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CTS Corp. (CTS)

Q4 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Bailey, and I will be your operator. At this time, I would like to welcome everybody to the CTS Corporation Fourth Quarter and Full Year 2021 Conference Call. All lines have been placed on mute to prevent background noise. A supplemental slide presentation to accompany the prepared remarks can be found on the company's website. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

At this time, I would like to turn the conference call over to Mr. Kieran O'Sullivan, CEO of CTS Corporation. Mr. O'Sullivan, you may begin your conference.

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.

Thanks, Bailey. Good morning and welcome everyone to our fourth quarter and full year 2021 earnings call. We delivered strong financial results and achieved record breaking new business awards despite pandemic-related and supply challenges. For the fourth quarter 2021, sales increased 7.7% to $133 million. Gross margin was 36.7% in the fourth quarter, up 200 basis points. Adjusted EBITDA margin was 20.9%, largely flat versus the fourth quarter of 2020. Fourth quarter adjusted diluted earnings per share increased 14% to $0.49. Fourth quarter operating cash flow was $26 million, and we achieved strong new business awards of $185 million, up from $104 million in the fourth quarter of 2020.

Turning to the full year 2021 results, sales rose 21% to $513 million. Gross margin was 36% for the full year, up 320 basis points. Adjusted EBITDA margin increased 270 basis points to 21%. Adjusted diluted earnings per share increased 72% to $1.93. Full year operating cash flow was $86 million and we saw new business awards of $694 million, up 57% from 2020, a record for CTS.

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Ashish will take us through the Safe Harbor statement. Ashish?

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

I would like to remind our listeners that this conference call contains forward-looking statements. These statements are subject to a number of risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements. Additional information regarding these risks and uncertainties is contained in the press release issued today, and more information can be found in the company's SEC filings. To the extent that today's discussion refers to any non-GAAP measures under Regulation G, the required explanations and reconciliations are available in the Investors section of the CTS website.

I'll now turn the discussion back over to our CEO, Kieran O'Sullivan.

Kieran M. O'Sullivan

President, Chief Executive Officer & Chairman, CTS Corp.

Thank you, Ashish. Turning to slide 3, we finished the year strong, delivering sales growth of nearly 8% in the fourth quarter and 21% for the full year. Excluding sales from the acquisition of Sensor Scientific, sales were up 6% organically in the fourth quarter and 19% for the full year. We continue to advance our diversification strategy throughout the year, with non-transportation revenues increasing by 25% for the full year. Customer demand remains strong, and while we saw some supply chain stabilization in the fourth quarter, ongoing supply shortages, a tight labor market, and inflationary pressures continue to remain a concern, I am proud of the team's execution in this challenging macroeconomic environment, remaining nimble to ensure we are delivering innovative products to our customers.

Further, we continue to benefit from our diverse and high quality customer base, in particular in the transportation end market where positive momentum continues to build. Some of our key customers were more successful in navigating the supply challenges. As a result, we outperformed the overall market in transportation supported by our team's strong execution in global sourcing, including the qualification of alternative sources of supply.

Gross margin in the fourth quarter increased 200 basis points to 36.7% and full year gross margin rose 320 basis points to 36% versus the prior year, as we continue to gain momentum from our diversification strategy despite margin pressures from supply side and freight cost pressures. While we expect cost pressures to persist throughout 2022, we remain confident we can continue to partner with our customers to share cost increases and execute successfully in the year ahead. Fourth quarter adjusted diluted earnings per share of $0.49 were up 14% from $0.43 in the same period last year. Full year adjusted diluted earnings per share of $1.93 increased 72% from 2020. Later, Ashish will add further color on our financial performance.

In the fourth quarter, we had strong new business wins of $185 million, up from $104 million in the same period last year. We added nine new customers in the quarter, including two Asian electric vehicle customers for chassis ride height and brake sensing applications. In industrial, we added a new customer for position sensing for a logistics electric vehicle, application, and new customer for an EMI filtering application of power management, and a temperature application in refrigeration. In medical, we added new customers for temperature sensing and intravascular ultrasound. And in communications, we added a new customer for a frequency application. New business awards for the full year totaled $700 million.

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Turning to slide 4. As I mentioned, we remain focused on continuing to advance our long-term strategy, which centers on diversifying our end market profile by expanding a range of technologies, products, customers, and geographic reach. We believe this enhances the value creation opportunity for our stakeholders as well as the quality of our earnings. We've made good progress on our diversification efforts, increasing non-transportation sales to 45% of total 2021 sales, compared to 35% of total sales in 2017. Full year 2021 non-transportation-related revenue increased 25% compared to 2020, while transportation-related revenue increased 18%. Looking ahead, we continue to focus on further diversification by growing non-transportation revenues faster while continuing to strategically grow our transportation business. As such, we are targeting an overall revenue growth rate of 10% with a goal of greater than 50% of total revenue from non-transportation end markets.

With our broad exposure across the industrial markets, CTS is well-positioned for growth, driven by the demand for increased automation, connectivity, and energy efficiency. We are making progress on transducer applications and flow measurement, an area with tremendous development potential. We are seeing a strong demand in inkjet printing for packaging and ceramic tile printing. In addition, we have advanced to the next step of qualification with an existing customer for a high temperature flow application and shipped samples to another European customer. Guitars continue to be popular leisure products and we continue to increase revenue with these customers. We also started shipments of a position sensor for an electric forklift application.

At the same time, we continue to broaden our offering in medical for traditional ultrasound technologies are driving substantial mid-to long-term growth. Additionally, expanding our temperature sensing offering in medical is a focus area for us, and we recently attained ISO 13485 certification, enabling us to supply products across multiple medical applications. Our sensors for sleep apnea equipment are in high demand, and we also recently advanced to second stage qualification for an assisted scalpel application.

In aerospace and defense, we are expanding our presence in undersea sonar applications and are developing samples with new European clients for whom we are now quoting next-generation technologies and have begun low-volume shipments with one customer. We are developing new material formulations based on textured piezo and single crystal technologies, which we anticipate will provide solid tailwinds for next-generation solutions and new applications with larger sonar rings and unmanned autonomous applications.

In transportation, the move towards electric and hybrid electric vehicles, as well as increased sensor content with passive safety and future e-brake applications present tremendous opportunities for us. Importantly, except for the smart actuator, the rest of our portfolio is agnostic to the propulsion system, which allows us to be flexible to meet the needs of our customers. In 2021, the global share of electric vehicles grew closer to 6% and we expect this to accelerate to 15% by 2025 and above 30% by the end of this decade with the Chinese market delivering the largest share gains. Demand for two-wheeler applications such as throttle sensing modules and throttle position sensors remains solid in the Asian markets.

Overall, across all end markets, demand remains robust, in particular in transportation, which we expect to continue given the low days on hand of vehicle inventories. As a result, we saw a 19% sequential improvement in transportation sales in the fourth quarter versus the third quarter. Although some of our automotive customers have confirmed demand through 2022, we continue to be concerned by supply challenges primarily in semiconductor and resin, along with labor challenges and further COVID interruptions, all of which continue to plague the market. The expectation is for increased volume in 2022 and a larger increase in 2023 as the supply recovers and new emission standards for 2024 are adopted. While we anticipate demand for automotive products this year to remain robust, growth could range from the low-single digits to mid-single digits and higher, depending on the impact of additional COVID interruptions and potential supply improvements. There is also a limited inventory of completed automobiles awaiting parts.

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In the accelerator module product line, we had a large win with a North American OEM. We also had wins with a Japanese OEM, and we're sourced by a North American OEM for a European application. For passive safety sensors, we had a large win with a North American OEM for a safety application and for a chassis ride height sensor. On the Mechatronics front, we were awarded extensions for existing products in production and for products in development. Progress in securing electric vehicle wins continued as we added two new customers in Asia for chassis and brake-sensing applications. In total, for the full year, we were awarded 21 platforms of various sizes for electric vehicle applications.

Our non-transportation end markets performed strongly in the fourth quarter, and on a year-over-year basis, sales increased 25% in total and 21% organically. Sales in industrial end markets remain robust, driven by demand in areas such as industrial printing and temperature products in pool and spas. We received multiple awards for HVAC applications. Our focus on extending into hot side temperature sensing applications such as water heating and industrial cooking appliances is gaining momentum and we delivered shipments to two new customers. We had wins for EMI filtering products, measurement transducers, and a virtual reality application. We also secured an RF reference design win for a new cellular band and extended a contract for a hard disk drive application.

While distribution sales are a smaller portion of our total revenues, demand remains robust as we continue to track inventory levels. Momentum in our medical end market continues as we extended contracts with three medical ultrasound customers. We also secured a contract for a cataract surgery application and added low-volume shipment to two intravascular customers. We continue to secure temperature sensing awards with existing customers, ranging from patient monitoring to critical freezer and disposable applications.

In defense, we continue to strengthen our portfolio of products as we work with research partners and received a sample order for an unmanned underwater autonomous vehicle application. We had several undersea solar wins and added a temperature sensor win for a low orbit satellite application. Overall, although we anticipate robust demand from non-transportation products in the first half of the year, we remain cautious about demand environment in the second half.

Turning to slide 5. Our strong balance sheet, which is bolstered by strong cash flow generation, continues to provide us with a solid foundation as we advance our diversification strategy. Our capital deployment strategy is focused on supporting organic growth investments, leveraging our financial strength to advance on M&A in alignment with our strategic priorities, and returning cash to shareholders. We remain committed to more effective capital management while maintaining our disciplined approach. The investments we've made in the front end process, including commercial resources and IT capabilities, along with implementing SAP across the organization, have strengthened our foundation and positioned us to execute on our strategy. We continue to build a solid M&A pipeline and are committed to leveraging value creating acquisitions to accelerate our growth and diversification efforts.

We will remain disciplined in our approach, focusing on complementary acquisitions that meet our criteria, including enhancing our technology portfolio, strengthening customer relationships, and expanding products, applications, and markets and geography. The sweet spot continues to be acquisition targets in the range of up to $50 million a year in sales. However, we remain open to larger opportunities that will advance our long-term strategy. As part of our capital allocation strategy, we continue to return cash to shareholders. This past quarter, we repurchased approximately $4 million of stock as part of the previously announced stock buyback program.

Moving to slide 6. At CTS, our purpose is to enable an intelligent and seamless world. Through deeper customer relationships, we play an instrumental role in helping our customers shape the future by designing components

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and solutions with effective and efficient technologies that make their products smarter. I've already highlighted our strides in supporting sustainable products like electric vehicles and how we play a pivotal role in promoting health and safety by supplying components used in non-invasive surgical devices such as medical ultrasound. We also understand that we have a responsibility to shape not only a smarter future, but one that will be sustainable for future generations. This begins with making sustainable business choices across our organization that create long-term value for our company, our stakeholders, and the communities in which we do business.

We have taken a number of actions on our sustainability journey. We have expanded our nominating and governance committee to include oversight of our sustainability initiatives. We believe strongly in the benefits of diversity. Our board is comprised of directors who reflect a diverse set of skills, backgrounds, perspectives, and experiences. And we are proud that more than 40% of our board is comprised of female and minority directors. On a regular basis, we reinforce our commitment to ethical business practices by conducting ethics and compliance training for all employees. We established a cross-functional ESG Steering Committee responsible for spearheading the company's sustainability initiatives.

We continue to support the ongoing development of our employees by rolling out several new training programs, including our Advanced Leadership Program, and we are continuing our legacy of community outreach and support through the launch of CTS CARES, our global program designed to support our charitable giving and community involvement initiatives. The CTS CARES platform advanced this past quarter as our employees across the globe participated in several community activities and contributed more than 600 hours to community projects.

Turning to slide 7. Summarizing our outlook for the year ahead, increased safety, automation, and efficiency needs will continue to drive demand for CTS solutions. Our non-transportation end markets are growing and we continue to use our core technology and domain expertise to expand our presence across end markets, while also finding deeper penetration with current end market applications. The pace of recovery in our transportation end market continues to be pressured by ongoing supply challenges and inflation, which are expected to persist in 2022.

Looking at the US light vehicle transportation market, the SAR dropped closer to $13 million for 2021, and we expect a $14 million to $15 million unit range for 2022. On hand days of supply are still at low levels. We expect to see an improving trend throughout 2022. European production is forecasted in the 17 million to 18 million unit range. China volumes are expected in the 24 million unit range, marginally up compared to 2021. The commercial vehicle market remains solid and is likely to remain robust throughout 2022. The biggest challenge to the outlook continues to be the supply of semiconductors.

From non-transportation markets, we continue to expand the customer base and range of applications in industrial, medical, and defense, in some cases inventory levels are returning to more normal quantities. As a result, although we anticipate robust order levels in the first half of the year, we remain cautious about the demand environment in the second half. We will also continue to track the impact of the supply challenges on our transportation end market.

In terms of guidance for full year 2022, we are forecasting sales in the range of $525 million to $550 million and adjusted diluted earnings per share in the range of $2 to $2.25.

Now, I'll turn it over to Ashish, who will walk us through the financial results in more detail. Ashish?

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Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

Thank you, Kieran. Moving to slide 9, fourth quarter sales were $132.5 million, up 8% compared to the fourth quarter of 2020 and up 8% sequentially from the third quarter. Sales to transportation customers declined 3% compared to the fourth quarter of 2020 as supply chain challenges continue impacting us and our customers. Sales to other end markets increased 25% year-over-year as the industrial, medical, aerospace, and defense end markets exhibited double-digit growth. Sales to the transportation end market increased 19% sequentially, driven by improvement in orders from our customers as the industry works through the supply chain challenges. Changes in foreign exchange rates impacted our revenue favorably by approximately $0.5 million. Our gross margin was 36.7% in the fourth quarter, up 200 basis points compared to the fourth quarter of 2020 and down 60 basis points compared to the third quarter of 2021.

Our global teams strong operational execution helped mitigate some of the impact of margin pressures driven by supply chain shortages and other inflationary factors. In the fourth quarter, SG&A and R&D expenses were $29 million or 22% of net sales versus $25 million or 20% of sales in the fourth quarter of 2020. The higher expenses in the quarter were primarily the result of higher incentive compensation expenses and a one-time charge related to the resolution of a legacy environmental matter. For the fourth quarter 2021, we reported earnings of $0.28 per diluted share. Adjusted earnings for the fourth quarter were $0.49 per diluted share compared to $0.43 per diluted share for the same period last year and $0.46 last quarter.

Turning to slide 10. Full year results for 2021 were $513 million, up 21% compared to 2020. Sales to transportation customers increased 18% year-over-year, driven by the recovery in the automotive industry. Sales to other end markets increased 25% year-over-year, as the industrial, medical, aerospace, and defense end markets all exhibited year-over-year strong double-digit growth. Our SSI acquisition added $7 million in sales in 2021, performing ahead of our expectations. Changes in foreign exchange rates impacted our revenue favorably by approximately $6.9 million.

We continue to focus on diversifying the business and non-transportation sales were up to 45% of our total sales in 2021. Our gross margin was 36% in 2021, up 320 basis points compared to 2020. Our global teams executed efficiently in the face of significant supply challenges to offset the impact of cost increases and deliver solid profitability improvement. Supply challenges and inflation are expected to continue impacting us in 2022. However, we continue to work closely with customers to share the cost increases, and we are confident in our ability to execute successfully.

For the restructuring program announced in 2020, we have achieved $0.18 of EPS in savings so far. Due to the robust demand environment and COVID limitations, some projects have been delayed. We are on track to achieve the lower end of our targeted annualized EPS savings of $0.22 to $0.26 by the end of 2022 with additional savings expected in 2023.

SG&A and R&D expenses were $106 million or 21% of sales in 2021 versus $92 million or 22% of sales in 2020. The higher expenses in 2021 were primarily the result of full restoration of cost reduction initiatives implemented in 2020 and higher incentive compensation expenses. For full year 2021, we reported a loss of $1.30 per share, driven largely by the non-cash pension settlement charge recorded during the year. Adjusted earnings for the full year 2021 were $1.93 per diluted share, compared to $1.12 per diluted share for 2020. We continue to focus on working capital efficiency and ended the year with 14.4% in controllable working capital.

We remain on track to complete the implementation of our SAP ERP system in early 2022. A majority of our sites have been running on SAP and we continue to optimize our learnings and capabilities. As part of our Focus 2025

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initiative, we are working on a CTS operating system focused on enhancing our continuous process improvement capabilities, and we expect the data available from the new ERP system to be a key enabler.

Moving to slide 11. We generated $86 million in operating cash flow for the full year 2021, up 12% compared to 2020. Our cash position remains strong with a cash balance of $141 million as of December 31, 2021, up from $92 million on December 31, 2020. Our long-term debt balance was $50 million, a slight decrease from $55 million on December 31, 2020. Our debt to capitalization ratio was at 9.7% at the end of the fourth quarter, compared to 11.4% at the end of 2020. In the fourth quarter, we updated our bank credit agreement. As part of this process, we addressed the changes related to LIBOR transition, increased the available credit to $400 million, and extended the maturity date to December 2026. Our available credit and strong cash flow generation provides us with a solid foundation to pursue M&A opportunities that will advance our diversification strategy.

This concludes our prepared comments. We would like to open the line for questions at this time.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from Karl Ackerman from Cowen. Karl, please go ahead.

Karl Ackerman
Analyst, Cowen and Company, LLC

Q

Yes. Good morning, Ashish and Kieran. I hope you're doing well.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.

A

Hi, Karl.

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.

A

Good morning, Karl.

Karl Ackerman
Analyst, Cowen and Company, LLC

Q

I have two questions for you.

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.

A

All right. Go ahead, Karl.

Karl Ackerman
Analyst, Cowen and Company, LLC

Q

Yeah. You indicated that your visibility for non-transportation markets remains healthy in the first half of 2022. Is your conservatism driven by a normalization of channel inventory or order backlog? Maybe if you could just speak to your conservatism for the back half of 2022 for non-transportation markets, that would be very helpful.

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Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.

A

Yeah. Karl, the primary part of that is coming from if we – distribution is a smaller portion of our business, probably closer to 10%, but we're starting to see inventory levels there return to normal, and we think that will also have a potential impact on the other end markets that we serve like industrial, medical, and defense. We've seen a strong rebound. We still have good demand at the moment – robust demand at the moment, but it's been strong for quite some time and we just don't have that same level of visibility into the second half of the year. So, that's why we remain a little bit cautious there.

Karl Ackerman
Analyst, Cowen and Company, LLC

Q

Understood. I appreciate that. I guess then moving to automotive, some of your peers quantified that a benefit from automotive restocking in calendar 2021 and suggested the inventory restocking may not carry over into 2022. Nevertheless, I think at least half of your automotive business is on consignment that should better align your supply with end market demand. But is your outlook for low-to mid-single-digit growth in automotive driven by automotive customers indicating your products are now balanced at a high level or are there other factors that may actually drive that growth rate higher, like the adoption of electric vehicles, like the adoption of incremental content growth that we may not be appreciating? Thank you.

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.

A

So, Karl, maybe a few comments on that. First of all, if you look at the industry reports out there, I'll just reference IHS. They're probably predicting global growth rate in the 7% to 9% range, that would – the 7% or so would be top end of our guidance kind of as we would look at it. On the other hand, the on hand days of supply is pretty low still. So, if you look at the North American market, it's still closer to the 30 days versus 50 plus days of supply of inventory. So, we should have some strength there, same for Europe. I think China performed strongly this past year, and we think that would be more flat this year. So, that's our view on the transportation market.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.

A

Karl, the expectation that we are providing for 2022, we are also building in potential upside as the supply chain recovers on the higher end of our estimate. But we are also watching carefully any COVID-related disruptions and that could push us to the lower end of our range. So, that's kind of how we are looking at the range of sales.

Karl Ackerman
Analyst, Cowen and Company, LLC

Q

Understood. Very appreciative. Thank you.

Operator: Thank you, Karl. The next question comes from Justin Long of Stephens. Justin, please go ahead.

Justin Long
Analyst, Stephens, Inc.

Thanks and good morning.

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Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.
A

Hi, Justin.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

Hi, Justin.

Justin Long
Analyst, Stephens, Inc.
Q

Hi. Given the first half versus second half commentary, Ashish, is there any way you could give us a little bit more color on what your guidance is baking in for revenue and earnings in the first half versus the second half as we just think about the cadence?

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

Justin, the first half on a year-over-year basis should look okay in terms of growth rates. And in the second half, I would expect us to be more flattish compared to 2021 and that's kind of what we are expecting on the distribution side on the non-transportation side is where we see the more challenging situation or lack of visibility. And as Kieran mentioned, transportation could be gradually improving during the year as hopefully the supply chain situation continues to improve. So, the transportation, we would expect to see gradual improvement through the year. And on the non-transportation side, we would see a stronger first half and then maybe more constrained second half, primarily due to demand.

Kieran?

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.
A

Justin, just one other thing to add what Ashish commented on. If you look at the electronics components side of things and you look at other companies as well, the book-to-bill rates have been really high in the last six months to 12 months and it's going to be challenging for that to continue at those kind of levels.

Justin Long
Analyst, Stephens, Inc.
Q

Understood. And Ashish, just to clarify one comment you made about the second half. When you talked about the year-over-year trend being kind of flattish, is that a comment about revenue, EPS or both?

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

I was focusing on revenue primarily, Justin, and the EPS will obviously get impacted to some extent from the revenue. And obviously, we are continuing to work on various improvements in our cost structure.

Justin Long
Analyst, Stephens, Inc.
Q

Okay, great. That's helpful. And going back to the supply chain, you mentioned in the earlier question that the guidance on the high end assumes the supply chain recovers. I was wondering if there was a way to kind of break

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out for us, how much of a headwind the supply chain was in 2021 when you look at the full year and what you're expecting that number to look like in 2022?

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.
A

Without going into the exact numbers, Ashish, I'll let you talk about that in a second. But, Justin, if you look at 2021, I think production bills were impacted by about $10 million because of the semiconductor shortages. If you look at this year, so far, we see at least $1 million out there in the different reports that you'll see out there with some indication saying that $1 million could be as high as $4 million. So, it's a bit of a dynamic environment at the moment.

Ashish?

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

And the other side of the supply challenges is obviously the cost side of it. If you recall in one of our calls last year, we talked about in the range of roughly $2 million a quarter of cost pressure. We are not expecting the same level, but we are expecting similar levels of cost pressure and slightly better, but still similar levels of cost pressure in 2022. So, that's the other side that we're watching very carefully, Justin. And our goal is to share that cost burden with our customer base and that's built into our EPS ranges as well depending on how much of that, as you know, it's much harder to get price increases on the transportation side.

Justin Long
Analyst, Stephens, Inc.
Q

Understood. And lastly, on the buyback, is that something that's getting factored into that 2022 guidance?

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

The 2022 guidance – our buyback is not a very big amount of buyback in any given year. So, we are assuming a modest impact, but nothing significant, Justin.

Justin Long
Analyst, Stephens, Inc.
Q

Okay. And I'm assuming nothing from M&A is factored into the guidance as well?

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

That is correct.

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.
A

Correct.

Justin Long
Analyst, Stephens, Inc.
Q

Okay, perfect. That's all I had. I appreciate the time.

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Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.

A

Thank you.

Operator: Thank you, Justin. The next question comes from John Franzreb from Sidoti. John, please go ahead.

John E. Franzreb
Analyst, Sidoti & Co. LLC

Q

Yeah. It seems we're trying to get our heads around the second half commentary. It sounds to me that you're using your distribution business as a leading indicator or is it a case where you actually see diminishing orders in a particular head market that give you real concern?

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.

A

So, John, as we said on transportation, the demand is there, it's all about supply chain. On the non-transportation outside of distribution, the order level is good, it's strong, it's robust. We have good visibility through the first two quarters, harder to have visibility beyond that. So that's where our concern comes in. And as I mentioned earlier, the book-to-bill rates out there for a lot of businesses have been very high and that's got to normalize a little bit. At the same time, I will tell you, we're making determined efforts to add new customers, new applications, so we are driving our business going forward. We're now looking to – it's not our goal to be to be flat. We want to do better, but it's a step by step in progress.

John E. Franzreb
Analyst, Sidoti & Co. LLC

Q

Kieran, would you typically have visibility into the second half with your non-transportation business at this point of the year?

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.

A

Not full visibility, John, for sure. I think our caution is on the high level of bookings we've seen over the last several quarters, that's really why we're being a little bit more cautious here. And again, on the other point that you asked about was distribution and we see some levels returning to normal and we've seen maybe one or two cases of situations out there where we think there could be a little bit of a buildup of inventory, but that's something we're still trying to clarify.

John E. Franzreb
Analyst, Sidoti & Co. LLC

Q

Okay. And you mentioned new customers and that's actually another in my questions. When you think about the new orders and the new wins that you're getting, are you seeing a particular customer in particular actually gravitating to your products more so than another or maybe a specific market lead having a better success and hit rate than others?

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.

A

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Yeah. I would say, John, that our ceramic product line has been strong and gaining new customers and new applications. We talked about in our prepared remarks about investments in the frontend. We've done a lot of investment there. We have some more to do across the rest of the business. But that product line in particular is – we've got three different technologies, one of the few companies in the world that have that. We go across multiple end markets. So, our R&D capability is leveraged across industrial, medical, and defense, so that's something that really helps us in that area as well.

John E. Franzreb
Analyst, Sidoti & Co. LLC

Q

Okay. And Ashish, you mentioned the potential of something in the neighborhood of $2 million per quarter of incremental gross margin pressure expectations this year. Is that before pricing initiatives or is that a net number kind of expectation this year?

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.

A

So, John, the $2 million per quarter was roughly what we experienced last year.

John E. Franzreb
Analyst, Sidoti & Co. LLC

Q

Right.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.

A

This year we're expecting incremental not quite $2 million, slightly better, but still in the range of $1.5 million to $2 million of incremental cost pressure that is before the price increases.

John E. Franzreb
Analyst, Sidoti & Co. LLC

Q

And as to – what's the lag to price increases and realization of those benefits?

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.

A

Our teams are already working on it, John. It takes a little bit of time to work through those discussions. And obviously, those are extremely tough discussions, even more so on the transportation side with every single customer. Wherever you have to have those discussions, it just takes a tremendous amount of effort to get through those discussions and continue to maintain or hopefully even build on those relationships that are so important to us.

John E. Franzreb
Analyst, Sidoti & Co. LLC

Q

Okay. And as far as the restructuring savings, you pushed some of it out into 2023. Is that going to be realized in the first half of 2023? Is it going to take the full year to get there?

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.

A

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We are thinking we should be able to achieve them probably closer to the third quarter, John. But, again, the situation is a little bit fluid given – it's primarily on the ceramic side that we've had some delays. And the demand is pretty strong, which is the primary reason we have slowed down the transition. So, sometime in the second half of 2023, we should be able to achieve and we are looking for another $0.02 to $0.03 in 2023.

John E. Franzreb
Analyst, Sidoti & Co. LLC

Q

Got it. Thanks for taking my question, guys. Good quarter.

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.

A

Thanks, John.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.

A

Thank you.

Operator: Thank you, John. The next question comes from Hendi Susanto from Gabelli Funds. Hendi, please go ahead.

Hendi Susanto
Analyst, Gabelli Funds LLC

Q

[Technical Difficulty] (00:42:00-00:42:05).

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.

A

Hendi, are you there?

Operator: Hendi, we're going to need you to come closer to the microphone if you would like to ask a question. We're unable to hear you.

[indiscernible] (00:42:22)

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.

A

Hendi, you're coming through now, but the line is still pretty faint.

Hendi Susanto
Analyst, Gabelli Funds LLC

Q

Oh, okay. I will call back, yeah.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.

A

No, no. It's fine now.

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Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.
A

It's very good, now.

Hendi Susanto
Analyst, Gabelli Funds LLC
Q

It's fine, now. Sorry, okay. So, Ashish and Kieran, so CTS delivered positive improvement in gross margin and operating margin in 2021. The gross margin of 36% in 2021 is commendable. How should we be thinking about gross margin and operating margin in 2022? There are margin pressure, price increases, COVID, and benefits of restructuring. I'm wondering whether that 36% gross margin is sustainable.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

So, Hendi, the expectation on gross margin, like we talked about, will have an impact of the inflation, a little bit of mix, price increases that we are working on. Our goal is to continue building on our gross margin levels. But we typically talk about a range of gross margin and we look at the expected range of gross margin to be between 34% and 38%. We used to say 34% to 37%, we are expanding that to 38%. As we continue working through the year, we want to clarify that more. Again, if we are able to get better price increases, I would expect us to continue building on that gross margin. Otherwise, we might see slight pressures. And that's the range of EPS that we have built in in our guidance at this time.

Kieran, do you want to add something?

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.
A

Yeah, just to add, Ashish. Hendi, this year and just like the past year, it's very dynamic, it's very challenging. The headwinds are coming in every direction and our teams have done outstanding work just in terms of sourcing and getting new supplies. But what I do want to emphasize, not just for this year, but for the longer term, we've said we want to get our margins closer to 37% and 38% and that's our goal. It's going to be a tough year, this year, just like last year.

Hendi Susanto
Analyst, Gabelli Funds LLC
Q

I see. And Ashish, any insight why the tax rate will be lower in 2022? Like we know that you have been working on, like several projects that may benefit the tax structure.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

Yeah. So, we had some unusual items in the fourth quarter, which took our tax rate higher. And earlier in the year, the higher tax rate was driven by the impact of the loss that we recorded on the pension plan. And again, that was a non-cash charge. So, once we removed those, we are actually expecting a slight increase in the 2022 tax rate as the mix of our income changes, depending on which country the income is coming from, so that has a slight impact on our tax rate.

Hendi Susanto
Analyst, Gabelli Funds LLC
Q

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And then, Kieran, my last questions, so how should we view the opportunity in EV, like do you have like updates for 2022?

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.
A

Hendi, as we said in our prepared remarks for 2021, we secured 2021 platforms of various sizes, a large portion of our product portfolio there is a propulsion agnostic. And at the same time, we're working on new products like current sensing, which one of those products would be going into production here in the next 12 months, which is very important for EVs. And we're in the pre-development stage on e-brake applications as we go more towards the link to ADAS on that side of it with the brake and the brake going by wire. So, they're just one or two examples in transportation, and we have some others on passive safety sensing as well. So, we feel good about it and we'd like to keep improving the content that we have there.

Hendi Susanto
Analyst, Gabelli Funds LLC
Q

Thank you, Ashish. Thank you, Kieran.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

Thanks, Hendi.

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.
A

Thanks, Hendi.

Operator: Thank you for that question. Next question comes from Richard Glass from Glass Capital Management. Richard, please go ahead.

Richard Fred Glass
Analyst, Glass Capital Management LLC
Q

Hey, guys. Nice quarter here. Nice year overall.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

Thank you, Richard.

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.
A

Thanks, Richard.

Richard Fred Glass
Analyst, Glass Capital Management LLC
Q

So, one thing I want to clarify related to that last question on gross margins. You had said 34% to 37% historically or feels like forever and now you're talking about 38%, should we move up the lower end of that? Should it be 35% to 38%? Is that a reasonable thing to think about going forward?

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Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

We have evaluated that, Richard. We just want to build a little bit more confidence, things that continue to impact us on a regular basis. We have talked about the inflationary pressures we are experiencing. Currency movements can also have a sizable impact on our gross margin. So, we're just being a little cautious...

Richard Fred Glass
Analyst, Glass Capital Management LLC
Q

Got it.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

...there, but our goal is to be on the higher end of that range.

Richard Fred Glass
Analyst, Glass Capital Management LLC
Q

I got it. So, it sounds like you guys are being conservative overall, which is maybe very conservative and that's fine. Do you guys have any large programs, which roll off in the next couple of years? Is there anything that's particularly meaningful in your book of business that is a sort of pig in the python, maybe that we should think about?

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.
A

No, I don't think so, Richard. I mean, we spoke a few years ago about hard disk drive winding down and it's a very small portion of our business today. We have some larger platforms where we've secured next-generation award, so there's good continuity there. There's always a risk of competition in second sourcing, but we feel like we're securing the right levels.

Richard Fred Glass
Analyst, Glass Capital Management LLC
Q

Okay. Sounds good.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

And Richard – go ahead, please, go ahead.

Richard Fred Glass
Analyst, Glass Capital Management LLC
Q

No, go ahead. I was going to ask a different question, so if you want to – if you want to flush that out.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.
A

Yeah. We have a normal churn. We have different platforms going off and new ones coming on every year. So, we're not expecting any unusual level of downward activity.

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Richard Fred Glass
Analyst, Glass Capital Management LLC

Q

Okay. Well, so there's always a leaky bucket that you have to fill up with new business, new programs, et cetera, but there's nothing particularly meaningful. I guess, what I'm wondering is given the level of new business wins, which has been fantastic for like the last year at least in terms of new programs, new orders, new customers book-to-bill. All of these metrics are looking really good and very strong numerically and just fundamentally overall. What I'm wondering is, is there a – you guys have talked about a mid-single-digit growth rate for a long time now organically and given the pace of new wins and the book-to-bill, et cetera, without any major programs coming off, is there a point in time we should maybe be thinking about a high-single-digit growth rate or is this just a particularly robust period and we're going to get back to normal times though pandemic isn't exactly normal times either, I guess. So, is that possible looking forward?

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.

A

So, Richard, two things to your question. Number one, we're obviously striving to grow more and better organically and complemented with acquisitions until we get to our 10%. If you look at the strong winds this year, we were really pleased with the level of the wins in the non-transportation side as well as the transportation. But just a little bit of commentary on the transportation side. Some quarters in 2020, because of the pandemic, that sourcing level was a little bit lower because our customers were delaying some platform changes and new awards. So, there's a little bit of tempering in that, but overall our goal is to do better than the 5%.

Richard Fred Glass
Analyst, Glass Capital Management LLC

Q

Okay. So, I guess without you guys committing, it sounds like it's possible, but no one's committing today to it and we should just think about that 5%. In terms of the M&A pipeline, would you say it's changed at all? Is it more robust, less robust given what's going on maybe with interest rates going up, has there been any change in the attitudes of sellers?

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.

A

Two things, I would say that valuations haven't changed significantly at all. What I would tell you is we've got a stronger focus on that, stronger emphasis, put some more extra resources on it, and they're working very diligently in the area because we see it as we got to leverage some of the balance sheet capability.

Richard Fred Glass
Analyst, Glass Capital Management LLC

Q

Got it. Okay, all right. Thanks a lot, guys. Good quarter.

Kieran M. O'Sullivan
President, Chief Executive Officer & Chairman, CTS Corp.

A

You're welcome, thanks.

Ashish Agrawal
Vice President & Chief Financial Officer, CTS Corp.

A

Thanks, Richard.

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Operator: Thank you, Richard. There are no further questions at this time. [Operator Instructions] As there are no further questions, I would now like to hand the conference back over to Mr. O'Sullivan. I turn the conference back over to you.

Kieran M. O'Sullivan

President, Chief Executive Officer & Chairman, CTS Corp.

Thanks, Bailey, and thank you all for your time. In conclusion, despite a challenging macroeconomic environment, we achieved strong financial results and made meaningful progress on our new business awards. I'm proud of our global team for rising to the challenge and demonstrating operational excellence. CTS is well-positioned for growth in 2022, driven by the demand for increased automation, connectivity, and energy efficiency, and supported by global teams whose deep expertise and custom engineering solutions fuel content growth across our customer base, as we continue to move up the value chain for our global stakeholders.

We want to thank you all for joining us today. This concludes our call.

Operator: This concludes today's conference call. You may now disconnect your lines.

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