

CTS Corporation (CTS-NYSE)

CTS: - New Design Wins Offset Weak EMS-Outperform

OUTLOOK

CTS Corporation designs, manufactures, assembles, and sells electronic components and sensors worldwide. The faster growing Components and Sensors segment has found new customers and markets for existing products. This should be a tail wind for CTS. The company has also diversified its EMS segment over the past several years to markets such as medical, defense and aerospace, and industrial. A 6-8% top-line growth rate along with the company's plan reduce its overhead cost structure as well as a recent acquisition which broadened CTS' automotive sensor technology and product portfolio will position the company for stronger growth in 2014.

Current Recommendation	Outperform
Prior Recommendation	Neutral
Date of Last Change	08/24/2009
Current Price (07/26/13)	\$14.46
Target Price	\$16.00

SUMMARY DATA

52-Week High	\$14.78
52-Week Low	\$8.04
One-Year Return (%)	59.35
Beta	2.07
Average Daily Volume (sh)	113,016

Shares Outstanding (mil)	34
Market Capitalization (\$mil)	\$485
Short Interest Ratio (days)	8.46
Institutional Ownership (%)	86
Insider Ownership (%)	5

Annual Cash Dividend	\$0.14
Dividend Yield (%)	0.97

5-Yr. Historical Growth Rates	
Sales (%)	-1.1
Earnings Per Share (%)	8.1
Dividend (%)	4.3

P/E using TTM EPS	15.0
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P/E using 2013 Estimate	13.8
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Zacks Rank	3
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Risk Level	Moderate
Type of Stock Industry	Small-Value Elec-Misc Comp

ZACKS ESTIMATES

Revenue

(in millions of \$)

	Q1	Q2	Q3	Q4	Year
	(Mar)	(Jun)	(Sep)	(Dec)	(Dec)
2011	152 A	147 A	146 A	144 A	589 A
2012	147 A	154 A	137 A	138 A	577 A
2013	150 A	152 A	156 E	160 E	617 E
2014					654 E

Earnings per Share

(EPS is operating earnings before non recurring items)

	Q1	Q2	Q3	Q4	Year
	(Mar)	(Jun)	(Sep)	(Dec)	(Dec)
2011	\$0.15 A	\$0.14 A	\$0.17 A	\$0.22 A	\$0.68 A
2012	\$0.07 A	\$0.18 A	\$0.20 A	\$0.18 A	\$0.64 A
2013	\$0.14 A	\$0.20 A	\$0.22 E	\$0.24 E	\$0.80 E
2014					\$0.88 E

WHAT'S NEW

On July 22, 2013, CTS Corporation reported financial results for its second quarter and six months, ended June 30, 2013. The company's second quarter resulted in a nearly 2 percent or \$2.733 million decrease in year over year revenues to \$151.561 million. This compares to revenues of \$154.294 million for the three months ended July 1, 2012.

The year over year decrease was primarily due to softness in EMS markets.

CTS secured new business in the second quarter with future revenues totaling a \$116 million compared to \$54 million of new business won in the first quarter and saw continued strength in its components and sensors segment. Sequentially, revenues improved by over 1 percent or \$2.049 million above the \$149.512 million from the first quarter fiscal 2013.

Metric	Q2 Performance	Breakdown	Takeaway
Components & Sensors	\$105.4 M versus \$76.8 M in the year ago quarter.	Automotive \$67.7 M benefitted from \$13.2 M of D&R acquisition. 2012 Auto sales were \$47.3 M	20% organic growth rate from 2012.
EMS	\$46.2 M down from revenue \$77.5M year ago.	While lower versus the year ago and sequential numbers quote activity has picked up significantly.	Weakness in Communications, Defense, Aerospace
Cash Flow	Cash Flow from Ops \$13.7 M	Compared to \$3.5 M cash usage a quarter ago	Strong cash flow
Management Outlook	Full year revenue guidance 6-8% growth from 2012. (EPS \$0.78-\$0.83)	Previous guidance for 12-15% growth	EPS guidance remains the same

Second quarter net loss was \$11.3 million, or \$0.34 per share, compared to net earnings of \$3.3 million, or \$0.10 per diluted share, in the same period last year.

The second quarter 2013 results includes a non-cash tax expense of \$0.32 per share related to the cash repatriation of \$30 million and restructuring and other costs of \$0.22 per share.

Excluding these costs, totaling \$0.54 per share, second quarter 2013 adjusted earnings were \$0.20 per share, a 43 percent increase over the first quarter of 2013 adjusted earnings of \$0.14 per share and 11 percent increase over adjusted earnings per share of \$0.18 in the second quarter of 2012.

Gross margin during the quarter jumped year over year to 23.4 percent from 16.8 percent for the quarter ended July 1, 2012.

The improvement in gross margin was primarily driven by CTS' components and sensor sales mix growing to 70 percent of total sales in the second quarter 2013 versus 50 percent in the second quarter 2012. This segment sales mix shift had a positive impact on gross margin of approximately 5 percentage points. Restructuring action and ongoing cost containment action assisted in the lift off in gross margin.

CTS announced a \$16 to \$20 million restructuring plan in mid-June 2013, with expected annual savings of approximately \$8 to \$10 million once fully implemented in 2014. The plan is designed to further improve the company's cost structure and capacity utilization. In the second quarter 2013, CTS recognized \$8.1 million, or \$0.17 per share, of restructuring and related charges associated with these actions. Anticipated 2013 pretax savings from these second quarter actions are estimated at approximately \$1.5 to \$2.0 million.

CTS Corporation's cash and equivalents for the second quarter ended June 30, 2013, was \$86.044 million while working capital fell to \$176.587 million. This compares to \$109.432 million of cash and equivalents and working capital of \$206.653 million for the first quarter ended March 31, 2013.

Still, second quarter 2013 cash flow from operations was \$13.7 million versus \$16.1 million in the same period last year, and improved from \$3.5 million cash usage in the first quarter 2013.

Second quarter 2013 capital expenditures were \$3.7 million versus \$2.5 million in 2012 and \$4.7 million in the first quarter 2013.

Similarly, second quarter free cash flow, which is defined as cash flow from operations less capital expenditures, was \$10 million compared to \$12.5 million last year, but improved from cash usage of \$8.2 million in the first quarter 2013.

Management continues to anticipate full year capital expenditures to be approximately 3% of sales.

Additionally, accounts receivable days were 54 days compared to 50 days last year. While management continues to closely manage its collection terms, CTS' DSO levels are expected to be slightly higher in 2013 compared to 2012.

Accounts payable days were 64 days, compared to 69 days last year while inventory turns fell to 5.6 from 6.5 last year as a result of delays in customer orders and the delays of new product launches in the company's EMS segment.

During the second quarter, CTS repurchased approximately 44,900 shares for \$445,000 at an average price of \$9.91 while the company repurchased approximately 150,000 shares for \$1.5 million during the first six months of 2013.

Approximately 318,000 shares remain from the 2012 share buyback authorization.

On June 11 the Board of Directors authorized a repurchase of up to 1 million additional shares of the company stock.

Management continues to expect sales from new programs and the D&R acquisition in the components and sensor segment to benefit the earnings in the coming quarters.

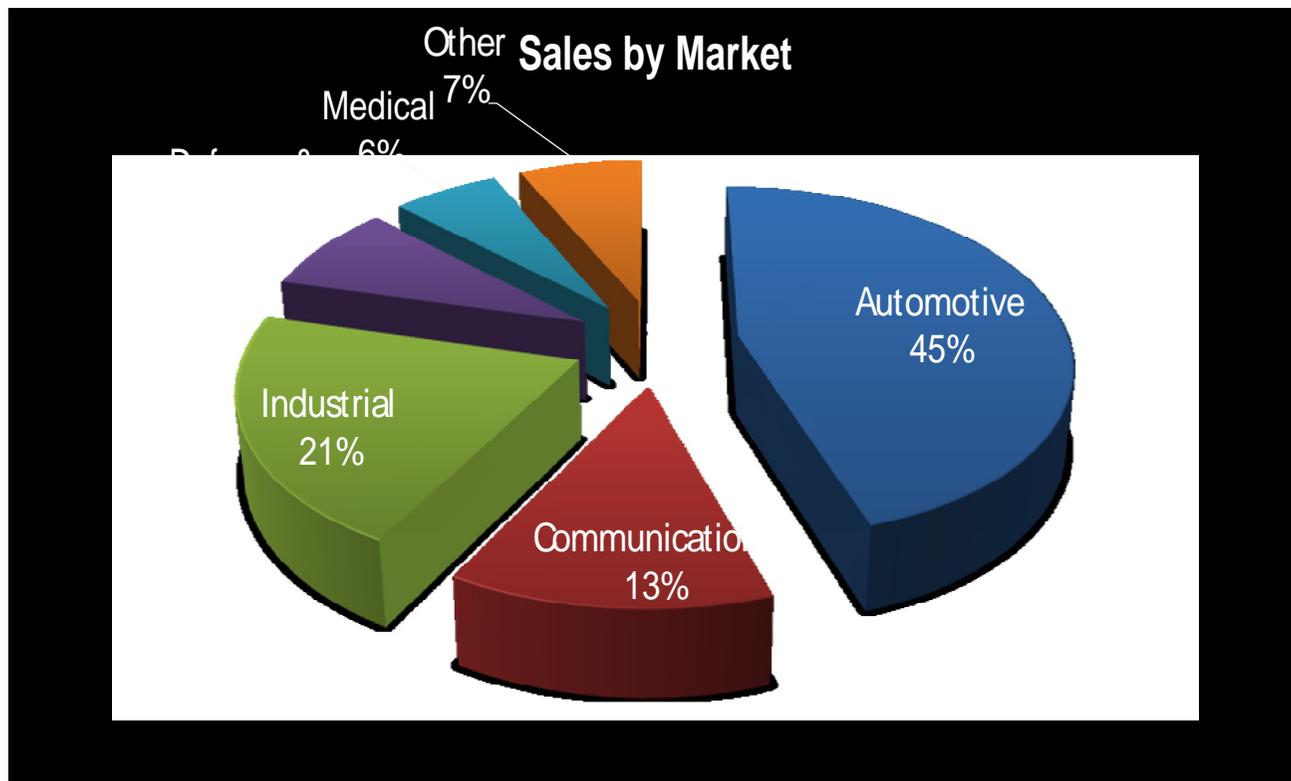
However, primarily as a result of softness at EMS, management is lowering its full-year 2013 sales guidance to a 6 percent to 8 percent increase over 2012, compared to the prior range at the low end of a 12 percent to 15 percent increase.

Still, management is maintaining 2013 adjusted earnings per share to be in the range of \$0.78 to \$0.83 per share, which excludes tax expense on cash repatriation, restructuring and related costs and CEO transition costs.

INVESTMENT THESIS

CTS is Diversified, Growing and Undervalued.

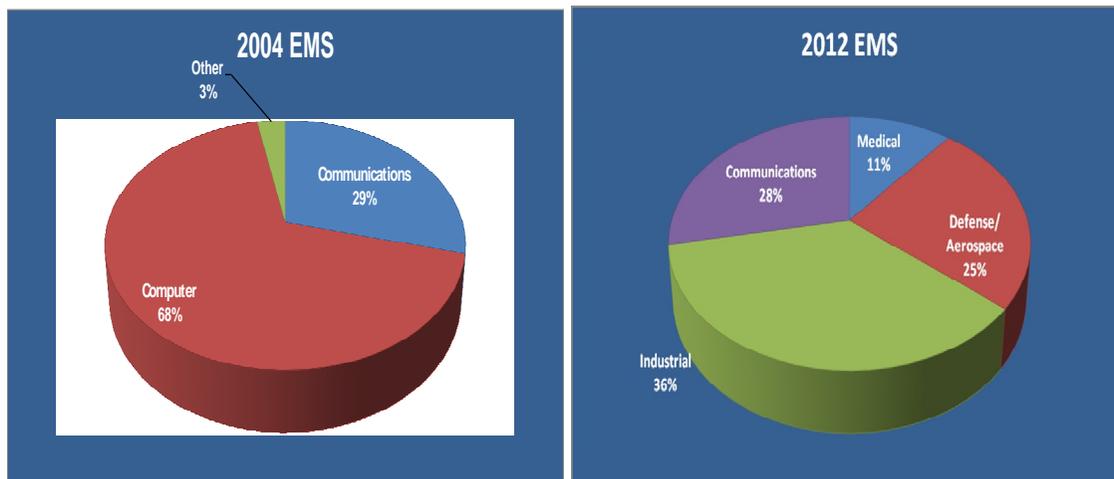
CTS has two reportable segments: Electronics Manufacturing Services (EMS) and Components and Sensors.



CTS Corporation designs, manufactures, assembles, and sells a broad line of electronic components and sensors. The firm also provides electronics manufacturing services primarily to original equipment manufacturers (OEMs), for the automotive, computer, communications, medical, industrial, and defense and aerospace markets. The firm was established in 1896 as a provider of high-quality telephone products and was incorporated as an Indiana corporation in February 1929. Along the way CTS had a hand in numerous technologies from the radio to the space shuttle Columbia.

CTS has two reportable segments: Electronics Manufacturing Services (EMS) and Components and Sensors. Investors should take notice of how the firm has diversified its EMS segment and how the Components and Sensors segment is benefiting from tailwinds such as

- Entering new markets for existing products.
- Double digit growth in wireless communications.
- Double digit growth in fuel economy and reduced emissions.



The slower growing EMS segment has been exceptionally diversified since 2004 into medical and industrial markets where margins are higher and cost to enter the market is significant. This will likely produce higher margins and more reliable revenue in what is CTS' largest segment. EMS Firms with strong footholds in Medical, Defense, and Industrial will outperform firms with more concentration in computer and communications. CTS aims to find customers with complex needs in niche sectors such as defense, aerospace, medical and industrial. This ensures less competition and higher margins.

Second Quarter Results

CTS' EMS segment sales decreased year over year by \$31.291 million to \$46.180 million primarily on lower demand in defense and aerospace and communications markets.

Additionally, the company's decision to close 2 EMS locations last year negatively impacted EMS revenue on a year over year basis.

Still, CTS' EMS management team is fully mobilized and management has the improvement actions started to deliver the return to more normal margins for the fourth quarter. Likewise, CTS' enhanced marketing initiatives are gaining traction as new business quote activity to-date is double digits over last year, signifying improved confidence for the next year.

The EMS segment's second quarter 2013 sales fell sequentially by \$5.270 million from \$51.450 million during the first quarter of 2013.

Components and Sensors

Components and Sensors are products which perform specific electronic functions for a given product family and are intended for use in customer assemblies. Components and Sensors consist principally of automotive sensors and actuators used in commercial or consumer vehicles; electronic components used in communications infrastructure and computer markets; components used in computer and other high-speed applications, switches, resistor networks, and potentiometers used to serve multiple markets; and fabricated piezoelectric materials and substrates used primarily in medical, industrial and defense and aerospace markets.

Sensors and Actuators

Sensors and Actuators (45% of sales) should see double-digit sales growth over 3-5 years. Green programs and fuel efficiency should provide a tail-wind. Products in this segment include Smart Actuator, Position Sensors, and Accelerator Pedal Modules.

Macro Trends Driving Growth in this area include

- Tougher emissions standards
- Need for increased fuel economy
- Improved safety & chassis management applications

CTS has sensor technology and strongly desires to diversify its base, the firm has been going beyond the traditional pedal-modules of position sensors has endeavored to convince its customers that they should be looking at a broader array of sensors from the company. In short the firm has found new customers and industries for its products.

The firm penetrated two of the largest diesel manufacturers with smart actuators for trucks and industrial engines. There have been four wins in all. This takes CTS into on-and-off highway diesel engines and trucks. This introduces the firm to commercial applications like construction, mining, and agriculture.

The total commercial market looks to be between \$750 million to \$1 billion. CTS target market share is 10%. Management sees projected sales at \$90 million through 2015 with the first year of significant sales in 2013. (\$20 million)

Electronic components

Electronic components (25% of sales) should see double-digit sales growth over 3-5 years. Social networks in developed countries and strong communications growth in emerging markets should provide a tail-wind. Communications infrastructure and Piezo Electronics are two CTS products in this segment.

This segment has been increasing market share and winning new customers. Looking closer at the segment, fabricated piezoelectric materials and substrates are used primarily in medical, industrial, defense and aerospace markets and most recently in the computer markets for hard disk drive applications. The firm's focus has been on specific solutions for customers requirements. For many customers CTS remains their sole source. Piezo-elements are used in many applications: Such as

Hard Disk Drive

CTS' new Piezoceramic product for high density disk drives are for next generation dual stage actuation disk drive for which is experiencing growth as a result of a shift of digital content storage to the "cloud."

Medical Ultrasound Imaging Transducers

Material has the ability to be precisely machined into very tall, narrow structures which exhibit superior mechanical strength.

Piezo Ink Jet Heads

High density formulations offer a significant advantage to customers in building these types of structures.

Hydrophones

Piezo-transducers that are used to receive acoustic signals underwater. These transducers are used to detect underwater oil reserves. CTS material is used because of its high sensitivity and the ability to provide high volume products.

WORLD INTERNET USAGE AND POPULATION STATISTICS						
World Regions	Population (2009 Est.)	Internet Users Dec. 31, 2000	Internet Users Latest Data	Penetration (% Population)	Growth 2000-2009	Users % of Table
Africa	991,002,342	4,514,400	65,903,900	6.70%	1359.90%	3.90%
Asia	3,808,070,503	114,304,000	704,213,930	18.50%	516.10%	42.20%
Europe	803,850,858	105,096,093	402,380,474	50.10%	282.90%	24.20%
Middle East	202,687,005	3,284,800	47,964,146	23.70%	1360.20%	2.90%
North America	340,831,831	108,096,800	251,735,500	73.90%	132.90%	15.10%
Latin America/caribbean	586,662,468	18,068,919	175,834,439	30.00%	873.10%	10.50%
Oceania/Austraila	34,700,201	7,620,480	20,838,019	60.10%	173.40%	1.20%
World Total	6,767,805,208	360,985,492	1,668,870,408	24.70%	362.30%	100.00%

*Source: Internetworldstats.com/howthingswork

In our opinion the internet is still growing, particularly with the growth of cloud storage. Asia has a relatively low 24.7% penetration rate compared to the population. Especially if one considers Asia which has approximately 56% of the world's population yet remains only 18.5% penetrated. Another trend to consider in assessing the CTS growth rate is the explosion of handheld devices such as iPhones and Android systems. There are in effect more and more devices being connected and each new connection needs some type of access and related storage for music and video content.

Second Quarter Results

Sales of the company's components and sensors segment jumped to \$105.381 million, a 37 percent or \$28.558 million year over year increase, of which included 20 percent organic growth, over the comparable quarter of 2012.

Likewise, within the segment, the components and sensors segment's automotive sales increased \$20.4 million, or 43%, year-over-year, primarily due to sales of \$13.2 million from the D&R Technology acquisition and higher sales from the recently launched smart actuator product. This was despite continued weakness in Europe.

Late in the fourth quarter CTS announced the synergistic acquisition of D&R Technologies, a leading designer and manufacturer of custom-designed automotive sensors with annual sales of approximately \$50 million. The acquisition expands CTS' strategic automotive sensor product platform with new customers and a broader product portfolio into applications for safety systems and vehicle chassis management.

The integration of D&R is progressing on schedule.

Similarly, CTS' new smart actuator for commercial diesel engines, which was launched late in the fourth quarter 2012, will be transformational to CTS as this product alone will provide over \$40 million in annual sales at full ramp.

Still, CTS' new smart actuator product for commercial diesel applications and grill shutter actuator product are expected to add over \$20 million of incremental sales in 2013.

It should further be noted that management is seeing synergistic benefits in terms of revenue growth and was awarded approximately \$40 million of new business to supply ride height sensors for several Asian and North American vehicle programs of a major U.S. automotive manufacturer with first shipments of the seven-year program beginning in 2015.

The Components and Sensors segment revenue improved sequentially by \$7.319 million from \$98.062 million for the first quarter of fiscal 2013.

VALUATION

According to the P/B, the P/S, and P/E CTS appears undervalued compared to industry.

Metric	CTS	Industry Average
P/B	1.90	2.60
P/E (TTM)	20.08	23.70
P/E 2014 (E)	16.43	17.80
P/S	0.80	2.20

Valuation

Here is how we view the valuation of CTS. (Background for valuation models <http://pages.stern.nyu.edu/~adamodar/>)

Two Stage Free Cash Flow to Equity Model

FCFE = Net Income - Net Capital Expenditure - Change in Net Working Capital + New Debt - Debt Repayment

Assumptions

- The firm is expected to grow at a higher growth rate in the first period.
- The growth rate will drop at the end of the first period to the stable growth rate.

Rationale for using the Model

As new products are introduced to new customers, we expect the firm to grow at a higher overall rate than the industry. As these products mature and the firm faces more competition, we expect the growth rate to level off.

Weakness of the Model

As you add more layers to the model it is more sensitive to the assumptions you make. The growth may look more "lumpy" than we have it in the model.

Output

We used the following inputs:

We value the company based on the average of our P/E multiple (18.2x 2014 estimated EPS) and our two stage intrinsic model. The semiconductor/Electronic group average P/E is between 14x-20x and EMS firms tend to be lower. We feel CTS should trade at a premium to its peers, given the fact that the company has the potential to build growth in new markets.

- An 8-year period with an earnings growth rate of 10.5% (average forecast) and a discount rate of 12.6%.
- A continuing period assumed to go on forever, with earnings growing at 5% and a discount rate of 11.23%.

With these inputs we arrive at a target price of \$16.00.

PROJECTED INCOME STATEMENT

INCOME STATEMENT (\$ Millions)	Jun-12	Sep-12	Dec-12	Mar-13	Jun-12	Sep-12	FY	FY	FY	FY	FY	FY
	Q2 12 E	Q3 12	Q4 12	Q1 13	Q2 13	Q3 13 E	2008	2009	2010	2011	2012	2013 E
REVENUE												
Net Revenue	154	137	138	150	152	156	691.7	499.0	552.6	588.5	576.9	617.3
Sequential Growth		-11%	1%	8%	1%	3%						
OPERATING EXPENSES												
Cost of Revenues	120.9	110.8	111.5	118.3	116.1	120.5	554.6	400.1	432.7	478.2	464.5	476.0
% of Revenue	78%	81%	81%	79%	77%	77%	80%	80%	78%	81%	81%	77%
Gross Profit -	33	27	27	31	35	36	137.1	98.8	119.9	110.3	112.4	141.3
Proforma Gross Margin	22%	19%	19%	21%	23%	23%	19.8%	19.8%	21.7%	18.7%	19.5%	22.9%
R&D + Engg	5.1	4.4	5.3	6.3	5.8	5.7	18.3	14.2	18.3	20.0	19.1	23.9
% of Revenue	3.3%	3.2%	3.9%	4.2%	3.8%	3.7%	2.6%	2.8%	3.3%	3.4%	3.3%	3.9%
SG&A	19.4	19.4	22.2	21.4	20.7	20.5	82.6	67.1	72	72	80	84
% of Revenue	12.6%	14.1%	16.1%	14.3%	13.7%	13.1%	11.9%	13.5%	13.1%	12.2%	13.9%	13.5%
GW Amort, Restructuring, other	3.14	(3.95)	(12.98)	0.56	7.24		(5.6)	35.4	1.44	(6.49)	(13.79)	8.25
% of Revenue												
Total Operating Expenses	27.6	19.8	14.6	28.2	33.8	26.2	95.3	116.7	92	85	86	116
% of Revenue	17.9%	14.4%	10.5%	18.9%	22.3%	16.8%	13.8%	23.4%	17%	14%	15%	19%
Operating Income -	5.7	6.8	12.2	3.0	1.7	9.3	41.8	-17.8	28	25	27	26
Operating Margin	3.7%	5.0%	8.8%	2.0%	1.1%	6.0%	6%	-4%	5%	4%	5%	4%
NON-OPERATING ITEMS												
Non operating Income/Expense	-1	1	0	0	-1	0	-1.3	-2.6	0.18	1	0	-2
% of Revenue	-0.78%	0.44%	0.35%	-0.14%	-0.62%	-0.13%	-0.19%	-0.52%	0.03%	0.19%	0.04%	-0.24%
Tax Provision	1.2	1.5	3.9	-0.8	12.1	1.5	-0.6	13.6	6	5	7	17
Effective Tax Rate												
Net Income -	3.3	5.9	8.8	3.6	-11.3	7.6	41.0	-34.1	22.0	21.0	20.3	7.3
Net Income Margin	2.1%	4.3%	6.4%	2.4%	-7.5%	4.9%	5.9%	-6.8%	4.0%	3.6%	3.5%	1.2%
Adjustments	0.08	0.03	-0.08	0.04	0.54	0.00	0	0	0	0.07	0.03	0.58
EARNINGS PER SHARE												
EPS - Basic	\$0.18	\$0.20	\$0.18	\$0.14	\$0.20	\$0.22	\$0.89	-\$1.01	\$0.67	\$0.68	\$0.64	\$0.80
EPS - Diluted	\$0.18	\$0.20	\$0.18	\$0.14	\$0.20	\$0.22	\$0.81	-\$1.01	\$0.67	\$0.68	\$0.64	\$0.80

Ken Nagy, CFA Zacks Investment Research

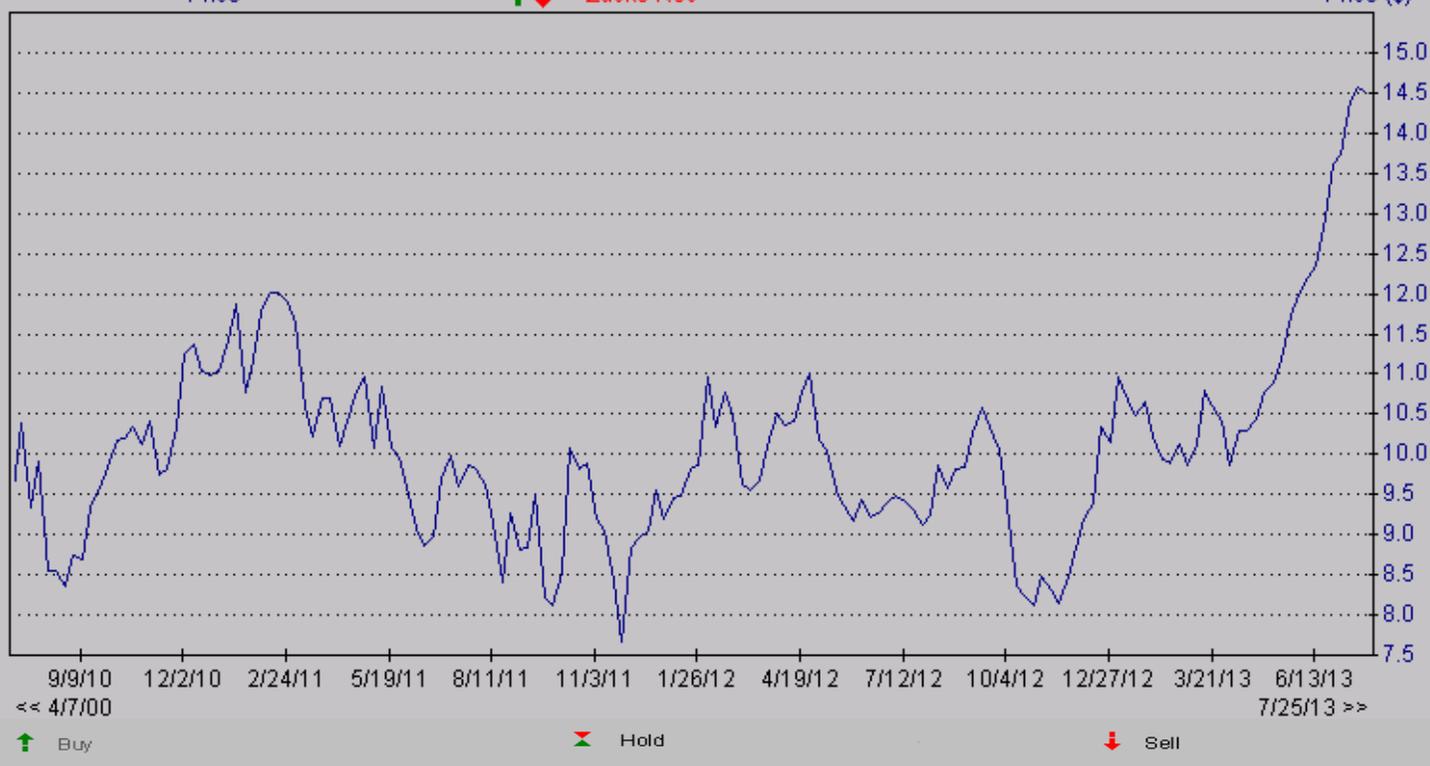
7/25/2013

HISTORICAL ZACKS RECOMMENDATIONS

CTS CORP (W)
Price

↑ ↓ Zacks Rec

Price (\$)



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