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GNTX.OQ - Q3 2022 Gentex Corp Earnings Call

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OVERVIEW:

GNTX reported 3Q22 net sales of $493.6m, net income of $72.7m and diluted EPS of $0.31. Expects calendar year 2022 revenue to be $1.90-1.95b.

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Gentex Reports Third Quarter 2022 Financial Results Conference Call. (Operator Instructions). Please be advised that today's conference is being recorded.

I would now like to hand the conference over to your speaker today, Josh O'Berski. Please go ahead.

Josh O'Berski - *Gentex Corporation - Director of IR*

Thank you. Good morning, and welcome to the Gentex Corporation Third Quarter 2022 Earnings Release Conference Call. I'm Josh O'Berski, Gentex's Director of Investor Relations, and I'm joined by Steve Downing, President and CEO; Neil Boehm, Vice President of Engineering and CTO; and Kevin Nash, Vice President of Finance and CFO.

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This conference call contains forward-looking information within the meaning of the Gentex safe harbor statement included in the Gentex Reports Third Quarter 2022 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 get us started today.

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

Thank you, Josh.

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For the third quarter of 2022, the company reported net sales of $493.6 million compared to net sales of $399.6 million in the third quarter of last year, which was a 24% increase quarter-over-quarter.

For the third quarter, global light vehicle production in North America, Europe, Japan, Korea and China, increased approximately 26% when compared to the third quarter of last year. Light vehicle production in the company's primary markets of North America, Europe and Japan, Korea was up 22% on a quarter-over-quarter basis. Some of the supply chain issues that plagued the industry in the third quarter of last year have improved and overall light vehicle production growth contributed to the company's quarter-over-quarter revenue growth. However, product mix for the third quarter and overall sales levels were still impacted by customer order adjustments, supply chain challenges and labor availability issues.

Together, these headwinds resulted in unit shipments being approximately 750,000 units lower than our original forecast at the beginning of the quarter, which resulted in a revenue shortfall of about $35 million to $40 million. While there appears to be some improved stability in the light vehicle production environment and the overall supply chain, the company continues to experience significant customer order fluctuations on a week-to-week basis and difficulty in sourcing advanced electronic components for our most complex products.

For the third quarter, the gross margin was 29.8% compared to a gross margin of 35.3% for the third quarter of last year. Gross margin was impacted on a quarter-over-quarter basis by raw material cost increases, unfavorable product mix and labor cost increases and prior commitments to annual customer price reductions. The continuation of cost increases in raw materials as well as unfavorable product mix had the most significant impact on our margin profile during the third quarter.

Additionally, while the overall improvement in sales levels helped offset fixed overhead costs during the third quarter, the increase in labor costs more than offset the gains in overhead absorption to create additional margin pressure. During the third quarter, product mix issues driven by component shortages in our advanced feature mirrors and lower sales to our Tier 2 customers contributed about 150 basis points of margin headwind that we believe will improve during the fourth quarter.

The company is also making progress on cost escalation conversations with our customers, and we expect relief to begin during the fourth quarter which should provide improvement in our margin profile as we move through 2023 and into 2024.

Operating expenses during the third quarter increased by 15% to $60.4 million compared to operating expenses of $52.7 million in the third quarter of last year. Operating expenses increased during the third quarter, primarily due to staffing, professional fees increased outbound freight expenses and travel-related expenses. Our operating expense growth for the third quarter continues to support our product development strategy as well as previously sourced new program launches, product redesigns and support of component supply issues and our ongoing commitment to new technology areas. The increase in operating expenses was in line with our plan and represents the level of development needed to achieve the forecasted growth rate for the rest of this year and into 2023.

Income from operations for the third quarter was $86.8 million compared to income from operations of $88.2 million for the third quarter of last year. During the third quarter, the company had an effective tax rate of 15.7%, which was primarily driven by the benefit of the foreign-derived intangible income deduction. Net income was $72.7 million for the third quarter compared to net income of $76.7 million for the third quarter of last year. The change in net income was primarily the result of the quarter-over-quarter changes in gross margins and operating profits. Earnings per diluted share for the third quarter were $0.31 compared to earnings per diluted share of $0.32 for the third quarter of 2021.

I will now hand the call over to Kevin for a third quarter financial details.

Kevin C. Nash - *Gentex Corporation - VP of Finance, CFO, Treasurer & CAO*

Thanks, Steve.

Automotive net sales in the third quarter of '22 were $480.9 million, a 23% increase when compared to $391.3 million in the third quarter of '21. And auto-dimming mirror unit shipments increased 17% during the quarter compared to the third quarter of '21.

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Other net sales in the third quarter of '22, which includes dimmable aircraft windows and fire protection products were $12.7 million compared to other net sales of $8.3 million in the third quarter of last year. Fire Protection sales increased by 78% for the third quarter of '22 compared to the third quarter of '21 and dimmable aircraft window sales decreased by 7% for the third quarter of '22 compared to the third quarter of '21. The company continues to expect that dimmable aircraft window sales will be negatively impacted until there is a more meaningful recovery of the aerospace industry and the Boeing 787 aircraft production levels improve.

Share repurchases. During the third quarter, the company repurchased 0.9 million shares of its common stock at an average price of $26 per share for a total of $22.3 million. For the 9-month period ended September 30, the company repurchased 3.3 million shares of its common stock for a total of $93.5 million. As of September 30, 2022, the company has approximately 21.5 million shares remaining available for repurchase pursuant to its previously announced share repurchase plan. The company intends to continue to repurchase additional shares of its common stock in the future in support of the previously disclosed capital allocation strategy, but share repurchases may vary from time to time and will take into account macroeconomic issues, including the lingering impacts of the COVID-19 pandemic and supply constraints, market trends and other factors of the company deems appropriate.

Shifting over to the balance sheet. The items mentioned today are valued as of September 30, 2022, and are compared to December 31 of '21, unless otherwise noted. Cash and cash equivalents were $222.9 million, down from $262.3 million, primarily due to capital expenditures and cash flow from operations. Short-term and long-term investments combined were $170.5 million, down from $213.1 million. This is primarily due to splitting out equity method investments of $39.7 million, which were previously reported under long-term investments. Accounts receivable was $292.4 million, up from $249.8 million due to the timing of sales within the quarter.

Inventories were $418.3 million, which increased from $316.3 million primarily in raw materials. The company has continued to be proactive related to raw materials inventory with ongoing supply chain issues, component shortage issues in addition to significant customer order volatility as well as our forecasted growth in the next 12 to 18 months, the company has taken on additional components of certain medium and long lead time items to help manage risk and meet customer demand. As previously mentioned, when the supply chain constraints start to alleviate and the component shortages begin to decline, the company will evaluate the proper levels of inventory at each commodity level. Accounts payable increased to $171.4 million, up from $98.3 million [primarily] due to increased inventory purchases and capital expenditures.

Let's take a look at preliminary cash flow items for the quarter. Third quarter 2022 cash flow from operations was $47.1 million, which was the same as operating cash flow in the third quarter of '21. And year-to-date cash flow from operations was $236.4 million compared to $299.4 million in operating cash flow for year-to-date '21, which was driven primarily by the year-to-date change in net income. Capital expenditures for the third quarter were $50.5 million compared with $13 million for the third quarter of '21, and year-to-date capital expenditures were $108.5 million compared to $44.4 million for year-to-date CapEx in '21. And lastly, depreciation and amortization for the third quarter was $23.2 million compared with $23.6 million for the third quarter of last year. And year-to-date depreciation and amortization was $73.3 million compared with $75.1 million for calendar year '21.

I'll now hand the call over to Neil for a product update.

Neil Boehm - *Gentex Corporation - CTO & VP of Engineering*

Thank you, Kevin.

For the third quarter of 2022, we experienced our highest total launch rate we've seen in the past 3 years. During the quarter, we had 50 launches of our interior and exterior auto-dimming mirrors and electronic features. Over 50% of the launches for the quarter were advanced feature launches with HomeLink, Full Display Mirror and our digital video recorder mirror leading the way.

Now for some updates on Full Display Mirror. We're excited to announce that during the third quarter, we began shipping our Full Display Mirror product to our 14th OEM, Hyundai on the new Palisade. Hyundai has been a great customer to work with on this exciting product, and it's great to see this technology in their vehicle. In addition to the Hyundai Palisade, we began shipping Full Display Mirror on 3 other vehicle nameplates: the Cadillac LYRIQ, the Mercedes Metris and the Subaru Outback. With these 4 new nameplates this quarter, we have now announced 79 nameplates

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that Full Display Mirror has been launched on. This technology continues to have growing interest and growth potential. We're excited to see how well this product is being received by our OEM customers and the end consumers.

Also in the third quarter of 2022, we began shipping our base auto-dimming mirror containing a digital video recorder in both the Toyota Yaris and the Yaris Cross for the Japanese market. These are our first launches of a base auto-dimming mirror with this DVR capability, and we believe this product has great potential to expand into other platforms as well as regions. This product is also the first Gentex DVR product that has an app available to allow the consumer to pull recorded information from the mirror to their phone, which creates a more consumer-friendly user experience.

The teams at Gentex have been doing an outstanding job executing the high volume and extreme -- extremely complex new launches that have been driving our new business growth, all while managing through the product redesigns that have been necessary due to component shortages that our industry has been facing.

As we look forward, our launch rates continue to look strong. And as we continue and come out of this redesigned cycle due to the component shortages, I'm excited about our ability to refocus all of our development efforts to new products and technologies.

I'll now hand the call back over to Steve for guidance and closing remarks.

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

Thanks, Neil.

The company's current forecast for light vehicle production for the fourth quarter of 2022 and full years 2022 and 2023 are based on the mid-October 2022 S&P Global Mobility forecast for light vehicle production in North America, Europe, Japan, Korea and China. Light vehicle production in these markets is expected to increase 3% for the fourth quarter as compared to light vehicle production for the fourth quarter of last year. For calendar year 2022, light vehicle production in these markets is forecasted to increase 5% when compared to calendar year 2021.

The company believes that revenue will remain difficult to forecast for the remainder of the year as a result of high levels of volatility in customer orders and vehicle production volumes, electronic supply chain constraints, labor shortages and overall economic uncertainty. Based on the updated light vehicle production forecast as well as year-to-date financials, the company is updating certain guidance estimates for calendar year 2022 to the following.

Revenue for the year is expected to be between $1.9 billion and $1.95 billion. Gross margins for the year are expected to be between 32% and 33%. Operating expenses are expected to be between $235 million and $240 million. Our estimated annual tax rate, which assumes no changes to the statutory rate is forecasted to be between 14% and 15%. Capital expenditures are expected to be between $140 million and $150 million, and depreciation and amortization is forecasted to be between $100 million and $105 million. Additionally, based on the company's current forecast for light vehicle production for calendar year 2023, the company still expects calendar year 2023 revenue growth of approximately 15% to 20% above the new 2022 revenue guidance of $1.9 billion and $1.95 billion.

Overall, the third quarter was impacted by the perfect storm of component supply issues that included both scarcity and cost increases, product mix issues, labor shortages and customer order volatility. While we are disappointed with this quarter's financial performance, we are confident in our ability to work through these issues and improve the gross margin profile as we move through the fourth quarter and into next year.

Beginning in the fourth quarter, we expect to see improvements to margins that will be driven by the benefit of the company's first rounds of cost escalation negotiations with customers to address ongoing commodity, freight and labor pricing pressure. These improvements should continue throughout next year and into 2024 as we work to offset cost increases with updated pricing. The plan we have developed and are executing to address these issues is consistent with our patient approach that we described previously and seeks to balance the need for pricing increases with our desire to continue to grow the business through new technology deployment at our customers.

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As the fourth quarter begins and we transition into 2023, we remain confident in our ability to grow the business and improve margins while at the same time expanding our technology portfolio. As we work to accomplish these objectives, we will continue to take a balanced, long-term approach to these challenges and believe that this plan will get us back to our targeted margin profile by the end of 2024. That completes our prepared comments for today.

Thank you for your time, and we can now proceed to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Luke Junk with Baird.

Luke L. Junk - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

I want to ask about the new [term] and a bigger picture question. First, in the near term, just wondering if you can help us unpack your sequential gross margin expectations as we go into the fourth quarter as implied by the updated full year guidance. Specifically, are the initial cost recoveries that you're contemplating already agreed to in the P&L sitting here in October? And conversely, what lessons should we take away from the third quarter in terms of things that could still pressure the margin sequentially?

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

Yes. So right now, there's -- the current financials that are running through to start the fourth quarter do not include the benefit of those price increases. So those are going to get finalized here in the next couple of months, but should take effect in the quarter for the quarter. And the second part of your question is kind of what lessons were left in Q3 that may leave a lingering effect.

And part of that, I think the biggest issue there that would be more than the bill material increases, the part that's the unknown piece that would -- could potentially go into Q4 would be the mix issues. So what happened in Q3 that the reason why we referenced the 150 basis points due to mix. We had some significant component issues on FDM during the quarter that caused us to miss a lot more units in the quarter than what we were expecting. And so that mix -- typically, when that happens, goes to base auto-dimming mirrors at a much lower margin profile. And with some of the launches we had and some of the business growth that we saw both -- really in all the markets, but especially some strong growth in the China market, what you saw with some margin pressure from base auto-dimming mirrors exceeding the percentage of business that we are expecting.

Luke L. Junk - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Steve, then I -- follow on actually flows right from that, and it's the impact of component shortages on FDM, so maybe either you or Neil could comment on this. So I'm just wondering the impact if we zoom out and look at FDM shipments for this year, if there's any way to quantify that, but more importantly, as we roll to 2023, just wondering if it's possible that you'll see a catch-up effect on FDM shipments next year if the components you need are more readily available? In other words, where do you envision the take rates next year versus your current level of FDM shipments?

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

Yes. So I'll start kind of with the number side, and I'm sure Neil will have some comments on kind of what's happening behind the scenes on availability of components and what that trend is. This year, we're probably by the time Q4 wraps up if we don't have any more significant issues, I would say this year is going to end up about 150,000 to 200,000 units light of where it would have been if we hadn't had the component issues.

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So we're putting up obviously record numbers on FDM shipments this year, and that growth has been pretty astounding. It would have been even better if we had availability of components. So that will kind of help you understand what the impact has been throughout the year and what we're expecting throughout Q4 in terms of FDM shipment availability due to component issues.

Neil, you want to jump in on that.

Neil Boehm - *Gentex Corporation - CTO & VP of Engineering*

Yes. Yes. I think from a component side, the team has been doing an outstanding job finding parts, trying to get the replacements built in and redesign the components into -- or design new components into the product. When we see next year, I think [it's] going to be a little bit of a challenge on a few parts. As we get into the -- probably the second quarter of next year, I think that's going to start to alleviate, and we'll have less pressure on getting and the availability of some of the parts that we've been struggling with. So I think as we go into next year, our ability to produce at the rate needed, especially the second half of next year, I think we'll actually be quite positive.

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

And Luke, I'm sorry, I did forget to answer 1 part of your question. The question is, heading into next year, what do we expect for volumes. Yes, we do think there will be some catch-up from parts that we missed this year. One thing we did experience throughout this year was we had several launch customers call and asked to increase demand versus their original forecast. And unfortunately, given the component issues, we weren't able to support those higher volumes. So if component issues were to get improved, we do think there's some tailwind based on the desire for that product that could happen into next year.

Operator

The next question comes from John Murphy with Bank of America.

John Joseph Murphy - *BofA Securities, Research Division - MD and Lead United States Auto Analyst*

Just a first question on the -- can you hear me?

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

Yes, sir.

John Joseph Murphy - *BofA Securities, Research Division - MD and Lead United States Auto Analyst*

Okay. Yes. On the revenue guide, I mean, at the midpoint of the range, it's basically largely unchanged, tightened -- you tightened it up here. You had this dismiss that you've alluded to of 700,000 units in the third quarter. You just mentioned FDM, you're still going to be [100,000] units [in light] relative to what you're expecting before. So I mean, it seems like despite the pressure in the third quarter and these other issues you're mentioning on mix, you haven't really taken the revenue number down that much. So I'm just -- I mean, obviously, costs are inflating and you're taking those up. So I understand that but there's not much change in truly in the revenue midpoint. So what makes you believe that you're going to make this up in the fourth quarter? Or is there something else going on here where you're following the IHS schedules and there may be just some risk in these numbers.

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Steven R. Downing - *Gentex Corporation - President, CEO & Director*

Yes. If you look at what we're expecting and what we're seeing the -- and I'm sorry, I keep saying IHS, but it's S&P Global mobility. So -- yes, it's going to take me at least 5 years before -- definitely doesn't roll off the tongue the same way. But one of the things that we're looking at when we look at the data heading into Q4, we do think there's some additional risk, especially on the component side. For us, we also believe on the vehicle volume side, there's going to be tough for the industry to keep up with that level of production in Q4. And then we know around the end of the year, especially between Thanksgiving and the holidays, that things start to lighten up a little bit. And usually -- and that's especially common when you have a very strained production environment than what we've seen in the last year. In other words, OEMs, just like the supply base have been working incredibly hard, trying to hit these levels of production. And so we think there's going to be at least a little bit of a pause at the end of the year to get people a rest.

John Joseph Murphy - *BofA Securities, Research Division - MD and Lead United States Auto Analyst*

Okay. And then the second thing on the component shortages. Obviously, this is persistent. You've been running [through] these issues and so is the whole industry for a while. I mean if you're going through these redesigns, how are you kind of ensuring supply going forward as you're working through the redesigns. And even if this chip shortage in aggregate continues into next year, which it sounds like it's going to, do you have the ability to kind of sidestep it with these redesigns and maybe get back on track with new chip supply elsewhere or redesign that allow you to thwart it?

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

So I'll go first and Neil will correct any misstatements of mine. But I think the 1 advantage of the redesigns is it's really hard to get guaranteed commitments. I mean when we're redesigning the new components, the team works really hard to try to get those commitments from the supply base. What we've experienced for the last 18 months has made us a little more jaded in terms of whether or not we actually believe those commitments will play out in reality.

But the 1 advantage of having multiple designs, for instance, let's say we have an FDM and we've maybe redesigned it once or at least twice, in particular, a part number. We now have several different building materials that are approved and validated an OEM meaning if -- even if the new components were to fall short, we're still securing. And you see part of this evidence in our inventory levels, where we're still securing parts under both designs because they have corporate common uses but then it also gives us more flexibility to be able to help an OEM by having multiple part numbers that are -- and multiple circuit designs that we can revert back to if other components become a problem.

John Joseph Murphy - *BofA Securities, Research Division - MD and Lead United States Auto Analyst*

Okay. Helpful. And then just lastly on ForEx. I mean, I got to imagine it's a benefit both on translation, but probably even on an economic basis. And can you kind of elucidate what maybe you saw in the third quarter, what you expect going forward?

Kevin C. Nash - *Gentex Corporation - VP of Finance, CFO, Treasurer & CAO*

Actually, it was a slight negative on the top line, probably 25, 30 basis points. So most of our stuff is denominated in the U.S., but we do have some in RMB and euro. So there was a slight negative on the top line and on the purchasing side as well, but it was probably 25 to 50 basis points on that.

John Joseph Murphy - *BofA Securities, Research Division - MD and Lead United States Auto Analyst*

Meaning the purchase on the cost side offset the theoretical benefit on the revenue side for a net negative. Is that a fair way to characterize it?

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Kevin C. Nash - *Gentex Corporation - VP of Finance, CFO, Treasurer & CAO*

Yes.

Operator

Our next question is from David Kelley with Jefferies.

Gavin Lorne Kennedy - *Jefferies LLC, Research Division - Equity Associate*

This is Gavin Kennedy on for David Kelly. Just starting with the gross margin drivers in the quarter, you noted 150 basis points of mix in Tier 2 headwinds. Can you walk us through the other impacts that you were seeing this quarter and the other moving parts there for the margins?

Kevin C. Nash - *Gentex Corporation - VP of Finance, CFO, Treasurer & CAO*

Yes. The biggest one that we've been talking about all year really is the raw material cost increases. And that was about 300 basis points of headwind. And then in addition to that, the labor headwinds of about 100 basis points. So when you combine all that together, that's about the main driver. There were some puts and takes inside of that, but those are the biggest ones that are moving down versus last year.

Gavin Lorne Kennedy - *Jefferies LLC, Research Division - Equity Associate*

All right. That makes sense. And then as a follow-up, your -- the guidance implies a meaningful ramp-up in the Q4. Do you expect to fully offset input cost headwinds in the quarter via pass-throughs? And are there any retroactive recoveries that might provide a onetime benefit in Q4?

Kevin C. Nash - *Gentex Corporation - VP of Finance, CFO, Treasurer & CAO*

Yes. So I mean there is -- I mean part of that implication is that there will be some onetime benefit from the recoveries that Steve talked about earlier. But we're looking at both -- some of that applies to '22, but into '23 and '24 as pricing changes going out. But that -- and so that would positively impact the Q4 margin specifically. And then we do see -- yes, the sales levels supporting some of that offset. And as we talked about, the mix was pretty weak towards base mirrors in the quarter, really driven by growth in China, outpacing the rest of the market. and then weakness in FDM. So I mean, we would expect that some of that would alleviate as well in Q4.

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

But if you look at our year-to-date gross margin performance, the full year range is very similar to where our year-to-date is. So it's not a meaningful step up in Q4 that helps us get to that full year guidance. In other words, any -- if we hit Q4 inside of that full year guidance range, that's what it takes to hit that for the full year.

Operator

Our next question is from Ryan Brinkman with JPMorgan.

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Ryan J. Brinkman - *JPMorgan Chase & Co, Research Division - Senior Equity Research Analyst*

Wanted to ask first on raw materials. I saw in the release, you discussed a quarter-over-quarter increase in raw material prices. It seemed to be in the context of comparing to the third quarter of '21. And so maybe year-over-year or not sequentially, but a basket of automotive commodities that we look at is down 42% versus 3Q last year. It's down 27% versus 2Q this year. And I think our index [is] heavily weighted towards steel, which you don't really buy and doesn't take into account some of your more [esoteric, PGM or coding] exposures or whatnot, but still sort of surprised that you're still experiencing the higher commodities. Maybe you can talk a little bit about what your exposures are there that are hurting your margin or if maybe the spot prices have started to move in the right direction already, but there's some kind of lag factor or hedging place in that might be offsetting the impact on the P&L as of now? And then based upon what you know today, what is your expectation for how raw materials may impact the margin going forward?

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

Yes, it's a great question. This really heralds back to the last 9 months, and our approach has been much more of a patient wait-and-see approach to understand the underlying supply base and materials market. What we were concerned about was going to OEMs too quickly with a -- not a complete picture of the cost scenario. And so given our income statement and our balance sheet and ability to wait a little longer, we wanted to wait until we felt like we were 80% of the way through the cost increases that we could portray a more accurate depiction to our customers and not have to go back 4, 5 or 6 times with this conversation. We feel like as we got about halfway through Q3, we felt like we understood the scenario fairly well.

Like I mentioned, we're about -- we feel like we're about 80% of the way through those cost increases. And so we began engaging really in Q3 and with heavy focus on trying to get most of these situations resolved in Q4 to set us up really for -- partially for Q4, but then also moving into 2023. And so there's been a lot of catch-up data that we had to provide to OEMs and there's obviously a lot of conversations that go around on the impact of these verification of the cost impact and then how do you set up contracts that reflect what we need to at least offset some of those costs. So we were a little bit behind some of the supply base in terms of asking for this money. That was done deliberately. Now that we're in this stage, we feel pretty confident and comfortable with the data presentation and where we're at and feel very comfortable that we're going to reach success over the next 18 months in getting these issues resolved.

Ryan J. Brinkman - *JPMorgan Chase & Co, Research Division - Senior Equity Research Analyst*

Okay. And I think when we first started talking about this like probably on the 3Q '21 call. I think you'd seen yourselves as maybe having the luxury to wait. You don't have any -- you're not levered, you're investment-grade. You've got an embarrassment of riches on the margin line versus Adient or others. They're levered, they're [junk-rated]. They only have mid-single-digit margin. And so people are being asked to deliver 1% to 2% annual customer price reductions in a 2% CPI world. You can offset that with 3% to 4% productivity in a 9% CPI world. Those suppliers had an emergency, whereas you guys could sort of wait.

I'm just curious if looking back, you still think maybe that was the correct approach or if you can make up for it. I mean I heard Ford earlier this week. They sounded like the most understanding that they'd ever been. They're like, first, we wanted to push back and then we're like, yes, these suppliers, they actually do have a point. And then they [pointed] up like to $1 billion. Are you still going to -- is that still going to be on the comp and you're going to be as compensated as the others went earlier? Or [are] maybe automaker (inaudible) less sympathetic for an investment-grade, non-levered supplier with 30% gross margin relative to a junk-rated one they have to help out or things could go wrong.

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

Well, I think it's -- I would tell you -- there's a lot of questions there, so I'll start working through them in order. But I think number one is, yes, we still believe our strategy was the right one and only time will tell. What I can tell you is the fact that we took our time, we have not been met with the resistance that you would expect if you were going to be told flat out no. One other thing is we are in a constrained environment. And so we -- most OEMs do realize that you have to at least negotiate some type of a favorable deal in order to guarantee the supply. This is the same issue

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we've seen with our supply base. And so it's not like you're going -- we're not going to get all the parts we want. OEMs have not been able to get all the parts that they want from the supply base either. And so there's a certain natural inclination towards making sure that we set up deals that are favorable for both the supplier and for the OEM, and that's still our focus. And that includes not only reprieve on bill material increases, but also long-term sourcing and contracts.

And so the different approach that we take isn't just focused on 100% getting our cost covered so that we can move on. It's about how do we balance the short-term return to profitability that we need for our shareholders and balancing that with how do we make sure we're getting the product awards that can help drive growth over the next 3 to 5 years. And so we're not taking a very shortsighted approach to that. For OEMs, we sit down and try to be very open about. We have significant cost issues that have to be addressed today. But at the same time, we're open to the concepts over the next 3 to 4 years of certain awards that could help us grow the business and produce some offset to cost issues through volume and through growth opportunities.

And so right now, I would tell you that we still think this is the most holistic approach and the right one for us for who we are. There's no doubt if you're petering on the brink of insolvency, that OEMs are very, very motivated to get you cash right away to make sure that doesn't happen. But it is something that we continue to work on, and we believe this is not going to be over in Q4. This is going to be a recurring theme for us throughout all of calendar year 2023.

Operator

Our next question comes from Josh Nichols with B. Riley.

Michael Joshua Nichols - *B. Riley Securities, Inc., Research Division - Senior Analyst of Discovery Group*

Just to touch on the margin point again. The full year guidance kind of implies a pretty healthy step up in gross margins for 4Q of like 300 bps plus. One, how much of that is coming from price increases versus mix? And then second part of the question is just how much of this customer base is going to have these increases that come through in 4Q versus how much may be remaining for early part of '23 that could result in a potential further step up for next year?

Kevin C. Nash - *Gentex Corporation - VP of Finance, CFO, Treasurer & CAO*

Yes. As Steve mentioned, right, we have a couple of different-pronged approach. One of them is approaching them about the cost inflation that we've seen to date and through from really the start of this last year through now. And so we would expect some of that to hit the fourth quarter, so call it 100, 150 basis points maybe in that range. The rest of it, as we talked about, mix was a little bit weak. So the rest of it is going to come through mix and if sales improve, hopefully offsetting that with our normal leverage cadence to get to that sequential improvement in margin. But as Steve, our year-to-date gross margin is in that 32% range already. So we just have to be -- have that sequential improvement from the overall product portfolio and a little bit from the recovery side.

And as you head into '23, again, this conversation is active in onetime recoveries and then piece price changes as we move into '23 and even beyond potentially. But we're going to balance that, as we said, right? We're looking for growth longer term and not just satisfying our needs today. So I think that our teams have been working through that and balancing that approach to help get that long term -- maintain that long-term philosophy.

Michael Joshua Nichols - *B. Riley Securities, Inc., Research Division - Senior Analyst of Discovery Group*

Yes. I mean it's fair to assume that, right, there's not going to be any price cuts that you typically see in the first quarter, given what's going on with the supply chain and component price increases. But just thinking about next year...

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Steven R. Downing - *Gentex Corporation - President, CEO & Director*

That's correct.

Michael Joshua Nichols - *B. Riley Securities, Inc., Research Division - Senior Analyst of Discovery Group*

Yes. Yes. I'm thinking about next year, you reaffirmed, right, the growth outlook, again, much higher than the market. I'm just curious, given that there's so much that's going on with a slowing economy, rising fuel prices, interest rates, but juxtaposing that is inventory levels that remain well, well below historical levels that would probably support or prevent any big slowdown that you might have previously with price cuts and inventory issues. So I'm just curious your thoughts about how you handicap that going into the next year. And the puts and takes to the risk and opportunities to the top line guide for next year.

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

Yes, you're exactly right. This is very interesting. I joke internally a lot that if it weren't real, it would be very, very fascinating from an overall macroeconomic standpoint to study this. Unfortunately, it's very real. But you're exactly right. You have a lot of puts and takes going on in the overall light vehicle production space right now where you have very low inventories, really pretty high demand. And -- but then you have this looming headwinds and obviously, interest rates causing a problem. My best guess is that those negative headwinds really won't play much of a factor until the second half of next year because it will take us the first half to meet current demand and get inventories back up to where they need to be on (inaudible). And then in the second half is where the biggest risk factor for next year resides around what the sales look like throughout the year.

What we're seeing, though, right now is the S&P Global Mobility forecast has pulled back -- Kevin is laughing at me trying to get that out of my mouth, but if we look at their forecast, it's pulled back quite a bit from where it was even 6 months ago for 2023. And so even at those lower levels of light vehicle production increases for next year, we still feel comfortable with our forecast. So we only need 4% to 5% help from a light vehicle production side to hit that 15% to 20%, meaning what we're implying is anywhere from a 10% to 12% outperformance to market. So if the market goes to a flat market for whatever reason, you'd still expect to see that outperformance. And that's really driven by the strength of our product portfolio.

Operator

(Operator Instructions) Our next question comes from David Whiston with Morningstar.

David Whiston - *Morningstar Inc., Research Division - Sector Strategist*

You've talked a lot about labor shortages today. I was just curious, are those on -- at Gentex? Are they the customer? Are they upstream or everywhere?

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

They're everywhere, and they definitely have impacted us as well. It's been a very tight labor market in West Michigan. And honestly, even with the changes in salaries and wages, it has been -- it's still a very constrained market

(technical difficulty)

get the team put together and the size we need to support this level of sales. So from an operational standpoint, we're running a tremendous amount of overtime right now to hit these sales levels. And obviously, that's been part of the headwind that Kevin described on the labor side that's impacted margins.

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David Whiston - *Morningstar Inc., Research Division - Sector Strategist*

And for you guys directly, is the labor need more on the hourly side or salary side?

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

It's both, but definitely, the hourly side is what is the biggest risk factor in driving the gross margin deterioration. The operating expense side, I have seen a step up in terms of higher salaries and wages on operating expenses as well. And we're holding together pretty well there because there our ability to outsource and use contractors to help offset, obviously, on the manufacturing side, that's not as easy.

David Whiston - *Morningstar Inc., Research Division - Sector Strategist*

And I've been hearing from dealers this week that they're not really expecting any kind of major recovery in Toyota, Honda inventory until middle of next year. I'm just curious what you're hearing from them and what you're thinking on that.

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

Yes. I mean, they're pretty quiet about what they communicate in terms of how they're going to get production levels back up to the inventory -- to meet some inventory needs or at least once that they have. This is purely speaking from our gut based on what we're seeing. But I would [tend] to agree. I don't think you're probably until the summer before you start to see any meaningful recovery in inventory levels. If it does happen, it's because that's bad news on the sales side, so -- from a vehicle sales standpoint.

David Whiston - *Morningstar Inc., Research Division - Sector Strategist*

Okay. And your stock really gets undervalued, in my opinion, and it seems to be pretty cheap right now. Are you -- I know there's macro storm clouds to consider, too, but at the same time, even if we do have a recession, auto volumes are likely to go up next year because of the chip shortage impact. So is it time to get more aggressive on buybacks?

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

Well, I think what we've -- position we've taken for the last 6 months has been just -- obviously, cash flow slowed up a little bit as we move to secure inventory and move inventory levels higher. When we look at this price, we would tend to agree with you. If you look at our growth prospects, the revenue, the desire for the products we have. The only negative that you would talk about is the gross margin deterioration. The one thing that we like to remind shareholders of that we've done this before, right? 2008, '09, our margins deteriorated. We rebuilt them in 2012 and '13. It happened again down into the low kind of 32% range. We know how they'll go to work on the income statement to drive value and improve margin profile. And so -- yes, we would agree with you. We look at this and say this is an opportune time to enter the market if you're long Gentex.

Operator

Our next question comes from James Picariello with BNP.

James Albert Picariello - *BNP Paribas Exane, Research Division - Research Analyst*

The bridge to the intact 15% to 20% revenue growth rate for next year, I just want to revisit that. Originally, that range was pegged to LVP growth of, I think, 10%. Now we're looking at a 4% industry assumption. So can you kind of unpack how you're thinking about what still informs the

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confidence? I imagine recovery pricing embedded in your net price, certainly helps better mix from improved trip supply and your redesign work, it probably adds another layer. But yes, I just want to get your take on that.

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

Yes. In addition to the factors you mentioned, I would say the single largest piece that adds confidence to our forecast is the amount of FDM that we had to say that we couldn't ship and produce this year. And how many OEMs we had to say we can't increase take rates because of the constraints on the raw material side. And so when we look at the LVP forecast, what we're seeing from our take rate standpoint and the things we had to say no to. We feel really good about the desire for our products, especially FDM and OECs as we head into next year.

And so like you mentioned, typically, you would see our forecast move a little bit closer to in line with the changes in LVP. I think heading into next year, we feel really comfortable with the demand for our products.

James Albert Picariello - *BNP Paribas Exane, Research Division - Research Analyst*

Got it. So I mean just on the customer recovery story line. I mean, your typical price down is something like 2% to 3%. What could your net pricing be for next year in terms of how successful these recovery negotiations could trend?

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

I would -- what we're modeling right now and what we believe needs to happen to hit the financial performance we're talking about is a net positive 50 to 100 basis points.

James Albert Picariello - *BNP Paribas Exane, Research Division - Research Analyst*

Net positive 150 to...

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

50 to 100. Yes. And that's in addition to what we -- yes. And that's in addition to what we pick up in the fourth quarter. So we're going to have some pick up in Q4 and then we expect to see on top of that another 50 to 100 basis points in positive pricing. And that's not taking in product mix or sales growth that's looking just at same kind product sales 1 year to the next.

James Albert Picariello - *BNP Paribas Exane, Research Division - Research Analyst*

Got it. And just my last one. The implied guidance for the fourth quarter has a gross margin level of basically 34%. How -- and I imagine that probably has some discrete benefit embedded. So how should we be thinking about the gross margin trajectory for next year through next year? What's the right exit rate for the fourth quarter in '23? Just kind of -- just so the bar is decently set in terms of the progress.

Steven R. Downing - *Gentex Corporation - President, CEO & Director*

Yes. If you actually look at our Q4, we would actually be slightly below that in terms of what we think Q4 guidance is. If you -- like Kevin mentioned, we're at 31.9% year-to-date on our current gross margin profile. So to hit the 32% to 33% really, really anywhere in that 32% to 33% range gets you there on a weighted average. If you're looking at the high end, then yes, we would need to be closer to that. We don't think we're going to get there in Q4 that early. And so we kind of thought what we're mapping out is really a -- Q4, all of '23 and then through 2024. What is your kind of [inner] velocity when you come into '23 and then what's your exit? When we get through '23, we're thinking we're going to finish by the end of

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'23. So let's call it, Q4 '23, we better be somewhere in the 33% to 34% range if we're going to then by the end of '24, get back to that 35%, 36% range. And so that's kind of the map that we've laid out. That's assuming that there's some headwinds and tailwinds in there and some of the things we've talked about.

It's also looking at some of the factors that we know to be -- we're not done with the cost escalation scenario from the supply base. So it's -- we think we're 80% of the way through it, but that implies there's still 20% to go on the supply base side and costs that we're going to have to absorb and find a way to either offset or get offset by our customer base. So we'd probably be a little below your estimate there for Q4 this year, but then growing and strengthening not only in Q4 but all the way through 2023 and through 2024.

Operator

At this time, there are no further questions. I would now like to turn the conference back to Josh O'Berski for closing remarks.

Josh O'Berski - *Gentex Corporation - Director of IR*

Thank you, everyone, for your time and questions today. As you may know, we will be at SEMA in Las Vegas next week, and we would welcome investors to join us in our booth. If you're interested in attending, please let me know. And that said, this concludes our call. We wish everyone a great weekend.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.

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