastic co-workers who stretch themselves every day to meet the challenges of our industry. They are engineers, logistics experts, technicians and service team members. We are working closely with customers to develop the next generation of equipment, and we are helping to make a positive change in agricultural production."

Major applications

Combines

Cotton pickers

Detasselers

Harvesters

Seeders

Sprayers

Tractors

Windrowers

No.1 in greens and gardens $5 billion market

Turf Care

In the United States, a prosperous economy and a recreation-loving population is creating a steady demand for equipment to maintain lawns, gardens, landscapes and golf courses. While turf care equipment has grown into a $5 billion market in the United States during the past decade, there has been a corresponding need for more cost effective and easier-to-use machines.

Since entering this market, Sauer has helped its OEM customers transform the turf care industry by providing more efficient and convenient drive-train products. Because of our innovative product design and responsive customer service, Sauer has become the preferred provider of power components to OEMs of consumer and commercial turf care power equipment. Our subsidiary, Hydro-Gear, manufactures hydrostatic transmissions, axles and integrated hydrostatic transaxles for the leading brands of mowers and tractors.

We pioneered a clutchless hydrostatic transmission to provide our customers with a cost-effectivedriveline system that operates with greater convenience and reliability than traditional mechanical gearshift transmissions. In just eight years, tractors equipped with hydrostatic transmissions have grown from 5% to more than 50% of the market.

During 1998, our performance in this market exceeded expectations, benefiting from strong garden tractor sales and increased use of integrated hydrostatic transaxles in lawn tractors. In addition to sustaining our leading market share in the United States, Sauer is expanding marketing efforts throughout Europe. We expect demand for our product will increase as more OEMs eliminate mechanical gearshift transmissions in favor of our hydrostatic transmissions, providing us with steadily increasing sales during the next several years. As the popularity of golf and gardening grows, exacting consumers will help drive the pursuit of perfect greens and gardens, which will provide greater need for high quality, cost-effective turf care equipment.

"Zero-turn mowers powered by our transmissions can turn on a dime and reduce cutting time by more than 30%."

Ray Hauser
Engineering and Marketing, Hydro-Gear
Sullivan, Illinois

Ray is a member of the Sauer team that helped our customers streamline lawn care maintenance with reliable, cost-effective, zero-turn mowers. "Today, all commercial zero-turn mowers use hydrostatic transmissions to power the drive wheels," explains Ray, a mechanical engineer and 10-year Sauer veteran. "And, we've made the zero-turn technology affordable, safe and easy to use for the consumer, too.Sauer has established itself as the industry's front runner by offering the most complete and effective line of hydrostatic transmission products."

Major applications

Commercial wide-area, walk-behind mowers

Commercial zero-turn mowers

General turf maintenance

Lawn and garden tractors

80 independent distributors 200 service centers

Speciality Vehicles

More than 20% of Sauer's total revenues are generated from a wide range of applications for the specialty vehicle market. Our customers in this highly fragmented market are small and mid-size original equipment manufacturers whose highly specialized vehicles benefit from the flexibility and performance of Sauer mobile hydraulic products. Sauer has established itself as a leader in the design and manufacture of high performance mobile hydraulics, which allow vehicles to perform functions that could be difficult and costly using mechanical shafts, gear boxes, clutches, belts and pulleys.

Our specialty OEM customers typically don't have resident hydraulics experts or lengthy product development cycles. Instead, they have come to rely on our expertise and value us as a responsive, single source supplier of total systems. We help them introduce new technology that adds utility and productivity to their equipment. As a result, mobile hydraulics has become the dominant technology for the propulsion and work function of off-highway equipment as well as for the work function of on-highway special purpose vehicles.

One of the fastest growing and best performing segments in this market is hydraulic-powered aerial lifts, which have virtually replaced scaffolding in construction and maintenance work. Developing technology is enabling higher and higher lift heights, which puts more demand on the precision of controls, smoothness, and safety of operation. Since many of these vehicles are sold to the rental industry where equipment must be very safe and easy to use and maintain, Sauer designs its systems to ensure the equipment performs safely, effectively, and with less labor intensity. We have had steady growth in this segment and expect it will continue for the foreseeable future.

The specialty vehicle market is a natural fit with our worldwide network of distributors that carry components to complement Sauer products and provide aftermarket service. Sauer sells its transmissions and systems to some 80 independent distributors that operate more than 200 service centers around the world.

*“Our new
aerial lift motor
was designed,
developed
and released
to production
in record time.”*

Steve Gorseth
Electronic Controls Design
Minneapolis, Minnesota

Randy Rodgers
Marketing
Ames, Iowa

Steve Frantz
Design Engineering
Ames, Iowa

It takes real teamwork to support the needs of the fast-moving, fast-growing aerial lift market. Representatives of Sauer's marketing, electrohydraulics and hydrostatic engineering departments all work together to help clients facilitate their product development process from initial concept through product design and delivery. "Nearly all of Sauer's core products are used in our aerial lift systems, plus we're rolling out a newly patented joystick and hydraulic motor, which are designed to further enhance aerial lift efficiency," says Randy. "We're working on something new all the time. Change is a way of life at Sauer and that's how we earned our reputation for being easy to do business with."

Major applications

Fruit pickers

Industrial lift trucks

Logging equipment

Marine equipment

Mining equipment

Oil field equipment

Railway maintenance

Rough terrain fork lifts

Self propelled boom aerial lifts

Self propelled scissor aerial lifts

Snow groomers

Sweepers

Tree shakers

Truck and bus fan drives

3 bugs

Think of balancing three Volkswagen Beetles on a postage stamp – that's the equivalent pressure generated by a Sauer hydraulic system, which can transmit 7,000 pounds of pressure per square inch.

100 pyramids

More than five hundred million tons of concrete are transported each year by transit mixers equipped with Sauer hydrostatic transmissions. That's enough to build 100 Great Pyramids!

2x

Sauer is a growth company on track to double its annual sales every 5 to 7 years.

25

2,000,000 square miles

Consider a lawn one half the size of the United States — that's about two million square miles and roughly the area of grass cut each year by all the mowers powered by Sauer transmissions.

40,000

The combined years of service that Sauer's 3,700 employees bring to their customers.

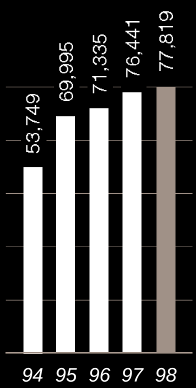
1,000,000

The number of off-highway vehicles equipped each year with Sauer hydraulics.

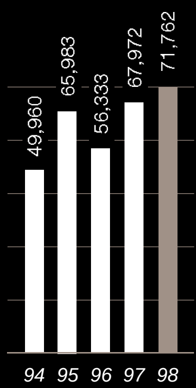
years

More than 500 Sauer employees have 25 or more years of hydraulic industry experience.

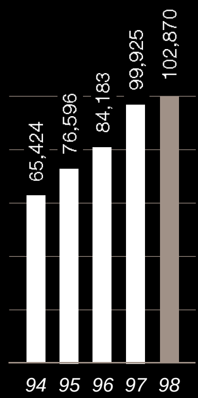
Sales by market



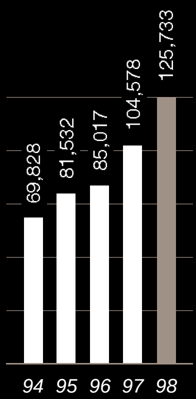
Construction
($ in thousands)



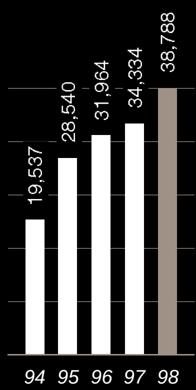
Road Building
($ in thousands)



Agriculture
($ in thousands)

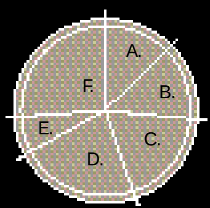


Turf Care
($ in thousands)



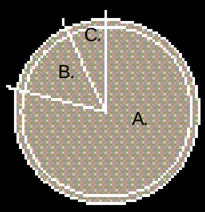
Speciality
($ in thousands)

1998 sales



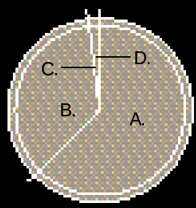
Markets
($ in thousands)

A. Construction	$ 77,819
B. Road Building	71,762
C. Agriculture	102,870
D. Turf Care	125,733
E. Specialty Vehicles	38,788
F. Distribution and other	147,552
	$ 564,524



Product Lines
($ in thousands)

A. Hydrostatic Transmissions *(primarily propel function)*	$ 445,585
B. Open Circuit Gear Pumps and Motors and Piston Pumps *(work function)*	78,384
C. Electrohydraulics and Controls *(control function)*	40,555
	$ 564,524



Geographic Regions*
($ in thousands)

A. North America	$ 351,100
B. Europe	196,706
C. Asia	11,039
D. Other	5,679
	$ 564,524

** Geograpic Regions – based on location of customer.*

financial review

Contents:

Management's discussion and analysis of financial condition and results of operations

Safe Harbor Statement This annual report and other written reports as well as oral statements made from time to time by the Company may contain "forward-looking statements," statements regarding matters that are not historical facts, but rather are subject to risks and uncertainties. These statements are based on current financial and economic conditions and rely heavily on the Company's interpretations of what it considers key economic assumptions. Actual future results may differ materially depending on a variety of factors. These factors, some of which are identified in the discussion accompanying such forward-looking statements, include, but are not limited to, general economic conditions, foreign currency movements, pricing and product initiatives and other actions taken by competitors, ability of suppliers to provide materials as needed, labor relations, the Company's execution of internal performance plans, and other changes to business conditions.

Overview Sauer Inc. designs, manufactures, and sells its products in North America and Europe and sells its products throughout the rest of the world either directly or through distributors. The Company also manufactures and sells its products in East Asia through its manufacturing plant and sales office in Shanghai, China. Sauer's products are used by original equipment manufacturers ("OEMs") of off-highway mobile equipment, including construction, road building, agriculture, turf care and specialty markets.

1998 was a year in which Sauer Inc. continued to grow, achieving record sales levels. As planned, the Company continued to make substantial investments in manufacturing capacity and product development to support new customer programs and additional growth in future years. The Minneapolis operations moved into a facility nearly doubling the available capacity, the Company's Slovakian operations continued to expand, and the Hydro-Gear plant completed an expansion of over 30,000 square feet. In addition, in early 1999, the Company completed construction of a new manufacturing facility in Lawrence, Kansas. In support of these and future expansions, the Company completed an initial public offering in May 1998 which helped fund these capital expenditures and the repayment of long-term debt. Management feels that the combination of these efforts positions the Company to support its goal of continuous, profitable growth.

During 1998, the economic climate in many parts of the world deteriorated. Asia continued to experience a recession, Brazil entered a period of economic instability and the agriculture markets in many parts of the world have been hit by a recession due in part to low commodity prices. These impacts, coupled with higher costs of growth created by investments in capacity and product development, led to 1998 net income slightly below the record level of 1997.

Impact of Currency Fluctuations The Company has operations and sells its products in many different countries of the world and therefore conducts its business in various currencies. The Company's financial statements, which are presented in U.S. dollars, can be impacted by foreign exchange fluctuations through both translation risk and transaction risk. Translation risk is the risk that the financial statements of the Company, for a particular period or as of a certain date, may be affected by changes in the exchange rates that are used to translate the financial statements of the Company's operations from foreign currencies into dollars. Transaction risk is the risk from the Company receiving its sale proceeds or holding its assets in a currency different from that in which it pays its expenses and holds its liabilities.

With respect to translation risk, fluctuations of currencies against the U.S. dollar can be substantial and therefore significantly impact comparisons with prior periods. The impact is a reporting consideration only and does not affect the underlying results of operations. As shown in the table below, the translation impact on making prior period comparisons with respect to the Company's net sales can be material. However, historically the translation impact on net income has not been significant.

	PERCENTAGE SALES GROWTH OVER PRIOR YEAR		
	1996	*1997*	*1998*
As Reported	4.7%	14.5%	5.5%
Without Currency Impact	6.1%	18.9%	5.7%

With respect to transaction risk, the impact on the Company's operating results is not significant. With its various manufacturing plants located primarily in its customers' countries of operation, generally the Company sells in the same currency in which it incurs its expenses.

Results of Operations

Thirteen Weeks Ended December 31, 1998 Compared to the Thirteen Weeks Ended December 31, 1997

Net Sales – Net sales for the fourth quarter 1998 of $127.2 million decreased by $6.9 million or 5.1% from fourth quarter 1997 net sales of $134.1 million, or a 6.9% decrease excluding the impact of currency fluctuation. The decrease in sales reflects the declining economic market mentioned above, particularly in the agriculture industry. In addition, 1997 fourth quarter net sales were increased by shipping delinquencies due to capacity constraints from the first half of 1997 which were subsequently shipped in the latter part of 1997. North American net sales of $87.6 million were $7.4 million less than 1997 fourth quarter sales of $95.0 million, a 7.8% decrease. Sales in Europe for the fourth quarter 1998 of $52.8 million were $1.5 million less than fourth quarter 1997 net sales of $54.3 million, or a decrease of 2.8%. Net sales in Europe were down 10.7% from fourth quarter 1997, excluding the impact of currency fluctuation.

Cost of Sales – Cost of sales for fourth quarter 1998 of $99.6 million was 78.3% of net sales, compared to 1997 fourth quarter cost of sales of $106.7 million which was 79.6% of net sales. Fourth quarter 1998 cost of sales was impacted by an inventory adjustment of $1.1 million at the Swindon, UK, operations related to the integration of a new business system. The Company also incurred one-time adjustments of $0.2 million for severance payments related to a 30% reduction in the workforce at the Swindon plant, as well as an adjustment for import duties of $1.1 million related to reclassification of imported production material at the Sullivan, Illinois, facility. Despite these one-time adjustments and the impact of start-up costs related to the Lawrence, Kansas facility, the Company achieved lower cost of sales as a percentage of net sales in fourth quarter 1998 due to its efforts to reduce and control costs in light of the softening economic climate.

Selling, General and Administrative Expenses – Selling, general and administrative expenses for fourth quarter 1998 of $14.0 million decreased by $0.6 million or 4.1% from fourth quarter 1997 expenses of $14.6 million. This decrease reflects the Company's efforts to slow the investments in sales and marketing, information technology, and training to support the Company's growth plans and to keep these costs in line with the current and projected sales growth. The Company anticipates these costs to level off in 1999 as a percentage of net sales as the Company focuses on keeping expenses in line with projected sales.

Research and Development Expenses – Research and development expenses totaled $5.6 million in the fourth quarter 1998, $0.1 million below the $5.7 million in the fourth quarter of 1997.

Nonoperating Expenses, Net – Net nonoperating expenses of $2.0 million in the fourth quarter 1998 were $.8 million more than the $1.2 million of net nonoperating expenses incurred in the fourth quarter of 1997. Net interest expense of $2.3 million in fourth quarter 1998 decreased by $0.1 million from the $2.4 million incurred in fourth quarter 1997. Other, net expenses for fourth quarter 1998 of $0.3 million differ from the other, net income reported in fourth quarter 1997 of $1.2 million relating to numerous immaterial items.

Provision for Income Taxes – Provision for income taxes in fourth quarter 1998 of $1.4 million was $0.6 million less than fourth quarter 1997 taxes of $2.0 million. The decrease in provision for income taxes results from the decrease in net income before income taxes of $0.9 million and the decrease in the effective tax rate from 37.0% in 1997 to 30.3% in fourth quarter 1998.

Net Income – Net income for fourth quarter 1998 of $3.2 million was $0.3 million or 8.6% less than fourth quarter 1997 net income of $3.5 million. The decrease in net income in the fourth quarter is a result of decreased sales and the one-time adjustments mentioned above.

1998 Compared to 1997

Net Sales – Net sales for 1998 of $564.5 million increased by $29.3 million or 5.5% from 1997 net sales of $535.2 million. Net sales increased by 5.7% excluding the impact of currency fluctuation. Net sales in North America of $392.9 million and in Europe of $240.0 million in 1998 showed improvement over 1997 of 6.3% and 2.7%, respectively. However, the majority of this increase occurred during the first half of 1998. Increased sales of hydrostatic transmissions, led by a $21.1 million increase in the turf care market, accounted for the major portion of the growth in net sales. Electrohydraulics and valves contributed $3.1 million to the increased sales levels. Gear pumps and motors experienced a decline in sales of $1.5 million due primarily to the slumping agriculture market in both Europe and North America.

Cost of Sales – Cost of sales for 1998 of $428.3 million was 75.9% of net sales, slightly higher than the 75.5% of net sales for 1997. Higher cost of sales due to initial start-up costs of the Lawrence, Kansas, facility coupled with the one-time adjustment for import duties reclassification and the reduced higher margin sales in Asia drove this percentage up, but was mostly offset by the Company's efforts to reduce and control costs during the latter part of 1998 in light of the economic softening.

Selling, General and Administrative Expenses – Selling, general and administrative expenses for 1998 of $54.5 million increased by $1.9 million or 3.6% from 1997 expenses of $52.6 million, representing general inflation. Early in 1998, the Company was continuing to invest in sales and marketing, information technology, and training to support the Company's growth plans and investments being made in manufacturing and research and development. However, the Company began to curb such investment later in the year to keep these costs in line with the current and projected sales growth. The Company anticipates these costs to remain level in 1999 as a percentage of sales as the Company focuses on keeping expenses in line with future sales projections.

Research and Development Expenses – Research and development expenses of $22.1 million increased by $1.4 million or 6.8% from 1997 and represent 3.9% of total net sales for 1998. This continued high level of spending on research and development reflects the Company's ongoing development of new customer programs and demonstrates the Company's emphasis on being the technology leader.

Nonoperating Expenses, Net – Net nonoperating expenses for 1998 of $8.4 million were $2.1 million higher than 1997 net expenses of $6.3 million. Net interest expense for 1998 of $8.8 million increased by $1.2 million over 1997 net expense of $7.6 million, reflecting higher bank borrowings from increased capital expenditures and working capital to support ongoing growth in sales and plans for future growth. Other, net expenses for 1998 increased by $0.9 million from 1997 relating to a loss on disposal of fixed assets at the West Branch, Iowa, facility of $0.5 million and numerous immaterial items.

Provision for Income Taxes – Provision for income taxes for 1998 of $15.4 million decreased by $.5 million from 1997 provision for income taxes of $15.9 million. The decrease is a result of the decline in net income before income taxes of $1.4 million. The effective tax rates for 1998 and 1997 were 36.9% and 37.0%, respectively.

Net Income – Net income fell slightly in 1998 to $26.3 million from $27.1 million in 1997, a decrease of $.8 million or 3.0%. Degrading economic conditions as mentioned above, coupled with the significant one-time adjustment related to the import duties reclassification and start-up costs mentioned in the fourth quarter discussion above led to the net income decline. As a result, North American 1998 net income of $25.3 million decreased by $1.6 million, or 5.9%, from 1997 net income of $26.9 million. Europe's 1998 net income of $5.7 million was down $.4 million or 6.6% from 1997 net income of $6.1 million.

Order Backlog – Total order backlog at the end of 1998 was $261.7 million, compared to $277.5 million at the end of 1997, a decrease of 5.7%. During the fourth quarter of 1998, only $130.3 million in new orders were written, a drop of 27.4% compared to the fourth quarter of 1997. However, the Company received a large order during the fourth quarter of 1997 at its Hydro-Gear facility which was received during the third quarter of 1998. Adjusting for this, orders in the fourth quarter 1998 were down by 12.4% from a year ago. The primary driver in the decline in order backlog was the significant downturn in the agriculture market.

1997 Compared to 1996

Net Sales – Net sales for 1997 of $535.2 million increased by $67.6 million or 14.5% from 1996 net sales of $467.6 million. Net sales increased by 18.9% excluding the impact of currency fluctuation. Unit volume growth accounted for the majority of the growth in net sales, with net price increases accounting for less than 1% of the growth. Sales of hydrostatic transmissions accounted for the major portion of the growth in net sales, growing by 21.5%, excluding the impact of currency fluctuation. This growth came from the strong North American and European growth of 22.6% and 14.8%, respectively. Gear pumps and motors showed little growth in net sales, affected by the slower growing European markets, the principal market for the Company's gear pumps and motors, compared to the North American market. Electrohydraulics and other products' net sales grew by 21.5%, excluding the impact of currency fluctuation, reflecting the strong growth of the Company's electrohydraulic valve business in North America.

Cost of Sales – Cost of sales for 1997 of $404.1 million was 75.5% of net sales compared to 75.7% of net sales for 1996. The slight improvement (decrease in cost of sales as a percent of net sales) can be attributed to the favorable impact of increased production volumes from net sales growth offsetting the current year's unfavorable impact of increased capital investment in manufacturing capacity. Cost of sales as a percentage of net sales improved in North America, while that in Europe worsened in 1997 compared to 1996.

Selling, General and Administrative Expenses – Selling, general and administrative expenses for 1997 of $52.6 million increased by $0.7 million or 1.4% from 1996 expenses of $51.9 million. The small increase reflects general inflation, partially offset by the cost reduction efforts in Germany and the favorable impact of currency fluctuations in translation. As a percentage of net sales, 1997 expenses were 9.8% compared to 11.1% in 1996. This improvement is a result of the growth in net sales compared to the relatively fixed nature of these expenses, along with the cost reduction efforts referred to above.

Research and Development Expenses – Research and development expenses for 1997 of $20.7 million increased by $0.2 million or 1.0% from 1996 expenses of $20.5 million. Without the impact of currency fluctuations the increase was 4.2%. This reflects normal increases in wage rates and other general inflation.

Nonoperating Expenses, Net – Net nonoperating expenses for 1997 of $6.3 million increased by $0.9 million from 1996 net nonoperating expenses of $5.4 million. Net interest expense for 1997 of $7.6 million increased by $1.6 million from 1996 net expense of $6.0 million due to the increase of one percentage point in the weighted average interest rate for 1997 compared to 1996 and the increase of $4.1 million in the average daily short-term borrowings for 1997 compared to 1996. Other income increased by $0.7 million due to changes in gains and losses relating to disposals of fixed assets and currency transactions.

Provision for Income Taxes – Provision for income taxes for 1997 of $15.9 million increased by $5.7 million from the 1996 provision of $10.2 million. The increase comes from the increase in net income before income taxes of $13.9 million and the increase in the effective tax rate for 1997 of 37.0% from the 1996 rate of 35.1%.

Net Income – Net income of $27.1 million increased by $8.2 million from 1996 net income of $18.9 million, driven by the 14.5% increase in net sales. North America accounted for the increase which was in line with its increase in net sales. European 1997 net income remained unchanged compared to 1996, due to level sales between years and the weaker Deutsche mark, which had a negative impact on U.S. dollar intersegment purchases from North America, but from which North America benefited on intersegment purchases from Europe.

Order Backlog – Total order backlog at the end of 1997 was $277.5 million compared to $227.0 million at the end of 1996, an increase of $50.5 million or 22.3%.

Liquidity and Capital Resources The Company's principal sources of liquidity have been from internally generated funds, from borrowings under its credit facilities and from the Company's initial public offering during 1998.

Net cash provided by operating activities for 1998 of $63.5 million increased by $20.8 million from $42.7 million for 1997. The increase between periods arose primarily from cash flow relating to improved management of inventories and receivables and increases in accrued liabilities.

Net borrowing increases under short and long-term credit facilities for 1998 were $2.6 million compared to the net increases in 1997 of $35.7 million. Net borrowings for 1998 showed little net change due to the net proceeds from the Company's initial public offering of $48.1 million during the second quarter.

Capital expenditures for 1998 of $98.6 million increased by $31.8 million from 1997 capital expenditures of $66.8 million. In 1998, the Company continued a trend in recent years of significant capital expenditures intended to increase the Company's production capacity, flexibility and efficiency and to improve product quality. Some of the more significant expenditures during 1998 included the acquisition of the real estate and building of the Company's main facility in Germany during the second quarter, the building of the recently completed manufacturing plant in Lawrence, Kansas, the addition of 30,000 square feet to the Hydro-Gear facility and the increased production capacity added in the Slovakian plants. In all, approximately 52% of 1998 capital expenditures occurred in North America, while 47% were in Europe and some small amounts in Asia.

The cash provided by operating activities and the initial public offering funded 1998 capital expenditures of $98.6 million, dividends of $7.7 million and distributions to minority interest partners of $7.9 million.

In light of the economic conditions mentioned in the "Overview" above, the Company is in the process of reevaluating its capital expenditure requirements for the next few years. The primary emphasis will be on adding capacity to handle additional new programs, to continue to improve long-term efficiency and to remain cost competitive. For example, the recently completed Lawrence plant will produce medium power hydrostatic transmissions. This additional plant space will free up capacity at the Company's Ames facility which will be used to expand the production of high power hydrostatic transmissions for new programs. However, in light of the economic softening referred to earlier, the Company is slowing its plans to transition production to the new Lawrence facility. The Company's manufacturing plants in Slovakia and China, which started production in 1995 and 1997, respectively, are still under development and will require further investment in production machinery to increase their operating capacity and efficiency, although this will be done in consideration of economic conditions. The Company plans to continue to fund its capital expenditures from internally generated funds and increased borrowings under its credit facilities which have been reduced with the funds obtained from the Company's initial public offering of common stock. These sources of funds are expected to be sufficient to support the planned capital expenditures and the Company's working capital requirements.

Effective May 15, 1998, the Company completed its initial public offering of common stock. The net proceeds to the Company from the sale amounted to approximately $48.1 million. The net proceeds were used to repay $15.0 million of long-term indebtedness, to purchase $15.7 million of real estate and buildings for the Company's main facility in Germany previously leased from Sauer Hydraulik, and the balance was used to fund capital expenditures.

Dividend Restrictions – At December 31, 1998, the Company had $47.0 million of unused lines of credit, consisting primarily of committed U.S. lines of credit and uncommitted European lines of credit. The Company's ability to pay dividends to its stockholders is effectively limited by certain restrictive covenants contained in the U.S. Operating Company's and German Operating Company's credit agreements, which limit the amount of dividends the U.S. Operating Company and German Operating Company can distribute to the Company. During 1998, the U.S. Operating Company made distributions to the Company of $12.0 million. At December 31, 1998, an additional $14.0 million was not restricted as to payment of dividends by the U.S. Operating Company. The German Operating Company did not make distributions to the Company during 1998 and at December 31, 1998, $3.0 million was not restricted as to the payment of dividends.

Other Matters

Year 2000 Compliance – The Year 2000 computer issue is the result of computer programs being written using two digits rather than four to define the applicable year. Any of the Company's systems or applications that have time-sensitive software may recognize a date using "00" as the year 1900 rather than the year 2000, which could result in a range of issues from system failures to miscalculations. Incomplete or untimely resolution of the Year 2000 issue by the Company or critically important suppliers or customers of the Company could have a materially adverse effect on the Company's business, operations or financial condition.

To mitigate this risk, the Company has established a company-wide initiative to identify, evaluate and address Year 2000 issues. Included in the scope of this initiative are the operational and financial information technology systems, embedded software contained in machinery and equipment, and other end-user computing resources and building systems. In addition, the project includes a review and evaluation of the Year 2000 compliance efforts of the Company's key suppliers and customers.

The Company's overall Year 2000 project approach and status is as follows:

Description of Approach	*Stage of Completion*	*Timetable for Completion*
Inventory and assessment for Y2K impact of all systems	90%	March 31, 1999
Compliance of operational and financial systems	85%	March 31, 1999
Compliance of computer-dependent machine tools and equipment	50%	June 30, 1999
Compliance of personal computers	50%	June 30, 1999
Compliance of building-related systems	25%	June 30, 1999

In addition to assessing the Company's Year 2000 readiness, the Company has contacted its major production suppliers via a confirmation letter program and received responses from approximately 95% of all those suppliers stating that Year 2000 readiness will be achieved by December 31, 1999. The Company cannot guarantee that third parties on whom it depends for essential supplies and materials will convert their critical systems and processes in a timely manner. Failure or delay by any of these parties could significantly disrupt the Company's business. Although no specific testing of the readiness of the Company's suppliers is currently planned, an ongoing evaluation of the Company's suppliers will be continued.

The Company's Year 2000 project is being completed primarily through the use of its internal information technology staff, with support from outside contractors where necessary. In addition, the Company's internal audit staff is performing periodic evaluations of all of the Company's business units to assess Year 2000 readiness. On-site Year 2000 reviews were completed at the end of 1998 with follow-up reviews scheduled to be completed by the end of the second quarter of 1999. The cost of the Company's information technology and internal audit staff to evaluate and upgrade the systems has not been separately accounted for or estimated as the Company does not believe this to be material. Although the Year 2000 project is a primary focus for each business unit, there have not been any material information technology projects which have been deferred due to the Year 2000 efforts. The cost of obtaining the operational and business system upgrades is part of the ongoing maintenance of the systems to remain current with new releases, and accordingly, has not been separately accounted for or estimated.

The Company believes its greatest risk lies within its operating and financial computer systems. Necessary changes to make these systems Year 2000 ready were made as of December 31, 1998. Testing of these systems will continue during the first half of 1999. If these systems were to fail, the Company would encounter difficulty performing functions such as compiling financial data, invoicing customers, paying suppliers and communicating production requirements to its manufacturing plants. While some of these functions could be performed manually, the Company presently is not certain what the extent of the impact on operations would be.

Company locations are adding Year 2000 specifics to standard contingency plans where warranted. There is no company-wide contingency plan relating to the Year 2000. The Company intends to have completed the essential Year 2000 changes by December 31, 1999. The Company's plans and the date on which the Company believes it will complete its Year 2000 computer modifications are based on its best estimates. These estimates, in turn, are based on numerous assumptions of future events, including third-party modification plans, continued availability of resources and other factors. The Company cannot be sure that these assumptions are accurate or that these estimates will be achieved, and actual results could differ materially from those anticipated.

Euro Currency Conversion – The Company has prepared for the conversion to the euro currency and has begun handling transactions in the euro as of the beginning of 1999. The Company's business systems are multi-currency functional and the Company's European operations transact business today in various European currencies, including the euro. The Company does not have an estimate of the cost it incurred to implement the euro currency, but does not believe the costs have had a material effect on the Company's financial condition or results of operations.

Asian Crisis Impact – Several countries in Asia continue to experience a severe economic crisis, characterized by reduced economic activity, lack of liquidity, highly volatile foreign currency exchange and interest rates and unstable stock markets. The Company has a 60% interest in a joint venture located in Shanghai, China, which manufactures and sells high power hydrostatic transmissions. The Company also has export sales into Asia. The joint venture business and export sales have been and will continue to be affected by the economic crisis. Sales for 1998 were down 31.7% from 1997 levels. With total assets of $13.5 million located in China and total Asian sales for 1998 of $12.2 million, the Company has experienced some adverse effect on the results of its operations, particularly given the higher margins attributable to such sales. Many of the Company's customers also sell into Asia. Any impact on their sales could have an adverse impact on the Company's sales. The Company does not believe that the Asian crisis will have as significant an impact in 1999 as in 1998. Sales for 1999 are expected to improve slightly over 1998. As a result, the Company does not believe the impact on its sales, either individually or together with the impact of the Asian crisis on export sales and the joint venture business, will have a material adverse effect on its financial condition or results of operations, although there can be no assurance in this regard.

Impact of Recently Issued Accounting Standards – During 1998, the Company adopted two newly-issued accounting standards relating to presentation and disclosure of certain information. The Company has also evaluated the effects of two additional standards issued in 1998 and has concluded that these, coupled with the two standards adopted, do not have any material effect on the Company's financial position or results of operations. See note 3 of the Notes to Consolidated Financial Statements.

Outlook – Since mid-1998, the general level of global economic confidence appears to have fallen considerably. In particular, the agriculture market has been severely hit with falling commodity prices, Asia continues to struggle, Brazil has now devalued its currency, and there are concerns over the general economy in North America. The Company derives less than 20% of its worldwide sales from the agriculture market, less than 3% from Asia and less than 1% from Brazil. While the Company expects to see a downturn in its core business of perhaps 10% in 1999, overall sales are expected to remain flat to slightly higher in 1999 due to a number of new customer programs which begin production in 1999. The Company expects to experience pressure on profit margins, although steps have already been taken to contain operating expenses and other fixed costs in order to lessen this pressure. The Company believes it will continue to out pace the growth in its markets due to ever-increasing opportunities in a broad range of applications coupled with an emphasis on controlling operating costs.

Consolidated statements of income

(Dollars in thousands, except share and per share data)	FOR THE YEARS ENDED DECEMBER 31, 1996	1997	1998
Net Sales	$467,566	$535,173	$564,524
Costs and Expenses:			
Cost of sales	354,034	404,065	428,311
Selling, general and administrative	51,856	52,575	54,513
Research and development	20,505	20,655	22,089
Total costs and expenses	426,395	477,295	504,913
Operating income	41,171	57,878	59,611
Nonoperating Income (Expenses):			
Interest expense	(6,523)	(8,305)	(9,244)
Interest income	564	698	430
Royalty income	1,156	1,150	986
Other, net	(584)	144	(576)
Nonoperating expenses, net	(5,387)	(6,313)	(8,404)
Income Before Income Taxes and Minority Interest	35,784	51,565	51,207
Provision for Income Taxes	(10,243)	(15,944)	(15,379)
Income Before Minority Interest	25,541	35,621	35,828
Minority Interest in Income of Consolidated Companies	(6,643)	(8,492)	(9,494)
Net income	$ 18,898	$ 27,129	$ 26,334
Basic and diluted net income per common share	$ 0.78	$ 1.12	$ 1.01
Weighted average basic shares outstanding	24,225,000	24,225,000	26,148,288
Weighted average diluted shares outstanding	24,225,000	24,225,000	26,150,302

The accompanying notes are an integral part of these statements.

Consolidated balance sheets

(Dollars in thousands, except share and per share data)	AS OF DECEMBER 31, 1997	1998
Assets		
Current Assets:		
Cash and cash equivalents	$ 7,363	$ 8,891
Accounts receivable (net of allowance for doubtful accounts of $3,195 and $3,166 in 1997 and 1998, respectively)	77,170	73,661
Inventories	89,031	89,195
Other current assets	9,557	9,984
Total current assets	183,121	181,731
Property, Plant and Equipment, net	191,690	262,527
Other Assets:		
Intangible assets, net	2,964	3,769
Deferred income taxes	6,463	2,328
Other	4,497	9,416
Total other assets	13,924	15,513
	$388,735	$459,771
Liabilities and Stockholders' Equity		
Current Liabilities:		
Notes payable and bank overdrafts	$ 60,278	$ 41,767
Long-term debt due within one year	952	2,398
Accounts payable	46,392	38,271
Accrued salaries and wages	6,385	7,683
Accrued warranty	9,398	8,601
Other accrued liabilities	15,897	12,884
Total current liabilities	139,302	111,604
Long-Term Debt	75,198	106,862
Other Liabilities:		
Long-term pension liability	28,959	33,044
Postretirement benefits other than pensions	12,784	13,608
Deferred income taxes	4,018	4,746
Other	10,374	5,419
Total other liabilities	56,135	56,817
Minority Interest in Net Assets of Consolidated Companies	32,799	35,584
Stockholders' Equity:		
Common stock, par value $.01 per share, authorized 45,000,000 shares in 1997 and 1998; issued 24,900,000 in 1997 and 28,072,050 in 1998; outstanding 24,225,000 in 1997 and 27,397,050 in 1998	249	281
Additional paid-in capital	75,098	120,092
Retained earnings	12,773	31,416
Accumulated other comprehensive income	(119)	1,813
Unamortized restricted stock compensation	—	(1,998)
Common stock in treasury (at cost), 675,000 shares in 1997 and 1998	(2,700)	(2,700)
Total stockholders' equity	85,301	148,904
	$388,735	$459,771

The accompanying notes are an integral part of these statements.

Consolidated statements of stockholders' equity and comprehensive income

(Dollars in thousands, except share and per share data)	*Number of Shares Outstanding*	*Common Stock*	*Additional Paid-in Capital*	*Retained Earnings (Deficit)*	*Accumulated Other Comprehensive Income*	*Unamortized Restricted Stock Compensation*	*Common Stock in Treasury*	*Total*
Year Ended December 31, 1996:								
Beginning balance	24,225,000	$249	$ 75,098	$(17,750)	$4,594	$ —	$(2,700)	$ 59,491
Comprehensive income:								
Net income	—	—	—	18,898	—	—	—	—
Pension adjustment	—	—	—	—	(92)	—	—	—
Translation adjustment	—	—	—	—	329	—	—	—
Total comprehensive income	—	—	—	—	—	—	—	19,135
Cash dividends ($.32 per share)	—	—	—	(7,752)	—	—	—	(7,752)
Ending Balance	24,225,000	249	75,098	(6,604)	4,831	—	(2,700)	70,874
Year Ended December 31, 1997:								
Comprehensive income:								
Net income	—	—	—	27,129	—	—	—	—
Pension adjustment	—	—	—	—	(177)	—	—	—
Translation Adjustment	—	—	—	—	(4,773)	—	—	—
Total comprehensive income	—	—	—	—	—	—	—	22,179
Cash dividends ($.32 per share)	—	—	—	(7,752)	—	—	—	(7,752)
Ending balance	24,225,000	249	75,098	12,773	(119)	—	(2,700)	85,301
Year Ended December 31, 1998:								
Comprehensive income:								
Net income	—	—	—	26,334	—	—	—	—
Pension adjustment	—	—	—	—	157	—	—	—
Translation adjustment	—	—	—	—	1,775	—	—	—
Total comprehensive income	—	—	—	—	—	—	—	28,266
Sale of common stock under initial public offering, net of expenses	3,000,000	30	48,070	—	—	—	—	48,100
Restricted stock grant	172,050	2	2,697	—	—	(2,699)	—	—
Amortization of restricted stock compensation	—	—	—	—	—	701	—	701
Cash dividends ($.29 per share)	—	—	—	(7,691)	—	—	—	(7,691)
Purchase of Neumünster facility	—	—	(5,773)	—	—	—	—	(5,773)
Ending balance	27,397,050	$281	$120,092	$ 31,416	$1,813	$(1,998)	$(2,700)	$148,904

The accompanying notes are an integral part of these statements.

Consolidated statements of cash flows

(Dollars in thousands)	1996	1997	1998
	FOR THE YEARS ENDED DECEMBER 31,		
Cash Flows from Operating Activities:			
Net income	$ 18,898	$ 27,129	$ 26,334
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	24,830	25,835	30,635
Minority interest in income of consolidated companies	6,643	8,492	9,494
(Increase) decrease in working capital —			
Accounts receivable, net	(428)	(16,620)	5,723
Inventories	4,719	(17,260)	2,514
Accounts payable	(7,126)	13,174	(8,915)
Accrued liabilities	2,930	(6,394)	(2,988)
Other	(2,796)	8,388	738
Net cash provided by operating activities	47,670	42,744	63,535
Cash Flows from Investing Activities:			
Purchases of property, plant and equipment	(56,284)	(66,750)	(98,582)
Purchase of minority interest	—	(3,959)	(693)
Proceeds from sales of property, plant and equipment	86	398	325
Net cash used in investing activities	(56,198)	(70,311)	(98,950)
Cash Flows from Financing Activities:			
Net borrowings (repayments) on notes payable and bank overdrafts	(18,067)	10,555	(11,363)
Net borrowings of long-term debt	36,647	25,171	13,916
Sale of common stock	—	—	48,100
Cash dividends	(7,752)	(7,752)	(7,691)
Distribution to minority interest partners	(1,560)	(4,623)	(7,885)
Net cash provided by financing activities	9,268	23,351	35,077
Effect of Exchange Rate Changes	(524)	(450)	1,866
Cash and Cash Equivalents:			
Net increase (decrease) during the year	216	(4,666)	1,528
Beginning balance	11,813	12,029	7,363
Ending balance	$ 12,029	$ 7,363	$ 8,891
Supplemental Cash Flow Disclosures:			
Interest paid	$ 6,826	$ 8,107	$ 9,447
Income taxes paid	$ 7,625	$ 18,495	$ 14,846
Supplemental schedule of noncash investing and financing activities:			
During 1998 the Company purchased the real estate and building of its main facility in Germany for $23,470. In conjunction with the acquisition, liabilities were assumed as follows:			
Fair value of assets acquired			$ 23,470
Cash paid for the real estate and building			(15,680)
Liabilities assumed			$ 7,790

The accompanying notes are an integral part of these statements.

Notes to consolidated financial statements

December 31, 1996, 1997 and 1998 (Dollars in thousands, except share and per share data)

(1) The Company and its Operations:

Sauer Inc., a U.S. Deleware corporation, and subsidiaries (the "Company") is a leading international manufacturer of components and systems that generate, transmit and control fluid power in mobile equipment. The Company's products are used by original equipment manufacturers of mobile equipment, including construction, agricultural and turf care equipment. The Company's products are sold throughout the world either directly, or through distributors.

The Company, which is a holding company, conducts its business in North America as Sauer-Sundstrand Company (the "U.S. Operating Company"), and in Germany as Sauer-Sundstrand GmbH & Co. (the "German Operating Company"). The Company also has manufacturing plants in the United Kingdom, Italy, Slovakia, and China, as well as sales companies in other locations. Sauer-Sundstrand GmbH (the "German Holding Company"), which is wholly owned by the Company, functions as a management and holding company on behalf of the Company.

The Company is majority owned by Mr. Klaus H. Murmann and certain of his family members, directly and through Sauer GmbH and other wholly owned companies. Sauer GmbH and Sauer GmbH and Co. Hydraulik K.G. ("Sauer Hydraulik") ("Murmann Limited Partners") hold limited partnership interests (the "Murmann Limited Partnership Interests") in the German Operating Company as described below. Sauer GmbH and Sauer Hydraulik, a German corporation and a German partnership, respectively, are wholly owned by the Murmann family.

(2) Business Ventures:

During 1991, the U.S. Operating Company and Agri-Fab, Inc. formed a business venture organized as a U.S. limited partnership under the name Hydro-Gear Limited Partnership ("Hydro-Gear"). The U.S. Operating Company contributed inventories and machinery and equipment with a carrying amount of $4,066 for a 60% interest in Hydro-Gear. The principal business of Hydro-Gear is the manufacture, sale, and distribution of hydrostatic and axle products to the turf care market.

On November 29, 1994, the German Holding Company and Povazské Strojarne, a.s. formed a business venture organized as a Slovakian corporation under the name Sauer Mechanika, a.s. The German Holding Company contributed approximately $6,000 of cash, technology, and machinery and equipment for a 65% interest in Sauer Mechanika. During 1997, the German Holding Company purchased the 35% interest held by its partner, Povazské Strojarne, a.s., for $3,959. The principal business of Sauer Mechanika is the manufacture of gear boxes for transit mixers.

On February 16, 1995, the Company and Shanghai Hydraulics and Pneumatics formed a business venture organized as a Chinese Limited Liability Foreign Investment Enterprise under the name Sauer Shanghai Hydraulic Transmission Company, Ltd. ("SHC"). The Company contributed $5,400 of cash, machinery and equipment and technology for a 50% interest in SHC. Operations commenced during 1996. During 1997, the Company contributed an additional $2,700 of cash to increase its interest in SHC to 60%. The principal business of SHC is the manufacture, sale and distribution of high power hydrostatic transmissions to the Chinese market.

On December 30, 1996, the German Holding Company and ZTS, a.s. formed a business venture organized as a Slovakian corporation under the name Sauer ZTS, a.s. The German Holding Company contributed approximately $5,800 of cash and technology for a 65% interest in Sauer ZTS, a.s. During 1998, the Company contributed an additional $693 to increase its interest in Sauer ZTS, a.s. to 80%. The principal business of Sauer ZTS, a.s. is the manufacture of high power hydrostatic transmissions.

On October 29, 1998, the Company and the U.S. Operating Company formed a business venture organized as a Brazilian limited liability company under the name Sauer-Sundstrand Ltda., (SAS Ltda.). On December 2, 1998, the Company, the U.S. Operating Company and SAS Ltda. entered into an agreement with the Company's Brazilian licensee, Power Transmission Industries Overseas Corporation (PTI) and certain parties related to PTI to purchase the assets and assume liabilities of PTI for approximately $1,500. As a result of this agreement, the license with PTI was terminated and SAS Ltda. acquired machinery and equipment, inventory, goodwill and other intangibles. The principal business of SAS Ltda. is the sale and distribution of hydrostatic transmissions and gear pumps and motors to the South American market.

(3) Summary of Significant Accounting Policies:

Basis of Presentation and Principles of Consolidation – The accounts of the Company are stated in accordance with generally accepted accounting principles in the U.S. The consolidated financial statements include the accounts of Sauer Inc. and subsidiaries on a consolidated basis for all periods presented. All significant intercompany balances and transactions have been eliminated in consolidation.

Sauer Inc. is the general partner and 80% owner of the German Operating Company. The Murmann Limited Partners have certain rights which include an annual cash payment equal to 7.9% of the income of Sauer Inc. and subsidiaries before taxes and the Murmann Limited Partnership Interests and the right to consent to certain actions of the German Operating Company. However, the Company has the right to elect by the action of its independent directors or the holders of its common stock other than the Murmann family, to terminate the Murmann Limited Partnership Interests in exchange for 2,250,000 shares of common stock of Sauer Inc. As such, the Company controls and consolidates the German Operating Company. The Murmann Limited Partners have no other property rights in the assets of the Company, the U.S. Operating Company, the German Operating Company or any other related entity.

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

New Accounting Principles – During 1998, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income." Total comprehensive income, consisting of net income and adjustments for minimum pension liability and foreign currency translation is disclosed on the face of the Statements of Stockholders' Equity and Comprehensive Income.

The Company also adopted SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits," which revises the disclosures made with respect to pension and other postretirement benefit plans. SFAS No. 132 does not change the measurement or recognition of those plans.

In April 1998, the American Institute of Certified Public Accountants ("AICPA") issued Statement of Position, ("SOP"), 98-5, "Reporting on the Costs of Start-up Activities," which requires that costs of start-up activities be expensed as incurred. These costs are defined, among others, as one-time activities relating to opening a new facility, introducing a new product or initiating a new process in an existing facility. The Company currently expenses these types of costs and therefore, does not believe that this statement will have a material impact on the Company's financial position or results of operations.

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," effective for fiscal years beginning after June 15, 1999, which requires an entity to recognize all derivatives as either assets or liabilities in the balance sheet and to measure those instruments at fair value. As the Company does not currently have any such instruments outstanding, the Company does not believe that this statement will have any material effect on the Company's financial position or results of operations.

Reclassification – Certain previously reported amounts have been reclassified to conform with the current period presentation.

Minority Interest – Minority interest in net assets and income reflected in the accompanying consolidated financial statements consists of:

(a) A minority interest held by Agri-Fab, Inc. in a U.S. limited partnership for 1996, 1997 and 1998.
(b) The Murmann Limited Partners, as holders of limited partnership interests, in the results of the German Operating Company equal to 8.5% of the income of Sauer Inc. and subsidiaries before taxes and the Murmann Limited Partnership Interests for 1996 and 1997 and 7.9% for 1998.
(c) A minority interest held by Povazské Strojarne, a.s. in a Slovakian corporation for 1996 and 1997.
(d) A minority interest held by Shanghai Hydraulics and Pneumatics in a Chinese equity business venture for 1996, 1997 and 1998.
(e) A minority interest held by ZTS, a.s. in a Slovakian corporation for 1997 and 1998.

The following tables set forth the components of minority interest in the consolidated balance sheets and consolidated statements of income:

Minority Interest Reflected in Consolidated Balance Sheets

	DECEMBER 31,	
	1997	*1998*
Hydro-Gear	$15,216	$18,928
German Operating Company	11,203	11,334
SHC	3,438	3,929
Sauer ZTS, a.s.	2,942	1,393
Total	$32,799	$35,584

Minority Interest (Income) Loss Reflected in Consolidated Statements of Income

	YEARS ENDED DECEMBER 31,		
	1996	*1997*	*1998*
Hydro-Gear	$(4,345)	$(6,339)	$(7,631)
German Operating Company	(2,707)	(4,001)	(3,573)
Sauer Mechanika, a.s.	168	291	—
SHC	241	1,480	1,319
Sauer ZTS, a.s.	—	77	391
Total	$(6,643)	$(8,492)	$(9,494)

Translation of Foreign Currencies – Assets and liabilities of consolidated foreign subsidiaries are translated into U.S. dollars at exchange rates in effect at year-end, while revenues and expenses are translated at average exchange rates prevailing during the year. The resulting translation adjustments are included in stockholders' equity. Gains or losses on transactions denominated in foreign currencies and the related tax effects, which are not material, are reflected in net income.

Cash and Cash Equivalents – Cash equivalents are considered by the Company to be all highly liquid instruments purchased with original maturities of three months or less.

Inventories – Inventories are valued at the lower of cost or market, using various cost methods, and include the cost of material, labor and factory overhead. The percentage of year-end inventory using average cost, last-in, first-out ("LIFO"), and first-in, first-out ("FIFO") was 61%, 32% and 7%, respectively, for 1997 and 61%, 33% and 6%, respectively, for 1998.

Property, Plant and Equipment and Depreciation – Property, plant and equipment are stated at historical cost, net of accumulated depreciation. Assets under capital lease are stated at the lower of fair market value or the present value of future minimum lease payments, net of accumulated depreciation. Depreciation is generally computed on the straight-line method for building equipment and buildings over 10 – 37 years and for machinery and equipment over 3 – 12 years. Additions and improvements that substantially extend the useful life of a particular asset are capitalized. Repair and maintenance costs ($13,110, $15,184 and $15,410 in 1996, 1997 and 1998, respectively) are charged to expense. Upon the sale of property, plant and equipment, the cost and related accumulated depreciation are removed from the accounts and any gain or loss is included in nonoperating income or expense.

Intangible Assets and Amortization – Intangible assets include goodwill, patents and other intangibles. These assets are stated at cost, net of accumulated amortization, and are being amortized over the lesser of 20 years or the specific remaining identifiable life on a straight-line basis. Goodwill was $1,201 and $2,294 as of December 31, 1997 and 1998, net of accumulated amortization of $4,950 and $6,409, respectively. Amortization of goodwill and other intangibles was $2,449 for 1996, $756 for 1997 and $644 for 1998.

Impairment of Long-Lived Assets – Consistent with the requirements of SFAS 121, the Company periodically assesses whether events or circumstances have occurred that may indicate the carrying value of its long-lived tangible and intangible assets may not be recoverable. The carrying value of long-lived tangible and intangible assets is evaluated based on the expected future non-discounted operating cash flows. When such events or circumstances indicate the carrying value of an asset may be impaired, the Company recognizes an impairment loss. Based upon its most recent analysis, the Company believes that no impairments existed at December 31, 1998.

Revenue Recognition – Net sales are recorded at the time of shipment to customers along with related expenses including estimates for warranty expense.

Income Taxes – The provision for income taxes has been determined using the asset and liability approach of accounting for income taxes. Under this approach, deferred taxes represent the future tax consequences expected to occur when the reported amounts of assets and liabilities are recovered or paid. The provision for income taxes represents income taxes paid or payable for the current year plus the change in deferred taxes during the year. Deferred taxes result from differences between the financial and tax bases of the Company's assets and liabilities and are adjusted for changes in tax rates and tax laws when changes are enacted. Valuation allowances are recorded to reduce deferred taxes when it is more likely than not that a tax benefit will not be realized.

(4) Basic and Diluted Per Share Data:

Basic and diluted net income per common share data is as follows:

	DECEMBER 31, 1997			DECEMBER 31, 1998		
	Net Income	*Shares*	*Net Income Per Share*	*Net Income*	*Shares*	*Net Income Per Share*
Basic net income per share	$27,129	24,225,000	$1.12	$26,334	26,148,288	$1.01
Effect of Dilutive Securities:						
Restricted stock	—	—	—	—	2,014	—
Diluted net income per share	$27,129	24,225,000	$1.12	$26,334	26,150,302	$1.01

Basic net income per common share is based on the weighted average number of common shares outstanding in each year. Diluted net income per common share assumes that outstanding common shares were increased by shares issuable upon exercise of those restricted stock shares for which market price exceeds exercise price, if any, less shares which could have been purchased by the Company with the related proceeds. Shares resulting in an antidilutive effect are excluded in accordance with SFAS No. 128. There were no restricted stock shares outstanding during 1997.

(5) Inventories:

The composition of inventories is as follows:

	DECEMBER 31, 1997	DECEMBER 31, 1998
Raw materials	$41,851	$40,621
Work in process	13,101	14,102
Finished goods and parts	40,461	41,574
LIFO allowance	(6,382)	(7,102)
Total	$89,031	$89,195

(6) Property, Plant and Equipment:

The cost and related accumulated depreciation of property, plant and equipment are summarized as follows:

	DECEMBER 31, 1997	DECEMBER 31, 1998
Cost—		
Land and improvements	$ 3,771	$ 4,597
Buildings and improvements	43,527	64,908
Machinery and equipment	307,364	380,562
Construction in progress	27,485	30,506
Plant and equipment under capital lease	638	698
Total cost	382,785	481,271
Less — Accumulated depreciation	(191,095)	(218,744)
Net property, plant and equipment	$ 191,690	$ 262,527

Depreciation expense for 1996, 1997 and 1998 was $22,381, $25,079, and $29,991, respectively.

(7) Pension Benefits:

The Company has noncontributory defined benefit plans covering substantially all employees. The benefits under these plans are based primarily on years of service and compensation levels. The Company's funding policy outside of Germany is to contribute annually an amount that falls within the range determined to be deductible for federal income tax purposes. The net pension liabilities reflected in the accompanying consolidated balance sheets result principally from unfunded pension plans of the Company's operations in Germany, where it is common practice to fund pension obligations at the time payments are made to retirees.

Pension expense for 1996, 1997 and 1998 for these defined benefit plans consists of the following components:

	1996	*1997*	*1998*
Service cost	$ 2,846	$ 3,042	$ 3,307
Interest cost	6,400	6,562	6,774
Expected return on plan assets	(4,578)	(6,395)	(5,277)
Amortization of prior service cost	321	318	454
Amortization of net loss	166	1,428	93
Amortization of transition obligation	(296)	(285)	(287)
Net pension expense	$ 4,859	$ 4,670	$ 5,064

The following table sets forth the plans' funded status as of the respective balance sheet dates:

	DECEMBER 31, 1997		DECEMBER 31, 1998	
	Assets Exceed Accumulated Benefits	*Accumulated Benefits Exceed Assets*	*Assets Exceed Accumulated Benefits*	*Accumulated Benefits Exceed Assets*
Benefit obligation at January 1	$(15,371)	$(70,312)	$(15,919)	$(75,842)
Service cost	(869)	(2,167)	(772)	(2,509)
Interest cost	(1,278)	(5,278)	(1,122)	(5,756)
Plan participant contributions	(343)	—	(373)	—
Plan amendments	—	—	—	(1,449)
Actuarial gain (loss)	1,369	(2,297)	(494)	(2,995)
Benefit payments	573	4,264	424	2,539
Effect of exchange rate changes	—	(52)	—	(1,700)
Benefit obligation at December 31	(15,919)	(75,842)	(18,256)	(87,712)
Reconciliation of fair value of plan assets				
Fair value of plan assets at January 1	20,127	45,167	22,560	50,527
Actual return on plan assets	1,948	6,915	1,714	6,256
Employer contributions	715	2,143	779	2,674
Plan participants' contributions	343	—	373	—
Benefit payments	(573)	(3,698)	(424)	(1,933)
Fair value of plan assets at December 31	22,560	50,527	25,002	57,524
Funded status at December 31	6,641	(25,315)	6,746	(30,188)
Unrecognized prior service cost	567	1,285	518	2,335
Unrecognized actuarial gain	(3,816)	(5,030)	(2,912)	(4,994)
Unrecognized net transition obligation	(1,149)	—	(862)	—
Net amount recognized	$ 2,243	$(29,060)	$ 3,490	$(32,847)

Amounts recognized in the balance sheet as of December 31:

	DECEMBER 31, 1997		DECEMBER 31, 1998	
	Assets Exceed Accumulated Benefits	*Accumulated Benefits Exceed Assets*	*Assets Exceed Accumulated Benefits*	*Accumulated Benefits Exceed Assets*
Long-term pension asset (liability)	$ 2,243	$(28,959)	$ 3,490	$(33,044)
Current pension liability	—	(738)	—	(984)
Intangible asset	—	71	—	869
Other accumulated comprehensive income	—	566	—	312
Net amount recognized	$ 2,243	$(29,060)	$ 3,490	$(32,847)

Significant assumptions used in determining pension expense and related pension obligations are as follows:

	DECEMBER 31,		
	1996	*1997*	*1998*
Discount rates —			
United States	7.5%	7.5%	7.0%
Germany	7.5	7.5	6.5
United Kingdom	9.0	9.0	7.0
Rates of increase in compensation levels —			
United States	5.0	5.0	4.5
Germany	3.5	3.5	2.5
United Kingdom	8.0	8.0	5.0
Expected long-term rate of return on assets —			
United States	8.5	8.5	8.5
United Kingdom	9.0	9.0	7.0

The plans' assets consist principally of short-term U.S. Government securities, UK Government securities, equity securities, fixed income contracts and insurance contracts.

(8) Postretirement Benefits Other than Pensions:

The Company provides health benefits for retired employees and certain dependents when the employee becomes eligible for these benefits by satisfying plan provisions which include certain age and/or service requirements. Health benefits for retirees of non-U.S. operations, where applicable, are provided through government-sponsored plans to which contributions by the Company are required. The health benefit plans covering substantially all U.S. employees are contributory, with contributions reviewed annually and adjusted as appropriate. These plans contain other cost-sharing features such as deductibles and coinsurance. The Company does not pre-fund these plans and has the right to modify or terminate any of these plans in the future.

The components of the postretirement benefit provisions of the Company-sponsored plans for 1996, 1997 and 1998 were as follows:

	1996	*1997*	*1998*
Service cost	$ 323	$ 365	$ 402
Interest cost	948	997	1,085
Net deferral and amortization	22	20	49
Postretirement benefit provision	$1,293	$1,382	$1,536

The funded status of the Company-sponsored plans was as follows:

	DECEMBER 31, *1997*	*1998*
Reconciliation of benefit obligation:		
Accumulated postretirement benefit liability at January 1	$(13,603)	$ (14,361)
Service cost	(365)	(403)
Interest cost	(997)	(1,085)
Actuarial gain (loss)	86	(1,489)
Benefit payments	518	624
Accumulated postretirement benefit liability at December 31	(14,361)	(16,714)
Reconciliation of fair value of plan assets:		
Fair value of plan assets at January 1	—	—
Employer contributions	518	624
Benefit payments	(518)	(624)
Fair value of plan assets at December 31	—	—
Funded status	(14,361)	(16,714)
Unrecognized actuarial loss	1,577	3,106
Postretirement benefit liability	$(12,784)	$(13,608)

The assumed weighted average annual rate of increase in the per capita cost of medical benefits is 8.0% for 1999 and is assumed to decrease ratably in 2000 and 2001 and remain level at 5.5% thereafter.

U.S. employees retiring after March 1, 1993, and hired prior to January 1, 1993, will receive the standard health benefits up to age 65 and then will be eligible for a Medicare reimbursement allowance based on years of service. U.S. employees hired after January 1, 1993, will only be eligible after age 65 for a Medicare reimbursement allowance based on years of service.

A one percent increase in the annual health care trend rates would have increased the accumulated postretirement benefit obligation at December 31, 1998, by $1,333, and increased postretirement benefit expense for 1998 by $160. The weighted average discount rate used to estimate the accumulated postretirement benefit obligation was 7.5% for 1997 and 7.0% for 1998.

(9) Long-Term Incentive Plan:

Effective June 1, 1998, the Company terminated its Phantom Share Plan. Phantom Share Rights outstanding at the time of termination were replaced by Restricted Common Stock as discussed below. Prior to termination, the grantee of a Phantom Share Right was entitled to the market value of a common share as of the December 31 immediately prior to the date the restrictions on such Phantom Share Right lapsed, and until the restrictions lapsed, a quarterly payment in an amount determined by the Board of Directors. At December 31, 1997, 110,400 Phantom Share Rights were outstanding. Compensation expense was recognized ratably over the period from the date of grant to the date the restrictions on a right lapsed. Earnings were also charged or credited for the aggregate appreciation or depreciation of the rights during the period as well as any quarterly payment to the grantees. Phantom share compensation expense included in the accompanying consolidated financial statements was $902, $955 and $0 for 1996, 1997 and 1998, respectively. The total value of the Phantom Shares outstanding as of December 31, 1997 was $3,257.

On June 1, 1998, the Company awarded 172,050 shares of restricted stock to a group of employees. The restricted stock award entitles the participants to full dividend and voting rights. Unvested shares are restricted as to disposition and subject to forfeiture under certain circumstances. The value of the award was established based on the market value of the stock as of the grant date. The shares vest beginning in year five after the date of grant at a rate of 20% per year thereafter.

Unearned compensation is shown as a reduction of stockholders' equity in the accompanying consolidated balance sheets and is being amortized ratably over the life of the grant. Unearned compensation was computed based on the market value of the restricted shares. Compensation expense recognized in conjunction with the restricted stock outstanding in 1998 amounted to $701.

The Company's Long-Term Incentive Plan provides for the grant of stock options, stock appreciation rights, restricted stock, performance units, performance shares and other incentive awards to officers and key employees and for the reimbursement to certain participants for the personal income tax liability resulting from such awards. The total number of shares of common stock which may be subject to awards or be issued under the Long-Term Incentive Plan will not exceed 2,400,000 shares, of which no more than 1,200,000 shares may be issued as restricted stock.

(10) Income Taxes:

The Company's income before income taxes is as follows:

	YEARS ENDED DECEMBER 31,		
	1996	*1997*	*1998*
United States	$26,963	$37,031	$37,838
Europe and other	2,178	6,042	3,875
Total	$29,141	$43,073	$41,713

The Company's primary German operation is structured as a partnership. This operation is subject to United States as well as German income tax regulations. The above analysis of pretax income and the following analysis of the income tax provision by taxing jurisdiction are therefore not directly related.

The (provision) benefit for income taxes by taxing jurisdiction location are as follows:

	YEARS ENDED DECEMBER 31,		
	1996	*1997*	*1998*
Current:			
United States			
Federal	$ (4,994)	$(11,476)	$ (8,029)
State	(877)	(1,261)	(957)
European and other	(4,096)	(3,443)	(3,230)
Total current	(9,967)	(16,180)	(12,216)
Deferred:			
United States			
Federal	400	1,593	(2,168)
State	(67)	(204)	(310)
European and other	(609)	(1,153)	(685)
Total deferred	(276)	236	(3,163)
Total income tax provision	$(10,243)	$(15,944)	$(15,379)

A reconciliation of the statutory and effective income tax (provision) benefit based on the Company's income before income taxes is as follows:

	YEARS ENDED DECEMBER 31,		
	1996	*1997*	*1998*
United States income tax provision at the statutory rate of 35%	$(10,199)	$(15,076)	$(14,600)
Deferred tax benefit not previously recognized	2,069	1,923	1,687
European and Asian locations' losses not tax benefited	(1,224)	(1,168)	(2,140)
Taxes on European locations' income at rates which differ from the U.S. rate	443	(270)	682
State income taxes, net of U.S. federal tax benefit	(614)	(871)	(704)
Other	(718)	(482)	(304)
Total income tax provision	$(10,243)	$(15,944)	$(15,379)

The components of the Company's net deferred tax assets and (liabilities), determined on a jurisdictional basis, are as follows:

	December 31, 1997		1998	
	Assets	Liabilities	Assets	Liabilities
U.S. tax credit carryforwards	$ 1,575	$ —	$ 1,474	$ —
Internal Revenue Code Section 743 and Other Tax Basis Step-Ups	4,473	—	3,776	—
Deferred compensation, post-retirement and accrued pension benefits	11,407	(923)	11,259	(1,082)
Tax over book depreciation	(5,055)	(3,195)	(7,118)	(3,594)
Inventory and warranty reserves not deducted for tax	5,283	—	5,652	—
Other items	2,125	100	1,443	(70)
U.S. tax on unremitted earnings of foreign subsidiaries	(2,168)	—	(2,400)	—
Gross deferred tax assets and (liabilities)	17,640	(4,018)	14,086	(4,746)
Valuation allowance	(3,187)	—	(3,057)	—
Net deferred tax assets and (liabilities)	14,453	(4,018)	11,029	(4,746)
Less — current portion	(7,990)	—	(8,701)	—
Net deferred tax assets and (liabilities), long-term	$ 6,463	$(4,018)	$ 2,328	$(4,746)

In 1990, the Company issued common stock in exchange for a 40.404% interest in the Sundstrand-Sauer Company partnership. The partnership filed an election under Internal Revenue Code (IRC) Section 754 and, accordingly, a tax basis step up was provided to the Company under IRC Section 743. In 1994, certain assets were sold from the German Operating Company to the German Holding Company to facilitate the establishment of Sauer Mechanika a.s., described in Note 2. For tax purposes, this was a taxable transaction and, accordingly, resulted in a tax basis step-up when the assets were ultimately contributed to Sauer Mechanika a.s. The remaining tax benefit from unamortized balances of these tax basis step-ups were $4,473 and $3,776 at December 31, 1997 and 1998, respectively.

During 1998 the valuation allowance relating to the Company's deferred income tax asset decreased by $130.

As of December 31, 1998, the Company had not provided federal income taxes on $4,331 of undistributed earnings recorded by certain subsidiaries outside the United States, exclusive of the UK, since these earnings were deemed permanently invested. Although it is not practicable to determine the deferred tax liability on the unremitted earnings, foreign tax credits would be available to reduce any U.S. tax liability if these foreign earnings were remitted.

The Company had the following tax return carryforwards available to offset future years' taxes at December 31,1998:

	Amount	*Expiration Dates*
German net operating losses	$56,500	None
U.S. foreign tax credits	$ 2,680	1999 – 2002

The German net operating losses do not produce a deferred tax asset on a consolidated basis due to the treatment of the German Operating Company as a partnership combined with the impact of foreign tax credits.

(11) Notes Payable and Long-Term Debt:

Long-term debt consisted of the following:

	December 31 1997	1998
Company's Revolving Credit Agreement, due August 2001	$15,000	$ —
U.S. Operating Company's Revolving Credit Facility, due March 2002	24,000	33,800
U.S. Operating Company's Senior Notes, due through December 2007	25,000	25,000
U.S. Operating Company's Industrial Development Revenue Bonds, due May 2026	9,000	9,000
German Holding Company's Long-Term Bank Facilities maturing through June 2018	—	32,829
Other borrowings	3,150	8,631
Total debt	76,150	109,260
Less — scheduled current maturities	(952)	(2,398)
Total long-term debt	$75,198	$106,862

Prior to its initial public offering, the Company's Revolving Credit Agreement ("Agreement") allowed the Company to borrow up to $15,000 at an interest rate based on the London interbank offered rate ("LIBOR"). The Company repaid this debt using proceeds from the initial public offering. At December 31, 1997, the interest rate on outstanding borrowings under the Agreement was 7.05%. The Agreement required the maintenance of certain financial results including maintaining minimum levels of net worth and cash flow and contained limitations on the payment of cash dividends.

The U.S. Operating Company's Revolving Credit Facility, dated November 6, 1997, permits the U.S. Operating Company to choose between two interest rate options and to specify what portion of the loan is covered by a specific interest rate option and the applicable funding period to which the interest rate option is to apply. The interest rate options are based on the bank's prime lending rate and LIBOR. The U.S. Operating Company's Revolving Credit Facility permits unsecured borrowings up to $45,000. At December 31, 1997 and 1998, the weighted average interest rate on outstanding borrowings was approximately 6.73% and 6.50%, respectively.

The U.S. Operating Company's Revolving Credit Facility contains certain restrictions and requires the U.S. Operating Company to maintain certain financial ratios, including limitations on the payment of cash dividends and maintaining profit before interest and taxes at least 2.5 times interest expense. Additionally, the U.S. Operating Company's Revolving Credit Facility requires the maintenance of net worth (as defined). The U.S. Operating Company was in compliance with the requirements at December 31, 1998 and required net worth was $64,986.

On May 1, 1996, the U.S. Operating Company issued $9,000 of Industrial Development Revenue Bonds ("Bonds"). The Bonds are at variable interest rates. At December 31, 1997 and 1998, the interest rate on the bonds was 4.7% and 4.95%, respectively. The Bonds are secured by a bank letter of credit. The Bonds contain certain covenants and restrictions similar to those included in the U.S. Operating Company's Revolving Credit Facility. At December 31, 1998, the U.S. Operating Company was in compliance with these requirements.

On December 15, 1997, the U.S. Operating Company issued $25,000 of 6.68% Senior Notes ("Senior Notes"). The Senior Notes have scheduled annual repayments starting with December 15, 2001 through December 15, 2007. The Senior Notes contain certain restrictions and require the maintenance of certain financial ratios which are similar to the U.S. Operating Company's Revolving Credit Facility. At December 31, 1998, the U.S. Operating Company was in compliance with these requirements.

The German Holding Company has a series of long-term bank facilities, with an aggregate principal of $32,829 at December 31, 1998. These facilities generally carry fixed rates of interest, ranging from 5.65% to 7.09%. These facilities contain a variety of repayment schedules and have final maturities ranging from December 2001 through June 2018.

Payments required on long-term debt outstanding as of December 31, 1998, during the years ending 1999 through 2003 and for years thereafter, are $2,398, $2,918, $5,880, $39,531, $5,731 and $52,802, respectively.

The Company from time to time employs off-balance sheet financial instruments to reduce its exposure to fluctuations in interest rates. These instruments include interest rate caps and swaps. The Company designates interest rate swaps as hedges of LIBOR-based bank debt, and accrues as interest expense the differential to be paid or received under the agreements as rates change over the lives of the contracts. As of December 31, 1998, there were no interest rate swap contracts outstanding.

The Company continually monitors its positions with, and the credit quality of, the financial institutions which are counterparties to its off-balance sheet financial instruments and does not expect non-performance by the counterparties. There were no interest rate contracts outstanding as of December 31, 1997 and 1998.

The Company also maintains revolving credit facilities, notes payable and bankers' acceptances for its European and other operations. The German Operating Company's credit agreement contains restrictions similar to those in the U.S. Operating Company's agreements. The German Operating Company was in compliance with the requirements at December 31, 1998, and required net worth was $11,597. At December 31, 1998, accounts receivable, inventories, property, plant and machinery and equipment in the amount of $46,708 were pledged as collateral under these European and other operations credit facilities. All U.S. debt is unsecured.

The weighted average interest rates on short-term borrowings at year-end were 6.6% in 1996, 6.8% in 1997 and 6.1% in 1998.

The status of lines of credit as of December 31, 1997, and 1998, is summarized below:

	1997	*1998*
Lines of credit—		
Used	$74,696	$75,567
Unused	51,975	47,032

The fair market value of long-term debt at December 31, 1997 and 1998 approximates the amounts recorded in the balance sheet based on information available to the Company with respect to interest rates and terms for similar financial instruments.

(12) Stockholders' Equity:

In 1998, the Board of Directors authorized a class of preferred stock with 4,500,000 shares authorized at $.01 par value. The issuance of preferred shares may adversely affect the rights of the holders of common stock. No preferred shares have been issued.

On May 12, 1998, the Company completed an initial public offering of 9,000,000 shares of common stock at an initial public offering price of $18 per share. Of the 9,000,000 shares of common stock offered, 3,000,000 were issued and sold by the Company and 6,000,000 were sold by management and members of the Murmann family. Prior to the offering, there was no public market for the Company's common stock. The shares of common stock are not convertible and the holders thereof have no preemptive subscription rights to purchase any securities of the Company.

The Company did not receive any of the proceeds from the sale of the shares by management or members of the Murmann family. The net proceeds to the Company from the initial public offering, after deducting applicable underwriting discounts and offering expenses, was $48,100. The net proceeds to the Company were used to repay long-term debt and for capital expenditures.

(13) Related Party Transactions:

On May 1, 1998, the Company acquired the real estate and building of its main facility in Germany, which was previously leased, from Sauer Hydraulik, which is owned by the Murmann family. The transaction was accounted for under the rules governing transactions occurring between entities under common control. As such, the assets were recorded at their historical cost basis of $17,697, debt outstanding of $7,790 was assumed, cash of $15,680 was paid to Sauer Hydraulik and $5,773 was recorded as a reduction to additional paid-in-capital. The reduction to additional paid-in-capital was computed as the excess of the facility's fair market value, as determined by an independent appraisal, over the seller's historical cost basis in accordance with common control accounting. Rent expense associated with the property while under the lease agreement was $2,633, $2,278 and $751 for 1996, 1997 and 1998, respectively.

(14) Commitments and Contingencies:

The Company leases certain facilities and equipment under operating leases, many of which contain renewal options. Total rental expense on operating leases during 1996, 1997 and 1998 was $5,484, $5,835 and $4,322, respectively.

Minimum future rental commitments under all non-cancelable leases as of December 31, 1998, during the years ending 1999 through 2003 and for years thereafter are $4,353, $3,974, $3,630, $2,011, $1,830 and $1,892, respectively.

The Company, from time to time, is involved in certain legal proceedings in the ordinary course of its business. The Company intends to vigorously defend against all such claims. However no assurance can be given that such matters will be resolved.

(15) Quarterly Financial Data (Unaudited):

	QUARTER				
	First	*Second*	*Third*	*Fourth*	*Total*
1997					
Net sales	$135,860	$146,273	$118,906	$134,134	$535,173
Gross profit	34,520	39,143	30,023	27,422	131,108
Net income	$ 7,894	$ 10,258	$ 5,512	$ 3,465	$ 27,129
Basic and diluted net income per common share	$ .33	$ .42	$ .23	$ .14	$ 1.12
1998					
Net sales	$152,876	$160,410	$123,992	$127,246	$564,524
Gross profit	34,739	42,025	31,829	27,620	136,213
Net income	$ 6,472	$ 10,624	$ 6,040	$ 3,198	$ 26,334
Basic and diluted net income per common share	$ .27	$ .41	$ .22	$ .11	$ 1.01

(16) Segment and Geographic Information:

The Company has two reportable segments defined by geographic region due to the difference in economic characteristics in which these segments operate. The activities of each reportable segment consist of the design, manufacture, and sale of hydraulic systems and other related components.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company evaluates individual segment performance based on net income. Intersegment sales are made at established transfer prices. The following table presents the significant items by segment:

	North America	*Europe*	*All Other*	*Eliminations*	*Total*
1996					
Trade sales	$272,780	$194,627	$ 159	$ —	$467,566
Intersegment sales	25,343	28,344	—	(53,687)[1]	—
Interest income	1,377	212	411	(1,436)[2]	564
Interest expense	2,760	3,864	1,335	(1,436)[2]	6,523
Depreciation and amortization	13,358	10,993	479	—	24,830
Net income (loss)	18,471	6,543	(3,094)	(3,022)[3]	18,898
Total assets	173,325	173,655	133,287	(142,740)[4]	337,527
Capital expenditures	24,556	31,550	178	—	56,284
1997					
Trade sales	$332,974	$201,130	$ 1,069	$ —	$535,173
Intersegment sales	36,557	32,424	582	(69,563)[1]	—
Interest income	1,441	518	228	(1,489)[2]	698
Interest expense	3,692	5,028	1,074	(1,489)[2]	8,305
Depreciation and amortization	13,834	11,230	771	—	25,835
Net income (loss)	26,873	6,142	(1,500)	(4,386)[3]	27,129
Total assets	200,167	184,533	159,223	(155,188)[4]	388,735
Capital expenditures	41,781	24,851	118	—	66,750
1998					
Trade sales	$360,641	$201,991	$ 1,892	$ —	$564,524
Intersegment sales	32,255	37,996	685	(70,936)[1]	—
Interest income	1,592	1,458	1,381	(4,001)[2]	430
Interest expense	5,128	7,437	680	(4,001)[2]	9,244
Depreciation and amortization	16,422	13,168	1,045	—	30,635
Net income (loss)	25,346	5,688	(1,127)	(3,573)[3]	26,334
Total assets	227,920	220,172	198,116	(186,437)[4]	459,771
Capital expenditures	51,728	46,331	523	—	98,582

Reconciliations:

(1) Elimination of intersegment sales.

(2) Elimination of intersegment interest income and expense from borrowings made between segments.

(3) Net income eliminations:

	1996	*1997*	*1998*
Minority interest in German Operating Company	$ (2,707)	$ (4,001)	$ (3,573)
Intersegment profit on intersegment sales	(315)	(385)	—
Total net income eliminations	$ (3,022)	$ (4,386)	$ (3,573)

(4) Total assets eliminations:

Investment in subsidiaries	$(127,415)	$(137,095)	$(144,391)
Intersegment receivables	(13,783)	(16,230)	(40,244)
Intersegment profit in inventory and other	(1,542)	(1,863)	(1,802)
Total assets eliminations	$(142,740)	$(155,188)	$(186,437)

A summary of the Company's net sales by product line is presented below:

	1996	*1997*	*1998*
Hydrostatic transmissions	$358,258	$417,864	$445,585
Open circuit gear pumps and motors and piston pumps	77,762	79,883	78,384
Electrohydraulics and controls	31,546	37,426	40,555
Total	$467,566	$535,173	$564,524

A summary of the Company's net sales and long-lived assets by geographic area is presented below :

	NET SALES [1]			LONG-LIVED ASSETS [2]	
	1996	*1997*	*1998*	*1997*	*1998*
United States	$247,339	$272,783	$335,606	$106,120	$141,021
Germany	45,909	49,931	47,400	26,517	46,930
United Kingdom	39,428	39,050	35,718	19,400	21,279
Slovakia	58	5,911	4,740	33,222	39,856
Other countries	134,832	167,498	141,060	10,845	17,210
Total	$467,566	$535,173	$564,524	$196,104	$266,296

(1) *Net sales are attributed to countries based on location of customer.*

(2) *Long-lived assets include property, plant and equipment net of accumulated depreciation, intangible assets net of accumulated amortization and certain other long-term assets.*

No single customer accounted for 10% or more of total consolidated sales in any year presented.

Report of management

The consolidated financial statements and other financial information of Sauer Inc. in this report were prepared by management, which is responsible for their contents. They reflect amounts based upon management's best estimates and informed judgments. In management's opinion, the financial statements present fairly the financial position, results of operations and cash flows of the company in conformity with generally accepted accounting principles.

The company maintains a system of internal accounting controls and procedures which is intended, consistent with reasonable cost, to provide reasonable assurance that transactions are executed as authorized, that they are included in the financial records in all material respects, and that accountability for assets is maintained. This system is augmented by written policies and procedures, careful selection and training of personnel, examinations by an internal auditing department and a continuing management commitment to the integrity of the system.

The financial statements have been audited to the extent required by generally accepted auditing standards by Arthur Andersen LLP, independent auditors. The independent auditors have evaluated the company's internal control structure and performed tests of procedures and accounting records in connection with the issuance of their report on the fairness of the financial statements.

The Board of Directors, through its Audit Committee composed entirely of outside directors, oversee management's responsibilities in the preparation of the financial statements and selects the independent auditors, subject to stockholder ratification. The Audit Committee meets regularly with the independent auditors, representatives of management, and the internal auditors, both separately and jointly, to review the activities of each and to assure that each is properly discharging its responsibilities. To ensure complete independence, the internal auditors and representatives of Arthur Andersen LLP have full access to meet with the Audit Committee, with or without management representatives present, to discuss the results of their examinations and their opinions on the adequacy of internal controls and the quality of financial reporting.

Tonio P. Barlage
President and Chief Operating Officer

Kenneth D. McCuskey
Treasurer

Report of Independent Public Accountants

To the Shareholders of Sauer Inc. and Subsidiaries:

We have audited the accompanying consolidated balance sheets of SAUER INC. (a Delaware corporation) AND SUBSIDIARIES as of December 31, 1997 and 1998, and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for each of the three years in the period ended December 31, 1998. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of SAUER INC. AND SUBSIDIARIES as of December 31, 1997 and 1998, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles.

Arthur Andersen LLP

ARTHUR ANDERSEN LLP
Chicago, Illinois
February 17, 1999

Selected Financial Data

DOLLARS IN THOUSANDS EXCEPT SHARE, PER SHARE AND EMPLOYEE DATA

	1994	*1995*	*1996*	*1997*	*1998*
Operating Data:					
Net sales	$362,482	$446,774	$467,566	$535,173	$564,524
Gross profit	86,517	110,074	113,532	131,108	136,213
Marketing	21,615	23,577	23,523	23,256	24,942
R&D	16,068	18,796	20,505	20,655	22,089
Administration	20,560	24,551	28,333	29,319	29,571
Total operating expenses	58,243	65,275	69,912	73,230	76,602
EBIT	24,341	38,419	35,100	50,680	50,527
Total interest expense, net	5,686	6,657	5,959	7,607	8,814
Net Income	11,374	26,580	18,898	27,129	26,334
Per Share Data:					
Income per common share, basic and diluted	$ 0.47	$ 1.10	$ 0.78	$ 1.12	$ 1.01
Cash dividends per share	$ 0.08	$ 0.32	$ 0.32	$ 0.32	$ 0.29
Weighted average basic shares outstanding	24,050,000	24,187,500	24,225,000	24,225,000	26,148,288
Weighted average diluted shares outstanding	24,050,000	24,187,500	24,225,000	24,225,000	26,150,302
Balance Sheet Data:					
Inventories	$ 64,131	$ 85,098	$ 78,273	$ 89,031	$ 89,195
Property, plant & equipment, net	89,620	117,827	152,321	191,690	262,527
Total assets	235,146	304,237	337,527	388,735	459,771
Total debt	68,766	92,169	108,632	136,428	151,027
Stockholder's equity	37,962	59,491	70,874	85,301	148,904
Debt to debt-equity	56.7%	53.6%	53.1%	53.6%	45.0%
Other Data:					
Backlog (at year end)	$187,400	$235,600	$227,000	$277,500	$261,700
Depreciation and amortization	18,204	19,898	24,830	25,835	30,635
Capital expenditures	21,350	45,689	56,284	66,750	98,582
EBITDA*	42,545	58,317	59,930	76,515	81,162
Number of employees (at year end)	2,628	2,899	3,055	3,751	3,710
Sales / total compensation expense	3.15x	3.37x	3.46x	3.66x	3.68x

** EBITDA – represents net income, plus provision for income taxes and net interest expense, plus depreciation and amortization.*

NYSE Price Range, Dividends

		1st	*2nd*	*3rd*	*4th*	*Full Year*
1997	High	N/A	N/A	N/A	N/A	N/A
	Low	N/A	N/A	N/A	N/A	N/A
	Dividends	$0.08	$ 0.08	$ 0.08	$ 0.08	$ 0.32
1998	High	N/A	$18.38	$16.50	$10.00	$18.38
	Low	N/A	13.25	7.56	6.06	6.06
	Dividends	$0.08	$ 0.07	$ 0.07	$ 0.07	$ 0.29

Sauer Inc.

Directors

**Tonio P. Barlage
President and Chief Operating Officer – Sauer Inc.

Nicola Keim

*Johannes F. Kirchhoff
Managing Director – FAUN
Umwelttechnik GmbH and Co.

**Klaus H. Murmann
Chairman and Chief Executive Officer – Sauer Inc.

Sven Murmann
Assistant Professor – University of Zurich

**David L. Pfeifle
Executive Vice President and General Manager – Sauer Inc.

*Agustin A. Ramirez
Chairman, Chief Executive Officer and President – HUSCO International Inc.

*Richard M. Schilling
Partner – Hinshaw and Culbertson Law Firm

Executive Officers

Klaus H. Murmann
Chairman and Chief Executive Officer

Tonio P. Barlage
President and Chief Operating Officer

David L. Pfeifle
Executive Vice President and General Manager

David J. Anderson
Vice President, Sales and Marketing – United States

Thomas K. Kittel
Vice President, Operations – Germany and Slovakia

Kenneth D. McCuskey
Treasurer and Secretary

Wolfgang Weisser
Vice President, Sales and Marketing – Europe

James R. Wilcox
Vice President and General Manager – Hydrostatics U.S.

**Member of Audit Committee and Compensation Committee*

***Member of Executive Committee*

Corporate Data

Stockholder Information

Annual Meeting
The annual meeting of company stockholders will be held at 10 a.m. April 22, 1999 at the Scheman Building, Iowa State Center, Iowa State University, Ames IA 50010

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49.4321.871.190

Stock Exchanges

Sauer Inc. common stock is listed on the New York Stock Exchange (SHS) and on the Frankfurt Germany Stock Exchange (SAR).

Form 10-K

The form 10-K annual report to the Securities and Exchange Commission is available to stockholders upon written request to Sauer Inc. Investor Relations at the above addresses.

Auditors

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