Morningstar on Gentex

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**Gentex Corp**

GNTX: XNAS (USA)

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| --- | --- | --- | --- |
| **Morningstar Rating for Stocks** | **Fair Value** | **Economic Moat** | **Capital Allocation** |
|  | $38.00 | Narrow | Standard |

**Gentex Targets Further Gross Margin Expansion**



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Mar 13, 2024

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[David Whiston](https://www.morningstar.com/people/david-whiston)

Jul 26, 2024

**Business Strategy and Outlook**

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 2,200 patents worldwide, some valid through 2048, and nearly 90% market share, up from 77% in 2003, Gentex has a narrow economic moat it should be able to protect for a long time, in our opinion.

The growth prospects for auto-dimming mirrors look strong. We estimate that in 2023, over 35% of all light vehicles produced had interior auto-dimming mirrors, and exterior auto-dimming mirror penetration is far below interior. Demand remains healthy with annual revenue growth often exceeding industry vehicle production growth. Growth will come from increased vehicle penetration as more automakers 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.

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 and nanofiber chemical sensing technology, which we see having application in autonomous ride hailing, dimmable sunroofs, universal toll payments, and a partnership with Simplenight for booking entertainment or e-commerce activities in the vehicle. Gentex also owns HomeLink, an in-vehicle connectivity system linking the vehicle to one's residence for garage or Internet of Things applications.

The future beyond autos (98% of revenue) looks bright to us, too. The company supplies auto-dimming passenger windows for the Boeing 787 and 777X and the Airbus A350. Gentex is also exploring healthcare smart lighting applications with the Mayo Clinic, movable lighting in airplane passenger cabins, nanofiber sensing that could have security uses outside of the auto industry, and using its camera technology to help the visually impaired.

**Bulls Say, Bears Say**

**Bulls**

Auto-dimming technology has applications to other parts of the car like headlights, as well as airplane windows and healthcare. 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 US easier than other auto suppliers can.

Biometrics, nanosensing, surgical room ultraviolet lighting, airplane windows, and electronic toll payments could open up meaningful new revenue streams for the company.

**Bears**

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 at times 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.

**Financial Strength**

Gentex is in excellent financial shape, with no debt, pension, or unions, and $226.4 million of cash on its balance sheet at the end of 2023. Cash and investments were about 20% of total assets at that time. The company has ample cash on hand to fund more R&D or a higher dividend if the board chooses. Total cash and investments were $525.5 million, or $2.29 per diluted share by our estimate. The company also does not have to deal much with foreign-exchange risk because over 90% of its customers pay in US dollars. Gentex has been paying a dividend since 2003. It took on $275 million of debt for the HomeLink acquisition which it finished paying off in 2018. In February 2023, Gentex obtained a $250 million unsecured credit facility that expires in February 2026. The line's capacity includes $35 million in swing loans and $20 million from letters of credit.

We prefer to see cash returned to shareholders via a higher dividend or share repurchases when the stock is trading below its intrinsic value. The investments to us look conservative and mostly consist of government bonds (including municipal bonds), corporate debt, and asset-backed securities loans. As of March 2018, the company targets cash and investments of $525 million, down from its previous target of $700 million. Management will often just speak in loose terms and say it targets around $500 million.

**Economic Moat**

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 enabled the firm to increase its auto-dimming mirror share to 89% in 2023. 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 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 from the low 80s in earlier 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 2011 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 original equipment manufacturers 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 expands 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 the company's consistent quality (in the mirror and 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 that 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 $40-$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 autonomous vehicles 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 low-20s during our five-year forecast period.

**Fair Value and Profit Drivers**

We are maintaining our fair value estimate of $38 per share for Gentex. Capital expenditure is tracking to be higher in 2023-24 than in recent years due to some capital investments delayed in 2020 and 2021 from the pandemic that were supposed to be done in 2022. However, that 2022 spending never happened due to a lack of available materials and equipment, so 2023 and 2024 are catch-up years and we model 2025 capital spending about 40% lower than our 2024 projection of about $250 million.

We model revenue to increase about 5.5% on a five-year compound annual basis. The gross margin averages slightly over 35% and management targets an end-2024 exit rate for gross margin expansion to 35%-36%, which we believe it can achieve. In early 2021, Gentex talked about gross margin returning long term to 38.5%-39.5% but has changed its thinking due to its newer low-cost base mirror product for Southeast Asia and a shifting product and geographic mix making that level unlikely to reach. For example, newly acquired and developed sensing technology for driver and cabin monitoring has a slightly lower gross margin than 39% and should gain penetration over time via demand for cabin monitoring sensors in robotaxi fleets and for more automakers wanting safety features for driver monitoring in personally owned vehicles. We model the operating margin to average about 23.7% during our five-year explicit forecast period and a midcycle level of about 25%. We model strong return assumptions beyond our five-year explicit forecast period because we think Gentex can deliver robust growth over time.

We project revenue based on a global vehicle production forecast, global auto-dimming mirror penetration, Gentex’s market share, and content per vehicle. We assume a continued increase in penetration for most of our forecast period due to attractive growth prospects from currently low penetration globally and Gentex's history. We believe additional margin expansion will remain difficult, but not impossible, since automakers always seek price concessions. On the October 2023 earnings call, management said it is aggressively seeking price renegotiation with about 20 electronics providers and 10 commodity vendors to combat what it sees as unreasonable continued price hikes by vendors despite improving supply chain conditions. If vendors do not cooperate, Gentex will terminate all or major pieces of its procurement with that firm and source elsewhere or internally. These efforts should help gross margin improve over 2024-25 versus recent levels.

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. Gentex increased FDM shipments by 50% in 2022 from 2021 and by another 45% in 2023 over 2022 to 2.44 million units, or 4.8% of total units. We think FDM has the potential to be in every vehicle in the developed world due to its superior function over a normal mirror. Gentex had FDM contracts with 14 automakers at end-2023, including General Motors and Toyota, covering about 86 models. We think its manufacturing efficiency, product expertise, and high-tech products will keep gross margin in the mid-30s, but continued research and development, annual price reductions, supply chain disruptions, and overhead spending will prevent major operating margin expansion. We project average annual capital expenditure averaging over 6% of revenue over our forecast period. We model annual capital spending at about 5% of revenue in the outer years of our forecast and R&D expenses of over 7% of revenue annually on average. Our weighted average cost of capital is 9%.

We model Gentex's auto-dimming mirror market share leveling off in the low-90s 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.

**Price vs Fair Value**

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GNTX is trading at a 18% discount.

**Price**

$31.20

Jul 26, 2024

**Fair Value**

$38.00

Jul 28, 2023

**Uncertainty**

Medium

**1-Star Price**

$51.30

**5-Star Price**

$26.60

**Economic Moat**

Narrow

**Capital Allocation**

Standard

Terms

**Risk and Uncertainty**

Our Morningstar Uncertainty Rating for Gentex is Medium. 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. Also, there is 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. 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. Competition for engineering talent is fierce, and Gentex may have difficulty attracting good talent to Western Michigan. Environmental, social, and governance issues for supply chain disruptions beyond Gentex’s control are a risk as well.

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 away, 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. Display images can cause motion sickness for some drivers as well. A dual camera/mirror system, which Gentex manufactures, provides a redundancy for safety in case a camera’s lens is blocked by weather or debris on the lens.

**Capital Allocation**

We award Gentex a Standard Morningstar Capital Allocation Rating under our capital allocation methodology that focuses on balance sheet health, investments, and shareholder distributions. We’ve long considered Gentex’s balance sheet a cash-rich and often debt-free fortress. There is no debt outstanding at end-2023, which is usually the case unless Gentex makes a large acquisition such as HomeLink. Gentex borrowed $75 million on its then $150 million credit line at the onset of the pandemic in 2020, but we think it did this because it just wanted to remind the bank it was still there rather than because it needed the money. The draw was repaid in the third and fourth quarters that year. Gentex did not need any debt during the Great Recession. We’ve long heard criticism from Gentex investors on being debt-free due to cost of capital and shareholder returns, and management has become more generous on buybacks since Steve Downing took over as CEO in January 2018. The cost of capital argument is valid, but we are fine with Gentex remaining debt-free as we believe a strong balance sheet is an underrated asset in the auto industry. In times of crisis, Gentex can keep receiving inventory because its vendors know it will pay them, or buy back stock after a large selloff. Plus, this liquidity, in our view, means financial distress for Gentex is not something shareholders need to worry about.

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%-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. We'd like to at least see management repurchase shares to offset dilution from stock-based compensation, which it has comfortably done in recent years.

The cash and investment hoard of $525.5 million at end-2023 gives the company plenty of funds to reinvest in the business as well as make acquisitions in emerging fields such as nanotechnology and fund camera sensing technology for autonomous vehicles or nonautomotive lighting and dimming products for aerospace and healthcare. Downing has said many times Gentex has to make its products obsolete or someone else will, so we think management is prudently thinking and investing for the future. In 2018, Downing lowered the company’s cash and investment target to $525 million. Management will often just speak in loose terms and say it targets around $500 million. There remains plenty of funds for a dividend increase if management wants to go that route, but it may not due to needing the flexibility to use the cash for reinvesting in the business, which for a technology-focused firm should remain the top capital allocation priority, in our view. We expect a 2024 dividend hike because 2023 net income returned to 2019 levels, a benchmark that management was waiting for.

After founder Fred Bauer retired in January 2018, new leadership under Downing became more aggressive with share buybacks. The diluted share count at end-2023 is down by about 23% since the end of 2015. We calculate that management bought back shares in 2023 at an average price per share of $29.67, and cumulative buybacks for 2003-23 at $2.7 billion were at an average price per share of $17.59. Management's comments to us indicate it is willing to repurchase stock even during 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 the second quarter of 2020, but did in the second half of 2020, so we think management's actions match its words on buybacks. The buyback plan does not expire and has 15.9 million shares of remaining authorization at the end of 2023.

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 in 2018 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 he disliked the double taxation of dividends. The company only started paying a dividend after US tax cuts in 2003. 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. So far, Downing’s preference seems to be remaining debt-free when possible.

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