Gentex Corp GNTX

We see Gentex's gross margin remaining flat, but we see its growth runway remaining long.

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Morningstar's Editorial Policies

Analyst Note 04/22/2016

We are not changing our moat rating or fair value estimate for Gentex after the company reported another typically healthy quarter. We see nothing to merit changing our investment thesis, as the company once again had auto-dimming mirror unit growth far exceeding industry vehicle production and we think did a great job on its procurement as purchasing reductions and leveraging overhead more than offset automakers annual price reductions, which are typically 2%-3%. Gentex's unit volume rose year over year by 11% compared with just a 1% increase in light-vehicle production in key markets across North America, Europe, and Asia. Gross margin increased 30 basis points from the prior year's quarter to 39.1%, while operating income and margin increased by 12% and 60 basis points, respectively, to 29.8%. Management maintained revenue guidance given in January for full-year 2016 and 2017. EPS increased by 8% to match consensus of $0.28, while revenue rose 10% to $405.6 million, slightly beating consensus. Gross margin may increase throughout the year depending on mix and the amount of additional purchasing cost reductions, so we are slightly increasing our 2016 EPS to $1.20 from $1.19.

The call also highlighted two more recent changes in the company compared with several years ago. First, buybacks will consistently be $25 million-$30 million every quarter with additional "opportunistic" repurchases depending on market conditions. Management rarely used to buy back stock. Second, the new plant opening for final assembly late this year will easily have its overhead absorbed right away. Gentex traditionally did not say this because it was a far smaller company; so it is a good example of a firm able to grow because of its cost advantage from scale, one of Gentex's moat sources in addition to switching costs and efficient scale. We continue to see no evidence that Gentex is being hurt by the threat of cameras replacing mirrors in automobiles.

Investment Thesis 12/22/2015

Gentex creates auto-dimming rear- and side-view mirrors that use electrochromic technology. These mirrors automatically darken to eliminate headlight glare for drivers and have many other applications. With over 1,200 patents worldwide, some valid through 2040, and a dominant 91% market share, Gentex has a narrow economic moat that it should be able to protect for a long time.

The growth prospects for auto-dimming mirrors look strong. Gentex estimates that in 2014, 25% of all cars had interior auto-dimming mirrors, and 7% had at least one exterior auto-dimming mirror. Demand remains robust and management in early 2016 said it expects 2017 year over year revenue growth of 6%-10%. This growth will come from increased vehicle penetration as more original-equipment

Morningstar's Take GNTX

Analyst

Price 05-23-2016	**Fair Value Estimate**	**Uncertainty**
15.5 USD	19 USD	High
Consider Buy	**Consider Sell**	**Economic Moat**
11.4 USD	29.45 USD	Narrow
Stewardship Rating		
Standard		

Bulls Say

- Auto-dimming technology has applications to other parts of the car like headlights, as well as outside autos such as airplane windows. Although small now, markets outside the auto industry could prove to be very large businesses down the road.
- The company's financial health is so strong that we think Gentex can survive any downturn in the U.S. easier than other auto suppliers can.
- Gentex's strong free cash flow and low-debt balance sheet could make the firm an acquisition candidate if the CEO retires.

Bears Say

- Cameras could replace Gentex's mirrors, if regulators allowed it. We don't think this is a likely threat, at least not anytime in the near future.
- Gentex could find better uses for all its cash, such as paying a higher dividend or buying back shares more quickly after the stock sells off. A higher dividend would give shareholders--instead of management--more control in allocating excess capital.
- As auto-dimming mirrors become available on more vehicle models, OEMs may want to lower their own costs by pressuring Gentex to reduce prices, or by supporting emerging competitors.

Competitors GNTX

More...

Name	Price	% Chg	TTM Sales $ mil
Gentex Corp	**$15.50**	**-2.24**	**1,580**
Continental AG	$208.02	-1.41	44,307
Continental AG ADR	$41.18	-1.01	44,307
Denso Corp ADR	$18.87	0.16	40,913
Denso Corp	$37.42	0.89	40,913
Johnson Controls Inc	$42.82	-0.28	36,317

manufacturers make the safety benefit of auto-dimming technology available and as Gentex's research leads to new, advanced-feature mirrors that ultimately become standard products.

SmartBeam, which automatically turns a vehicle's brights on or off and can also allow brights to be on continuously, is sold mostly in Europe, but its safety benefits could expand if U.S. regulators change current rules. Research has found that drivers use their brights optimally only about 25% of the time. In May 2012, Gentex announced a long-awaited lane departure system. Active safety is a very fast-growing field, so more camera products are likely to show up on other vehicle programs. A new example is the full display mirror which the driver can toggle between a normal auto-dimming mirror and a display image while driving.

Over the long term, Gentex's technology also could be brought to more airplane windows. The company (in conjunction with PPG Aerospace) supplies auto-dimming passenger windows for the Boeing 787, which could eventually expand to more firms. The September 2013 purchase of HomeLink from Johnson Controls is another expansion outside the mirror. In July 2014, Gentex announced that HomeLink will move into other auto applications such as linking a home to snowmobiles and farm vehicles. It also is targeting RFID parking barriers in Asia.

Economic Moat 12/22/2015

Gentex's cost advantage from economies of scale, its customers' switching costs, and efficient scale give the firm a narrow moat. Patents, innovations such as SmartBeam, and a consistent world-class manufacturing process have let the firm increase its auto-dimming mirror share to 91%. We see this as representative of efficient scale because Gentex does not give any reason for a customer to try another auto-dimming mirror supplier nor leave room for many competitors. The firm's technological leadership increases our confidence that Gentex will hold, if not keep increasing, market share. Given that the company is patient with its engineers in order to encourage innovation, we do not think Gentex will lose its competitive edge. Its research and development spending as a percentage of revenue is one of the highest in our supplier coverage. Gentex was the first to market with electrochromic automatic-dimming mirrors, so the company enjoyed pricing benefits from the early adopters of the technology. Its unique product and its ability to commercialize the technology and continually make patent-protected innovative changes to the automatic dimming mirror has enabled Gentex to generate returns on invested capital vastly superior to other auto suppliers. The company's market share gain to 91% of auto-dimming mirrors from the low 80% range in recent years shows the superior quality of its product and the reliability of Gentex to deliver on time, suggesting that customers would face switching costs to move over to Magna Mirrors.

However, the company is probably not a wide-moat candidate, in our opinion. Even Gentex faces customer demands for annual price reductions of about 2%-3%. Gentex's gross margins declined to 32.6% in the recession years of 2008 and 2009, from 43.2% in 1999. Suppliers are at the mercy of the automakers' production schedules and relentless annual demands for price concessions. Each automaker's volume makes the supplier very dependent on this large source of revenue. Furthermore, the auto industry is so cyclical that in bad times even the best parts suppliers cannot avoid large declines in return on invested capital and profit. In Gentex's case, ROIC was more than 40% in the late 1990s but fell to about 15% in 2009, before rebounding to as much as 25% in subsequent years. Cost-cutting helps ease the pain, but it does not restore all lost profit. We model ROIC in the low 20% range over our five-year forecast period.

Valuation 03/08/2016

We are raising our fair value estimate to $19 per share from $18 in light of a slightly higher long-term earnings growth rate than previously modeled beyond our five-year forecast period. We model revenue to increase 6.5% on a five-year compound annual basis and operating margins to average about 28.5% during our five-year explicit forecast period. We project revenue based on a global vehicle production forecast, global auto-dimming mirror penetration, Gentex's market share, and average selling price. We assume a continued increase in penetration throughout our forecast period due to attractive growth prospects and Gentex's history. We believe additional margin expansion will remain difficult, since automakers always seek price concessions. However, we think higher unit volume, innovation by Gentex, and HomeLink's gross margins at nearly 60% will mitigate this risk. As an example, there is potential for SmartBeam's dynamic forward lighting product to grow in the United States if the push by the industry to overhaul outdated headlight regulation succeeds. Another innovation is the full display mirror, that started production in 2015's fourth quarter in the Cadillac CT6 sedan. We have driven the Cadillac CT6 and think that the full display mirror is far safer than a conventional mirror. Although major revenue growth from this mirror is not expected until 2017 or 2018, we think it has potential to be in every vehicle in the developed world due to its superior function over a normal mirror. We think the firm's manufacturing efficiency, product expertise, and high-tech products will keep gross margins higher than in recent years but continued research and development, annual price reductions, and overhead spending will prevent major operating margin expansion. We project capital expenditures to average 7.2% of revenue per year and R&D expenses of about 6% of revenue on average. We model Gentex's auto-dimming mirror market share going to 92% over our five-year explicit forecast period because we see no major threat from other firms. Gentex's quality and reliability are very hard to beat, and customers do not source mirrors solely based on price, which reduces the threat from low-cost Asian suppliers.

Risk 12/22/2015

Gentex's only large competitor is Magna Mirrors (formerly Donnelly). Magna has much deeper pockets than Gentex and could invest substantially in its auto-dimming mirror group to try to beat Gentex's technology advantage or devote more sales resources than Gentex can afford. Also, there is always the possibility that a new and superior technology will be invented and take over the auto-dimming mirror market, but we consider this risk remote. The HomeLink acquisition could prove to not be as lucrative as management expected. Finally, it is possible that Gentex could be put out of the automotive supply chain if governments start allowing camera technology to replace all types of mirrors in a vehicle, as Europe now does. Although we think cameras replacing mirrors is more than a decade a way if it even happens at all, our fair value estimate may be severely reduced if such legislation causes consumers to prefer cameras over mirrors in large volume. The company's expertise in camera systems, however, may make this legislative risk far less problematic than Gentex's critics fear. Furthermore, currently display-only systems require retooling of the vehicle and cost more than a mirror. Uncertainty as to image quality in poor weather or from other obstructions needs to be considered by regulators, as well. In light of this regulatory risk, the fact that Gentex's stock price is not immune to the cycle whims of the auto industry, and more active safety content possibly being placed in the center stack, dashboard, or window, rather than the mirror, our fair value uncertainty rating is set at high.

Management 03/08/2016

Chairman and CEO Fred Bauer, 73, founded Gentex in 1974 and owns 2.8% of the company. Management has achieved returns on invested capital far exceeding the cost of capital for many years, which we expect to continue. The company generates so much free cash flow (typically about 10% to over 20% of sales) that until the HomeLink acquisition in Sept. 2013, it had amassed cash and an investment portfolio, mostly consisting of stocks and government bonds, amounting to more than half of assets. Rather than piling up investments, we would prefer to see an even higher dividend or more share repurchases when the stock is trading well below our fair value estimate. At a minimum, we'd like to see management repurchase shares to offset dilution from stock based compensation. At year-end 2015, the diluted share count had increased by about 2.9% since 2012 but remains much lower than about five years ago.

A share repurchase in the third quarter of 2012 was the company's first since the fourth quarter of 2008. No shares were repurchased in 2013, but management spent $30 million on buybacks in 2014 and $111.3 million in 2015. The buyback plan does not expire and has authorization to repurchase another approximately 9.6 million shares including the 5 million share increase announced in February 2016. We think management recognizes when its shares are cheap enough to buy back, but wish it would act on that knowledge sooner. To be fair, the leadership team put in place a few years ago is more willing to buyback shares than we've seen under prior regimes. We think Bauer's capital-allocation preference is share repurchases because of his dislike of the double taxation of dividends. The company only started paying a dividend after tax cuts in 2003 under President Bush.

Overview

Profile:

Gentex was founded in 1974 to produce smoke-detection equipment. The company sold its first glare-control interior mirror in 1982 and its first model using electrochromic technology in 1987. Automotive revenue is about 98% of total revenue, and the company is constantly developing new applications for the technology to remain on top. Sales from 2015 totaled about $1.5 billion on 33 million units shipped. The company is based in Zeeland, Michigan.