

CTS CORP
Form 10-Q
November 03, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended October 1, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Transition Period from _____ to _____

Commission File Number: 1-4639

CTS CORPORATION

(Exact name of registrant as specified in its charter)

Indiana
(State or other jurisdiction
of incorporation or
organization)

35-0225010
(IRS Employer
Identification
Number)

905 West Boulevard North,
Elkhart, IN
(Address of principal executive

46514
(Zip Code)

offices)

Registrant's telephone number, including area code: 574-293-7511

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of October 30, 2006:

35,804,763

CTS CORPORATION AND SUBSIDIARIES

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CTS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS - UNAUDITED
(In thousands of dollars, except per share amounts)

	Three Months Ended		Nine Months Ended	
	October 1, 2006	October 2, 2005	October 1, 2006	October 2, 2005
Net sales	\$ 165,676	\$ 149,210	\$ 482,094	\$ 462,886
Costs and expenses:				
Cost of goods sold	136,830	120,224	387,194	373,393
Selling, general and administrative expenses	17,725	16,159	55,168	51,773
Research and development expenses	3,775	3,976	11,937	13,330
Gain on sales of assets - Note L	(1,332)	(353)	(2,114)	(806)
Restructuring charges - Note C	486	—	3,368	—
Operating earnings	8,192	9,204	26,541	25,196
Other (expense) income:				
Interest expense	(803)	(1,254)	(2,948)	(4,553)
Interest income	199	239	522	1,054
Other	231	33	293	(267)
Total other expense	(373)	(982)	(2,133)	(3,766)
Earnings before income taxes	7,819	8,222	24,408	21,430
Income tax expense	1,907	1,892	5,955	7,771
Net earnings	\$ 5,912	\$ 6,330	\$ 18,453	\$ 13,659
Net earnings per share — Note K				
Basic	\$ 0.16	\$ 0.17	\$ 0.51	\$ 0.37
Diluted	\$ 0.15	\$ 0.16	\$ 0.48	\$ 0.35
Cash dividends declared per share	\$ 0.03	\$ 0.03	\$ 0.09	\$ 0.09
Average common shares outstanding:				
Basic	35,861	36,284	35,841	36,434
Diluted	40,266	41,013	40,215	41,072

See notes to condensed consolidated financial statements.

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CTS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS — UNAUDITED
(dollars in thousands)

	October 1, 2006	December 31, 2005*
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 29,723	\$ 12,029
Accounts receivable, less allowances (2006 - \$1,787; 2005 - \$2,373)	101,747	91,265
Inventories — Note F	67,229	60,564
Other current assets	21,212	16,816
Total current assets	219,911	180,674
Property, plant and equipment, less accumulated depreciation (2006 - \$249,076; 2005 - \$252,545)	96,292	109,676
Other Assets		
Prepaid pension asset — Note H	156,855	152,483
Goodwill	24,657	24,657
Other intangible assets, net	39,950	42,347
Deferred income taxes	22,017	22,011
Other	1,803	2,088
Total other assets	245,282	243,586
Total Assets	\$ 561,485	\$ 533,936
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Notes payable	\$ 9,458	\$ 13,299
Current portion of long-term debt - Note G	176	164
Accounts payable	75,641	67,196
Accrued liabilities	46,319	39,274
Total current liabilities	131,594	119,933
Long-term debt - Note G	60,645	68,293
Other long-term obligations	19,398	16,139
Shareholders' Equity		
Preferred stock - authorized 25,000,000 shares without par value; none issued	—	—
Common stock — authorized 75,000,000 shares without par value; 53,687,419 shares issued at October 1, 2006 and 53,576,243 shares issued at December 31, 2005	276,290	275,211
Additional contributed capital	26,762	24,743
Retained earnings	312,178	296,956
Accumulated other comprehensive earnings (loss)	2,671	(244)
	617,901	596,666
Cost of common stock held in treasury (17,789,331 shares at 2006 and 17,717,657 shares at 2005) - Note M	(268,053)	(267,095)
Total shareholders' equity	349,848	329,571
Total Liabilities and Shareholders' Equity	\$ 561,485	\$ 533,936

**The balance sheet at December 31, 2005, has been derived from the audited financial statements at that date.*

See notes to condensed consolidated financial statements.

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CTS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS - UNAUDITED
(In thousands of dollars)

	Nine Months Ended	
	October 1, 2006	October 2, 2005
Cash flows from operating activities:		
Net earnings	\$ 18,453	\$ 13,659
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	18,978	19,826
Prepaid pension asset	(4,697)	(6,579)
Equity-based compensation	2,960	1,842
Restructuring charges	3,368	—
Gain on sales of assets	(2,114)	(806)
Deferred income taxes	—	3,048
Changes in assets and liabilities, net of effects from purchase of SMTEK		
Accounts receivable	(10,482)	6,348
Inventories	(6,664)	(1,366)
Other current assets	(4,443)	(2,927)
Accounts payable and accrued liabilities	11,725	(4,681)
Other	1,406	1,358
Total adjustments	10,037	16,063
Net cash provided by operating activities	28,490	29,722
Cash flows from investing activities:		
Payment for purchase of SMTEK, net of cash acquired	—	(35,561)
Capital expenditures	(11,108)	(12,549)
Proceeds from sales of assets	14,453	1,636
Net cash provided by (used in) investing activities	3,345	(46,474)
Cash flows from financing activities:		
Repayment of debt assumed in connection with purchase of SMTEK	—	(13,013)
Payments of long-term debt	(81,562)	(135,819)
Proceeds from borrowings of long-term debt	73,850	135,144
Decrease in short-term notes payable	(3,841)	(311)
Dividends paid	(3,227)	(3,259)
Purchase of treasury stock	(946)	(7,525)
Other	(149)	(4)
Net cash used in financing activities	(15,875)	(24,787)
Effect of exchange rate on cash and cash equivalents	1,734	(2,381)
Net increase (decrease) in cash and cash equivalents	17,694	(43,920)
Cash and cash equivalents at beginning of year	12,029	61,005

Cash and cash equivalents at end of period	\$	29,723	\$	17,085
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Supplemental cash flow information

Cash paid during the period for:

Interest	\$	2,249	\$	3,347
Income taxes—net	\$	3,123	\$	4,851

Supplemental schedule of noncash investing and financing activities:

Refer to Note E, “Supplemental Schedule of Noncash Investing and Financing Activities”

See notes to condensed consolidated financial statements.

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CTS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS - UNAUDITED
(In thousands of dollars)

	Three Months Ended		Nine Months Ended	
	October 1, 2006	October 2, 2005	October 1, 2006	October 2, 2005
Net earnings	\$ 5,912	\$ 6,330	\$ 18,453	\$ 13,659
Other comprehensive earnings (loss):				
Cumulative translation adjustment	932	(411)	2,915	(2,370)
Comprehensive earnings	\$ 6,844	\$ 5,919	\$ 21,368	\$ 11,289

See notes to condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS - UNAUDITED
October 1, 2006

NOTE A—Basis of Presentation

The accompanying condensed consolidated interim financial statements have been prepared by CTS Corporation (CTS or the Company), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to such rules and regulations. The unaudited condensed consolidated interim financial statements should be read in conjunction with the financial statements, notes thereto, and other information included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

The accompanying unaudited condensed consolidated interim financial statements reflect, in the opinion of management, all adjustments (consisting of normal recurring items) necessary for a fair statement, in all material respects, of the financial position and results of operations for the periods presented. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ materially from those estimates. The results of operations for the interim periods are not necessarily indicative of the results for the entire year.

Certain reclassifications have been made for the periods presented in the consolidated financial statements to conform to the classifications adopted in 2006.

NOTE B—Share-Based Compensation

Effective January 1, 2006, CTS adopted the provisions of the Financial Accounting Standards Board's (FASB) Financial Accounting Standard (FAS) No. 123(R), "Share-Based Payment." FAS No. 123(R) requires that CTS recognize expense related to the fair value of stock-based compensation awards in the Unaudited Condensed Consolidated Statement of Earnings.

Prior to January 1, 2006, CTS accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and its related Interpretations. Accordingly, stock-based compensation expense was not recognized in the Unaudited Condensed Consolidated Statement of Earnings for stock options granted with an exercise price equal to the market value of the common stock on the grant date. However, prior years' financial statements did include pro forma disclosures for equity-based awards as if the fair-value approach had been followed. The following table presents the pro forma net earnings and net earnings per share for the three and nine-month periods ending October 2, 2005, as if CTS had applied the provisions of FAS No. 123(R) during those periods:

<i>(\$ in thousands, except per share amounts)</i>	Three Months Ended October 2, 2005	Nine Months Ended October 2, 2005
Net earnings, as reported	\$ 6,330	\$ 13,659
Deduct: Stock-based employee compensation cost, net of tax, as if fair value based method were used	(192)	(472)

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Pro forma net earnings	\$	6,138	\$	13,187
Net earnings per share - basic, as reported	\$	0.17	\$	0.37
Pro forma net earnings per share - basic		0.17		0.36
Net earnings per share - diluted, as reported		0.16		0.35
Pro forma net earnings per share - diluted	\$	0.16	\$	0.34

CTS has elected to follow the modified prospective transition method allowed by FAS No. 123(R), and therefore, will apply the provisions of FAS No. 123(R) to awards modified or granted after January 1, 2006. In addition, for awards which were unvested as of January 1, 2006, CTS will recognize compensation expense in the Unaudited Condensed Consolidated Statement of Earnings over the remaining vesting period. The compensation expense for these awards will be based on the grant-date fair value as calculated for the prior years' pro forma disclosures. As allowed under the modified prospective transition method, the financial results for prior periods have not been restated. The cumulative effect of the change in accounting principle from APB No. 25 was not material.

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As a result of adopting FAS No. 123(R), CTS has included additional compensation expense relating to stock option awards to employees in its operating earnings, earnings before income taxes, net income, and earnings per share. The impact of this incremental expense, for the three and nine-month periods ending October 1, 2006 is shown in the following table:

	Three Months Ended October 1, 2006	Nine Months Ended October 1, 2006
<i>(\$ in thousands, except per share amounts)</i>		
Impact of adopting FAS No. 123(R) on:		
Operating earnings	\$ 157	\$ 903
Earnings before income taxes	157	903
Net earnings	94	542
Net earnings per share:		
Basic	\$ —	0.02
Diluted	\$ —	0.01

Prior to the adoption of FAS No. 123(R), CTS presented tax benefits in excess of recognized cumulative compensation costs as operating cash flows in the Unaudited Condensed Consolidated Statement of Cash Flows. FAS No. 123(R) requires these cash flows be classified as financing cash flows. CTS has classified \$157,000 and \$35,000 of these excess tax benefits as financing cash flows for the nine-month periods ending October 1, 2006 and October 2, 2005, respectively.

At October 1, 2006, CTS had five equity-based compensation plans: the 1988 Restricted Stock and Cash Bonus Plan (1988 Plan), the 1996 Stock Option Plan (1996 Plan), the 2001 Stock Option Plan (2001 Plan), the Nonemployee Directors' Stock Retirement Plan (Directors' Plan), and the 2004 Omnibus Long-Term Incentive Plan (2004 Plan). As of December 2004, additional grants can only be made under the 2004 Plan. CTS believes that equity-based awards align the interest of employees with those of its shareholders.

The 2004 Plan, and previously the 1996 Plan and 2001 Plan, provides for grants of incentive stock options or nonqualified stock options to officers, key employees, and nonemployee members of CTS' board of directors. In addition, the 2004 Plan allows for grants of stock appreciation rights, restricted stock, restricted stock units, performance shares, performance units, and other stock awards.

The following table summarizes the compensation expense included in the Unaudited Condensed Consolidated Statement of Earnings for the three and nine-month periods ending October 1, 2006 and October 2, 2005 relating to equity-based compensation plans:

	Three Months Ended		Nine Months Ended	
	October 1, 2006	October 2, 2005	October 1, 2006	October 2, 2005
<i>(\$ in thousands)</i>				
Stock options ⁽¹⁾	\$ 167	\$ 25	\$ 938	\$ 71
Restricted stock units	680	584	1,856	1,546
Restricted stock	48	74	166	225
Total	\$ 895	\$ 683	\$ 2,960	\$ 1,842

⁽¹⁾ Stock option expense includes \$10 and \$25 in the quarters ending October 1, 2006 and October 2, 2005, respectively, and \$35 and \$71 for the nine-month periods ending October 1, 2006 and October 2, 2005,

respectively, related to non-employee director stock options.

The following table summarizes plan status as of October 1, 2006:

	2004 Plan	2001 Plan	1996 Plan
Awards originally available	6,500,000	2,000,000	1,200,000
Stock options outstanding	332,000	916,225	313,550
Restricted stock units outstanding	639,918	—	—
Awards exercisable	85,350	834,675	300,250
Awards available for grant	5,390,101	—	—

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Stock options are exercisable in cumulative annual installments over a maximum 10-year period, commencing at least one year from the date of grant. Stock options are generally granted with an exercise price equal to the market price of the Company's stock on the date of grant. The stock options generally vest over four years and have a 10-year contractual life. The awards generally contain provisions to either accelerate vesting or allow vesting to continue on schedule upon retirement if certain service and age requirements are met. The awards also provide for accelerated vesting if there is a change in control event.

The Company estimates the fair value of the stock option on the grant date using the Black-Scholes option-pricing model and assumptions for expected price volatility, option term, risk-free interest rate, and dividend yield. Expected price volatilities are based on historical volatilities of the Company's stock. The expected option term is derived from historical data on exercise behavior. The range of option terms shown below results from certain groups of employees exhibiting different behavior. The dividend yield is based on historical dividend payments. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

	Nine Months Ended	
	October 1, 2006	October 2, 2005
Expected volatility	53.3% - 58.2%	52.4%
Weighted-average expected volatility	54.1%	52.4%
Expected dividends	0.9%	1.1%
Expected term	4.0 -10.0 years	10.0 years
Weighted-average risk-free rate	5.1%	4.1%

A summary of the status of stock options as of October 1, 2006 and October 2, 2005, and changes during the nine-month periods then ended, is presented below:

	October 1, 2006		October 2, 2005	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding at beginning of year	1,567,499	\$ 15.93	1,636,900	\$ 16.80
Granted	93,000	13.68	136,600	11.11
Exercised	(37,624)	8.53	(24,950)	8.60
Expired	(52,150)	23.07	(118,750)	24.86
Forfeited	(8,950)	9.43	(36,800)	9.14
Outstanding at end of period	1,561,775	\$ 15.76	1,593,000	\$ 15.98
Exercisable at end of period	1,220,275	\$ 16.94	996,007	\$ 19.07

The total intrinsic value of stock options exercised during the nine-month periods ended October 1, 2006 and October 2, 2005 was \$183,000 and \$86,000 respectively. The exercise price of options granted during the nine-month periods ending October 1, 2006 and October 2, 2005 equaled the trading price of the company's stock on the grant date.

A summary of the weighted-average remaining contractual term and aggregate intrinsic value of options outstanding and exercisable at October 1, 2006 is presented below:

	Weighted-average Remaining Contractual Life	Aggregate Intrinsic Value
Options outstanding	6.1 years	—
Options exercisable	5.5 years	—

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A summary of the nonvested stock options as of October 1, 2006 and October 2, 2005, and changes during the nine-month periods then ended, is presented below:

	October 1, 2006		October 2, 2005	
	Options	Weighted-average Grant-Date Fair Value	Options	Weighted-average Grant-Date Fair Value
Nonvested at beginning of year	488,943	\$ 5.35	813,400	\$ 5.87
Granted	93,000	6.53	136,600	6.51
Vested	(231,493)	4.74	(316,207)	7.24
Forfeited	(8,950)	4.52	(36,800)	4.53
Nonvested at end of period	341,500 ⁽¹⁾	\$ 6.11	596,993	\$ 5.24

⁽¹⁾ Based on historical experience, CTS currently expects approximately 292,408 of these options to vest.

The total fair value of shares vested during the nine-months ended October 1, 2006 and October 2, 2005 was approximately \$1,097,277 and \$2,289,000 respectively. As of October 1, 2006, there was \$811,000 of unrecognized compensation cost related to nonvested stock options. That cost is expected to be recognized over a weighted-average period of 1.4 years. CTS recognizes expense on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in substance, multiple awards.

The following table summarizes information about stock options outstanding at October 1, 2006:

Range of Exercise Prices	Options Outstanding		Options Exercisable		
	Number Outstanding at 10/1/06	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number Exercisable at 10/1/06	Weighted-Average Exercise Price
\$ 7.70 - 11.11	897,175	6.83	\$ 9.36	660,675	\$ 8.94
13.68 - 16.24	237,800	7.10	14.10	132,800	14.34
23.00 - 33.63	321,800	4.28	24.56	321,800	24.56
35.97 - 50.00	103,500	3.95	47.02	103,500	47.02
56.94 - 79.25	1,500	3.03	64.38	1,500	64.38

Restricted Stock Units

Stock settled restricted stock units (RSUs) entitle the holder to receive one share of common stock for each unit when the unit vests. RSUs are issued to officers and key employees as compensation. Generally, the RSUs vest over a five-year period. A summary of the status of RSUs as of October 1, 2006 and October 2, 2005, and changes during the nine-month periods then ended is presented below:

	October 1, 2006		October 2, 2005	
	RSUs	Weighted-average Grant-Date Fair Value	RSUs	Weighted-average Grant-Date Fair Value
Outstanding at beginning of year	525,898	\$ 11.49	252,000	\$ 11.07

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Granted	236,700	13.67	340,438	11.75
Settled	(100,110)	11.23	(52,410)	