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GNTX.OQ - Q4 2020 Gentex Corp Earnings Call

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**OVERVIEW:**

Co. reported 4Q20 net sales of $529.9m, net income of $143.3m and diluted EPS of $0.58. Expects 2021 revenue to be $1.94-2.02b.





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## CORPORATE PARTICIPANTS

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

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

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

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

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

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## PRESENTATION

**Operator**

Ladies and gentlemen, thank you for standing by, and welcome to the Gentex Fourth Quarter 2020 Financial Results Conference Call. (Operator Instructions)

I would now like to hand the conference over to one of your speakers today, Mr. Josh O'Berski, Director of Investor Relations. Sir, please go ahead.

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

Thank you. Good morning, and welcome to the Gentex Corporation Fourth Quarter 2020 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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Now I will turn the call over to Steve Downing, who will get us started today. Steve?

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

Thank you, Josh. Before we get started with the financial performance for the quarter, I want to take just a few minutes to thank everyone who has helped us during the last few months.

To our customers and the supplier community, we want to thank you for your communication and teamwork that allowed us to keep up with orders during the second half of this year. We couldn't have done it without your help. To the entire team at Gentex, thank you. Once again, you have outdone yourself. Despite the obstacles, and there have been many this year, you found a way to deliver record-setting results.

Now let's dig into the financial summary. During the fourth quarter, the company experienced record net sales of $529.9 million, which represents a 19% increase over the fourth quarter of 2019. We were able to accomplish this sales growth by a combination of a 14% increase in the auto-dimming mirror unit shipments and a 96% increase in FDM mirror unit shipments. This growth rate was in contrast to global light vehicle production that increased by approximately 3% for the quarter. And if you look a little deeper into the global light vehicle production numbers for Q4, you will see that China production was up 6% quarter-over-quarter, but the rest of the regions were only up about 1% versus last year. In total, our outperformance to the underlying market was 16% for the quarter, which represents one of the highest growth rates for the company in many years.

For calendar year 2020, the company shipped 1.053 million units of Full Display Mirror, which was a 42% increase when compared to 739,000 units shipped in 2019. The growth rate of FDM in 2020 was incredibly strong, especially when compared to a light vehicle production market that declined approximately 16% for calendar year 2020 due to the impact of the pandemic.

The gross margin in the fourth quarter of 2020 was 40.9% compared with a gross margin of 36.5% last year. This was the highest gross margin since the second quarter of 2004 and was a 440 basis point improvement from the fourth quarter of 2019. The gross margin increase was driven by record sales levels, positive product mix, benefits from our cost reduction efforts earlier in the year, leverage on our overhead costs and purchasing cost reductions that together more than offset our annual customer price reductions.

Income from operations for the fourth quarter was $162.4 million, which was an increase of 46% and a new record. Operating income improved significantly during the quarter as a result of the higher sales and gross margin levels. Net income for the fourth quarter was $143.3 million, which was an increase of 44% and also a new record. Earnings per diluted share for the fourth quarter was $0.58, which was an increase of 49% versus last year and was also a record for the company.

During the fourth quarter, strong sales levels, combined with the cost discipline we have been executing throughout the year, resulted in record performance at every level of the income statement. During the fourth quarter, the company repurchased 2.5 million shares at an average price of $31.82 per share. For calendar year 2020, the company repurchased 10.6 million shares at an average price of $27.10 per share. Our share repurchases during calendar year 2020 resulted in a 4% reduction in the diluted share count.

For calendar year 2020, the company paid $117.2 million in dividends, repurchased $288.5 million in stock for a total cash return to shareholders of $405.7 million. When you combine this level of financial performance with our common sense approach to capital allocation, we believe we have forged a pathway to a significant increase in overall shareholder returns.

I'll now hand the call over to Kevin for fourth quarter financial details.

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

Thank you, Steve. Automotive net sales during the fourth quarter of 2020 were $521.6 million, representing a 20% increase when compared to $433.8 million in the fourth quarter of '19. Interior auto-dimming mirror unit shipments increased 13% compared to the fourth quarter of '19, and exterior auto-dimming mirror unit shipments increased 16% for the same period. As previously mentioned, strength in FDM unit shipments also contributed to the significant outperformance for the quarter.

Other net sales in the fourth quarter of '20, which includes dimmable aircraft windows and fire protection products, were $8.3 million, a decrease of 17% compared to other net sales of $10 million in the fourth quarter of '19. Dimmable aircraft window sales decreased by 34% for the fourth quarter of 2020 when compared to the fourth quarter of '19. The company expects that dimmable aircraft window sales will continue to be impacted until the aerospace industry strengthens and the Boeing 787 production levels improve.

In terms of the balance sheet, during the fourth quarter, the company increased its activity in share repurchases, but we also continued to keep our focus on maintaining high levels of liquidity, so that we remain well positioned for multiple economic scenarios. Additionally, as mentioned in the press release, the company paid off the remaining $25 million on its revolving line of credit during the fourth quarter of 2020.

I'll now mention some key balance sheet items as of December 31, 2020, as compared to December 31, '19. Cash and cash equivalents increased to $423.4 million, up from $296.3 million, primarily due to year-to-date cash flow from operations and investment maturities, which were partially offset by share repurchases, dividend payments and capital expenditures. Short-term investments were $27.2 million, down from $140.4 million, with the bulk of those maturities not reinvested during the calendar year. Long-term investments were $162 million, up from $139.9 million. As a reminder, long-term investments include things like FDIC insured CDs, treasury notes as well as corporate and municipal debt. As of the end of the year, the portfolio remains in a good position with the bulk of the corporate and municipal holdings invested in A-rated or better institutions.

Accounts receivable increased to $284.9 million from $235.4 million. The increase in AR was due to the significant increase in sales during the fourth quarter and the timing of sales within the quarter.

Inventories were $226.3 million, down from $248.9 million, as a result of lower raw material and finished good levels. Accounts payable decreased to $84.8 million, down from $97.6 million, and accrued liabilities were $92.9 million, up from $74.3 million. Increases were due to higher accrued salaries and wages, employer payroll taxes as well as accrued income taxes.

Fourth quarter 2020 cash flow from operations was $135.4 million, up from $122 million in the fourth quarter of '19. The increase in cash flow was driven by increases in net income for the quarter, but was partially offset by fluctuations in working capital. Year-to-date cash flow from operations was $464.5 million, which compares to $506 million for year-to-date cash flow for 2019. The decrease on a year-over-year basis was driven by the COVID-19 impacted reduction in overall business and related cash flows during the second quarter of 2020.

Capital expenditures for the fourth quarter were $14.7 million compared with $26.3 million for the fourth quarter of '19, and year-to-date capital expenditures were $51.7 million compared to $84.6 million in year-to-date '19. And depreciation and amortization for the fourth quarter was $26.3 million compared with $25.4 million for the fourth quarter of '19 and year-to-date D&A was $104.7 million, which was the same as calendar year '19.

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

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

Thank you, Kevin. Earlier this month, Gentex participated in the 2021 virtual Consumer Electronics Show. CES has become the preferred platform for Gentex to showcase our technologies and capabilities. This year at CES, we had to adjust our normal product-driven approach to the new virtual venue. Gentex created all-new virtual tools to help communicate our product evolution and the direction of the technology.

The first product area I'll discuss is in digital vision. As we continue to roll out and develop our Full Display Mirror product, we have been focused on ways to add new features that have been either requested by customers or are where we see opportunity to leverage the platform as a part of major developing trends in the automotive market.

For CES this year, we created individual videos, demonstrating how digital video recording and trailer towing could be added to the portfolio. Both of these products utilize the base of FDM technology. And by adding additional cameras or recording technology, we've expanded the feature set to meet an ever-increasing demand from our customers.

In the sensing product area, we also have shown some new technology paths. First, we announced the acquisition of Vaporsens, a nanofiber sensing company out of Utah. The Vaporsens technology is capable of being deployed across multiple verticals to support sensing for hazardous chemicals, explosives or to provide data regarding air quality. We're excited about the potential for this technology because it harnesses our core competencies to create sensing capability that surpasses anything in the market today.

Second, we announced that we're bringing smoke and vape sensing to a robo tech feed as part of the sold program that we're currently launching. This development leverages our heritage as a particulate smoke detection company, but now expanded into the automotive HVAC system. Gentex has the unique ability to deliver smoke detection while meeting the stringent requirements of automotive.

The third area of focus was in-cabin sensing. We demonstrated in the virtual platform, called the visual sensing system in or near the mirror area, could help provide greater visibility into the vehicle. This demonstration showed how our technology can provide in-cabin sensing for driver monitoring features, but can also provide sensing in the rear seats of the vehicle so that features like child detection, notification of objects left behind or which seats passengers are occupying can all be seen to provide new safety and convenience features for our OEM customers and consumers.

The last product area I'll focus on today is the connected and transactional vehicle. As our integrated toll module product has been rolling out with our lead customer, Audi, we have been working on building relationships in different areas to further enable the capability of ITM products in the area of transactional vehicles. Late in 2020, we announced a partnership with a company called PayByCar. PayByCar is utilizing toll tag systems such as ITM and a hardware infrastructure placed at a gas station site to enable payment for fueling through the toll system. We believe this is the first step of many that could utilize the ITM hardware to perform non-toll-based transactions.

Additionally, we announced a partnership with Simplenight. Simplenight is an e-commerce aggregator. We're working with them to broaden their offering for the vehicle. This includes the ability to make reservations at restaurants, buy movie tickets, make hotel accommodations and much more. Gentex is currently working to connect Simplenight to our HomeLink Connect app, which will allow users the ability to perform e-commerce function seamlessly.

While the necessity for a virtual CES format created some challenges for us in engaging with our customers, our marketing team did an outstanding job of creating new tools that help explain these new products. These tools will support our sales and technology initiatives as we go through 2021 and beyond.

We welcome, everyone, to go to our website at gentex.com and look for the Virtual CES link, or you can also head to gentextech.com to explore the new product concepts for yourself.

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

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

Thanks, Neil. The company's current forecast for light vehicle production for 2021 and 2022 is based on the mid-January 2021 IHS market forecast for light vehicle production in North America, Europe, Japan, Korea and China. Based on this information, light vehicle production in the company's primary markets is expected to increase approximately 12% over the 2020 calendar year volumes.

For calendar year 2022, the light vehicle production in the company's primary markets is forecasted to increase over the 2021 estimated volumes by approximately 3%. Based on these light vehicle production forecasts, we are providing guidance estimates for calendar year 2021 for each of the following areas. Revenue for 2021 is expected to be between $1.94 billion and $2.02 billion, gross margins for the year are expected to be between 39% and 40%. Operating expenses are currently forecasted to be approximately $210 million to $220 million. Our estimated annual tax rate, which assumes no changes to the statutory rate is forecasted to be between 16% and 18%. Capital expenditures for 2021 are expected to be between $85 million and $95 million, and depreciation and amortization is forecasted to be between $105 million and $110 million.

In addition, based on the mid-January 2021 light vehicle production estimates for calendar year 2022, the company is currently estimating that revenue for calendar year 2022 will grow between 4% and 8% above our current revenue estimates for calendar year 2021.

In closing, as I reflect on 2020, there is no doubt that it was one of the most trying and turbulent years we have encountered as a team. We know these issues have not completely gone away and that there's still many risks ahead for the industries we support and for our business. However, despite these issues, we are hopeful that 2021 will develop in line with our forecast, which suggests a record year for the company, not just in terms of revenue, but for the profitability of the business as well.

Perhaps the most important reason why I'm optimistic is the team. This team delivered world-class operating results within months of encountering crippling shutdowns and changes to our business due to the pandemic. The results this quarter shattered many records of the company and reset the profitability of the business as we move forward. But more importantly, it showed all of us that this team is capable to anything it sets its mind to.

We believe that our financial discipline and performance, combined with our operational efficiency, new product pipeline and common sense approach to capital allocation provide the pathway to significant shareholder returns.

That completes our prepared comments for today. Thank you for your time, and we can now move to questions.

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## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions)

Our first question comes from the line of James Picariello with KeyBanc Capital Markets.

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**James Albert Picariello** - *KeyBanc Capital Markets Inc., Research Division - Analyst*

Congrats on a fantastic quarter here. So FDM shipments, let's start there, finished the year just under 1.1 million, which, given that it was a pandemic year, pretty phenomenal. I mean, how should we be thinking about FDM unit growth for 2021? I mean, previously, I think the idea was to take the average unit growth over the last 3 years. But I mean, I think that exercise would have been far conservative even for 2020. So just wondering if there's another way we could look at this.

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

I think if you look -- I think it would be about -- would guide about the same methodology. And if you include this past year's performance, you'd start to see an uptick, obviously, this year and that growth rate of FDM. So I think it would be -- it would probably be -- if you did a 3-year moving average, it would probably be closer to what the trajectory looks like for next year.

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**James Albert Picariello** - *KeyBanc Capital Markets Inc., Research Division - Analyst*

Okay. And then just a follow-on to that. I mean, any update on the timing for OEMs 9 and 10 when they should begin shipping?

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

Yes. So I think both 9 and 10 are in the first half of this year.

**James Albert Picariello** - *KeyBanc Capital Markets Inc., Research Division - Analyst*

Okay. As we think about the cadence for this year, I mean, we could obviously see IHS production volumes, but how can we think about the company's growth over market? I mean, clearly, there will be a difficult fourth quarter comp this year. But I mean, also just from a margin standpoint, any color on what we should extrapolate and not extrapolate from the second half '20 performance from a margin standpoint?

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

Yes. I think if you look at the last 6 months, you're just over 40% average. We know that that's a hair higher than it will be in '21 for a couple of reasons. We know there's a lot of shortages happening in the industry, which means, obviously, pricing pressure on components, it's going to be a little tougher than it was in 2020. But then we also know that sales aren't going to run at the same rate it was, for instance, in Q4, so which it would have a slight negative impact on margins going forward.

But if you look at that guide for the full year of 39% to 40%, we feel pretty comfortable with operating in and around that range for the whole year. We don't really see it overweighted in any one quarter. I think the risk factor, like you mentioned, really comes down to the second half of the year in terms of what are those comps going to look like. And then we know there's a lot of catch-up happening in the industry right now from the Q2 shutdowns. And the question is, what is the new run rate for production once that catch-up period is done, what is the global SAAR and what does that look like for the entire supply base.

**Operator**

And our next question comes from the line of David Kelley with Jefferies.

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

Just maybe following up on the last point, the gross margin discussion. Your guide for 2021, it's better than the target you referenced during Q3 earnings specifically. So maybe if you could just talk about what specifically has changed in the last few months. The revenue growth guidance hasn't changed. So is it product-specific or anything from the cost savings side we should be thinking about?

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

Yes, it's really a combination of a couple of variables. Number one is the mix has been very positive with FDM strength and OEC strength, that's been a margin tailwind. The cost efficiencies and the things that we did in the second quarter to improve the profitability of the business are playing out, perhaps even better than what we had initially estimated. So those are all positive trends. And there's a whole lot of others, but then there are some headwinds as well, as it relates to, especially on the component side.

So we're trying to -- you're looking at all those positives and the customer pricing and what's going on in the marketplace on the shortage side, looking at all those, and we feel like it's still a net improvement versus our long-term guidance we had given previously, which was the 38.5% to 39.5%. So if you look at that and say, "Hey, you're 50 basis points basically better than where we were a few months ago." It's -- we feel really good about the discipline of the business and our operational efficiencies at the levels we're at right now.

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

Okay. Great. That's helpful. And then maybe following up with the OpEx 2021. We have the structural cost savings benefit. At some point, I would expect we should see some T&E expenses start to ramp back up. But can you just talk about some of the puts and takes there and maybe how you're thinking about R&D this year?

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

Yes. So I mean, that's a good acknowledgment. As you mentioned, Travel and Entertainment has still been fairly low. But some of the things that have kind of filled the gap there is air shipments. So a lot of premium freight that we've been experiencing really in the back half of the year with a tighter supply chain. So we would expect that as things calm down a little bit, you -- the freight costs kind of abate a little bit and backfilled by some of that travel. But we would expect that, that probably isn't going to really pick up until the back half of the year. I mean, as we sit today, travel restrictions are heavier than they were a year ago.

But all the things that Neil mentioned, obviously don't come for free. So we are very focused on that R&D budget. Partnerships that are -- either have equity stakes with them or things that drive us for the longer term, we continue to be focused on them. So we feel really good about the things that we've done so far, but there are other things in the hopper that we continue to invest in. And we're putting resources to the things that Neil mentioned earlier.

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

Okay. Great. And then one last one, if I could squeeze it in. 2022 revenue growth guidance, I get that's a long way away, but it is a bit below your usual targeted out-year outgrowth. Is there some conservatism built in here, just given some of the ongoing market uncertainties you referenced or if you could just talk about if there are any other inputs we should be thinking about that might change the outgrowth cadence, that would be great?

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

Yes. I think the biggest factor there isn't necessarily conservatism built in. It's really about the 2021 guide being quite a bit higher than what we actually think production will come in at. So that outgrowth of market and the growth that we've experienced in the back half of this year and then compound it with the growth rate for next year. When you start to look at those in combination, we just -- we look at it and say, "Hey, 2022 is -- it's a tough comp coming off a very solid '21 number that we're guiding to right now."

If there is any conservatism built into it, it's really a little bit of skepticism. If you look at a lot of that growth that's estimated for '22 on the vehicle production side, a lot of that's out of Europe. I think it's like a 6% growth rate on '22 for Europe. And so we're maybe a little skeptical about whether or not that's actually going to pan out to those levels. If you look at the macro side of what's going on in that space, and I'm not sure that we would necessarily agree with IHS' number there that it's going to be that kind of a growth rate in Europe in 2022.

**Operator**

Our next question comes from the line of Ryan Brinkman with JPMorgan.

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

Maybe to start, what is the latest that you're seeing in terms of the semiconductor shortage impacting the industry? Can you talk about the degree to which you're seeing any indirect impact to Gentex from lower customer production? And I know you incorporate chips into some of your devices. Are you seeing any direct impact? I think, as of the time of CES, you hadn't yet, but I thought to ask, just given I know a lot of suppliers are scrambling here to avoid direct impacts.

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

Yes, it's absolutely impacting the industry, and in 2 ways. Number one is, obviously, there's a lot of decommitments happening from the supply base in terms of volumes that we've put in orders for, many times, almost a year out, and suppliers are struggling to keep up. Obviously, it's a complicated supply chain that they're dealing with. And so that has everyone moving around.

A couple of safeguards that Gentex has always put into place as we tend to carry a little higher raw inventory than most suppliers to try to help prevent these types of issues. The other one is the team has been working really hard, looking at product redesigns, other alternatives, when there are issues. Fortunately, so far, we haven't had any shutdowns of customers.

But to your point, that's the second half of the issue, and that is many OEMs are starting to take days off or portions of a week at certain plants and certain product lines to give the industry time to catch up on the silicon side. So it's something that we continue to watch. Fortunately, so far, it hasn't affected us directly in terms of our ability to supply. But it's always a risk factor.

And then number two, what is probably more likely is that it's going to impact overall production levels at some point. Probably not an extended period. Most of the industry is looking at the first half of '21 being really tight, and then hopefully, the second half will start to free up a little bit.

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

Okay. And then just to dig into that earlier discussion of gross margin a little bit more and maybe the trajectory throughout the year. I think historically you see a little bit of a step down in 1Q, maybe given disproportionate number of annual customer price reductions taking place around the turn of the calendar. Then you claw that back, you have performance and productivity throughout the year. Do you see that pattern taking place this year again?

And then just also, is the tone and tenor of annual customer price reductions any different this year versus prior years, just given maybe some of the stress that some of the customers might be feeling? And I hesitate to ask, but 39% to 40% gross margin, I don't see why that would necessarily be an embracement of riches when 37% to 38%, you guys were able to get away with for a long time. But just any kind of thoughts on discussions with automakers, if they're any different from the past, et cetera?

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

Thanks, Ryan. Yes. So as you mentioned, and you're the best at asking 7-part questions. So I'll forget the back half (inaudible). But all else being equal, yes, APR typically is front-end weighted, January and April. A lot of our customers take those price downs. The one unique thing about this year, like Steve already mentioned is they're still playing catch up for the most part. So sales levels are probably elevated a little higher. So that tends to -- that may offset it.

But then the one other factor is tightness in the supply chain side. So components -- the shortages are putting the ball back into the supplier's hands as far as leverage. So pricing is going to be a little bit constrained or cost downs, if you will. So I would say all in all, it's probably pretty evenly textured, but you still do have the same constraint on APR dropping kind of first quarter margin, all else being equal, and then building back up over the year.

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

And I would say that the pressure on the supply community from OEMs isn't really any different than it has been. I think right now, what we're seeing is mostly collaboration. OEMs trying to work with the entire supply base to make sure that components are being handled, distributed and that they can keep their supply base up and running. I think everyone's aware what's going on in the silicon industry. So I think most OEMs understand, there's going to be some price pressure from the supply side on raw components.

**Operator**

And our next question comes from the line of John Murphy with Bank of America.

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

Just a first question on vehicle mix. I mean, obviously, the automakers are hustling to rebuild inventory and meet growing demand. So they're building everything sort of at the higher end. I'm just curious what you're seeing in schedules and if you expect that to continue into 2021? And maybe this is sort of a new phenomenon that produced a little bit less with better and better mix. Just curious your thoughts on that.

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

Yes. I think, at the beginning, you're absolutely right, when they were coming out of those shutdowns, they were obviously trying to build a very rich mix of vehicles. I think now that's kind of settled down. It's more about what is the consumer -- what's the demand from the consumer side. That's probably the most shocking part of the coming out of the pandemic is the flow and optimism in the consumer base, like how many vehicles themselves are being purchased. I think that was a little surprising to us, watching inventory levels overall for each OEM and what's happening. There's still a little bit of work to do, but I would estimate that sometime in Q2, we'll be through that catch-up period and back into a normalized run rate.

The question about mix is always a fascinating one. It's really about interest rates, borrowing and what a consumer wants. So we don't see anything changing that drastically. One thing we know for sure is our features right now are doing really well with the consumer. They're desirable. They're priced appropriately. Products like FDM have a lot of pool right now with the consumer.

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

Okay. And then just a second question, I mean, raws are -- or sort of the raw complex going into the vehicle is generally kind of inflating. I'm just curious what you're seeing on that side. I mean, obviously, it's being driven by strong demand and volume. So it's a good thing, right? So the reason it's rising is because there's demand pull. I'm just curious what you're seeing there and how much of a headwind or not that might be in 2021.

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

John, you broke up just for a second at the beginning. Can you say -- could you say that again?

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

Yes. I'm just curious what you're seeing on raw costs -- raw material costs that are -- that you guys -- usually you guys are dealing with. I mean, the reason they're rising is because demand -- there's demand pull. So it's for good reasons. I'm just curious how you're thinking about that in 2021.

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

Yes. In fact, and honestly, that's one of the things we've modeled in is that we're not expecting to get the same out of the supply base is what we have historically. So we do have some contracts that cover products longer-term on the pricing side. But anything that you're negotiating this year, yes, there's definitely some pressure from the supplier community for, if not price stability, in some instances, even price increases.

So when we look at it, we model it. We're not -- this year, for instance, all those factors, both what we got out of suppliers and all the operational efficiencies, offset our customer pricing and some. Next year probably won't get quite that same level of performance. So it's definitely one of the negative factors as we put together, but it's all contemplated inside of our margin guidance as well.

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

Got you. And then just lastly, as you look at -- it's not post-COVID because we're still in the middle of it, but the actions you've taken initially because of COVID and what you worked through last year, do you -- what kind of structural changes do you think you will be able to capture or what changes you made that you think will be structural over time that might help incremental margins over time or just margins generally?

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

Yes. I think all the changes that we made in Q2 were structural, and that we expected those to continue. As we build back the business, the costs -- like we have for the last several years, the costs we're adding back are in line with growth rates and support sold business. So you shouldn't see anything change from that model, which is you'd expect our costs, both on the gross -- on the COG side, all the way through operating expenses to move roughly in line with sales growth.

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

So this 39% to 40% gross margin, you think is the new baseline off of where you will potentially grow or improve in 2022. Is that a fair statement?

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

Yes. Like we mentioned before, the 38.5%, 39.5%, we had talked about for the last year. So we didn't believe that there was any reason why we couldn't sustain that for at least a couple of years. And I would say that, that new guidance, I mean, we haven't looked at product mix all the way into 2022 yet. But if we manage the cost the way we're describing, there's no reason why that's not attainable.

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**Operator**

And our next question comes from the line of Luke Junk with Baird.

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

First question, I want to ask about ITM and connected cars. So based on your announcement over the past few months, you're increasingly leaning into this space relative to PayByCar and the Simplenight partnerships. What I'm wondering is how that's being informed by the interest level that you're seeing in general from the OEM community? And if we look at ITM specifically, how it's tracking versus your expectations a year ago?

And then second part of the question would just be in terms of the value proposition for some of these elements that could have maybe recurring elements to them, how you sort of position that for the OEMs as well at a high level?

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

Sure. Absolutely. I think one of the interesting parts with ITM in general is that product continues to roll out across the Audi fleet like we've described before. This coming year, there will be more platforms that will deploy it. And I think they'll be on every platform when we get into 2022, if I'm not mistaken. So it's continued to grow.

When we talk about expanding the features and capability of the transactional vehicle, that's not just something we're dreaming of. It's something that our customers are looking for an expansion of. So as the technology and the hardware platform gets added to the vehicle, how do you continue to add more value to the vehicle itself or to the consumer and how it gets used. So the PayByCar is a great example of leveraging the existing technology, but now offering to the consumer that next step advantage of a transactional piece at the gas pump using that platform they've already paid for.

So we see that continuing to build. Simplenight is another stretch on that, where it's now getting into additional features and functions, reservations and beyond where we believe the consumers want that seamless interface from their computer to their car to their phone, and that's what Simplenight enables is that ability to bring all those together and offer them one complete system.

So we're excited about it. We think there's some great opportunities on how that can help grow and expand. The PayByCar is a great initial one leveraging the hardware, and the Simplenight takes it beyond just a hardware play.

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

Okay. That's great, really helpful. A follow-up question on the adoption rate curve for the Full Display Mirror. And what I was hoping you could comment specifically on is, what you're seeing in terms of take rates right now relative to what you've disclosed in the past. The comment earlier in the call that products like the FDM have a lot of pull, seems to suggest there's some movement there and just hoping for any additional color you could share.

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

Yes. I think if you look at the last half of the year, for instance, the product mix was really strong. One of those, like we mentioned, was partially because OEMs were building higher content vehicles. And with that, what we're seeing is very high take rates on the vehicles we were on. So initially, we had said we would expect on a high-end very luxury vehicle. Like Cadillac, when they first launched, you're running 50% to 70% take rates. And then as you move down, had trucks -- higher-end trucks and SUVs, maybe in the 20% to 30%. And then on entry-level vehicles, you're going to have much lower take rates.

What we've seen in the last 6 months are actually running even above those levels. And the fundamental question is, how long will that last? Is it the new norm or is it going to come back down to more standardized packaging? What we're seeing for the first half of 2021 would imply that, that trend continues at higher take rates.

And so we're pretty optimistic. One thing is for sure. There's been some studies and some consumer engagement from OEs that really like the feature. So we think regardless of what goes on with the whole product line, we think we're going to continue to see a lot of pull on the Full Display Mirror side because of the customer interest.

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**Operator**

And our next question comes from the line of David Whiston with Morningstar.

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

First on gross margins. I know for this year, it's 39% to 40% guidance. But were you saying long term, you still think it's 38.5% to 39.5% or do you think it's now better?

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

No. I think there's a potential for us to run at that guidance for '21 into '22. We have obviously a lot of work to do to make that happen, but that's definitely feasible.

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

But you don't want to talk about beyond that at this point, right? Is it too uncertain?

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

Yes. I think right now, we haven't -- modeling out that far is really difficult to predict. But as you know with us, David, I mean if we get -- once we get there, we don't like we don't like retrenching it all. So I can promise you that by the time we get close to it, we're going to be doing everything in our power to make sure we can maintain it.

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

Right. And your guidance for this year right now, though, it does not include any shutdowns related to the chip shortage, even if they're beyond Gentex's control?

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

Yes. There's -- IHS is actually modeling in downtime at most OEMs, not extended for very long periods, but kind of rolling shutdowns a week or two at a time for the first half of the year, and then there's not much contemplated in the second half due to supplier issues or part shortages.

So it's a fairly modest impact. I forget, it was a few hundred thousand vehicles. I think, when IHS made their latest update globally. So it's not a huge change to overall production, but there is some of that built into the forecast.

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

Right. And you were talking earlier about skepticism about IHS' EU number. Was that for 2022 only or both this year and next year?

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

Really, its kind of more for '22.

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

Okay. And then just one last more big picture question, strategic one. Have you guys ever thought about making a software for AVs or is that something you think that's really not in your wheelhouse and there's plenty of other players already?

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

Well, I think when we look at that, I mean, we're open to the concept, if an OEM partner wanted to come and ask us for help, then we would be open to that concept. But to go out and try to market that is probably not something that -- a, we would have necessarily the credibility to pull off right now. And so we're -- like we wake up every day, always willing to look at new opportunities and assess whether or not we can create a value proposition there.

I think as we sit here today, we would look and say, well, we're probably not the right partner necessarily to develop that and provide it. But if that changes, we would absolutely try to create a new business model that would work for the OEM and for us.

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**Operator**

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

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

Exceptionally strong quarter. I was wondering if you could maybe provide a little bit more detail about like the the cadence of the revenue trajectory, given that this is a little bit of a different setup here. The OEMs are still playing catch up, right, as far as inventory levels, especially in 1Q and probably into 2Q. And are you expecting that 1Q to be a little bit stronger? And how may that trend through the rest of the year?

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

Yes. You're exactly right. I mean Q4, Q1, don't look too dissimilar outside of the chip issues, if there are any pickups there. Really strong into the second quarter. But then I think like Steve mentioned already, comps start to get higher and then the normalization of what production actually looks like in the second half probably starts to play out a little bit more. So you have a little bit of strength and then maybe a little taper heading into the back half of the year.

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

Yes. As you kind of mentioned, there's always a number of things up in the air, right, especially this year, it's a little bit different than obviously what we have seen before. I just wonder kind of your thoughts about like the impact to Gentex. We've been seeing, one, some higher end vehicles and an increasing percentage of the mix, right, trucks and SUVs, also the potential for like fiscal stimulus on the federal side and a return to more aggressive maybe manufacture incentives as inventories normalize? And just kind of your thoughts on those areas.

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

No, you're absolutely right. I think that's what's really kind of driven the strength in the second half of this year and the first half of next year is going to be playing that catch-up from the second quarter, which was pretty much nonexistent in a lot of the markets. And so that -- once that catch-up period is over, then it really comes back to consumer demand. And the question, I think, longer term, we all have to wrestle with is, what are the lasting economic impacts of the pandemic and some of the policies that have been put in place.

So one, we're watching carefully. And the reason why we made a lot of the structural changes we did in Q2 was we knew we needed to prepare for either scenario. And fortunately, that's worked out well so far. We know we have to continue to watch it, and no one ever knows if it's going to be completely done, if this is a recessionary market for the next few years or whether or not it's a stable market.

One thing is for sure is we've lowered the fixed overhead of the business significantly. And so we feel like we're prepared for both either flat to an expanding market, or even if this market retrenches, we believe we put the right discipline in place, and we have adjusted our cost structure to be able to handle that first wave of any type of a downturn or recession.

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

And then last question for me. This is a little bit longer-term question, I guess, but you're seeing an increasing number of auto OEMs talking about moving to a much larger percentage of their lineup going to EV, right? Over time, also some legislations out of states like California, right, where that tends to be the new shift going forward, if you look at least a 5- to 10-year horizon. How is that like Gentex positioned for that? Does that -- are you kind of indifferent to whether you're using gas or EV? Is there a better mix shift for you, or just kind of curious about the longer term opportunity, puts and takes on that?

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

Yes. The short answer is that we're really not affected by the powertrain, whether that is gas, diesel or electric. So there's nothing structurally there that will impact it. The one side benefit to us is what we've seen is most EVs right now are selling on the higher end of the marketplace, which tends to be good for us.

We would look at and say that's not necessarily correlated, but it is a happy accident of sorts where most of the EVs that are rolling out right now tend to be by luxury OEs or higher end builders. Most of the cost focused EVs have even added higher technology features, and that's worked out really well for us over the last several years.

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**Operator**

And I'm showing no further questions at this time. And I would like to turn the conference back over to Mr. Josh O'Berski for any further remarks.

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

This actually concludes our call. Thank you, everyone, for your time and the great questions. Hope you have a great weekend.

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**Operator**

Ladies and gentlemen, this concludes today's program. You may all disconnect. Everyone, have a great day.

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