Zacks Equity Research

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# CTS Corporation (CTS-NYSE)

## CTS: Solid Quarter- Expecting Double-Digit Top and Bottom-Line Growth in 2011- Outperform

| | |
|---|---|
| **Current Recommendation** | **Outperform** |
| Prior Recommendation | Neutral |
| Date of Last Change | 08/24/2009 |
| Current Price (01/28/11) | $11.19 |
| **Six- Month Target Price** | **$12.00** |

## OUTLOOK

CTS Corporation designs, manufactures, assembles, and sells electronic components and sensors worldwide. On January 26, 2011 the firm presented December quarter results. The Combination of design wins in automotive sensors and actuator programs in the third quarter of 2010, including a light commercial vehicle diesel engine program in India, along with acquiring Swiss-based Fordahl should contribute to double-digit revenue and earnings growth in 2011.

## SUMMARY DATA

| | |
|---|---|
| **52-Week High** | **$11.90** |
| **52-Week Low** | **$7.05** |
| **One-Year Return (%)** | **48.12** |
| **Beta** | **2.04** |
| **Average Daily Volume (sh)** | **112,887** |
| **Shares Outstanding (mil)** | **34** |
| **Market Capitalization ($mil)** | **$383** |
| **Short Interest Ratio (days)** | **6.57** |
| **Institutional Ownership (%)** | **96** |
| **Insider Ownership (%)** | **4** |
| **Annual Cash Dividend** | **$0.12** |
| **Dividend Yield (%)** | **1.07** |
| **5-Yr. Historical Growth Rates** | |
| **Sales (%)** | **-5.1** |
| **Earnings Per Share (%)** | **-9.4** |
| **Dividend (%)** | **0.0** |
| **P/E using TTM EPS** | **16.7** |
| **P/E using 2010 Estimate** | **15.8** |
| **P/E using 2011 Estimate** | **N/A** |
| **Zacks Rank** | **3** |

| | |
|---|---|
| **Risk Level** | **Above Avg.,** |
| **Type of Stock** | **Small-Value** |
| **Industry** | **Elec-Misc Compn** |
| **Zacks Rank in Industry** | **26 of 47** |

## ZACKS ESTIMATES

**Revenue**
(in millions of $)

| | Q1 (Mar) | Q2 (Jun) | Q3 (Sep) | Q4 (Dec) | Year (Dec) |
|---|---|---|---|---|---|
| 2008 | 173 A | 186 A | 170 A | 163 A | 692 A |
| 2009 | 118 A | 120 A | 127 A | 134 A | 499 A |
| 2010 | 129 A | 139 A | 139 A | 145 A | 552 A |
| 2011 | 148 E | 155 E | 152 E | 163 E | 618 E |

**Earnings per Share**
(EPS is operating earnings before non recurring items)

| | Q1 (Mar) | Q2 (Jun) | Q3 (Sep) | Q4 (Dec) | Year (Dec) |
|---|---|---|---|---|---|
| 2008 | $0.18 A | $0.27 A | $0.16 A | $0.15 A | $0.77 A |
| 2009 | -$0.03 A | $0.06 A | $0.13 A | $0.19 A | $0.35 A |
| 2010 | $0.13 A | $0.17 A | $0.20 A | $0.14 A | $0.63 A |
| 2011 | $0.16 A | $0.18 E | $0.17 E | $0.21 E | $0.72 E |

Zacks Projected EPS Growth Rate - Next 5 Years % **15**

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## WHAT'S NEW

On January 26th 2011 CTS announced results for the fourth quarter of fiscal year 2010 ending December 2010. Revenue for the period was $145.0 million up 4.0% sequentially from $139.4 million and up 8.3% year over year.

Components and Sensors sales decreased $6.4 million, or 9%, from the third quarter of 2010. Automotive sensor and actuator product sales decreased $3.1 million, or 7%, from timing of certain new program ramps, and sales of electronic component products decreased $3.2 million, or 11%, primarily in sales of components for infrastructure applications. In 2010 Components and Sensors segment sales, as a percent of total company sales, increased to 51% from 43% helping overall gross margins and operating earnings returns.

EMS fourth quarter 2010 sales increased $11.2 million, or 16%, from the fourth quarter of 2009, due to higher demand in the defense and aerospace, industrial, communications and computer markets. Sequentially EMS sales increased $12.0 million, or 18%, from the third quarter of 2010 reflecting higher sales primarily in the defense and aerospace, communications and computer markets.

Full-year cash flow from operations was $19.3 million and capital expenditures were $13.3 million, or 2.4% of sales. Total debt, as a percentage of total capitalization, was 20.3% at year-end 2010, compared to 16.9% at year-end 2009. New program launch and new customer-related inventory and higher year-end sales-driven receivables lowered the cash flow in 2010. However, management expects working capital to moderate somewhat in 2011.

**Bringing Estimates Up**

Management anticipates full-year 2011 sales to increase in the range of 9% to 13% over 2010 and diluted earnings per share to be in the range of $0.70 to $0.75. Normal quarterly seasonality is expected with stronger second and fourth quarters compared to the first and third quarters.

**Diversification (A 2010 Story)**

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.

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. Smart Actuator, Position Sensors, and Accelerator Pedal Module are three CTS products in this segment. Drilling down further to Smart Actuators 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. 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)

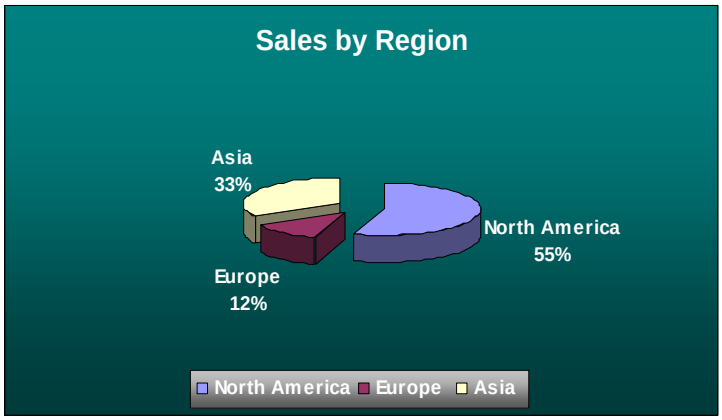
Electronic Components (20% of sales) should see double-digit sales growth over 3-5 years. Social networks in developed countries and strong communications growth in emerging markets should provide a tail-wind. Communications infrastructure and Piezo Electronics are two CTS products in this segment.
This 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:

## INVESTMENT THESIS

CTS remains well positioned to achieve solid revenue growth and operating leverage as end markets turn around in the long run, given the company's competitive advantage led by innovation and laser-like focus on expense management. The slower growing EMS segment has been exceptionally diversified since 2004 and is a complement to the faster growing Sensors and Actuators and Electronic components business.

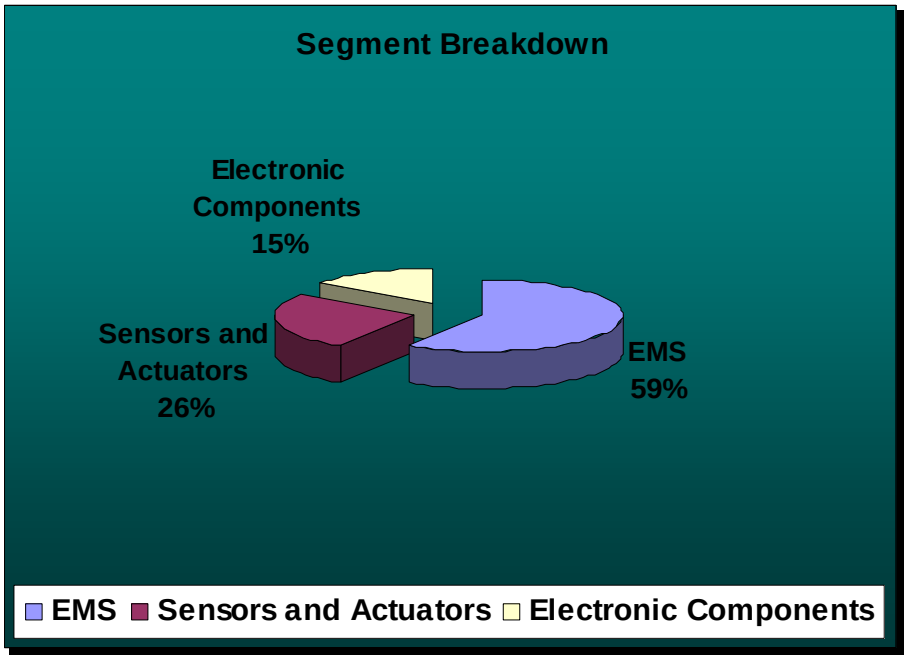
CTS has two reportable segments: Electronics Manufacturing Services (EMS) and Components and Sensors.




**Electronics Manufacturing Services (EMS)**
EMS includes the higher level assembly of electronic and mechanical components into a finished subassembly or assembly performed under a contract manufacturing agreement with an OEM or other contract manufacturer. The firm also provides full turnkey manufacturing and completion including design, bill-of-material management, logistics, and repair.

Products from the EMS segment are principally sold in the communications, computer, medical, industrial, and defense and aerospace OEM markets. Other smaller markets include OEM customers in consumer electronics, instruments and controls, and networking. Products from the Components and Sensors segment are principally sold in the automotive and communications OEM markets. Other smaller markets include computer, medical, and defense and aerospace.

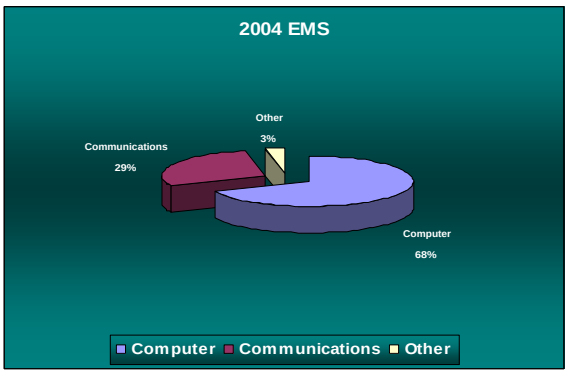
**Components and Sensors**
Components and sensors are products which perform specific electronic functions for a given product family and are intended for use in customer assemblies. Components and sensors consist principally of automotive sensors and actuators used in commercial or consumer vehicles; 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.

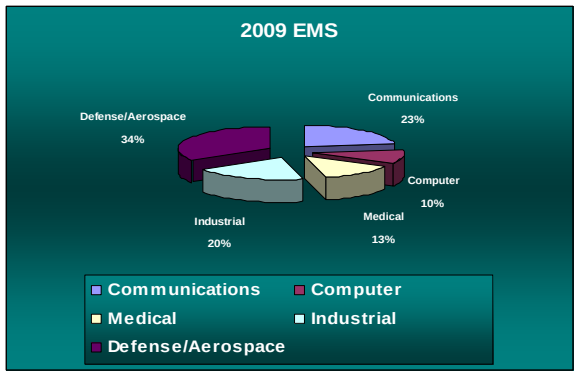



*note Components and Sensors represent one segment

**EMS: Niche markets, Diversification and Alternative Energy**

The slower growing EMS segment has been exceptionally diversified since 2004 into medical and industrial 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.




Looking at the EMS industry, the economic down turn will increase the chasm between the haves and the have nots. We expect to see industry consolidation and a few firms may exit the business altogether. Despite the lack of visibility into future quarters we feel the winners in the EMS space will benefit from continued OEM outsourcing, and benefit from new opportunities as firms exit the business. 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.

**Sensors and Actuators; Potential in Emissions Regulations**
The sensors and Actuators segment has the potential to see double digit sales growth over the next 3-5 years. Green initiatives, the need for increased fuel economy, and market share gains in Automotive provide a positive back drop for the segment.

Driven by tighter emissions regulations that require stricter engine controls, the market for smart actuator technology in commercial and passenger vehicles is growing rapidly and according to CSM Worldwide could grow to the $750 million to $1 billion range by 2010. The firm's target market share is 10%.The smart actuator is used as a key part of a turbocharger system. This initial CTS application will be used on diesel engines for light duty diesel trucks sold in the North American market with production beginning

**Electronic Components; Growth in Developed and Emerging Communications**
The Electronic Components segment also has the potential for double digit sales growth over the next three to five years. Driven by growth in communications infrastructure, the firm has been increasing market share and winning new customers.

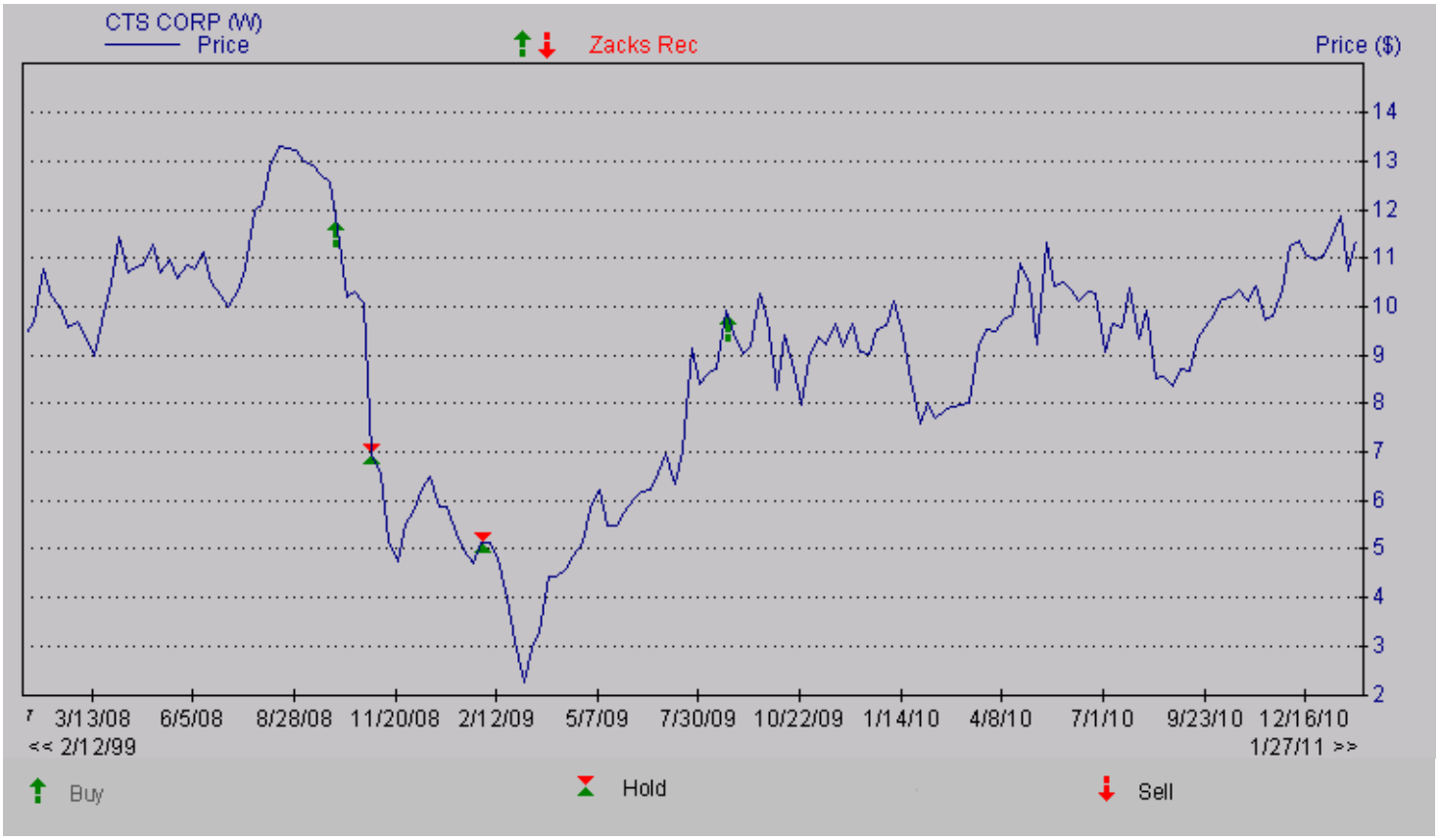
| WORLD INTERNET USAGE AND POPULATION STATISTICS | | | | | | |
|---|---|---|---|---|---|---|
| World Regions | Population ( 2009 Est.) | Internet Users Dec. 31, 2000 | Internet Users Latest Data | Penetration (% Population) | Growth 2000-2009 | Users % of Table |
| Africa | 991,002,342 | 4,514,400 | 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 Blackberries. There are in effect more and more devices being connected and each new connection needs some type of access.

WiMAX has the potential to do to broadband Internet access what cell phones have done to phone access. In the same way that many people have given up their "land lines" in favor of cell phones, WiMAX could replace cable and DSL services, providing universal Internet access just about anywhere you go. WiMAX will also be as painless as WiFi -- turning your computer on will automatically connect you to the closest available WiMAX antenna. The main problems with broadband access are that it is pretty expensive and it doesn't reach all areas. The main problem with WiFi access is that hot spots are very small, so coverage is sparse.

## HISTORICAL ZACKS RECOMMENDATIONS




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