Zacks Small-Cap Research

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CTS Corporation (CTS-NYSE)

CTS: Cutting Numbers as Currency Threatens; Will Acquisitions Help?

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	08/24/2009
Current Price (02/06/2015)	$16.60
Target Price	**$18.00**

OUTLOOK

By selling off its low-margin stagnant EMS business in October 2013, CTS has emerged as a more focused, higher margin business in the components and sensors market. Its cash hoard of $135 million is available for future overseas acquisitions expected to reduce its dependency on the low growth automotive market and possibly lower tax rates.

In addition, it is finding new opportunities for its sensor portfolio in the automotive market, growth in piezo ceramic technologies and design wins in ClearPlex technology for electronic filtering, all of which should drive growth in 2015 and beyond. In 2017, 2014 automotive design wins are expected to kick in to accelerate growth from current levels.

SUMMARY DATA

52-Week High	**$21.59**
52-Week Low	**$15.47**
One-Year Return (%)	**-10.5**
Beta	**1.51**
Average Daily Volume (sh)	**63,187**
Shares Outstanding (mil)	**33**
Market Capitalization ($mil)	**$556**
Short Interest Ratio (days)	**5.61**
Institutional Ownership (%)	**88**
Insider Ownership (%)	**2**
Annual Cash Dividend	**$0.16**
Dividend Yield (%)	**0.96**
5-Yr. Historical Growth Rates	
Sales (%)	**-3.7**
Earnings Per Share (%)	**10.3**
Dividend (%)	**7.5**
P/E using TTM EPS	**17.1**
P/E using 2014 Estimate	**14.8**
P/E using 2015 Estimate	**14.4**
Zacks Rank	**3**

Risk Level	**Average**
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)
2013	98 A	105 A	104 A	102 A	410 A
2014	101 A	103 A	100 A	100 A	404 A
2015	101 E	102 E	103 E	104 E	410 E
2016					430 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2013	$0.11 A	$0.22 A	$0.18 A	$0.25 A	$0.82 A
2014	$0.19 A	$0.25 A	$0.29 A	$0.24 A	$0.97 A
2015	$0.25 A	$0.27 A	$0.30 A	$0.32 E	$1.05 E
2016					$1.16 E

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WHAT'S NEW

Currency Headwinds Hit Earnings…

CTS reported earnings on target with our expectations, but gave guidance on its earnings call of revenues expected to be $400-430 million in 2015 and adjusted EPS of $0.98 to $1.10 when we were at $424 million and $1.12. The reason is continuing weak sales in Europe, but even more so currency changes versus the Euro and the Chinese Renminbi. The company believes this has the potential of cutting another 2-3% off sales and $0.08 to $0.10 off earnings per share. If the dollar stays where it is, the company expects it to negatively impact EPS by $0.04 to $0.05. Given the dollar strength, we are cutting our 2015 EPS to $1.05 from $1.12 and revenues to $410 from $424 million.





…But Acquisitions Could Add to Revenues

Given the tepid guidance, the investment thesis has changed for 2015 at CTS. While 2014 reaped the benefits of the 2013 restructuring through much higher margins and adjusted earnings growth of 29%, 2015 should be an acquisition year. The company is flush with $135 million in cash, albeit overseas, and plans to use some of it to acquire companies that can:

- lessen its dependence on the light vehicle automotive market
- improve its manufacturing cost structure
- increase exposure to faster growth markets
- reduce taxes, because anywhere else in the world they invest, has a lower tax rate than the US.

The company has given guidance for revenues in 2015 of $400-430 million, the mid-point of which is a 2.7% increase. The also expect very modest margin improvement, as 90% of the gains have already been absorbed in 2014. And there could be a small amount of tax rate reduction. As far as restructuring, all that is currently in the works is the shift of the Canadian operation to lower cost China and Mexico throughout the remainder of this year. The company will now focus on product development and sales and marketing to grow the company.

While some growth is better than no growth, we believe that investors may find the stock uninteresting right now, which of course makes it an ideal entry point. The stock is down 24% from its high of $21.65 in March 2014, despite being a much more profitable company. Its profile however has gone from a growth stock to flattish with no apparently impetus. We would argue that this impetus would be the potential of acquisitions followed sequentially with significant design wins that will generate meaningful revenue growth in 2017.

If we assume that the company can make accretive acquisitions with is excess cash we estimate that it has $118 million to spend which would still leave it with 5% of assets in cash. Using comps of 1.2 times sales, giving them a 25% premium for an acquisition, the company could add almost $80 million in additional revenue without adding any debt. That would increase revenues 19%. So adding this to organic growth of 5% for the next two years and say 15% in 2017, the company could go from $404 million last year to $580 million in 2017 or 12.8% revenue CAGR going forward. This does not include any margin improvement or tax rate improvement that we would expect.

Based on an enterprise value to sales of 1.2, CTS stock could move up 35% between now and the end 2016 when looking forward at 2017 revenues.

Q4 2014 Shows Flat Revenues and Adjusted EPS

While revenues came in flat year over year as expected, earnings were slightly light as there was no sequential margin improvement as we had grown accustomed to expect from this company in 2014. Clearly this was disappointing, as was the statement by management that 90% of the margin improvement for the company has already been realized and other than a move of the Canadian operations, there was little planned to make any significant changes. Revenues came in at $100.4 million, down 2% from last year and flat with the $100.0 million reported in Q2. Weakness in parts of the globe for cars has not helped grow the business as of late. Clearly this is a reason the company plans to pursue acquisitions external to cars.

Gross margins ticked up nicely to 32.9% versus 29.5% last year and 32.5% in Q2 2014 due primarily to material and labor efficiencies. R&D increased $300,000 over last year and the company focuses on new products. While G&A was cut, Sales and Marketing increased causing SG&A to rise $1.5 million over last year. Both this year and last had one-time restructuring charges that are not included in this analysis.

The biggest swing factor now, and going forward is currency. This quarter, the company took a large hit of $1.8 million in other income versus a gain last year of $1.4 million. With operating income of $10.3 million in

the quarter, a swing of $3.2 million is meaningful to EPS. Adjusted operating income without one-time charges were up 56%. But currency (mostly) caused adjusted EPS to be virtually flat with last year. No wonder management is cautious going forward.

CTS secured new orders $171 million in the quarter (of which $145 million was automotive) versus $88 million in Q3, $89 million in Q2, and $136 million in the first quarter. This was 119% higher than the $78 million that was won in Q4 2013. Included in this number is an accelerator module program with a German OEM—a new large customer.

CTS Corporation's cash balance was $132 million, and long-term debt was $75 million.

INVESTMENT THESIS

- With $135 million in cash on the balance sheet (albeit overseas), the company is in an excellent position to pursue growth through acquisition. We believe the company has enough excess cash to by companies totally upwards of $80 million in incremental revenue.
- The company has design wins that will develop into revenues two years out. Based on current design wins, 2017 should sow very strong growth.
- The company's guide down and limited near term prospects could be a good entry point for investors expecting accretive acquisitions in the near future.

COMPANY BACKGROUND

CTS Corporation (CTS) designs, manufactures, assembles, and sells electronic components and sensors worldwide. Over 65% of revenues are sold to the light vehicle automotive market. 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.

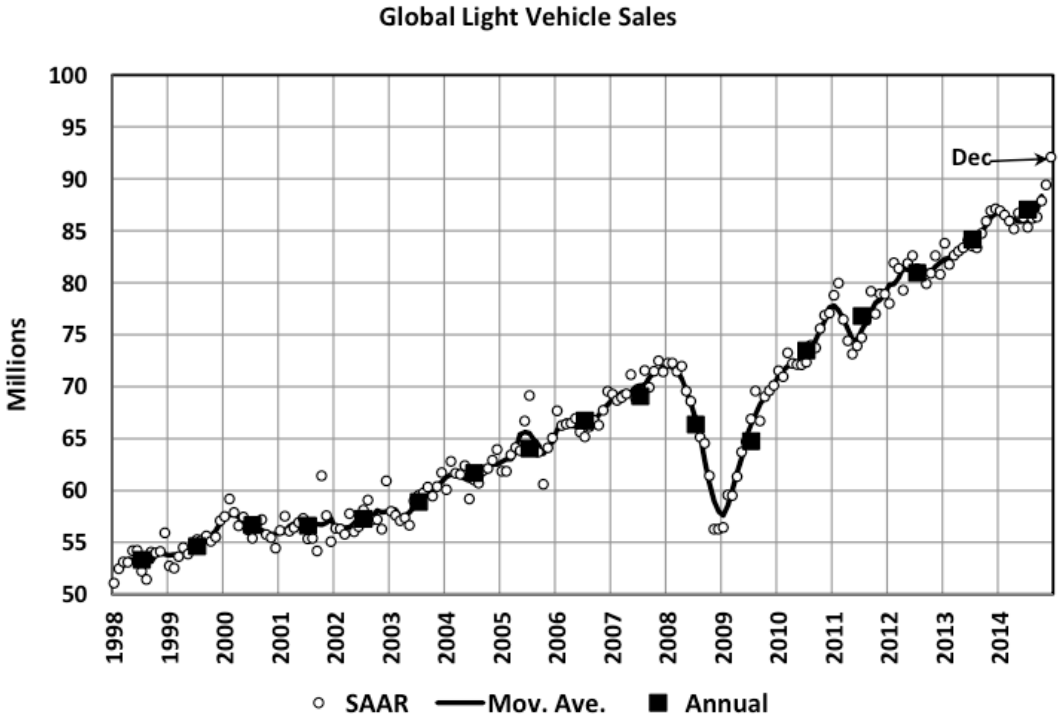
On October 3, 2013, its Electronics Manufacturing Solutions (EMS) business was sold for $75 million in cash. The company used the cash generated from the sale to pay down debt and as a war chest for potential acquisitions.

INDUSTRY OUTLOOK

65% of the company's sales come from the light vehicle market that has totally recovered from the 2009 lows. According to LMC Automotive, the seasonally adjusted selling rate for December 2014 was 92 million units up 3.5% from a year ago. By 2018, volumes are expected to be at 100 million an increase of 15% in four years, a CAGR of 3.5% per year. In order to exceed this growth we expect CTS to grow by acquisition and increasing market share as well as entering new markets for its products.

Commentary

- The Global Light Vehicle market ended 2014 on a high note with a best-ever seasonally adjusted annualised rate of sales of 92 mn units/year as a number of markets posted good year-end results.
- Chinese sales led the way as the selling rate topped 25 mn units/year but other markets such as the US, Western Europe and even Brazil fared well.



Source: LMC Automotive

	Sales (units)						Selling rate (Units/year)			
	Dec 2014	Dec 2013	Percent Change	Year to date 2014	Year to date 2013	Percent Change	Dec 2014	Year to date 2014	Year 2013	Percent Change
WORLD	7,965,381	7,377,278	8.0%	87,166,563	84,225,254	3.5%	92,065,276	87,166,563	84,225,254	3.5%
USA	1,504,467	1,357,044	10.9%	16,490,861	15,572,933	5.9%	16,810,034	16,490,861	15,572,933	5.9%
CANADA	131,393	113,223	16.0%	1,852,817	1,742,475	6.3%	1,917,002	1,852,817	1,742,475	6.3%
WESTERN EUROPE	1,031,481	999,052	3.2%	13,554,779	12,887,851	5.2%	14,040,556	13,554,779	12,887,851	5.2%
EASTERN EUROPE	507,502	510,074	-0.5%	4,551,297	4,937,213	-7.8%	5,177,484	4,551,297	4,937,213	-7.8%
JAPAN	423,280	413,928	2.3%	5,444,030	5,255,108	3.6%	6,239,295	5,444,030	5,255,108	3.6%
KOREA	165,769	134,370	23.4%	1,621,678	1,507,985	7.5%	1,794,972	1,621,678	1,507,985	7.5%
CHINA	2,436,707	2,110,765	15.4%	23,689,302	21,875,132	8.3%	25,631,196	23,689,302	21,875,132	8.3%
BRAZIL / ARGENTINA	380,942	381,805	-0.2%	3,972,534	4,478,532	-11.3%	4,293,983	3,972,534	4,478,532	-11.3%
OTHER	1,383,840	1,357,017	2.0%	15,989,264	15,968,025	0.1%	16,160,755	15,989,264	15,968,025	0.1%

Notes:
The percentage change in the final column compares the average selling rate in the year-to-date with the last full year.
Late reporting countries and estimates are included in "Other".
Eastern Europe includes Turkey.
China includes estimate of light vehicle imports.

VALUATION

Compared to other companies in its industry, CTS appears fairly valued 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 from a low of $8 in November of 2012, right before Kieran O'Sullivan was appointed President and CEO, and reached a recent peak of $21.59 on April 2nd 2014, after it had executed its strategy to sell of the low margin/money losing businesses and rapidly increase earnings. We expect the company's stock price to grow in line with its earnings growth rather than multiple expansion. Since we expect the company to grow earnings in 2015 by 8.7% we expect the stock price to move up accordingly. The upside in the stock near term would be acquisition and long term in 2017 when current design wins accelerate earnings in 2017. At current multiples we expect the stock to move up from $16.60 today to $18 by the end of 2015.

Comps Valuation Data ($ in millions)

	Cal 2015E Revenue	LTM EBIDA Margin	5-Yr CAGR	Cal '15 P/E	P/E/G	EV/2015E Sales	EV/TTM EBITDA
)SIS	$997	17.0%	18.0%	19.2	1.1	1.4	8.7
IEI	$903	14.6%	25.0%	16.1	0.6	1.5	10.8
YNA	$1,918	8.1%	18.0%	12.6	0.7	1.4	13.9
ANM	$6,600	5.1%	15.0%	9.7	0.6	0.3	5.9
lean	$2,605	11.2%	19.0%	14.4	0.8	1.2	9.8
ledian	$1,458	11.4%	18.0%	14.4	0.7	1.4	9.7
TS	$410	14.8%	18.0%	15.7	0.9	1.3	8.6

PROJECTED INCOME STATEMENT

	March Q1 14	June Q2 14	Sept Q3 14	Dec Q4 14	March Q1 15E	June Q2 15E	Sept Q3 15E	Dec Q4 15E	Restated 2013	2014	2015E	2016E
REVENUE												
Net Revenue (restated)	$100.7	$103.0	$100.0	$100.4	$101.0	$102.0	$102.8	$104.0	$409.5	$404.0	$409.8	$430.3
Yr-to-yr Gr.	3%	-2%	-4%	-2%	0%	-1%	3%	4%	34.5%	-1.3%	1.4%	5.0%
OPERATING EXPENSES												
Cost of goods sold	70.1	69.2	67.5	67.4	67.0	67.0	67.0	$67.5	288.1	$274.1	$268.5	285.0
Gross Margin	30.6	33.8	32.5	33.0	34.0	35.0	35.8	36.5	121.4	130.0	141.3	145.3
% of Sales	30.4%	32.8%	32.5%	32.9%	33.7%	34.3%	34.8%	35.1%	29.6%	32.2%	34.5%	33.8%
SG&A	13.6	15.8	13.9	15.8	15.6	15.5	15.3	$15.2	70.0	59.1	$61.6	63.4
R&D	5.6	5.3	5.8	5.8	5.9	6.0	6.1	$6.2	23.2	22.6	$24.2	26.6
One-time charges	0.5	2.7	1.6	1.1	0.5	0.5	0.0	$0.0	10.5	5.9	$1.0	0.0
Tot Operating Exp.	19.8	23.9	21.3	22.7	22.0	22.0	21.4	21.4	103.7	87.6	86.8	90.1
Operating Income	10.8	9.9	11.2	10.3	12.0	13.0	14.4	15.1	17.7	42.3	54.5	55.2
Oper Inc B4 One-time	11.3	12.7	12.8	11.4	12.5	13.5	14.4	15.1	28.1	48.3	54.5	55.2
				56%								
Operating margin	11.3%	12.3%	12.8%	11.4%	12.4%	13.2%	14.0%	14.5%	6.9%	11.9%	13.3%	12.8%
Net Interest	0.0	0.1	0.1	0.3	0.3	0.3	0.3	0.3	(1.4)	0.6	1.1	1.1
Other income	(1.8)	(0.4)	0.6	(1.8)	(1.0)	(1.0)	(1.0)	(1.0)	1.7	(3.4)	(4.0)	0.0
Pretax Income	9.1	9.6	11.9	8.8	11.3	12.3	13.7	14.4	18.1	39.4	51.6	56.3
Taxes	3.9	3.3	3.8	1.8	3.5	3.8	4.2	4.5	16.1	12.8	$16.0	17.4
Tax Rate	43.3%	34.0%	31.9%	31.9%	31.0%	31.0%	31.0%	31.0%	88.9%	32.5%	31.0%	31.0%
Net Income Cont. Ops.	5.2	6.4	8.1	7.0	7.8	8.5	9.4	9.9	2.0	26.6	35.6	38.8
Yr-to-yr Gr.	73.2%	-162.0%	58.7%	67.9%	50%	33%	16%	42%	-84.5%	1232.7%	33.7%	9.2%
EPS-Basic-Cont. Op	$0.15	$0.19	$0.24	$0.21	$0.23	$0.25	$0.28	$0.30	$0.06	$0.79	$1.07	$1.18
EPS-Fully dil. Cont. Ope	$0.15	$0.19	$0.24	$0.21	$0.23	$0.25	$0.28	$0.30	$0.06	$0.78	$1.05	$1.16
Yr-to-yr Gr.	72.6%	-160.9%	48.7%	69.8%	52%	35%	18%	44%	-84.3%	1237.3%	35.2%	10.3%
EPS-Adjusted	**$0.19**	**$0.25**	**$0.29**	**$0.24**	**$0.25**	**$0.27**	**$0.30**	**$0.32**	**$0.75**	**$0.97**	**$1.05**	**$1.16**
Yr-to-yr Gr.	76.4%	15.5%	61.1%	0.0%	28.2%	6.2%	3.5%	31.4%	17.2%	29.3%	8.7%	10.3%
Share Out	33.7	33.7	33.6	33.4	33.4	33.3	33.1	33.0	33.6	33.6	33.2	32.9
Fully diluted shares	34.3	34.2	34.1	33.9	33.9	33.8	33.6	33.5	34.2	34.1	33.7	33.4
Yr-to-yr Gr.	0.3%	1.8%	-0.7%	-1.1%	-1%	-1%	-1%	-1%	-0.8%	-0.3%	-1.2%	-1.0%
New Orders	136	89	88	171								

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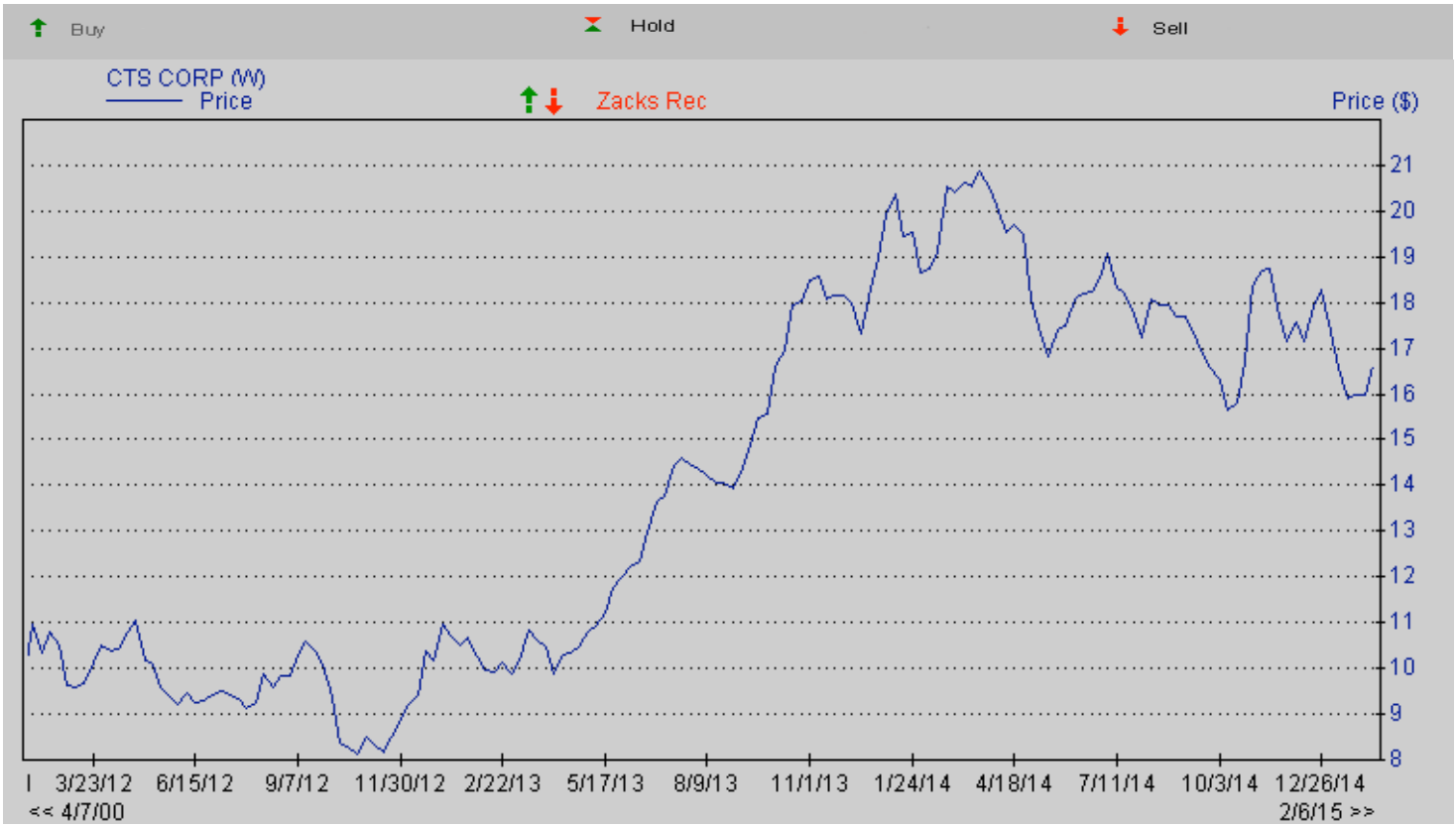

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