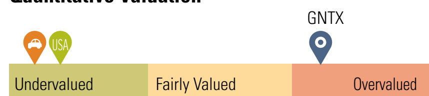
Gentex Corp GNTX (XNAS)

Morningstar Rating	Last Price	Fair Value Estimate	Price/Fair Value	Trailing Dividend Yield %	Forward Dividend Yield %	Market Cap (Bil)	Industry	Stewardship
★★★	29.44 USD	31.00 USD	0.95	1.66	1.68	7.01	Auto Parts	Standard
23 Oct 2020 21:43, UTC	23 Oct 2020	23 Oct 2020 21:42, UTC		23 Oct 2020	23 Oct 2020	23 Oct 2020		

Morningstar Pillars	Analyst	Quantitative
Economic Moat	Narrow	Narrow
Valuation	★★★	Overvalued
Uncertainty	High	Medium
Financial Health	—	Strong

Source: Morningstar Equity Research

Quantitative Valuation



	Current	5-Yr Avg	Sector	Country
Price/Quant Fair Value	1.11	1.01	0.80	0.83
Price/Earnings	24.0	15.5	16.2	20.1
Forward P/E	19.0	—	12.3	13.9
Price/Cash Flow	16.7	12.7	10.2	13.1
Price/Free Cash Flow	19.9	16.4	17.7	19.5
Trailing Dividend Yield%	1.66	1.87	2.46	2.35

Source: Morningstar

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.
- Biometrics, surgical room utlraviolet lighting, and electronic toll payments could open up new revenue streams for the company.

Bears Say

- Cameras could replace Gentex's mirrors, if regulators throughout the world allowed it. We don't think this is a likely threat, at least not anytime in the near future in very large volume.
- Gentex hoards cash but has made good effort to buy back stock while increasing its dividend. 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.

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We Believe Gentex's Third Quarter Shows the Chance for a Strong 2021

Business Strategy and Outlook

David Whiston, CFA, CPA, CFE, Analyst, 23 October 2020

Gentex manufactures 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 1,500 patents worldwide, some valid through 2044, and a dominant 94% market share, up from 77% in 2003, Gentex has a narrow economic moat it should be able to protect for a long time despite the economic damage from COVID-19.

The growth prospects for auto-dimming mirrors look strong. Gentex estimates that in 2018, about 31% of all cars had interior auto-dimming mirrors, and about 13% 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.

The future beyond autos looks bright to us, too. The company supplies auto-dimming passenger windows for the Boeing 787, and has agreements to supply the 777X, and unspecified Airbus planes. Gentex is also targeting RFID parking barriers in Asia with HomeLink and exploring healthcare smart lighting applications with the Mayo Clinic.

Analyst Note

David Whiston, CFA, CPA, CFE, Analyst, 23 October 2020

Gentex reported a 9.1% year-over-year increase in third quarter diluted EPS with the $0.48 posted beating Refinitiv's consensus of $0.41. Revenue fell 0.7% but was the second-highest total ever recorded other than third-quarter 2019, so the good quarter faced a tough comparable. In light of 2020 trending better than modeled as a recovery from the pandemic is happening faster than expected in the spring, Gentex introducing 2021 revenue guidance of 15%-20% growth from 2020, cost reductions from second quarter in our view enabling the chance of gross margins next year of nearly 40%, and the time value of money, we are increasing our fair value estimate to $31 from $25.

We expect for at least through 2021, provided there is not another pandemic-induced shutdown, that the $35 million in savings realized from salaried headcount reductions in second quarter, combined with continued volume recovery from the coronavirus, should enable strong quarters for Gentex. Management is also willing to frequently repurchase its shares, and the company should be debt free by the end of 2020 with only $25 million in borrowings outstanding on the credit line. The balance sheet is a fortress in our opinion, with $612.1 million of cash and investments, and continued rollout of new high tech products, such as the full display mirror and the integrated toll module, should lead to strong earnings growth for a while. Upside also exists should aircraft production rebound because the autodimming windows product currently on the Boeing 787 will eventually get new business from the Boeing 777X and yet to be named Airbus planes per prior Gentex announcements.

The share buyback program has 11.9 million shares of authorization left, and the company repurchased 1.2 million in third quarter at an average price per share of $26.93. We expect the board will not hesitate to authorize more buybacks over time.

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Economic Moat

David Whiston, Analyst, 23 October 2020

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 94%. 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 94% 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

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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- to upper 20s and low-30s for most of our five-year forecast period.

Fair Value & Profit Drivers

David Whiston, Analyst, 23 October 2020

In light of 2020 trending better than modeled as a recovery from the pandemic is happening faster than expected, Gentex introducing 2021 revenue guidance of 15%-20% growth from 2020, cost reductions from second quarter we think enabling the chance of gross margins next year of nearly 40%, and time value of money, we are increasing our fair value estimate to $31 from $25. We model revenue to increase about 6.6% on a five-year compound annual basis, up from 3.7% in our prior model, with about a 12% decline in 2020 due to COVID-19 and then high-single-digits to mid-teens growth in the outer years of our forecast period. We model operating margin to average about 26% during our five-year explicit forecast period, up from about 24%. 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 for some of our forecast period due to attractive growth prospects and Gentex's history. We believe additional margin expansion will remain difficult but not impossible, since automakers always seek price concessions.

The full display mirror, which the company refers to as FDM, 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. Gentex has FDM contracts with eight automakers as of fall 2020, including GM and Toyota. 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 about 7% of revenue on average. Our long term tax rate is 19% and our weighted average cost of capital is 9%.

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.

Risk & Uncertainty

David Whiston, Analyst, 23 October 2020

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.

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Stewardship

David Whiston, Analyst, 23 October 2020

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 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, 42, 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, 45, joined Gentex in 1999 and worked his way up to the CFO role in February 2018. He is also treasurer. Five of the board's nine members joined since 2014 and two members joined in 2018. CEO Downing joined the board in 2020 for the first time.

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 15% 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, $591.8 million in 2018 including buyback of Bauer's shares, and $331.5 million in 2019. The diluted share count at year-end 2019 is down by nearly 15% since the end of 2015. Management bought back shares in 2019 at an average price per share of $24.06 and cumulative buybacks for 2003-19 at $1.87 billion were at an average of $14.76 by our calculation. Management's comments to us indicate it is willing to repurchase stock even in the midst of a recession, which we agree with but it's rare as most firms prefer to hoard cash in the depths of a crisis. During the coronavirus pandemic, Gentex did not buy back stock in second quarter 2020 but did in the third quarter, so we think management's actions match its words on buybacks.

We think management recognizes when its shares are cheap enough to buy back but, in the past under prior leadership, we wished it would have acted on that knowledge sooner. The leadership team put in place several years ago is far more willing to buy back shares than we've seen under the prior regime; 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 could occur with Bauer retired. We are fine with Gentex remaining debt free however, as we feel a strong balance sheet is an underrated asset in the auto industry. In times of crisis, Gentex can keep receiving supplies because its vendors know Gentex will pay them, or buying back stock after a large sell-off. Plus this liqudity, in our view, means financial distress for Gentex is not something shareholders need to worry about.

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 11.9 million shares of authorization left at the end of

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Analyst Notes Archive

Gentex Has a Rare Poor Quarter for Q2, but We Are Not Worried

David Whiston, Analyst, 24 July 2020

Gentex reported a rare poor quarter, but this is entirely attributable to the severe decline in vehicle production in the second quarter in North America and Europe due to the coronavirus. We have already been modeling conservative figures for 2020 and 2021, so we are leaving our fair value estimate unchanged. Gentex's balance sheet remains a fortress with about $585 million in cash and investments and only $75 million in debt, so we reiterate our opinion that Gentex is one of the safest, if not the safest, automotive stocks to invest in during a recession for the long-term investor.

Revenue and mirror unit shipments fell 51% year over year, which was worse than the quarter's 45% decline in global light-vehicle production but better than the North American and European industry's 69% and 62% respective output declines. Adjusted diluted earnings per share of $0.02 missed the Refinitiv consensus of $0.12. The company took an $8.8 million severance charge to record layoffs across production, research, and corporate positions, which yields annualized savings of $35 million effective as of the third quarter. This expense reduction should help lead to strong earnings once vehicle volume recovers, but for now, no level of cost cuts can catch up with the severe revenue decline, so Gentex could not adequately cover its costs. Gross margin fell to 19.1% from 37.7% in the year-ago quarter.

The recovery is already underway as automaker inventories badly need to be replenished following COVID-19 shutdowns in the spring. Management did not give 2021 guidance and only gave second-half 2020 guidance. The implied full-year 2020 revenue figure is $1.55 billion-$1.59 billion; we have been modeling $1.58 billion. Even if things get worse in 2020, which we think only happens if there's another COVID-19-induced plant shutdown, we do not expect a large fair value estimate reduction after the third quarter because we'd expect Gentex's long-term earnings story to remain intact.

We Believe Gentex's Third Quarter Shows the Chance for a Strong 2021

David Whiston, Analyst, 23 October 2020

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Gentex Corp GNTX ★★[Q] 23 Oct 2020 02:00 UTC

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23 Oct 2020	23 Oct 2020 02:00 UTC	23 Oct 2020			
29.44	25.80	7,014.5 Mil	Consumer Cyclical	Auto Parts	USA United States

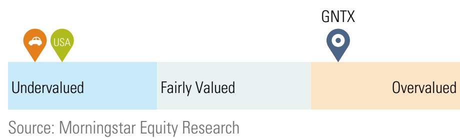
There is no one analyst in which a Quantitative Fair Value Estimate and Quantitative Star Rating are attributed to; however, Mr. Lee Davidson, Head of Quantitative Research for Morningstar, Inc., is responsible for overseeing the methodology that supports the quantitative fair value. As an employee of Morningstar, Inc., Mr. Davidson is guided by Morningstar, Inc.'s Code of Ethics and Personal Securities Trading Policy in carrying out his responsibilities. For information regarding Conflicts of Interests, visit http://global.morningstar.com/equitydisclosures

Company 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 97% of total revenue, and the company is constantly developing new applications for the technology to remain on top. Sales from 2019 totaled about $1.9 billion with 42.9 million mirrors shipped. The company is based in Zeeland, Michigan.

Quantitative Scores

		Scores All	Rel Sector	Rel Country
Quantitative Moat	Narrow	99	99	97
Valuation	Overvalued	5	4	7
Quantitative Uncertainty	Medium	100	100	98
Financial Health	Strong	97	86	97



Source: Morningstar Equity Research

Valuation

	Current	5-Yr Avg	Sector Median	Country Median
Price/Quant Fair Value	1.11	1.01	0.80	0.83
Price/Earnings	24.0	15.5	16.2	20.1
Forward P/E	19.0	—	12.3	13.9
Price/Cash Flow	16.7	12.7	10.2	13.1
Price/Free Cash Flow	19.9	16.4	17.7	19.5
Trailing Dividend Yield %	1.66	1.87	2.46	2.35
Price/Book	3.8	3.0	1.6	2.4
Price/Sales	4.4	3.4	0.9	2.4

Profitability

	Current	5-Yr Avg	Sector Median	Country Median
Return on Equity %	16.1	20.8	12.2	12.9
Return on Assets %	14.1	17.6	5.4	5.2
Revenue/Employee (K)	273.3	321.1	566.3	325.9

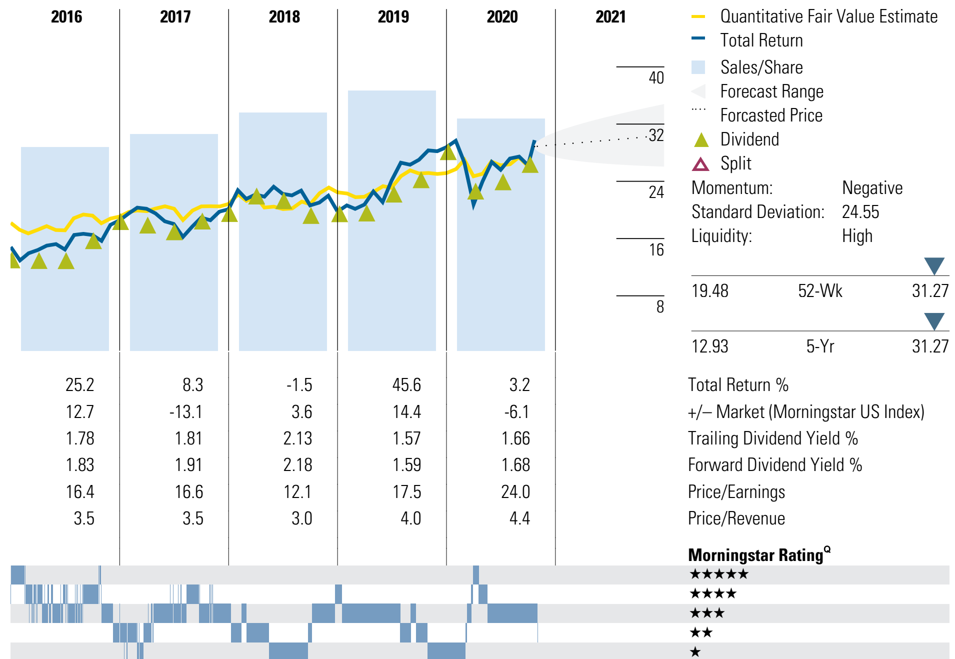
Financial Health

	Current	5-Yr Avg	Sector Median	Country Median
Distance to Default	0.8	0.8	0.6	0.5
Solvency Score	—	—	486.0	552.4
Assets/Equity	1.1	1.2	1.8	1.7
Long-Term Debt/Equity	—	—	0.2	0.4

Growth Per Share

	1-Year	3-Year	5-Year	10-Year
Revenue %	1.4	3.5	6.2	13.1
Operating Income %	-3.9	-1.5	4.1	17.8
Earnings %	2.5	11.7	11.1	21.6
Dividends %	72.7	17.1	13.0	10.0
Book Value %	7.4	5.1	7.7	11.2
Stock Total Return %	7.0	17.7	14.3	12.6

Price vs. Quantitative Fair Value



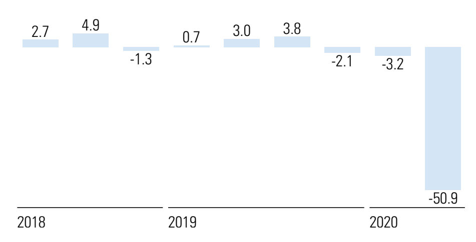
2016	2017	2018	2019	2020	2021	
25.2	8.3	-1.5	45.6	3.2		Total Return %
12.7	-13.1	3.6	14.4	-6.1		+/– Market (Morningstar US Index)
1.78	1.81	2.13	1.57	1.66		Trailing Dividend Yield %
1.83	1.91	2.18	1.59	1.68		Forward Dividend Yield %
16.4	16.6	12.1	17.5	24.0		Price/Earnings
3.5	3.5	3.0	4.0	4.4		Price/Revenue

2015	2016	2017	2018	2019	TTM	**Financials** (Fiscal Year in Mil)
1,544	1,679	1,795	1,834	1,859	1,605	Revenue
12.2	8.8	6.9	2.2	1.4	-13.6	% Change
459	512	523	508	489	337	Operating Income
15.0	11.5	2.3	-2.9	-3.9	-31.0	% Change
318	348	407	438	425	299	Net Income
352	471	501	552	506	423	Operating Cash Flow
-98	-121	-104	-86	-85	-68	Capital Spending
254	351	397	466	421	355	Free Cash Flow
16.4	20.9	22.1	25.4	22.7	22.1	% Sales
1.08	1.19	1.41	1.62	1.66	1.19	EPS
10.2	10.2	18.5	14.9	2.5	-28.3	% Change
1.00	1.01	1.22	1.67	1.80	1.44	Free Cash Flow/Share
0.34	0.36	0.39	0.33	0.57	0.47	Dividends/Share
5.74	6.45	7.23	7.11	7.65	7.42	Book Value/Share
291,338	287,738	280,281	259,329	251,278	245,780	Shares Outstanding (K)
						Profitability
19.3	19.1	20.6	22.4	22.4	16.1	Return on Equity %
15.3	15.6	17.5	19.7	20.0	14.1	Return on Assets %
20.6	20.7	22.7	23.9	22.9	18.7	Net Margin %
0.74	0.75	0.77	0.83	0.87	0.76	Asset Turnover
1.2	1.2	1.1	1.1	1.1	1.2	Financial Leverage
39.1	39.8	38.7	37.7	37.0	33.8	Gross Margin %
29.7	30.5	29.2	27.7	26.3	21.0	Operating Margin %
226	178	—	—	—	—	Long-Term Debt
1,723	1,910	2,050	1,862	1,938	1,823	Total Equity
3.9	3.8	3.7	3.7	3.7	3.3	Fixed Asset Turns

Quarterly Revenue & EPS

Revenue (Mil)	Mar	Jun	Sep	Dec	Total
2020	453.8	229.9	—	—	—
2019	468.6	468.7	477.8	443.8	1,858.9
2018	465.4	455.0	460.3	453.4	1,834.1
2017	453.5	443.1	438.6	459.6	1,794.9
Earnings Per Share ()					
2020	0.36	-0.01	—	—	—
2019	0.40	0.42	0.44	0.39	1.66
2018	0.40	0.40	0.42	0.41	1.62
2017	0.33	0.31	0.31	0.46	1.41

Revenue Growth Year On Year %



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Research Methodology for Valuing Companies

Qualitative Equity Research Overview
At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally standardized, proprietary discounted cash flow, or DCF, modeling templates. We use scenario analysis, in-depth competitive advantage analysis, and a variety of other analytical tools to augment this process. We believe this bottom-up, long-term, fundamentally based approach allows our analysts to focus on long-term business drivers, which have the greatest valuation impact, rather than short-term market noise.

Morningstar's equity research group ("we," "our") believes that a company's intrinsic worth results from the future cash flows it can generate. The Morningstar Rating for stocks identifies stocks trading at an uncertainty-adjusted discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk-adjusted discount to their fair values whereas 1-star stocks trade at premiums to their intrinsic worth.

Four key components drive the Morningstar rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's fair value, (3) our uncertainty around that fair value estimate and (4) the current market price. This process ultimately culminates in our single-point star rating.

1. Economic Moat
The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. We define excess economic profits as returns on invested capital (or ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (or WACC). Without a moat, profits are more susceptible to competition. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low-quality no-moat companies will see their normalized returns gravitate toward the firm's cost of capital more quickly than companies with moats.

To assess the direction of the underlying competitive advantages, analysts perform ongoing assessments of the moat trend. A firm's moat trend is positive in cases where we think its sources of competitive advantage are growing stronger; stable where we don't anticipate changes to competitive advantages over the next several years; or negative when we see signs of deterioration.

All the moat and moat trend ratings undergo periodic review and any changes must be approved by the Morningstar Economic Moat Committee, comprised of senior members of Morningstar's equity research department.

2. Estimated Fair Value
Combining our analysts' financial forecasts with the firm's economic moat helps us assess how long returns on invested capital are likely to exceed the firm's cost of capital. Returns of firms with a wide economic moat rating are assumed to fade to the perpetuity period over a longer period of time than the returns of narrow-moat firms, and both will fade slower than no-moat firms, increasing our estimate of their intrinsic value.

Our model is divided into three distinct stages:

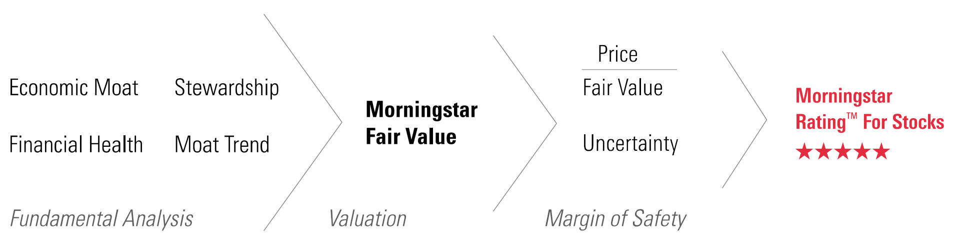
Stage I: Explicit Forecast
In this stage, which can last five to 10 years, analysts make full financial statement forecasts, including items such as revenue, profit margins, tax rates, changes in working-capital accounts, and capital spending. Based on these projections, we calculate earnings before interest, after taxes, or EBI, and the net new investment, or NNI, to derive our annual free cash flow forecast.

Stage II: Fade
The second stage of our model is the period it will take the company's return on new invested capital—the return on capital of the next dollar invested ("RONIC")—to decline (or rise) to its cost of capital. During the Stage II period, we use a formula to approximate cash flows in lieu of explicitly modeling the income statement, balance sheet, and cash flow statement as we do in Stage I. The length of the second stage depends on the strength of the company's economic moat. We forecast this period to last anywhere from one year (for companies with no economic moat) to 10–15 years or more (for wide-moat companies). During this period, cash flows are forecast using four assumptions: an average growth rate for EBI over the period, a normalized investment rate, average return on new invested capital, or RONIC, and the number of years until perpetuity, when excess returns cease. The investment rate and return on new invested capital decline until the perpetuity stage is reached. In the case of firms that do not earn their cost of capital, we assume marginal ROICs rise to the firm's cost of capital (usually attributable to less reinvestment), and we may truncate the second stage.

Stage III: Perpetuity
Once a company's marginal ROIC hits its cost of capital, we calculate a continuing value, using a standard perpetuity formula. At perpetuity, we assume that any growth or decline or investment in the business neither creates nor destroys value and that any new investment provides a return in line with estimated WACC.

Because a dollar earned today is worth more than a dollar earned tomorrow, we discount our projections of cash flows in stages I, II, and III to arrive at a total present value of expected future cash flows. Because we are modeling free cash flow to the firm—representing cash available to provide a return to all capital providers—we discount future cash flows using the WACC, which is a weighted average of the costs of equity, debt, and preferred stock (and any other funding sources), using expected future proportionate long-term market-value weights.

Morningstar Research Methodology for Valuing Companies



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Research Methodology for Valuing Companies

3. Uncertainty Around That Fair Value Estimate

Morningstar's Uncertainty Rating captures a range of likely potential intrinsic values for a company and uses it to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The Uncertainty Rating represents the analysts' ability to bound the estimated value of the shares in a company around the fair value estimate, based on the characteristics of the business underlying the stock, including operating and financial leverage, sales sensitivity to the overall economy, product concentration, pricing power, and other company-specific factors.

Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case, and a 25% probability that the company will perform worse than the bear case. The distance between the bull and bear cases is an important indicator of the uncertainty underlying the fair value estimate.

Our recommended margin of safety widens as our uncertainty of the estimated value of the equity increases. The more uncertain we are about the estimated value of the equity, the greater the discount we require relative to our estimate of the value of the firm before we would recommend the purchase of the shares. In addition, the uncertainty rating provides guidance in portfolio construction based on risk tolerance.

Our uncertainty ratings for our qualitative analysis are low, medium, high, very high, and extreme.

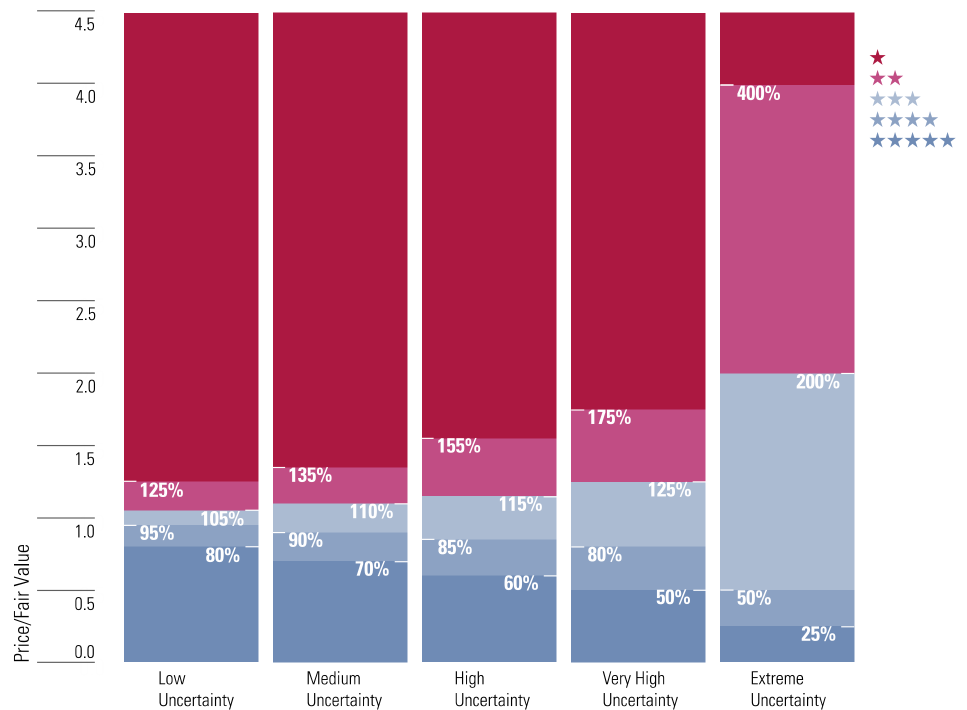
- Low–margin of safety for 5-star rating is a 20% discount and for 1-star rating is 25% premium.
- Medium–margin of safety for 5-star rating is a 30% discount and for 1-star rating is 35% premium.
- High–margin of safety for 5-star rating is a 40% discount and for 1-star rating is 55% premium.
- Very High–margin of safety for 5-star rating is a 50% discount and for 1-star rating is 75% premium.
- Extreme–margin of safety for 5-star rating is a 75% discount and for 1-star rating is 300% premium.

4. Market Price

The market prices used in this analysis and noted in the report come from exchange on which the stock is listed, which we believe is a reliable source.

For more details about our methodology, please go to https://shareholders.morningstar.com.

Morningstar Equity Research Star Rating Methodology



Morningstar Star Rating for Stocks

Once we determine the fair value estimate of a stock, we compare it with the stock's current market price on a daily basis, and the star rating is automatically re-calculated at the market close on every day the market on which the stock is listed is open.

Please note, there is no predefined distribution of stars. That is, the percentage of stocks that earn 5 stars can fluctuate daily, so the star ratings, in the aggregate, can serve as a gauge of the broader market's valuation. When there are many 5-star stocks, the stock market as a whole is more undervalued, in our opinion, than when very few companies garner our highest rating.

We expect that if our base-case assumptions are true the market price will converge on our fair value estimate over time, generally within three years (although it is impossible to predict the exact time frame in which market prices may adjust).

Our star ratings are guideposts to a broad audience and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors.

The Morningstar Star Ratings for stocks are defined below:

★★★★★ We believe appreciation beyond a fair risk-adjusted return is highly likely over a multiyear time frame. The current market price represents an excessively pessimistic outlook, limiting downside risk and maximizing upside potential.

★★★★ We believe appreciation beyond a fair risk-adjusted return is likely.

★★★ Indicates our belief that investors are likely to receive a fair risk-adjusted return (approximately cost of equity).

★★ We believe investors are likely to receive a less than fair risk-adjusted return.

★ Indicates a high probability of undesirable risk-adjusted returns from the current market price over a multiyear time frame, based on our analysis. The market is pricing in an excessively optimistic outlook, limiting upside potential and leaving the investor exposed to Capital loss.

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Other Definitions

Last Price: Price of the stock as of the close of the market of the last trading day before date of the report.

Stewardship Rating: Represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions.

Quantitative Valuation: Using the below terms, intended to denote the relationship between the security's Last Price and Morningstar's quantitative fair value estimate for that security.

- ► Undervalued: Last Price is below Morningstar's quantitative fair value estimate.
- ► Fairly Valued: Last Price is in line with Morningstar's quantitative fair value estimate.
- ► Overvalued: Last Price is above Morningstar's quantitative fair value estimate.

Risk Warning

Please note that investments in securities are subject to market and other risks and there is no assurance or guarantee that the intended investment objectives will be achieved. Past performance of a security may or may not be sustained in future and is no indication of future performance. A security investment return and an investor's principal value will fluctuate so that, when redeemed, an investor's shares may be worth more or less than their original cost. A security's current investment performance may be lower or higher than the investment performance noted within the report. Morningstar's Uncertainty Rating serves as a useful data point with respect to sensitivity analysis of the assumptions used in our determining a fair value price.

Quantitative Equity Reports Overview

The quantitative report on equities consists of data, statistics and quantitative equity ratings on equity securities. Morningstar, Inc.'s quantitative equity ratings are forward looking and are generated by a statistical model that is based on Morningstar Inc.'s analyst-driven equity ratings and quantitative statistics. Given the nature of the quantitative report and the quantitative ratings, there is no one analyst in which a given report is attributed to; however, Mr. Lee Davidson, Head of Quantitative Research for Morningstar, Inc., is responsible for overseeing the methodology that supports the quantitative equity ratings used in this report. As an employee of Morningstar, Inc., Mr. Davidson is guided by Morningstar, Inc.'s Code of Ethics and Personal Securities Trading Policy in carrying out his responsibilities.

Quantitative Equity Ratings

Morningstar's quantitative equity ratings consist of:
(i) Quantitative Fair Value Estimate
(ii) Quantitative Star Rating
(iii) Quantitative Uncertainty
(iv) Quantitative Economic Moat
(v) Quantitative Financial Health
(collectively the "Quantitative Ratings").

The Quantitative Ratings are calculated daily and derived from the analyst-driven ratings of a company's peers as determined by statistical algorithms. Morningstar, Inc. (""Morningstar," "we," "our") calculates Quantitative Ratings for companies whether it already provides analyst ratings and qualitative coverage. In some cases, the Quantitative Ratings may differ from the analyst ratings because a company's analyst-driven ratings can significantly differ from other companies in its peer group.

Quantitative Fair Value Estimate: Intended to represent Morningstar's estimate of the per share dollar amount that a company's equity is worth today. Morningstar calculates the quantitative fair value estimate using a statistical model derived from the fair value estimate Morningstar's equity analysts assign to companies. Please go to https://shareholders.morningstar.com for information about fair value estimates Morningstar's equity analysts assign to companies.

Quantitative Economic Moat: Intended to describe the strength of a firm's competitive position. It is calculated using an algorithm designed to predict the Economic Moat rating a Morningstar analyst would assign to the stock. The rating is expressed as Narrow, Wide, or None.

- ► Narrow: assigned when the probability of a stock receiving a "Wide Moat" rating by an analyst is greater than 70% but less than 99%.
- ► Wide: assigned when the probability of a stock receiving a "Wide Moat" rating by an analyst is greater than 99%.
- ► None: assigned when the probability of an analyst receiving a "Wide Moat" rating by an analyst is less than 70%.

Quantitative Star Rating: Intended to be the summary rating based on the combination of our Quantitative Fair Value Estimate, current market price, and the Quantitative Uncertainty Rating. The rating is expressed as 1-Star, 2-Star, 3-Star, 4-Star, and 5-Star.

★: the stock is overvalued with a reasonable margin of safety.
Log (Quant FVE/Price)<–1*Quantitative Uncertainty

★★: the stock is somewhat overvalued.
Log (Quant FVE/Price) between (–1*Quantitative Uncertainty, –0.5*Quantitative Uncertainty)

★★★: the stock is approximately fairly valued.
Log (Quant FVE/Price) between (–0.5*Quantitative Uncertainty, 0.5*Quantitative Uncertainty)

★★★★: the stock is somewhat undervalued.
Log (Quant FVE/Price) between (0.5*Quantitative Uncertainty, 1*Quantitative Uncertainty)

★★★★★: the stock is undervalued with a reasonable margin of safety. Log (Quant FVE/Price) >1*Quantitative Uncertainty

Quantitative Uncertainty: Intended to represent Morningstar's level of uncertainty about the accuracy of the quantitative fair value estimate. Generally, the lower the quantitative Uncertainty, the narrower the potential range of outcomes for that particular company. The rating is expressed as Low, Medium, High, Very High, and Extreme.

- ► Low: the interquartile range for possible fair values is less than 10%.
- ► Medium: the interquartile range for possible fair values is less than 15% but greater than 10%.
- ► High: the interquartile range for possible fair values is less than 35% but greater than 15%.
- ► Very High: the interquartile range for possible fair values is less than 80% but greater than 35%.
- ► Extreme: the interquartile range for possible fair values is greater than 80%.

Quantitative Financial Health: Intended to reflect the probability that a firm will face financial distress in the near future. The calculation uses a predictive model designed to anticipate when a company may default on its financial obligations. The rating is expressed as Weak, Moderate, and Strong.

- ► Weak: assigned when Quantitative Financial Health <0.2
- ► Moderate: assigned when Quantitative Financial Health is between 0.2 and 0.7
- ► Strong: assigned when Quantitative Financial Health >0.7

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This Report has not been made available to the issuer of the security prior to publication.

Risk Warning

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The quantitative equity ratings are not statements of fact. Morningstar does not guarantee the completeness or accuracy of the assumptions or models used in determining the quantitative equity ratings. In addition, there is the risk that the price target will not be met due to such things as unforeseen changes in demand for the company's products, changes in management, technology, economic development, interest rate development, operating and/or material costs, competitive pressure, supervisory law, exchange rate, and tax rate. For investments in foreign markets there are further risks, generally based on exchange rate changes or changes in political and social conditions.

A change in the fundamental factors underlying the quantitative equity ratings can mean that the valuation is subsequently no longer accurate.

For more information about Morningstar's quantitative methodology, please visit http://global.morningstar.com/equitydisclosures.

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Gentex Corp GNTX (XNAS)

Morningstar Rating	Last Price	Fair Value Estimate	Price/Fair Value	Trailing Dividend Yield %	Forward Dividend Yield %	Market Cap (Bil)	Industry	Stewardship
★★★	29.44 USD	31.00 USD	0.95	1.66	1.68	7.01	Auto Parts	Standard
23 Oct 2020 21:43, UTC	23 Oct 2020	23 Oct 2020 21:42, UTC		23 Oct 2020	23 Oct 2020	23 Oct 2020		

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