Zacks Small-Cap Research

April 26, 2012
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CTS Corporation (CTS-NYSE)

CTS: - Look For a Very Strong Second Half of 2012- Outperform

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	02/23/2012
Current Price (04/25/12)	$10.97
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.

Certain reimbursement payments (flood) will be recorded later on in the year. This will have the effect of a strong second half. We see a strong 2012 as business returns to form.

SUMMARY DATA

52-Week High	**$11.00**
52-Week Low	**$7.40**
One-Year Return (%)	**2.94**
Beta	**1.94**
Average Daily Volume (sh)	**88,797**
Shares Outstanding (mil)	**34**
Market Capitalization ($mil)	**$375**
Short Interest Ratio (days)	**16.06**
Institutional Ownership (%)	**84**
Insider Ownership (%)	**3**
Annual Cash Dividend	**$0.14**
Dividend Yield (%)	**1.28**
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	147 A	154 E	165 E	177 E	643 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	$0.07 A	$0.15 E	$0.21 E	$0.33 E	$0.76 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 April 24, 2012, CTS Corporation, reported financial results for its first quarter, ended April 1, 2012. The first quarter resulted in a 3 percent decrease in year over year revenues to $146.969 million which compares to revenues of $151.518 million for the three months ended April 3, 2011.

It should be noted that the first quarter benefited from some insurance recoveries that related to 2011 expenses, due to a normal timing lag in recovery. However, lost EMS sales due to Thailand and an overall weak start to 2012 negatively impacted the Company's seasonally weak first quarter.

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 6 percent year over year or $4.4 million.

The year over year increase in the segment revenues was primarily driven by a $2.6 million or 10 percent increase in sales of electronic components as well as a $1.8 million or a 4 percent increase automotive sensor and actuator sales.

Electronic component sales benefited from the Company's new piezoceramic HDD product launch and incremental sales from the Valpey-Fisher acquisition while automotive sensor and actuator sales profited from the introduction of a new global pedal module.

It should be noted that the Company entered into a definitive merger agreement to acquire Valpey-Fisher in the fourth quarter 2011 and completed the acquisition in January 2012.

Sequentially, the components and sensors segment increased by $5.7 million or 8 percent, driven by a $3.7 million or 15 percent increase in electronic component products as well as a $2.0 million or 4 percent increase in automotive sensor and actuator sales.

Furthermore, CTS continues its success in winning new programs in the faster growing Asia markets.

Earlier in the week, CTS announced it was awarded four new automotive sensor programs in the first quarter and that the products service light vehicle markets in Japan, Korea and China.

Three of the awards are for pedal modules and one is for exhaust gas recirculation sensors and productions of two of the programs will start this year.

The new programs are expected to bring over $17 million in new revenues over the five year life of these programs.

As a result, the Company expects sensor sales for full year 2012 to increase 14% to 15% year over year, driven by new business and new product introduction.

The Company's EMS segment sales fell by $11.0 million or 8.9 percent compared to the first quarter of 2011. The drop was primarily due to the impact of the flooding in Thailand.

Sequentially, EMS segment sales fell $2.7 million or 4 percent. The sequential drop reflects a decreased in

the defense and aerospace and communications markets, partially offset by increases in the industrial and medical markets.

Here again, during the first quarter, the October 2011Thailand flood negatively impacted EMS sales, expenses and inventories.

Likewise, gross margin was negatively impacted by flood related expense of $6 to $7 million, of which the Company expects to recover $4 million of this in the second quarter.

CTS Corporation's first quarter net income fell by $2.833 million to $2.283 million from net income of $5.116 million for the comparable quarter of 2011.

Based on a weighted average number of diluted common shares of 34.718 million shares, diluted net income per share for the first quarter resulted in net income of $0.07 per diluted share during the first quarter of fiscal 2012. This compared to a diluted net income per share of $0.15 on a weighted average number of diluted shares of 35.075 million shares during the three months ended April 3, 2011.

It should be further be noted that during the first quarter 2012, results were affected by a non-cash pension expense of approximately $1.0 million, or $0.02 per share as well as a delayed recovery of approximately $0.8 million, or $0.02 per share.

Gross margin for the three months ended April 1, 2012 dropped to 15.0 percent from 19.3 percent for the first quarter, ended April 3, 2011.

Still, during the first quarter 2012, CTS repurchased $2.7 million of its Company shares which equates to approximately 272,100 shares at an average price of $10.05.

Likewise, the Company has approximately 302,000 shares remaining in its one million share buyback authorization.

CTS Corporation's cash and equivalents for the first quarter ended April 1, 2012, improved to $84.441 million while working capital totaled $176.999 million. This compares to $76.412 million of cash and equivalents and working capital of $159.149 million for the first quarter ended April 3, 2011.

Controllable working capital was 18.3 percent of annualized sales, about 1 percent higher than last year and first quarter 2012 free cash flow from operation was the usage of $8 million versus $5.7 million a year ago.

From a working capital perspective accounts receivables days improved to 51 days, from 53 days for the first quarter of 2011.
Still, the first quarter debt balance increased by $34.3 million from year-end as a result of higher working capital requirements, the Thailand flood and approximately $15 million for the Valpey-Fisher acquisition, net of cash acquired.

Management maintained its 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 the negative impact from the Thailand flood and Japanese earthquake.

Similarly, CTS expects capital expenditures to be approximately 3 percent of sales in 2012.

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.

Likewise, CTS anticipates its second quarter adjusted diluted earnings per share to be in the range of $0.15 to $0.21 in the second quarter.

The Company's major initiatives currently are centered on re-commissioning of the Thailand EMS facility, consolidation of Asian engineered frequency manufacturing from China into Singapore, and the launching of its second pedal module for a global vehicle platform.

Furthermore, all major growth initiatives and new product introductions have just been launched or are on schedule to be launched later this year.

Likewise, while the distribution buy/sell business started off weak, it finished the quarter with sales to distribution book to bill ratio of 1.07, showing improved demand and overall, management expects sales in second half of the year to be much stronger as ordering and shipments improved in March 2012.

INVESTMENT THESIS

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



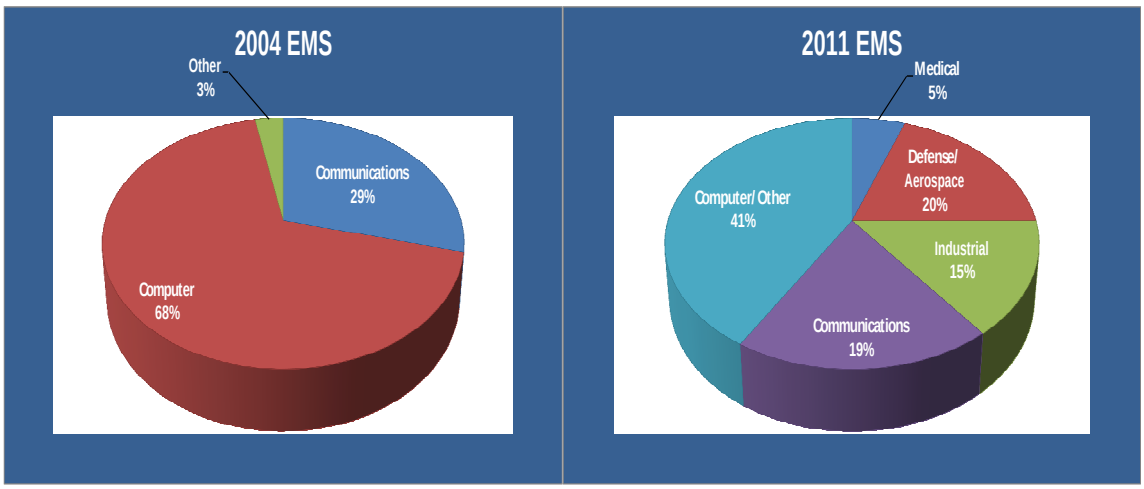
Electronics Manufacturing Services (EMS)

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 facility has the capacity to support $15 million in annual sales of this new Piezoceramic component. This could translate 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. First quarter 2012 Electronic component sales benefited from the Company's new piezoceramic HDD product launch and incremental sales from the Valpey-Fisher acquisition while automotive sensor and actuator sales profited from the introduction of a new global pedal module.

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)

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 Android systems. There are in effect more and more devices being connected and each new connection needs some type of access.

VALUATION

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

Metric	CTS	Industry Average
EV/EBITDA	7.23	7.35

Metric	CTS	Industry Average
P/E TTM	18.17	14.07
P/E 2012 (E)	14.02	16.34
P/E 2013 (E)	12.72	15.0
P/S	0.64	0.95

Valuation
Here is how we value the shares.

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.
- The free cash flow to equity is the correct measure of expected cash flows to stockholders. (rather than dividends)

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 (20.0x 2012 estimated EPS) and our two stage intrinsic model. The semiconductor/Electronic group average P/E is between 18x-24x 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%.

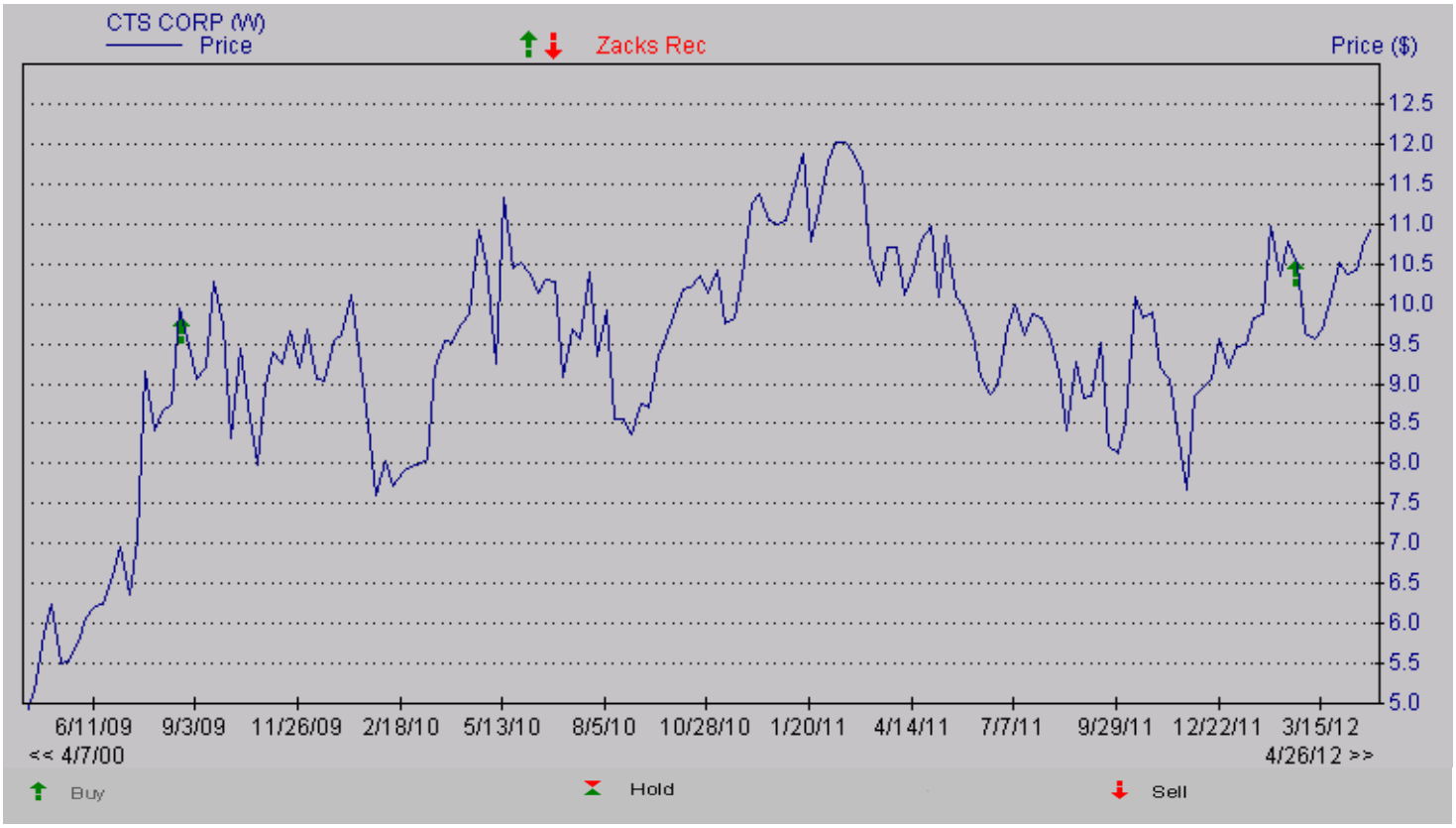
With these inputs we arrive at a target price of $14.00.

PROJECTED INCOME STATEMENT

INCOME STATEMENT ($ Millions)	Mar-11 Q1 11	Jun-11 Q2 11	Sep-11 Q3 11	Dec-11 Q4 11	Mar-12 Q1 12	Jun-12 Q2 12 E	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012 E
REVENUE												
Net Revenue	**152**	**147**	**146**	**144**	**147**	**154**	**686.0**	**691.7**	**499.0**	**552.6**	**588.5**	**643.0**
Sequential Growth		*-3%*	*-1%*	*-1%*	*2%*	*5%*						
OPERATING EXPENSES												
Cost of Revenues	122.4	119.1	118.6	118.2	121.3	124.3	553.3	554.6	400.1	432.7	478.2	512.5
% of Revenue	*81%*	*81%*	*81%*	*82%*	*83%*	*81%*	*81%*	*80%*	*80%*	*78%*	*81%*	*80%*
Gross Profit -	**29**	**28**	**27**	**26**	**26**	**30**	**132.7**	**137.1**	**98.8**	**119.9**	**110.3**	**130.5**
Proforma Gross Margin	*19%*	*19%*	*19%*	*18%*	*17%*	*19%*	*19.3%*	*19.8%*	*19.8%*	*21.7%*	*18.7%*	*20.3%*
R&D + Engg	5.0	4.6	5.2	5.2	4.3	4.1	15.9	18.3	14.2	18.3	20.0	17.2
% of Revenue	*3.3%*	*3.1%*	*3.5%*	*3.6%*	*3.0%*	*2.7%*	*2.3%*	*2.6%*	*2.8%*	*3.3%*	*3.4%*	*2.7%*
SG&A	18.4	18.1	18.3	16.8	19.4	19.0	82.1	82.6	67.1	72	72	79
% of Revenue	*12.1%*	*12.3%*	*12.6%*	*11.7%*	*13.2%*	*12.3%*	*12.0%*	*11.9%*	*13.5%*	*13.1%*	*12.2%*	*12.3%*
GW Amort, Restructuring, other		*0.69*	*$ (3.80)*	*$ (3.39)*			*2.4*	(5.6)	*35.4*	1.44	*-649%*	
% of Revenue												
Total Operating Expenses	23.4	23.3	19.7	18.6	23.7	23.1	100.4	95.3	116.7	92	85	96
% of Revenue	*15.4%*	*15.9%*	*13.5%*	*12.9%*	*16.2%*	*15.0%*	*14.6%*	*13.8%*	*23.4%*	*17%*	*14%*	*15%*
Operating Income -	**5.8**	**4.5**	**7.8**	**7.2**	**1.9**	**6.6**	**32.3**	**41.8**	**-17.8**	**28**	**25**	**34**
Operating Margin	*3.8%*	*3.1%*	*5.3%*	*5.0%*	*1.3%*	*4.3%*	*5%*	*6%*	*-4%*	*5%*	*4%*	*5%*
NON-OPERATING ITEMS												
Non operating Income/Expense	0.83	0.51	-0.26	0.01	0	0	0.2	-1.3	-2.6	0.18	1	1
% of Revenue	*0.55%*	*0.35%*	*-0.17%*	*0.01%*	*0.25%*	*0.26%*	*0.02%*	*-0.19%*	*-0.52%*	*0.03%*	*0.19%*	*0.16%*
Tax Provision	1.5	0.9	1.6	1.4	0.0	1.8	7.1	-0.6	13.6	6	5	9
Effective Tax Rate												
Net Income -	**5.1**	**4.1**	**5.9**	**5.9**	**2.3**	**5.2**	**25.4**	**41.0**	**-34.1**	**22.0**	**21.0**	**26.3**
Net Income Margin	*3.4%*	*2.8%*	*4.0%*	*4.1%*	*1.6%*	*3.4%*	*3.7%*	*5.9%*	*-6.8%*	*4.0%*	*3.6%*	*4.1%*
Adjustments	**0**	**0.02**	**0**	**0.05**			**0**	**0**	**0**	**0**	**0.07**	**0**
EARNINGS PER SHARE												
EPS - Basic	$0.15	$0.14	$0.17	$0.22	$0.07	$0.15	$0.72	$0.89	-$1.01	$0.67	$0.68	$0.77
EPS - Diluted	$0.15	$0.14	$0.17	$0.22	$0.07	$0.15	$0.66	$0.81	-$1.01	$0.67	$0.68	$0.76

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