Zacks Small-Cap Research

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CTS Corporation (CTS-NYSE)

CTS: Currency Headwinds Mask Accelerating Growth

Current Recommendation	**Buy**
Prior Recommendation	Hold
Date of Last Change	08/24/2009
Current Price (04/30/2015)	$17.94
Target Price	**$21.50**

OUTLOOK

The company is continuing is focus on improving margins and its dependence on the automotive market, which is 2/3 of sales. Its has over of $120 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 2015 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	**$19.09**
52-Week Low	**$15.47**
One-Year Return (%)	**0.56**
Beta	**1.43**
Average Daily Volume (sh)	**85,224**
Shares Outstanding (mil)	**33**
Market Capitalization ($mil)	**$599**
Short Interest Ratio (days)	**4.81**
Institutional Ownership (%)	**88**
Insider Ownership (%)	**2**
Annual Cash Dividend	**$0.16**
Dividend Yield (%)	**0.88**
5-Yr. Historical Growth Rates	
Sales (%)	**-3.7**
Earnings Per Share (%)	**10.3**
Dividend (%)	**7.5**
P/E using TTM EPS	**18.3**
P/E using 2014 Estimate	**17.1**
P/E using 2015 Estimate	**15.5**
Zacks Rank	**4**

Risk Level	**Below 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	98 A	102 E	104 E	106 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	$0.20 A	$0.27 E	$0.30 E	$0.32 E	$1.05 E
2016					$1.16 E

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WHAT'S NEW

Record Orders Portend Future Growth

CTS had an excellent earnings growth this quarter on a constant currency basis, but lost much of its progress due to currency translation. While reporting revenues of $98 million versus $101 million last year after currency effects, before currency translation, that would have been $100.6 million versus $100.7 million. More importantly, these sales were at higher gross margin in accordance with the corporate strategy. Gross margin was 32.7% versus 30.9% a year ago (ex the one-time expense). $2.1 million in higher reported SG&A spending however negated the gross margin improvement and operating income was a flattish $11.2 million versus $11.3 million. However, in last year's numbers the company included a one-time gain on the sale of fixed assets in the SG&A number of approximately $2 million dollars (this was never broken out), restructuring charge of $531,000 in Cost of Goods Sold and $501,000 in restructuring costs. If these were taken out, operating earnings would have been $9.9 million and the company would have shown a 14% increase in operating profit year over year.

On a reported basis there was a huge swing in tax rate. This quarter the company used a 30.2% tax rate versus 43.3% last year. Last year's rate was affected by one-time write offs. When adjusting EPS for one-time effects, EPS came in at $0.20 versus an adjusted $0.19 last year. However on a constant currency basis, CTS would have reported $0.23. The adjusted number only takes out one-time items, but not stock-based compensation. Often a non-GAAP EPS number would take out this stock-based compensation that rose to $1.5 million this quarter versus $0.8 last year yielding $0.26 per share versus $0.21, growth of 24%. We believe the one-time gain on sale of fixed assets in Q1 2014 contributed about $0.02 in EPS. Removing that also, would show an EPS gain of 37% growth.

CTS reached a new quarterly record this quarter securing $192 million in new orders (of which $92 million was automotive) versus $171 million in Q4 and $136 million in Q1 2014 (up 41.2%). The majority of the $100 million in non-automotive orders was for hard drive (HDD) components over a three-year period and was an extension of a previous contract.

CTS Corporation's cash balance was $138 million (or $4.08 per share), and long-term debt was $83 million. The company authorized another $25 million to be used for stock buy backs and is raising debt against its overseas cash to fund it.

We are keeping our estimates the same for 2015, as we believe that business could improve later this year despite currency issues. We are raising our 12-month target price to $21.50 to reflect the increased valuation of its peer group that trades at a much higher enterprise value to sales multiple of 1.9 times.

Company Growth Strategy

Currently two thirds of the company's sales are to the automotive industry, and while that business is growing, the company is trying to become less dependent on that sector and move the percentage down to 50%. The idea is to grow the non-automotive part of the business both through new products and a refresh of old products, and by acquisition. On the acquisition side the company would like to expand internationally with a special focus on Europe and to expand its technologies. For example, in piezoelectronics, CTS has only has one technology and would like to add the ability to manufacture using tape cast and single crystal which would broaden its product offering to meet different specifications. When specifications are narrow, only one production methodology will work. As an example of refreshing old products, the company plans to refresh its switches and expand the product line by adding switches such as rotary, slide and tact. Since products like these can be sold off the shelf as well as by design wins, the sales cycle is much shorter and can be two months to two years versus the three to four years the automotive industry typically takes.

Other new products that will launch near term, and should added to sales quicker than automotive are ClearPlex and in piezoelectric components.

Sales Strategy

The company has become much more proactive in seeking sales opportunity and rather than wait for customers to come to it, it is going our looking for ways to help customers and find new applications of its current products as well as develop new custom ones. The major change of late has been positioning sales teams nearer the customer. For example, now there are salespeople located in Germany to sell both to the automotive markets and the non-automotive business where previously that location was served from staff in Scotland. Given its recent first-time design win with a German automotive OEM, a local presence can only aid prospects. This win is expected to generate $35-36 million over four to five years and is just a foot in the door of the potential the European OEMs. The company also recently added sales staff in Detroit as well as salespeople to sell piezoelectric products in Japan.

Company Reiterates Guidance

The company reiterated guidance of revenues to be $400-430 million in 2015 and adjusted EPS of $0.98 to $1.10. The main reason is continued currency impacts versus the Euro and the Chinese Renminbi. The company believes this has the potential of cutting another 2-3% off sales and $0.05 to $0.08 off earnings per share versus current guidance. Given the dollar continued strength, our 2015 EPS remains at $1.05 and revenues at $410 million.





Acquisitions Could Add to Revenues

The company is flush with $138 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 they invest, has 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 $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. An added benefit would be a lower overall tax rate as any country outside the US would have lower taxes.

INVESTMENT THESIS

- With $138 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.
- New products and the refresh of old products should accelerate revenues in the later half of this year.
- 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 very strong 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 1.3 enterprise value to sales versus a group average of 1.9 times. Once the company begins to show higher growth 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 somewhat undervalued compared to an average on a basis enterprise value to sales despite having a slightly higher EBITDA margin and a higher growth rate. Were CTS to trade at the mean of 1.9xs projected 2015 sales it would be 45% higher. There is however risk in the 2015 sales numbers due to the currency headwinds in the marketplace. We believe the company deserves at least a valuation of 1.6 times sales or a target price of $21.50.

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	$ 8,570	16.8%	13.9%	17.8	1.3	1.7	10.2
DLPH	$ 15,520	15.3%	13.3%	15.6	1.2	1.7	10.0
OSIS	$ 997	17.0%	18.0%	20.1	1.1	1.5	9.3
MEI	$ 904	16.5%	25.0%	16.4	0.7	1.7	10.8
ST	$ 3,080	25.2%	12.9%	19.3	1.5	4.1	20.6
SYNA	$ 1,989	9.9%	18.0%	12.2	0.7	1.6	15.8
SRI	$ 674	8.5%	12.0%	15.6	1.3	0.6	7.4
Mean	$ 1,529	15.4%	17.2%	16.7	1.0	1.9	12.8
Median	$ 997	16.5%	18.0%	16.4	1.1	1.6	10.8
CTS	$ 410	16.2%	18.0%	16.7	0.9	1.3	8.0

BALANCE SHEET

Balance Sheets $ In Thousands	March 31, 2015	Dec. 31, 2014	% Change
Current Assets			
Cash and cash equivalents	$138,333	$134,508	2.8%
Accounts receivable, net	67,056	56,894	17.9%
Inventories, net	28,580	27,887	2.5%
Other current assets	20,741	21,112	-1.8%
Total current assets	254,710	240,401	6.0%
Property, plant and equipment, net	70,462	71,414	-1.3%
Other Assets			
Prepaid pension asset	34,304	32,099	6.9%
Goodwill	32,047	32,047	0.0%
Indefinite-lived intangible asset	690	690	0.0%
Other intangible assets, net	34,929	35,902	-2.7%
Deferred income taxes	42,586	43,120	-1.2%
Other	1,469	1,253	17.2%
Total other assets	146,025	145,111	0.6%
Total Assets	471,197	456,926	3.1%
Current Liabilities			
Accounts payable	44,168	43,343	1.9%
Accrued payroll and benefits	9,211	11,283	-18.4%
Accrued liabilities	29,471	25,356	16.2%
Total current liabilities	82,850	79,982	3.6%
Long-term debt	83,200	75,000	10.9%
Post retirement obligations	2,963	3,049	-2.8%
Other long-term obligations	9,050	9,106	-0.6%
Shareholders' Equity			
Preferred stock			
Common stock	300,706	299,892	0.3%
Additional contributed capital	39,554	39,153	1.0%
Retained earnings	385,100	380,145	1.3%
Accumulated other comprehensive loss	(104165)	(104233)	-0.1%
Total shareholders' equity before treasury stock	621,195	614,957	1.0%
Treasury stock	(328061)	(325168)	0.9%
Total shareholders' equity	293,134	289,789	1.2%
Total Liabilities and Shareholders' Equity	$471,197	$456,926	3.1%
Current Ratio	3.1	3.0	2.3%
Quick Ratio	2.7	2.7	2.7%
Working Capital	171,860	160,419	7.1%
Cash % of Assets	29%	29%	-0.3%
Cash per share	$4.08	$3.96	2.8%
Enterprise Value	551.3	515.0	7.0%

PROJECTED INCOME STATEMENT

	March Q1 14	June Q2 14	Sept Q3 14	Dec Q4 14	March Q1 15	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	$98.3	$101.9	$104.0	$106.0	$409.5	$404.0	$410.2	$430.7
Yr-to-yr Gr.	3%	-2%	-4%	-2%	-2%	-1%	4%	6%	34.5%	-1.3%	1.5%	5.0%
OPERATING EXPENSES												
Cost of goods sold	70.1	69.2	67.5	67.4	66.2	68.0	67.0	$67.5	288.1	$274.1	$268.7	285.0
Gross Margin	30.6	33.8	32.5	33.0	32.1	33.9	37.0	38.5	121.4	130.0	141.5	145.7
% of Sales	30.4%	32.8%	32.5%	32.9%	32.7%	33.3%	35.6%	36.3%	29.6%	32.2%	34.5%	33.8%
SG&A	13.6	15.8	13.9	15.8	15.7	15.7	15.8	$15.8	70.0	59.1	$63.0	64.9
R&D	5.6	5.3	5.8	5.8	5.2	5.4	5.6	$5.8	23.2	22.6	$22.0	24.2
One-time charges	0.5	2.7	1.6	1.1	0.7	0.5	0.0	$0.0	10.5	5.9	$1.2	0.0
Tot Operating Exp.	19.8	23.9	21.3	22.7	21.6	21.6	21.4	21.6	103.7	87.6	86.2	89.1
Operating Income	10.8	9.9	11.2	10.3	10.5	12.3	15.6	16.9	17.7	42.3	55.3	56.6
Oper Inc B4 One-time	11.3	12.7	12.8	11.4	11.2	12.8	15.6	16.9	28.1	48.3	55.3	56.6
				56%								
Operating margin	11.3%	12.3%	12.8%	11.4%	11.4%	12.6%	15.0%	15.9%	6.9%	11.9%	13.5%	13.1%
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)	(1.0)	(1.0)	(1.0)	1.7	(3.4)	(4.7)	0.0
Pretax Income	9.1	9.6	11.9	8.8	9.0	11.5	14.8	16.1	18.1	39.4	51.4	57.4
Taxes	3.9	3.3	3.8	1.8	2.7	3.6	4.6	5.0	16.1	12.8	$15.9	17.8
Tax Rate	43.3%	34.0%	31.9%	31.9%	30.2%	31.0%	31.0%	31.0%	88.9%	32.5%	30.9%	31.0%
Net Income Cont. Ops.	5.2	6.4	8.1	7.0	6.3	7.9	10.2	11.1	2.0	26.6	35.5	39.6
Yr-to-yr Gr.	73.2%	-162.0%	58.7%	67.9%	22%	25%	26%	60%	-84.5%	1232.7%	33.6%	11.5%
EPS-Basic-Cont. Op	$0.15	$0.19	$0.24	$0.21	$0.19	$0.24	$0.31	$0.34	$0.06	$0.79	$1.07	$1.21
EPS-Fully dil. Cont. Ope	$0.15	$0.19	$0.24	$0.21	$0.19	$0.23	$0.30	$0.33	$0.06	$0.78	$1.05	$1.19
Yr-to-yr Gr.	72.6%	-160.9%	48.7%	69.8%	23%	26%	28%	62%	-84.3%	1237.3%	35.2%	12.6%
EPS-Adjusted	**$0.19**	**$0.25**	**$0.29**	**$0.24**	**$0.20**	**$0.26**	**$0.33**	**$0.36**	**$0.75**	**$0.97**	**$1.05**	**$1.19**
Yr-to-yr Gr.	76.4%	15.5%	61.1%	0.0%	3.1%	1.7%	13.0%	48.1%	17.2%	29.3%	8.7%	12.6%
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	192							

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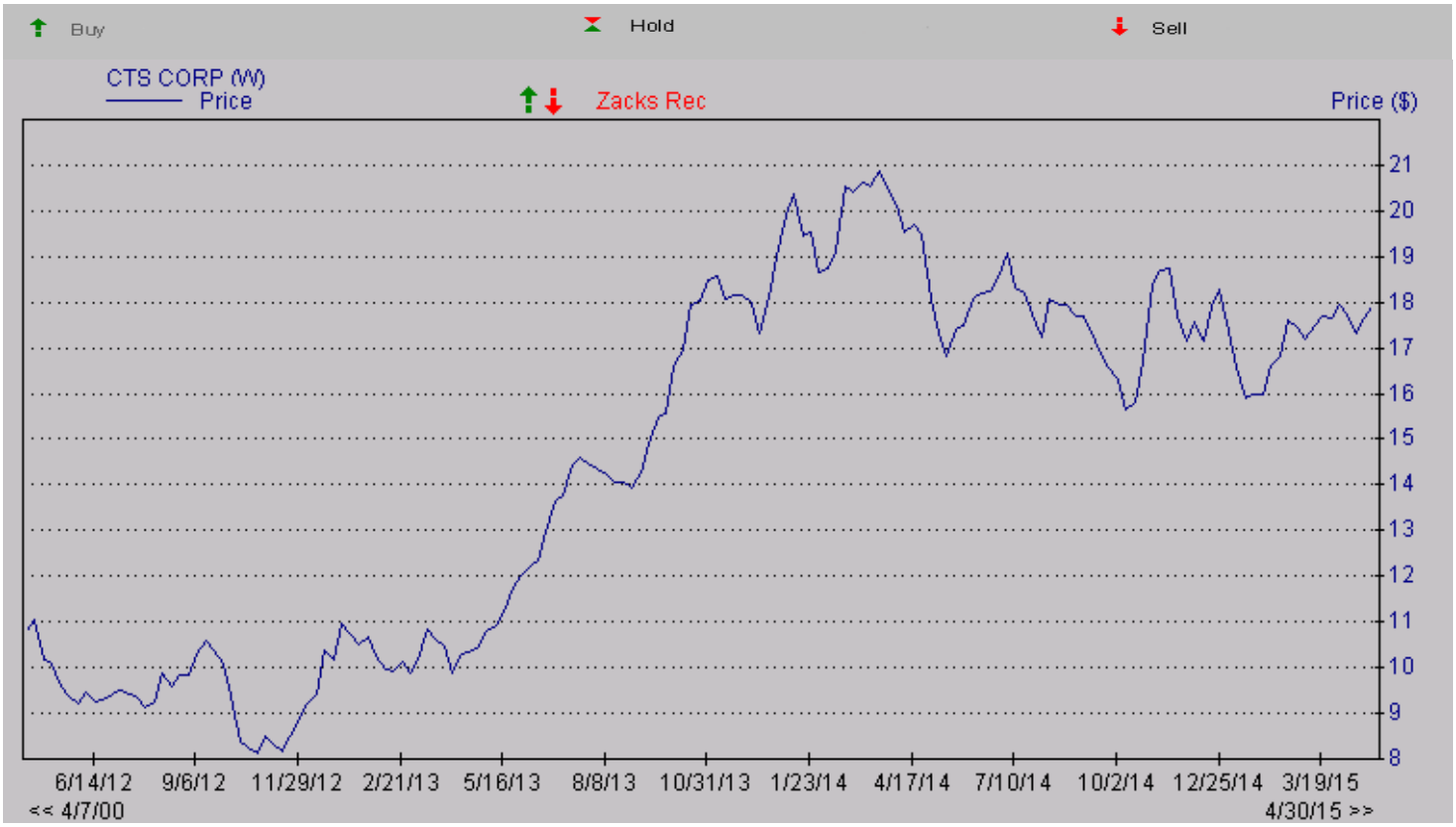

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