

Presentation

Operator

Hello, and welcome to the CTS Corporation Third Quarter 2023 Conference Call. My name is Alex, I'll be coordinating the call today.
[Operator Instructions]

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

Kieran M. O'Sullivan
Chairman, President & CEO

Thanks, Alex. Good morning, and thank you for joining our third quarter 2023 earnings call. We continue to see weak demand in industrial and distribution markets impacting sales as elevated inventories at our customers slowly correct. We are also seeing softening in commercial vehicle demand across the light vehicle transportation market, the impact of the UAW strike was low for the third quarter.

We continue to expand our customer base in industrial and medical markets where we had several product wins. We also secured our first development award for a motor position sensor with application in electrified vehicles. Our focus on profitable growth, driving diversification through our advanced materials capability and growth through electrification and mobility markets with innovative new products remain our highest priorities.

I am pleased with our team's prudent management of operating expenses during the quarter, given the current sales softness. We remain focused on achieving our long-term strategic growth goals while also improving our operational performance. For the third quarter 2023, sales were \$135 million, down 11% compared to the same period last year. Adjusted gross margin was 34.5%, down 210 basis points from the same period in 2022. Adjusted diluted earnings per share of \$0.54, down \$0.08 compared to the third quarter of 2022.

We added 8 new customers in the quarter. I already mentioned the first Motor Position Development Award, which opens a new product line opportunity, enabling us to capture additional growth through the electrification megatrend and builds momentum beyond the first e-break win last quarter.

Ashish will take us through the safe harbor statement. Ashish?

Ashish Agrawal
VP & CFO

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 over to our CEO, Kieran O'Sullivan.

Kieran M. O'Sullivan
Chairman, President & CEO

Thank you, Ashish. We continue to experience challenging demand dynamics driven primarily by higher levels of customer inventory. Sales were \$135 million, down 11% from the same period last year. While the UAW strike had a low sales impact in the quarter, we expect it will pressure sales further in the fourth quarter. Operationally, with the reduced volume, we continue to focus on cost reductions.

As communicated, we will have some temporary cost increases as we complete our previously announced Mexico site consolidation. Work is progressing on the site consolidation, and we are on track to complete the transition next year. Inflationary impacts are improving but continue to be a challenge in some areas. We are adjusting pricing in partnership with our customers as we are still experiencing certain raw material cost increases and continued wage inflation, especially in Mexico and certain other countries.

We are also prioritizing our organic growth projects and new product investments while focusing on disciplined management of operating expenses during the softer short-term sales environment. We added 8 new customers in the quarter with new production orders and through qualification progress on sample orders. In addition, we are partnering with 5 new customers in industrial, 2 in medical and 1 in transportation to qualify our products in different applications. We had solid new business awards, especially for electrification platforms. We had a book-to-bill rate in the quarter of 0.93. Non-transportation sales declined 20% in the third quarter compared to the prior year period.

In the industrial market, sales continue to be soft, driven by decreased demand for micro actuators used in industrial printing applications due primarily to softness in China. We're also seeing softness across other industrial sensing applications and distribution as inventory levels continue to correct. We were successful with several wins, sales wins, securing a production order for kitchen appliances with wins for EMC, two-wheel and RF applications.

We also had wins for multiple temperature applications ranging from HVAC and compressor monitoring to refrigeration applications. We are engaged with new customers for potential sensing applications varying from pro audio, industrial printing, tunable optics and home appliances to tractor controls and wheel balancing. In medical markets, where sales continue on an improving trend, we are seeing stronger demand. We had multiple wins in the quarter for traditional medical ultrasound, intravascular ultrasound and therapeutic applications.

Our targeted business development efforts are progressing as we engage with new customers across multiple sample qualifications with applications in traditional ultrasound, therapeutics, optical encoders and an application deploying ultrasound for precise tissue destruction used for cancer treatment.

We expect the long-term prospects for aerospace and defense end market to be solid given our enhanced capabilities and new material formulations. Aerospace and defense sales are expected to be solid through the end of the year. We received multiple orders in the quarter for defense sonar and RF applications and secured underwater unmanned vehicle contracts. Additionally, we had wins for temperature sensing in communication satellites and for piezo material in aircraft emergency location beacons.

Looking ahead for the balance of 2023 in non-transportation end markets, we expect continued softness in the industrial end market and distribution as customer inventory levels continue to correct. For defense and medical markets, we anticipate a stable environment and solid progress on the qualification of our products for prospective new customers.

Long-term, we expect our material formulations and in-house know-how to continue to support our growth in key high-quality non-transportation end markets in line with our diversification strategy. Additionally, we anticipate the megatrends of automation, connectivity and efficiency as well as growth in minimally invasive medical procedures will provide us momentum as we continue expansion in these markets.

Transportation sales were \$76 million in the third quarter. Sales were down approximately 3% from the same period last year. We have now entered a softer demand environment for commercial vehicle products and anticipate fourth quarter sales to be lower, driven by a decrease in aftermarket demand that had been stronger post-COVID for restocking.

On the light vehicle front, we continue to track market share dynamics in China given the competition between local and transplant OEMs. In the third quarter, we had solid wins across all product categories and continue to gain momentum in electrification. In accelerator modules, we secured wins with OEMs in North America and Europe and were awarded a haptic module for a European OEM that provides the driver feedback on speed, distance and other information as customized by the vehicle manufacturer. We added a new product win for an accelerometer sensor with a North American OEM, where we expect a shorter-than-normal development period as well as additional opportunities as we go forward.

Total booked business was \$1.4 billion at the end of the quarter. We are driving to achieve our goal of having more than 25% of our light vehicle revenue come from electrified platforms by 2025. Progress on securing electric vehicle business continued as we added 11 electric vehicle wins in the quarter, including accelerator modules and haptics, chassis ride height sensors, accelerometers and current sensors where we continue to gain momentum in the market, benefiting from Maglab's strong pipeline of new opportunities.

As we look to our future, we are excited by the opportunity the transition to electrification offers us. We continue to see the foot well in the vehicle as a space where we expect to expand our product offering with traditional accelerator modules, haptic modules, new e-brake products offering weight and cost advantages and the future introduction of our Drive pad technology, a low travel accelerator product that enables driver interface customization and increases the footwell design flexibility for our customers. We expect these and other sensor applications will increase our ability to grow content with a potential SAM of greater than \$1 billion.

Summarizing our outlook for full year 2023. The North American light vehicle market is expected to be in the 15 million unit range, subject to the impact of the UAW strike. European production is forecasted in the 16 million to 17 million unit range. China volumes are expected in the 26 million unit range. While my comments -- in my earlier comments focused on the reduction in commercial vehicle demand in the fourth quarter, we also expect this softness to continue in 2024.

For non-transportation markets, in line with our diversification strategy, we aim to expand the customer base and range of applications in the industrial, medical and defense end markets. Inventory levels continue to correct to more normal levels, especially in certain industrial applications and in distribution. We estimate this demand softness to remain at reduced levels into early 2024. Demand in defense and medical markets is expected to remain solid.

In terms of guidance for full year 2023, we previously communicated that we expected sales in the range of \$565 million to \$585 million and adjusted diluted earnings per share in the range of \$2.20 to \$2.40. Given the continued softness in distribution and the industrial markets during the second half of the year, the impact of the UAW strike and the softening commercial vehicle market, we are now updating the guidance for sales in the range of \$545 million to \$555 million and adjusted diluted earnings per share in the range of \$2.15 to \$2.25.

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

Ashish Agrawal
VP & CFO

Thank you, Kieran. Third quarter sales were \$135 million, down 11% compared to the third quarter of 2022. Sales to the transportation end market decreased 3% year-over-year, driven by softness in sales of smart actuators for commercial vehicles.

Sales to other end markets declined by approximately 20% year-over-year due to the inventory reduction related slowdown primarily in the industrial and distribution end market. Adjusted gross margin was 34.5% in the third quarter, down 210 basis points compared to the third quarter of 2022.

As expected, margins were impacted by an unfavorable end market mix. Foreign exchange rates also impacted gross margin unfavorably by approximately \$1.8 million. We are seeing continued pressure on wage costs in some of the countries we operate in.

On the material side, we are still experiencing cost increases in some specific areas, and we are working with our customers to share these cost increases. As Kieran highlighted, we remain focused on making operational improvements and driving cost reductions to enable long-term gross margin expansion.

In light of the market conditions, we implemented temporary cost reduction measures to flex our cost structure in the second half of this year. In the third quarter, our operating expenses were lower, also due to a reversal of approximately \$2.5 million in reserves related to incentive plans. We expect our fourth quarter total operating expenses, excluding restructuring costs, to be slightly higher than the third quarter.

In the third quarter, we reported earnings of \$0.44 per diluted share. Our adjusted earnings were \$0.54 per diluted share compared to \$0.62 per diluted share in the same period last year.

Next, discussing our cash flow and balance sheet. We generated \$22 million in operating cash flow during the third quarter of 2023. Free cash flow was \$19 million as we carefully managed capital expenditures. Year-to-date, operating cash flow was \$57 million and free cash flow was \$46 million. Controllable working capital was 19.5% compared to 15.6% in the same period last year.

As mentioned on prior calls this year, we are transitioning from our Juarez facility with activity picking up in the second half of 2023. We have built up some safety stock to facilitate the transition and are expecting a further increase in the fourth quarter. Our goal is to work through the safety stock quickly in 2024.

In the third quarter, we repurchased 188,700 shares of CTS stock for approximately \$8.3 million. Year-to-date, we have returned approximately \$30 million to shareholders through buybacks and dividends. Our balance sheet remains healthy. We had a cash balance of \$160 million at the end of September 2023, up from \$151 million in June 2023, supported by healthy operating cash generation in the third quarter.

Our long-term debt balance was \$77 million on our total \$400 million facility. Our robust balance sheet and strong cash flow generation give us a strong foundation, enabling us to make strategic acquisitions and drive long-term growth for CTS. This concludes our prepared comments. We would like to open the line for questions at this time.

Question and Answer

Operator

[Operator Instructions] Our first question for today comes from Joshua Buchalter from TD Coen.

Joshua Louis Buchalter
TD Cowen, Research Division

I appreciate that you called out the UAW has an impact -- a UAW strike as an impact in the third quarter of the year and also recognize like this is literally happening in real time. But is there any way you can quantify how much of an impact that was in the third quarter and the fourth quarter outlook? And is there any reason to think that this wouldn't -- whatever was lost because the strike wouldn't be made up in the next couple of quarters as well?

Kieran M. O'Sullivan
Chairman, President & CEO

Joshua, thanks for your question. So for the third quarter, the UAW impact was pretty minimal. But as we go forward, we see -- we've already been impacted in the fourth quarter, and we see that impact probably in the \$2 million to \$4 million range. And I also mentioned softness in commercial vehicle, and we would see that somewhere maybe in the 10 million unit range for the fourth quarter.

Joshua Louis Buchalter
TD Cowen, Research Division

Got it. And then thanks for all the details on the site consolidation. Is there any way to quantify or help like-for-like? How much of a margin tailwind that could be once you get fully up and running in your steady state in Mexico?

Ashish Agrawal
VP & CFO

Yes, Josh, what we have called out for that is it's a Mexico-to-Mexico transition. So we are not expecting a significant change in profitability just from the move itself. We are looking to have more stability in our production processes, and that will enable us to do more business with the customers that we have at our existing wireless location.

Joshua Louis Buchalter
TD Cowen, Research Division

Got it. And then last one for me. It was interesting you called out China domestic competition in the prepared remarks. Is that something new that you're seeing? Is that changing materially? Is it any specific products or end markets where you're feeling that the most. I'll be quiet now.

Kieran M. O'Sullivan
Chairman, President & CEO

Yes, Joshua, on that one. We've spoken about it in the last few quarters. We have 2 larger customers over there, Toyota and Honda. They've lost some share short term. So that's something we're keeping a close eye on it obviously impacts us.

Operator

Our next question comes from John Franzreb of Sidoti & Company.

John Edward Franzreb
Sidoti & Company, LLC

I'd like to go back to the change in the revenue guidance. You called out \$10 million from commercial vehicle and \$2 million to \$4 million from UAW. But what about the balance that makes up that \$25 million midpoint? It certainly seems in the second quarter, you were a little bit optimistic that some of those industrial end markets would rebound. What changed?

Kieran M. O'Sullivan
Chairman, President & CEO

John, the inventory build up and if you read just the industry sentiment out there on inventory levels, while it's improving in terms of burning down the inventory, we're not there at the level we'd like to be at yet. So when you look at the guide going forward in terms of where we're going to be end of the year and the fourth quarter softness, it's a combination of that continued industrial and distribution softness. Now the softness that we see in commercial vehicle and the UAW strike, which obviously is still impacting 2 of our customers directly.

John Edward Franzreb
Sidoti & Company, LLC

Okay. And then is just maybe customer specific. Toyota has been a laggard in rebuilding their inventory compared to the Detroit 3. Any sense of when they're going to catch up a little bit? What are you hearing from their production rates and what their outlook looks like?

Kieran M. O'Sullivan
Chairman, President & CEO

I think Toyota continues to do well in Europe and North America. Our concern, John, more is in China, where the competition and pricing has been a bit more tougher. And also, the transition to electrification has been a little faster. I know Toyota has come out in recent days and said that, hey, now we're seeing a softness in demand for EVs and hybrids are going to benefit. So that's something we'll continue to track.

John Edward Franzreb
Sidoti & Company, LLC

Okay. But no sense when they're going to rebuild their inventory here in North America because they're at the lowest end of the curve

Ashish Agrawal
VP & CFO

Yes, John, they obviously are not communicating to us directly in terms of what their intentions are. We do see there orders as they place them a few weeks out. We are monitoring it carefully, but I wouldn't be calling out any significant uptick or downtick from there.

John Edward Franzreb
Sidoti & Company, LLC

Okay. And just again, on the end markets, the commercial vehicle end market, there's certainly some trepidation about how '24 would look like versus '23. Any early thoughts about what you're budgeting as far as kind of a build rate in '24 versus '23 as far as up or down or any kind of relative expectations?

Kieran M. O'Sullivan
Chairman, President & CEO

No, John. What I would tell you is, obviously, we've got a good line of sight to Q4. That's why I called out the range of \$10 million. That's our estimate. And into 2024, just given the taper off that's been there and that catch-up in the aftermarket side of it, that softness will continue into the first quarter, what the full year would be like. We'll give you a better guide in our Q1 earnings call. That's the best I can tell you at the moment.

Operator

Our next question is from Justin Long of Stephens.

Justin Trennon Long
Stephens Inc., Research Division

And I wanted to circle back to the comment that you made about commercial vehicle weakness driving a \$10 million headwind. Were you referring to a sequential headwind in revenue relative to the third quarter or was that a year-over-year comment?

Kieran M. O'Sullivan
Chairman, President & CEO

No, sequential Justin.

Justin Trennon Long
Stephens Inc., Research Division

Okay. So if I kind of run the math on the implied revenue guidance for the fourth quarter, it seems to suggest that the midpoint, about \$10 million of sequential pressure 3Q to 4Q. And based on the UAW strike and commercial vehicle weakness, it sounds like all of that is coming from those 2 items. So is that the right interpretation? And how are you thinking about non-transportation revenue sequentially in the fourth quarter? Could it look more stable?

Kieran M. O'Sullivan
Chairman, President & CEO

Yes. You've characterized it correctly with the CV drop, commercial deal drop and the UAW. And on the other markets getting more stable and hoping to see some improvement coming in that area.

Justin Trennon Long
Stephens Inc., Research Division

Okay. Understood. And Ashish, you touched on operating costs earlier a bit. But if I look at the SG&A line, in particular, it was a pretty significant decrease in the third quarter relative to the second quarter, about \$5 million. It sounds like half of that roughly was the incentive adjustment. What drove that other path? And could you just talk about the sustainability of some of the cost cuts, it sounds like you're implementing into next year?

Ashish Agrawal
VP & CFO

Yes. So overall, Justin, you're looking at the numbers correctly. We have taken short-term cost improvement measures for Q3 and for Q4. What you'll also see is that R&D expenses were slightly elevated in the third quarter because of just timing of different projects. So overall, when I look at operating expenses, excluding restructuring, we are expecting a slight increase in the fourth quarter compared to Q3, but not significant. And the increase is primarily because of that reserve release that I talked about for incentive compensation.

Justin Trennon Long
Stephens Inc., Research Division

Okay. And is there a way to quantify the other temporary cost reductions? And how much longer those could last, kind of what are the designs of the catalysts that you're looking for to put those costs back in the business whenever demand improves?

Ashish Agrawal
VP & CFO

Yes. So we are looking, just in the second half of the year is our primary objective. And then we'll keep reviewing things as we go further along.

Justin Trennon Long
Stephens Inc., Research Division

Okay. Understood. And last one for me. The book-to-bill was close to 1x in the quarter despite some of the demand challenges and no environment that's uncertain. Could you just comment on the order pipeline that you're seeing today and your comfort level that we can continue to trend around this 1x book-to-bill?

Kieran M. O'Sullivan
Chairman, President & CEO

Justin on winning new business in terms of that side of it, we're doing very well. You heard me mention a new motor position sensor. That's a new market for us. It opens up an opportunity with a SAM of about \$700 million, growing at a double-digit percent. We see great progress in current sensing. We've got a good pipeline of opportunities. And that's just on top of what's happening in medical and defense, where we've been doing well. So it's a tough quarter. You're calling what it is, but we feel like we've got good momentum going and winning new business. The book-to-bill quarter-to-quarter going forward is going to be kind of more of a steady improvement. But longer term, medium to longer term, we feel good about the wins we're getting.

Operator

Our next question comes from Hendi Susanto of [CTS].

Hendi Susanto
Gabelli Funds, LLC

I just have a question on the labor wage increase and then the raw material cost increase, should we -- like is there any way, where we can think about the magnitude, whether the those 2 account for, like, let's say, like single-digit percentage of the cost of goods sold or like just to get some insight into the magnitude of the gross margin pressure on those 2 ends?

Kieran M. O'Sullivan
Chairman, President & CEO

Yes. So Hendi, if you go back to the last 2 years, we were seeing some significant increases which we called out and we quantified. The dynamic is improving. What we wanted to call out is that we are still seeing some areas of pressure on the wage side, it's in Mexico. It's in some other countries that we operate in, in Europe. The materials is improving, but there are some places, some specific suppliers where we still have challenges. So that's what we are trying to call out. I wouldn't be saying that it has a significant margin impact for our business. And as I mentioned on the call, we are still working with our customer base to share those cost increases as appropriate just so that we are managing the overall margin impact.

Ashish Agrawal
VP & CFO

And Hendi, one thing I want to highlight is where we have those challenges, and we feel they're not best to market, we're not shy about turning on new sources.

Hendi Susanto
Gabelli Funds, LLC

I see. And Kieran, may I seek your insight in terms of the UAW strike, whether the impact can go beyond Q4?

Kieran M. O'Sullivan
Chairman, President & CEO

I would hope not, Hendi. The impact is big enough for. You obviously heard last night that the Ford is up for a proposed settlement at this stage. Our bigger customers are with GM and Stellantis. But given what's happening with Ford, I would hope things would convert soon and not get into next year at all.

Hendi Susanto
Gabelli Funds, LLC

I see, yes. And then Kieran congratulations on securing the first win in eBrake. May I know when the commercial sales of eBrake associated with that win may start?

Kieran M. O'Sullivan
Chairman, President & CEO

Hendi, it's a very -- it's a new product. It's complex. The first revenues come in either late '26 or '27. And the product is very popular with our customer. We have a lot of interest in it as well. We see this as a platform that can be just like our accelerator modules, a \$50 million-plus platform over years.

Hendi Susanto
Gabelli Funds, LLC

Okay. Yes. And then the awards that you have in the AC motor carton sensors, what is the timing of the commercial sales?

Kieran M. O'Sullivan
Chairman, President & CEO

On the current sensors and actual fact with what we've done out of the maglab acquisition, we already have some impact in sales in industrial applications. The automotive ones take a little bit longer, but they're on a good trajectory. It's not going to be 3 or 4 years. It's going to be closer to 2 years.

Operator

Thank you. At this time, we currently have no further questions. So I'll hand back to Kieran O'Sullivan for any further remarks.

Kieran M. O'Sullivan
Chairman, President & CEO

Thanks, Alex, and thank you all for your time. Despite the near-term headwinds, CTS is well positioned for future growth driven by the megatrends of increased automation, connectivity and energy efficiency. Overall, we are focused on our long-term goals to drive profitable growth, the solid wins in the quarter, expansion of customers, new development contracts and pipeline of opportunities underscore our strong confidence in CTS' future. I want to thank our global teams for their support in driving our strategic initiatives, successfully launching several new products and continuing to give back to those less fortunate in our communities during the quarter. We also continue to work hard to enhance our operational performance. Thank you all for joining us today. This concludes our call.

Operator

Thank you for joining today's call. You may now disconnect your lines.