Zacks Equity Research

July 27, 2010
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CTS Corporation (CTS-NYSE)

CTS: Solid Quarter- Sees sensor technologies expanding to new areas- Outperform

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	08/24/2009
Current Price (07/26/10)	$10.63
Six- Month Target Price	**$12.00**

OUTLOOK

CTS Corporation designs, manufactures, assembles, and sells electronic components and sensors worldwide. On July 27, 2010 the firm presented June quarter results. Results were strong with regard to earnings, business wins, and cash flow. Look for free cash to jump over the next two quarters to $20-$25 million for 2010. Further management reported sensor technologies are beginning to contribute to new areas such as diesel, which opens the CTS up to construction, mining and agriculture. This should be a tail wind for 2012 top line numbers. We see value in the shares at current prices and rate the stock Outperform.

SUMMARY DATA

52-Week High	**$11.77**
52-Week Low	**$7.05**
One-Year Return (%)	**25.02**
Beta	**2.08**
Average Daily Volume (sh)	**168,324**
Shares Outstanding (mil)	**34**
Market Capitalization ($mil)	**$361**
Short Interest Ratio (days)	**5.39**
Institutional Ownership (%)	**N/A**
Insider Ownership (%)	**4**
Annual Cash Dividend	**$0.12**
Dividend Yield (%)	**1.13**
5-Yr. Historical Growth Rates	
Sales (%)	**-2.1**
Earnings Per Share (%)	**-8.9**
Dividend (%)	**0.0**
P/E using TTM EPS	**17.1**
P/E using 2010 Estimate	**17.4**
P/E using 2011 Estimate	**14.9**
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	145 E	155 E	568 E
2011	155 A	160 E	165 E	173 E	653 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	$0.16 E	$0.15 E	$0.61 E
2010	$0.17 A	$0.17 E	$0.18 E	$0.19 E	$0.71 E

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

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WHAT'S NEW

On July 27th 2010 CTS announced results for the second quarter of fiscal year 2010 ending June 2010. Revenue for the period was $138.9 million up 7.3% sequentially from $129.4 million and up 15.4% year over year.

While the firm reported strength across the board, we note two items from the conference call that we feel are key to long-term growth.

- The ramp of free cash flow over the next quarter.
- Sensor technology expanding to newer areas.

CTS expect global cash from operations to improve through the second half of 2010, and to generate positive free cash flow in the range of $20 to $25 million for 2010. (From essentially breakeven in the first half of 2010) The explanation lies in the timing of cash increases in working capital. The profitability was high in the first half, but because the firm sales were ramping up predominately all cash goes towards funding working capital. Once sales levels are high and sustained with relatively small uptick in growth, working capital should begin to generate. The firm also had an unusually low accounts payable at the end of the second quarter.

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. The most recent appraisal CTS did on a brand new sensor application, (albeit with small volumes), was significant because it represented taking its sensing technology to a newer application. The second opportunity is CTS sensors going into diesel engines, which are taking CTS into on-and-off highway diesel engines and trucks. This introduces the firm to commercial applications like construction, mining, and agriculture. Finally in electronic components, CTS employs a similar strategy. The firm is taking its piezoceramic product, which traditionally was only used in ultrasonic medical application, commercial inkjet applications, or energy exploration and applying it to a high-density disc-drive actuation application.

Broken down by segment, the Components and Sensors segment decreased revenue $1.1 million, down 1.5% quarter over quarter and up 45.7% year over year. The year over year improvement reflected sales improvement resulted from higher automotive sensor and actuator product and electronic component product demand, across nearly all product lines. EMS sales increased $10.6 million, or 18.9%, sequentially, primarily from increased demand in most of its served markets. Year over year EMS sales declined 5.9%.

CTS filed 20 new patent applications in the second quarter this year, versus only nine in the year ago quarter. The firm was granted 11 new patents in the second quarter of 2010, versus seven in the second quarter of 2009.

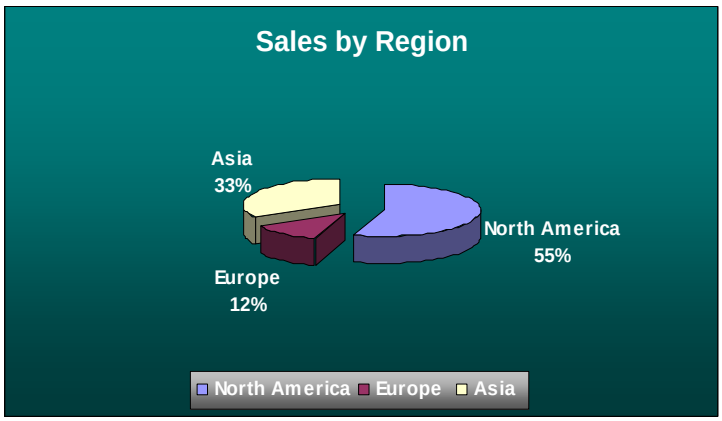
CTS ended the quarter with $65.2 million in cash, up $14.1 million from year end 2009, and up $6.5 million from the first quarter 2010. Cash flow from operations for the quarter was $1 million. This brings net cash provided by operating activities for year to date 2010 to $6.3 million. Including capital expenditures of $6.2 million, year to date 2010 free cash flow was break even.

Management sharpened its full-year 2010 top-line growth rate to 12-15% growth from 2009 (previously +15%-20%). On the bottom-line Full-year 2010 diluted earnings per share are now estimated in the range of $0.55 to $0.62 compared to the previous range of $0.52 to $0.60.

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.

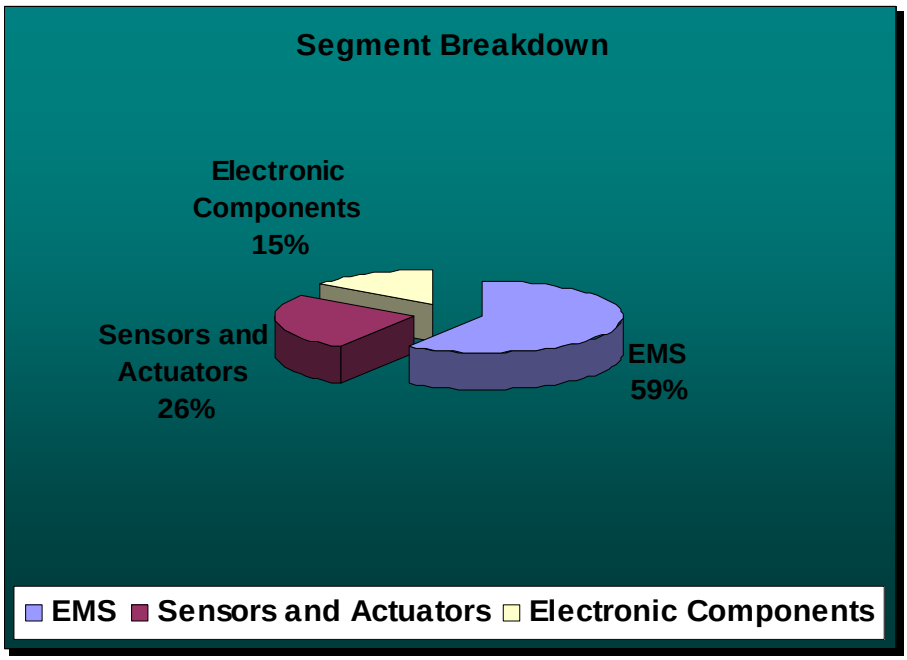


Electronics Manufacturing Services (EMS)
EMS includes the higher level assembly of electronic and mechanical components into a finished subassembly or assembly performed under a contract manufacturing agreement with an OEM or other contract manufacturer. The firm also provides full turnkey manufacturing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

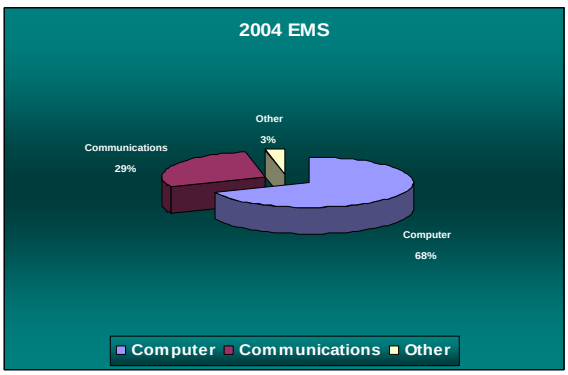
used in communications infrastructure and computer markets; components used in computer and other high-speed applications, switches, resistor networks, and potentiometers used to serve multiple markets; and fabricated piezoelectric materials and substrates used primarily in medical, industrial and defense and aerospace markets.

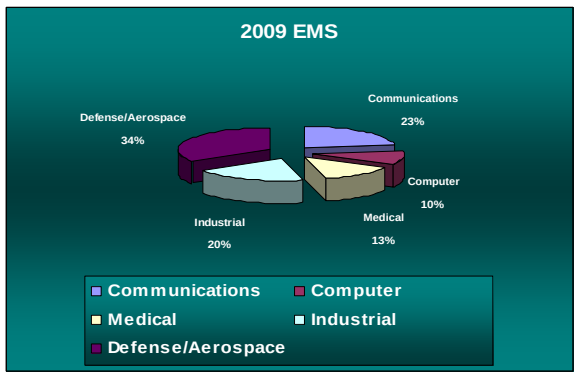


*note Components and Sensors represent one segment

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.

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	

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.

PROJECTED INCOME STATEMENT & BALANCE SHEET

INCOME STATEMENT ($ Millions)	Jun-09 Q209	Sep-09 Q309	Dec-09 Q409	Mar-10 Q1 10	Jun-10 Q2 10	Sep-10 Q3 10 E	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010 E	FY 2011 E
REVENUE												
Net Revenue	**120.4**	**126.6**	**120.4**	**126.6**	**138.9**	**145**	**655.6**	**686.0**	**691.7**	**499.0**	**568.0**	**653.0**
Sequential Growth		*5%*	*-5%*	*5%*	*10%*	*4%*						
OPERATING EXPENSES												
Cost of Revenues	98.5	100.4	98.5	100.4	108.5	113.1	534.8	553.3	554.6	400.1	443.0	506.1
% of Revenue	*82%*	*79%*	*82%*	*79%*	*78%*	*78%*		*81%*	*80%*	*80%*	*78%*	*77%*
Gross Profit -	**21.9**	**26.2**	**21.9**	**26.2**	**30.3**	**32**	**120.8**	**132.7**	**137.1**	**98.8**	**125.0**	**146.9**
Proforma Gross Margin	*18.2%*	*20.7%*	*18.2%*	*20.7%*	*21.9%*	*22%*	*18.4%*	*19.3%*	*19.8%*	*19.8%*	*22.0%*	*22.5%*
R&D + Engg	3.5	3.4	3.5	3.4	4.3	4.6	15.9	15.9	18.3	14.2	17.0	20.0
% of Revenue	*2.9%*	*2.7%*	*2.9%*	*2.7%*	*3.1%*	*3.2%*	*2.4%*	*2.3%*	*2.6%*	*2.8%*	*3.0%*	*3.1%*
SG&A	15.2	16.5	15.2	16.5	18.3	19.3	70.9	82.1	82.6	67.1	74	84
% of Revenue	*12.7%*	*13.0%*	*12.7%*	*13.0%*	*13.2%*	*13.3%*	*10.8%*	*12.0%*	*11.9%*	*13.5%*	*13.0%*	*12.9%*
GW Amort, Restructuring, other	-	-	-	-			*3.40*	2.4	*(5.6)*	35.4		
% of Revenue												
Total Operating Expenses	18.7	19.9	18.7	19.9	22.6	23.9	90.2	100.4	95.3	116.7	91	104
% of Revenue	*15.5%*	*15.7%*	*15.5%*	*15.7%*	*16.3%*	*16.5%*	*13.8%*	*14.6%*	*13.8%*	*23.4%*	*16%*	*16%*
Operating Income -	**3.2**	**6.3**	**3.2**	**6.3**	**7.7**	**8.0**	**30.7**	**32.3**	**41.8**	**-17.8**	**34**	**43**
Operating Margin	*2.6%*	*5.0%*	*2.6%*	*5.0%*	*5.6%*	*5.5%*	*5%*	*5%*	*6%*	*-4%*	*6%*	*7%*
NON-OPERATING ITEMS												
Non operating Income/Expense	-0.5	-0.6	-0.5	-0.6	-0.5	-1	0.0	0.2	-1.3	-2.6	-3	-4
% of Revenue	*-0.39%*	*-0.47%*	*-0.39%*	*-0.50%*	*-0.35%*	*-0.34%*	*0.00%*	*0.02%*	*-0.19%*	*-0.52%*	*-0.53%*	*-0.54%*
Tax Provision	9.7	1.2	9.7	1.2	1.4	1.7	6.5	7.1	-0.6	13.6	10	15
Effective Tax Rate												
Net Income -	**-7.0**	**4.5**	**-7.0**	**4.5**	**5.9**	**5.9**	**24.2**	**25.4**	**41.0**	**-34.1**	**20.9**	**24.4**
Net Income Margin	*-5.8%*	*3.6%*	*-5.8%*	*3.5%*	*4.2%*	*4.0%*	*3.7%*	*3.7%*	*5.9%*	*-6.8%*	*3.7%*	*3.7%*
Stock Based Comp	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
EARNINGS PER SHARE												
EPS - Basic	-$0.21	$0.13	-$0.21	$0.13	$0.17	$0.16	$0.68	$0.72	$0.89	-$1.01	$0.61	$0.71
EPS - Diluted	-$0.21	$0.13	-$0.21	$0.13	$0.17	$0.16	$0.63	$0.66	$0.81	-$1.01	$0.61	$0.71
EPS - (EXCL Charges)	$0.06	$0.13	$0.06	$0.13	$0.06	$0.16	$0.65	$0.71	$0.77	$0.35	$0.61	$0.71

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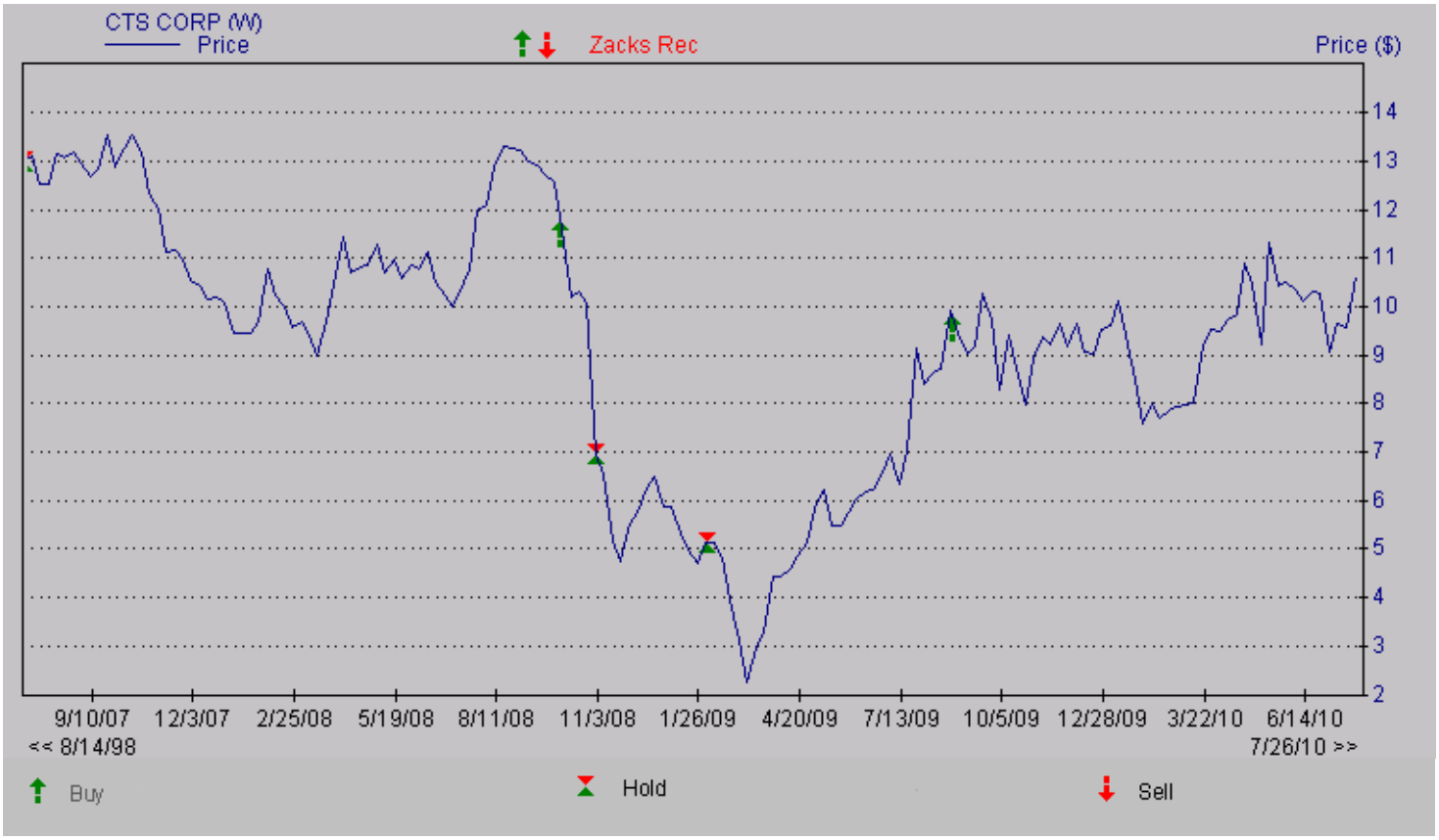
HISTORICAL ZACKS RECOMMENDATIONS



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