Gentex Corp GNTX

We see Gentex's growth runway as long but not free of headwinds.

Investment Thesis 01/05/2018

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 92% market share, up from 77% in 2003, 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 2016, 28% of all cars had interior auto-dimming mirrors, and 8% had at least one exterior auto-dimming mirror. Demand remains robust with annual revenue growth the past two years at 12% and 9%. 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. 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 at high speed. Other growth areas include biometrics in mirrors 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 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 01/05/2018

Gentex's cost advantage from economies of scale, its customers' switching costs, efficient scale, 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 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

Morningstar's Take GNTX

Analyst

Price 09-27-2019	Fair Value Estimate	Uncertainty
		High

Economic Moat
Narrow

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 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 recently 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.

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.

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 mid-20s over our five-year forecast period.

Valuation 10/20/2017

Our fair value estimate is $20 per share. We expect tax reform lowering the federal statutory rate to 25% from 35% and eliminating business tax credits for research and U.S. production. We model revenue to increase about 5% on a five-year compound annual basis and operating margins to average about 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 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 two vehicles with this mirror and think that the full display mirror is far safer than a conventional auto-dimming mirror. Although major revenue growth 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 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 7.1% 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 94% 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. In our opinion, Gentex would benefit from any major reduction in U.S. corporate tax rates because it makes all its products in Michigan.

Risk 01/05/2018

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.

Management 01/05/2018

Former chairman and CEO Fred Bauer, 74, 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. He will be paid $596,000 in 2018, $447,000 in 2019 and 2020, and $298,000 in 2021 and 2022. Bauer also receives a $2.1 million retirement payout, and Gentex will buy a building it uses owned by Bauer for $950,000. Gentex will also repurchase between about 5.5 million and 6.4 million Gentex shares owned by Bauer, about 2.3% of the company per the last proxy filing 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 will become chairman while president, interim CFO, and treasurer Steve Downing, 39, is now CEO. 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. He is no longer COO but remains interim CFO. We think Downing is holding too many roles at this point; we'd like to see him hire a new CFO and relinquish the treasurer role to focus on being CEO. Downing does not have an employment agreement, but that may change now that he is CEO.

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 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 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. Management did buy back stock to lower the 2016 share count by 1.7% from 2015 and repurchased over 2% of the company in 2018 by buying back Bauer's shares upon his retirement.

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, and $163.4 million in 2016. Repurchases continued in 2017 at a robust rate, more than offsetting dilution from stock-based compensation. The buyback plan does not expire and has authorization to repurchase another approximately 14.9 million shares as of September. 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 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. We expect Downing to continue buybacks.

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 2016 totaled about $1.7 billion on 36.1 million mirrors shipped. The company is based in Zeeland, Michigan.