Zacks Small-Cap Research

November 1, 2012
Ken Nagy, CFA

www.zacks.com
111 North Canal Street, Chicago, IL 60606

CTS Corporation (CTS-NYSE)

CTS: - Restructuring Will Pay Off - Outperform

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	02/23/2012
Current Price (10/31/12)	$8.28
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	**$7.68**
One-Year Return (%)	**-9.28**
Beta	**2.04**
Average Daily Volume (sh)	**76,791**
Shares Outstanding (mil)	**34**
Market Capitalization ($mil)	**$281**
Short Interest Ratio (days)	**11.16**
Institutional Ownership (%)	**79**
Insider Ownership (%)	**3**
Annual Cash Dividend	**$0.14**
Dividend Yield (%)	**1.69**
5-Yr. Historical Growth Rates	
Sales (%)	**-3.9**
Earnings Per Share (%)	**0.5**
Dividend (%)	**3.0**
P/E using TTM EPS	**12.4**
P/E using 2012 Estimate	**12.4**
P/E using 2013 Estimate	**11.0**
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	137 A	141 E	626 E
2013					600 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	$0.20 A	$0.23 E	$0.67 E
2013					$0.75 E

© Copyright 2012, Zacks Investment Research. All Rights Reserved.

WHAT'S NEW

On October 23, 2012, CTS Corporation reported financial results for its third quarter and nine months, ended September 30, 2012.

The Company's third quarter resulted in a nearly 6 percent or $8.713 million decrease in year over year revenues to $137.357 million compared to revenues of $146.070 million for the three months ended October 2, 2011.

The segments diverged as sales of the Company's components and sensors segment grew by 9.4 percent year over year to $75.565 million, primarily as a result of new product launch activities for new customers and the successful integration of an acquisition from earlier this year.

Likewise, within the segment, electronic component sales improved by $4.6 million, or 17 percent, primarily from improved piezoceramic product demand for HDD and incremental sales from the acquisition while automotive sensor and actuator sales improved by $1.9 million, or 5 percent, from the launch of the new grill shutter actuator and a double-digit increase in pedal module sales.

Furthermore, the segment's operating earnings before corporate and shared services charges increased $1.754 million to $9.492 million compared to the same period of last year primarily due to higher sales and timing of customer reimbursements, which was partially offset by higher non-cash pension expenses.

Still, the decrease in consolidated sales was primarily a result of a $15.189 million, or 19.7 percent, year-over-year reduction in the lower margin EMS segment sales due to the weak global economy, as certain customers delayed orders, particularly in the defense and aerospace and communications markets.

Similarly, the EMS segment's operating earnings before corporate and shared services charges fell by $1.668 million year over year to $4.202 million as a result of the lower sales.

Sequentially, the components and sensors segment fell by $1.258 million from $76.823 million for the second quarter fiscal 2012.

Within the segment, electronic component products improved by $2.2 million over the second quarter.

Likewise, despite the lower sales, segment operating earnings before corporate and shared services charges improved sequentially by $1.094 million as a result of lower operating expenses including pension and timing of customer reimbursements.

However, the EMS segment's third quarter 2012 sales decreased sequentially by $15.679 million, or just over 20 percent from the second quarter of 2012.The segment's third quarter operating earnings before corporate and shared services charges decreased $1.884 million from the second quarter due to the segment's lower sales. Net income for the quarter increased by $54,000 to $5.917 million compared to net income of $5.863 million for the comparable quarter of 2011.

Based on a weighted average number of diluted common shares of 34.471 million shares, diluted net income per share for the second quarter resulted in net income of $0.17 per diluted share during the third quarter of fiscal 2012. This compared to a diluted net income per share of $0.17 on a weighted average number of diluted shares of 34.994 million shares during the three months ended October 2, 2011.

CTS Corporation's cash and equivalents for the third quarter ended September 30, 2012, improved to $88.620 million while working capital improved to $173.080 million. This compares to $83.039 million of cash and equivalents and working capital of $167.012 million for the second quarter ended July 1, 2012.

Regarding working capital, accounts receivable was 52 days and accounts payable of 64 day were both the same as last year while inventory balance of $75 million declined $16 million from last year resulting in improved turns of 5.6 compared to 5.4 from last year.

Net debt decreased by $8.1 million during the quarter which resulted in a debt to capital ratio of 25.8 which compares to 26.8 from last quarter and up from the prior year ratio of 23.6. Management expects the debt to capital ratio to further improve in the fourth quarter.

Third quarter cash flow from operations was a strong $13.0 million, compared to $4.5 million for the previous year which was driven by lower working capital requirements. Likewise, year-to-date cash flow from operations nearly doubled to $25.0 million compared to $13.4 million in the same period 2011.

Capital expenditures were $2.9 million versus $3.7 million from a year ago while year-to-date capital expenditures were $9.8 million, which was slightly lower than last year. Still, management expects capital expenditures to remain in the range of $16 to $18 million as previously projected.

As a result of the weak economic environment, the Company is taking proactive actions to further reduce its overhead cost structure which is expected to position the company for stronger growth in 2013. Overall, these actions are anticipated to make CTS' global manufacturing footprint simpler and more cost effective.

While CTS' electronic components operation will remain at the Tianjin, China facility due to its expected growth with increasing piezo component production to support HDD applications, the Company plans to close its EMS operation at the facility.

This action, combined with earlier restructuring actions taken in 2012, will reduce headcount by approximately 10 percent, and the Company's global footprint by approximately 17 percent, with total fourth quarter restructuring charges expected to be in the vicinity of $3 million.

Likewise, CTS' manufacturing efficiency improvement initiatives has allowed the Company to reduce its manufacturing floor space requirements at its Singapore facility.

Accordingly, CTS entered into an agreement to sell and lease back approximately one-third of its Singapore facility. The transaction is expected to close in the fourth quarter 2012 with net proceeds of approximately $17.5 million and an anticipated pretax gain of approximately $7.5 million.

During the third quarter 2012, CTS authorized the repurchase of up to one million shares as a result of its prior authorization of one million shares being completed. The Company repurchased approximately 91,000 of its common stock in open market transactions during the three months ended September 30, 2012.

Management lowered its guidance, expecting its full-year 2012 sales to now be essentially flat, with its Components and Sensors segment growing by 10 percent to 13 percent and its EMS segment declining 9 percent to 12 percent. The Company lowered this guidance from its previously expected 4 percent to 7 percent year over year increase in sales, primarily due to its third quarter results, the current weak global economic outlook and the negative impact of the Japan/China territory dispute. Correspondingly, management is cutting its previous guidance of diluted earnings per share for the full year. Management lowered its 2012 adjusted earnings per share guidance to $0.70 to $0.75 from a previous range of $0.75 to $0.80 per share, which excludes the expected $7.5 million gain from the Singapore facility sale leaseback in the fourth quarter.

Still, it should be noted that new product launch activity in CTS' Components and Sensors segment remains robust and the Company continues to win new business.

During the third quarter the Company was authorized to supply actuary pedal modules for a major

Japanese OEM for vehicles sold into a local India market from CTS' newly established facility in India beginning later in 2013.

Likewise, the Company won three new sensor programs including a parking position sensor which is a brand new product for CTS. The Company's SMART Actuator launch, its most significant new product introduction, is on schedule for later this year while its piezoceramic component for disk drive applications , the Company's other significant new product, continues to ramp as a much larger percentage of disk drives in the market are being switched to dual state actuation. What's more, the Company is in the process in increasing its capacity by approximately 20% to meet the growing demand of its HDD piezo products in 2013.

The Company is generating strong free cash flow and its balance sheet remains strong. Free cash flow improved to $10.1 million compared to $0.9 million from a year ago while year to date free cash flow was $14.6 million compared to $3.3 million from last year. Management now expects full year cash flow to be in the range $22 million to $26 million, up from its previous guidance of $19 million to $24 million.
It should be noted that the updated projection excludes the estimated $17.5 million of cash that the Company expects to receive in the Singapore sale leaseback transaction in the fourth quarter.

As a result, management believes that these factors as well as its strategic actions to further reduce cost structure while driving key growth programs will allow CTS to emerge stronger when the markets rebound.

INVESTMENT THESIS

CTS is Diversified, Growing and Undervalued.

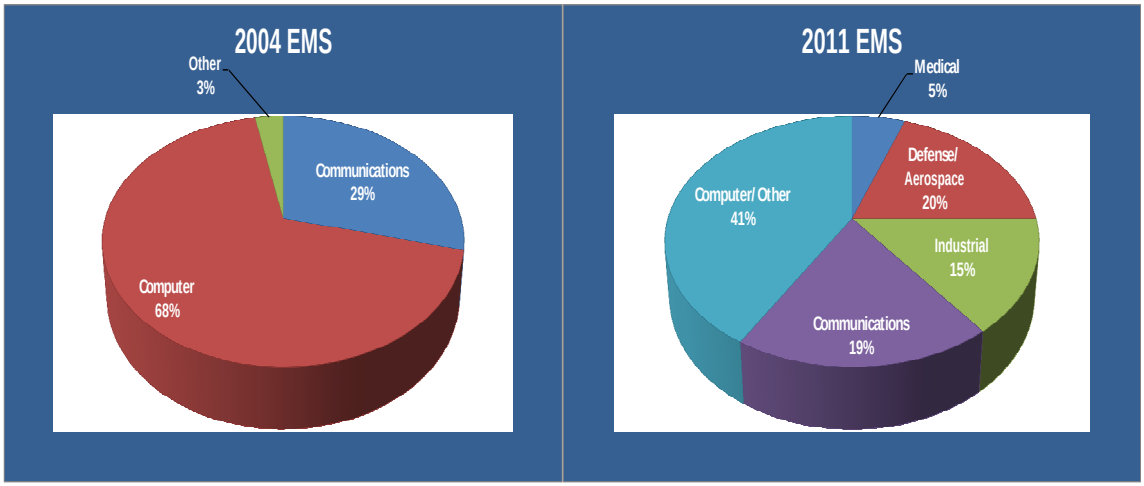
CTS has two reportable segments: Electronics Manufacturing Services (EMS) and Components and Sensors.



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 fairly valued. 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	5.9	7.6

Metric	CTS	Industry Average
P/B	1.10	4.10
P/E 2012 (E)	12.35	16.34
P/E 2013 (E)	11.04	15.15
P/S	0.50	4.00

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:

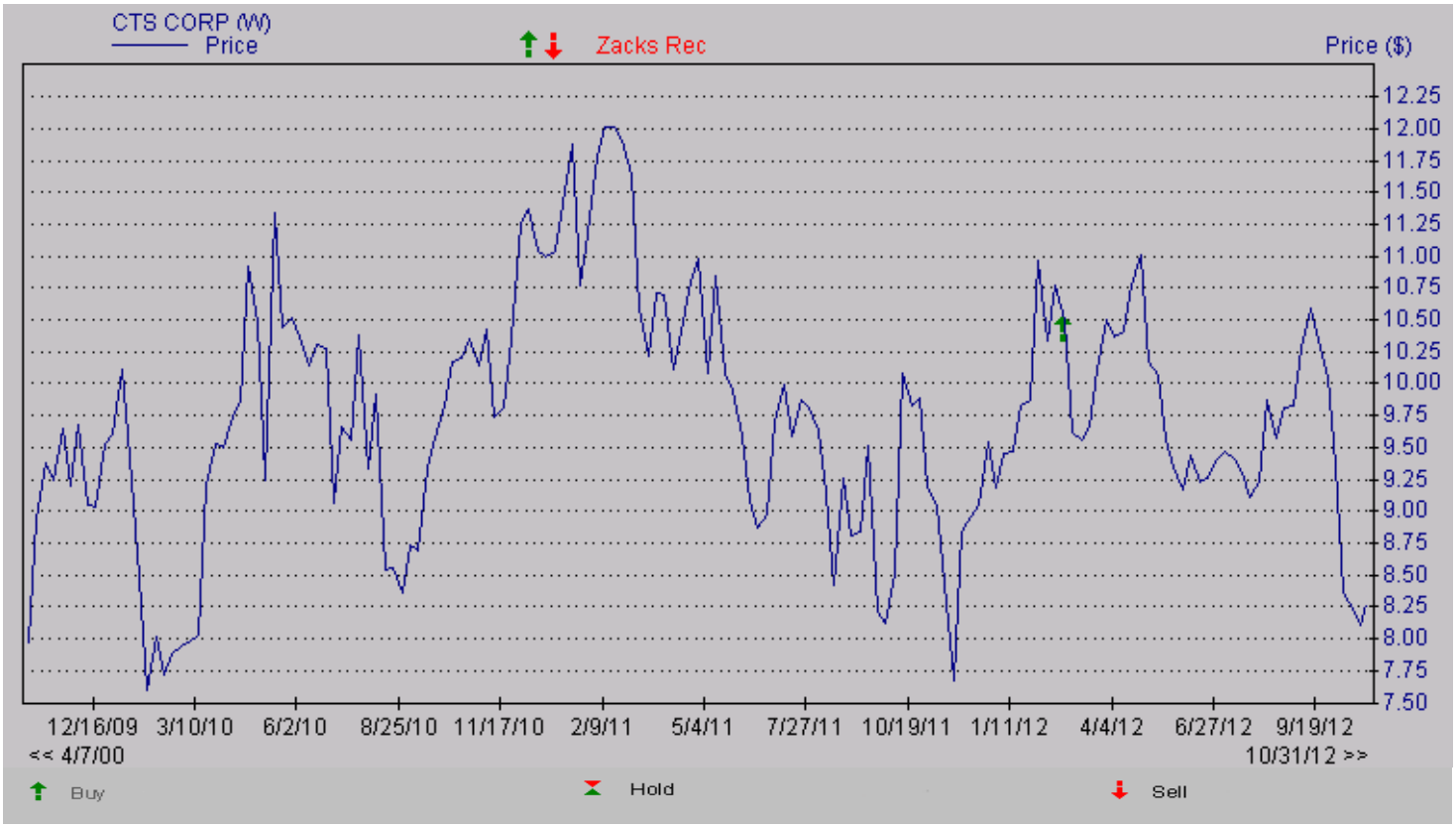
We value the company based on the average of our P/E multiple (18.0x 2013 estimated EPS) and our two stage intrinsic model. The semiconductor/Electronic group average P/E is between 14x-20x and EMS firms tend to be lower. We feel CTS should trade at a premium to its peers, given the fact that the company 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

HISTORICAL ZACKS RECOMMENDATIONS



DISCLOSURES

The following disclosures relate to relationships between Zacks Investment Research ("ZIR") and Zacks Small-Cap Research ("Zacks SCR") and the issuers covered by the Zacks SCR analysts in the Small-Cap Universe.

ZIR or Zacks SCR Analysts do not hold or trade securities in the issuers which they cover. Each analyst has full discretion on the rating and price target based on their own due diligence. Analysts are paid in part based on the overall profitability of Zacks SCR. Such profitability is derived from a variety of sources and includes payments received from issuers of securities covered by Zacks SCR for non-investment banking services. No part of analyst compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in any report or blog.

ZIR and Zacks SCR do not make a market in any security nor do they act as dealers in securities. Zacks SCR has never received compensation for investment banking services on the small-cap universe. Zacks SCR does not expect received compensation for investment banking services on the small-cap universe. Zacks SCR has received compensation for non-investment banking services on the small-cap universe, and expects to receive additional compensation for non-investment banking services on the small-cap universe, paid by issuers of securities covered by Zacks SCR. Non-investment banking services include investor relations services and software, financial database analysis, advertising services, brokerage services, advisory services, investment research, and investment management.

Additional information is available upon request. Zacks SCR reports are based on data obtained from sources we believe to be reliable, but is not guaranteed as to accuracy and does not purport to be complete. Because of individual objectives, the report should not be construed as advice designed to meet the particular investment needs of any investor. Any opinions expressed by Zacks SCR Analysts are subject to change. Reports are not to be construed as an offer or the solicitation of an offer to buy or sell the securities herein mentioned. Zacks SCR uses the following rating system for the securities it covers. Buy/Outperform: The analyst expects that the subject company will outperform the broader U.S. equity market over the next one to two quarters. Hold/Neutral: The analyst expects that the company will perform in line with the broader U.S. equity market over the next one to two quarters. Sell/Underperform: The analyst expects the company will underperform the broader U.S. Equity market over the next one to two quarters.

The current distribution of Zacks Ratings is as follows on the 1010 companies covered: Buy/Outperform- 14.8%, Hold/Neutral- 77.7%, Sell/Underperform – 7.1%. Data is as of midnight on the business day immediately prior to this publication.

© Copyright 2012, Zacks Investment Research. All Rights Reserved.