Gentex Keeps Rolling Along to End 2019 Despite Global Uncertainties

David Whiston
Sector Strategist

Analyst Note | by David Whiston Updated Jan 31, 2020

Gentex finished 2019 with a solid fourth quarter that shows its growth story is not near an end. Diluted EPS did decline year over year by 5% to $0.39 while revenue fell 2%; however, both figures beat the Refinitiv consensus ($0.02 EPS beat). We are not changing our fair value estimate but as always we will reassesses all modeling assumptions after Gentex files its 10-K. Management's 2020 guidance calls for as much as a nearly 8% rise in revenue over 2019's $1.859 billion as the rollout of the high-priced full display mirror continues and auto dimming mirror penetration continues its gradual penetration increase. FDM full-year unit volume grew 89% over 2018 to 739,000 units while total company mirror volume rose 3% to 42.9 million. This 3% growth rate is impressive given management called out an approximate 6% decline in global light vehicle production. 2020 revenue guidance is also well above the industry's light vehicle production based on Gentex citing IHS' negative 1% forecast decline versus 2019 for the combined areas of North America, Europe, Japan, Korea, and China.

As long as the U.S. and Europe do not fall into recession we don't see major problems looming for Gentex this year, though the coronavirus in China may cause further production shutdowns beyond what the industry is already planning for in the first nine days of February. The start of a year also means Gentex starts its annual pricing battle when early in the year it incurs annual pricing reductions from its customers, as is customary in the auto industry. The company then, usually after first quarter, obtains pricing reductions from its suppliers as well as improves its cost structure via finding manufacturing efficiencies. Gentex is very good at this, which is one reason it can keep its gross margins in the upper 30% range.

Business Strategy and Outlook | by David Whiston Updated Oct 31, 2019

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 1,400 patents worldwide, some valid through 2043, and a dominant 92% market share, up from 77% in 2003, Gentex has a narrow economic moat it should be able to protect for a long time.

The growth prospects for auto-dimming mirrors look strong. Gentex estimates that in 2017, about 30% of all cars had interior auto-dimming mirrors, and about 12% had at least one exterior auto-dimming mirror. Demand remains healthy with annual revenue growth often exceeding industry vehicle production growth. Growth will come from increased vehicle penetration as more original-equipment 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 as proposed in October 2018. Research has found that drivers use their brights optimally only about 25% of the time. Active safety is a very fast-growing field, so more camera products are likely to show up on other vehicle programs and Gentex develops its own cameras. A recent example is the full display mirror, which the driver can toggle between a normal auto-dimming mirror and a display image while driving at high speed. Other growth areas include biometrics in mirrors, which we see having application in autonomous ride hailing, dimmable sunroofs, and universal toll payments.

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 and 777X and could eventually expand to more aircraft makers. The September 2013 purchase of HomeLink from Johnson Controls is another expansion outside the mirror. It also is targeting RFID parking barriers in Asia with HomeLink.

Economic Moat | by David Whiston Updated Oct 31, 2019

Gentex's cost advantage from economies of scale, its customers' switching costs, and intangible assets 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 92%. We see this as representative of a moat 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 92% of auto-dimming mirrors from the low 80s 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.

Auto suppliers are not chosen purely on price. A firm has to be reliable and get it right every time while also serving an automaker globally. There are not many suppliers that can do that, let alone mirror suppliers that can. Once a supplier has the business, it is extremely rare to lose it, especially during a vehicle program, because automakers then have to remove tooling from the supplier, which can cost millions. An automaker would also have to incur expensive validation testing of a new supplier, all while the production line is not making any vehicles and decimating an automaker’s ability to recoup its fixed costs. Gentex also has traditionally kept a debt free balance sheet, partly so its cash hoard ensures it can keep its supply chain moving (such as in the Great Recession or after the Japan tsunami) and thus will never be the reason an automaker has to stop its production line.

This consistent reliability is not something that just anyone who can get a loan to start a mirror company could do easily or quickly. Automakers' move to more global platforms is very good news for Gentex since a supplier must be able to service the OEM consistently all over the world. A regional player cannot do this, and we think a small firm would be hesitant to borrow lots of money to add new facilities and overhead all over the world without any guarantee of winning new business. Automakers want the same supplier on a program all over the world due to scale benefits for them and reliability with a vendor that knows the vehicle program.

Gentex grows its share and keeps competitors at bay by bringing many, often patented, offerings (SmartBeam, HomeLink, FDM, telematics, and so on) into the electrochromic mirror, which, along with Gentex's consistent quality (both in the mirror and in the ease of integration of the mirror into the vehicle's other systems), makes it hard to beat in a proposal. These add-on features make the automaker money too because they are typically bundled with other non-Gentex features in an expensive tech or safety package on a vehicle. This allows the automaker to offer a variety of trims without having to redesign a vehicle's interior at great expense. Gentex has also told us the customer (the automaker) makes more money on Gentex products than Gentex does, which helps the switching cost moat source because a customer has little reason to switch on something it is buying for say $45 and selling as one part of a multi-thousand dollar option package. Also, with growth potential in vision systems (FDM, camera monitoring systems), the connected car via HomeLink and the integrated tolling module service, and large area dimmable surfaces (sunroofs, airplane windows), we don't think AVs automatically mean doom for Gentex.

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 about 25% in subsequent years. Cost-cutting helps ease the pain, but it does not restore all lost profit. We model ROIC in the mid-20s for most of our five-year forecast period.

Fair Value and Profit Drivers | by David Whiston Updated Oct 31, 2019

We are maintaining our fair value estimate at $23. We model revenue to increase about 3.5% on a five-year compound annual basis with high single digit top line growth in the outer years of our forecast due to growth after an assumed slowdown. We model operating margin to average about 25% 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.

The full display mirror is an innovation we like. We have driven several vehicles with this mirror and think that the full display mirror is far safer than a conventional auto-dimming mirror. Although major revenue from this mirror is not expected for a few more years, 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 in the upper 30% range but continued research and development, annual price reductions, and overhead spending will prevent major operating margin expansion. We project capital expenditures in the upper 5% of revenue range for most of our forecast period and R&D expenses of over 7% of revenue on average. Our long term tax rate is 19%.

We model Gentex's auto-dimming mirror market share going to 95% 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. We keep our Stage II profit assumptions lower than we normally would to handicap the risk of cameras replacing mirrors long-term.

Risk and Uncertainty | by David Whiston Updated Oct 31, 2019

Gentex's only large competitor is Magna Mirrors. 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. Some products such as high-beam assist are increasingly going into bundled packages in higher-trim vehicles, which means more competition for Gentex’s SmartBeam product. 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 and Japan now do under UN-ECE Regulation 46. Although we think cameras replacing mirrors in large volume 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 or fully autonomous cars lead to no mirrors in a vehicle. 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. A dual camera/mirror system provides a redundancy for safety in case a camera's lens is blocked by weather or debris on the lens. 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.

Stewardship | by David Whiston Updated Oct 31, 2019

Former chairman and CEO Fred Bauer founded Gentex in 1974 and owned 2.3% of the company until his retirement in January 2018. Bauer retired from the board as well but remains an employee for advisory services for five years after retiring. He will be paid $447,000 in 2019 and 2020, and $298,000 in 2021 and 2022. Bauer also received a $2.1 million retirement payout, and Gentex bought a building it uses owned by Bauer for $950,000. Gentex also repurchased about 5.5 million Gentex shares owned by Bauer for $20.98 a share, about 2.3% of the company and effectively all of Bauer's stock. This retirement package is more generous than we'd like to see but not surprising, given that Bauer is the founder.

Lead independent director James Wallace is now chairman, while President Steve Downing, 41, added the CEO role in January 2018. Downing joined Gentex in 2002, and we think he is an outstanding executive and the right choice for CEO because of his strong knowledge of Gentex's finances as well as its products and operations. Downing was CFO and treasurer until his promotion to president, COO, and treasurer in August 2017. Downing does not have an employment agreement, but that may change now that he is CEO, though Gentex typically does not have contracts with its executives. Kevin Nash, 44, joined Gentex in 1999 and worked his way up to the CFO role in February 2018. He is also treasurer. Four of the board's nine members joined since 2014 and two members joined in 2018. CEO Downing is not on the board, which we are fine with as it allows power to be more with the board than management, but we would not be surprised if Downing joined the board one day and even became chairman.

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 25% of sales) that until the HomeLink acquisition in September 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 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.

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, $111.3 million in 2015, $163.4 million in 2016, $231.4 million in 2017, and $591.8 million in 2018 including buyback of Bauer's shares. The diluted share count at year-end 2018 is down by nearly 9% since the end of 2015. Management bought back shares in 2018 at an average price per share of $22.38 and cumulative buybacks for 2003-18 at $1.54 billion were at an average of $13.63 by our calculation.

We think management recognizes when its shares are cheap enough to buy back but, in the past, we wished it would have acted on that knowledge sooner. The leadership team put in place a few years ago is far more willing to buy back shares than we've seen under prior regimes; we just want Gentex to do it only when the stock is trading well below our fair value estimate. We think Bauer's capital-allocation preference was 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 George W. Bush. We don't expect a major change in capital allocation under Downing, but a small amount of debt being a permanent part of the capital structure is more likely with Bauer retired.

Downing’s first stamp on capital allocation came with a March 2018 announcement of a 10% dividend increase and a lowering of the target for cash and investments to $525 million from $700 million. These moves suggest to us that dividends and buybacks will remain part of capital allocation on a regular basis. March 2018 and March 2019 both saw announcements increasing the repurchase authorization. The plan does not expire and has 22.5 million shares of authorization left at the end of September.