Zacks Small-Cap Research

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CTS Corporation (CTS-NYSE)

CTS: - 12-15% 2013 Top-line Growth Rate- Outperform

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	02/23/2012
Current Price (02/01/13)	$10.24
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.

A 12-15% top-line growth rate along with the company's plan reduce its overhead cost structure will position the company for stronger growth in 2013.

SUMMARY DATA

52-Week High	**$11.25**
52-Week Low	**$8.04**
One-Year Return (%)	**-1.66**
Beta	**2.05**
Average Daily Volume (sh)	**74,395**
Shares Outstanding (mil)	**34**
Market Capitalization ($mil)	**$346**
Short Interest Ratio (days)	**10.32**
Institutional Ownership (%)	**85**
Insider Ownership (%)	**3**
Annual Cash Dividend	**$0.14**
Dividend Yield (%)	**1.37**
5-Yr. Historical Growth Rates	
Sales (%)	**-3.9**
Earnings Per Share (%)	**0.5**
Dividend (%)	**3.5**
P/E using TTM EPS	**12.4**
P/E using 2012 Estimate	**12.4**
P/E using 2013 Estimate	**11.0**
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)
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 A	137 A	138 A	577 A
2013	160 E	175 E	160 E	155 E	650 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
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	$0.14 A	$0.18 A	$0.20 A	$0.18 A	$0.70 A
2013	$0.18 E	$0.23 E	$0.18 E	$0.16 E	$0.75 E

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WHAT'S NEW

On January 28, 2013, CTS Corporation reported financial results for its fourth quarter and full year, ended December 31, 2012. The company, whose competition includes AVX and PLXS has several growth drivers such as Pedal Modules and is finding a way to get New Products to New Customers

The Company's fourth quarter resulted in a nearly 4 percent or $5.701 million decrease in year over year revenues to $138.298 million compared to revenues of $143.999 million for the three months ended December 31, 2011.

Sequentially, revenues improved by $941,000 or nearly 1 percent over the $137.357 million from the third quarter fiscal 2012.

Sales of the Company's components and sensors segment grew by $5 million or 7 percent year over year to $75.675 million, despite the continued negative impact of the Japan/China territory dispute and the weak European economy.

Likewise, within the segment, sales of electronic components increased $6.3 million or 26% from higher piezoceramic product demand for HDD and incremental sales from the Valpey-Fisher acquisition.

Early in 2012 CTS acquired Valpey-Fisher, a designer and manufacturer of precision frequency products with annual sales of $15 million. The acquisition was accretive during their first year.

The components and sensors segment's automotive product sales declined year over year by only $1.4 million, benefiting from sales of new products.

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.

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

Furthermore, it should be noted that the Automotive Sensors and Actuators business continues to do extremely well, with six new program wins in the fourth quarter, which include three new, and three replacement programs.

Likewise, management anticipates its Sensors and Actuator sales to grow year-over-year by a strong 40 to 45 percent in 2013, driven by the D&R acquisition, and organic new products like smart actuator's growth.

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. Integration efforts are proceeding on schedule.

The acquisition is expected to be slightly accretive in 2013, even after recognizing non-cash amortization of intangibles created by the acquisition.

The decrease in consolidated sales was primarily a result of a $10.677 or 15 percent, year-over-year reduction in the lower margin EMS segment sales due to lower government spending in the defense and aerospace markets and from closing a small, unprofitable operation in the U.K.

Still, EMS segment gross and operating margins in the fourth quarter and full-year improved, as the Company continued to take cost actions and completed its recovery of insurance reimbursements for flood related expenses, lost sales, and business disruption.

Sequentially, the Components and Sensors segment improved by $110,000, up from the $75.565 million in the third quarter of fiscal 2012.

Similarly, the EMS segment's fourth quarter 2012 sales improved sequentially by $831,000, or just over 1 percent from the third quarter of 2012.

Net income for the quarter increased year over year by $2.976 million or 51 percent to $8.832 million from net income of $5.856 million for the comparable quarter of 2011.

Sequentially, Net income improved by $2.915 from $5.917 million for the quarter ended September 30, 2012.

The improvement in net income was primarily due to a $10.334 million gain on the Singapore facility sale-leaseback transaction as well as improved margins.

Gross margin during the quarter improved year over year to 19.4 percent from 17.9 percent for the quarter ended December 31, 2011.

Based on a weighted average number of diluted common shares of 34.330 million shares, diluted net income per share resulted in net income of $0.26 per diluted share during the fourth quarter of fiscal 2012. This compared to a diluted net income per share of $0.17 on a weighted average number of diluted shares of 34.945 million shares during the three months ended December 31, 2011.

For the full year ended December 31, 2012, year over year revenues fell slightly to $576.918 million from $588.506 million for full year ended December 31, 2011.

Still, full-year Components and Sensors segment revenue increased 9 percent on a year over year basis.

The improvement was driven primarily by a 15 percent year over year improvement in electronic component sales due to higher piezoceramic product demand for HDD and the Valpey-Fisher acquisition and a 5 percent year over year improvement in automotive sensors and actuators sales as a result of higher pedal module sales and new products, despite lower sales relating to the Japan/China dispute, the weak European economy and unfavorable currency impacts.

Full-year EMS segment revenue decreased $36.2 million, or 12 percent year over year as a result of lower government defense spending, the closure of a small, unprofitable operation in the U.K. and disruptions from the Thailand flood.

However, lower sales in defense and aerospace, communications and computer markets were partially offset by double-digit increases in industrial and medical sales.

Net income for the twelve months fell by $634,000 year over year to $20.333 million for the full year ended December 31, 2012. This compares to $20.967 million for the comparable twelve months ended December 31, 2011.

Here again, fiscal 2012 results benefited from a $10.334 million gain on the Singapore facility sale-leaseback transaction.

Based on a weighted average number of diluted shares of 34.523 million shares, diluted net income per share resulted in net income of $0.59 per diluted share during the full year fiscal 2012. This compared to a diluted net income per share of $0.60 on a weighted average number of diluted shares of 35.006 million shares during the twelve months ended December 31, 2011.

Still, CTS Corporation's cash and equivalents for the fourth quarter ended December 31, 2012, improved to $109.571 million while working capital improved to $194.646 million. This compares to $88.620 million of cash and equivalents and working capital of $173.080 million for the third quarter ended September 30, 2012.

Full year fiscal 2012 cash flow from operations was a strong $41.7 million, compared to $22.2 million for the previous year primarily due to reduced inventories and as the disruptions from the Thailand flood is now past.

Similarly, full-year free cash flow was $27.6 million, coming in higher than management's guidance range of $22 to $26 million and rocketing past last year's free cash flow of $8.7 million.

Full year capital expenditures were $13.5 million, or 2.3% of sales, compared to $15.6 million, or 2.6% of sales, in the prior year.

Additionally, accounts receivable days were 51 days, similar to last year, and accounts payable days were 65 days, compared to 70 days last year. Likewise, inventory decreased $16.7 million during the year, helping inventory turns improve to 6.0 from 5.0 last year.

It should be noted that as a result of the weak economic environment, the Company has taken proactive actions to further reduce its overhead cost structure which is expected to position the company for stronger growth in 2013.

Restructuring actions initiated in 2012 are substantially complete, with the EMS China closure to be completed by the end of the first quarter 2013.

Furthermore, during the third quarter 2012, CTS authorized the repurchase of up to one million shares as a result of its prior authorization of one million shares being completed.

During the fourth quarter the Company repurchased approximately 440,000 shares of common stock in open market transactions for $3.8 million.

Finally, management believes that as a result of the 2012 restructuring actions, new product launches and recent acquisitions, CTS will drive double-digit growth.

Accordingly, management anticipates full-year 2013 sales to increase in the range of 12 percent to 15 percent over 2012 revenues and diluted earnings per share to be in the range of $0.73 to $0.78.

It should be noted that the 2013 diluted earnings per share estimate includes approximately $0.05 per share of CEO transition-related costs.

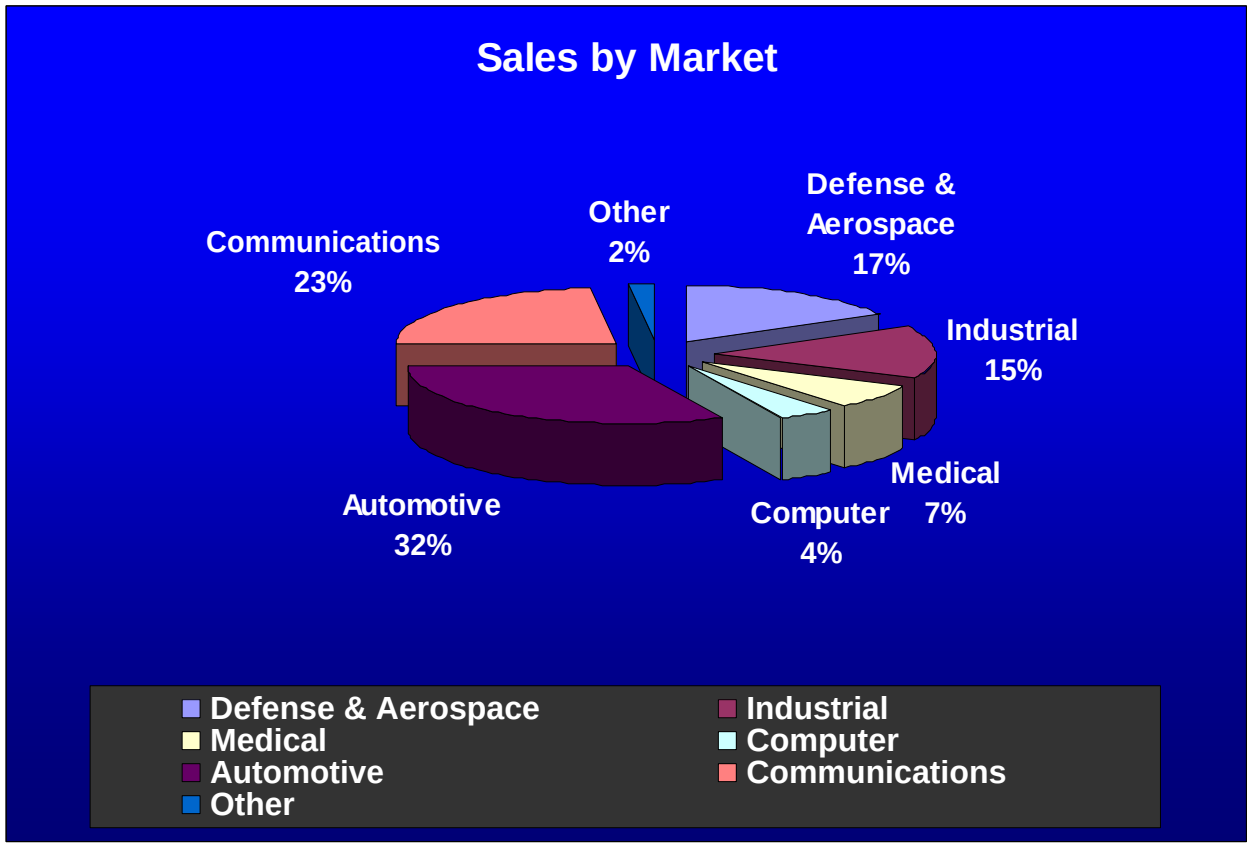
Likewise, management expects gross margin percent to continue to improve another 100 to 150 basis points in 2013.

Similarly, first quarter 2013 results are expected to show normal seasonality with gradual improvements during the year.

INVESTMENT THESIS

CTS is Diversified, Growing and Undervalued.

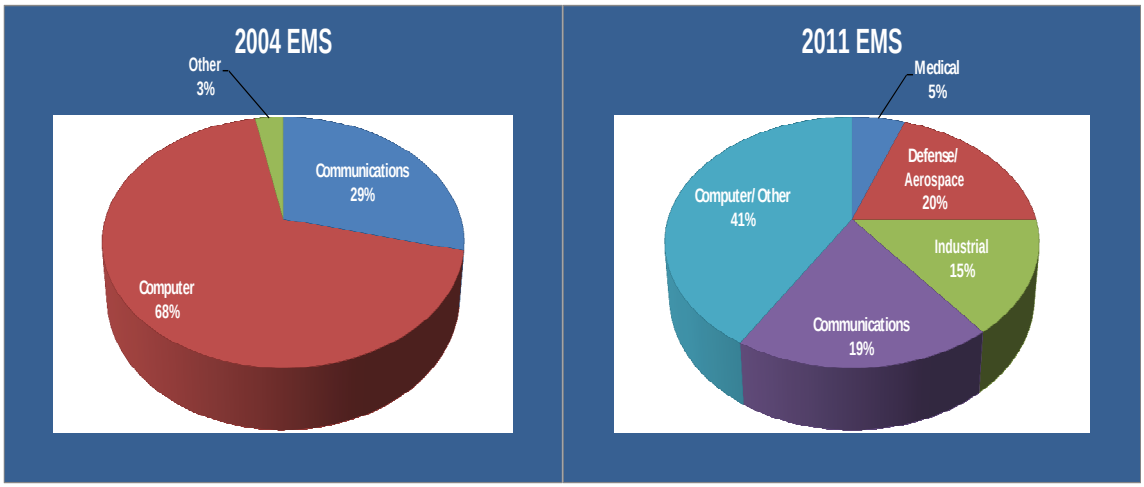
CTS has two reportable segments: Electronics Manufacturing Services (EMS) and Components and Sensors.



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.

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.

Sensors and Actuators

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. Products in this segment include Smart Actuator, Position Sensors, and Accelerator Pedal Modules.

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.

On April 13, 2011 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 22' 2011 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.

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 (19% 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: Such as

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.

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.

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

Metric	CTS	Industry Average
P/B	1.3	1.6
P/E 2012 (TTM)	14.6	14.9
P/E 2013 (E)	13.6	15.15
P/S	0.60	0.70

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 (18.0x 2013 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 10.0% (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%.

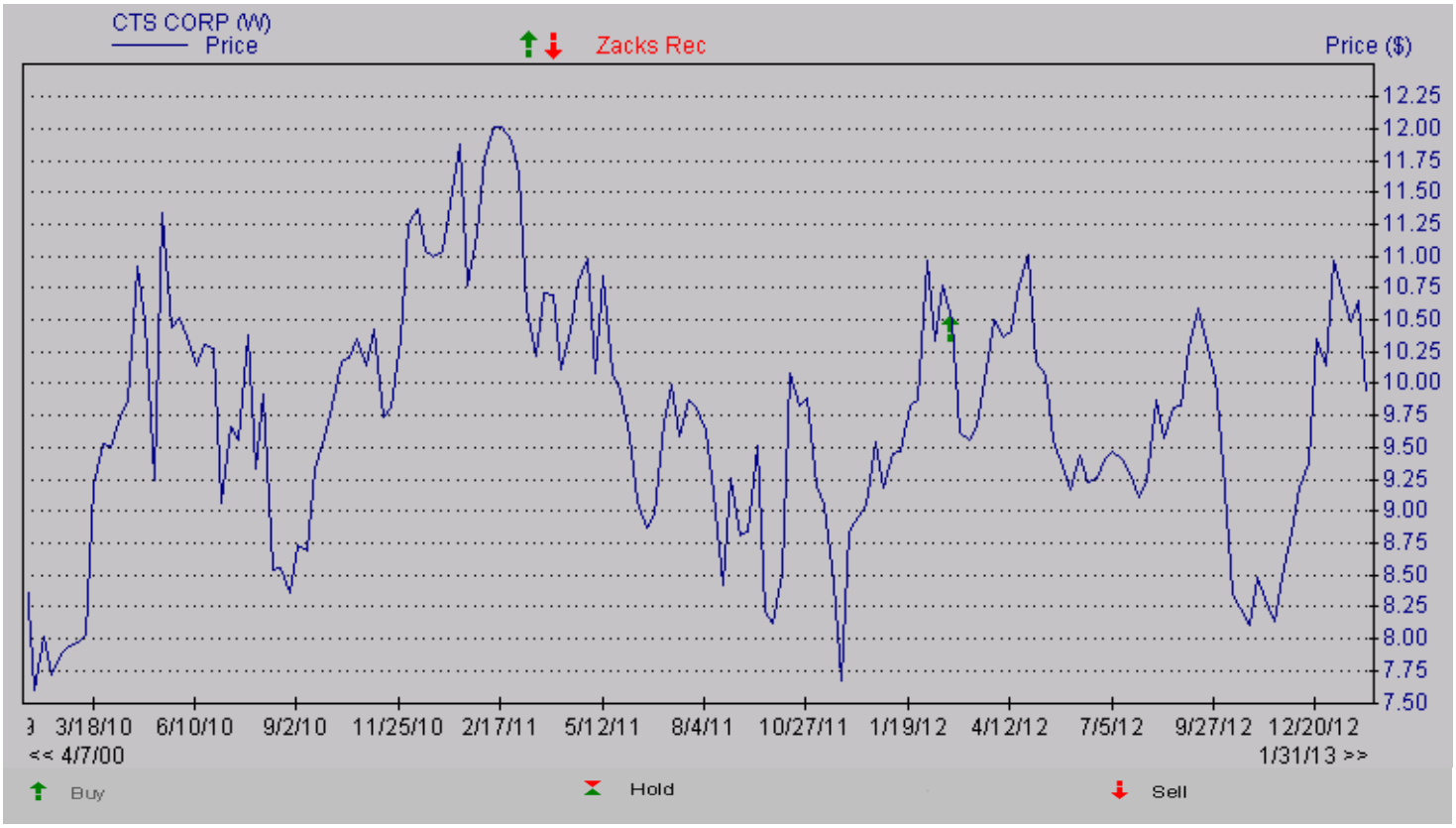
With these inputs we arrive at a target price of $14.00.

PROJECTED INCOME STATEMENT

INCOME STATEMENT ($ Millions)	Dec-11 Q4 11	Mar-12 Q1 12	Jun-12 Q2 12 E	Sep-12 Q3 12	Dec-12 Q4 12	Mar-12 Q1 13 E	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013 E
REVENUE												
Net Revenue	**144**	**147**	**154**	**137**	**138**	**160**	**691.7**	**499.0**	**552.6**	**588.5**	**576.9**	**650.0**
Sequential Growth		*2%*	*5%*	*-11%*	*1%*	*16%*						
OPERATING EXPENSES												
Cost of Revenues	118.2	121.3	120.9	110.8	111.5	127.5	554.6	400.1	432.7	478.2	464.5	520.0
% of Revenue	*82%*	*83%*	*78%*	*81%*	*81%*	*80%*	*80%*	*80%*	*78%*	*81%*	*81%*	*80%*
Gross Profit -	**26**	**26**	**33**	**27**	**27**	**33**	**137.1**	**98.8**	**119.9**	**110.3**	**112.4**	**130.0**
Proforma Gross Margin	*18%*	*17%*	*22%*	*19%*	*19%*	*20%*	*19.8%*	*19.8%*	*21.7%*	*18.7%*	*19.5%*	*20.0%*
R&D + Engg	5.2	4.3	5.1	4.4	5.3	5.2	18.3	14.2	18.3	20.0	19.1	17.2
% of Revenue	*3.6%*	*3.0%*	*3.3%*	*3.2%*	*3.9%*	*3.3%*	*2.6%*	*2.8%*	*3.3%*	*3.4%*	*3.3%*	*2.6%*
SG&A	16.8	19.4	19.4	19.4	22.2	20.0	82.6	67.1	72	72	80	79
% of Revenue	*11.7%*	*13.2%*	*12.6%*	*14.1%*	*16.1%*	*12.5%*	*11.9%*	*13.5%*	*13.1%*	*12.2%*	*13.9%*	*12.1%*
GW Amort, Restructuring, other	*$ (3.39)*		*$ 3.14*	*(3.95)*	*$ (12.98)*		*(5.6)*	35.4	*1.44*	-649%	*(13.79)*	
% of Revenue												
Total Operating Expenses	18.6	23.7	27.6	19.8	14.6	25.2	95.3	116.7	92	85	86	96
% of Revenue	*12.9%*	*16.2%*	*17.9%*	*14.4%*	*10.5%*	*15.8%*	*13.8%*	*23.4%*	*17%*	*14%*	*15%*	*15%*
Operating Income -	**7.2**	**1.9**	**5.7**	**6.8**	**12.2**	**7.3**	**41.8**	**-17.8**	**28**	**25**	**27**	**34**
Operating Margin	*5.0%*	*1.3%*	*3.7%*	*5.0%*	*8.8%*	*4.6%*	*6%*	*-4%*	*5%*	*4%*	*5%*	*5%*
NON-OPERATING ITEMS												
Non operating Income/Expense	0.01	0	-1	1	0	-1	-1.3	-2.6	0.18	1	0	1
% of Revenue	*0.01%*	*0.25%*	*-0.78%*	*0.44%*	*0.35%*	*-0.63%*	*-0.19%*	*-0.52%*	*0.03%*	*0.19%*	*0.04%*	*0.15%*
Tax Provision	1.4	0.0	1.2	1.5	3.9	1.8	-0.6	13.6	6	5	7	9
Effective Tax Rate												
Net Income -	**5.9**	**2.3**	**3.3**	**5.9**	**8.8**	**4.5**	**41.0**	**-34.1**	**22.0**	**21.0**	**20.3**	**26.0**
Net Income Margin	*4.1%*	*1.6%*	*2.1%*	*4.3%*	*6.4%*	*2.8%*	*5.9%*	*-6.8%*	*4.0%*	*3.6%*	*3.5%*	*4.0%*
Adjustments	**0.05**	**0.07**	**0.08**	**0.03**	**-0.08**	**0.05**	**0**	**0**	**0**	**0.07**	**0.10**	**0**
EARNINGS PER SHARE												
EPS - Basic	$0.22	$0.14	$0.18	$0.20	$0.18	$0.18	$0.89	-$1.01	$0.67	$0.68	$0.70	$0.76
EPS - Diluted	$0.22	$0.14	$0.18	$0.20	$0.18	$0.18	$0.81	-$1.01	$0.67	$0.68	$0.69	$0.75

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