Zacks Small-Cap Research

October 30, 2013
Ken Nagy, CFA

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

CTS Corporation (CTS-NYSE)

CTS: - Components and Sensors is Now the Story- Outperform

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	08/24/2009
Current Price (10/29/13)	$18.70
Target Price	**$20.00**

OUTLOOK

CTS Corporation (CTS) designs, manufactures, assembles, and sells electronic components and sensors worldwide. The growing Components and Sensors segment has found new customers and markets for existing products. On October 3, 2013, CTS announced that Benchmark Electronics, Inc. acquired its Electronics Manufacturing Solutions (EMS) business for $75 million in cash. The EMS segment had been experiencing a slowdown in revenues in 2013 due to the combination of the firm selectively walking away from some business as well as weakness in certain end markets such as Defense. The company that will emerge will be a high growth, higher margin business with a proven track record of successfully finding new customers in existing markets.

SUMMARY DATA

52-Week High	**$18.77**
52-Week Low	**$8.12**
One-Year Return (%)	**126.59**
Beta	**2.21**
Average Daily Volume (sh)	**136,560**
Shares Outstanding (mil)	**34**
Market Capitalization ($mil)	**$630**
Short Interest Ratio (days)	**8.45**
Institutional Ownership (%)	**84**
Insider Ownership (%)	**5**
Annual Cash Dividend	**$0.14**
Dividend Yield (%)	**0.75**
5-Yr. Historical Growth Rates	
Sales (%)	**-1.1**
Earnings Per Share (%)	**8.1**
Dividend (%)	**4.6**
P/E using TTM EPS	**24.6**
P/E using 2014 Estimate	**23.4**
P/E using 2014 Estimate	**21.3**
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)
2011	152 A	147 A	146 A	144 A	589 A
2012	147 A	154 A	137 A	138 A	577 A
2013	150 A	152 A	160 A	98 E	559 E
2014					440 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
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	$0.18 A	$0.64 A
2013	$0.14 A	$0.20 A	$0.24 A	$0.24 E	$0.80 E
2014					$0.88 E

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WHAT'S NEW

Solid Quarter for CTS as Components and Sensors is Set to Be the Single Segment

On October 28, 2013, CTS Corporation, the designer and manufacturer of electronic components and sensors and a provider of electronics manufacturing services (EMS) to original equipment manufacturers (OEMs), reported financial results for its third quarter and nine months, ended September 29, 2013.

The company's third quarter revenues were solid, improving year over year by over 16 percent or $22.206 million to $159.563 million. This compares to revenues of $137.357 million for the three months ended September 30, 2012. Sequentially, revenues improved by over 5 percent or $8.002 million above the $151.561 million from the second quarter fiscal 2013.The year over year jump was primarily due strong sales from CTS' component and sensor segment.

Sales of the company's components and sensors segment jumped to $103.632 million, a 37 percent or $28.067 million year over year increase. Likewise, within the segment, the jump was primarily due to sales of $11.8 million from the D&R Technology acquisition.

Late in the fourth quarter 2012, CTS announced the synergistic acquisition of D&R Technologies, a leading designer and manufacturer of custom-designed automotive sensors with annual sales of approximately $50 million. The acquisition expands CTS' strategic automotive sensor product platform with new customers and a broader product portfolio into applications for safety systems and vehicle chassis management.

Metric	Q3 Performance	Breakdown	Takeaway
EMS	Sales decreased $5.9 M year over year and increased $9.8 M sequentially	CTS Sold the EMS Business on October 2,2013	75 million in cash will be used to pay down debt.
Components & Sensors	Sales increased $28.1 M year over year and decreased by $1.7 M Sequentially.	Of the 28.1 M increase $11.8 M was a result of the D&R acquisition. 2012	Components and Sensors will be the single segment in the new company. Investors can expect higher margins and revenue growth.
Cash Flow	Cash Flow from Ops $15.3 M vs $13.7 M last quarter.	Up year over year as well as sequentially.	Strong cash flow generation
Management Outlook	Full year revenue guidance $555-560M, reflects EMS divestiture. (EPS $0.78-$0.83)	Management feels its better positioned for profitable growth	EPS guidance remains the same

Sequentially, the Components and Sensors segment revenue fell by $1.749 million from $105.381 million for the second quarter of fiscal 2013. The quarter over quarter decrease was primarily driven by softness in demand for CTS' HDD products which is expected to continue into the early part of 2014 and then

return to more normal levels as inventories are depleted and new platforms are launched.

CTS' EMS segment sales decreased year over year by $5.861 million to $55.931 million. The EMS segment's third quarter 2013 sales grew sequentially by $9.751 million from $46.180 million during the second quarter of 2013. The segment was sold on October 2, 2013 for $75 million.

Third quarter net income was $6.819 million, or $0.20 per share, compared to net earnings of $5.917 million, or $0.17 per diluted share, in the same period last year.

Still, the third quarter 2013 results include restructuring and other costs of $0.04 per share. Excluding these items, third quarter 2013 adjusted earnings were $0.24 per share compared to adjusted earnings of $0.20 per share in the same period last year and $0.20 per share in the second quarter 2013.

Gross margin during the quarter jumped year over year to 23.5 percent from 19.4 percent for the quarter ended September 30, 2012. Sequentially, gross margin was flat from the 23.4 percent for the second quarter fiscal 2013. The 4.1 percentage point improvement in gross margin was primarily due to the component and sensor segment mix growing to 65 percent of total sales in the third quarter of 2013 versus 55 percent in the third quarter of 2012. Additionally, the restructuring action and ongoing cost containment action assisted in the lift off in gross margin.

CTS announced a $16 to $20 million restructuring plan in June 2013, with expected annual savings of approximately $8 to $10 million once fully implemented in 2014. The plan is designed to further improve the company's cost structure and capacity utilization.

CTS secured new orders of $105 million in the quarter as well as received its first award with an Asian OEM which is expected to launch in 2016.

CTS Corporation's cash and equivalents for the third quarter ended September 29, 2013, was $96.730 million while working capital improved to $186.042 million. This compares to $86.044 million of cash and equivalents and working capital of $176.587 million for the second quarter ended June 30, 2013.

Debt at the end of the third quarter was $128.6 million versus $153.5 million at the end of 2012 resulting in a debt to capitalization ratio of 32.3 percent compared to 36.4 percent at year end 2012.

Still, third quarter 2013 cash flow from operations improved to $15.3 million compared to $13.7 million in the second quarter 2013 and $13.0 million in third quarter 2012.

Third quarter 2013 capital expenditures were $2.5 million versus $2.9 million in 2012 and $3.7 million in the second quarter 2013. Third quarter free cash flow, which is defined as cash flow from operations less capital expenditures, was $12.8 million compared to $10.1 million last year and improved from cash usage of $10.0 million in the second quarter 2013. Management continues to anticipate full year capital expenditures to be approximately 3% of sales.

On June 11 the Board of Directors authorized a repurchase of up to 1 million additional shares of the company stock. Similarly, during the third quarter, CTS repurchased approximately 49,800 shares for $731,000 at an average price of $14.69 while the company repurchased approximately 200,000 shares for $2.2 million during the first nine months of 2013.

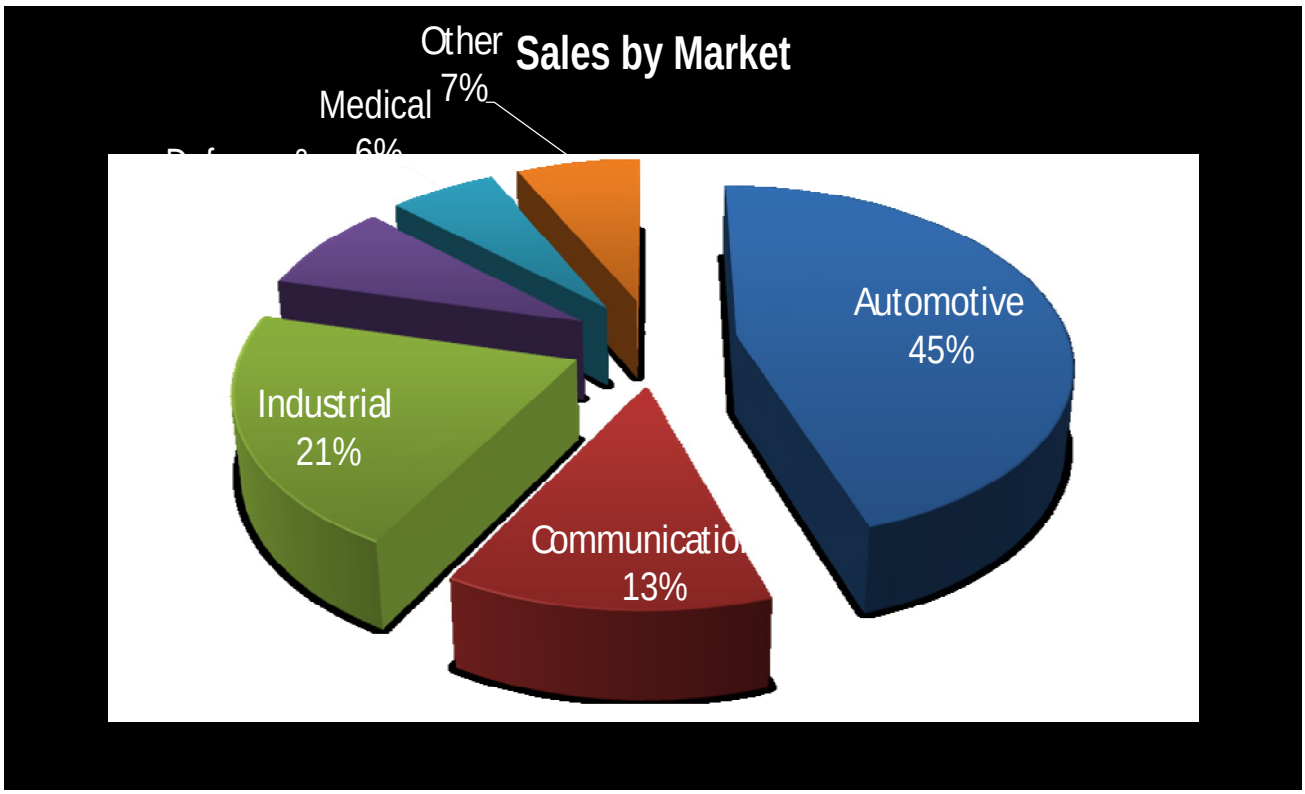
Management expects full-year 2013 sales to be in the range of $555 million to $560 million reflecting the October 2, 2013 EMS divestiture. In early October 2013, CTS announced that Benchmark Electronics, Inc. acquired its Electronics Manufacturing Solutions (EMS) business for $75 million in cash. The sale will enable the management team to more quickly focus on core business. Still, management is maintaining 2013 adjusted earnings per share to be in the range of $0.78 to $0.83 per share.

INVESTMENT THESIS

- With Components and Sensors as the lone segment at CTS, the firm will be a faster growing company. The Sensors and Actuators business enjoys macro trends such as tougher emissions standards, the need for increased fuel economy, and improved safety & chassis management applications. The Electronic Components business has similar high growth macro trends such as higher volume of data traffic in global markets.

- Despite the EMS segment being exceptionally diversified since 2004, it was slowing down overall company growth rate and hurting the average margin rate. This was clear at the end of the second quarter of 2013, when margins were stronger given the contribution from Components and Sensors. Investors should consider margin expansion as part of the story.

- CTS has been successful in finding new customers in existing markets. This happened with sensor technology in commercial markets and also in the fabricated piezoelectric business with disk drive.



CTS Just became a High Growth, Higher Margin Company

CTS Corporation (CTS) designs, manufactures, assembles, and sells electronic components and sensors worldwide. The faster growing Components and Sensors segment has found new customers and markets for existing products. Over the past several years the company has also diversified its Electronics Manufacturing Solutions (EMS) segment to markets such as medical, defense and aerospace, and industrial.

On October 3, 2013, CTS announced that Benchmark Electronics, Inc. acquired its Electronics Manufacturing Solutions (EMS) business for $75 million in cash. The EMS segment had been experiencing a slowdown in revenues in 2013 due to the combination of the firm selectively walking away from some business as well as weakness in certain end markets such as Defense.

The company that will emerge will be a high growth, higher margin business with a proven track record of successfully finding new customers in existing markets.

Details of the Agreement

The agreement with Benchmark Electronics includes approximately 1,000 employees and five manufacturing facilities which are located in Moorpark, CA, Londonderry, NH, Bangkok, Thailand, Matamoros, Mexico, and San Jose, CA.

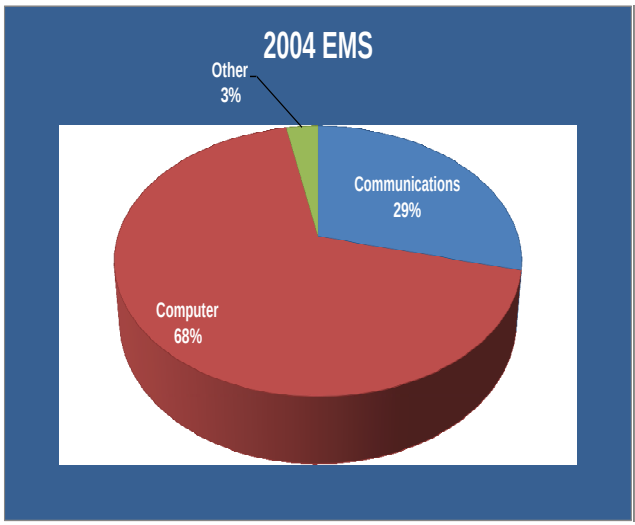
The sale provides additional capital to increase CTS' sales and marketing capabilities, to generate organic growth in higher margin businesses and to pursue value-enhancing external opportunities in higher growth segments and geographies that are complimentary to the company's core business. CTS will be better positioned to meet the evolving needs of its customers, increase margins through the introduction of new value-added products, as well as grow in attractive adjacencies which in turn will all enhance shareholder value.

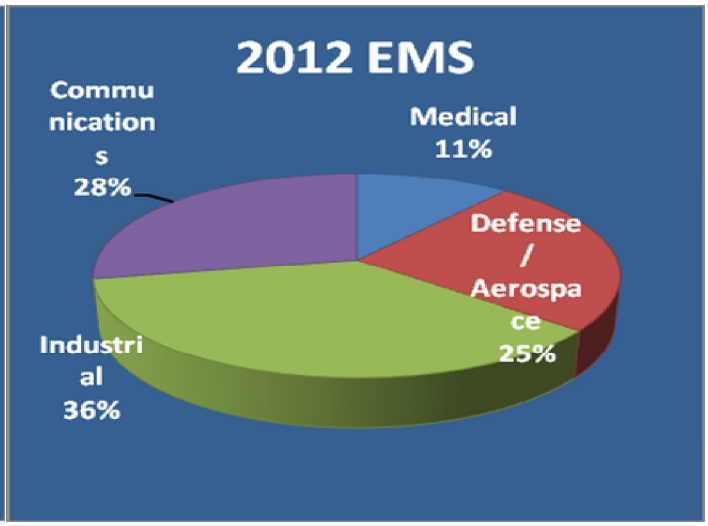
Finally, while driving growth in its components and sensors business, management intends to increase productivity and margin by continuing to simplify global footprint through the consolidation of manufacturing facilities in best cost locations and optimizing operating costs in all areas.

The History of EMS at CTS

The EMS segment accounted for $222 million in revenue or 39 percent of CTS' consolidated revenues and 14 percent of operating earnings over the past twelve months.

The slower growing EMS segment was exceptionally diversified since 2004 into medical and industrial markets where margins were higher and cost to enter the market was significant. This produced higher margins and more reliable revenue in what was CTS' largest segment. CTS saw that firms with strong footholds in Medical, Defense, and Industrial would outperform firms with more concentration in computer and communications and made a clear effort to diversify. CTS aim in EMS was to find customers with complex needs in sectors such as defense, aerospace, medical and industrial.





The transaction allows CTS' to simplify its business strategy and focus on its Components and Sensors business.

During the latest quarter, CTS saw sales of it Components and Sensors segment jump to $105.381 million, a 37 percent or $28.558 million year over year increase, of which included 20 percent organic growth, over the comparable quarter of 2012.

Within the segment, the Components and Sensors segment's automotive sales increased $20.4 million, or 43 percent year-over-year, primarily due to sales of $13.2 million from the D&R Technology acquisition and higher sales from the recently launched smart actuator product.

Late in the fourth quarter CTS announced the synergistic acquisition of D&R Technologies, a leading designer and manufacturer of custom-designed automotive sensors with annual sales of approximately $50 million.

CTS' gross margin during the latest quarter jumped year over year to 23.4 percent from 16.8 percent for the quarter ended June 30, 2012. The improvement in gross margin was primarily driven by CTS' components and sensor sales mix growing to 70 percent of total sales in the second quarter 2013 versus 50 percent in the second quarter 2012. This segment sales mix shift had a positive impact on gross margin of approximately 5 percentage points

Sensors and Actuators

CTS estimates the Sensors and Actuators segment of their business will incur double-digit sales growth. The organization views this as organic growth that is predominantly research and development driven. These products serve commercial markets and regular automobiles to reduce emissions and improve fuel economy. Factors that have become incredibly desirable in a vehicle over the last decade. Due to recent acquisitions, CTS has expanded the product portfolio and engineering capabilities in sensors and actuators to suit dynamic consumer sentiment. Green programs and fuel efficiency should provide a tail-wind. Products in this segment include Smart Actuator, Position Sensors, and Accelerator Pedal Modules.

Macro Trends Driving Growth in this area include

- Tougher emissions standards
- Need for increased fuel economy
- Improved safety & chassis management applications

Finding New Customers in Existing 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.

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
CTS expects double-digit sales growth from its electronic components division over the next 3-5 years. Global markets now have a higher volume of data traffic, thus increasing the demand for suitable products. CTS manufactures multiple electronic components that enable these devices (i.e. Smart Phones, tablets etc.) to function. The firm sees the increase in emerging markets, as well as, current economies as an indication of future upward sales trends. For example, the shift to cloud computing increases the necessity for digital storage capacity, which requires a multitude of components that CTS fabricates. The considerable growth in this segment is highlighted in CTS's recent contract. CTS signed a four year manufacturing deal to provide Piezo Ceramic Materials to hard disk drive manufacturers that should provide $50-$60 million in future revenue. This is another example of a new customer and a new growth area.

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, defense and aerospace markets and most recently in the computer markets for hard disk drive applications. 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

Hard Disk Drive
CTS' new Piezoceramic product for high density disk drives are for next generation dual stage actuation disk drive for which is experiencing growth as a result of a shift of digital content storage to the "cloud."

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.

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, particularly with the growth of cloud storage. Asia 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 and related storage for music and video content.

VALUATION

According to the P/B, the P/S, and P/E CTS appears fairly valued to undervalued compared to industry.

Metric	CTS	Industry Average
P/B	2.00	2.60
P/E (TTM)	24.60	23.70
P/E 2014 (E)	21.25	17.80
P/S	1.09	2.20

Here is how we view the valuation of CTS.

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 forward P/E multiple (20x 2014 estimated EPS) and our two stage intrinsic model. The Zacks peer group average forward P/E is 17.5x. 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 and will be expanding margins. We were conservative with regard to growth and discount rate.

- An 8-year period with an earnings growth rate of 15.0% (average forecast) and a discount rate of 12.0%.
- A continuing period assumed to go on forever, with earnings growing at 5% and a discount rate of 11.18%.

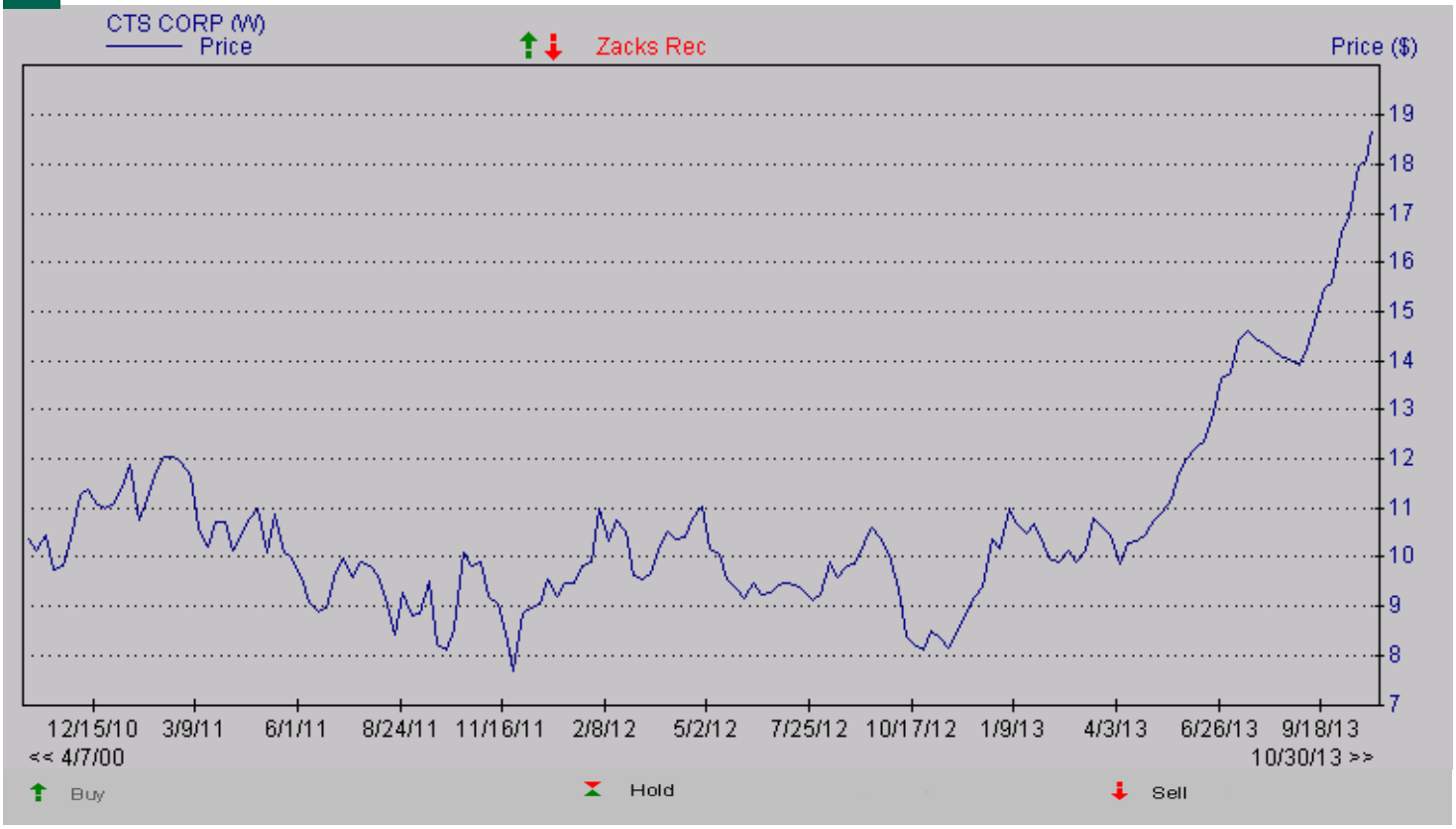
With these inputs we arrive at a target price of $20.00.

PROJECTED INCOME STATEMENT

INCOME STATEMENT ($ Millions)	Sep-12 Q3 12	Dec-12 Q4 12	Mar-13 Q1 13	Jun-13 Q2 13	Sep-13 Q3 13	Dec-13 Q4 13 E	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013 E
REVENUE												
Net Revenue	**137**	**138**	**150**	**152**	**160**	**98**	**691.7**	**499.0**	**552.6**	**588.5**	**576.9**	**558.6**
Sequential Growth	*#DIV/0!*	*1%*	*8%*	*1%*	*5%*	*-39%*						
OPERATING EXPENSES												
Cost of Revenues	110.8	111.5	118.3	116.1	122.0	67.5	554.6	400.1	432.7	478.2	464.5	423.9
% of Revenue	*81%*	*81%*	*79%*	*77%*	*76%*	*69%*	*80%*	*80%*	*78%*	*81%*	*81%*	*76%*
Gross Profit -	**27**	**27**	**31**	**35**	**38**	**31**	**137.1**	**98.8**	**119.9**	**110.3**	**112.4**	**134.7**
Proforma Gross Margin	*19%*	*19%*	*21%*	*23%*	*24%*	*31%*	*19.8%*	*19.8%*	*21.7%*	*18.7%*	*19.5%*	*24.1%*
R&D + Engg	4.4	5.3	6.3	5.8	5.7	6.0	18.3	14.2	18.3	20.0	19.1	23.7
% of Revenue	*3.2%*	*3.9%*	*4.2%*	*3.8%*	*3.6%*	*6.1%*	*2.6%*	*2.8%*	*3.3%*	*3.4%*	*3.3%*	*4.2%*
SG&A	19.4	22.2	21.4	20.7	20.8	13.5	82.6	67.1	72	72	80	76
% of Revenue	*14.1%*	*16.1%*	*14.3%*	*13.7%*	*13.0%*	*13.8%*	*11.9%*	*13.5%*	*13.1%*	*12.2%*	*13.9%*	*13.7%*
GW Amort, Restructuring, other	*(3.95)*	*(12.98)*	*0.56*	*7.24*	*$ 0.95*		*(5.6)*	35.4	*1.44*	(6.49)	*(13.79)*	*8.76*
% of Revenue												
Total Operating Expenses	19.8	14.6	28.2	33.8	27.4	19.5	95.3	116.7	92	85	86	109
% of Revenue	*14.4%*	*10.5%*	*18.9%*	*22.3%*	*17.2%*	*19.9%*	*13.8%*	*23.4%*	*17%*	*14%*	*15%*	*19%*
Operating Income -	**6.8**	**12.2**	**3.0**	**1.7**	**10.1**	**11.0**	**41.8**	**-17.8**	**28**	**25**	**27**	**26**
Operating Margin	*5.0%*	*8.8%*	*2.0%*	*1.1%*	*6.3%*	*11.2%*	*6%*	*-4%*	*5%*	*4%*	*5%*	*5%*
NON-OPERATING ITEMS												
Non operating Income/Expense	1	0	0	-1	0	0	-1.3	-2.6	0.18	1	0	-1
% of Revenue	*0.44%*	*0.35%*	*-0.14%*	*-0.62%*	*0.19%*	*0.30%*	*-0.19%*	*-0.52%*	*0.03%*	*0.19%*	*0.04%*	*-0.10%*
Tax Provision	1.5	3.9	-0.8	12.1	3.6	3.5	-0.6	13.6	6	5	7	18
Effective Tax Rate												
Net Income -	**5.9**	**8.8**	**3.6**	**-11.3**	**6.8**	**7.8**	**41.0**	**-34.1**	**22.0**	**21.0**	**20.3**	**6.8**
Net Income Margin	*4.3%*	*6.4%*	*2.4%*	*-7.5%*	*4.3%*	*7.9%*	*5.9%*	*-6.8%*	*4.0%*	*3.6%*	*3.5%*	*1.2%*
Adjustments	**0.03**	**-0.08**	**0.04**	**0.54**	**0.04**	**0.01**	**0**	**0**	**0**	**0.07**	**0.03**	**0.63**
EARNINGS PER SHARE												
EPS - Basic	$0.20	$0.18	$0.14	$0.20	$0.24	$0.24	$0.89	-$1.01	$0.67	$0.68	$0.64	$0.83
EPS - Diluted	$0.20	$0.18	$0.14	$0.20	$0.24	$0.24	$0.81	-$1.01	$0.67	$0.68	$0.64	$0.82

Ken Nagy, CFA Zacks Investment Research 10/28/2013

HISTORICAL ZACKS RECOMMENDATIONS



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