Gentex Corp GNTX

Gentex's gross margins have been strong but we do not see that lasting forever.

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Analyst Note 04/22/2015

Gentex reported first-quarter results that gave us no reason to change our fair value estimate or moat rating. Diluted earnings per share increased 13% from the prior year's quarter to $0.26, beating consensus of $0.25. Revenue increased 10% to $368.9 million, which slightly beat consensus of $367.3 million. Given Gentex's dominant position in auto-dimming mirrors, we are not surprised to see the company increase mirror unit shipments by 11% despite a 2% decline in industry light-vehicle production across Gentex's main markets. Exterior mirror volume increased 23% while interior rose 7% as the company's new exterior products with advanced features such as lane departure gain traction.

We were very encouraged to hear on the call that many advanced product lines continue to grow in both sedans and light-truck models but especially in B and C segment vehicles. We have long said that compact vehicles in the U.S. are no longer cheap "econoboxes" and that these vehicles, along with safety rules and consumer demand, will pull high-tech content into these smaller vehicle segments.

HomeLink continues to have a healthy growth runway in its core North American market, where penetration continues to grow and is now over 40%. European penetration remains an opportunity with very low single digit penetration today, and management spoke of introducing HomeLink to China but gave no timeline. New geographic markets combined with new markets in North America via motorcycles and ATVs give this very high gross margin business plenty of growth runway in our view.

The company continues to repurchase shares in an attempt to keep its cash hoard in check. During the first quarter the company repurchased 1.4 million shares for $25 million and will repurchase shares going forward based on macroeconomic conditions, market trends, and other factors. The repurchase plan does not expire and we estimate that it has about 4.8 million shares of authorization remaining.

Investment Thesis 03/02/2015

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 1,000 patents worldwide, some valid through 2039, and a dominant 90% 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

Morningstar's Take GNTX

Analyst

Price 05-18-2015	**Fair Value Estimate**	**Uncertainty**
17.57 USD	18 USD	High
Consider Buy	**Consider Sell**	**Economic Moat**
10.8 USD	27.9 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 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	**$17.57**	**0.40**	**1,409**
Johnson Controls Inc	$50.46	-0.04	42,686
Continental AG ADR	$48.23	0.21	40,827
Continental AG	$234.00	0.00	40,827
Denso Corp ADR	$26.58	1.35	35,538
Denso Corp	$49.77	0.30	35,538

exterior auto-dimming mirror. Management believes that during the next 10-12 years, auto-dimming mirrors can achieve about 45% market share. This 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. 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 on the Ford Explorer that combines SmartBeam technology with driver assistance firm Mobileye's lane departure technology. Active safety is a very fast-growing field, so this product may show up on other vehicle programs.

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, lawnmowers, ATVs, and farm vehicles. With plenty of cash and a fortress balance sheet, Gentex has lots of room to grow.

Economic Moat 03/02/2015

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 90%. 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 90% of auto-dimming mirrors from 85% 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 more than 20% 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 03/02/2015

We are raising our fair value estimate to $18 per share from $15. We've recalibrated our capital cost assumptions for Gentex to better align with the returns equity and debt investors are likely to demand over the long-run. We now assume a 9% cost of equity, down from 10% so as to match the 9% rate of return we expect investors will demand of a diversified equity portfolio. Our pre-tax cost of debt assumption rises to 5.8% from 4% as we move to incorporate a normalized long-term real rate environment into our model (2.25% for inflation-protected Treasuries), while taking into account the spread creditors are likely to demand given the company's credit quality. A 2.25% long-term inflation outlook underpins our capital cost assumptions. Given Gentex's nearly all equity capital structure, these changes cause our weighted average cost of capital assumption to decline 80 basis points to 8.8%. We model revenue to increase over 8% on a five-year compound annual basis and operating margins to average nearly 28% 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 more rapid increase in penetration throughout our forecast period than previously modeled 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. We think the firm's manufacturing efficiency, product expertise, and high-tech products will keep gross margins higher than in recent years but continued R&D and overhead spending will prevent major operating margin expansion. We project capital expenditures to average nearly 7% of revenue per year and R&D expense of about 7% of revenue on average. We model Gentex's auto-dimming mirror market share going to 91% from 90% 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 03/02/2015

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. Although we think this risk is more than a decade away from becoming a reality should it even occur, our fair value estimate may be severely reduced if such legislation became more than a remote possibility. The company's expertise in camera systems, however, may make this legislative risk far less problematic than Gentex's critics fear. 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, we recently raised our fair value uncertainty rating to high from medium.

Management 03/02/2015

Chairman and CEO Fred Bauer, 72, founded Gentex in 1974 and owns 3.1% 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, 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. 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. The buyback plan does not expire and has authorization at Dec. 31 to repurchase another 6.2 million shares. We think management recognizes when its shares are cheap enough to buy back, but wish it would act on that knowledge sooner. We think Bauer's capital-allocation preference is share repurchases because of his dislike of the double taxation of dividends.

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 97% of total revenue, and the company is constantly developing new applications for the technology to remain on top. Sales from 2014 totaled about $1.4 billion on 29 million units shipped. The company is based in Zeeland, Michigan.