Zacks Small-Cap Research

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CTS Corporation (CTS-NYSE)

CTS: Margins and Orders Continue to Improve Locking In Growth in Future Years

Current Recommendation	**Buy**
Prior Recommendation	Hold
Date of Last Change	08/24/2009
Current Price (07/28/2015)	$18.77
Target Price	**$21.50**

OUTLOOK

The company is continuing to focus on growing sales and lessening its dependence on the automotive market, which is 2/3 of sales. Its has $122 million in excess cash available for future overseas acquisitions to reduce its dependency on this market and possibly further lower tax rates. It is finding new opportunities for its sensor portfolio and piezo ceramic technologies and ClearPlex technology for electronic filtering while it refreshes older product lines and expands offerings, all of which should drive growth in 2016 and beyond. Long term, by 2017, 2014 automotive design wins are expected to kick in to accelerate growth from current levels.

SUMMARY DATA

52-Week High	**$19.57**
52-Week Low	**$15.47**
One-Year Return (%)	**5.42**
Beta	**1.52**
Average Daily Volume (sh)	**86,836**
Shares Outstanding (mil)	**33**
Market Capitalization ($mil)	**$623**
Short Interest Ratio (days)	**5.82**
Institutional Ownership (%)	**88**
Insider Ownership (%)	**2**
Annual Cash Dividend	**$0.16**
Dividend Yield (%)	**0.85**
5-Yr. Historical Growth Rates	
Sales (%)	**-5.7**
Earnings Per Share (%)	**9.7**
Dividend (%)	**7.4**
P/E using TTM EPS	**18.2**
P/E using 2015 Estimate	**18.8**
P/E using 2016 Estimate	**17.1**
Zacks Rank	**3**

Risk Level	**Low**
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	98 A	100 A	98 E	99 E	395 E
2016					415 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	$0.20 A	$0.30 A	$0.23 E	$0.27 E	$1.00 E
2016					$1.10 E

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WHAT'S NEW

Q2 Earnings Beat As Margins Continue to Improve

CTS showed better earnings than expected and adjusted EPS beat our estimate by $0.04 due to cost improvements from consolidating production and moving from 20 locations worldwide to 11 as well as a temporarily reduced tax rate. Despite lower than expected revenues of $100 million (versus our estimate of $102 million), gross margins still came in at 33.3% improving from 32.8% last year. Lower expenses due in part to currency translation plus the lower than expected tax rate (ex-one-time tax adjustments) were the cause of the beat. Clearly the company's strategy of consolidation to lower cost locations and the pursuit of higher margin business is working.

Revenues came in at $100.1 down from $103.0 last year, of which $2.1 million was due to currency translation with the dollar strength hitting the Euro the most. The company is now giving guidance that revenues for the year should come in the range of $390 to $405 million meaning the second half should be in the range of $192 to $207 million a midpoint of $199.5. Although the second half of the year is typically noticeably stronger than the first half, this year does not seem to hold that pattern given the strength of the dollar. Additionally the company indicated that there is weakness worldwide in the cellular infrastructure, computer and oil and gas industries. Clearly oil prices are showing their effects.

The biggest positive for the quarter just reported was the stellar new order count coming in at $169 million versus $89 last year. Of the $169 million $117 million was from automotive. Adding these numbers with the first quarter total new orders in 2015 to date are $361 versus $225, up 60%. While these orders will show a small amount of revenues in 2016, clearly it is a sign that going forward, revenues should accelerate in outer years.

The company reported two one-time charges that were taken out in the adjusted number. One was $2.1 million for continued restructuring, mainly in moving Canada, and the second was for the tax treatment of foreign taxes. The company is amending its tax returns from 2006 to 2013 in which the treatment of foreign taxes will be changed from deductions to credits and in addition it increased its reserve against certain other foreign tax. This quarter it adjusted its taxes, but still expects the tax rate for the year to be near 30% and in the low thirties going forward.

When adjusting EPS for one-time effects, EPS came in at $0.30 versus an adjusted $0.25 last year, up 18%

CTS Corporation's cash balance was $147 million (or $4.38 per fully diluted share), and long-term debt was $89 million. In the quarter the company bought back 462,000 shares spending $8.5 million. While the company borrowed against foreign cash to fund this, it believes more cash will be thrown off in the US going forward and more of the buyback will be funded internally.

We are reducing our estimates for the next two quarters and the year, going from $1.05 to $1.00. Given the currency headwinds as well as the weakness in oil and gas and personal computers, which we do not see coming back any time soon, we believe it is not prudent to keep expectations high near term. It is possible however that the company may be able to make an acquisition between now and year-end. It continues to look for opportunities in Europe and to expand its technologies. In piezoelectronics, CTS would like to add the ability to manufacture using tape cast and single crystal that would broaden its product offering to meet different specifications. It is also interested in opportunities in piezoelectric components.

Currency Impacts

Currency will continue to impact revenues this year, most due to the Euro rather than Chinese currency. Interestingly, the conversion rate of CNY to the dollar on June 30, 2014 and June 30, 2015 was exactly the same at 6.20. The Euro conversion has gone from 0.73 to 0.89 in the same time period, up 22%. All of CTS's current guidance is based on currencies staying where they are for the rest of the year.

CNY per 1 USD

27 Jul 2013 00:00 UTC - 27 Jul 2015 14:41 UTC
USD/CNY close:**6.20951** low:**6.04370** high:**6.31503**



EUR per 1 USD

27 Jul 2013 00:00 UTC - 27 Jul 2015 14:44 UTC
USD/EUR close:**0.90141** low:**0.71784** high:**0.95280**



Future Acquisitions Could Add Significantly to Revenues

The company is flush with $147 million in cash, albeit almost all 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 it could invest, would have a lower tax rate than the US.

If we assume that the company can make accretive acquisitions with is excess cash we estimate that it has $122 million to spend which would still leave it with 5% of assets in cash. Using comps of 1.6 times enterprise value to sales, the company could add almost $76 million in additional revenue without adding any debt. However in the space CTS is shopping revenue multiple could be much higher. This has been the main reason the company has yet to buy as it finds prices historically high and believes that the auto cycle is at a peak, leading to extreme valuation at this point in time. Alternatively, this might make CTS itself a good acquisition target based on its relatively low revenue multiple.

As a comparison, Sensata Technologies acquired Schrader International, the leader in tire sensors, last year for $1 billion. Schrader was expected to generate $550 in revenue in 2014 giving it a valuation of 1.8 times enterprise value to sales. It also bought DeltaTech Controls for $190 million with the expectation of $125 million in revenues or a 1.5 times sales valuation.

INVESTMENT THESIS

- By reducing its physical locations from 20 to 11 (once Canada move is complete) lower cost manufacturing facilities, the company is boosting operating margins and has reduced its tax rate.
- The company is now focused on higher margin products and reducing its dependence on the automotive market which could reduce fluctuations in results while increasing its total addressable market.
- With $147 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 buy companies totally upwards of $100 million in incremental revenue.
- New products and the refresh of old products could add to revenues later this year although it could be dampened by currency translation.
- The company has already booked automotive design wins that will develop into meaningful revenues two years out. Based on current design wins, 2017 should show stronger growth.
- Once US Dollar currency gains anniversary, the company will exhibit much greater sales and earnings growth.

- The company is undervalued versus its peer group at only 1.4 enterprise value to sales versus a group average of 1.6 times. Both as a going concern and as an acquisition target, CTS stock is attractive. Once the company begins to show higher growth next year and beyond we believe that gap will close.

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, but the company is working to reduce that percentage. 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.

VALUATION

Compared to other companies in its industry, CTS appears slightly undervalued on an enterprise value to sales basis compared to the average in its industry. These comparables are automotive parts makers in general, however Sensata Technologies is a specialist in sensors and enjoys a much higher profit margin than the others, as well as a higher growth rate fueled by both internal growth and acquisitions. Should CTS transform itself to a higher margin higher growth business given its focus is sensors and similar products it may be valued more like Sensata Technologies (ST) that trades at 3.6 times enterprise value to sales.

Comps Valuation Data ($ in millions)

	Cal 2015E Revenue	LTM EBITDA Margin	5-Yr CAGR	Cal '15 P/E	P/E/G	EV/2015E Sales	EV/TTM EBITDA
BWA	$8,170	16.8%	12.7%	16.0	1.3	1.5	8.9
DLPH	$15,480	15.5%	13.2%	14.5	1.1	1.6	9.5
OSIS	$975	16.9%	18.0%	18.6	1.0	1.4	8.2
MEI	$853	16.7%	15.0%	12.6	0.8	1.0	5.6
ST	$3,070	24.1%	14.7%	16.6	1.1	3.6	17.5
SYNA	$1,986	15.0%	15.0%	11.7	0.8	1.4	11.2
SRI	$670	7.7%	12.0%	12.7	1.1	0.6	7.8
Mean	$1,511	16.1%	14.9%	14.5	1.0	1.6	10.1
Median	$975	16.7%	15.0%	12.7	1.0	1.4	8.2
CTS	$395	16.2%	18.0%	18.9	1.0	1.4	8.0

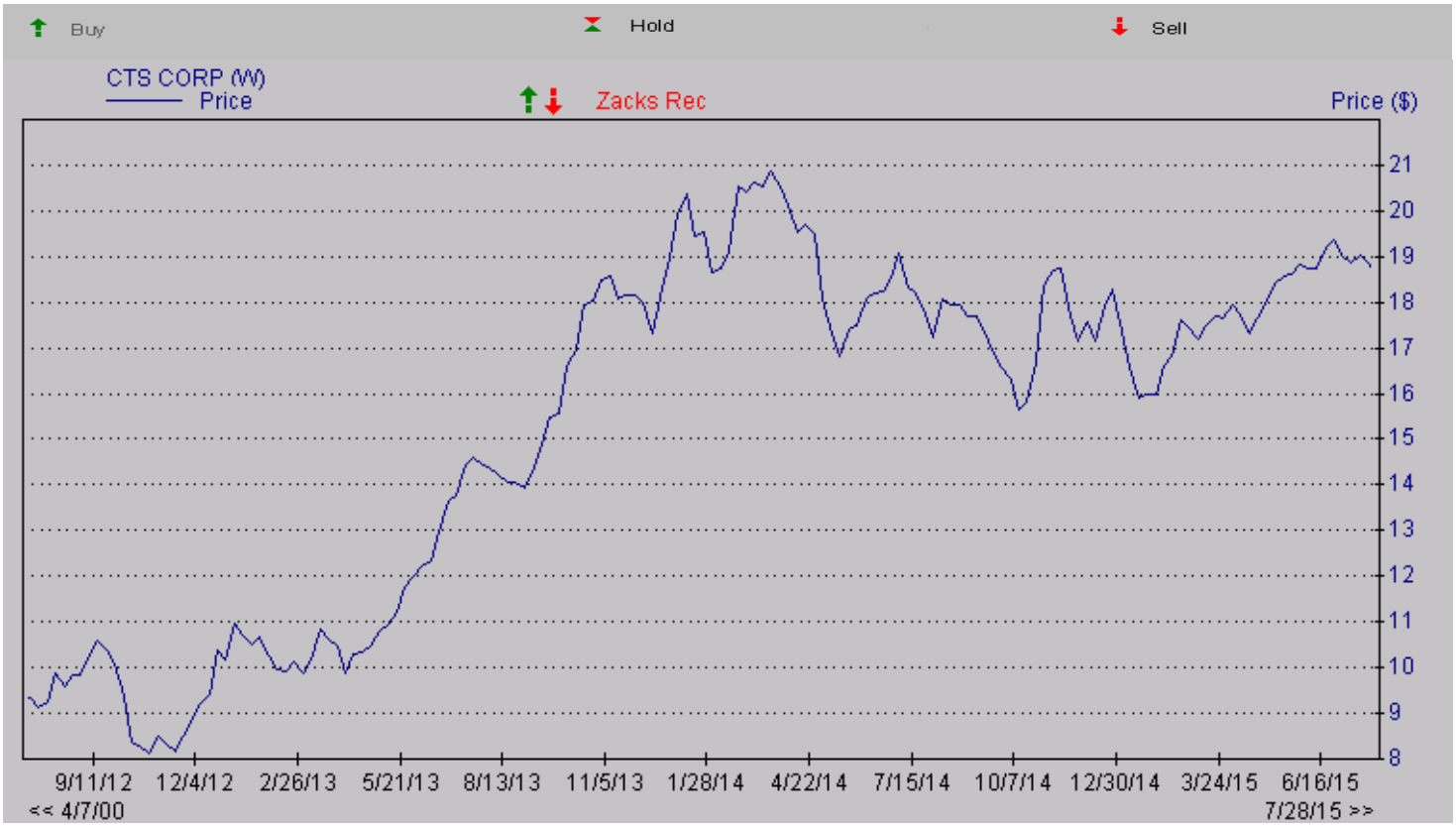
BALANCE SHEET

$ In Thousands	June 30, 2015	March 31, 2015	% Change
Current Assets			
Cash and cash equivalents	$146,791	$138,333	6.1%
Accounts receivable, net	63,046	67,056	-6.0%
Inventories, net	30,424	28,580	6.5%
Other current assets	21,400	20,741	3.2%
Total current assets	261,661	254,710	2.7%
Property, plant and equipment, net	70,166	70,462	-0.4%
Other Assets			
Prepaid pension asset	36,563	34,304	6.6%
Goodwill	32,047	32,047	0.0%
Indefinite-lived intangible asset	690	690	0.0%
Other intangible assets, net	33,945	34,929	-2.8%
Deferred income taxes	53,088	42,586	24.7%
Other	1,110	1,469	-24.4%
Total other assets	157,443	146,025	7.8%
Total Assets	489,270	471,197	3.8%
Current Liabilities			
Accounts payable	45,724	44,168	3.5%
Accrued payroll and benefits	10,364	9,211	12.5%
Accrued liabilities	27,395	29,471	-7.0%
Total current liabilities	83,483	82,850	0.8%
Long-term debt	88,700	83,200	6.6%
Post retirement obligations	2,908	2,963	-1.9%
Other long-term obligations	8,647	9,050	-4.5%
Shareholders' Equity			
Preferred stock			
Common stock	300,869	300,706	0.1%
Additional contributed capital	40,237	39,554	1.7%
Retained earnings	402,863	385,100	4.6%
Accumulated other comprehensive loss	(101900)	(104165)	-2.2%
Total shareholders' equity before treasury stock	642,069	621,195	3.4%
Treasury stock	(336537)	(328061)	2.6%
Total shareholders' equity	305,532	293,134	4.2%
Total Liabilities and Shareholders' Equity	$489,270	$471,197	3.8%
Current Ratio	3.1	3.1	2.0%
Quick Ratio	2.8	2.7	1.5%
Working Capital	178,178	171,860	3.7%
Cash % of Assets	30%	29%	2.2%
Cash per share	$4.44	$4.14	7.2%
Enterprise Value	570.3	551.3	3.5%

PROJECTED INCOME STATEMENT

	March Q1 14	June Q2 14	Sept Q3 14	Dec Q4 14	March Q1 15	June Q2 15	Sept Q3 15E	Dec Q4 15E	Restated 2013	2014	2015E	2016E
REVENUE												
Net Revenue (restated)	$100.7	$103.0	$100.0	$100.4	$98.3	$100.1	$98.0	$99.0	$409.5	$404.0	$395.4	$415.2
Yr-to-yr Gr.	3%	-2%	-4%	-2%	-2%	-3%	-2%	-1%	34.5%	-1.3%	-2.1%	5.0%
					$198.4	$191.6						
OPERATING EXPENSES												
Cost of goods sold	70.1	69.2	67.5	67.4	66.2	66.7	65.8	$66.0	288.1	$274.1	$264.7	274.5
Gross Margin	30.6	33.8	32.5	33.0	32.1	33.4	32.2	33.0	121.4	130.0	130.7	140.7
% of Sales	30.4%	32.8%	32.5%	32.9%	32.7%	33.3%	32.9%	33.3%	29.6%	32.2%	33.1%	33.9%
SG&A	13.6	15.8	13.9	15.8	15.7	15.2	15.8	$15.8	70.0	59.1	$62.5	64.4
R&D	5.6	5.3	5.8	5.8	5.2	5.5	5.6	$5.8	23.2	22.6	$22.1	24.3
One-time charges	0.5	2.7	1.6	1.1	0.7	2.1	0.0	$0.0	10.5	5.9	$2.9	0.0
Tot Operating Exp.	19.8	23.9	21.3	22.7	21.6	22.8	21.4	21.6	103.7	87.6	87.5	88.7
Operating Income	10.8	9.9	11.2	10.3	10.5	10.5	10.8	11.4	17.7	42.3	43.2	51.9
Oper Inc B4 One-time	11.3	12.7	12.8	11.4	11.2	12.7	10.8	11.4	28.1	48.3	46.1	51.9
Operating margin	11.3%	12.3%	12.8%	11.4%	11.4%	12.7%	11.0%	11.5%	6.9%	11.9%	11.7%	12.5%
Net Interest	0.0	0.1	0.1	0.3	0.2	0.2	0.2	0.2	(1.4)	0.6	0.8	0.8
Other income	(1.8)	(0.4)	0.6	(1.8)	(1.7)	0.1	0.1	0.1	1.7	(3.4)	(1.3)	0.0
Pretax Income	9.1	9.6	11.9	8.8	9.0	10.9	11.1	11.7	18.1	39.4	42.7	52.7
Taxes	3.9	3.3	3.8	1.8	2.7	(8.2)	3.4	3.5	16.1	12.8	$12.8	16.4
Tax Rate	43.3%	34.0%	31.9%	31.9%	30.2%	-75.7%	30.6%	29.9%	88.9%	32.5%	30.0%	31.0%
						23%						
Net Income Cont. Ops.	5.2	6.4	8.1	7.0	6.3	19.1	7.7	8.2	2.0	26.6	29.9	36.4
Yr-to-yr Gr.	73.2%	-162.0%	58.7%	67.9%	22%	200%	-5%	18%	-84.5%	1232.7%	12.3%	21.8%
EPS-Basic-Cont. Op	$0.15	$0.19	$0.24	$0.21	$0.19	$0.58	$0.23	$0.25	$0.06	$0.79	$0.90	$1.11
EPS-Fully dil. Cont. Ope	$0.15	$0.19	$0.24	$0.21	$0.19	$0.57	$0.23	$0.25	$0.06	$0.78	$0.89	$1.10
Yr-to-yr Gr.	72.6%	-160.9%	48.7%	69.8%	23%	206%	-3%	20%	-84.3%	1237.3%	14.3%	23.0%
EPS-Adjusted	**$0.19**	**$0.25**	**$0.29**	**$0.24**	**$0.20**	**$0.30**	**$0.23**	**$0.27**	**$0.75**	**$0.97**	**$1.00**	**$1.10**
Yr-to-yr Gr.	76.4%	15.5%	61.1%	0.0%	3.1%	18.1%	-20.3%	12.9%	17.2%	29.3%	3.3%	9.4%
Share Out	33.7	33.7	33.6	33.4	33.4	33.1	32.9	32.8	33.6	33.6	33.0	32.7
Fully diluted shares	34.3	34.2	34.1	33.9	33.9	33.6	33.4	33.3	34.2	34.1	33.5	33.2
Yr-to-yr Gr.	0.3%	1.8%	-0.7%	-1.1%	-1%	-2%	-2%	-2%	-0.8%	-0.3%	-1.7%	-1.0%
New Orders	136	89	88	171	192	169						

HISTORICAL ZACKS RECOMMENDATIONS



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