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CTS Corp. (CTS)

Q4 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Hello everyone, and welcome to the CTS Q4 2022 Earnings Call. My name is Bruno and I will be operating your call today. [Operator Instructions]

I will now hand over to your host, Mr. Kieran O'Sullivan, President, CEO. Mr. Kieran. Please go ahead.

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

Thanks, Bruno. Good morning and welcome everyone to our fourth quarter and full year 2022 earnings call. We delivered solid financial results in the face of economic uncertainties that remain elevated, driven in part by the current geopolitical environment in Europe, demand softness, as well as rising interest rates and inflation. Although supply constraints are easing as we experienced shortened lead times, we expect inflation and some supply pressures to remain a challenge, especially in the first quarter of 2023.

As discussed in October, we were impacted in the fourth quarter by supply issues from a semiconductor supplier for our smart actuator product line. Our focus on profitable growth, diversification through our advanced materials capability and the electrification in mobility markets remain our highest priorities. We are energized and focused on achieving our long-term growth goals and improving our operational performance.

For the fourth quarter 2022, sales were \$142 million, an increase of 7.4% from the same period last year, including the negative impact of the anticipated short-term semiconductor supply pressures we noted in our last earnings call. Adjusted gross margin was 36.3%, down 38 basis points from the same period last year. Adjusted EBITDA margin was 22.9%, up 200 basis points versus the fourth quarter of 2021. Adjusted diluted earnings per share increased 14% to \$0.56 on a year-over-year basis. Operating cash flow was \$25.5 million, compared to \$26

million in the fourth quarter of 2021. New business awards were \$71 million. We added four electric vehicle platform wins in the quarter and 10 new customers in non-transportation markets.

Turning to full year 2022 results, sales rose 14.4% to \$587 million from \$513 million in 2021. Adjusted gross margin was 36.5%, up 50 basis points from 2021. Adjusted EBITDA margin increased 180 basis points to 22.8% from last year. Adjusted diluted earnings per share increased 27% from \$1.93 to \$2.46. Operating cash flow was \$121 million, up \$35 million from 2021. New business awards were \$523 million below the elevated levels we achieved in 2021, as transportation customers delayed sourcing awards while they managed critical supply constraints.

Going forward, we are reintroducing total book-to-business for transportation only and also introducing book-to-bill ratios for the company to provide more visibility into long and short term trends. We continue to make progress on our diversification strategy, as non-transportation sales increased to approximately 48% of our overall revenue, up from 45% last year.

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 will now turn the discussion back to our CEO, Kieran O'Sullivan.

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

Thanks, Ashish. Overall, we achieved strong results in 2022, finishing the year, delivering sales growth of 7.4% in the fourth quarter and 14.4% for the full year. Organic sales, which excludes sales from our two acquisitions in 2022, were essentially flat in the fourth quarter, due in part to the impact of the temporary semiconductor shortage. Full-year sales grew nearly 10% organically. We continue to advance our diversification strategy throughout the year, with non-transportation revenues increasing 24% and up 13%, organically. Transportation sales were up 7% from last year.

Customer demand was somewhat tempered towards the end of the year. We did see some supply chain stabilization in the fourth quarter, thanks in part to the agility of our teams to keep us on track to manage through the temporary semiconductor shortage that impacted sales. We expect to see continued easing of the semiconductor supply constraints, with supply expected to normalize by the end of the first quarter of 2023.

We continue to benefit from our diverse and high quality customer base across our end markets. The integration of the acquisitions we completed in 2022, TEWA Sensors and Ferroperm remain on track and are performing well. These acquisitions have further strengthened our ability to add new applications and improved our distribution offerings, which have helped us to continue to gain traction with our customers.

Gross margin for the fourth quarter decreased 38 basis points to 36.3%, and full year gross margin rose 50 basis points to 36.5% versus 2021. We continue to gain momentum from our diversification strategy despite margin pressures from supply side cost increases. While we expect cost pressures to persist in 2023, we remain confident in our ability to partner with our customers to share these cost increases and to execute successfully together in the year ahead.

Our customer retention rate speaks to the deep relationships and value we provide our customers. In addition, to offset these pressures and support long-term margin improvement, we remain focused on implementing operational improvement projects. Fourth quarter adjusted diluted earnings per share of \$0.56 was up 14% from \$0.49 in the same period last year. Full year adjusted diluted earnings per share of \$2.46 increased 27% from 2021. Later, Ashish will add further color on our financial performance.

We added 10 new customers in the quarter, including one EV customer for a temperature sensing application. In industrial, we added five new customers with broad applications, including test and measurement, home appliances, small cell stations, and temperature applications in both water heating and refrigeration. In medical, we added four new customers, three for ultrasound imaging, and another for an ultrasonic dental cleaning application. New business awards for the full year totaled \$523 million, down from 2021's elevated levels as certain transportation awards were delayed from the fourth quarter to 2023. We expect a stronger performance in the year ahead as automotive supply challenges ease for our customer sourcing teams.

Our book-to-bill ratio was 0.9 in the fourth quarter and 1.0 for the full year. The recent reduction in the bookings reflects normalization from several quarters of elevated book-to-bill rates in 2021 and the early parts of 2022. We will continue to include the book-to-bill ratio in our future communications for added transparency.

As we've previously mentioned, consolidation of the sites in Denmark resulting from the acquisition of Ferroperm is underway and is expected to be completed in the third quarter of 2023. More recently, we began the process of consolidating our Juarez location into the Matamoros site in Mexico. This consolidation is driven by multiple factors, including the stability of the workforce in Matamoros, as well as the need to strategically align our operations in Mexico to achieve better efficiencies. The consolidation is expected to be completed within the next 18 months.

In the non-transportation end markets, we have achieved strong double-digit growth in the last couple of years. Our material formulations have continued to drive our performance throughout key high growth end markets. Customers view our leading edge technologies, deep industry experience, and vertical integration as key differentiators, helping us deliver long-term value. Our in-house know-how and proprietary processes, coupled with our competencies across three leading piezo of ceramic technologies, are a proven key competitive advantage, enabling us to develop new piezo or material formulations such as textured and lead-free. Our global foundry footprint positions us to support and drive growth for our customers.

In the industrial market, demand for micro-actuators used in industrial printing applications has softened, primarily driven by demand in China. Across temperature sensing, we see more stable demand, although at a reduced level, which has been helped by the addition of new customers in refrigeration and cooler display applications. We are working with a customer on a hydrogen fuel cell temperature application and added new wins in industrial food preparation.

For our EMC product line, we signed a contract with a European OEM and expect shipments to begin this year. We also secured RF wins for precision off-road vehicle tracking. With our portfolio of sensor and control products, we are at the various stages of qualification for home appliance, automation and marine applications. In the fourth

quarter, we added temperature sensor products to our distribution portfolio across Europe and US markets and are assessing the viability of moving piezo ceramic products through this channel.

In medical markets, we see good momentum in the year ahead. Our targeted business development efforts continue to progress, as we add new customers and new applications. We added four new customers, three for medical ultrasound, and one for an ultrasonic dental cleaning application. Across our portfolio of ultrasound applications, we received prototype orders for three new programs and a preproduction order for a new program with an existing customer. Our temperature portfolio continues to support growth in medical applications. We secured our first single Crystal Technology Award for an application in pacemakers with an existing Ferroperm customer and a new contract with an existing customer.

In therapeutics, we received a next generation award with an existing customer. Sales to the medical end market were a little softer in the fourth quarter as our customers focused on managing their inventory levels. However, we expect demand to be solid in 2023. We remain confident in the long-term prospects for the aerospace and defense end market, given our enhanced capabilities, new material formulations and the geopolitical landscape. We received multiple orders across several defense Tier 1s for sonar, hydrophone and sonobuoy applications. We also had wins for munition, detonation and countermeasure applications. A new application is in development for depth detection where we expect first orders in the first half of 2023.

With temperature sensing products, we received orders in aerospace, defense and space applications. We continue to make progress in unmanned underwater vehicle applications where we are deploying our single crystal technology and obtained additional advanced development awards. Finally, we were awarded new contracts for RF filter products and precision frequency applications. Looking ahead at 2023 for non-transportation end markets, growth remains mixed in certain industrial applications, distribution continues to adjust inventory levels, while defense and medical end markets remain more resilient and in some cases, we are improving our market share.

As I mentioned, we remain focused on advancing our long-term growth strategy, which centers on diversifying our end market profile through expansion of our technologies, products, customers and geographic reach. This strategy enhances the value creation opportunity for our stakeholders as well as the quality of our earnings. We have made good progress on diversification efforts over the past year, notably increasing non-transportation sales to approximately 48% of total 2022 sales. Full year 2022 non-transportation related revenue increased 24% compared to 2021, while transportation related revenue increased 7%.

Looking ahead, we will continue to focus on further diversification to grow non-transportation revenues at a faster pace, leveraging our balance sheet to pursue M&A opportunities while continuing to strategically grow our transportation business and strengthen our product portfolio. As a result, we continue to target long-term revenue growth of 10%, with a goal of greater than 50% of total revenues coming from non-transportation markets in the years ahead.

Transportation sales in the fourth quarter were negatively impacted by the short-term IC shortage we discussed in our last earnings call, resulting in sales declining approximately 9%, sequentially. We expect this temporary shortage to be resolved by the end of the first quarter. For the full year, our transportation sales grew by 7%, despite supply challenges and unfavorable currency impact.

We anticipate automotive demand to be flat to up low single digits in 2023. IHS is forecasting 4% growth globally, attributed to a stronger rebound in Europe and North America. Transportation total business was \$1.48 billion at the end of the year. Since the last time we published total book business, we have made a few changes. First, to

simplify, we have removed the contracts for our non-transportation customers as these contracts are shorter in duration and we will track them in our book-to-bill ratio.

Second, as you know, the auto market has faced supply chain issues that have meaningfully impacted volumes globally in the last few years, and the recovery is expected to take longer. We have adjusted our transportation total booked business numbers to reflect changes in industry production volumes from 2020 onwards. In 2022, we saw significant delays in sourcing decisions as our customers focused on supply challenges to maintain current production.

In the fourth quarter, we had wins in the accelerator module product line with an Asian OEM across two platforms. For Chassis ride height sensing, we had wins with a North American OEM. On the mechatronics front, we were awarded extensions related to existing products in commercial vehicle applications. More importantly, we are driving to achieve our goal of having 25% of our light vehicle revenue come from electrified platforms by 2025. Progress on securing electric vehicle wins continued as we added four electric vehicle platform wins, including an application in a European shuttle vehicle.

In two-wheeler applications, we had an award with an Asian OEM. We are also excited by the progress made in 2022 as we gain traction towards achieving our goal from new products. In the fourth quarter, we launched products on the Toyota Yaris, General Motors Buick GL8 in China, Honda MDX, and Renault Duster in South America, as well as passive safety sensors with a Tier 1 customer. The move towards electric and hybrid vehicles, as well as increased sensor content with passive safety and future eBrake applications present tremendous opportunities for us. Smart actuators aside, the majority of our portfolio is agnostic to the propulsion system, creating flexibility for us to meet the needs of our customers.

In 2022, the global share of electrified automobiles grew to approximately 10% to 12% of global vehicle share, and we expect this to accelerate to 15% or more by 2025 and above 30% by the end of the decade, with the Chinese market delivering the largest share gains followed by Europe. Demand for two-wheel applications, such as throttle sensing modules and throttle position sensors, is rebounding from recent softness in Asian markets.

We continue to invest in the company's future growth and are strengthening our electrification portfolio through M&A. We are pleased to announce the completion of our acquisition of maglab AG on February 6. maglab has deep expertise in magnetic system design and current measurement solutions for use in e-mobility, industrial automation, and renewable energy applications. The company's domain expertise, coupled with CTS' commercial, technical and operational capabilities position us to advance our status as a recognized innovator in electric motor sensing and controls markets. We'd like to welcome the maglab team to CTS. We look forward to working together to achieve our goal of greater than 25% of light vehicle sales from electrified platforms and expanding into other end markets.

Our balance sheet, bolstered by strong cash flow generation, continues to provide us with a solid foundation to further our diversification strategy. Our capital deployment priorities remain focused on supporting organic growth investments, leveraging our financial strength to advance M&A in alignment with our long-term growth strategy, and finally returning cash to shareholders. We remain committed to effective capital management, while maintaining a disciplined approach to acquisitions, as we have done in the past.

The investments we've made in the front end processes, including commercial resources and IT capabilities, along with implementing SAP across the organization, have strengthened our foundation, operational performance and positioned us to execute on our strategy. We are pleased with the progress made in 2022 with the integration of TEWA Sensors and Ferroperm and our financial performance.

We continue to build a solid M&A pipeline and are committed to leveraging value creating acquisitions in order to accelerate our growth and diversification. As mentioned, we will remain disciplined in our approach, focusing on acquisitions that meet our criteria, including enhancing our technology portfolio, strengthening customer relationships, as well as expanding products, applications, end markets and geography. We have continued to target acquisitions 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.

In line with our capital allocation strategy, we continue to return cash to shareholders. This past quarter, we repurchased approximately \$8 million of stock as part of the previously announced buyback program. We have returned a total of \$142 million to shareholders since 2013. At CTS, our purpose is to enable an intelligent and seamless world. Through deep customer relationships, we play an instrumental role in helping our customers shape the future by designing components and solutions with effective and efficient technologies that make their products smarter.

I've previously 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 medical devices such as medical ultrasound. We are driving our growth on battery electric vehicles and hybrid light vehicle platforms, and our goal is to achieve greater than 25% by 2025.

We understand we have responsibility to help 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, creating long-term value for our company, our stakeholders, and the communities in which we do business. We work to bring these values to light through the CTS Cares platform, through which our employees across the globe participated in community activities and contributed more than 4,400 hours to community projects in 2022.

Additionally, to report on our progress in driving sustainability throughout our operations, we plan to issue our first sustainability report in the second quarter of 2023. 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 with new products and new customers, while also finding deeper penetration with current end market applications.

We expect the transportation market to be flat to up low single-digits. Looking at the US light vehicle transportation market, the SAAR was closer to 14 million for 2022 and we expect the 14 million to 15 million unit range for 2023. European production is forecasted in the 16 million to 17 million unit range. China volumes are expected in the 26 million unit range, marginally up compared to 2022.

The commercial vehicle market remains solid and we expect it to be robust throughout the first half of 2023. The near-term semiconductor supply challenge, which I mentioned earlier, will impact our sales in the coming months. However, we expect it to be resolved by the end of the first quarter. For non-transportation markets in line with our diversification strategy, we continue to expand the customer base and range of applications in the industrial, medical and defense end markets.

In some cases, inventory levels are correcting to more normal quantities, especially in certain industrial applications and in distribution impacting volume in 2023. Demand in defense and medical markets remains more resilient. As I mentioned earlier, we expect a softer first quarter at levels similar to the fourth quarter of 2022 and an improving trend for the rest of the year.

Overall, we remain energized and focused on our long-term goals to drive profitable growth in the face of near-term challenges and improving our operational performance. In terms of guidance for full year 2023, we are forecasting sales in the range of \$580 million to \$640 million and adjusted diluted earnings per share in the range of \$2.40 to \$2.70.

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

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

Thank you, Kieran. Fourth quarter sales were at \$142 million, up 7% compared to the fourth quarter of 2021, and down 6% sequentially from the third quarter of 2022. Foreign currency exchange rates impacted revenue unfavorably by approximately \$4.3 million, mainly due to the changes in euro and Chinese renminbi exchange rates, sales to non-transportation end markets increased 22% year-over-year, supported by another quarter of double-digit growth in the industrial and medical end markets.

Our two acquisitions added \$9 million in sales during the quarter. Sales to transportation customers were down 4% compared to the fourth quarter of 2021 and decreased 9% sequentially. The primary driver for the softness in transportation revenue was the supply issue that impacted sales of our actuator product line. Our adjusted gross margin was 36.3% in the fourth quarter, down 38 basis points compared to the fourth quarter of 2021 and down 24 basis points compared to the third quarter of 2022. We continue to partner with our customers to partially offset the impact of cost increases we have experienced.

Foreign exchange rates impacted gross margin unfavorably by \$1.7 million in the quarter. While some parts of our 2020 restructuring program will be completed in 2023, we have realized \$0.25 of EPS in savings to-date. Earnings per diluted share were \$0.47 in the fourth quarter. Adjusted earnings for the fourth quarter were \$0.56 per diluted share, compared to \$0.49 per diluted share in the same time last year and \$0.62 per diluted share in the prior quarter.

For the full year, we achieved \$587 million in revenue, an increase of 14% compared to 2021. Sales to the transportation end market grew 7% and sales to other end markets grew 24% in 2022. We achieved strong double-digit growth in the industrial and medical end markets and made solid progress in sales to the aerospace and defense end market.

Our two acquisitions performed well and added approximately \$23 million in revenue during the year. Foreign exchange rates impacted sales unfavorably by almost \$11 million in 2022. Overall, as we continue to focus on diversifying our business, non-transportation sales were over 48% of our total sales in 2022, up from 44.6% in 2021. Our gross margin was at 36.5% in 2022, up 50 basis points compared to 2021. Our global teams executed efficiently in the face of significant supply challenges to offset the impact of cost increases and delivered solid results.

Supply challenges and inflation are expected to continue impacting us in 2023. However, we continue to work closely with our customers to share the cost increases, and we are confident in our ability to execute successfully. Foreign exchange rates impacted gross margin unfavorably by approximately \$3.6 million. For the full year of 2022, our earnings were \$1.85 per diluted share. Adjusted earnings for the full year of 2022 were \$2.46 per diluted share compared to \$1.93 per diluted share for 2021, an increase of 27%. We achieved 22.8% EBITDA in 2022, an improvement of 180 basis point compared to 2021.

Moving on to cash flow generation and the balance sheet. We generated \$25.5 million in operating cash flow for the fourth quarter of 2022 and \$121 million for the full year, up from \$86 million in 2021. Our 2022 operating cash flow number includes \$27 million in surplus cash received from the termination of our US pension plan. Our balance sheet remains strong with a cash balance of \$157 million as of December 31, 2022, up from \$141 million on December 31, 2021.

Our long-term debt balance was at \$84 million, up from \$50 million as of December 31, 2021, due to the partial funding of our Ferroperm acquisition. Our debt to capitalization ratio was at 14.2% at the end of the fourth quarter, compared to 9.7% at the end of 2021. We remain focused on strong cash generation and are committed to maintaining a healthy balance sheet to continue to support organic growth and strategic acquisitions.

During the quarter, we repurchased approximately 199,000 shares of CTS stock, totaling approximately \$8 million. In total, in 2022, we returned over \$27 million to shareholders through dividends and buybacks.

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 is from Brady Lierz from Stephens. Mr. Brady, your line is now open. Please go ahead.

Brady Lierz

Analyst, Stephens, Inc.

Q

Yeah. Good morning, everyone. This is Brady on for Justin, and thank you for taking my question. So, you mentioned expectations for a softer first quarter in the release. Did you kind of talk about the drivers to that comment and maybe kind of quantify the order of magnitude of that softness against your expectations for the remainder of 2023? And then, I've got a follow up.

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

Yeah. Brady, just the real drivers for the first quarter softness, first of all, is the continued IC shortage we talked about in the last earnings call, which will be something that will be resolved at the end of the quarter. So, it's still a temporary thing we're working through. And then we were seeing softness in industrial and distribution primarily. That's where we've got some things that we're working through. You heard me say softness in micro-actuators for industrial printing and some other applications and the inventory levels in distribution. On the flip side, the medical side, defense side remain robust and resilient, and we feel good about that for the rest of the year as well, as well as flat to single-digit growth in transportation.

Brady Lierz

Analyst, Stephens, Inc.

Q

Okay. Thanks so much. And then, maybe just a quick follow up, so your 2023 revenue and EPS guide kind of implies margins remain relatively flat on a year-over-year basis. Could you kind of talk about few of the things that might be offsetting a potential for some margin expansion in 2023?

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

A

Yeah, Brady, that's a good question. If you look at the range that we provided, we're dealing with some volume uncertainty in different end markets. And we are also looking at exchange rate as well as continued cost pressures on the raw materials side that we have already talked about in the past. So, those are some of the things that we are watching for carefully. And the other thing that we want to stay ahead of is, as the economy evolves during the year, we could potentially see price pressures from our customers and we'll be working the supply chain very hard to make sure that we can offset any pressures on the price side with cost savings from our material suppliers.

Brady Lierz

Analyst, Stephens, Inc.

Q

Okay. Great. That makes sense. I'll pass it on.

Operator: Thank you, Mr. Brady. Our next question is from Joshua Buchalter from Cowen. Mr. Joshua, your line is now open. Please go ahead.

Joshua Buchalter

Analyst, Cowen & Co. LLC

Q

Hey, team. Good morning. Thanks for taking my question and congrats on all the progress in 2022. I wanted to ask again about the component shortage impacting your transport market. Is that sort of a single point of failure and they just can't get enough of the component for the actuator? And I guess, what gives you the confidence that you'll be able to get that cleared up in 2023? And within the guide, are there any embedded – I know in the past you talked about your customers not being able to get semis also. I was wondering if that's still impacting the transportation segment as well? Thank you.

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

Joshua, thanks for the question. It's not a customer thing. It's a supply thing for us. It's one part, it's a very well-designed in part and take the design and substitution to replace. It would take quite some time to qualify. Obviously, we're preparing for that for the future. But it will be solved by the end of the first quarter. We're already seeing an improved trend and we have the commitments and the capacity that's lined up to make that happen. So, we feel good about resolving it.

And as you said, it is impacting our sales in the first quarter just like it did in the fourth quarter as well.

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

A

Yeah. Josh, to...

Joshua Buchalter

Analyst, Cowen & Co. LLC

Q

Got it. Thank you.

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

...answer the second part of your – sorry, go ahead.

A

Joshua Buchalter

Analyst, Cowen & Co. LLC

No, no. Please continue. Sorry.

Q

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

You had also asked about the embedded risk from our customer volumes in our guide. There is some level of build and you'll see that we have guided to a slightly wider range that we normally do. And embedded in that is some level of uncertainty primarily on the demand side of the equation. We see a continuing improving trend on the supply side, but we are watching carefully how the demand scenario looks in the interim.

What I would also add is that we are very well-positioned, in our opinion, on the mid- to long-term growth of the business with all the development activity that's underway, and the traction that we're getting in winning in different end markets in industrial, medical, and aerospace and defense.

A

Joshua Buchalter

Analyst, Cowen & Co. LLC

Okay. Thank you for all that color. And for my follow up, if we sort of account for TEWA and Ferroperm, and I think another acquisition you did, I'm writing it at around \$10 million to \$20 million of organic growth implied in the guide. One, I guess, can you confirm if I'm in the ballpark? And secondly, can you walk us through directionally which end markets and products you expect to contribute most. It sounds like aerospace and defense and medical in particular, but would be helpful to hear your directional color there? Thank you.

Q

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

So, Josh, I think the first part of your question was asking about the expected contribution from acquisitions to this year's revenue, is that right?

A

Joshua Buchalter

Analyst, Cowen & Co. LLC

Well, it was more of – yeah, it was more about like what are the underlying drivers of the organic growth if we sort of back out the half a year of Ferroperm in 2020 – yeah.

Q

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

Okay. So, like Kieran mentioned, we are expecting transportation to be flat to up low single digits and that's going to be mostly driven by the demand environment. Industrial, we are seeing some softness at the moment, including in the distribution space. Our expectation is that that could last Q1 and Q2 with potential for more stable to some recovery in the second half of the year. Medical and aerospace and defense look pretty stable to us at the moment. So, that's kind of how we are looking at 2023 in terms of expectations by the different end markets.

A

Kieran, would you want to add something?

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

Yeah. Just since Joshua asked about acquisitions, you heard in our prepared comments, Joshua, that we acquired maglab. It's a company based in Switzerland. It's got an expertise in magnetic system design, primarily focused on custom current sensing and position sensing solutions. So, it's a great addition for us. It doesn't come with revenues or anything. We're really bringing in a technical capability to advance our electrification strength and position going forward.

Joshua Buchalter

Analyst, Cowen & Co. LLC

Q

Thanks, guys. Appreciate it.

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

Thank you.

Operator: Our next question is from John Franzreb from Sidoti. Mr. John, your line is now open. Please go ahead.

John E. Franzreb

Analyst, Sidoti & Co. LLC

Q

Good morning, guys. And thanks for taking the questions.

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

Good morning, John.

John E. Franzreb

Analyst, Sidoti & Co. LLC

Q

What your thoughts on revenues for the year? I guess my first – I thought that your non-transportation revenues would up for the year. But now I'm wondering, with the distribution shortfall, maybe lessening into the second quarter. Are you looking at a potentially down year in non-transportation?

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

No, John, we would see it – just across those non-transportation markets, we would see growth in medical and in aero and defense. What we are seeing is that mixed results in industrial and inventory corrections in distribution, which is impacting volumes.

John E. Franzreb

Analyst, Sidoti & Co. LLC

Q

Okay. And also, in your prepared remarks, you mentioned something about potential pricing from your customers, could you talk a little bit what you meant by that?

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

A

John, we haven't seen anything yet, but we are keeping our eyes and ears open on what's happening on that front. If there is softening of demand then there's a potential that we could see some pressure. And as I mentioned earlier, we would want to stay ahead on the supply chain side to be able to offset that with any material cost favorability that we might be able to get.

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

John, I would tell you, we're very focused on the alignment with our supply side casting, making sure that's in line as we go forward to protect our margins.

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

A

Yeah. In the current environment here, holding prices as well as pushing some smaller price increases through – in certain parts of our business.

John E. Franzreb

Analyst, Sidoti & Co. LLC

Q

Okay. So, you were able to push through pricing during the recovery and you're worried about push back in, I guess, mostly in the transportation market should there be a weakening, is that a fair assessment?

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

A

Yeah. I would say, in transportation, but I would go a little bit broader in the industrial, distribution space as well.

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

And, John, one other comment is, just to make sure we're all calibrated, is cost pressures have not gone away yet. They're still there. They're still real for companies.

John E. Franzreb

Analyst, Sidoti & Co. LLC

Q

Got it. Got it. And then, go back to an earlier question about how do the Q1 lines up versus Q4. I normally would think that seasonally it would be stronger. I just want to make sure that that's still the case on a normalized basis or is the aforementioned revenue problems result in something that's more flattish or even down versus Q4?

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

So, John, our comments were that you can expect Q1 sales to be roughly in line with where we finished Q4, because of the semiconductor shortage and some adjustments in inventory as it comes to distribution or industrial markets. But again, we said very clearly an improving trend for the rest of the year. We feel very good about our medical and aerospace and defense markets. And transportation is a little bit of – is it flat, is it up a few single digits, that's what we're trying to gauge. And to Ashish's point, we'll give a wide guide. We'll have a much better sense as we get through the first quarter with how the macroeconomic situation is evolving.

John E. Franzreb

Analyst, Sidoti & Co. LLC

Q

Perfect. Thanks, Kieran, and appreciate you taking my questions. Thanks.

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

You're welcome, John.

Operator: Our next question is from David Kelley from Jefferies. David, your line is now open. Please go ahead.

David L. Kelley

Analyst, Jefferies LLC

Q

Hey. Good morning, guys, and thanks for taking my questions. Maybe a question on the supply constraints, but from the angle of commercial vehicles, which I believe you noted in the PowerPoint, would likely have an impact on the first quarter. So, can you talk specifically a bit more about visibility to your commercial vehicle exposure? And do you also expect those constraints to ease with kind of broader transport exposure as we work through Q1?

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

So, David, good morning to you. The softness we're seeing in Q1 is pretty much similar to the softness we had in Q4 due to the semiconductor shortage. And again, I want to emphasize that's going to get fixed by the end of the first quarter. We feel like we're on a good track with that. And then to your visibility on the commercial vehicle side, we feel good about the first six months of the year. I would tell you even some of our customers out there feel good about the rest of the year. We're just waiting to see the first six months evolve and take it from there.

David L. Kelley

Analyst, Jefferies LLC

Q

Okay. Got it. Thank you. And just you noted the strengthening EV platform wins. If we take a step back, we're seeing some OEMs cut EV pricing in the US. The US EV incentives were just adjusted. That now includes more models. So, can you talk broadly about the bidding opportunity in electrification if you're seeing a meaningful uptick there in the recent months from customers and you've got the target out there to increase revenues? But maybe talk about the cadence over the next couple years, how you're expecting momentum to unfold in electrification?

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

Yes, David. I think as we all know on the transportation side, pricing pressures and the competitive side of it is always high. We haven't seen any meaningful change. And I imagine on the electric vehicles, when you're big dollar items like displays and other things that go in there, you're going to experience a lot of pressure. Our products tend to be smaller dollar value, highly engineered and customized to the customer's requirements where, as you know, dependability, quality and innovation is important.

So, we feel pretty good. Our focus more so is strengthening the portfolio. With the small acquisition we've done in Switzerland, we see that as a good step forward. But we're also very excited about eBrake applications and other things we've been developing around moderate current sensing that we think are going to build nice momentum

for us in transportation markets. And also, we're looking at, how do we move that into other mobility applications as well.

David L. Kelley

Analyst, Jefferies LLC

Okay. Got it. Thanks, guys. Appreciate the time.

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

Thanks, David.

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

Thanks, David.

Operator: [Operator Instructions] Our next question is from Hendi Susanto from Gabelli Funds. Hendi, your line is now open. Please go ahead.

Hendi Susanto

Analyst, Gabelli Funds LLC

Good morning, Kieran. Good morning, Ashish.

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

Morning, Hendi.

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

Hi, Hendi.

Hendi Susanto

Analyst, Gabelli Funds LLC

Kieran, like, my first question is, is the softness in chip shortage unique to CTS since you have like a custom-designed products, meaning that I think, in general, for the market, the chip shortage is better? Therefore, we shouldn't expect like any negative surprise outside of that particular chip shortage?

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

Hendi, probably the best way to address that is, we've gone through two-plus years without actually impacting our customers with any shortages. We've obviously had tight situations and qualify to manage substitutions. And we feel bad about this one, because it's in a design that's going to move into the next generation design and the lead time to substitute another part wasn't exactly the easiest thing to do, so it's just the one part that goes into this one commercial vehicle application. And again, we will have it fixed by the end of the quarter, and it's improving. But that's the one shortage we're working through. It's not impacting any other part of the portfolio.

Hendi Susanto

Analyst, Gabelli Funds LLC

Q

Okay. Got it. Yeah. And then, Kieran, some electronic contract manufacturing and semiconductor companies are expecting positive demand and a continued positive growth in automotive. Having said that, I think those companies are in different bases of the transportation supply chain. May I inquire like, what is the case of CTS automotive sales to be flat in 2023 under, let's say, like the low end scenario?

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

Hendi, what was the last part of your question? You just broke up.

Hendi Susanto

Analyst, Gabelli Funds LLC

Q

Yeah. So, what is the case of the select CTS automotive sales to be flat in 2023? Like, what kind of scenario may contribute to CTS automotive sales to be flat, whether it's let's say like the SAAR numbers will be significantly worse than what you have stated or like what are some external market situation for your lower end of the automotive sales at the flat year-over-year growth in 2023?

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

Yeah, Hendi. The way we're looking at it a little bit is if you look at the SAAR, it's one thing, we could expect softness in China where the market has been softening for a period of time now. Some people would say a second half pickup in China. We've seen mixed results in Europe. We think North America, maybe up a little bit to flat. But you're seeing different companies give different views that they're in your traditional automotive suppliers. Some are up high single digits, some are flat, some are slightly down. I don't think too many are down, more flat is the situation. And the way we look at it is, obviously, we're impacted a little bit in the first quarter from the shortage, which is a temporary thing. And then, as we look at the rest of the year, will China rebound as strong as it should rebound? That's one thing that's on our mind and what's going to evolve in the commercial vehicle space, we see it has been robust in the first half of the year, but not sure that's going to hold up for the full year. They would be some of the things that would take us towards a more flat view.

Hendi Susanto

Analyst, Gabelli Funds LLC

Q

That's very helpful, Kieran. Thank you. And then Kieran, up in electronic vehicles, I think people usually talk about the increase in dollar contents, which would be a – like how should we think about CTS benefiting from increasing dollar contents per vehicle? And would you be able to share the timing of new product introductions?

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

Hendi, we haven't disclosed content per vehicle, it's something we are tracking internally, because it's a key part of how we manage our growth trajectory. We've launched accelerator modules into both electric vehicles and hybrid electric. We've got current sensing that will be launched with the European OEM this year for electrification application. We're very excited about the eBrake. I think we said in our last earnings call, we're in pre-development activity with a customer. And we're really focused on getting that portfolio as solid as it can be to make sure we're growing with the market as we go forward.

Hendi Susanto

Analyst, Gabelli Funds LLC

Q

Got it. And then, Ashish, I think the EPS guidance is above my projection. So, can you share more colors on gross margin and OpEx for the high end of the EPS guidance?

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

A

So, Hendi, the high end and the low end of the EPS guidance will be fairly consistently mirroring our volume. So, if you look at it from the range of revenue, if you're on the high end, then we'd see some leverage on OpEx as well as our gross margin. And if we are on the lower end, then we'll be focusing on managing costs a lot more carefully as we navigate through a tougher environment. So, that's what I would point to.

We are continuing to focus on pricing. We are continuing to focus on managing the cost side of it. As Kieran mentioned earlier, material cost is still an issue, we are seeing some increases in labor costs. But so far in terms of managing that equation, we've been able to do that fairly well, and I expect that we'll do the same in 2023. The other area that we'll be watching carefully is how the currency movements are happening. That impacted us pretty significantly negatively in 2022. So we'll keep an eye on that as well.

Hendi Susanto

Analyst, Gabelli Funds LLC

Q

Okay. And then, Ashish, any insight on CapEx? I think CapEx was like below your business model in 2022 and I'm wondering what 2023 may look like?

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

A

Yeah. So, CapEx was slightly lower. I'm expecting 2023 to be more in line with our longer-term expectations. But obviously, as you know, Hendi, we will be looking at all CapEx requirements carefully and making the appropriate capital allocation decisions based on the amount of return we can generate. So, we always watch that equation carefully.

Hendi Susanto

Analyst, Gabelli Funds LLC

Q

And may I just clarify, I think your long-term model has CapEx at around 4%. So, when you mention closer to your business model, does that imply closer to 4% of the revenue?

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

A

Yeah, that would be a reasonable assumption, Hendi.

Hendi Susanto

Analyst, Gabelli Funds LLC

Q

Okay. Yes. Thank you, Ashish. Thank you, Kieran.

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

A

Thanks, Hendi.

Ashish Agrawal

Vice President & Chief Financial Officer, CTS Corp.

Thank you.

Operator: We currently have no further questions. I will now hand back to our speaker and CEO, Mr. Kieran M. O'Sullivan. Mr. Kieran, please go ahead.

Kieran M. O'Sullivan

Chairman, President & Chief Executive Officer, CTS Corp.

Thanks, Bruno, and thank you, ladies and gentlemen. In conclusion, despite experiencing a challenging macroeconomic environment towards the end of the year, we achieved solid financial results in 2022. CTS is well-positioned for future growth, driven by demand, for increased automation, connectivity, and energy efficiency. We are supported by global teams whose deep expertise and custom engineered solutions, fuel growth across our customer base, driving sustained long-term value for our global stakeholders.

Thank you for joining us today. This concludes our call.

Operator: Ladies and gentlemen, this concludes today's call. Thank you for joining. You may now disconnect your lines.

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