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GNTX.OQ - Q3 2021 Gentex Corp Earnings Call

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OVERVIEW:

GNTX reported 3Q21 net sales of $399.6m, net income of $76.7m, and diluted EPS of $0.32. Expects 2021 revenue to be $1.68-1.75b and 2H21 net sales to be $770-840m.

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to Gentex Reports Third Quarter 2021 Financial Results Conference Call. (Operator Instructions)

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

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

Thank you. Good morning, and welcome to the Gentex Corporation Third Quarter 2021 Earnings Release Conference Call. I'm Josh O'Berski, Gentex' 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 Financial '21 -- 2021 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*

Thanks, Josh. For the third quarter of 2021, the company reported net sales of $399.6 million compared to net sales of $474.6 million in the third quarter of 2020. On a quarter-over-quarter basis, global light vehicle production in the company's primary regions of Europe, North America, Japan, Korea and China decreased 23% when compared to the third quarter of 2020. Additionally, when compared to the mid-July 2021, IHS Markit light vehicle production forecast in the company's primary regions actual light vehicle production during the third quarter of 2021 declined in excess of 3.1 million units or 19% as a result of the ongoing industry-wide part shortages and global supply chain constraints.

The largest shortfall in light vehicle production for the third quarter of 2021 came from the European and North American markets, which together experienced actual light vehicle production levels that declined by approximately 27% compared to the third quarter of 2020. The reduction in light vehicle production compared to forecast was led by several OEM customers that deploy high levels of the company's product content including both interior and exterior auto-dimming mirrors and other electronic features such as Full Display Mirror and HomeLink. While we have been dealing with the impacts of supply chain constraints throughout the first half of 2021, the effects of the electronic component shortages worsened during the third quarter of this year.

In fact, the change in OEM schedules during the quarter was estimated to have negatively impacted demand by at least 2.5 million mirrors during the quarter. We estimate that the lost revenue on these units was approximately $125 million. Despite these challenges, our team has done a remarkable job of securing components as well as providing unique solutions for our customers that included complete redesigns in order to avoid constrained components to help minimize the impact to OEM production schedules.

For the third quarter of 2021, the gross margin was 35.3% compared to a gross margin of 39.7% for the third quarter of 2020. Compared to the third quarter, the gross margin was primarily impacted by the lower sales levels stemming from the 23% quarter-over-quarter decline in light vehicle production in the company's primary regions.

However, the gross margin was also impacted by lower-than-expected price reductions on raw materials, increases in freight and other supply chain-related costs as well as some component cost increases. While the gross margin for the third quarter of 2021 was below our original forecast, we were pleased with the overall performance of the company, given the significant reduction in sales versus our forecast coming into the quarter.

Since the beginning of the pandemic, we have worked hard as an organization to reduce overhead costs, which helped stabilize our profitability in the third quarter despite this unpredictably large change in revenue. In fact, our estimates show that had the sales level been in the range of our original forecast for the quarter, then our gross margins would have been very close to our previous guidance for the second half of 2021.

Operating expenses during the third quarter of 2021 increased by 7% to $52.7 million compared to operating expenses of $49.4 million in the third quarter of 2020. Income from operations for the third quarter of 2021 was $88.2 million compared to income from operations of $138.9 million for the third quarter of 2020. During the third quarter of 2021, the company had an effective tax rate of 15%, which was primarily driven by the benefit of the foreign-derived intangible income deduction and discrete benefits from stock-based comp.

Net income was $76.7 million for the third quarter of 2021 compared to net income of $117.1 million in the third quarter of 2020. The change in net income was primarily the result of the quarter-over-quarter change in sales, gross margins and operating profits. Earnings per diluted share for the third quarter were $0.32 compared to earnings per diluted share of $0.48 for the third quarter of 2020.

I will now hand the call over to Kevin for 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 '21 were $391.3 million, compared with $464.7 million in the third quarter of 2020. Auto-dimming mirror unit shipments decreased 7% during the quarter compared to the third quarter of last year. Other net sales in the third quarter of '21, which includes dimmable aircraft windows and fire protection products, were $8.3 million compared to other net sales of $10 million in the third quarter of '20.

And dimmable aircraft window sales decreased by 34% for the third quarter of '21 when compared to the third quarter of 2020. 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 of '21, the company repurchased 2.83 million shares of common stock at an average price of $32 per share for a total of $90.6 million. As of September 30, 2021, we have approximately 25.4 million shares remaining available for repurchase pursuant to our previously announced share repurchase plan, and we intend to continue to repurchase additional shares of 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 impact of the COVID-19 pandemic and supply constraints, market trends and other factors, the company deems appropriate.

Shifting gears a little bit, let's look at the balance sheet. The balance sheet items mentioned today are valued as of September 30, 2021, and are compared to December 31 of '20, unless otherwise noted. Cash and cash equivalents were $269.9 million, down from $423.4 million primarily due to share repurchases, dividend payments and capital expenditures that more than offset cash flow from operations.

Short-term and long-term investments combined were $211.6 million, up from $189.2 million. Accounts receivable was $241.2 million, down from $284.9 million due to the lower sales in the current period. And inventories were $292.6 million, which increased from $226.3 million, the majority of this was change in raw materials and primarily within that electronics. And accounts payable increased to $100.5 million, up from $84.8 million, primarily due to increased purchases as well as month-end payment timing.

And quickly, let's take a look at the cash flow statement. Third quarter '21 cash flow from operations was $47.1 million compared with $138.6 million in the third quarter of 2020. Operating cash flow was impacted by the lower net income quarter-over-quarter as well as shifts in working capital and deferred taxes. And year-to-date cash flow from operations was $299.4 million, down from $329 million for year-to-date 2020.

CapEx for the third quarter of 2021 was $13 million compared with $8.2 million for the third quarter of 2020. And year-to-date, capital expenditures were $44.4 million and compared to capital expenditures of $37 million in 2020. And lastly, depreciation and amortization for the third quarter of '21 was $23.6 million compared with $25.1 million for the third quarter of 2020. And year-to-date D&A was $75.2 million compared to D&A of 2020 -- in 2020 of $78.5 million.

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

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

Thank you, Kevin. In the third quarter of 2021, there were 12 net new nameplate launches of our interior and exterior auto-dimming mirrors and electronic features. Of these 12 net new nameplate launches, approximately 75% were advanced features with HomeLink and Full Display Mirror leading the way. Also in the third quarter of '21, there were several new base inside auto-dimming mirror launches and of these, 40% were for the China domestic market. This is evidence of the continued growth of our baseline technology in this growing market.

During the third quarter of 2021, we began shipping Full Display Mirror to our tenth and 11th OEM customers on light commercial and passenger vans. We're excited to announce that both Fiat and Mercedes are now shipping Full Display Mirror on their vehicles. For Fiat, we're shipping on the Fiat Ducato. And at Mercedes, we started to ship Full Display Mirror on the Mercedes Vito. These vehicles offer a new market opportunity for us as a company.

Over the last few years, we've shown examples of our technology that can be deployed in the commercial van market, and these FDM awards and launches are helping us find new opportunities for growth. In addition to these new OEMs launching FDM, we're excited to announce that we began shipping Full Display Mirror on the Jeep Grand Cherokee and the Jeep Grand Wagoneer. Our OEM and consumer feedback continues to be very strong in regards to Full Display Mirror technology. And with the addition of these new nameplates, we are currently shipping Full Display Mirror on 60 vehicle nameplates around the world.

On another technology front, we're excited to announce that we began shipping Integrated Toll Module to our second OEM customer, Mercedes. Mercedes has introduced the ITM technology on the EQS, and we're looking forward to see how the consumers will continue to adopt this technology going forward. Tolling in North America continues to evolve, and we see the ITM technology as a great way for an OEM to take a step into the transactional vehicle of the future while helping to keep the aesthetics of the vehicle intact. Despite all of the chaos caused by component shortages, and supply constraints, the launch and development activities have never been busier. The Gentex team has done an amazing job balancing the immediate needs of the shortages and the longer-term needs of developing new products and technologies that will drive our future growth.

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 2021 and full years 2021 and 2022 are based on the mid-October 2021 IHS Markit forecast for light vehicle production in North America, Europe, Japan, Korea and China. Light vehicle production in the company's primary markets is forecasted by IHS Markit to decrease 20% for the fourth quarter of 2021 compared to last year. It is important to note, however, that this vehicle production forecast for the fourth quarter represents a sequential increase in light vehicle production of 2.5 million units in our primary markets when compared to the third quarter.

Forecasted vehicle production volumes for the fourth quarter of 2021 and calendar years 2021 and 2022 are included in our press release. Based on this light vehicle production forecast and the actual results of the third quarter of 2021, the company is providing updated guidance estimates for the second half of the year. The company's current estimate is that net sales for the second half of 2021 will be between $770 million and $840 million. This revenue forecast is based on the combination of the third quarter actual revenue as well as the company's opinion that component shortages and supply constraints will continue to drive production below the IHS Markit light vehicle production forecast shown in our press release.

Our revenue guidance includes manual adjustments to account for the company's estimates of the impact that the global supply constraints will have on overall light vehicle production. The company has also updated its cost and profitability models to include the estimated impact stemming from these expected lower vehicle production levels, elevated raw material prices, freight expenses and labor costs.

The updated financial guidance for the second half of 2021 replaces all previous guidance for the second half of 2021 and is as follows: revenue for the second half of 2021 is expected to be between $770 million and $840 million; gross margins for the second half of the year are expected to be between 35% and 36%; operating expenses for the second half of 2021 are forecasted to be approximately $105 million to $108 million; our estimated tax rate for the second half of 2021, which assumes no changes to the statutory rate, is forecasted to be between 15% and 16%; capital expenditures for the second half of 2021 are expected to be between $50 million and $60 million; and depreciation and amortization for the second half of 2021 is forecasted to be between $48 million and $52 million.

Based on the mid-October 2021 light vehicle production estimates for 2022, the company estimates that revenue for calendar year 2022 will be approximately 15% to 20% higher than the updated 2021 revenue estimates of $1.68 billion to $1.75 billion. On a positive note, overall vehicle inventory levels are at historic lows, demand from our customers continues to remain strong and interest from our customers in our core products and new technology areas for future projects is very high. So despite the incredibly turbulent last 18 months and the next few quarters, which we expect to continue to be challenging due to supply chain constraints, our long-term growth prospects have never been higher, and we continue to believe that the next several years will produce above-market growth rates that should provide us the opportunity to achieve excellent shareholder returns.

In conclusion, I would like to take just a minute to thank the entire team at Gentex for their incredible effort over the last 6 months. Our customers will never know the full story of how much work you have done in redesigns, abbreviated developments, early mornings and late nights trying to find solutions to these supply chain challenges, but I do. And I just want to thank you publicly again for the amazing effort and performance.

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) Your first question comes from the line of Luke Junk from Baird.

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

First question, I wanted to ask about FDM, and I appreciate the update on the tenth and 11th OEM customers. I realize there's a lot of moving parts right now between production volatility, shifting vehicle mix and whatnot. But do you have a view on how FDM take rates are trending this year? On an underlying basis, earlier this month. J.D. Power highlighted some very positive consumer feedback on camera rearview mirrors for the second straight year. And I was just hoping you could put that in context of what you're seeing in the business with respect to take rates specifically?

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

Yes. Thanks for the question. What I would say is on take rates in general, they've definitely been trending higher. Now part of that is because we believe the feature is compelling and consumers, like you mentioned, in the J.D. Power study, obviously, value the feature. But the other part, especially during the first half of this year, with limited production capacities, OEMs were tending to build higher-end vehicles. And so that obviously helped our feature content. But what I would say started to change in Q3 was quite frankly, OEMs were willing to build almost anything. And so I would say the take rates have changed, but not really because of a mix issue or I mean desire issue...

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

Customer preference. Yes.

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

Issue on our side but because of a mix issue in terms of OEMs were starting to scale back some of the feature content because they knew it wasn't possible to get all the electronics, they needed to build those vehicles. So it's really been a tale of kind of 2 halves of the year. The first half was very rich on the feature mix side. Q3 was trending a little lower and primarily driven by the constraints that exist on the electronic side.

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

Okay. And then I wanted to ask a question about supply chain as well. And specifically what you're seeing in your supply chain right now, both for chips and other electronic components. I know that your teams are very close to the situation. So just be interested to see what you're seeing real time and if there's any signs of light in the channel right now?

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

Yes. I would say really what we're dealing with is this is a daily issue. So the teams are literally triaging this issue. And every day, you come in, there's a new problem, a new issue, different components that are constrained. And so it's -- like we mentioned in the call, this is actually getting worse and over the Q3 period -- into Q2, it was bad, Q3 got drastically worse. And what we're seeing at the beginning of Q4 is we haven't reached that bottom yet. And so we believe this is at least several more quarters of these types of issues we're going to have to deal with.

Operator

Your next question comes from the line of David Kelley from Jefferies.

David Lee Kelley - *Jefferies LLC, Research Division - Equity Analyst*

Maybe starting with the top line. I was hoping if you could talk a bit more about the moving parts into the fourth quarter here, you're effectively guiding to flat revenues versus Q3. It sounds like based on the prepared remarks, you're below IHS in your LVP assumptions. But maybe if you could just walk us through if you're assuming any incremental step-up in LVP at all? And also how you're thinking about some of the other drivers such as mix and outgrowth going into year-end here?

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

Yes. If you look at the IHS data, it suggests a 2.5 million unit increase from Q3 to Q4. We believe Q4 is going to look much, much closer to Q3 production levels. So we would tend to be pretty bearish. And the primary reason is we don't see the supply side able to support that additional volume in a short period of time. So if you follow that logic through, I mean, we basically outperformed by 700 basis points versus the reduction in -- reduction in light vehicle production. We would say, we would assume that to be continue. If you look over the last 18 months, that's been roughly the outperformance versus the market really for some time. So kind of that upper end of the mid-single digits is kind of where we've been outperforming up.

David Lee Kelley - *Jefferies LLC, Research Division - Equity Analyst*

Okay. Got it. That's helpful. And then maybe shifting gears to gross margin trajectory. Can you give us a sense of how you're thinking about some of the opportunities to recover whether it's raw material cost or pass on some of the elevated electronic component cost? And as we think about the revenue growth guidance for the out year for 2022, obviously you're not guiding to next year yet. But maybe if you could walk us through how you're thinking about leverage ability of the gross margin line into next year.

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

Yes. I'd say, first, on the ability to get compensated from our customers on the increased cost structure. We know this is a trend in the industry, and it's not going away soon. So there's going to be a lot of suppliers having this conversation with OEMs. I think OEMs are going to have to address this to some degree with the supply base. Our goal here is to try to make sure we understand it before we go in and ask for relief because the cost increases aren't done yet. It's really just the beginning of that cycle. So before we go in and try to renegotiate anything, we're going to be trying to make sure we understand the full picture first. Certain other Tier 1s probably won't have that luxury or going to move sooner. And that will obviously help establish the playing field for what's going to be acceptable at an OEM level.

In terms of future guidance, if you remember, our original guide for this year was, I think, 38.5% to 39.5%. Our initial take on 2022 would be that it's probably going to be slightly lower than that, given the material cost pressures that we're seeing and without having line of sight yet in terms of any ability to get compensated back from our customers. So we would say it's probably trend into 50 to 100 basis points lighter than that, assuming there's not help from the customer.

David Lee Kelley - *Jefferies LLC, Research Division - Equity Analyst*

Okay. That's really helpful. Maybe one more, if I could squeeze it in, just a follow-up to that point. The electronic component costs, you noted the ongoing shortages and deterioration as far as volumes go, but are you continuing to see cost of rising from your electronic suppliers? Or any plateauing there? And how should we think about some of the further pressures, if any, into next year?

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

Yes. We're -- this -- like we talked about earlier, this isn't going to end anytime soon. So as long as there's constraints, obviously, the power and the relationship moves to the supply base on constrained components. So I think you're going to continue to see pricing pressure, really until there's additional capacity or unfortunately, if demand were to drop. But right now, we don't see any time in the next 18 months where that equation changes. And so we're going to continue to expect to see some pressure from the supply base.

Operator

Your next question comes from the line of John Murphy from Bank of America.

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

I've got a few questions in this we're getting certain time. So an answer them as best you can or whatever you can. But when you talk about the fourth quarter, you're talking about units getting about 2.5 million units better. I'm just curious why you think you kind of have that visibility in the fourth quarter, and you seem to be saying it's not getting much better, but it is getting better. So I'm a little bit confused as to what the message is in the near term.

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

No, we were referencing IHS is forecasting vehicle production to get 2.5 million units better. We actually think that our revenue is going to be very similar to Q3. And we think the overall vehicle production will be much more similar to Q3 than what IHS is forecasting. So we don't see the industry being able to support that additional volume.

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

Got it. Okay. And as you go into early next year, I know it's difficult to call. But I mean, where is -- where do you think the nadir is? I mean, if you're talking about revenue being up 15% to 20% year-over-year. It seems like you've got some idea that somewhere in the year, things shift. I mean what gives you that kind of comfort? And where do you think that nadir is?

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

Well, I think when you look at what happened this year, there were some -- definitely some real troughs in terms of vehicle production, that if you take those out and you run at a more constant run rate, it provides -- I mean, I think right now, IHS is forecasting 9% vehicle production growth from '21 to '22. And so we're looking at that saying, yes. And the demand that we saw from our customers is actually better. So that would put us -- that guidance range would be about 7% -- at midpoint would be 7.5% outgrowth versus the market, which is what we've been running at. And so we think there's going to be some improvement in the supply base at some point next year. It may take until midyear before some of the constraints start to alleviate and start to improve. But we don't see any reason why the first half couldn't be slightly better than the first half of this year as well.

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

Got it. Okay. But you're counting on second half being the real -- I mean, being the real turning point where things kind of hopefully normalize and things start really flowing.

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

Yes.

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

Okay. And if we were to think about a 15% to 20% revenue bump year-over-year, all else equal, that would imply some pretty good operating leverage and improvement in margins. But what we've seen recently, particularly in this quarter is SG&A went off as sales went down. Raws are rising. I mean, there's cost inflation that seems to be seeping into the system almost everywhere. I mean, how do you think about the operating leverage and positive mix versus rising costs next year? And I'm not asking -- it certainly wouldn't pin you on an absolute margin target right now, but maybe if you can talk about sort of the benefit of volume mix versus cost inflation, whether it be in raws or input costs or labor? How should we think about the major buckets there?

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

Yes, that's a great question. I mean I think one of the things that with the sales drop in the current quarter, what we've seen is obviously the fixed cost piece is becoming a bigger portion of our overhead cost. As you do grow in that 15%, 20% range, you do stand to be able to leverage that a little bit better. And with the changing production schedules or the OEM schedules, that does create inefficiencies.

So you had labor time, people working hectic schedules because much of these schedules have changed during -- from the beginning of the week to the end of the week and so you have to staff accordingly as if you're going to build the full schedule and they change. So I think if -- as we get back to something that's more stable and growing, and we can predict OEM behavior better, we can staff better. But certainly, there are cost inflation things going on, but part of what we've had so far and what we have continuing into next year, is good product growth.

You have a ton of -- a lot of FDM growth, OEC continues to be a driver of growth even into next year. And so those things help create a little bit of tailwind on the margins that do help offset some of these other costs that some of them are transitory, but help offset some of the -- hopefully offset some of the price increases that we're experiencing.

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

One thing I'll add to that, too, just quickly, John, is the R&D expense is, I believe, a bullish sign because that's reflective of the work we're doing to drive revenue 3 years out. And so that's in our estimate, at least and what we really want to drive home is those are not tied to the current issues that we're experiencing. Those are some of the same resourcing that's been working so hard on is not dropping the ball on those new product awards and those new OEM launches and the real R&D that's going on behind the scenes on some of the future growth behind the scenes on some of the future growth drivers.

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

Got you. And then just lastly, real quick. On the inventory number, I think you guys cited $269.2 million at the end of the quarter versus $226 million at the end of last year, about a 19% increase. I mean, it's a big number as sales are grinding down and things are getting tighter. You mentioned raws were part of that inflation. I mean what's going on there? Is there some prebuild that maybe you're doing in addition to some of that raw inflation?

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

Yes, if you read between the lines, right, Steve talked about $100 million, $125 million of sales falling out of the forecast, a lot of that is in high electronic content stuff. So I mean, we're buying displays, electronic content, the things that we can get, and we're anticipating orders from customers because these orders were real from customers at the beginning of the quarter and throughout the quarter. So we have a buildup in electronic displays for FDM and a lot of our high electronic feature set. So it's really just a driver. It's that pent-up raw material from things that didn't come to fruition. So we would expect that to bleed off as things grow. But these are components that are fairly new and have very low risk of obsolescence. So it's nothing that's a risk to us.

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

I'm sorry, do you have -- I mean, I don't know if you can give us a mix of finish versus unfinished inventory there, meaning that you're absorbing a lot of not just the purchase cost, but the labor cost and production cost and assembly cost and not getting the revenue yet. And then we flip the script forward to quarter 2, 3, whenever it's going to be later and all the stuff starts to flow out and you've absorbed some of these costs in prior quarters. I mean what...

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

If you look at our inventory, it's probably 80% raw material. I mean we don't carry even more than a couple of weeks, few weeks of finished goods on hand. We turn those pretty quick. We tend to carry more inventory as we've talked about for several years in order to avoid things like shutting down customers. So I mean that's a strategic play for us.

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

So there's not a mass prebuild going on here. It's really just getting stocked up and ready to go.

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

No. Yes.

Operator

Your next question comes from the line of Ryan Brinkman from JPMorgan.

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

Thanks for taking my question, which is really about vehicle mix. It looks like your implied level of sales in the fourth quarter at the midpoint of the back half guide is, I think, $405 million, which would be 24% lower year-over-year versus IHS, which is currently looking for global light vehicle production down 20%; and North America, Europe, Japan, Korea, production down 20%, which I think you compare a bit more, too.

So I just wanted to ask on the drivers of the sort of implied underperformance there in the fourth quarter, given that you have been significantly outperforming. And I know in your press release, you talked about products with high-end features maybe having been disproportionately impacted by production cuts. But on prior quarter calls, I think we've been talking about how automakers were allocating scarce semiconductors where possible to their highest-end vehicles that were more likely to be equipped with your advanced feature mirrors, et cetera.

So can you just maybe elaborate on what is contributing to the difference in the trend in growth versus market? And then as you look out to next year, for the 15% to 20% growth, that's 4.4 to 9.4 points better than IHS' outlook for 10.6% and growth in light vehicle production. So that would be a significant reversal from the trend that you see in the fourth quarter. Maybe you can talk about what's giving you the confidence in the implied outperformance there, if maybe what's happening with mix next year? And then how much is backlog contributing to the outperformance next year?

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

Yes. That's a very well-stated question. I think if you look at our Q4 guidance, what we're -- the IHS data will show down 20% right now. But what we're suggesting is there's a couple of million units of risk in the IHS production forecast. So if you then adjust it, if you looked at production then based on us taking those units out, what you would see is it's still about the same level of outperformance because that would be another 10% or 12% down more than the 20%. So you'd be looking at if Q3 happens again, you're going to be talking more like 30% down on a year-over-year basis.

And then our guidance would be at about the same level of outperformance. So really, it's about the fundamental assertion that the market -- IHS Markit believes that it's going to improve sequentially, and we're a little more skeptical than they are about the ability for the industry to support that level of production. But to your point, though, looking into 2022, that's really that outperformance versus the market is really the run rate we've been at for a while. And so one of the things we like to talk about here is don't look at these short-term periods of Q3 or Q4 as indicative of where the market is.

We believe that 2022 will start to see some response. You'll start to see the supply base able to amp up a little bit to help support higher volumes. And in that environment, we should do really well. And then, Ryan, I think the second part of your question was about mix. And really, how does that factor in? And what we would say is in the first half of the year, your assertion there is completely accurate, right, which was OEMs knew they were limited in terms of how much they could build. So they were building the absolute highest end of their vehicle lineups.

What's changed really is in Q3, given so many constraints, OEMs were really willing to build pretty much anything. And so unfortunately, based on packaging, that meant a lot of fluctuation for us, not just about our ability to produce the parts they wanted, but also about what everyone else in the industry could produce. So if they couldn't build the top term levels, they're willing to build a mid-grade and that sometimes has impacted demand for our products.

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

Okay. That's really helpful color. And then just last question here is on capital allocation. You've bought back $91 million of stock in the quarter, which is pretty in line with the average that you've repurchased over the past 3 quarters. You've certainly differentiated yourselves relative to other suppliers and continuing to allocate capital toward repurchases throughout the oscillated macro environment.

Just wanted to check on the appetite for continuing to buy back stock in the uncertain environment. Remember, the Gentex of old, the 8, 9, 10 years ago, would stop its repurchases at the drop of a hat with any sort of macro fluctuation. I don't know if there's something you're trying to communicate in terms of you're going to just continue to chip away at this. Or what your thought process is in this uncertain environment?

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

No. I think Q3 hopefully is a positive sign that we believe in the long-term growth rate of the business. And whenever we see favorable prices, we're going to take advantage of that. One of the things we also look at is we want to make sure the balance sheet is well bolstered. We believe that over the next couple of years, there may be opportunities more on the acquisition side. Hopefully, valuations will come back in line. So if you see us take our foot off the gas as it relates to repurchases, it's only because we're either contemplating or getting ready for something that could be on the horizon as it relates to fair values and the possibility of acquisitions going up.

One of the things we've always tried to be very candid about is a lot of the multiples that we're trading over the last couple of years we just didn't see a spot for us. We felt like it was overpaying. However, given the constraints and the things that are happening in the industry, some of those valuations might be moving back in our favor. And if so, we want to make sure we're ready to move.

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

Okay. And maybe just final question. As we look forward to CES here, what you guys might be looking forward to showcase. Obviously, you're not going to make any huge announcements in advance, but is there any sort of theme in terms of a couple of years ago? We're looking at medical. You've been making a lot of waves this year with your sort of, what is it called Vaporsens or whatnot, some of the other things? What are the technological trends that maybe we should keep an eye on, et cetera.

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

Well, I think first and foremost, what we're excited about is, I mean, we basically missed the entire year, and that's a great marketing platform for us. So we're, first and foremost, just excited to get back and be there and try to engage with customers face-to-face. That's pretty exciting. I think the team is pretty amped up and ready to go for that one. If you can't hold off until January, we're going to be at SEMA, so stop by if you're a bored or have nothing better to do.

But the goal there on the theme side has been to continue to expand on -- especially on the sensing platform side, large area devices, so our core electrochromics but in larger formats. So -- not only in aerospace, but also in automotive. So you're going to see a lot of that, right, which is how can core electrochromics play a role, not only in the car today, but in the ridesharing or autonomous vehicle of the future. But then more importantly, what are the sensing skills that we have and how do you deploy those skills in the new feature content. So that's really been the theme for the last couple of years, we're going to continue to drive that home this year at CES.

Operator

(Operator Instructions) Your next question comes from the line of Josh Nichols from B. Riley.

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

Well, one point I kind of wanted to hit on, well, clearly, there's a lot going on in the automotive supply chain, and that's probably going to last over the next few quarters. But it seems like the gap is actually kind of widening. And I'm just thinking about this as the fact that while production capacity is limited. But you have an exceptionally strong consumer and record low inventories. I'm just kind of curious, like what are your thoughts on how long it takes to actually rectify, right, the supply and the inventory situation? I would think that while there's some near-term headwinds that, that provides you with a lot better longer-term visibility than you probably would have as long as the consumer stays strong.

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

No, you're exactly right. The hard part right now is getting through the short period of time, trying to make sure you're taking care of customers and delivering, making sure you have to predict where they're going to be and what they're going to need and make sure you can secure the components, obviously. But the hard part is getting through this period. The upside of what's happening on the macro side of the industry is -- should be phenomenal for us over the long period because it's going to take a while to rebuild not only get back to production levels and SAARs that make sense based on demand, but also to rebuild the inventory levels at the dealership.

So we believe really for the first time in a while, not only is our product portfolio strong and a lot of demand for our products. But there's going to be some tailwinds from the overall industry over the next couple of years. And I really believe it's going to take at least a year, maybe 2 years to kind of get back to the level of inventories that OEMs are looking for. And that's all assuming, to your point, that overall demand from the consumer doesn't change, which we don't see any reason why that won't continue for at least the next couple of years.

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

So then, I mean, you've been kind of spot on. You've been skeptical about some of the IHS numbers. I think you said similar commentary right on the last quarter that you thought that they were probably a little bit aggressive. And clearly, you think that the 4Q numbers are too high. I guess like it's hard to look out a year given what's going on. But I guess if you look at the SAARs that they're estimating for next year, in North America, it's like 15 million and 70 million globally. And I guess what are your thoughts on those numbers? And like do you think those are achievable? Or kind of what has happened to get there with puts and takes?

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

Yes. Well, thanks for noticing that we were probably -- the last couple of quarters has been odd. We've been probably one of the few companies that's been talking about issues around the industry. So occasionally, you think, well, maybe we're being overly paranoid, but obviously this quarter kind of showed that we weren't wrong in our assumption that the industry was pretty constrained and there were going to be challenges.

When you look out over the numbers for next year, they're not way out over the ski tips in terms of can the industry support those level of volumes. There might be a little bit of risk in terms of the supply chain side of hitting those. We don't believe there is a demand challenge at those levels of production. So we think there -- we think there's plenty of pent-up demand to support those production levels. The question is, can the industry keep up.

If you look at the year-over-year change from an IHS standpoint, we don't believe that those are so far reaching that the industry can't get there. Maybe the first half of next year might be a little bit of a challenge, but the back half for sure, there should be some capacity increases on the supply side that should help get to those numbers.

Operator

Your next question comes from the line of David Whiston from Morningstar.

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

Steve, you talked earlier about Gentex can wait to -- unlike other suppliers to ask for some input recoveries from OEMs? And is that just fortuitous luck on timing? Or is there another reason?

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

Well, I think if you look at our profitability, we are able to wait a little longer than some because of that. And then more importantly, we think it's prudent because the game is changing daily. And so going in and negotiating early is a noise to your best advantage because you don't know how much higher pricing can go and what is really going on. If demand hits what we're predicting, then we think it's going to be a constrained environment for a long time, in which case, the supply base will have a lot more leverage.

And so you're going in now and talking to an OEM about cost increases, which you may only see 20% or 30% of right now, is probably not prudent. Because you're going to want to see that full picture before you go in and have the conversation. Our preference has always been to walk in with a full story and a complete picture, not try to do it 5x over the next few years.

So -- and quite honestly, it allows the industry to understand what's happening for OEMs and our customers to get their legs under them and understand truly what's happening in the industry on the cost side and then to find out what is their position with their consumers. So ultimately, you have to understand all that in the full consequence before you go in and have a partial conversation. So fortunately for us, our profitability does allow us to wait a little longer than certain suppliers.

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

And the OEMs probably understand that dynamic, too, though, but I assume it's totally up to the supplier to initiate these talks? Or will the OEM come to you early?

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

No. They rarely answer their phone when you want to have a conversation like this. So no, not expecting a warm reception when we go in to have these. Typically, for us, what also helps is usually we have contracts preestablishing pricing for a couple of years. One of the things that you're able to do in this is talk about renegotiating those price downs or talking about -- it's not always just about price escalation. Sometimes it can be about netting against price reductions that you pre-committed to. There's also future awards and business growth opportunities. So there's -- it's a many-faceted question, and we try to walk in with that big picture in place and not get into a dime conversation about this one part has got to go up by $0.05 right now or else. It's more about, hey, let's look at the whole book of business, and let's talk about where we're going as partners.

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

And Neil, you said earlier that there's some technology in China that's gaining penetration. I missed exactly what tech you were referring to. Do you mind repeating that?

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

Yes, no problem. Actually, it was the increases in base mirror launches continue to go up in the Chinese domestic market.

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

Core auto demand.

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

No problem. Just our core auto dimming, continues to grow and continues to expand into additional local platforms.

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

And so I guess in China, did you kind of start backwards in the sense that you started with a more advanced content first on the like of the Germans? Or is there still a lot of room to go advanced in China from here?

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

I think there's still a lot of room to grow from an advanced technology side. Obviously, electrochromics came in with JV partners being -- a lot of the Europeans came into the China market. Now what we've been seeing is continued expansion of that base technology to local domestic manufacturers as well, and it continues to grow and grow at a decent rate.

Operator

Your next question comes from the line of Charlie Sloan of Oak Family Advisors.

Charles Melcher Sloan - *Oak Family Advisors, LLC - President*

Great quarter, by the way. And I can only imagine the employee base, how hard they're working to get all this stuff done for the OEMs so that you're not the ones sitting there not allowing production to occur. And so it's really amazing. I mean you guys are pretty small, right, but you guys have a pretty wide berth of commitments you have to fulfill. So that's awesome.

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

Thanks for that. That's very well said.

Charles Melcher Sloan - *Oak Family Advisors, LLC - President*

Yes. It's amazing. With regard to your R&D, Steve, you talked about your R&D and how people should notice. When you look at the R&D or the components of those, is mostly that the core auto market? Or are you expanding your R&D into other areas that should -- that investors might want to focus on?

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

Yes, I would say the core of the R&D budget, I'd say about 85% of it is focused on automotive. The other 15% is really looking at projects in aerospace, fire protection, but also just kind of blue sky type projects. So things that -- technologies that could also reside in automotive, but things that aren't necessarily just focused on pure auto. In other words, there are underlying kind of core competencies or things that we're trying to develop at a core level.

Charles Melcher Sloan - *Oak Family Advisors, LLC - President*

Okay. And so things -- but not like maybe hard glass for Josh O'Berski cell phone?

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

Yes. No, it's -- some of it are those type of technologies as well, right? Looking at things that could change how we approach electrochromics in the field. If you look at -- for instance, when we talk about large area devices, you're talking about taking electrochromics and making a much larger version of a device, there's a lot of core technology that has to go along with that, right? The ability to bend much larger piece of a glass, different types and different substrates that electrochromics could be applied on and ways of going about darkening. And so those are all kind of -- they all have line of sight into automotive, but they also could apply to a lot of different industries as well.

Charles Melcher Sloan - *Oak Family Advisors, LLC - President*

Sure. So -- and so keep that up, and we're very pleased with the share buyback commitment that you showed this quarter. And I think it does speak to the smarter vision you have to the future. So anyway. And then finally, with regard to the OEMs, when is that annual price reduction kick in, I forgot. Is that midyear or is that at the beginning of every year?

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

About 85% of our customers on January 1. So we still have a few customers who are -- especially in Asia who are on aging fiscal year. So there's some on April 1, and we do have a few other projects here and there that are randomly spaced throughout the year. Certain contracts are based on 1 year after SOP of a vehicle, for instance. So some of those just happened at random times throughout the year. But I'd say about 85% of our price downs happen on January 1.

Charles Melcher Sloan - *Oak Family Advisors, LLC - President*

Okay. And so you still expect those, but those are always open to discussions privately.

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

Correct.

Operator

There's no further questions at this time. I will now turn the call back to Josh O'Berski. Please go ahead, sir.

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

Thank you, everyone, for your time and questions today. As Steve noted, we will be at SEMA and CES in the coming months, and we'd welcome investors at our booth during those shows. So please reach out to your analyst or to myself, and we can confirm the details. Thanks again, and have a great weekend.

Operator

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