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GNTX - Q4 2016 Gentex Corp Earnings Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen. Welcome to the Gentex reports fourth-quarter 2016 and year-end financial results conference call. Today's call is being recorded.

And now I would like to turn the meeting over to Mr. Josh O'Berski with Gentex, Investor Relations Manager. Please go ahead, sir.

Josh O'Berski - *Gentex Corporation - IR Manager*

Thank you. Good morning and welcome to the Gentex Corporation fourth-quarter 2016 earnings release conference call. I'm Josh O'Berski, Gentex Investor Relations Manager and I'm joined by Steve Downing, Senior Vice President and Chief Financial Officer; Kevin Nash, Vice President and Chief Accounting Officer; and Neil Boehm, Vice President of Engineering. This call is live on the Internet by way of an icon on the Gentex website at www.Gentex.com. All contents of this conference call are the property of Gentex Corporation and may not be copied, published, reproduced, rebroadcast, retransmitted, transcribed or otherwise redistributed.

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This conference call contains forward-looking information within the meaning of Gentex's Safe Harbor statement included in the Gentex reports fourth-quarter and year-end 2016 financial results press release from earlier this morning, and, as always, shown on the Gentex website.

Your participation in this conference call implies consent to these terms.

Now I'll turn the call over to Steve Downing who will give the fourth-quarter 2016 financial summary.

Steve Downing - *Gentex Corporation - SVP and CFO*

Thank you, Josh. For the fourth quarter of 2016, the Company reported net sales of $419.9 million, an increase of 4% compared to net sales of $405.6 million for the fourth quarter of 2015. The increase was primarily due to a 4% increase in auto dimming interior and exterior rearview mirror shipments on a quarter-over-quarter basis. During the fourth quarter of 2016, a raw material shortage of a specific commodity which is used in the majority of the Company's interior and exterior auto dimming mirrors impacted the ability of the Company to meet full customer demand for the fourth quarter, and resulted in a negative impact to unit shipments and revenue for the quarter.

Also during the most recently completed quarter, incremental plant shutdowns at OEMs and inventory adjustments at certain Tier 1 customers negatively impacted quarterly unit shipments and revenue. The combined negative impact on revenue of these issues was approximately $15 million in the quarter.

For calendar year 2016, the Company's net sales increased 9% to $1.68 billion compared to $1.54 billion for calendar year 2015, primarily as a result of a 9% increase in auto dimming interior and exterior mirror unit shipments.

The gross profit margin in the fourth quarter of 2016 was 40.3% compared with a gross profit margin of 40.2% in the fourth quarter of 2015. The positive impact of strong advanced feature shipments during the quarter, as well as purchasing cost reductions, more than offset the costs and inefficiencies associated with the aforementioned raw material shortage and sales shortfall, as well as the customary impacts related to annual customer price reductions.

For calendar year 2016, the gross profit margin was 39.8% compared with a gross profit margin of 39.1% for calendar year 2015.

For the full year, favorable product mix, as well as purchasing cost reductions, more than offset the impact of annual customer price reductions.

Operating expenses during the fourth quarter of 2016 were $41.2 million, up 13% compared to operating expenses of $36.6 million in the fourth quarter of 2015. Operating expenses during the quarter were higher than anticipated primarily due to premium freight charges and travel costs associated with the aforementioned raw material shortages as well as foreign office expenses, which were impacted by unfavorable exchange rates. In total, these costs negatively impacted fourth-quarter operating expenses by approximately $1.2 million.

For calendar year 2016, operating expenses were $156.7 million, up 8%, compared to $145 million in calendar year 2015. For calendar year 2016, operating income increased 11.5% to $511.7 million, up from $458.8 million in calendar year 2015.

Net income for the fourth quarter of 2016 was $88.8 million compared to net income of $88.4 million in the fourth quarter of 2015. Net income in calendar year 2016 was $347.6 million, up 9% compared with net income of $318.5 million in calendar year 2015.

Earnings per diluted share in the fourth quarter of 2016 were $0.31 compared with earnings per diluted share of $0.30 in the fourth quarter of 2015. Earnings per diluted share were $1.19 for calendar year 2016 compared with $1.08 for calendar year 2015.

During the fourth-quarter 2016, the Company repurchased 2.3 million shares of its common stock at an average price of $17.94 per share; and for the year ended December 31, 2016, repurchased 10.3 million shares of its common stock at an average price of $15.85 per share, pursuant to its previously announced share repurchase plan.

As of December 31, 2016, the Company had 6.7 million shares remaining available for repurchase in the plan. The Company intends to continue to repurchase additional shares of its common stock in the future, depending on macroeconomic issues, market trends, and other factors that the Company deems appropriate.

During the fourth quarter of 2016, the Company made additional debt payments on its revolver of $15 million; and for calendar year 2016, paid down $40 million, which was in addition to normally scheduled principal payments on the Company's term loan of $1.9 million and $7.5 million for the fourth-quarter and calendar-year 2016, respectively.

The Company may, at its discretion, pay additional principal towards its loans in the future, depending on macroeconomic trends, capital expenditure spending, cash and money market interest rates, the amount of available free cash, and other factors that it deems appropriate for timing and amounts of incremental debt payments.

Now I'll turn the call over to Kevin Nash with fourth-quarter 2016 financial details.

Kevin Nash - *Gentex Corporation - VP and CAO*

Thank you, Steve. Auto dimming unit shipments in the fourth quarter of 2016 increased 4% compared with the fourth quarter of 2015; and for calendar year 2016, increased 9% compared to calendar year 2015. As a result, automotive net sales in the fourth quarter were $411.5 million, up 4% compared with $395.9 million in the fourth quarter of 2015; and for calendar 2016, were $1.64 billion, up 9% compared with $1.51 billion in calendar 2015.

Other net sales were $8.4 million in the fourth quarter of 2016, down 13% compared with $9.7 million in the fourth quarter of 2015; but for calendar 2016, were up 7% to $39.2 million when compared with $36.7 million in calendar year 2015, primarily due to a 15% year-over-year increase in fire protection sales.

The effective tax rate during the fourth quarter of 2016 was 31.2%, which varied from the statutory rate of 35% primarily due to the domestic manufacturing deduction.

Now for some balance sheet items which represent comparisons of December 31, 2016, versus December 31, 2015, unless otherwise noted. Cash and cash equivalents were $546.5 million, down $5.1 million from $551.6 million, due to share repurchases, capital expenditures, purchase of short-term investments, cash dividends, and accelerated debt repayments; but was mostly offset by cash flow from operations during the year.

Accounts receivable was $211.6 million, up from $196 million, primarily due to the timing of sales within each of the periods. Inventories were $189.3 million, up from $174.7 million. Short-term investments were $177 million, up from $4.5 million. Long-term investments were $49.9 million, down from $95.2 million, both of which were driven by changes in investment mix. Accounts payable was $80 million, up from $66.4 million, primarily due to increased inventory purchases and capital expenditures. And accrued liabilities were $69.9 million, up from $64.7 million.

Cash flow from operations for the fourth quarter of 2016 increased to $118.4 million from $68.4 million in the fourth quarter of 2015; and year-to-date cash flow from operations increased to $471.5 million from $351.6 million in calendar year 2015, both primarily due to increases in net income and changes in working capital.

Capital expenditures for the fourth quarter were $29.5 million compared with $35.7 million in the fourth quarter of 2015; and calendar year 2016 CapEx was $121 million compared with $97.9 million for calendar year [2015]. Lastly, depreciation and amortization expense for the fourth quarter was $19.7 million; and for calendar year 2016, was $88.6 million.

I will now hand the call back over to Steve for a business development update.

Steve Downing - *Gentex Corporation - SVP and CFO*

Thanks, Kevin. Despite the supplier issues and inventory adjustments that occurred recently, the fourth quarter and last few weeks have been a very exciting time for Gentex. The Company presented at the SEMA automotive aftermarket show in November and debuted our new aftermarket version of the full display mirror, as well as the new HomeLink module designed for utility and ATV vehicles.

This event was followed quickly by the CES Show in January, where the Company debuted several new technologies. Our booth this year was anchored by new products that addressed two of the emerging trends in automotive: camera monitoring systems, or CMS; and the connected car. The Gentex product offering showed a fully functional three-camera system in combination with our new full display mirror.

Two of the three cameras were housed in newly designed exterior mirrors behind our electrochromic glass, while the third camera was located in the shark fin antenna on the roof of the vehicle. The exterior mirrors were designed as a much smaller package to reduce weight and drag while improving fuel economy. This system offered the benefits of our full auto dimming capability and functionality, while providing a protected and ideal location for the cameras.

The third camera, which was uniquely packaged in the shark fin antenna, offers a high location on the car with optimal field of view and the best overall performance for bad weather environments.

These three camera feeds were then combined into our new, generation 2, full display mirror as the location of the video output and demonstrated several new display concepts that included software-enhanced images, dynamic warning indicators, split screens, as well as stitched imagery that displayed all three cameras together into a single panoramic view.

We believe this combination of traditional electrochromic mirrors and the new digital camera and display technology is a unique solution that addresses all use cases and offers the consumer the safest and most user-friendly combination of technologies available today.

The second major area of focus for Gentex at CES was related to connected car technology. One of the new product offerings included the evolution of HomeLink technology. This new product integrates low-energy Bluetooth into our HomeLink device that allows the consumer to connect their smart device with the HomeLink module in the car, and thereby be able to accomplish normal HomeLink operation and home automation functionality through a single push of a HomeLink button.

Gentex has created a cloud-based API that interfaces with many of the mainstream home automation systems and leverages the mobile device for easy integration, and helps protect the integrity of the vehicle by not embedding those software components directly onto the vehicle bus system.

Additionally, Gentex showed a functional prototype of our Integrated Toll Module System, or ITM, that debuted at CES in 2016. Recently, we have signed an extension of our agreement with our partner, TransCore, which now enables us to offer the ITM system in Canada and Mexico, in addition to the United States.

The Gentex product offering now includes connected car to home products through HomeLink, and connected car to infrastructure through our Integrated Toll Module solution. HomeLink and ITM together include a critical security device and enable a transactional car environment. These new products led us to the realization of a need to find a secure solution for the vehicle environment.

Our last new product announcement at CES was an embedded biometric solution for vehicles that leverages iris scanning technology to create a secure environment in the vehicle. Gentex displayed a functional proof of concept that was capable of registering people in just a few seconds. There are many use cases for authentication in the car, which range from vehicle security to start functionality to personalization of mirrors, music, seat location and temperature, to the ability to control transactions; not only for our Integrated Toll Module system, but also for the ride-sharing car of the future.

I will now and the call over to Neil Boehm for a product and technology update.

Neil Boehm - *Gentex Corporation - VP of Engineering*

Thank you, Steve. To begin, we'd like to provide an update on the full display mirror launches. As we have discussed previously, General Motors was our launch customer for this brand new technology. And through the fourth quarter of 2016, our full display mirror product is now available on six different nameplates in the GM lineup.

At CES in 2016, we debuted FDM on the Cadillac CT6 and XT5 in our booth. This was quickly followed by the Cadillac CTS; and, later in the year, by the Cadillac Escalade and the Escalade ESV.

The latest launch of our FDM product came in the fourth quarter on the Chevy Bolt. This vehicle represents the first non-Cadillac-branded vehicle in GM's lineup to offer our full display mirror. Additional OEM launches for FDM are expected to occur this year, and will be announced once our customers make this information available.

On the launch side, the Company has continued to demonstrate solid growth, not only for our inside and outside electrochromic mirrors, but also for our advanced technology products that are often housed inside of those mirrors. In 2016, the total number of launches for the Company was approximately 10% higher versus the number of launches in 2015.

The fourth quarter was extremely strong as it relates to net exterior auto dimming mirror launches, with the fourth quarter representing the strongest quarter of the year and one of the highest net launch rates in Company history for our exterior auto dimming mirrors.

The Company also continues to grow the number of applications with our advanced features. Over the last year, we have spent time further explaining interior and exterior auto dimming mirror growth rates and the importance of advanced features in driving revenue growth. Currently our advanced features account for approximately 1/2 of revenue growth, which is primarily driven by the growth of frameless interior mirror executions and electronic content from SmartBeam, HomeLink, compass displays, lighting technology, and the full display mirror.

For the fourth quarter and calendar year 2016, advanced feature launches represented about 60% of all interior auto dimming mirrors launches for the Company, which is ahead of our historic level and represents the strength in feature growth and complexity of our product offering.

I will now hand the call back over to Steve for 2017 and 2018 guidance and closing remarks.

Steve Downing - *Gentex Corporation - SVP and CFO*

Thanks, Neil. Our guidance for calendar year 2017 is based on the mid-January 2017 IHS production forecast for light vehicles produced in North America, Europe, and Japan/Korean markets. The current IHS production forecast for these markets is expected to increase 1% for calendar year 2017. And based on that, the Company estimates that net sales for calendar year 2017 will be between $1.78 billion and $1.85 billion.

The Company estimates that gross profit margin for calendar year 2017 will be between 39% and 40%. Annual customer price reductions continue to be a known headwind for the Company. However, with the current projected 2017 sales forecast and our projected product mix for 2017, we believe that we can offset the majority of those annual customer price reductions with purchase and cost reductions and operational efficiency.

From an operating expense standpoint, the Company expects ER&D and SG&A expenses for calendar year 2017 to be between $165 million and $172 million.

Based on current tax laws, the Company estimates its tax rate to be between 31.5% and 32.5% for calendar year 2017.

And to continue to support future growth and program launches, the Company estimates that capital expenditures for 2017 will be between $115 million and $130 million. And, lastly, depreciation and amortization is estimated to be between $95 million and $105 million for calendar year 2017.

When looking at IHS's forecast for 2018 production in our primary markets, which is currently forecasted to increase by 1% over 2017 production, the Company estimates that revenue for 2018 will increase approximately 6% to 10% over currently forecasted 2017 revenue.

We can now proceed to questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Chris Van Horn, FBR.

Chris Van Horn - *FBR Capital Markets & Co. - Analyst*

Congratulations on the continued margin performance. Just first question on the revenue headwinds in the quarter -- could you just give us a sense of the timing of these? Are they short-term in nature? Were they one-time in nature? Do you see anything maybe reoccurring? And then on the plant shutdowns, was that an idling or was that just programs kind of going away?

Steve Downing - *Gentex Corporation - SVP and CFO*

Sure. First on the material shortage, that was one-time in nature. By the end of the quarter, we feel like we've secured enough material to get us back in solid position. Obviously when we talk about the operational inefficiencies of having supplier shortages, it costs money. We believe we've incurred most of those in fourth quarter. There are some slight costs that we'll incur in Q1, but we don't think they are material in that they are not going to change the operational performance of the business significantly.

When you look at the revenue shortfall on the Tier 1 side, we believe those are one-time in nature. We should make up those sales predominately in Q1 but really throughout the rest of 2017. This has happened -- it was about two years ago we had a similar issue. It's really typically based on our Tier 1 customers; the amount of inventory they're carrying; and, then, them going through end-of-year process and making adjustments based off inventory levels.

And then you look at the OE shutdowns. These were really one-time in nature in that there were increased shutdowns versus what was already announced from the OEM side. So we don't believe those will have any residual effects. We don't think there's any out planned shutdowns beyond what's already publicly available. So we should see a kind of recurring -- kind of recurrence to normal revenue levels with the beginning of Q1.

Chris Van Horn - *FBR Capital Markets & Co. - Analyst*

Okay. Great. And then kind of looking forward, and certainly on the heels of all the product announcements at CES, could you give us a sense of what you saw a lot of traction from your customers at the show? And then you've kind of exceeded this 50% of advanced features number in the past couple of quarters. Do you have a goal in mind of what that number could wind up to be, just going forward?

Steve Downing - *Gentex Corporation - SVP and CFO*

Sure. First on the CES side, I think Neil and I will probably jump in with a couple of comments around what the customer interest has been around those products. I guess I'll start with the connected car, and I'll let Neil handle the camera monitoring side.

If you look at the connected car technology, we believe there's a lot of interest, not only for our HomeLink and home automation side; but the Integrated Toll Module system has a lot of interest on the OEM side. So we announced previously we have kind of one committed OEM now. We believe there will be a couple more in the next 6 to 12 months that we believe we'll be able to secure contracts with.

Beyond that, the iris demo -- Chris, as you experienced when you were there -- there was a lot of customer interest there. So we have, since the close of CES, we've had a lot of follow-up conversations. A lot of customers are asking us to get mobile demos to them so that they can experience that in a vehicle environment, or at least in a conference room, and show it with their teams. So there is a lot of work ahead of us over the next year or so in terms of creating proof of concepts and demos that OEMs can experience.

Neil Boehm - *Gentex Corporation - VP of Engineering*

In regards to the CMS property, or the camera monitoring system, I think the biggest and largest feedback we had on that was the hybrid nature of the camera plus mirror. And as you walk through the logical path of why to have both systems, it resounded and stuck with a lot of customers on the logic behind it and the need for it, based on the consumers. Not everybody likes to drive with a display technology, so having the ability to have a mirror, or switch between the two technologies, actually caught a lot of customers kind of by surprise and we're very interested and excited about it.

Steve Downing - *Gentex Corporation - SVP and CFO*

Chris, what was the second half of your question?

Chris Van Horn - *FBR Capital Markets & Co. - Analyst*

The advanced features has become a bigger part of your revenue mix. Do you have a target in mind of what that could look like?

Steve Downing - *Gentex Corporation - SVP and CFO*

We don't really have an arbitrary target in terms of anything we're trying to get to. Obviously what we don't want to do is become overweight in any one area, whether that's mirrors by themselves, or in advanced features without mirrors. What we'd love do is see those two move roughly in that 50% to 60% kind of range together. In other words, we want mirrors to continue to grow; obviously we believe the last couple of years, despite some of the concern around mirror growth and the longevity of mirrors.

One of the things Neil talked about in his prepared comments was that outside mirror growth was really strong, especially in Q4. Those are new launches that are occurring right now for programs that are probably going to run five or six years. And so really we're excited about the growth of the core interior and exterior mirrors, and then combination seeing a little more strength in terms of those advanced features. Honestly, if we were at about that between 80% and 60% of our launches being advanced features, that would be probably the ideal breakout for us.

Chris Van Horn - *FBR Capital Markets & Co. - Analyst*

Okay. Great. Thank you very much.

Operator

Rich Kwas, Wells Fargo Securities.

Rich Kwas - *Wells Fargo Securities, LLC - Analyst*

Good morning, gentlemen. A question for Neil: I heard the comment around 10% growth on launches. Do you have the Q4 numbers that you provided last quarter that were similar to what you provided in Q3, around net launches for Q4? Is that available?

Neil Boehm - *Gentex Corporation - VP of Engineering*

For the quarter, we were -- the net was 12 net launches for the quarter.

Steve Downing - *Gentex Corporation - SVP and CFO*

But that does include some losses on microphones that we talked about last quarter. So if you pair that back, it's more like 17. So it is a growth on a year-over-year basis.

Rich Kwas - *Wells Fargo Securities, LLC - Analyst*

Right. So 17 net new -- or new, minus 5, where there was some content loss.

Steve Downing - *Gentex Corporation - SVP and CFO*

Yes. It was a net of 12.

Rich Kwas - *Wells Fargo Securities, LLC - Analyst*

Net of 12. Okay. All right. And then just on your comment around previous question, what Chris was asking around recovery. So 6% to 10% growth at 17 is consistent with what you said a year ago. The base arguably here, a little lighter versus what people were expecting -- we were expecting for 2016. So you talked about kind of recovery in pickups. How do we think about that? It doesn't seem to be embedded in the 6% to 10% growth.

So is that -- should we interpret that as there's maybe some conservatism in there around that? It would just seem like if some of this stuff was pushed that you would get some recovery in 2017, but I just don't know what's included in the 6% to 10%.

Steve Downing - *Gentex Corporation - SVP and CFO*

Yes. But if you look at that $15 million over next years, you are talking about slightly less than 1% total for annual revenue, even if you recovered it all. Now like we've mentioned, about one-third of it we don't think it probably will recover because it's OEM plant shutdowns. Our guess is that that's taking car inventory out of the marketplace to get those overall vehicle inventory levels back down. And so really you are talking about, more than likely, recovering about two-thirds of it.

So when you start talking about $10 million over a $1.7 billion-some, you are really talking about 0.5% or 0.6% growth rate. So it's -- yes, we tend to be a little conservative. But you look at it and we have to assume, as we stand here this year, we have to assume that fourth quarter would typically be met with some of the more Tier 1 inventory adjustments next year as well. It does happen, it seems, about every other year; some years are more drastic than others. In Q4, especially next year, it is always tough to predict what those will look like.

I think the other thing I will point out is that we talk about 1% growth rate in 2017 and 2018 from a vehicle production standpoint. But in reality, in our primary markets, it's actually 0.7% growth rate in production in 2017, and it's barely over 0.5% in 2018. So while we are still talking in that 6% to 8%, even at the midpoint, outgrowth versus production rates.

Rich Kwas - *Wells Fargo Securities, LLC - Analyst*

Okay. And just, Steve, as we think about gross margins, within the range typically what happens is you have lower gross margins in the first half of the year. And then it gets better because you get the price reductions out of the way, and you get productivity benefits whatnot. Should we think about the normal cadences -- from a sequential standpoint, you had a nice number here this quarter. Should we think of it as kind of a pretty decent drop sequentially in Q1 that kind of builds off that?

Steve Downing - *Gentex Corporation - SVP and CFO*

Yes, normally that would be the case. When you look at the impact of annual price reductions, you would see that drop off, really most of it affecting in January and then April, given the timing of our customers' price reduction schedules.

Now the one thing that I would say that would change that next year potentially is if you look at the production rates on a quarter-by-quarter basis, Q1 is quite a bit stronger from a production growth rate standpoint than the rest of the year. So to the extent to which our margin will move roughly in line with growth rates, so that is the other factor that you have to consider.

So what we've talked about historically is if we're growing at 6% to 10%, you typically will see margin tailwinds. Obviously if you are at the bottom end of that range, you will tend to see more flattish gross margins. And then if you are growing at below 5%, normally you see some margin headwind.

Rich Kwas - *Wells Fargo Securities, LLC - Analyst*

Okay. Great. Thanks. I'll pass it on.

Operator

Brett Hoselton, KeyBanc.

Brett Hoselton - *KeyBanc Capital Markets - Analyst*

Can you talk a little bit about M&A? I know that you've taken a greater interest in that in recent years, and you obviously have a fair amount of cash on your balance sheet. So can you kind of talk a little bit about what your expectations are?

Steve Downing - *Gentex Corporation - SVP and CFO*

Sure. So one thing we didn't talk a whole lot about so far today -- but the iris scanning technology that we debuted at CES -- we actually took a minority position with the Company that helped create that technology. So we have been active on the research side and looking -- obviously we're open to further positions in the space, especially as it relates around technology.

So when you talk about Gentex's structure and we look at what our philosophy around merger and acquisitions is, it's typically not looking for an income statement. It doesn't mean we're opposed to it, but it's tough for us to find targets in automotive that meet our criteria for revenue growth, profitability, but also strategic lineup as it relates to IP and kind of unique products.

However, on the M&A side, there tend to be more targets that are available, and so we continue to look. Obviously we're not trying to be everything to everyone. We're looking for very strategic products that would fit into our product portfolio and help evolve our technology over time.

When you look at the strategic partnership with TransCore on the Integrated Toll Module system, and then you look at the minority position we took in Delta ID for the iris scanning -- these are very good strategic fits. They fit really well with our current product lineup, and we think help take us to the next level as it relates to the car of the future.

Brett Hoselton - *KeyBanc Capital Markets - Analyst*

As you think about where you'd like to grow and so forth, is it primarily in the automotive space or are there also interest elsewhere?

Steve Downing - *Gentex Corporation - SVP and CFO*

There's absolutely interest elsewhere. Obviously we love products that have a relevance in automotive. We know the market really well. We feel like we can build a solid business case in that industry. What we're really looking for and hopeful of is that we can find the technologies and investment technologies that are relevant in automotive, but have the potential to take us outside of automotive.

That's not to say that if it was a pure play outside of automotive that we would say no to it. It just has to be something that we have good, fundamental skill set at from an engineering standpoint, and the availability to produce effectively.

Brett Hoselton - *KeyBanc Capital Markets - Analyst*

Thank you, Steve.

Operator

David Leiker, Baird.

Joe Vruwink - *Robert W. Baird & Co. - Analyst*

Hi, this is Joe Vruwink for David. A few more questions on gross margins. So Q4 was a pretty large beat, and that came despite all the disruptions you faced. The guidance for 2017 implies a year-over-year decline is likelier than that. But nothing you really said on the call when we think about advance features offsetting pricing; high exterior mirror launch mix moderating supplier cost. All that seems to be positive for gross margin. So what might we be missing?

Kevin Nash - *Gentex Corporation - VP and CAO*

I think you hit the nail on the head. It's just, you've got to make sure you are quantifying correctly. Annual customer price reductions averaged 2.5% to 3% down, so that is a big hurdle to overcome. We continue to work towards and our goal is to offset those with purchasing cost reductions but it doesn't always happen. And then mix is the one that's the variable. So we do have strong launch activity but sometimes it moves in your favor, sometimes it doesn't.

I think the fourth quarter represented while we did have some shortages in the certain customers that were impacted from more base mirror type customers. And so we actually had favorable product mix as a result of the shortage; but in addition to the offsets from the inefficiencies. But I don't think you're wrong as far as all your inputs.

Steve Downing - *Gentex Corporation - SVP and CFO*

I think it's important to look at -- if you look at the full-year 2016 gross margin performance, it's inside of the range and the guidance that we're providing. So it's not -- if you take the midpoint of our guidance, it's slightly below; but you are talking 20, 30 bps below the full-year performance of 2016.

Joe Vruwink - *Robert W. Baird & Co. - Analyst*

Yes. Okay. And then any change you might foresee, and competitive dynamics with some of the proposed border taxes? The fact that you're US manufacturing, period -- does that --? You already have a lot of market share. But do you see any maybe benefit for you, headwinds that you might have to counter, things like that, with what's been proposed so far?

Kevin Nash - *Gentex Corporation - VP and CAO*

I think we're sitting in a pretty good position. If you look at our entire business model, we are a net exporter. We do import some of our raw materials for inputs, but two-thirds of our business leaves the country. We manufacture everything in the United States. As we talked about a little earlier, we're paying 32% tax rates so we feel like we're going to benefit from that, as well, potentially if changes happen. But the bigger question is if border taxes happen, does that change demand for vehicles if they become more expensive? And that's not really in our control. But we feel like from all other perspectives, being a United States company with all of our presence here will benefit us if there's changes.

Joe Vruwink - *Robert W. Baird & Co. - Analyst*

Okay. Great. And then my last question. The change in the investment portfolio -- how might that impact the investment income into 2017?

Steve Downing - *Gentex Corporation - SVP and CFO*

If you look at the changes, really last year were very low levels of investment income that affected the income statement. So you really should see very little impact to our ability to produce net income, based off of the smaller investment portfolio. So I wouldn't expect any type of changes, really. If you look at what we're moving into -- so shorter duration type, fixed-income assets -- they are not great percentage returns; but they should more than offset what we were able to make on the portfolio previously.

Joe Vruwink - *Robert W. Baird & Co. - Analyst*

And so that line item is going to look more just like your debt payments?

Steve Downing - *Gentex Corporation - SVP and CFO*

Yes. It will be -- we should be able to offset some of those debt payments with some of the lower returns on fixed income.

Joe Vruwink - *Robert W. Baird & Co. - Analyst*

Okay. I see. Great. That's it. Thanks, guys.

Operator

Jason Rodgers, Great Lakes Review.

Jason Rodgers - *Great Lakes Review - Analyst*

Good morning. I just wanted to follow up on the raw material shortage. I don't know if you could quantify the revenue and costs related specifically to the shortage; if you lost any customers; and how you can avoid it in the future.

Steve Downing - *Gentex Corporation - SVP and CFO*

First there was about $5 million in terms of the revenue impact. And you are really only talking about 25 to 50 basis points of margin impact due to the inefficiencies around that. Fortunately we were able to manage this. So we didn't have any plant shutdowns. We didn't cause any OEM issues.

Obviously the biggest cost we incurred in that process was expedited freight. So in other words, we're having to air ship parts to get them to the OEMs on time to make sure we're not affecting them.

So it did not cost us any customer issues. It didn't cost us any type of contract issues. In fact, most of our OEM customers were very pleased with how we responded and how we met that challenge. The issue is always one of trying to make sure -- now you go back and look at how do you make sure this never happens again.

As part of the process we've been going through as a team is making sure that we have other sources available, if we need them; and making sure we understand the constraints around our suppliers better than we did, coming into the quarter.

Jason Rodgers - *Great Lakes Review - Analyst*

All right. And just as a follow-up, I wanted to ask about the CMS product. When might that be available? Will it be sold as a replacement to the full display mirror, are a stand-alone product? And how does the ASP compare to FDM?

Neil Boehm - *Gentex Corporation - VP of Engineering*

So I'll cover the product side; I'll let Steve cover the ASP side. So the CMS -- the first we debuted it was at CES this year, so only about three weeks ago. So we're actually working with customers on how that product could be implemented and brought to market. The response we got as we showed the concept of the camera integrated with the mirror was overwhelming from an interest level. Because many customers were struggling with how to provide the camera system with a display without having redundancy; so the actual mirror provides for redundancy. So there's no SOP target dates, but if you take a normal automotive launch cycle, you are 4 to 5 years out. And them from a --

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Steve Downing - *Gentex Corporation - SVP and CFO*

And because this is a complex product, the development with an OEM is going to take probably at least a year longer for them to see the concept, buy into it, work with their teams on how they want to develop this and integrate this into their vehicle.

So this is probably a product that you won't see -- even if it's picked up fairly quickly -- you probably won't see it on the road for five years. And that's what's exciting about the product really for us is we talk about the future of the car. There's been a lot of speculation around what that means for Gentex. When we show this product, our customers' response is pretty uniform, and that is: the solution make sense, the combination of both known technologies from today plus technology of the future.

When you look at it, your question around -- is it additive to the full display mirror? And the answer is, absolutely. Obviously you need a good display location. We believe the full display mirror has been very sticky with our customers in terms of the right location for that type of information, and the redundancy that Neil mentioned.

So when you are really talking about ASPs, it's really tough to predict. And the reason why is how you go about pulling off the system can go a lot of different directions. Obviously you have increased number of cameras on the car. So those are going to run anywhere from $40 to $60 apiece, depending on what kind of camera and how high of a pixelation that they want in that device. You start talking about the processing block, and where that's going to happen. Are you going to do image stitching or are you just going to have dedicated displays for each one? Those can go all kinds of different directions.

And is it focused on the US market or the European market? Given the different regulations in those marketplaces, some of them drive additional displays beyond just our FDM -- so in order to have a full camera monitoring solution. So you look at it; obviously this is a pretty expensive system to add to a car. More importantly, though, we think that having that in combination with our EC mirrors in that location makes a lot of sense. So it's a little early to start predicting what revenue can look like from this type of system.

Jason Rodgers - *Great Lakes Review - Analyst*

Okay. Thank you for that. Just if I could squeeze in one more. I wanted to ask if the new plant was completed, and if any of the CapEx budget for 2017 has any amount in there for that plant.

Steve Downing - *Gentex Corporation - SVP and CFO*

The plant itself is completed. We are -- about half of the manufacturing space is currently being utilized for both distribution and final assembly. We do have some increased capital in 2017. Part of that CapEx is related to finishing the rest of that manufacturing space. We expect that to operational probably mid-next -- well, mid-this year now -- so mid-2017.

And beyond that you'll see some of that increase in capital is designed around equipment to fill that space. So you'll continue to see us be deliberate in our growth strategy. Obviously, for us, we're trying to do a better job of master planning our facilities and making sure that we're giving the shareholders a smoother bridge of understanding what CapEx needs to look like to help support these double-digit or near double-digit growth rates over the next couple of years.

Jason Rodgers - *Great Lakes Review - Analyst*

Thank you.

Operator

Ryan Brinkman, JPMorgan.

Ryan Brinkman - *JPMorgan - Analyst*

I'd like to follow-up on the earlier discussion about tax code changes. So you referenced the obvious benefit in terms of your exports receiving favorable treatment under a border adjusted tax. You interestingly mentioned a potential offset in terms of higher prices of vehicles potentially reducing demand, which could be a little bit under the radar screen.

But there's a bunch of other factors, too, like the corporate tax rate going from 35% to 15% under the Trump proposal. And then, two, the immediate deduction of capital expenditures, which I have to imagine would help you a lot.

So have you tried to do any scenario analyses around what your effective tax rate could go to, potentially, were a combination of these changes to come into effect? There is some speculation that perhaps it could even fall, for example, by half. Is that reasonably possible?

Kevin Nash - *Gentex Corporation - VP and CAO*

I think the primary drivers for our tax rate are federal taxes and state taxes, and a 35% nominal tax rate for federal taxes -- the deduction there is the domestic manufacturing deduction of which we are a big beneficiary of. So yes, if the federal tax rate drops in half, we would expect some of the deductions to go away, such as the manufacturing deduction. That's one of the things being tossed around. But moving that nominal rate down to 15% or 20% would be a big benefit for us.

Steve Downing - *Gentex Corporation - SVP and CFO*

And even some of the essential potential offsets that are being discussed to help bring about that lower tax rate wouldn't probably eat up more than, say, 5% or so of that improvement. So you would still see a significant improvement in our overall tax rate.

Kevin Nash - *Gentex Corporation - VP and CAO*

And so the general comment I made about vehicle demand is really more of a macro issue of -- if there's a 35% border tax. That's left to be seen in what that does for overall consumer demand. (technical difficulty) But we would move generally ahead of the market like we do today. So we have modeled that internally. We feel like we're in the driver's spot, like I said. But we're not speculating as to what that means until it's legislated.

Ryan Brinkman - *JPMorgan - Analyst*

Great. That sounds very encouraging. And then one of the reasons why the border adjusted tax proponents claim it wouldn't be just a tremendous windfall for exporters, or tremendous headwind for importers, is because the dollar is theorized to rally significantly under that scenario.

But can you just kind of remind us of how your contracts are priced in dollars, relative to local currency? I think it's like almost entirely in dollars. And then would you expect that automakers would look to renegotiate that over time? Or would this be a potential big benefit for you over the -- you wouldn't see that offset that many other companies would see?

Steve Downing - *Gentex Corporation - SVP and CFO*

Sure. If you look at it, about 95% of our sales are denominated in US dollars. So obviously with all these conversations come the possibility for customers in the expensive dollar causing problems. But that's regardless of tax rates. Honestly, that would be tied more to the value of the currency.

If you look over the last 15 years, we've fluctuated anywhere from, say, 85% to 95% of our sales denominated in dollars. And we've gone through significant currency changes during those periods. We've always been able to find a way to renegotiate deals with our customers that give them obviously the positive business case for buying our products, and still leave us with our fundamental financial performance intact.

So it's really difficult, as we stand here today, to predict all the different ways this can go. What we do know is we continue to stay focused on new technology and that helps us grow our business with our customers. Beyond that, the tax situation and some of the potential issues that could cause with the expense of our products from a dollar standpoint are all problems that we have to address.

Now, if those are likely correlated, to some degree, obviously any type of tax improvement would probably more than offset any type of pricing issues that we struggled with due to the cost of the -- or price of the dollar.

Ryan Brinkman - *JPMorgan - Analyst*

Interesting. Thanks. And then just on a different topic. If you sort of look at the midpoint of your operating expense guide for 2017 implies about an increase of 8% versus 2016. That is sort of similar to the big point of your revenue growth guidance, too.

So at least using the midpoints, it would seem that you wouldn't expect to lever expenses in 2017; versus ordinarily, I think, probably you could. So is that because of some sort of lingering premium freight issue, or due to development costs for new products, or some other factor that we should be thinking about?

Steve Downing - *Gentex Corporation - SVP and CFO*

No; that's absolutely our strategy. So our goal is to move our expenses roughly in line with sales growth. And that is designed around the products and the advanced technologies that we are working on five years from now. And the products that we showed at CES are going to require an increase in engineering effort.

So when you look at those products, we talk about iris and authentication in the car, and home automation and then also the CMS products -- those are going to require increased engineering effort and demand from the business. So our intention is to be deliberate about that and to continue to invest in the core engineering process internally in Zeeland.

Kevin Nash - *Gentex Corporation - VP and CAO*

Yes, and if you would look at the breakout of those two operating lines, you would see that ER&D is going to be probably at the higher end of the range, and SG&A is going to be somewhere in the mid-single-digit growth rate.

Ryan Brinkman - *JPMorgan - Analyst*

Okay. Got it. Investing for future revenue growth. Okay. Thanks so much, guys.

Operator

Matt Stover, SIG.

Matt Stover - *Susquehanna Financial Group/SIG - Analyst*

Thank you very much. Two questions; most of them have been addressed. The first one is just a detail. If I'm looking at the SG&A as a percent of sales in the fourth quarter, it looks like it was up about 50 bps versus last year. And I'm just wondering if there was something unusual in that that we should think about.

Kevin Nash - *Gentex Corporation - VP and CAO*

So part of it -- if you look at the press release -- a little over $1.2 million in the quarter was related to the issue. So about $1 million of it was related to premium freight of -- that was about $800,000; had some increased travel costs associated with the raw material shortage. And the balance of it was actually strength in the Japanese yen in our foreign office in Japan. So unfavorable exchange rates there went against us for about $200,000. The rest of it is (multiple speakers) go ahead.

Matt Stover - *Susquehanna Financial Group/SIG - Analyst*

So premium freight showed up in SG&A?

Kevin Nash - *Gentex Corporation - VP and CAO*

It does. (multiple speakers) That shows up there, which, like Steve said, there may be a little bit lingering in Q1, but not nearly to that extent.

Steve Downing - *Gentex Corporation - SVP and CFO*

To be fair, when we talk about premium freight that Kevin is referring to, that's premium freight out, so that's getting our parts to our customers.

Matt Stover - *Susquehanna Financial Group/SIG - Analyst*

Second question is if we're looking at the bracketing of growth over the next two years between 5% and 9%, I recognize this is an imperfect process, forecasting. But how would you recommend that we think about what would guide towards the low end of that range and toward the high end of that range? Is that more variability on the end market? Is that more variability to a particular customer? Or is that tied to any particular product?

Steve Downing - *Gentex Corporation - SVP and CFO*

I think the single biggest issue that will affect that is overall production levels, but also the macroeconomic environment. So one of the things we talk about, not only in the number of vehicles that are produced, but what segment of vehicles are produced; and then beyond that, what price point are those vehicle selling at?

So one of the early indicators for a recession for us that we look for is what is the average content? What is the average sell price of the car itself, not necessarily how many are produced. And as a content play in automotive, that's one of the things we have to focus on. So those would be the single biggest drivers for the business.

We're not overly exposed to any one OEM. If you look at it, our largest customer tends to be around 14% of revenue. And so we don't have any type of exposure issues to any one OEM, or to one region. About two-thirds of our sales our overseas or into foreign production markets. So we feel like we're pretty well diversified geographically, as well.

Matt Stover - *Susquehanna Financial Group/SIG - Analyst*

One last question to follow on is -- are you folks seeing any evidence of trim package changes that your customer would -- that would then have a negative mix impact to you, in terms of mirror content and that sort of thing?

Steve Downing - *Gentex Corporation - SVP and CFO*

No; I think last year, we talked about the BMW de-contenting of some passenger-side outside mirrors where they had taken auto-dimming off. Other than that, that's the only real packaging concern that we've dealt with in the last 18 months, where something strategically changed at an OEM.

Matt Stover - *Susquehanna Financial Group/SIG - Analyst*

Okay. Thanks very much.

Operator

David Whiston, Morningstar.

David Whiston - *Morningstar - Analyst*

I wanted to go back to the first of the possible tax changes. Obviously you'd have a lot more money coming in. And can you talk at all about what you would want to do with that money -- from holding it, to buybacks, perhaps hiring more engineers? And kind of related to that is can you talk about hiring more engineers? Is it really tough to compete with Silicon Valley for the talent? Are you having to offer a lot of stock option awards, anything like that, to get people to come to Michigan?

Steve Downing - *Gentex Corporation - SVP and CFO*

As you can imagine -- well, first of all, yes; if the tax laws were to change, we'd be looking at focused on investing in the business itself as our primary use of that cash. But that's no different than our strategy today; it would just be amplified slightly. So we'd be focused on trying to find new ways and creative ways to add engineering talent.

As it relates to today, we have a pretty good success rate finding engineering talent so that's not too big of a concern. However, as we start to emerge into some of these new products, what we found is that partnering or looking at targets from an M&A standpoint in those areas is very attractive at times.

So when we talk about the iris scanning technology, the fundamental -- the company there that we invested in was actually a Silicon Valley-based company. If you look at our camera monitoring system, we've partnered with a Silicon Valley-based company to help us with the graphics processing side, an umbrella. So you continue to look for and find new ways to partner.

Even those engineering costs don't necessarily need to be just employees. They can be contracts that you set up in place, or help on the underlying technology. So we'll continue to look and be creative at how we acquire engineering resources. Obviously convincing someone from Palo alto to move to West Michigan is a bit of a challenge. But beyond that, besides the weather it's not an over concern, in any stretch, that there is somehow a lack of engineering talent available to us.

David Whiston - *Morningstar - Analyst*

That's good to hear. Can you remind me, too, with HomeLink, have you -- are you exploring or do you already have any kind of relationship with Nest or Amazon's Alexa? Is that something you are interested in, if you don't have it?

Neil Boehm - *Gentex Corporation - VP of Engineering*

We continue to do some background into those areas, and we are doing some work with Alexa's product, and demonstrating the capability of how HomeLink can function with that technology. So we are looking at what's in it from a mainstream, from a technology, making sure that our efforts are tying into those products to be more seamless from a consumer side.

David Whiston - *Morningstar - Analyst*

Okay. And just one more question: can you say specifically what commodity was in short supply?

Steve Downing - *Gentex Corporation - SVP and CFO*

Sure. It was actually the primary plastic that we use for making the cases for the inside and outside mirrors.

David Whiston - *Morningstar - Analyst*

Okay. Can you say if you get that from overseas?

Steve Downing - *Gentex Corporation - SVP and CFO*

No; it's actually a domestic product.

David Whiston - *Morningstar - Analyst*

Okay. Thank you.

Operator

John Murphy, Bank of America Merrill Lynch.

Aileen Smith - *BofA Merrill Lynch - Analyst*

This is Aileen Smith on for John. Not to beat a dead horse here; but going back to the raw material shortages, can you talk about the potential impact on that specific commodity price, if there was one? You had mentioned that you secured enough of it by the end of the quarter. But did it come at a significantly higher cost? And do you anticipate any material change to the input cost of that commodity, should be shortages persist?

Steve Downing - *Gentex Corporation - SVP and CFO*

No; there were no material price changes, per se. So there won't be a bill material impact to this on a go-forward basis.

Aileen Smith - *BofA Merrill Lynch - Analyst*

Okay. And switching gears to capital allocation, it looks like you've placed an increasing focus in recent quarters on paying down debt, while still repurchasing shares. And in the past you've commented about repurchasing shares at a fairly consistent pace.

Is the refocus on that debt paydown driven in any way by your current view of the industry and where it's going, and your desire to kind of fortify the balance sheet before the cycle turns?

Steve Downing - *Gentex Corporation - SVP and CFO*

No; those are always side benefits, but the real focus is in -- has been on our ability to outperform our cash generation estimates. And as we outperform and generate more cash than anticipated, we look at creative ways of how to deploy that.

One of the things that is important to keep in mind is that our debt structure is the designed to end in the fall of 2018, at which point we'll either have to refinance that debt or pay it off completely. So it's a good time to start kind of working towards that point, for the end of 2018, to be prepared for whatever, and offer up the most flexibility for Gentex as it relates to our debt structure.

Aileen Smith - *BofA Merrill Lynch - Analyst*

Okay. Great. Thanks. And just a quick housekeeping one. Looking at your interior versus exterior mirrors, there's been some variation in the growth trajectory of each of them over the past couple years. And I understand that you had faced some de-contenting by BMW on the exterior mirror side. But how should we think about interior versus exterior mirror shipment growth, going forward, especially since that has some impact on your pricing and your margins?

Steve Downing - *Gentex Corporation - SVP and CFO*

Sure. So before we get to the projections of what those will look like, we'll talk about the last couple of years that you referenced. Really over the last couple of years, exterior mirrors -- especially two years ago, and throughout 2015 -- exterior mirrors posted almost a 20% growth rate for a lot of our major markets. And so after a solid couple years of growth rates that were above -- we were in the double-digit growth range -- those are going to moderate a little bit back in line, closer what our inside mirror growth rates would be. So we would expect those to be both kind of in that mid- to high-single-digit range for both inside and outside mirrors over the coming years.

Aileen Smith - *BofA Merrill Lynch - Analyst*

Okay. Great. Thanks. That's it for me.

Operator

Ed Terwilliger, HighTower.

Ed Terwilliger - *HighTower - Analyst*

So just going back on expanding outside of auto, I was hoping you could comment on the partnership with Boeing for the 787 platform, and if you are exploring any more opportunities in the aerospace industry?

Steve Downing - *Gentex Corporation - SVP and CFO*

Absolutely. So the 787 was a great program launch for us. Obviously it was our first foray into aerospace, so there was a lot of life lessons learned during that process, as you can imagine. There's continued interest from different manufacturers. We continue to be active in business jets at the NBAA show and some other business jet environments. We continue to believe that there will be additional commercial applications available to us over the coming years, as well.

The hardest part for us to get used to is the pace with which aerospace does move; it is a little slower than automotive. Now the design cycles are longer and the approval process is tougher, so we understand the [why]. But we continue to be very excited about the potentials for growth in the aerospace market.

Ed Terwilliger - *HighTower - Analyst*

Great. Thank you.

Operator

And this concludes our Q&A session. I would like to turn the call back to Josh O'Berski for final remarks.

Josh O'Berski - *Gentex Corporation - IR Manager*

Thank you, everyone, for joining in the call. Great questions; and if you have any follow-ups, please don't hesitate to reach out.

Operator

Ladies and gentlemen, this concludes our conference for today. You may all disconnect. Have a wonderful day.