CTS CORP
Form 10-Q
May 31, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended April 1, 2007
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Transition Period from _______________ to _______________

Commission File Number: 1-4639

CTS CORPORATION
(Exact name of registrant as specified in its charter)

Indiana (State or other jurisdiction of incorporation or organization)	35-0225010 (IRS Employer Identification Number)
905 West Boulevard North, Elkhart, IN (Address of principal executive offices)	46514 (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the

Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes x No o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of May 29, 2007: 35,884,265.

CTS CORPORATION AND SUBSIDIARIES

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

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

	Three Months Ended April 1, 2007	Three Months Ended April 2, 2006
Net sales	**$ 163,258**	$ 150,493
Costs and expenses:		
Cost of goods sold	**132,920**	120,452
Selling, general, and administrative expenses	**21,241**	16,886
Research and development expenses	**4,120**	4,092
Loss/(gain) on sales of assets	**29**	(496)
Restructuring charge	**—**	1,962
Operating earnings	**4,948**	7,597
Other (expense) income:		
Interest expense	**(691)**	(1,111)
Interest income	**479**	125
Other	**386**	3
Total other expense	**174**	(983)
Earnings before income taxes	**5,122**	6,614
Income tax expense - Note J	**1,076**	1,574
Net earnings	**$ 4,046**	$ 5,040
Net earnings per share - Note H		
Basic	**$ 0.11**	$ 0.14
Diluted	**$ 0.11**	$ 0.13
Cash dividends declared per share	**$ 0.03**	$ 0.03
Average common shares outstanding:		
Basic	**35,824**	35,821
Diluted	**40,410**	40,234

See notes to condensed consolidated financial statements.

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CTS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS - UNAUDITED
(In thousands of dollars)

	April 1, 2007	December 31, 2006*
ASSETS		
Current Assets		
Cash and cash equivalents	**$ 36,364**	$ 38,630
Accounts receivable, less allowances (2007 - $2,182; 2006 - $2,139)	**101,671**	106,012
Inventories, net - Note C	**71,763**	60,543
Other current assets	**23,495**	22,435
Total current assets	**233,293**	227,620
Property, plant and equipment, less accumulated depreciation (2007 - $263,577; 2006 - $259,548)	**94,082**	96,468
Other Assets		
Prepaid pension asset - Note E	**102,899**	100,666
Goodwill	**24,657**	24,657
Other intangible assets	**38,359**	39,154
Deferred income taxes – Note J	**33,298**	37,401
Other	**1,858**	1,867
Total other assets	**201,071**	203,745
Total Assets	**$ 528,446**	$ 527,833
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Notes payable	**$ 3,513**	$ 5,425
Current portion of long-term debt – Note D	**—**	186
Accounts payable	**76,168**	78,205
Accrued liabilities	**42,501**	41,865
Total current liabilities	**122,182**	125,681
Long-term debt - Note D	**60,000**	60,635
Other long-term obligations	**22,668**	22,494
Shareholders' Equity		
Preferred stock - authorized 25,000,000 shares without par value; none issued	**—**	—
Common stock - authorized 75,000,000 shares without par value; 53,766,073 shares issued at April 1, 2007 and 53,718,801 shares issued at December 31, 2006	**277,123**	276,553
Additional contributed capital	**28,304**	27,899
Retained earnings	**318,340**	315,370
Accumulated other comprehensive loss	**(30,622)**	(31,283)
	593,145	588,539
Cost of common stock held in treasury (2007 - 17,897,708 shares and 2006 - 17,717,657 shares)	**(269,549)**	(269,516)
Total shareholders' equity	**323,596**	319,023
Total Liabilities and Shareholders' Equity	**$ 528,446**	$ 527,833

******The balance sheet at December 31, 2006, has been derived from the audited financial statements at that date.*

See notes to condensed consolidated financial statements.

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

	Three Months Ended	
	April 1, 2007	**April 2, 2006**
Cash flows from operating activities:		
Net earnings	**$ 4,046**	$ 5,040
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	**5,772**	6,687
Equity-based compensation – Note B	**1,094**	865
Changes in assets and liabilities:		
Accounts receivable	**4,341**	(3,216)
Inventories	**(11,220)**	(366)
Other current assets	**(980)**	(2,906)
Prepaid pension asset	**(2,233)**	(1,197)
Accounts payable and accrued liabilities	**2,642**	(1,825)
Other	**656**	(453)
Total adjustments	**72**	(2,411)
Net cash provided by operating activities	**4,118**	2,629
Cash flows from investing activities:		
Capital expenditures	**(2,687)**	(2,479)
Proceeds from sales of assets	**36**	513
Net cash used in investing activities	**(2,651)**	(1,966)
Cash flows from financing activities:		
Payments of long-term debt	**(857)**	(34,165)
Proceeds from borrowings of long-term debt	**—**	34,040
Increase (decrease) in short-term notes payable	**(1,912)**	825
Dividends paid	**(1,076)**	(1,076)
Other	**36**	39
Net cash used in financing activities	**(3,809)**	(337)
Effect of exchange rate on cash and cash equivalents	**76**	282
Net increase (decrease) in cash and cash equivalents	**(2,266)**	608
Cash and cash equivalents at beginning of year	**38,630**	12,029
Cash and cash equivalents at end of period	**$ 36,364**	$ 12,637
Supplemental cash flow information		
Cash paid during the period for:		
Interest	$ **228**	$ 559
Income taxes—net	$ **162**	$ 1,360

See notes to condensed consolidated financial statements.

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

	Three Months Ended April 1, 2007	Three Months Ended April 2, 2006
Net earnings	**$ 4,046**	$ 5,040
Other comprehensive earnings:		
Cumulative translation adjustment	**1**	535
Amortization of retirement benefit adjustments (net of tax)	**660**	—
Comprehensive earnings	**$ 4,707**	$ 5,575

See notes to condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS - UNAUDITED
April 1, 2007

NOTE A - Basis of Presentation

The accompanying condensed consolidated interim financial statements have been prepared by CTS Corporation (CTS or the Company), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to such rules and regulations. The unaudited condensed consolidated interim financial statements should be read in conjunction with the financial statements, notes thereto, and other information included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

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

NOTE B - Equity-Based Compensation

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

At April 1, 2007, CTS had five equity-based compensation plans: the 1988 Restricted Stock and Cash Bonus Plan (1988 Plan), the 1996 Stock Option Plan (1996 Plan), the 2001 Stock Option Plan (2001 Plan), the Nonemployee Directors' Stock Retirement Plan (Directors' Plan), and the 2004 Omnibus Long-Term Incentive Plan (2004 Plan). As of December 2004, additional grants can only be made under the 2004 Plan. CTS believes that equity based awards align the interest of employees with those of its shareholders.

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

The following table summarizes the compensation expense included in the Unaudited Condensed Consolidated Statement of Earnings for the three months ended April 1, 2007 and April 2, 2006 relating to these plans:

($ in thousands)	**April 1, 2007**	**April 2, 2006**
Stock options [(1)]	$ 178	$ 223
Restricted stock units	875	581
Restricted stock	41	61

Total	$	1,094	$	865

[(1)] *Stock option expense includes $5 and $14 in the quarters ending April 1, 2007 and April 2, 2006, respectively, related to non-employee director stock options.*

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The following table summarizes the status of these plans as of April 1, 2007:

	2004 Plan	2001 Plan	1996 Plan
Awards originally available	6,500,000	2,000,000	1,200,000
Stock options outstanding	323,300	879,388	296,550
Restricted stock units outstanding	574,961	—	—
Awards exercisable	122,188	818,188	283,950
Awards available for grant	5,426,447	—	—

Stock Options

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

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

A summary of the status of stock options as of April 1, 2007 and April 2, 2006, and changes during the three-month periods then ended, is presented below:

	April 1, 2007		April 2, 2006	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding at beginning of year	1,526,863	$ 15.88	1,567,499	$ 15.93
Granted	—	—	—	—
Exercised	(9,150)	8.59	(16,000)	8.54
Expired	(7,625)	37.32	(20,475)	26.93
Forfeited	(10,850)	11.66	(7,050)	9.31
Outstanding at end of period	1,499,238	$ 15.85	1,523,974	$ 15.89
Exercisable at end of period	1,187,488	$ 16.96	1,061,481	$ 18.38

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The total intrinsic value of share options exercised during the quarters ended April 1, 2007 and April 2, 2006 was $54,600 and $65,000, respectively.

A summary of the weighted-average remaining contractual term and aggregate intrinsic value of options outstanding and exercisable at April 1, 2007 is presented below:

	Weighted-average Remaining Contractual Life	Aggregate Intrinsic Value
Options outstanding	5.5 years	$ 3,776
Options exercisable	4.9 years	3,082

A summary of the nonvested stock options as of April 1, 2007 and April 2, 2006, and changes during the three-month periods then ended, is presented below:

	April 1, 2007		April 2, 2006	
	Options	Weighted-average Grant-Date Fair Value	Options	Weighted-average Grant-Date Fair Value
Nonvested at beginning of year	340,900	$ 6.11	488,943	$ 6.94
Granted	—	—	—	—
Vested	(18,300)	4.96	(19,400)	4.62
Forfeited	(10,850)	6.95	(7,050)	4.64
Nonvested at end of period [(1)]	311,750	$ 6.15	462,493	$ 7.06

[(1)] *Based on historical experience CTS currently expects approximately 310,000 of these options to vest.*

The total fair value of shares vested during the quarters ended April 1, 2007 and April 2, 2006 was $91,000 and $90,000, respectively. As of April 1, 2007, there was $472,000 of unrecognized compensation cost related to nonvested stock options. That cost is expected to be recognized over a weighted-average period of 1.3 years. CTS recognizes expense on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in substance, multiple awards.

The following table summarizes information about stock options outstanding at April 1, 2007:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at 4/1/07	Weighted-Average Remaining Contractual of Life (Years)	Weighted-Average Exercise Price	Number Exercisable At 4/1/07	Weighted-Average Exercise Price
$ 7.70 – 11.11	849,513	6.4	$ 9.39	632,863	$ 8.95

13.68 – 16.24	234,300	6.6	14.11	139,200	14.36
23.00 – 33.63	314,175	3.8	24.53	314,175	24.53
35.97 – 50.00	100,750	3.5	46.94	100,750	46.94
56.94 – 79.25	500	2.7	79.25	500	79.25

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Service-Based Restricted Stock Units

Service-based restricted stock units (RSUs) entitle the holder to receive one share of common stock for each unit when the unit vests. RSUs are issued to officers and key employees as compensation. Generally, the RSUs vest over a five-year period. A summary of the status of RSUs as of April 1, 2007 and April 2, 2006, and changes during the three-month periods then ended is presented below:

	April 1, 2007		April 2, 2006		
	RSUs	Weighted-average Grant-Date Fair Value	RSUs		Weighted-average Grant-Date Fair Value
Outstanding at beginning of year	658,138	12.21	525,898	$	11.49
Granted	1,500	15.65	20,000		12.26
Converted	(56,377)	13.48	(12,310)		12.27
Forfeited	(28,300)	12.25	(13,460)		11.25
Outstanding at end of period	574,961	12.35	520,128	$	11.51
Weighted-average remaining contractual life	4.3 years		4.9 years		

As of April 1, 2007, there was $3.3 million of unrecognized compensation cost related to nonvested RSUs. That cost is expected to be recognized over a weighted-average period of 1.6 years. CTS recognizes expense on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in substance, multiple awards.

Performance-Based Restricted Stock Units

During the first quarter of 2007, CTS established performance-based restricted stock unit awards for certain executives. Executives will receive between 0% to 200% of their target awards based on achievement of year-over-year sales growth and free cash flow performance goals for fiscal year 2007. Restricted stock unit awards will be made in 2008 following a determination of the extent to which performance goals were achieved. Performance-based restricted stock units will cliff vest and convert one-for-one to CTS common stock three years after the end of the 2007 fiscal year. CTS intends to review its assumptions about the level of performance goal achievement on a quarterly basis and to adjust the related compensation expense accordingly. CTS recorded compensation expense of $45,000 related to performance-based restricted stock units during the first quarter of 2007.

Restricted Stock and Cash Bonus Plan

CTS' 1988 Plan originally reserved 2,400,000 shares of CTS' common stock for sale at market price, or award, to key employees. Under the 1988 Plan, 28,866 shares of Restricted Stock were outstanding as of April 1, 2007. Shares sold or awarded are subject to restrictions against transfer and repurchase rights of CTS. In general, restrictions lapse at the rate of 20% per year beginning one year from the grant date. In addition, the 1988 Plan provides for a cash bonus to the participant equal to the fair market value of shares on the dates restrictions lapse, in the case of an award. The total bonus paid to any participant during the restricted period is limited to twice the fair market value of the shares on the date of award or sale. As of April 1, 2007, there was $144,000 of total unrecognized compensation cost related to nonvested Restricted Stock. That cost is expected to be recognized over a weighted-average period of 1.3 years. CTS recognizes expense on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in substance, multiple awards.

Stock Retirement Plan

The Directors' Plan provides for a portion of the total compensation payable to nonemployee directors to be deferred and paid in CTS stock. The Directors Plan was frozen effective December 1, 2004. All future grants will be from the 2004 Plan.

NOTE C - Inventories

Inventories consist of the following:

($ in thousands)	**April 1, 2007**	**December 31, 2006**
Finished goods	**$ 14,871**	$ 12,336
Work-in-process	**16,767**	15,059
Raw materials	**40,125**	33,148
Total inventories	**$ 71,763**	$ 60,543

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NOTE D – Debt

Long-term debt was comprised of the following:

($ in thousands)	April 1, 2007	December 31, 2006
Revolving credit agreement due in 2011	$ —	$ —
Convertible, senior subordinated debentures at a weighted-average interest rate of 2.125%, due in 2024	60,000	60,000
Term loan, weighted-average interest rate of 8.0% (2007) and 7.3% (2006), due in 2011	—	821
	60,000	60,821
Less current maturities	—	186
Total long-term debt	$ 60,000	$ 60,635

On June 27, 2006, CTS entered into a new $100 million, unsecured revolving credit agreement. Under the terms of the new revolving credit agreement, CTS can expand the credit facility to $150 million. There were no amounts outstanding under the new revolving credit agreement at April 1, 2007. Interest rates on the new revolving credit agreement fluctuate based upon LIBOR and the Company's quarterly total leverage ratio. CTS pays a commitment fee on the undrawn portion of the new revolving credit agreement. The commitment fee varies based on the quarterly leverage ratio and was 0.15 percent per annum at April 1, 2007. The new revolving credit agreement requires, among other things, that CTS comply with a maximum total leverage ratio and a minimum fixed charge coverage ratio. Failure of CTS to comply with these covenants could reduce the borrowing availability under the new revolving credit agreement. CTS was in compliance with all debt covenants at April 1, 2007.

The revolving credit agreement requires CTS to deliver quarterly financial statements, annual financial statements, auditors certifications and compliance certificates within a specified number of days after the end of a quarter and year-end. Due to the accounting investigation described in Note B "Restatement of the Consolidated Financial Statements" in CTS' Annual Report on Form 10-K filed on May 15, 2007, the company and its lenders entered into an agreement under which the lenders agreed to waive these dates until June 30, 2007. Additionally, the new revolving agreement contains restrictions limiting CTS' ability to: dispose of assets; incur certain additional debt; repay other debt or amend subordinated debt instruments; create liens on assets; make investments, loans or advances; make acquisitions or engage in mergers or consolidations; engage in certain transactions with CTS' subsidiaries and affiliates; and the amounts allowed for stock repurchases and dividend payments. The new revolving credit agreement expires in June 2011. The former $75 million revolving credit agreement was terminated in connection with the execution of the new revolving credit agreement.

CTS has $60 million convertible senior subordinated debentures (2.125% Debentures). These unsecured debentures bear interest at an annual rate of 2.125%, payable semiannually on May 1 and November 1 of each year through the maturity date of May 1, 2024. The 2.125% Debentures are convertible, under certain circumstances, into CTS common stock at a conversion price of $15.00 per share (which is equivalent to an initial conversion rate of approximately 66.6667 shares per $1,000 principal amount of the notes). Upon conversion of the 2.125% Debentures, in lieu of delivering common stock, the Company may, at its discretion, deliver cash or a combination of cash and common stock.

The conversion price of the 2.125% Debentures will be adjusted if CTS completes certain transactions, including: distribution of shares as a dividend to substantially all shareholders; subdivision, combination or reclassification of its common stock; distribution of stock purchase warrants to substantially all shareholders; distribution of cash, stock or property to shareholders in excess of $0.03 per share; or purchase of its common stock pursuant to a tender offer or exchange offer under certain circumstances.

Holders may convert the 2.125% Debentures at any time during a conversion period if the closing price of CTS common stock is more than 120% of the conversion price ($18.00 per share) for at least 20 of the 30 consecutive trading days immediately preceding the first trading day of the conversion period. The conversion periods begin on February 15, May 15, August 15, and November 15 of each year. Holders may also convert the notes if certain corporate transactions occur. As of April 1, 2007, none of the conditions for conversion of the 2.125% million Debentures were satisfied.

CTS may, at its option, redeem all or a portion of the 2.125% Debentures for cash at any time on or after May 1, 2009, at a redemption price equal to the principal amount of the notes plus any accrued and unpaid interest at the redemption date. Holders may require CTS to purchase for cash all or part of their notes on May 1, 2009, 2014, and 2019, or upon the occurrence of certain events, at 100% of the principal amount of the notes plus accrued and unpaid interest up to, but not including, the date of purchase.

As of December 31, 2006, the Company also had an $0.8 million (denominated in Thailand Baht) outstanding term loan that was assumed in connection with the acquisition of SMTEK. This loan was secured by machinery and equipment at the Thailand manufacturing facility and was repaid by CTS in March 2007.

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NOTE E - Retirement Plans

Effective December 31, 2006, CTS adopted all of the provisions of FAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)." FAS No. 158 requires employers to: a) recognize the funded status of a benefit plan—measured as the difference between plan assets at fair value and the benefit obligation—in its statement of financial position, b) recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to FAS No. 87, "Employers' Accounting for Pensions," or FAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions,"c) measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position, and d) disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. As required by the standard, CTS has applied these FAS No. 158 requirements prospectively.

Net pension (income) / postretirement expense for the three months ended April 1, 2007 and April 2, 2006 includes the following components:

	Pension Plans		Other Postretirement Benefit Plans	
($ in thousands)	**April 1, 2007**	**April 2, 2006**	**April 1, 2007**	**April 2, 2006**
Service cost	$ 1,211	$ 1,276	$ 6	$ 4
Interest cost	2,996	3,012	83	75
Expected return on plan assets [1]	(6,338)	(6,175)	—	—
Amortization of prior service cost	225	134	—	—
Amortization of gain/loss	839	644	—	—
Curtailment loss	—	325	—	(81)
(Income)/expense, net	$ (1,067)	$ (784)	$ 89	$ (2)

[1] *Expected return on plan assets is net of expected investment expenses and certain administrative expenses.*

In the first quarter of 2006, CTS recognized a pension plan curtailment loss of approximately $0.3 million and another postretirement benefit plan curtailment gain of approximately $0.1 million due to reduced employment levels. Also, effective April 1, 2006, CTS closed one of its U.S. defined benefit plans to new participants.

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NOTE F - Segments

FAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," requires companies to provide certain information about their operating segments. CTS has two reportable segments: 1) Electronics Manufacturing Services (EMS) and 2) Components and Sensors.

EMS includes the higher level assembly of electronic and mechanical components into a finished subassembly or assembly performed under a contract manufacturing agreement with an OEM or other contract manufacturer. Additionally, for some customers, CTS provides full turnkey manufacturing and completion including design, bill-of-material management, logistics, and repair.

Components and sensors are products which perform specific electronic functions for a given product family and are intended for use in customer assemblies. Components and sensors consist principally of automotive sensors and actuators used in commercial or consumer vehicles; electronic components used in communications infrastructure and computer markets; terminators, including ClearONE™ terminators, used in computer and other high speed applications, switches, resistor networks, and potentiometers used to serve multiple markets.

The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies in the Company's annual report on Form 10-K. Management evaluates performance based upon segment operating earnings before restructuring and related charges, interest expense, other non-operating income, and income tax expense.

Summarized financial information concerning CTS' reportable segments is shown in the following table:

($ in thousands)	**EMS**	**Components and Sensors**	**Total**
First Quarter of 2007			
Net sales to external customers	**$ 93,726**	**$ 69,532**	**$ 163,258**
Segment operating earnings	**3**	**4,945**	**4,948**
Total assets	**170,179**	**358,267**	**528,446**
First Quarter of 2006			
Net sales to external customers	$ 82,865	$ 67,628	$ 150,493
Segment operating earnings	(781)	10,499	9,718
Total assets	154,041	384,227	538,268

Reconciling information between reportable segments' operating earnings and CTS' consolidated pre-tax income is shown in the following table:

($ in thousands)	**First Quarter 2007**	**First Quarter 2006**
Total segment operating earnings	**$ 4,948**	$ 9,718
Restructuring and related charges - Components and Sensors	**—**	(2,121)
Interest expense	**(691)**	(1,111)
Interest income	**479**	125

Other income		**386**		3
Earnings before income taxes	**$**	**5,122**	$	6,614

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NOTE G -Contingencies

Certain processes in the manufacture of CTS' current and past products create hazardous waste by-products as currently defined by federal and state laws and regulations. CTS has been notified by the U.S. Environmental Protection Agency, state environmental agencies and, in some cases, generator groups, that it is or may be a Potentially Responsible Party (PRP) regarding hazardous waste remediation at several non-CTS sites. In addition to these non-CTS sites, CTS has an ongoing practice of providing reserves for probable remediation activities at certain of its manufacturing locations and for claims and proceedings against CTS with respect to other environmental matters. In the opinion of management, based upon presently available information relating to all such matters, either adequate provision for probable costs has been made, or the ultimate costs resulting will not materially affect the consolidated financial position, results of operations, or cash flows of CTS.

Certain claims are pending against CTS with respect to matters arising out of the ordinary conduct of its business. For all claims, in the opinion of management, based upon presently available information, either adequate provision for anticipated costs has been made or the ultimate anticipated costs resulting will not materially affect CTS' consolidated financial position, results of operations or cash flows.

NOTE H - Earnings Per Share

FAS No. 128, "Earnings per Share," requires companies to provide a reconciliation of the numerator and denominator of the basic and diluted earnings per share (EPS) computations. The calculations below provide net earnings, average common shares outstanding, and the resultant earnings per share for both basic and diluted EPS for the quarters ending April 1, 2007 and April 2, 2006.

($ in thousands, except per share amounts)	**Net Earnings (Numerator)**	**Shares (in thousands) (Denominator)**	**Per Share Amount**
First Quarter 2007			
Basic EPS	**$ 4,046**	**35,824**	**$ 0.11**
Effect of dilutive securities:			
Convertible debt	**251**	**4,000**	
Equity-based compensation plans	**—**	**586**	
Diluted EPS	**$ 4,297**	**40,410**	**0.11**
First Quarter 2006			
Basic EPS	$ 5,040	35,821	$ 0.14
Effect of dilutive securities:			
Convertible debt	241	4,000	
Equity-based compensation plans		413	
Diluted EPS	$ 5,281	40,234	$ 0.13

The following table shows the potentially dilutive securities which have been excluded from the first quarter 2007 and 2006 dilutive earnings per share calculation because they are either anti-dilutive, or the exercise price exceeds the average market price.

(Number of shares in thousands)	Three Months Ended April 1, 2007	April 2, 2006
Stock options where the assumed proceeds exceed the average market price of common shares during the period	550	834
Securities related to the 6.5% convertible debentures	—	274

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NOTE I – Leases

CTS incurred approximately $1.5 million and $1.3 million of rent expense in the quarters ending April 1, 2007 and April 2, 2006, respectively. The future minimum lease payments under the Company's operating leases are $4.2 million for the remainder of 2007, $4.6 million in 2008, $4.3 million in 2009, $3.0 million in 2010, $2.3 million in 2011, and $2.7 million thereafter.

NOTE J – Income Taxes

On January 1, 2007, the Company adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48). FIN 48 clarifies the accounting for uncertainty in income tax positions recognized in accordance with FAS No. 109, "Accounting for Income Taxes." FIN 48 requires that an enterprise must determine whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. A tax position that meets the more-likely-than-not threshold is then measured to determine the amount of benefit to recognize in the financial statements.

At the date of adoption, CTS had approximately $4.3 million of unrecognized tax benefits, which, if recognized, would affect the effective tax rate. Of this amount, approximately $3.6 million was reclassified from current tax liabilities to a reduction of the long-term deferred tax asset in accordance with the provisions of FIN 48. The remaining $0.7 million was reclassified from current tax liabilities to long term deferred tax liabilities. Adoption of this interpretation had no other impact on the Company's condensed consolidated financial statements. For the three months ended April 1, 2007, CTS did not have a change to its total unrecognized tax benefits of $4.3 million. These benefits are not expected to be realized within the next twelve months.

CTS' continuing practice is to recognize interest and/or penalties related to income tax matters as income tax expense. As of April 1, 2007, there were no significant amounts accrued for interest and/or penalties related to uncertain income tax positions.

The Company's tax years are subject to examination for all U.S. jurisdictions from 2003 through 2006. The international tax statutes vary widely and the tax years subject to examination range from 2001 through 2006. Taxing authorities also have the ability to review prior tax years to the extent of net operating losses and tax credit carryforwards and apply these changes to open tax years. CTS does not anticipate any significant changes in the unrecognized tax benefits within the next twelve months as the result of examinations or lapse of statutes of limitation.

The provisions for income taxes for the first quarter of 2007 were calculated using an estimated full year rate of 21.0% compared to 23.8% for the first quarter of 2006 and an actual effective rate of 21.1% for the full year 2006. The reduction in the effective tax rate between first quarter 2006 and first quarter 2007 was attributable to a higher percentage of foreign earnings on lower taxed jurisdictions relative to total foreign earnings.

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NOTE K – New Accounting Pronouncements

EITF 06-03 "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)"
In June 2006, the Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No. 06-03, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)" (EITF 06-03). EITF 06-03 provides that the presentation of taxes assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer on either a gross basis (included in revenue and costs) or on a net basis (excluded from revenues) is an accounting policy decision that should be disclosed. The previsions of EITF 06-3 are effective for CTS as of January 1, 2007. CTS classifies sales taxes on a net basis in its consolidated financial statements.

FAS No. 157 "Fair Value Measurements"
In September 2006, the FASB issued FAS No. 157, "Fair Value Measurements"(FAS No. 157). FAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. FAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements, and accordingly, does not require any new fair value measurements. FAS No. 157 is effective for CTS beginning January 1, 2008. CTS is currently reviewing the provisions of FAS No. 157, but does not expect it to have a material impact on its consolidated financial statements.

FAS No. 159 "The Fair Value Option for Financial Assets and Financial Liabilities"
In February 2007, the FASB issued Financial Accounting Standard No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (FAS No. 159). FAS No. 159 provides the option to report certain financial assets and liabilities at fair value, with the intent to mitigate volatility in financial reporting that can occur when related assets and liabilities are recorded on different bases. This statement is effective for CTS beginning January 1, 2008. CTS does not expect FAS No. 159 to have a material impact on its consolidated financial statements.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

CTS is a global manufacturer of components and sensors used primarily in the automotive, communications, and computer markets. The Company also provides electronic manufacturing solutions, including design and supply chain management functions, primarily serving the communications, computer, industrial, medical and defense and aerospace markets under contract arrangements with the original equipment manufacturers (OEMs). Sales and marketing are accomplished through CTS sales engineers, independent manufacturer's representatives, and distributors. Sales are reported through two segments, Electronics Manufacturing Services (EMS) and Components and Sensors.

In the first quarter of 2007, sales of EMS and Components and Sensors segments represented 57.4% and 42.6% of CTS' total sales respectively, compared to 55.1% and 44.9% respectively in the first quarter of 2006.

As discussed in more detail throughout the Management's Discussion and Analysis:

- Sales increased by $12.8 million, or 8.5%, in the first quarter of 2007 from the first quarter of 2006. Sales in the EMS segment increased by 13.1% compared to the first quarter of 2006, while sales in the Components and Sensors segment increased by 2.8% versus the first quarter of 2006.

- Gross margins, as a percent of sales, were 18.6% and 20.0% in the first quarter of 2007 and 2006, respectively. Gross margins decreased due to an unfavorable change in the segment sales mix versus the first quarter of 2006 as the EMS segment, which inherently generates a lower gross margin, increased to 57.4% of total sales in first quarter of 2007 compared to 55.1% of total sales in the same period of 2006. In addition, higher sales of lower margin products in the Components and Sensor Segment affected the gross margins adversely. Royalty income was also lower year-over-year.

- Selling, general and administrative, and research and development expenses were 15.5% of total sales in the first quarter of 2007 compared to 13.9% of total sales in the first quarter of 2006. Growth in the percent of sales is primarily related to two factors. First quarter 2007 included approximately $1.3 million of legal and accounting fees associated with the recent accounting investigation (refer to Note B, "Restatement of the Consolidated Financial Statements" in CTS' Annual Report on Form 10-K filed May 15, 2007), while first quarter 2006 included approximately $1.5 million for a favorable insurance claim settlement, which had the effect of reducing general and administrative expenses.

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