Zacks Small-Cap Research

April 29, 2014
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CTS Corporation (CTS-NYSE)

CTS: Zacks Company Report- OUTPERFORM Margin Improvement Could Exceed Expectations

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	08/24/2009
Current Price (4/28/2014)	$18.95
Target Price	**$20.00**

OUTLOOK

By selling off its low-margin stagnant EMS business in October 2013, and using that cash to pay down debt, CTS Corporation (CTS) is emerging as a more focused higher margin, higher growth business in the components and sensors market. Its automotive business (65% of sales) is benefiting from the robust car market. It is finding new opportunities for its sensor portfolio in the automotive market, growth in piezo ceramic technologies for industrial hard drives and design wins in ClearPlex technology for electronic filtering, all of which should drive growth in 2015 and beyond.

SUMMARY DATA

52-Week High	**$21.59**
52-Week Low	**$10.30**
One-Year Return (%)	**80.81**
Beta	**1.98**
Average Daily Volume (sh)	**87,932**
Shares Outstanding (mil)	**34**
Market Capitalization ($mil)	**$639**
Short Interest Ratio (days)	**4.28**
Institutional Ownership (%)	**95**
Insider Ownership (%)	**2**
Annual Cash Dividend	**$0.16**
Dividend Yield (%)	**0.82**
5-Yr. Historical Growth Rates	
Sales (%)	**1.5**
Earnings Per Share (%)	**15.6**
Dividend (%)	**6.3**
P/E using TTM EPS	**21.5**
P/E using 2014 Estimate	**19.0**
P/E using 2015 Estimate	**17.2**
Zacks Rank	**2**

Risk Level	**Below Avg.**
Type of Stock	**Small-Blend**
Industry	**Elec-Misc Comp**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	147 A	154 A	137 A	76 R	305 R
2013	98 R	105 R	104 R	102 A	410 A
2014	101 A	106 E	108 E	114 E	430 E
2015					465 E

Earnings per Share
(Non-GAAP Fully Diluted EPS before non-recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	$0.07 A	$0.18 A	$0.20 A	$0.18 A	$0.64 A
2013	$0.14 A	$0.20 A	$0.24 A	$0.25 A	$0.82 A
2014	$0.19 A	$0.22 E	$0.24 E	$0.35 E	$1.00 E
2015					$1.10 E

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WHAT'S NEW

First Quarter Shows Huge Operating Margin Improvement, Raising Estimates

On April 28, 2014, CTS Corporation reported financial results for its first quarter, ended March 31, 2013 on a continuous operations basis versus a restated 2013 quarter which beat our EPS estimates by three cents. Accordingly we are raising annual estimates by three cents, but believe that management guidance is extremely conservative. If we take guidance of revenue growth of 4-6% and keep current expense levels fairly constant for the year as the company suggests, EPS could well exceed $1.00 for the year. Investors would be well advised to sit still and see how the restructuring plays out as there could be upside surprises. The company is not yet at peak margins and still plans to move production around to best-cost locations. So far they have announced moving Canadian operations to Mexico and China and corporate employees to Elkhart. Other locations mentioned include Scotland. This may not only improve product costs be most certainly the corporate tax rate.

This quarter was the second full quarter since the divestiture of its EMS division (on October 2, 2013). As a result the company reported revenues on a continuing operations basis. Revenues in the quarter were $100.7 million versus $98.1 million last year, up just 3%. Adjusted EPS, taking out all one-time expenses was reported as $0.19 versus $0.11 up 72.7%, and handily beating our estimate of $0.16. While revenue growth was in-line, the reduction in SG&A without the divested operations was impressive.

The company's two businesses had differing sales results with sensors and mechatronics up 6% and electric components down 4%. The company blames the decline on continued weakness in hard disk drives and engineered frequency. Components for hard drives that contribute in the range of $10-20 million dollars per year to the company have suffered slippage, as a major customer delays the conversion of some of its platforms. The revenue level for this product line is now at a low, but should experience growth.

The first quarter EPS as reported contained $0.04 of one-time charges: $0.02 for restructuring and $0.02 for a tax asset write off. The company is not yet finished with realigning its global footprint and investors should expect more restructuring charges some time in 2014 at the time actions are taken. The company plans to continue to consolidate manufacturing in best-cost locations.

Gross margin was up to 30.4% versus 27.3% last year, and 29.5% in Q4 2013, as the remaining products have been cost reduced. We expect continued improvement throughout the year from these levels.

The big story is of course the huge saving in SG&A and R&D as the money losing businesses were jettisoned and facilities consolidated. SG&A decreased from $17.7 million to $13.6 million while sales were virtually flat, or 23.2%. R&D costs declined from $6.3 million to $5.6 million. This resulted in a huge improvement in operating margins, ex-one-time write offs, from 2.9% to 11.3%.

Other income was a loss of $1.8 million from currency translation, primarily a big hit from China.

CTS secured new orders of $136 million in the quarter compared with only $78 million in Q4 2013.

CTS Corporation's cash was $119 million, down from from $124 million in Q4, or $3.47 per share. This is the seasonal pattern as a result of the timing of payroll in the first quarter.

Cash flow from operations improved to $15.9 million (or 15.8% margin) for the quarter compared to $9.9 million in the 2013 quarter, up 61%. This puts it at a $63.6 million run rate. Using a $616 million enterprise value, that is a ratio of 9.7 times EBITDA. We believe as the company's margin rises, so will its valuation.

Capital expenditures were $2.8 million putting free cash flow at $13 million. The company also bought back 28,000 shares of stock at a cost of $495,000.

INVESTMENT THESIS

- Via divestiture, CTS has transitioned to a higher margin company and as a result is showing rapid earnings growth despite tepid sales growth. Its new business model will provide higher cash flows and profits for investors going forward and with that, the potential for higher dividends and multiple expansion.
- With over 65% of revenues now sold to the light vehicle industry, the company could benefit by new investors looking for exposure to new car sales without picking a specific manufacturer, and having an overweight exposure to the Asian carmakers.
- Given the drastic restructuring and conservative outlook, the company could exceed earnings estimates as it takes actions to improve its global footprint and rationalize operations and tax rates.
- The company has upside that is not priced into the stock by the introduction of a number of new products that could gain traction in the coming year. Particularly in:
    - Piezo ceramics (used on high-end hard drives to read data faster and more accurately.)
    - Smart actuators (that combine software and hardware in complicated mechatronics for simplified consolidated auto parts resulting in lower parts and labor costs for customers.)
    - ClearPlex technology (that may be designed into small base stations used in building out cellular telecom networks.) They are used to filter electronic signals and are smaller and more energy efficient than parts currently in use.

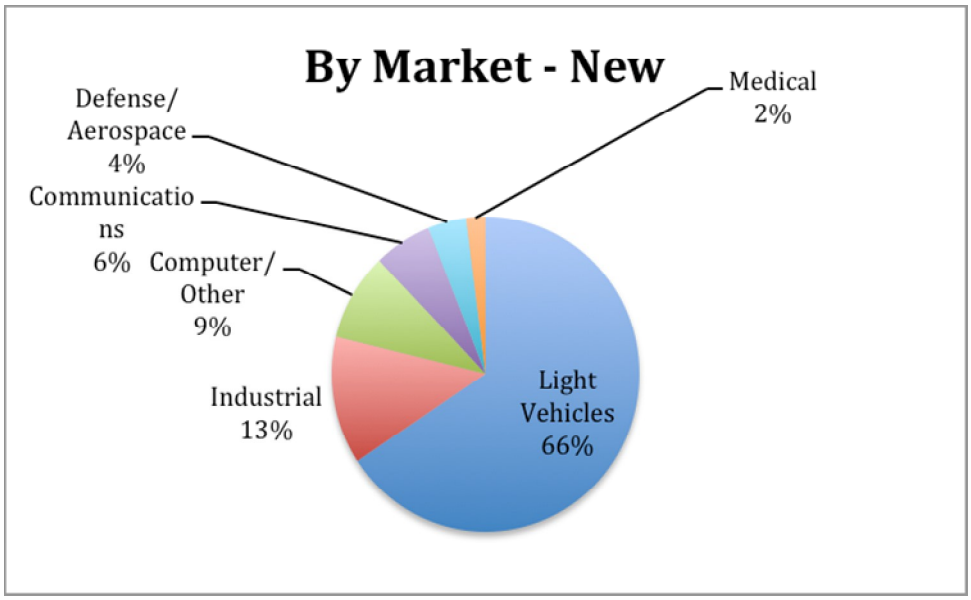
COMPANY BACKGROUND

CTS Operating Margins Move Higher

CTS Corporation (CTS) designs, manufactures, assembles, and sells electronic components and sensors worldwide. It has found new customers and markets for existing products. It designs and manufactures an extensive line of vehicle sensors and actuators used in powertrain, safety, fuel and emissions control systems; ceramic and crystal-based engineered electronic components used primarily in wireless communications infrastructure equipment, and piezoelectric materials, heat management and resistive-based components used in medical, defense and aerospace, computer, consumer and industrial equipment applications.

On October 3, 2013, Benchmark Electronics, Inc. acquired its Electronics Manufacturing Solutions (EMS) business for $75 million in cash. This segment drove down company margins as well as growth potential and the company has used the cash generated from the sale to pay down debt and reduce interest expense.

CTS Markets As of December 31, 2013



VALUATION

Compared to other companies in its industry, CTS appears fairly valued to undervalued compared to an average on a basis of PE to growth and enterprise value as well as on a cash flow basis. The share price has increased in value in the past twelve months due primarily to the restructuring efforts that are forecasted to increase the company's cash flow by over 50% in the 2014 calendar year. This quarter cash flow increased 61% making that goal look easily beatable.

As a result, although the company looks rich on a trailing basis, on a forecasted basis the company trades in line with its peers. We believe estimates for the company are conservative and that the stock could appreciate as these projections are surpassed as the year progresses.

Looking forward to 2015, we expect the stock could appreciate another 12% in the next nine months as investors begin to focus on 2015. At current multiples we expect the stock to move up from $18.40 today to over $20 by year-end 2014.

Comps Valuation Data ($ in millions)

	Cal 2014E Revenue	LTM EBIDA Margin	5-Yr Hist. CAGR	Cal '14 P/E	P/E/G	EV/2014E Sales	EV/TTM Cash Flow
OSIS	$ 934	15.3%	26.0%	16.0	0.6	1.3	9.4
MEI	$ 793	11.2%	18.5%	14.3	0.8	1.4	12.5
SYNA	$ 933	20.1%	10.7%	16.5	1.5	2.0	11.3
SANM	$ 6,200	4.6%	5.1%	10.9	2.1	0.3	6.4
Mean	$ 2,215	12.8%	15.1%	14.4	1.3	1.3	9.9
Median	$ 934	13.3%	14.6%	15.1	1.2	1.4	10.3
CTS	$ 430	11.5%	10.5%	18.0	1.7	1.4	13.1

PROJECTED INCOME STATEMENT

Q2 Should Be Better Than Q1

Q2 for CTS should be an improvement over Q1 in both sales and earnings as sales ramp through out the year. Versus the year before we only know the sales number, as the year ago quarter will be restated. Using Q1 as a guide, this year's quarter will be much improved.

With higher sales expected to be at $105 million, EPS should be even higher as expenses are expected to be flat dollar wise and the tax rate should be closer to the 31% with out the one-time tax expense in the first quarter. We are expecting fully diluted EPS at $0.24.

The company's growth should accelerate throughout the year and be back end weighted as new products ramp.

Modest Sales Growth is Expected But Margins Should Greatly Improve

Management expects full-year 2014 sales to show growth of only 4-6% or a range of $426-434 million and to be back half weighted as new product offerings kick in. We are forecasting sales of $430 million versus a restated $409 million in 2013.

While CTS expects only modest sales growth in 2014, the real story is an improvement in operating margins. Sales in 2014 should improve in the second half of the year as sales to hard drive manufacturers return to more normal levels and new products kick in.

Given the much lower SG&A reported in the Q1, we are raising our EPS estimate to $1.00 for the year ending December 31,2014, and maintain that that could be conservative. The unknown is what the company plans to spend on new initiatives.

Sales Should Accelerate in 2015

As new product design in kick into gear and the revamp of the company is stabilized. We believe the newly revitalized company could grow sales 8% to $460 million and increase pretax income and cash flow over 10%. We expect an EPS of $1.10 versus $1.00 in 2014, although we may revisit that model as the year progresses.

CTS Corp.
Income Statement

	Dec Q4 12	March Q1 13R	June Q2 13R	Sept Q3 13R	Dec Q4 13	March Q1 14E	June Q2 14E	Sept Q3 14E	Dec Q4 14E	As Reported 2010	As Reported 2011	Restated 2012	Restated 2013	2014E	2015E
REVENUE															
Net Revenue (restated)	$75.7	$98.1	$105.4	$103.6	$102.4	$102.0	$106.0	$108.0	$114.0	$552.6	$588.5	$304.5	$409.5	$430.0	$465.0
Yr-to-yr Gr.		NA	NA	NA	35%	4%	1%	4%	11%	11%	6%	-48%	34%	5%	8%
OPERATING EXPENSES															
Cost of goods sold	53.3	118.3	116.1	122.0	72.2	71.5	73.0	74.0	$73.5	432.7	478.7	213.0	288.1	292.0	315.0
Gross Margin	22.4	(20.2)	(10.7)	(18.4)	30.2	30.5	33.0	34.0	40.5	119.9	109.8	91.5	121.4	138.0	150.0
%of Sales	29.6%	-20.6%	-10.1%	-17.8%	29.5%	29.9%	31.1%	31.5%	35.5%	21.7%	18.7%	30.1%	29.6%	32.1%	32.3%
SG&A	17.7	21.4	20.7	20.8	17.2	16.8	16.2	16.0	$16.0	69.8	69.3	63.1	69.9	65.0	69.0
R&D	5.3	6.3	5.8	5.7	5.5	5.6	6.0	6.3	$7.1	18.3	20.0	20.9	23.2	25.0	27.0
One-time charges	(8.4)	0.6	7.2	1.0	2.3	0.0	0.0	0.0	$0.0	1.4	(7.3)	(6.9)	10.5	0.0	0.0
Tot Operating Exp.	14.6	28.2	33.8	27.4	25.1	22.4	22.2	22.3	23.1	89.6	82.0	77.1	103.6	90.0	96.0
Operating Income	7.7	(48.5)	(44.4)	(45.9)	5.1	8.1	10.8	11.7	17.4	30.3	27.8	14.4	17.8	48.0	54.0
Yr-to-yr Gr.															
Oper Inc B4 One-time	(0.6)	(47.9)	(37.2)	(44.9)	7.5	8.1	10.8	11.7	17.4			7.5	28.3	48.0	54.0
Pre-tax margin												2.5%	6.9%	11.2%	11.6%
Net Interest	(0.3)	(0.5)	(0.6)	(0.4)	0.0	0.0	0.0	0.0	0.0	0.2	1.1	(0.8)	(1.5)	0.0	0.0
Other income	0.4	0.3	(0.3)	0.7	1.4	0.0	0.0	0.0	0.0			0.2	1.7	0.0	0.0
Pretax Income	7.8	(48.7)	(45.4)	(45.6)	6.5	8.1	10.8	11.7	17.4	30.5	28.9	13.8	18.1	48.0	54.0
Taxes	1.9	(0.8)	12.1	3.6	1.8	2.5	3.3	3.6	5.4	6.0	5.4	1.0	16.1	14.9	16.7
Tax Rate	24.4%	1.7%	-26.7%	-7.8%	27.9%	31.0%	31.0%	31.0%	31.0%	19.6%	18.6%	6.9%	88.8%	31.0%	31.0%
Net Income Cont. Ops.	5.9	(47.8)	(57.5)	(49.1)	4.7	5.6	7.5	8.1	12.0	24.5	23.6	12.9	2.0	33.1	37.3
Yr-to-yr Gr.	0.2%	-908.4%	-1841.8%	-930.4%	-21.1%				156.6%						
EPS-Basic	$0.18	($1.43)	($1.71)	-$1.46	$0.14	$0.17	$0.22	$0.24	$0.36	$0.72	$0.69	$0.38	$0.06	$0.99	$1.12
EPS-Fully dil.	$0.17	($1.40)	($1.71)	-$1.43	$0.14	$0.16	$0.22	$0.24	$0.35	$0.70	$0.67	$0.37	$0.06	$0.97	$1.10
Yr-to-yr Gr.															
EPS-Adjusted	0.18	0.14	20.0%	24.0%	0.25	$0.16	$0.22	$0.24	$0.35	$0.70	$0.67	$0.64	$0.84	$0.97	$1.10
Yr-to-yr Gr.	NA	100.0%	11.1%	20.0%	38.9%	16.8%	8.9%	-1.6%	71.4%				NA	15.9%	12.6%
Share Out	33.6	33.5	33.6	33.7	33.6	33.5	33.5	33.5	33.5	34.1	34.3	33.9	33.6	33.5	33.4
Fully diluted shares	34.3	34.2	33.6	34.3	34.3	34.2	34.2	34.2	34.2	34.8	35.0	34.5	34.0	34.0	34.0
Yr-to-yr Gr.		-1.6%	-1.3%	-0.4%	0.0%	-1.6%	0.5%	-0.8%		3.0%	0.5%	-1.4%	-1.5%	0.0%	0.0%

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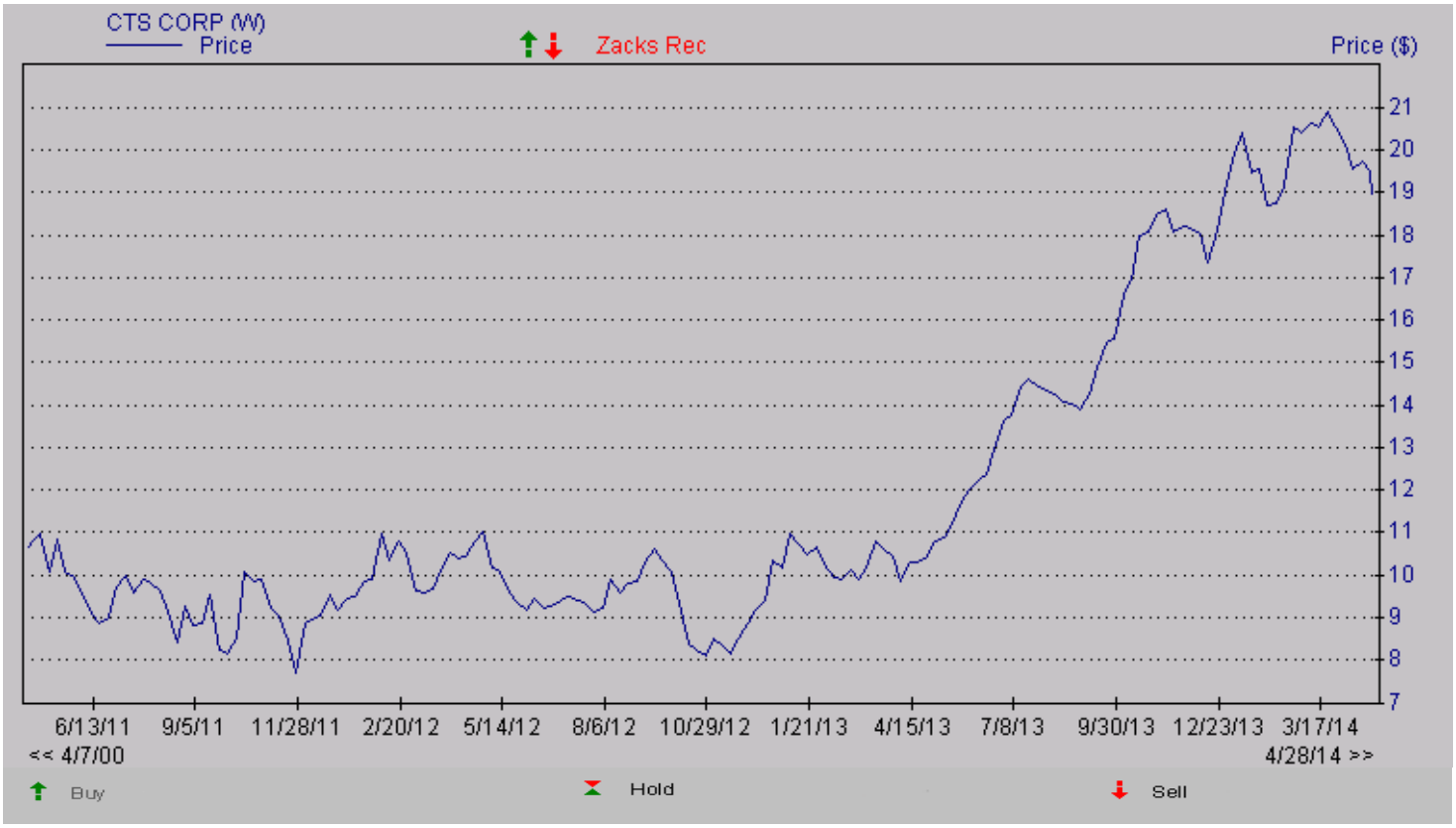

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Sell/Underperform: The analyst expects the company will underperform the broader U.S. Equity market over the next one to two quarters.

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