Zacks Small-Cap Research

July 30, 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 (7/29/2014)	$17.95
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) has emerged as a more focused higher margin business in the components and sensors market. Its automotive business (65% of sales) is benefiting from the robust light vehicle market. 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.

SUMMARY DATA

52-Week High	**$21.59**
52-Week Low	**$13.76**
One-Year Return (%)	**23.58**
Beta	**1.64**
Average Daily Volume (sh)	**81,977**
Shares Outstanding (mil)	**33.7**
Market Capitalization ($mil)	**$606**
Short Interest Ratio (days)	**7.82**
Institutional Ownership (%)	**87**
Insider Ownership (%)	**2**
Annual Cash Dividend	**$0.16**
Dividend Yield (%)	**1.1**
5-Yr. Historical Growth Rates	
Sales (%)	**1.7**
Earnings Per Share (%)	**17.4**
Dividend (%)	**6.9**
P/E using TTM EPS	**19.3**
P/E using 2014 Estimate	**18.0**
P/E using 2015 Estimate	**16.3**
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)
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	103 A	103 E	103 E	410 E
2015					430 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 R	$0.22 R	$0.24 E	$0.25 A	$0.82 A
2014	$0.19 A	$0.25 A	$0.27 E	$0.28 E	$1.00 E
2015					$1.10 E

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WHAT'S NEW

Company Guides Slightly Lower for Year Results

On July 28, 2014, CTS Corporation reported adjusted EPS of $0.25 versus a restated $0.22 for its second quarter, ended June 30, 2014. This beat our estimate by one cent despite a $2 million short fall in revenues. Reported revenues were $103 million versus $105 million last year. While the company had expected some growth for the year, continued weakness in the HDD market is causing to company to believe revenues will now be in the range of $400-415 million. Last year's restated revenues, taking out the divested operation, were $410 million and so it looks as if the company could have a down year if HDD sales do not come back.

Sensors and mechatronics, two thirds of sales were up only 3% this quarter versus 6% in Q1 and electric components down 12% versus down 4% in Q1. Clearly comparisons are getting tougher. The company continues to blame the decline on continued weakness in hard disk drives and engineered frequency. CTS is hopeful that the HDD business will pick up, as it believes customers have depleted inventories and will need to reorder. To corroborate, we have seen other companies selling to the PC industry reporting dismal sales for several quarters.

The second quarter EPS as reported contained $2.7 million in restructuring charges. This was primarily for Canada, a process that was started in Q2 and has not yet been completed. As a result, we believe there could be some further charges in 2014.

Gross margin was up to 32.8% versus 30.7% last year continuing to improve due to manufacturing efficiency as well as cost reduction in materials and labor.

Operating expenses, excluding one-time charges, were $21.1 million for the quarter versus $22.9 million last year. However this rose slightly from the $19.3 million last quarter as the company added to sales and marketing by locating closer to customers. Operating margin, ex-one-time write offs, is now 12.3% versus 9% last year and 11.3% in Q1. The company continues to make progress here and we expect they have not yet peaked.

Other income was a loss of $409,000 down from the $1.8 million loss in Q1 both due to currency translation.

CTS secured new orders of $89 million in the quarter down from $136 million in the first quarter but up from $78 million in Q4 2013.

CTS Corporation's net cash was $51 million, or $1.49 per share.

Cash flow from operations was $16.1 million for the quarter similar to Q1. This puts it at a $64.4 million run rate. Using a $. We believe as the company's margin rises, so will its valuation.

Capital expenditures were $3.2. The company also spent $4.6 million buying back stock and paying its dividend. The vast majority of the company's cash is overseas and we expect that acquisitions will be outside the US in order to use this cash.

INVESTMENT THESIS

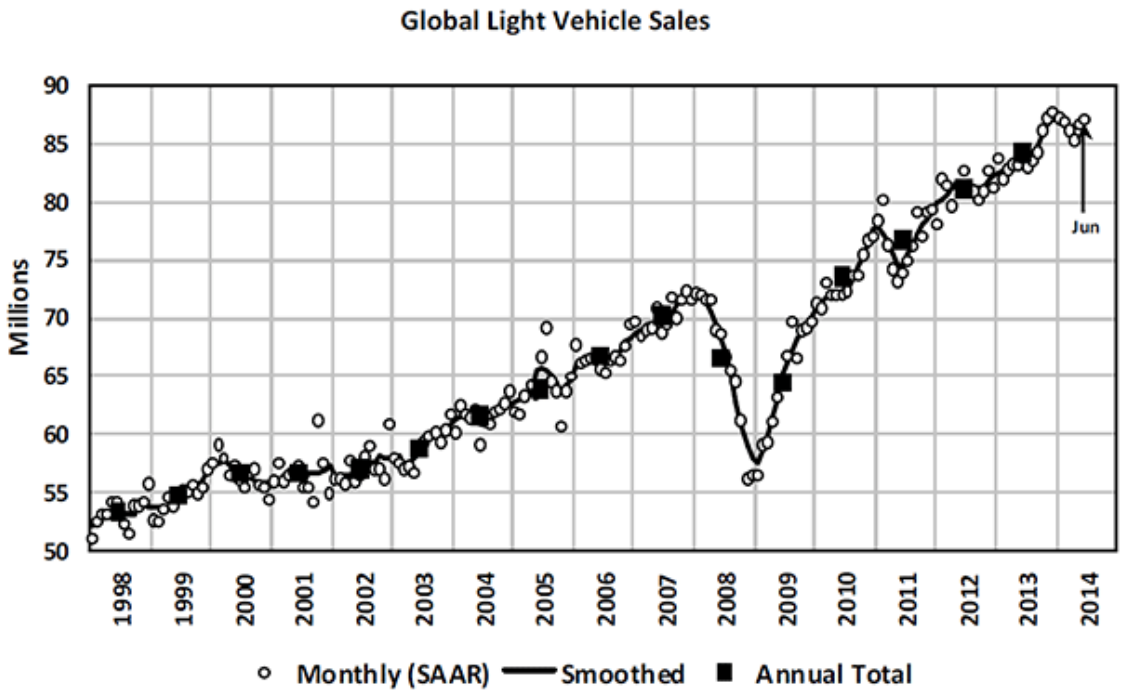
- Via divestiture, CTS has transitioned to a higher margin company and as a result is showing earnings growth despite tepid sales. Its new business model will provide higher cash flows and profits for investors going forward and with that, the potential for higher dividends and multiple expansion.
- 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.
- Its solid balance sheet provides the company with the ability to make synergistic acquisitions to fuel growth.
- 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 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, its Electronics Manufacturing Solutions (EMS) business was sold $75 million in cash. The company used the cash generated from the sale to pay down debt.

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 global unit sales for 2014 should be 87 million units. Improvements in China, the US and Western Europe have offset weakness in South America and Eastern Europe. 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.



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, which has increased profitability.

Looking forward to 2015, we expect the stock could appreciate another 10% in the next months as investors begin to focus on 2015. At current multiples we expect the stock to move up from $17.95 today to over $20 by year-end 2014.

Jul 30, 2014

Comps Valuation Data ($ in millions)

	Cal 2014E Revenue	LTM EBIDA Margin	5-Yr Hist. CAGR	Cal '14 P/E	P/E/G
OSIS	$ 921	15.3%	27.1%	19.2	0.7
MEI	$ 839	12.8%	33.3%	17.9	0.5
SYNA	$ 1,105	18.8%	12.6%	16.1	1.3
SANM	$ 6,300	4.9%	6.0%	11.7	1.9
Mean	$ 2,291	12.9%	19.7%	16.2	1.1
Median	$ 1,013	14.1%	19.8%	17.0	1.0
CTS	$ 410	13.7%	11.5%	17.9	1.6

Q3 Should Be Similar to Q1

Q2 for CTS should be similar Q1 in both sales and earnings as there are no current drivers to improve sales materially. Versus the year before, we only know the sales number that was $103.6 million, as the year ago quarter will be restated. Using Q2 as a guide, this year's quarter could be flat or down with last year. EPS however should be even higher, as margins have greatly improved since last year due to restructuring efforts. We are expecting fully diluted EPS at $0.27.

Modest Sales Growth is Expected But Margins Should Greatly Improve

Management expects full-year 2014 sales to be flat within range of $400-415 million as they experience continued softness in the hard disk drive business. We are forecasting sales of $410 million versus a restated $409 million in 2013.

In 2014, the real story is an improvement in operating margins. Sales in 2014 could improve in the second half of the year as sales to hard drive manufacturers return to more normal levels and new products kick in, but so far there is no evidence of that.

We are maintaining our EPS estimate of $1.00 for the year ending December 31,2014 as margins continue to impress despite flat sales.

Sales Should Grow Again in 2015

In 2015 we are expecting sales growth of 5% slightly higher than the growth in the light vehicle industry. By then the management's investment in R&D as well as the potential for acquisitions should make that growth achievable even without a return in the HDD business. HDD is increasingly being replaced by solid drives in addition to the PC and notebooks being weak. The company's strength in piezo ceramics should find applications elsewhere such as in medical imaging as was evidenced in a design win this quarter. We project sales of $210 million in 2015 and an EPS of $1.10 versus this year's $1.00 showing we believe margins will continue to improve.

	March Q1 13R	June Q2 13R	Sept Q3 13R	Dec Q4 13	March Q1 14A	June Q2 14A	Sept Q3 14E	Dec Q4 14E	As Reported 2010	As Reported 2011	Restated 2012	Restated 2013	2014E	2015E
REVENUE														
Net Revenue (restated)	$98.1	$105.4	$103.6	$102.4	$100.7	$103.0	$103.0	$103.3	$552.6	$588.5	$304.5	$409.5	$410.0	$430.5
Yr-to-yr Gr.	NA	NA	NA	35%	3%	-2%	-1%	1%	11%	6%	-48%	34%	0%	5%
OPERATING EXPENSES														
Cost of goods sold	71.3	73.0	NA	72.2	70.1	69.2	69.2	$68.6	432.7	478.7	213.0	288.1	277.0	289.0
Gross Margin	26.8	32.4	NA	30.2	30.6	33.8	33.8	34.8	119.9	109.8	91.5	121.4	133.0	141.5
% of Sales	27.3%	30.7%	NA	29.5%	30.4%	32.8%	32.8%	33.7%	21.7%	18.7%	30.1%	29.6%	32.4%	32.9%
SG&A	17.7	17.2	NA	17.2	13.6	15.8	15.2	$15.5	69.8	69.3	63.1	69.9	60.2	63.2
R&D	6.3	5.8	NA	5.5	5.6	5.3	5.5	$5.6	18.3	20.0	20.9	23.2	22.0	23.5
One-time charges	0.2	7.0	NA	2.3	0.5	2.7	0.0	0.0	1.4	(7.3)	(6.9)	10.5	3.2	0.0
Tot Operating Exp.	24.1	30.0	NA	25.1	19.8	23.9	20.7	21.0	89.6	82.0	77.1	103.6	85.4	86.8
		22.9			19.3	21.1								
Operating Income	2.7	2.4	NA	5.1	10.8	9.9	13.1	13.7	30.3	27.8	14.4	17.8	47.6	54.8
Oper Inc B4 One-time	2.9	9.5	NA	7.5	11.3	12.7	13.1	13.7			7.5	28.3	47.6	54.8
Operating margin	2.9%	9.0%			11.3%	12.3%					2.5%	6.9%	11.6%	12.7%
Net Interest	(0.5)	(0.6)	NA	0.0	0.0	0.1	0.1	0.1	0.2	1.1	(0.8)	(1.5)	0.4	0.0
Other income	(0.5)	0.4	NA	1.4	(1.8)	(0.4)	0.0	0.0			0.2	1.7	(2.2)	0.0
Pretax Income	1.7	2.2	NA	6.5	9.1	9.6	13.2	13.9	30.5	28.9	13.8	18.1	45.8	54.8
Taxes	(1.3)	12.5	NA	1.8	3.9	3.3	4.0	4.3	6.0	5.4	1.0	16.1	15.5	17.0
Tax Rate	-77.7%	560.0%	NA	27.9%	43.3%	34.0%	30.5%	30.8%	19.6%	18.6%	6.9%	88.8%	34.0%	31.0%
Net Income Cont. Ops.	3.0	(10.3)	NA	4.7	5.2	6.4	9.2	9.6	24.5	23.6	12.9	2.0	30.2	37.8
Yr-to-yr Gr.	-49.5%	NA	NA	-21.1%	73.2%	NA	NA	105.5%						
EPS-Basic	$0.09	-$0.31	NA	$0.14	$0.15	$0.19	$0.27	$0.29	$0.72	$0.69	$0.38	$0.06	$0.90	$1.12
EPS-Fully dil.	$0.09	-$0.31	NA	$0.14	$0.15	$0.19	$0.27	$0.28	$0.70	$0.67	$0.37	$0.06	$0.88	$1.10
Yr-to-yr Gr.					72.6%									
EPS-Adjusted	0.11	0.22	NA	0.25	$0.19	$0.25	$0.27	$0.28	$0.70	$0.67	$0.64	$0.84	$1.00	$1.10
Yr-to-yr Gr.	100.0%	NA	NA	38.9%	76.4%	15.5%	NA	37.3%				NA	18.8%	10.6%
Share Out	33.5	33.6	33.7	33.6	33.7	33.7	33.8	33.7	34.1	34.3	33.9	33.6	33.7	33.7
Fully diluted shares	34.2	33.6	34.3	34.3	34.3	34.2	34.2	34.2	34.8	35.0	34.5	34.0	34.2	34.2
Yr-to-yr Gr.	-1.6%	-1.3%	-0.4%	0.0%	0.3%	0.5%	-0.8%		3.0%	0.5%	-1.4%	-1.5%	0.7%	0.0%

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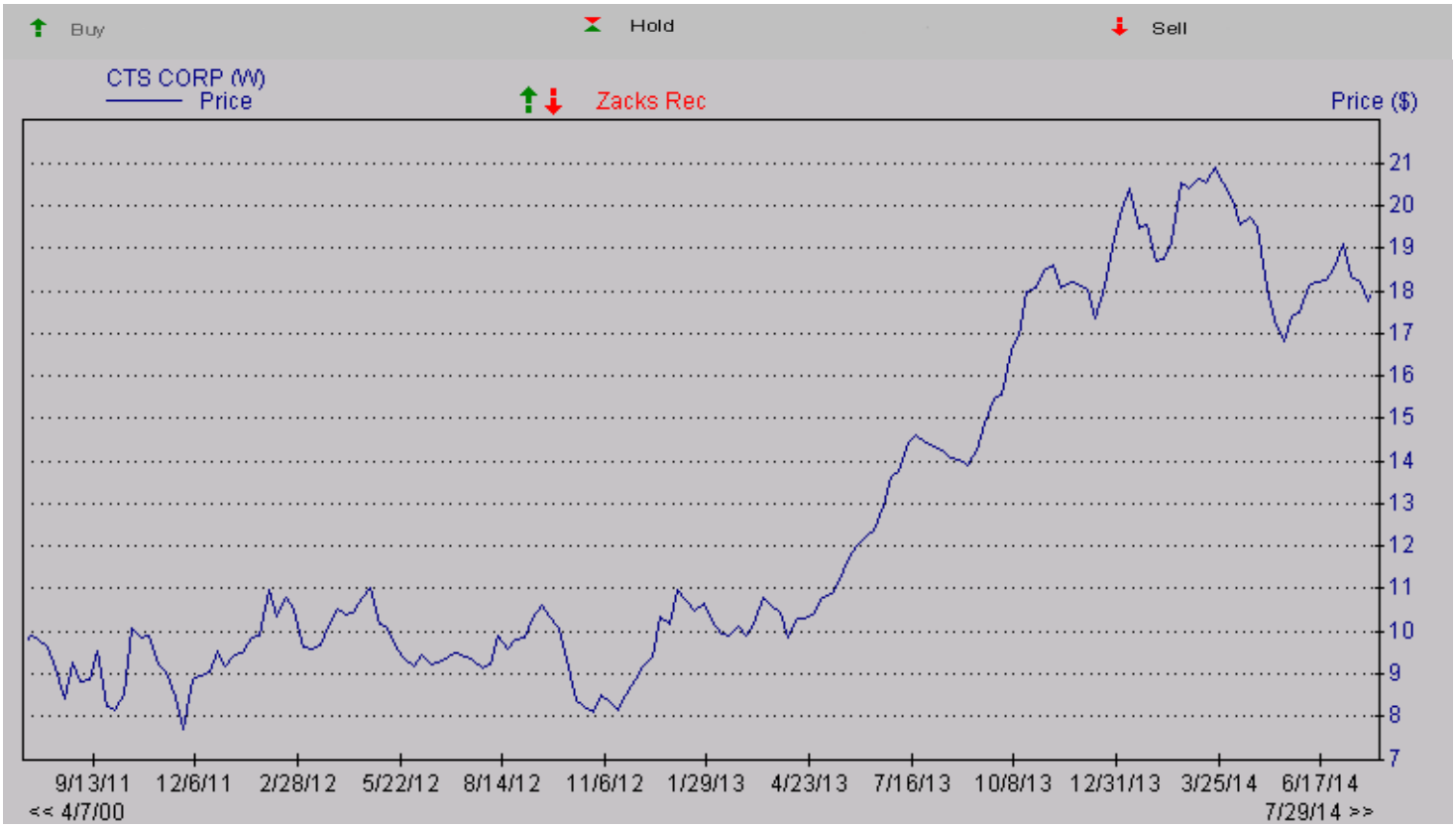

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