Zacks Small-Cap Research

October 28, 2014
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CTS Corporation (CTS-NYSE)

CTS: Zacks Company Report- OUTPERFORM
Betting on the Tortoise, Steady Progress
Improving Profitability

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	08/24/2009
Current Price (10/27/2014)	$16.68
Target Price	**$20.00**

OUTLOOK

By selling off its low-margin stagnant EMS business in October 2013, CTS Corporation (CTS) has emerged as a more focused higher margin business in the components and sensors market. It strategic plan has improved earnings and should steadily increase shareholder's return through reduced costs, improved product offerings and diversifying acquisitions coupled with a modest dividend.

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	**$15.64**
One-Year Return (%)	**-4.80**
Beta	**1.55**
Average Daily Volume (sh)	**116,179**
Shares Outstanding (mil)	**33.6**
Market Capitalization ($mil)	**$561**
Short Interest Ratio (days)	**10.7**
Institutional Ownership (%)	**87**
Insider Ownership (%)	**2**
Annual Cash Dividend	**$0.16**
Dividend Yield (%)	**0.96**
5-Yr. Historical Growth Rates	
Sales (%)	**0.7**
Earnings Per Share (%)	**15.7**
Dividend (%)	**7.3**
P/E using TTM EPS	**17.0**
P/E using 2014 Estimate	**16.7**
P/E using 2015 Estimate	**15.2**
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	100 A	101 E	405 E
2015					424 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	$0.11 R	$0.22 R	$0.18 R	$0.25 A	$0.82 A
2014	$0.19 A	$0.25 A	$0.29 A	$0.28 E	$1.00 E
2015					$1.12 E

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WHAT'S NEW

Slow and Steady CTS is Emerging as a More Profitable Business

While showing disappointing revenue growth, CTS continues to surprise to the upside on earnings. It is clear now that the sale of its EMS division in 2013 was the right thing to do as shown by the significantly higher profitability of the remaining entity despite flat sales. Each quarter has shown continued margin improvement and we expect more of the same throughout 2015. Coupled with a reduced tax rate and the potential of accretive acquisitions made with its $130 million war chest of cash, we believe patient investors will be rewarded. Despite now forecasting lower revenues, **we are raising our 2015 EPS estimate slightly due to higher than expected cost reductions** by the company. We are going to $1.12 EPS in 2015 from $1.10 while lowering revenues to $424 million from $430 million due to continued weakness in Europe and mixed results in China.

Despite Lower Revenues, Margins Almost Double

On October 27, 2014, CTS Corporation reported adjusted EPS of $0.29 versus a restated $0.18 for its second quarter, ended September 30, 2014, up 61% year over year. This beat our estimate by two cents despite a $3 million short fall in revenues. Reported revenues were $100 million versus $103.6 million last year, down 4%. However, last year's sales included a one time special order of $3.9 million to an automotive OEM customer. Without this one-time sale, automotive sales would have been up 2.9% in line with industry growth, while the rest of the business showed a decline of 4.5%. The hard disk drive sector, which has been showing weakness, was nonetheless up sequentially. While frequency products were weak, there was growth in HDD and other piezo products. The company plans to launch a new low power Oven Controlled Crystal Oscillator (OCXO) product sometime in the first half of 2015 to refresh the product line and reinvigorate sales.



In the automotive business most of what sells in 2014, was booked in 2011 and 2012, so much of the revenue upside will come much later on into 2016 and 2017 from that 65% of the business. There can however be upside in the other 40% as new products are introduced.

Gross margin was up to 32.5% versus 30.9% last year, but down slightly from 32.8% Q2 no doubt due to lower revenues.

Operating expenses, excluding one-time charges, were $19.7 million versus $21.1 million for Q2 and $23.5 million last year. Operating margin, ex-one-time write offs, is now 12.8% versus 8.2% last year and 12.3% in Q2. We expect the company to continue to inch up margins going forward and this is the reason earnings should continue to grow faster than revenues again in 2015. The company believes that about 70% of the margin improvement has been already achieved from the restructuring and there will be another 30% in improvement due from that going forward. That is not to say that other events such as new higher margin products, increased sales and product mix would not also improve margins.

The third quarter EPS as reported contained $1.6 million in restructuring charges. According to plans, there should be continuing restructuring charges in the next few quarters as well as the company continues its march to optimize its cost structure by moving operation around to least cost locations.

CTS secured new orders of $88 million in the quarter down from $89 million in Q2 and $136 million in the first quarter.

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

The company spent $2.7 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 huge 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, accretive acquisitions and multiple expansion.
- With $130 million in cash on the balance sheet (albeit overseas), the company is in an excellent position to pursue growth through acquisition.
- 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.
- 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, smart actuators, and ClearPlex technology.
- At 14xs 2015 estimated EPS of $1.12 and an enterprise value to sales ratio of only 1.3 times, we believe the stock is modestly undervalued compared to its peers. Given an average valuation versus its peers, we believe the stock could move up 20% by next year based on our estimates.

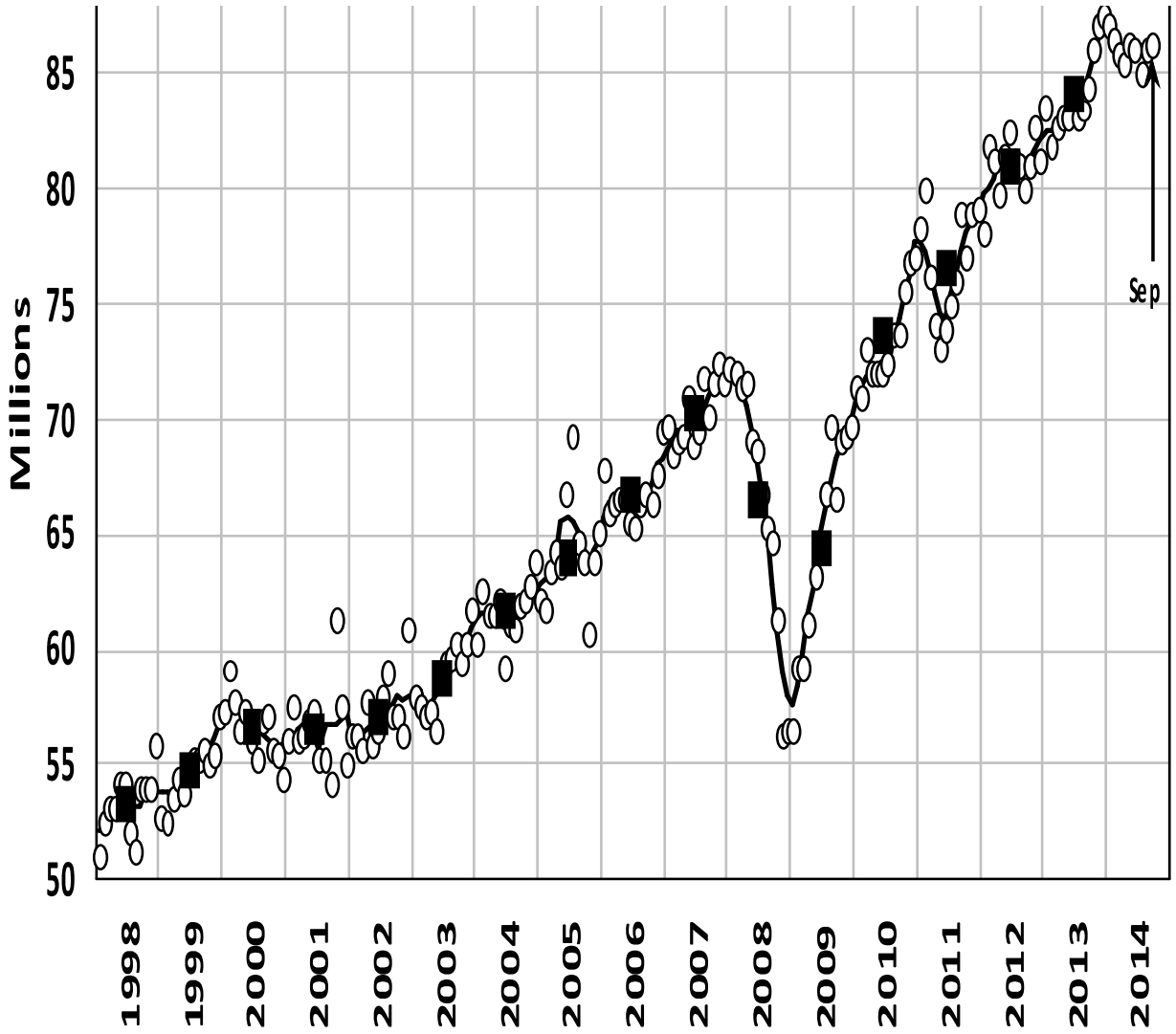
COMPANY BACKGROUND

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 for $75 million in cash. The company used the cash generated from the sale to pay down debt.

INDUSTRY OUTLOOK

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 seasonally adjusted selling rate for September 2014 was 86.2 million units down slightly from 86.6 earlier this year but up 2.9% from a year ago. However in China light commercial vehicle sales have been weakened by impending emissions regulations. 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.



Source: LMC Automotive

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 20% in the next months as investors begin to focus on 2015. At current multiples we expect the stock to move up from $16.68 today to $20 by 2015.

Comps Valuation Data ($ in millions)

	Cal 2014E Revenue	LTM EBIDA Margin	5-Yr Hist. CAGR	Cal '14 P/E	P/E/G	EV/2014E Sales	EV/TTM EBITDA
OSIS	$934	17.0%	28.7%	20.4	0.7	1.4	8.7
MEI	$852	13.7%	39.2%	19.0	0.5	1.5	11.7
SYNA	$1,047	16.2%	14.5%	12.8	0.9	1.8	11.3
SANM	$6,300	4.9%	7.9%	9.6	1.2	0.3	6.0
Mean	$2,283	12.9%	22.5%	15.4	0.8	1.3	9.4
Median	$991	14.9%	21.6%	15.9	0.8	1.5	10.0
CTS	$404	13.7%	12.4%	16.7	1.3	1.3	7.9

Flattish Sales Are Expected But Margins Should Greatly Improve

Management expects full-year 2014 sales to be at the low end of the $400-415 million range as they experience some global softness particularly in Europe. We are now forecasting sales of $404 million versus a restated $409 million in 2013.

In 2014, the real story has been a huge improvement in operating margins due to cost optimization and the jettisoning of the money losing EMS operations in late 2013. Additionally, sales in to hard drive manufacturers have improved slightly return to more normal levels.

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

Sales Should Grow Again in 2015

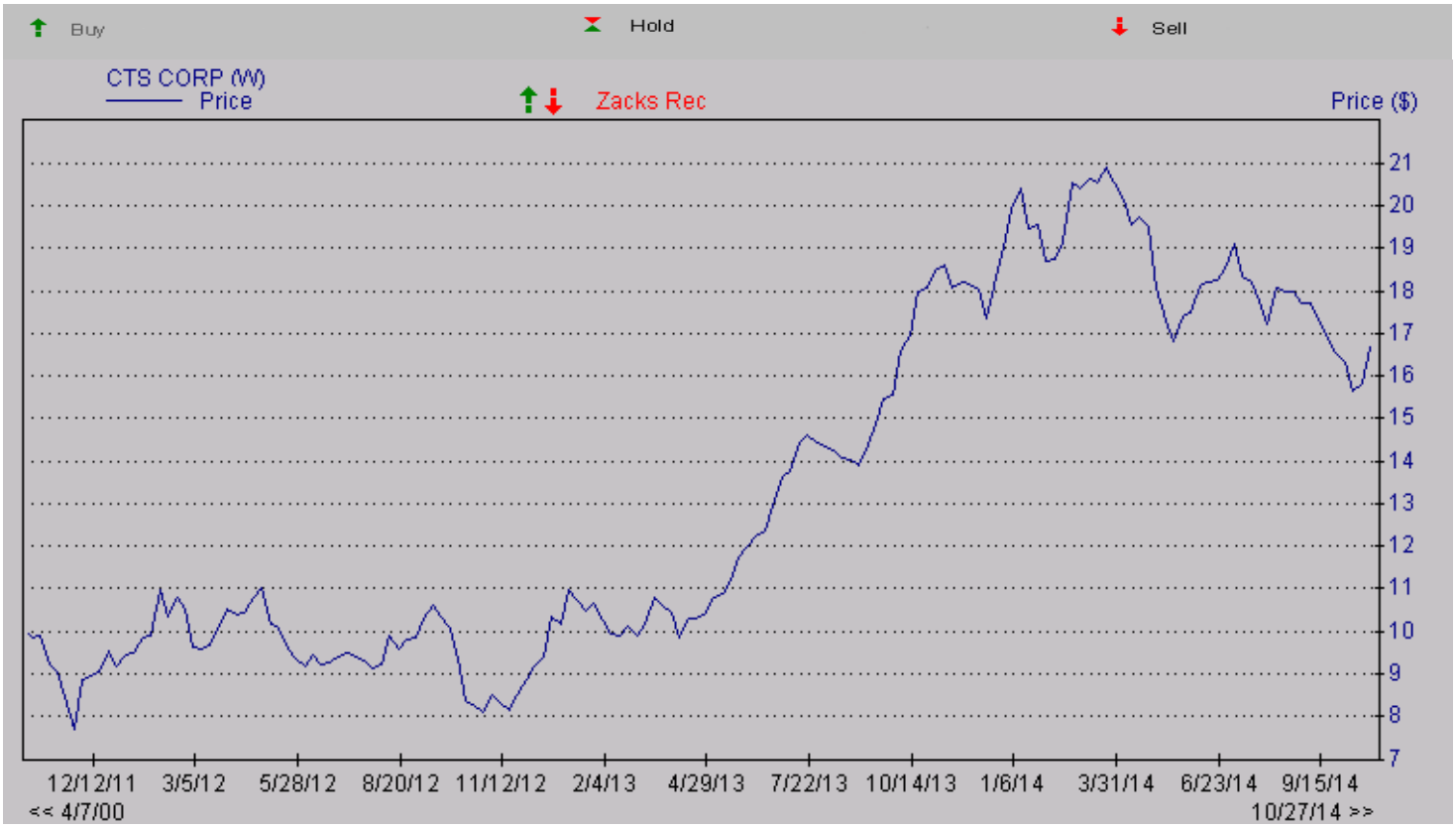
In 2015, we are expecting sales growth of 5% slightly higher than the growth in the light vehicle industry. By then the management's investment in R&D as well as the potential for acquisitions should make that growth achievable even without a return in the HDD business. HDD is increasingly being replaced by solid drives in addition to the PC and notebooks being weak. We project sales of $424 million in 2015 and an EPS of $1.12 versus this year's $1.00. We believe margins will continue to improve and the company continues to fine-tune, and the tax rate should be cut by as much as 4 percentage points as operations are moved around the globe.

Despite the tepid results of these two transition years, we expect the company to pick up steam in 2016 and beyond as new business picked up in 2014 translates into sales in the automotive market.

	March Q1 13R	June Q2 13R	Sept Q3 13R	Dec Q4 13A	March Q1 14A	June Q2 14A	Sept Q3 14A	Dec Q4 14E	Restated 2012	Restated 2013	2014E	2015E
REVENUE												
Net Revenue (restated)	$98.1	$105.4	$103.6	$102.4	$100.7	$103.0	$100.0	$100.4	$304.5	$409.5	$404.0	$424.2
Yr-to-yr Gr.	NA	NA	NA	35%	3%	-2%	-4%	-2%	-48%	34%	-1%	5%
OPERATING EXPENSES												
Cost of goods sold	71.3	73.0	71.6	72.2	70.1	69.2	67.5	67.8	213.0	288.1	274.5	286.0
Gross Margin	26.8	32.4	32.0	30.2	30.6	33.8	32.5	32.6	91.5	121.4	129.5	138.2
% of Sales	27.3%	30.7%	30.9%	29.5%	30.4%	32.8%	32.5%	32.5%	30.1%	29.6%	32.1%	32.6%
SG&A	17.7	17.2	17.8	17.2	13.6	15.8	13.9	13.9	63.1	69.9	57.3	58.1
R&D	6.3	5.8	5.7	5.5	5.6	5.3	5.8	5.8	20.9	23.2	22.6	24.4
One-time charges	0.2	7.0	0.9	2.3	0.5	2.7	1.6	1.0	(6.9)	10.5	5.8	0.0
Tot Operating Exp.	24.1	30.0	24.4	25.1	19.8	23.9	21.3	20.7	77.1	103.6	85.7	82.5
		22.9	23.5		19.3	21.1						
Operating Income	2.7	2.4	7.6	5.1	10.8	9.9	11.2	11.8	14.4	17.8	43.8	55.7
Oper Inc B4 One-time	2.9	9.5	8.5	7.5	11.3	12.7	12.8	12.8	7.5	28.3	49.6	55.7
Operating margin	2.9%	9.0%	8.2%		11.3%	12.3%	12.8%	12.8%	2.5%	6.9%	12.3%	13.1%
Net Interest	(0.5)	(0.6)	(0.4)	0.0	0.0	0.1	0.1	0.1	(0.8)	(1.5)	0.4	0.0
Other income	(0.5)	0.4	0.5	1.4	(1.8)	(0.4)	0.6	0.0	0.2	1.7	(1.6)	0.0
Pretax Income	1.7	2.2	7.7	6.5	9.1	9.6	11.9	12.0	13.8	18.1	42.6	55.7
Taxes	(1.3)	12.5	2.6	1.8	3.9	3.3	3.8	3.8	1.0	16.1	14.8	17.3
Tax Rate	-77.7%	560.0%	33.3%	27.9%	43.3%	34.0%	31.9%	31.9%	6.9%	88.8%	34.9%	31.0%
Net Income Cont. Ops.	3.0	(10.3)	5.1	4.7	5.2	6.4	8.1	8.1	12.9	2.0	27.7	38.4
Yr-to-yr Gr.	-49.5%	NA	NA	-21.1%	73.2%	-162.0%	58.7%	74.2%				
EPS-Basic	$0.09	-$0.31	$0.16	$0.14	$0.15	$0.19	$0.24	$0.24	$0.38	$0.06	$0.82	$1.14
EPS-Fully dil.	$0.09	-$0.31	$0.16	$0.14	$0.15	$0.19	$0.24	$0.24	$0.37	$0.06	$0.81	$1.12
Yr-to-yr Gr.					72.6%	-160.9%	48.7%	75.0%				
EPS-Adjusted	0.11	0.22	$0.18	0.25	$0.19	$0.25	$0.29	$0.26	$0.64	$0.84	$1.00	$1.12
Yr-to-yr Gr.	100.0%	NA	NA	38.9%	76.4%	15.5%	61.1%	16.5%		NA	19.1%	12.4%
Share Out	33.5	33.6	33.7	33.6	33.7	33.7	33.6	33.6	33.9	33.6	33.7	33.7
Fully diluted shares	34.2	33.6	34.3	34.3	34.3	34.2	34.1	34.2	34.5	34.0	34.2	34.2
Yr-to-yr Gr.	-1.6%	-1.3%	-0.4%	0.0%	0.3%	1.8%	-0.7%	-0.5%	-1.4%	-1.5%	0.5%	0.0%

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Sell/Underperform: The analyst expects the company will underperform the broader U.S. Equity market over the next one to two quarters.

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