Zacks Small-Cap Research

July 26, 2011
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CTS Corporation (CTS-NYSE)

CTS: - Looking for a Strong Second Half- Outperform

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	08/24/2009
Current Price (07/25/11)	$9.70
Six- Month 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.

On July 25, 2011 the firm announced its second quarter earnings and on July 26, 2011 CTS hosted a conference call. We see a strong second half as Japan returns to form.

SUMMARY DATA

52-Week High	**$12.27**
52-Week Low	**$7.96**
One-Year Return (%)	**-7.51**
Beta	**2.02**
Average Daily Volume (sh)	**148,180**
Shares Outstanding (mil)	**34**
Market Capitalization ($mil)	**$333**
Short Interest Ratio (days)	**11.25**
Institutional Ownership (%)	**88**
Insider Ownership (%)	**3**
Annual Cash Dividend	**$0.12**
Dividend Yield (%)	**1.24**
5-Yr. Historical Growth Rates	
Sales (%)	**-5.5**
Earnings Per Share (%)	**-7.9**
Dividend (%)	**0.0**
P/E using TTM EPS	**14.7**
P/E using 2011 Estimate	**13.6**
P/E using 2012 Estimate	**11.9**
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)
2009	118 A	120 A	127 A	134 A	499 A
2010	129 A	139 A	139 A	145 A	552 A
2011	152 A	147 A	155 E	163 E	617 E
2012	163 E	165 E	165 E	167 E	660 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
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	$0.17 A	$0.67 A
2011	$0.15 A	$0.14 A	$0.18 E	$0.24 E	$0.71 E
2012	$0.19 E	$0.20 E	$0.20 E	$0.22 E	$0.81 E

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WHAT'S NEW

On July 25, 2011 CTS announced results for the second quarter of fiscal year 2011 ending July 3, 2011. Revenue for the period was $146.9 million down 3% sequentially from $151.5 million and up 5.8% year-over-year.

Components and Sensors sales decreased $4.2 million, or 6%, year-over-year. Automotive product sales decreased over the year while electronic component product demand remained relatively flat. Sequentially the Components and Sensors segment top-line decreased $4.0 million or 5.6%. The decrease was a result of decreased demand in automotive products offset by improved demand across most electronic component product lines. The Components and Sensors operating profit on a year-over year basis fell by $3.1 million due to the impact of lower sales, higher commodity prices and higher research and development expense. Sequentially operating profit for Components and Sensors fell $0.9 million due to lower sales, partially offset by lower operating costs.

EMS second quarter 2011 sales increased $12.3 million, or 18.5%, on a year-over-year basis, due to higher demand across all markets served. Sequentially EMS sales were down 0.8% ($78.9 million versus $79.5 million), due to lower defense and aerospace and computer sales, partially offset by improved sales in the industrial market. EMS operating profit for the second quarter was $0.4 million compared to a loss of $0.2 million for the comparable quarter of 2010 and break even during the first quarter of 2011. The increase was primarily a result of improved cost control.

Management maintained its full-year 2011 sales to be 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.

Looking at the balance sheet cash and cash equivalents stood at $75.06 million up from $74.16 million a quarter ago. Capital expenditures were 2.3% of sales ($3.4 million) compared to 3.4% ($4.7 million) a year ago.

CTS Expands Into Growth Markets

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.

On April 13th 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 22nd 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

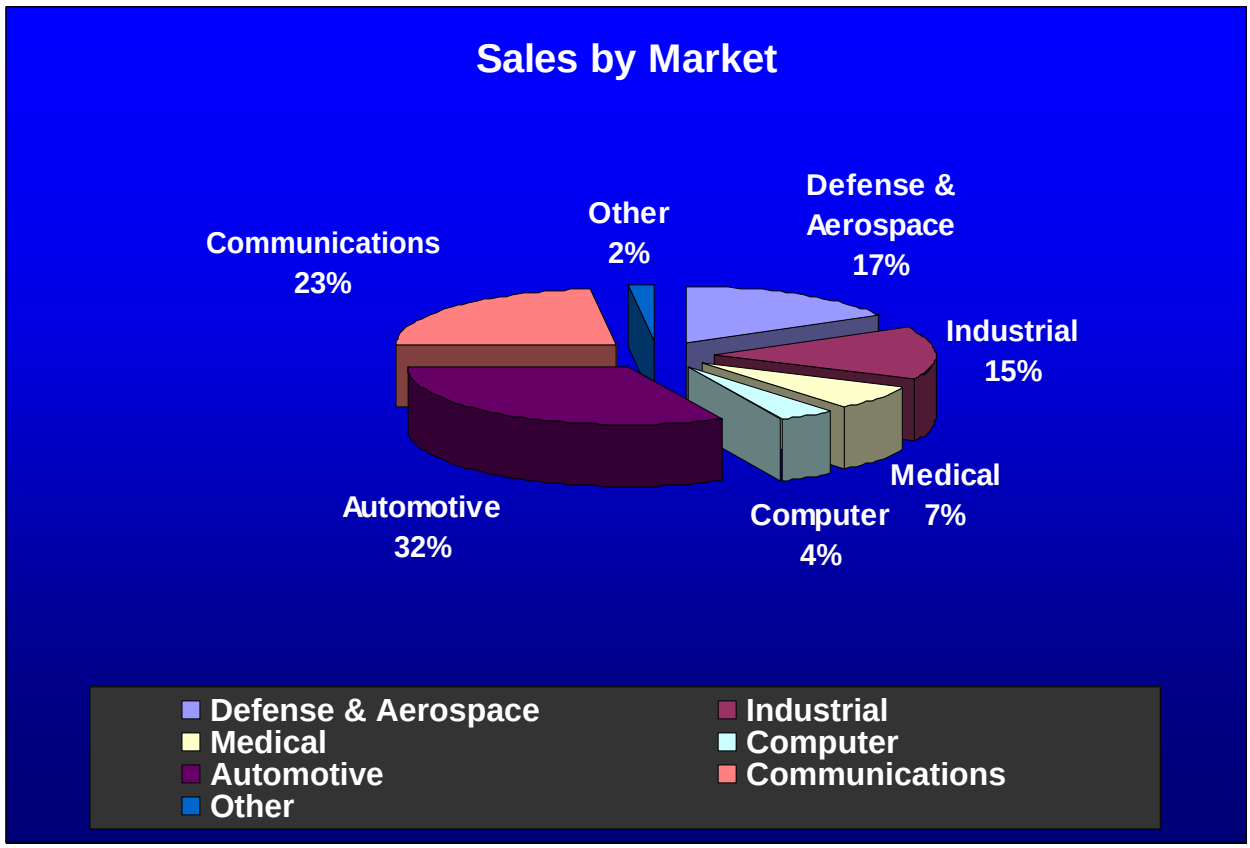
production of the high-volume smart actuator programs for light and medium-duty trucks are launched in late 2012.

Smart actuators in the commercial market is an area where CTS has great potential to tap a very large market. In the second half of 2010 the firm penetrated two of the largest diesel manufacturers with smart actuators for trucks and industrial engines. There were four wins in all prior to the March Announcement. 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)

INVESTMENT THESIS

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

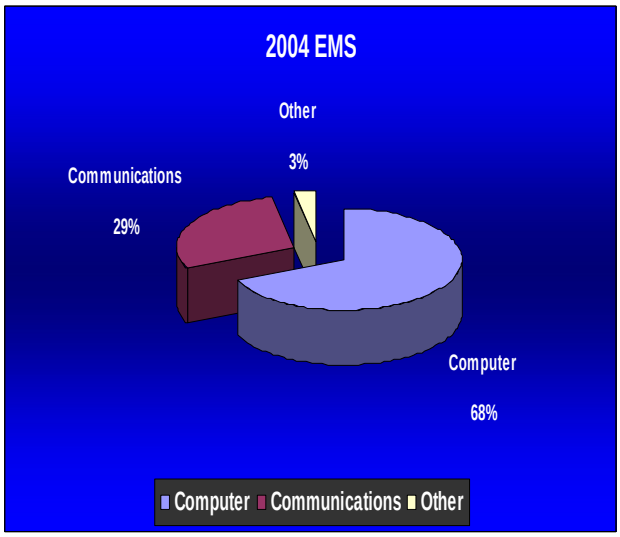


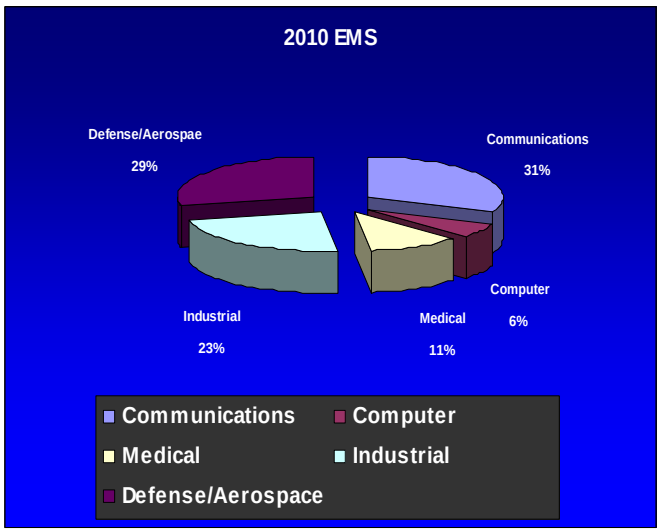
Electronics Manufacturing Services (EMS)
EMS includes the higher level assembly of electronic and mechanical components into a finished subassembly or assembly performed under a contract manufacturing agreement with an OEM or other contract manufacturer. The firm also provides full turnkey manufacturing 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.

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.





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.

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.

*note Components and Sensors represent one segment

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: Here are four.

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 estimate is that the facility has the capacity to support $15 million in annual sales of this new Piezoceramic component. This initiative is expected to incur net expenditures in hiring, training and depreciation in the second quarter, and become breakeven to the bottom-line in the third quarter. The component will be a net positive contributor with $2 million to $3 million in sales and approximately $1 million in margins in the fourth quarter of 2011. This translates 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.

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.

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 area. Smart Actuators in the commercial market is an area where CTS has been making significant progress. CTS sees a potential $90 million over several years from a market that could be as large as $1 billion.

VALUATION

CTS remains well positioned to achieve solid revenue growth and operating leverage as end markets expand in the long run, given the company's competitive advantage led by innovation. The slower growing EMS segment has been exceptionally diversified since 2004 and is a complement to the faster growing Sensors and Components segment. The company is trading at a reasonable 13.6x 2011 estimated EPS.

We value the company based on the average of our P/E multiple (19.5x 2011 estimated EPS) and our two stage intrinsic model. The semiconductor/Electronic group average P/E is between 22x-26x 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.

The intrinsic value is essentially a sum of the company's future earnings, minus any long-term debt. Dividing the intrinsic value by the number of shares outstanding yields an intrinsic stock price. We used the following inputs:

- 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%.

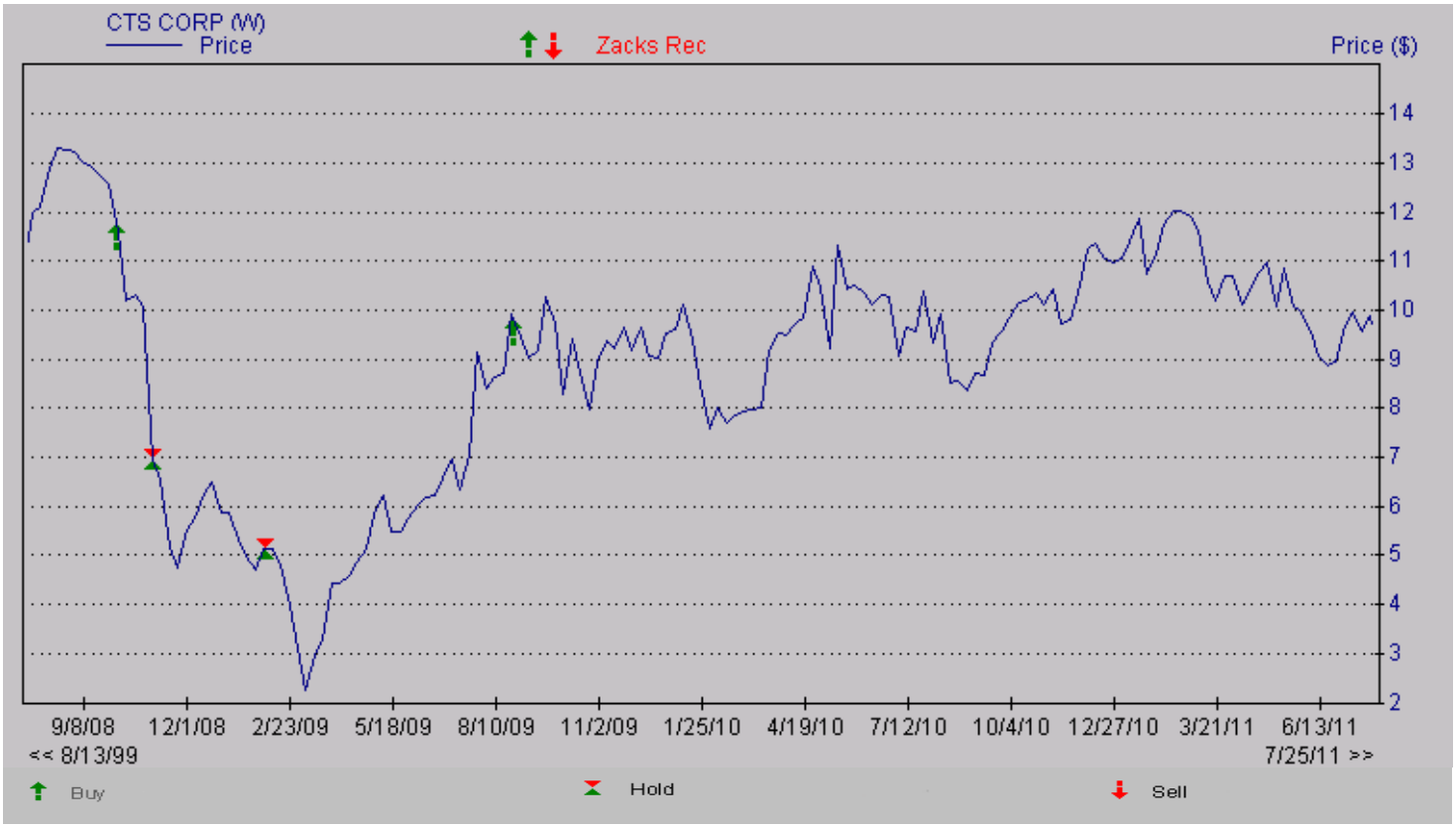
With these inputs we arrive at a target price of $14.00.

PROJECTED INCOME STATEMENT

INCOME STATEMENT ($ Millions)	Jun-10 Q2 10	Sep-10 Q3 10	Dec-10 Q4 10	Mar-11 Q1 11	Jun-11 Q2 11	Sep-11 Q3 11 E	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011 E	FY 2012 E
REVENUE												
Net Revenue	**138.9**	**139**	**145.0**	**152**	**147**	**155**	**686.0**	**691.7**	**499.0**	**552.6**	**617.0**	**660.0**
Sequential Growth		*0%*	*4%*	*4%*	*-3%*	*6%*						
OPERATING EXPENSES												
Cost of Revenues	108.5	109.3	115.9	122.4	119.1	125.5	553.3	554.6	400.1	432.7	494.0	510.0
% of Revenue	*78%*	*78%*	*80%*	*81%*	*81%*	*81%*	*81%*	*80%*	*80%*	*78%*	*80%*	*77%*
Gross Profit -	**30.3**	**30**	**29.1**	**29**	**28**	**30**	**132.7**	**137.1**	**98.8**	**119.9**	**123.0**	**150.0**
Proforma Gross Margin	*21.9%*	*22%*	*20.1%*	*19%*	*19%*	*19%*	*19.3%*	*19.8%*	*19.8%*	*21.7%*	*19.9%*	*22.7%*
R&D + Engg	4.3	5.1	4.3	5.0	4.6	5.0	15.9	18.3	14.2	18.3	19.7	20.5
% of Revenue	*3.1%*	*3.7%*	*3.0%*	*3.3%*	*3.1%*	*3.2%*	*2.3%*	*2.6%*	*2.8%*	*3.3%*	*3.2%*	*3.1%*
SG&A	18.3	17.1	17.4	18.4	18.1	18.3	82.1	82.6	67.1	72	73	84
% of Revenue	*13.2%*	*12.3%*	*12.0%*	*12.1%*	*12.3%*	*11.8%*	*12.0%*	*11.9%*	*13.5%*	*13.1%*	*11.8%*	*12.8%*
GW Amort, Restructuring, other			*$ 1.40*		*0.69*		*2.4*	(5.6)	*35.4*	1.44		
% of Revenue												
Total Operating Expenses	22.6	22.2	23.1	23.4	23.3	23.3	100.4	95.3	116.7	92	93	105
% of Revenue	*16.3%*	*15.9%*	*15.9%*	*15.4%*	*15.9%*	*15.0%*	*14.6%*	*13.8%*	*23.4%*	*17%*	*15%*	*16%*
Operating Income -	**7.7**	**7.8**	**6.0**	**5.8**	**4.5**	**6.2**	**32.3**	**41.8**	**-17.8**	**28**	**30**	**45**
Operating Margin	*5.6%*	*5.6%*	*4.2%*	*3.8%*	*3.1%*	*4.0%*	*5%*	*6%*	*-4%*	*5%*	*5%*	*7%*
NON-OPERATING ITEMS												
Non operating Income/Expense	-0.5	2	-0.3	1	1	1	0.2	-1.3	-2.6	0.18	-1	-3
% of Revenue	*-0.35%*	*1.14%*	*-0.18%*	*0.55%*	*0.35%*	*0.48%*	*0.02%*	*-0.19%*	*-0.52%*	*0.03%*	*-0.16%*	*-0.38%*
Tax Provision	1.4	2.4	0.9	1.5	0.9	0.9	7.1	-0.6	13.6	6	5	15
Effective Tax Rate												
Net Income -	**5.9**	**6.9**	**4.8**	**5.1**	**4.1**	**6.1**	**25.4**	**41.0**	**-34.1**	**22.0**	**24.8**	**27.6**
Net Income Margin	*4.2%*	*5.0%*	*3.3%*	*3.4%*	*2.8%*	*3.9%*	*3.7%*	*5.9%*	*-6.8%*	*4.0%*	*4.0%*	*4.2%*
Adjustments	**0**	**0**	**0.03**	**0**	**0.02**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
EARNINGS PER SHARE												
EPS - Basic	$0.17	$0.20	$0.17	$0.15	$0.14	$0.18	$0.72	$0.89	-$1.01	$0.67	$0.72	$0.81
EPS - Diluted	$0.17	$0.20	$0.17	$0.15	$0.14	$0.18	$0.66	$0.81	-$1.01	$0.67	$0.71	$0.81

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HISTORICAL ZACKS RECOMMENDATIONS



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