Zacks Small-Cap Research

April 24, 2012
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CTS Corporation (CTS-NYSE)

CTS: - CTS is poised for Growth- Outperform

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	02/23/2012
Current Price (04/23/12)	$10.51
Target Price	**$14.00**

OUTLOOK

CTS Corporation designs, manufactures, assembles, and sells electronic components and sensors worldwide. The company has diversified its EMS segment over the past several years to markets such as medical, defense and aerospace, and industrial. The faster growing Components and Sensors segment has found new customers and markets for existing products. This should be a tail wind for CTS.

On April 13, 2012 the firm announced certain reimbursement payments (flood) would be late. The EPS outlook for the year remains. We see a strong 2012 as business returns to form.

SUMMARY DATA

52-Week High	**$10.99**
52-Week Low	**$7.40**
One-Year Return (%)	**-0.35**
Beta	**1.94**
Average Daily Volume (sh)	**83,172**
Shares Outstanding (mil)	**34**
Market Capitalization ($mil)	**$359**
Short Interest Ratio (days)	**16.06**
Institutional Ownership (%)	**84**
Insider Ownership (%)	**3**
Annual Cash Dividend	**$0.14**
Dividend Yield (%)	**1.33**
5-Yr. Historical Growth Rates	
Sales (%)	**-5.5**
Earnings Per Share (%)	**-3.4**
Dividend (%)	**1.7**
P/E using TTM EPS	**15.4**
P/E using 2012 Estimate	**13.4**
Zacks Rank	**3**

Risk Level	**Moderate**
Type of Stock	**Small-Value**
Industry	**Elec-Misc Comp**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2009	118 A	120 A	127 A	134 A	499 A
2010	129 A	139 A	139 A	145 A	552 A
2011	152 A	147 A	146 A	144 A	589 A
2012	160 E	164 E	165 E	166 E	655 E

Earnings per Share
(EPS is operating earnings before non recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2009	-$0.03 A	$0.06 A	$0.13 A	$0.19 A	$0.35 A
2010	$0.13 A	$0.17 A	$0.20 A	$0.17 A	$0.67 A
2011	$0.15 A	$0.14 A	$0.17 A	$0.22 A	$0.68 A
2012	$0.06 E	$0.23 E	$0.24 E	$0.25 E	$0.78 E

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WHAT'S NEW

CTS Corporation's 2011 Fiscal year was biblical, as the firm dealt with the adverse effects of earthquakes, fires and floods. Patient investors should be rewarded with double digit top and bottom-line growth and healthy free cash flow in 2012.

On January 25, 2012, CTS Corporation, reported financial results for its fourth quarter and fiscal year, ended December 31, 2011.

The fourth quarter resulted in a nearly 1 percent decrease in year over year revenues to $143.999 million which compares to revenues of $145.025 million for the three months ended December 31, 2010. The fourth quarter results were negatively impacted by approximately $11 million to $13 million due to the flooding in Thailand. CTS had previously disclosed that its EMS Scotland Facility experienced a fire related disruption during the second quarter of 2011 while its Thailand Facility was affected by floods in the third quarter of 2011.

Still, the Company's Components and Sensors segment sales grew by 8 percent year over year, which was primarily driven by a $5.3 million or 17 percent increase in automotive sensor and actuator sales which were offset by a 5 percent drop in electronic component product sales.

Sequentially, the Components and Sensors segment increased $1.6 million or 2 percent, driven by a $4.9 million or 12 percent increase in automotive sensor and actuator sales offset by a $3.3 million or 12 percent drop in the sales of electronic component products.

The Company's EMS segment sales fell by $6.3 million or 8% compared to the fourth quarter of 2010. Here again, the drop was primarily due to the flooding in Thailand. Sequentially, EMS segment sales fell $3.7 million or 5 percent, again reflecting the flooding in Thailand.

Still, CTS Corporation's fourth quarter net income increased by 22 percent or $1.056 million to $5.856 million from net income of $4.800 million for the comparable quarter of 2010.

Based on the weighted average number of diluted common shares of 34.945 million shares, diluted net income per share for the fourth quarter resulted in net income of $0.17 per basic share during the fourth quarter of fiscal 2011. This compared to a diluted net income per share of $0.14 on a weighted average number of diluted shares of 34.952 million shares during the three months ended December 31, 2010.

It should be noted that a restructuring and related charge of $2.4 million or $0.05 per share was included in the fourth quarter compared to a restructuring and related charge of $1.7 million or $0.03 per share during the comparable quarter of 2010.

Gross margin for the three months ended December 31, 2011 dropped to 17.9 percent from 20.1 percent for the fourth quarter, ended December 31, 2010.

For the year ended December 31, 2011, year over year revenues improved by $35.865 million or 6.5 percent to $588.506 million while net income fell by 4.9 percent or $1.071 million to $20.967 million.
The increase in full year revenues was primarily driven by a 14 percent increase in year over year EMS segment revenue which was driven by a 28 percent increase in industrial sales and a 20 percent increase in defense and aerospace sales.

Based on the weighted average number of diluted common shares of 35.006 million shares, diluted net income per share resulted in net income of $0.60 per diluted share during the fiscal year ended December 31, 2011. This compared to a diluted net income per share of $0.63 on a weighted average number of diluted shares of 34.849 million shares during the fiscal year ended December 31, 2010.

It should be noted that full year diluted earnings per share included $0.07 per share for restructuring and certain legal expenses. Additionally, management estimates that the lost earning impact from the natural disaster net of all insurance recoveries for the full year was a loss of approximately $0.02 per share.

Gross margin for the year fell to 18.7 percent compared to gross margin of 21.7 percent for the fiscal ended December 31, 2010.

Approximately half of the percentage decline in gross margin is mainly due to a higher percentage of EMS sales in 2011 versus 2010 and the other half of the decrease is primarily due to higher year over year commodity and precious metal costs as well as certain new product costs related to CTS' hard disk drive product.

Still, during the fourth quarter CTS announced a 17 percent dividend increase to its shareholders, increasing the annual dividend to $0.14 per share from its previous rate of $0.12 per share.

The increase in dividend reflects the Company's confidence in future cash generation.
Furthermore, during fiscal 2011, CTS repurchased $3.6 million of its Company shares which equates to approximately 403,000 shares at an average price of $8.86, of which approximately 257,000 were repurchased during the fourth quarter.

Along the same lines, the Company has approximately 574,000 shares remaining in its one million share buyback authorization.

CTS Corporation's cash and equivalents for the fiscal year ended December 31, 2011 improved to $76.412 million while working capital totaled $159.149 million. This compares to $73.315 million of cash and equivalents and working capital of $146.555 million for the fourth quarter ended December 31, 2010.

Along the same lines the Company finished the year with debt of $74.4 million and a debt to capitalization ratio of 22 percent.

However, it should be noted that in January CTS completed the acquisition of Valpey-Fisher, the designer and manufacturer of engineered electric components.

The Company originally announced that it entered into a definitive merger agreement to acquire Valpey-Fisher in the fourth quarter 2011.

Still, new products in the Components and Sensors segment as well as the Valpey-Fisher acquisition is expected to allow the CTS' electronic components sales to increase 15 percent to 20 percent in 2012 over 2011 as well as help operating margins.

Along the same lines, management provided guidance, expecting its full-year 2012 sales to be in the range of 10% to 13% over sales from fiscal 2011. The increase is expected to be primarily driven by key new program launches as well as the Company's moving past from the negative impact from the Thailand flood and Japanese earthquake.

Diluted earnings per share for the full year are anticipated to be in the range of $0.75 to $0.80 and full year free cash flow to be in the range of $16 to $21 million.

However, the 2012 earnings guidance includes a net adverse impact of approximately $0.05 per share from a combination of higher expected effective tax rate, higher pension costs, and an expected property damage insurance recovery.

CTS Expands Into Growth Markets
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.

On April 13th CTS announced that CTS Automotive Products was awarded three new production programs with Chinese vehicle manufacturers for its Electronic Throttle Control (ETC) Accelerator Pedal Modules plus a new Transmission Sensor program for a North American platform. All four awards represent new business and will result in an increase in CTS' global market share. The pedal modules for the Chinese vehicles will be manufactured in CTS' facility in Zhongshan, China. The transmission sensors will come out of CTS' facility in Matamoros, Mexico and will be used in a new luxury all-electric vehicle. This is CTS' second business award for transmission sensors. Shipments have already begun for some of the programs. The remaining programs will launch over the next 18 months. Revenues from these four awards are expected to reach approximately $15 million over the anticipated five-year lives of the program. While these programs are small they represent new business area for the firm.

On March 22nd the firm announced that CTS Automotive Products has launched its first smart actuator production program for use on heavy-duty industrial engines that are produced by a major heavy equipment manufacturer. This low volume, highly-engineered smart actuator was launched after extensive testing for use on a series of heavy-duty industrial engines for pumps and power generation. This program was awarded two years ago and becomes the first brushless DC smart actuator for the commercial market to go to production. CTS' diversification into new markets and customers will be further enhanced when production of the high-volume smart actuator programs for light and medium-duty trucks are launched in late 2012.

Smart actuators in the commercial market is an area where CTS has great potential to tap a very large market. In the second half of 2010 the firm penetrated two of the largest diesel manufacturers with smart actuators for trucks and industrial engines. There were four wins in all prior to the March Announcement. 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)

INVESTMENT THESIS

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

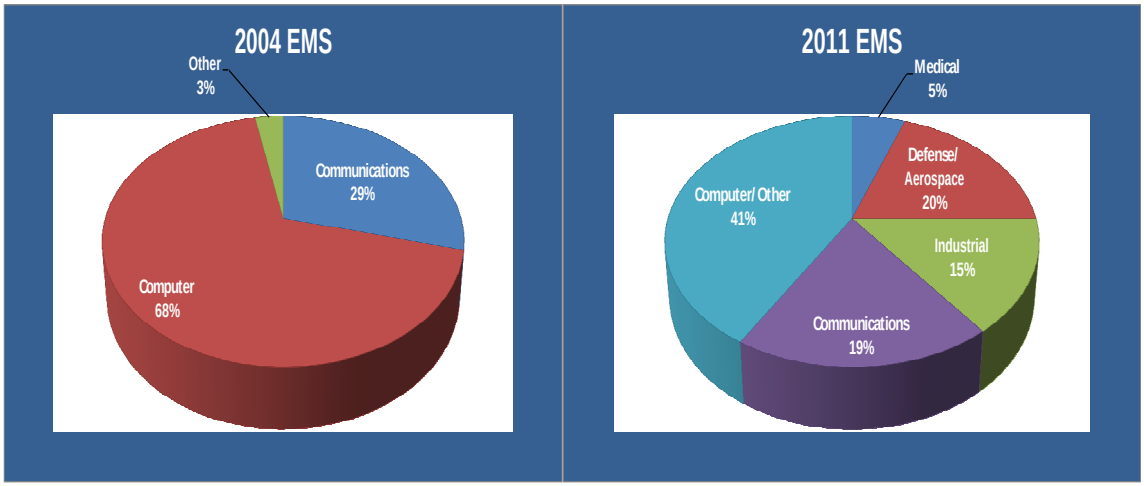


Electronics Manufacturing Services (EMS)
EMS includes the higher level assembly of electronic and mechanical components into a finished subassembly or assembly performed under a contract manufacturing agreement with an OEM or other contract manufacturer. The firm also provides full turnkey manufacturing and completion including design, bill-of-material management, logistics, and repair.

Products from the EMS segment are principally sold in the communications, computer, medical, industrial, and defense and aerospace OEM markets. Other smaller markets include OEM customers in consumer electronics, instruments and controls, and networking. Products from the Components and Sensors segment are principally sold in the automotive and communications OEM markets. Other smaller markets include computer, medical, and defense and aerospace.

EMS: Niche markets, Diversification and Alternative Energy

The slower growing EMS segment has been exceptionally diversified since 2004 into medical and industrial 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.



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.

End Market	5 year CAGR
Consumer	5-7%
Computer	6-8%
Communication	5-8%
Industrial	10-12%
Automotive	11-13%
Medical	12-15%
Zacks Estimates	

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.

*note Components and Sensors represent one segment

Electronic components (20% 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 and defense and aerospace markets. 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: Here are four.

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.

Micro pumps
Miniature compressors, pumps and synthetic jet products.

CTS is in the process of ramping the new piezoceramic component for the next generation of high density, hard disk drive application. A 10,000 square foot plus 1K level clean room has been commissioned in Tianjin, China. The estimate is that the facility has the capacity to support $15 million in annual sales of this new Piezoceramic component. This initiative is expected to incur net expenditures in hiring, training and depreciation in the second quarter, and become breakeven to the bottom-line in the third quarter. The component will be a net positive contributor with $2 million to $3 million in sales and approximately $1 million in margins in the fourth quarter of 2011. This translates to incremental annualized Piezoceramic sales of approximately $10 million and $3 million to $4 million in additional gross margin contributions in 2012 for the electronic components business from a new product and new customer standpoint.

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/howthings work**

In our opinion the internet is still growing and 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 Blackberries. There are in effect more and more devices being connected and each new connection needs some type of access.

Sensors and actuators (32% of sales) should see double- digit sales growth over 3-5 years. Green programs and fuel efficiency should provide a tail-wind. Smart Actuator, Position Sensors, and Accelerator Pedal Module are three CTS products in this area. Smart Actuators in the commercial market is an area where CTS has been making significant progress. CTS sees a potential $90 million over several years from a market that could be as large as $1 billion.

VALUATION

CTS remains well positioned to achieve solid revenue growth and operating leverage as end markets expand in the long run, given the company's competitive advantage led by innovation. The slower growing EMS segment has been exceptionally diversified since 2004 and is a complement to the faster growing Sensors and Components segment. The company is trading at a reasonable 13.4x 2012 estimated EPS.

We value the company based on the average of our P/E multiple (17.8x 2012 estimated EPS) and our two stage intrinsic model. The semiconductor/Electronic group average P/E is between 22x-26x 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.

The intrinsic value is essentially a sum of the company's future earnings, minus any long-term debt. Dividing the intrinsic value by the number of shares outstanding yields an intrinsic stock price. We used the following inputs:

- An 8-year period with an earnings growth rate of 10.0% (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%.

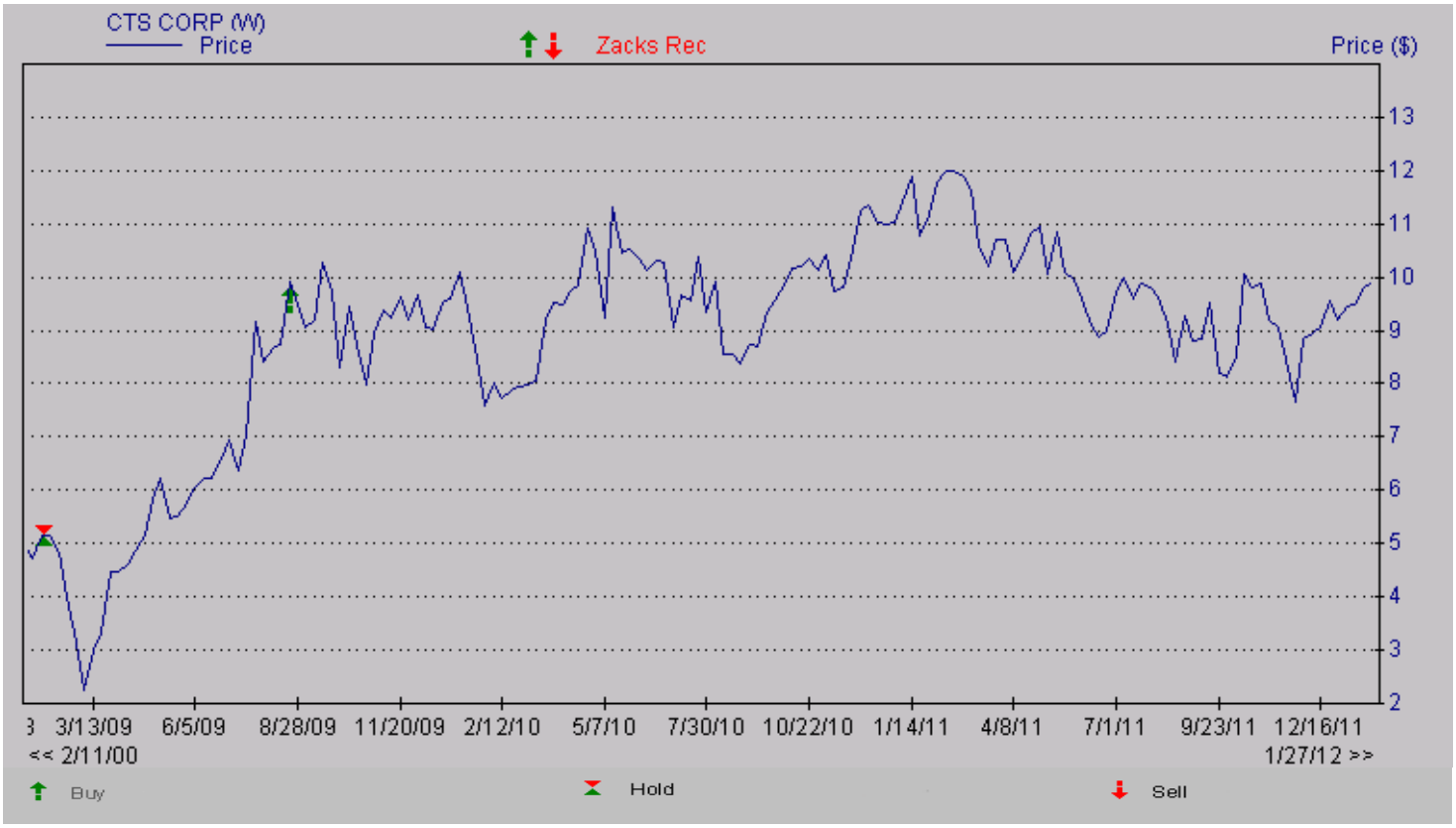
With these inputs we arrive at a target price of $14.00.

PROJECTED INCOME STATEMENT

INCOME STATEMENT ($ Millions)	Dec-10 Q4 10	Mar-11 Q1 11	Jun-11 Q2 11	Sep-11 Q3 11	Dec-11 Q4 11	Mar-12 Q1 12 E	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011 E	FY 2012 E
REVENUE												
Net Revenue	**145.0**	**152**	**147**	**146**	**144**	**160**	**686.0**	**691.7**	**499.0**	**552.6**	**588.5**	**655.0**
Sequential Growth		*4%*	*-3%*	*-1%*	*-1%*	*11%*						
OPERATING EXPENSES												
Cost of Revenues	115.9	122.4	119.1	118.6	118.2	130.0	553.3	554.6	400.1	432.7	478.2	506.0
% of Revenue	*80%*	*81%*	*81%*	*81%*	*82%*	*81%*	*81%*	*80%*	*80%*	*78%*	*81%*	*77%*
Gross Profit -	**29.1**	**29**	**28**	**27**	**26**	**30**	**132.7**	**137.1**	**98.8**	**119.9**	**110.3**	**149.0**
Proforma Gross Margin	*20.1%*	*19%*	*19%*	*19%*	*18%*	*19%*	*19.3%*	*19.8%*	*19.8%*	*21.7%*	*18.7%*	*22.7%*
R&D + Engg	4.3	5.0	4.6	5.2	5.2	5.3	15.9	18.3	14.2	18.3	20.0	20.5
% of Revenue	*3.0%*	*3.3%*	*3.1%*	*3.5%*	*3.6%*	*3.3%*	*2.3%*	*2.6%*	*2.8%*	*3.3%*	*3.4%*	*3.1%*
SG&A	17.4	18.4	18.1	18.3	16.8	19.0	82.1	82.6	67.1	72	72	84
% of Revenue	*12.0%*	*12.1%*	*12.3%*	*12.6%*	*11.7%*	*11.9%*	*12.0%*	*11.9%*	*13.5%*	*13.1%*	*12.2%*	*12.9%*
GW Amort, Restructuring, other	*$ 1.40*		*0.69*	*$ (3.80)*	*$ (3.39)*		*2.4*	(5.6)	*35.4*	1.44	*-649%*	
% of Revenue												
Total Operating Expenses	23.1	23.4	23.3	19.7	18.6	24.3	100.4	95.3	116.7	92	85	105
% of Revenue	*15.9%*	*15.4%*	*15.9%*	*13.5%*	*12.9%*	*15.2%*	*14.6%*	*13.8%*	*23.4%*	*17%*	*14%*	*16%*
Operating Income -	**6.0**	**5.8**	**4.5**	**7.8**	**7.2**	**5.7**	**32.3**	**41.8**	**-17.8**	**28**	**25**	**44**
Operating Margin	*4.2%*	*3.8%*	*3.1%*	*5.3%*	*5.0%*	*3.6%*	*5%*	*6%*	*-4%*	*5%*	*4%*	*7%*
NON-OPERATING ITEMS												
Non operating Income/Expense	-0.26	0.83	0.51	-0.26	0.01	0	0.2	-1.3	-2.6	0.18	1	-3
% of Revenue	*-0.18%*	*0.55%*	*0.35%*	*-0.17%*	*0.01%*	*-0.16%*	*0.02%*	*-0.19%*	*-0.52%*	*0.03%*	*0.19%*	*-0.38%*
Tax Provision	0.9	1.5	0.9	1.6	1.4	1.8	7.1	-0.6	13.6	6	5	15
Effective Tax Rate												
Net Income -	**4.8**	**5.1**	**4.1**	**5.9**	**5.9**	**3.7**	**25.4**	**41.0**	**-34.1**	**22.0**	**21.0**	**26.6**
Net Income Margin	*3.3%*	*3.4%*	*2.8%*	*4.0%*	*4.1%*	*2.3%*	*3.7%*	*5.9%*	*-6.8%*	*4.0%*	*3.6%*	*4.1%*
Adjustments	**0.03**	**0**	**0.02**	**0**	**0.05**	**-0.05**	**0**	**0**	**0**	**0**	**0.07**	**0**
EARNINGS PER SHARE												
EPS - Basic	$0.17	$0.15	$0.14	$0.17	$0.22	$0.06	$0.72	$0.89	-$1.01	$0.67	$0.68	$0.78
EPS - Diluted	$0.17	$0.15	$0.14	$0.17	$0.22	$0.06	$0.66	$0.81	-$1.01	$0.67	$0.68	$0.77

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