Zacks Small-Cap Research

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CTS Corporation (CTS-NYSE)

CTS: - Bottom-Line Outlook is Maintained - Outperform

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	02/23/2012
Current Price (07/25/12)	$8.74
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 insurance recoveries will be recorded later on in the year. This will have the effect of a slightly stronger second half. We see a strong 2013 as new programs contribute to sales.

SUMMARY DATA

52-Week High	**$11.03**
52-Week Low	**$7.40**
One-Year Return (%)	**-10.91**
Beta	**2.00**
Average Daily Volume (sh)	**61,010**
Shares Outstanding (mil)	**34**
Market Capitalization ($mil)	**$298**
Short Interest Ratio (days)	**16.05**
Institutional Ownership (%)	**79**
Insider Ownership (%)	**3**
Annual Cash Dividend	**$0.14**
Dividend Yield (%)	**1.60**
5-Yr. Historical Growth Rates	
Sales (%)	**-5.1**
Earnings Per Share (%)	**-2.3**
Dividend (%)	**2.4**
P/E using TTM EPS	**13.7**
P/E using 2012 Estimate	**11.7**
P/E using 2013 Estimate	**10.4**
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)
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	160 E	165 E	626 E
2013					658 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	$0.07 A	$0.18 A	$0.23 E	$0.27 E	$0.75 E
2013					$0.84 E

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WHAT'S NEW

Solid Quarter at CTS, Bottom-Line Outlook is Maintained

On July 23, 2012, CTS Corporation reported financial results for its second quarter and six months, ended July 1, 2012. The Company's second quarter resulted in a $7.375 million or 5 percent increase in year over year revenues to $154.294 million which compares to revenues of $146.919 million for the three months ended July 3, 2011.

Sales of the Company's components and sensors segment grew by 8 percent year over year or $8.8 million. The year over year increase in the segment revenues was primarily driven by a $7.0 million, or 17 percent increase, in automotive sensor and actuator sales as Japanese automotive customers recovered from last year's earthquake. Likewise, electronic component sales increased by $1.8 million, or 7 percent, year over year.

Electronic component sales benefited improved piezoceramic product demand, including HDD sales, and incremental sales from the Valpey-Fisher acquisition. The Company entered into a definitive merger agreement to acquire Valpey-Fisher in the fourth quarter 2011 and completed the acquisition in January 2012.

Still, CTS Corporation's electronics manufacturing services (EMS) segment's second quarter sales decreased $1.4 million, or 2 percent, year over year primarily as a result of the continued impact of the Thailand flood, which was partially offset by new customer program ramps.

However, it should be noted that the Company's Thailand EMS facility, which had been out of service since the October 2011 flood, is now fully operational with substantially all production having been transferred back to Thailand from the California EMS facilities.

Sequentially, the components and sensors segment was flat while the EMS segment's second quarter 2012 sales increased $6.9 million, or 10 percent over the first quarter of 2012.

Gross margin for the three months ended July 1, 2012 dropped to 16.8 percent from 19.0 percent for the second quarter, ended July 3, 2011.

CTS Corporation's second quarter net income fell by $831,000 to $3.301 million from net income of $4.132 million for the comparable quarter of 2011.

Based on a weighted average number of diluted common shares of 34.576 million shares, diluted net income per share for the second quarter resulted in net income of $0.10 per diluted share during the second quarter of fiscal 2012. This compared to a diluted net income per share of $0.12 on a weighted average number of diluted shares of 35.025 million shares during the three months ended July 3, 2011.

During the second quarter 2012, results were affected by restructuring and related charges of approximately $0.08 per share. Likewise, in the second quarter 2011, results were affected by restructuring and legal charges of $0.02 per share.

Excluding these items, adjusted second quarter 2012 earnings per share were up 29 percent at $0.18 compared to $0.14 in the same period last year.

For the six months ended July 1, 2012, year over year revenues improved by 1.0 percent or $2.826 million to $301.263 million from $298.437 million for the first half of 2011.

Gross margin for the six months fell to 15.9 percent compared to gross margin of 19.1 percent for the six months ended July 3, 2011.

Net income for the six months fell by $3.664 million year over year to $5.584 million for the six months ended July 1, 2012. This compares to $9.248 million for the comparable six months ended July 3, 2011.

Based on a weighted average number of diluted shares of 34.647 million shares, diluted net income per share resulted in net income of $0.16 per diluted share during the first six months of 2012. This compared to a diluted net income per share of $0.26 on a weighted average number of diluted shares of 35.050 million shares during the six months ended July 3, 2011.

CTS Corporation's cash and equivalents for the first quarter ended July 1, 2012, equaled $83.039 million while working capital totaled $167.012 million. This compares to $84.441 million of cash and equivalents and working capital of $176.999 million for the first quarter ended April 1, 2012.

Second quarter cash flow from operations was $16.1 million while year-to-date cash flow from operations was $12.0 million, compared to $8.8 million in the same period 2011.

The second quarter cash flow from operations was CTS Corporation's highest level since the third quarter of 2009.

Similarly, CTS' second quarter debt balance decreased $11.7 million from the first quarter as a result of its strong cash flow.

Still, management lowered its guidance, expecting its full-year 2012 sales to now be in the range of 4% to 7% over sales from 2011.

The Company lowered its guidance from the previously expected 10% to 13% year over year increase in sales as a result of lower than expected global economic growth, including negative economic growth in Europe and also due to a stronger dollar.

However, management is maintaining its guidance of diluted earnings per share for the full year to be in the range of $0.75 to $0.80 as a result of expected restructuring savings.

Nevertheless, during the second quarter 2012, CTS repurchased $2.9 million of its Company shares which equates to approximately 300,400 shares at an average price of $9.68.

Likewise, year to date, the Company repurchased approximately 572,500 shares for $5.6 million, at an average price of $9.86.

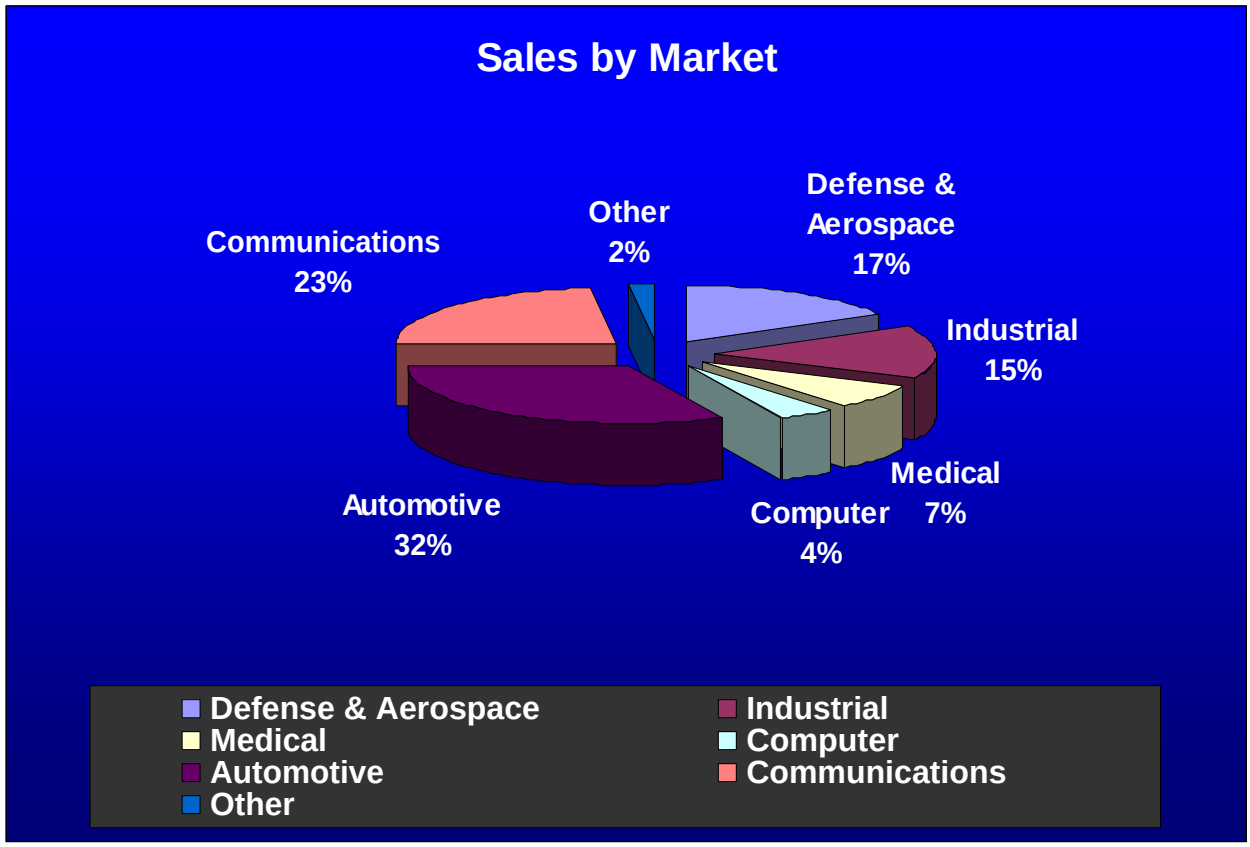
Furthermore, during the second quarter, CTS initiated a $5 million restructuring plan with expected annual savings of approximately $6 million.

Last, CTS' new grill shutter actuator product was launched in May, one quarter earlier than originally planned and production on its major smart actuator program is expected to begin as scheduled in late fourth quarter.

INVESTMENT THESIS

CTS is Diversified, Growing and Undervalued.

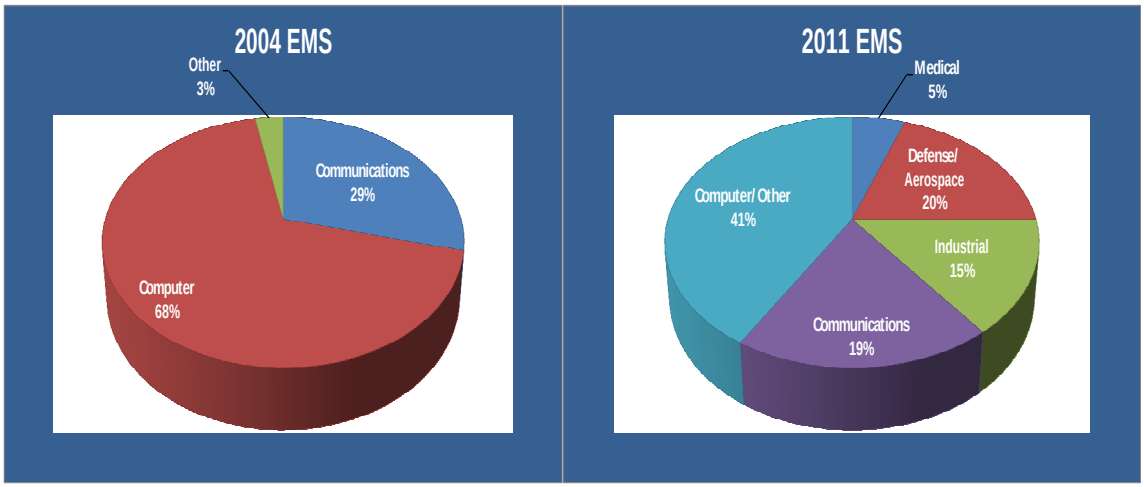
CTS has two reportable segments: Electronics Manufacturing Services (EMS) and Components and Sensors.



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. According to the enterprise multiple the firm looks overvalued. Recall that CTS Corporation's 2011 Fiscal year was biblical, as the firm dealt with the adverse effects of earthquakes, fires and floods. As the firm rebuilds this business, receives insurance payments, restructures its cost model, and enters new markets this metric will likely come down.

Metric	CTS	Industry Average
EV/EBITDA	13.17	8.21

Metric	CTS	Industry Average
P/B	1.12	2.82
P/E 2012 (E)	11.65	16.34
P/E 2013 (E)	10.40	15.15
P/S	0.50	2.45

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 2012 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)	Jun-11 Q2 11	Sep-11 Q3 11	Dec-11 Q4 11	Mar-12 Q1 12	Jun-12 Q2 12 E	Sep-12 Q3 12 E	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012 E	FY 2013 E
REVENUE												
Net Revenue	**147**	**146**	**144**	**147**	**154**	**160**	**691.7**	**499.0**	**552.6**	**588.5**	**626.0**	**658.0**
Sequential Growth		*-1%*	*-1%*	*2%*	*5%*	*4%*						
OPERATING EXPENSES												
Cost of Revenues	119.1	118.6	118.2	121.3	120.9	125.5	554.6	400.1	432.7	478.2	495.0	525.0
% of Revenue	*81%*	*81%*	*82%*	*83%*	*78%*	*78%*	*80%*	*80%*	*78%*	*81%*	*79%*	*80%*
Gross Profit -	**28**	**27**	**26**	**26**	**33**	**35**	**137.1**	**98.8**	**119.9**	**110.3**	**131.0**	**133.0**
Proforma Gross Margin	*19%*	*19%*	*18%*	*17%*	*22%*	*22%*	*19.8%*	*19.8%*	*21.7%*	*18.7%*	*20.9%*	*20.2%*
R&D + Engg	4.6	5.2	5.2	4.3	5.1	5.2	18.3	14.2	18.3	20.0	19.5	17.2
% of Revenue	*3.1%*	*3.5%*	*3.6%*	*3.0%*	*3.3%*	*3.3%*	*2.6%*	*2.8%*	*3.3%*	*3.4%*	*3.1%*	*2.6%*
SG&A	18.1	18.3	16.8	19.4	19.4	19.3	82.6	67.1	72	72	79	79
% of Revenue	*12.3%*	*12.6%*	*11.7%*	*13.2%*	*12.6%*	*12.0%*	*11.9%*	*13.5%*	*13.1%*	*12.2%*	*12.5%*	*12.0%*
GW Amort, Restructuring, other	*0.69*	*$ (3.80)*	*$ (3.39)*		*$ 3.14*		*(5.6)*	35.4	*1.44*	-649%	*$ 3.14*	
% of Revenue												
Total Operating Expenses	23.3	19.7	18.6	23.7	27.6	24.5	95.3	116.7	92	85	101	96
% of Revenue	*15.9%*	*13.5%*	*12.9%*	*16.2%*	*17.9%*	*15.3%*	*13.8%*	*23.4%*	*17%*	*14%*	*16%*	*15%*
Operating Income -	**4.5**	**7.8**	**7.2**	**1.9**	**5.7**	**10.1**	**41.8**	**-17.8**	**28**	**25**	**30**	**37**
Operating Margin	*3.1%*	*5.3%*	*5.0%*	*1.3%*	*3.7%*	*6.3%*	*6%*	*-4%*	*5%*	*4%*	*5%*	*6%*
NON-OPERATING ITEMS												
Non operating Income/Expense	0.51	-0.26	0.01	0	-1	-1	-1.3	-2.6	0.18	1	-2	1
% of Revenue	*0.35%*	*-0.17%*	*0.01%*	*0.25%*	*-0.78%*	*-0.63%*	*-0.19%*	*-0.52%*	*0.03%*	*0.19%*	*-0.32%*	*0.15%*
Tax Provision	0.9	1.6	1.4	0.0	1.2	1.8	-0.6	13.6	6	5	6	9
Effective Tax Rate												
Net Income -	**4.1**	**5.9**	**5.9**	**2.3**	**3.3**	**7.3**	**41.0**	**-34.1**	**22.0**	**21.0**	**21.9**	**29.0**
Net Income Margin	*2.8%*	*4.0%*	*4.1%*	*1.6%*	*2.1%*	*4.5%*	*5.9%*	*-6.8%*	*4.0%*	*3.6%*	*3.5%*	*4.4%*
Adjustments	**0.02**	**0**	**0.05**	**0.00**	**0.08**	**0.02**	**0**	**0**	**0**	**0.07**	**0.12**	**0**
EARNINGS PER SHARE												
EPS - Basic	$0.14	$0.17	$0.22	$0.07	$0.18	$0.23	$0.89	-$1.01	$0.67	$0.68	$0.76	$0.85
EPS - Diluted	$0.14	$0.17	$0.22	$0.07	$0.18	$0.23	$0.81	-$1.01	$0.67	$0.68	$0.75	$0.84

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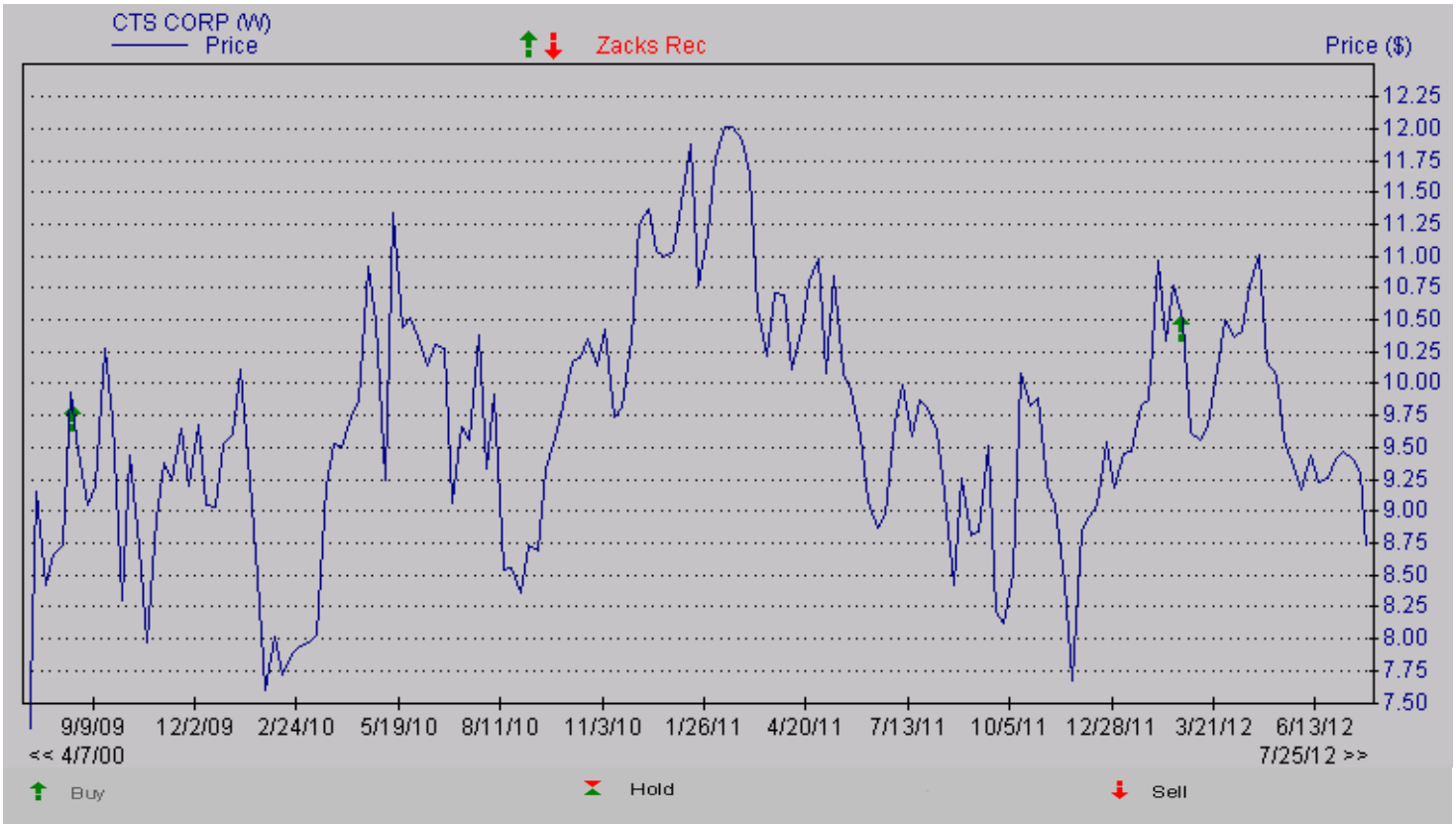
HISTORICAL ZACKS RECOMMENDATIONS



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