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GNTX.OQ - Q3 2020 Gentex Corp Earnings Call

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OVERVIEW:

Co. reported 3Q20 net sales of $474.6m, net income of $117.1m and diluted EPS of $0.48. Expects 2H20 revenue to be $940-960m.

REFINITIV

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PRESENTATION

Operator

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

I would now like to hand the conference to your speaker today, Josh O'Berski, Director of Investor Relations. Please go ahead, sir.

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

Thank you. Good morning, and welcome to the Gentex Corporation Third 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'll turn the call over to Steve Downing, who will get us started today.

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

Thank you, Josh. For the third quarter of 2020, the company reported net sales of $474.6 million, which was a decline of 1% compared to net sales of $477.8 million in the third quarter of 2019. We finished the third quarter of 2020 with the second highest sales quarter in company history, behind only the third quarter of 2019. The impact of the COVID-19 pandemic that created extended shutdowns in the automotive industry during much of the second quarter continued to impact global light vehicle production, which was down 4% for the third quarter.

When looking at regional production for the third quarter of 2020, the China market expanded by 11%, the European and Japan/Korea markets were each down approximately 8% and the North American market was relatively flat. The company's largest revenue-generating markets are North America, Europe, Japan and Korea, which were collectively down 5% quarter-over-quarter.

The third quarter began with a slow start as orders in July were far behind prior year actual results. But as the quarter progressed, our customer orders continued to grow, and ultimately, the quarter ended at the highest sales levels of the year. The change in sales volumes from the second quarter to the third quarter created numerous difficulties from an operations and planning perspective, but our team met the challenge and is doing an unbelievable job to meet our customer orders with a very high level of operational efficiency.

During the third quarter, volumes increased so quickly that it became very difficult for our operations teams to keep up. But in typical Gentex fashion, we had many salaried employees volunteer to help build parts to ensure we were able to meet our customers.

For the third quarter of 2020, the gross margin was 39.7% compared to a gross margin of 37.7% for the third quarter of 2019. Gross margin improved significantly on a quarter-over-quarter basis, which was driven by the strength in orders during the quarter and the previously announced $35 million in annualized structural cost reductions that took place in the second quarter of 2020. Gross margin was also positively impacted by purchasing cost reductions and improvements in tariff-related costs, which together were able to offset the impact caused by annual customer price reductions. The cost savings actions that we took during the second quarter had a sizable and direct impact on the results reported today. These efforts have reset profitability of the company for the second half of 2020 and set the stage for what we believe will be strong margin performance as we head into 2021 and beyond.

The third quarter of 2020 margin performance was the result of quick decision-making and flawless execution by the entire Gentex team. Operating expenses during the third quarter of 2020 decreased by 5% to $49.4 million compared to operating expenses of $52.2 million in the third quarter of 2019. The decrease was primarily driven by the structural cost reductions made during the second quarter of 2020.

Income from operations for the third quarter of 2020 was $138.9 million, which was an increase of 8% when compared to income from operations of $128.1 million for the third quarter of 2019. Operating income improved on a quarter-over-quarter basis, driven by product mix, operational efficiency and the structural cost changes that were executed in the second quarter. It was also positively impacted by the fact that many of the industry trade shows that we normally participate in have been canceled due to the pandemic, and most of our business development teams have been unable to travel to customers globally. The company looks forward to being able to do display products at trade shows and getting back to more normalized levels of business travel to our global customers.

Once these selling expenses begin to increase, it is expected to have an approximate negative impact of 50 to 100 basis points on operating margin, but should help the company secure our future order pipeline. During the third quarter of 2020, the company's effective tax rate was 18.1%, up from 15% during the third quarter of 2019. The increase in the tax rate was driven by lower foreign-derived intangible income deduction, lower discrete benefits and certain state taxes. The company had a 5% increase in net income to $117.1 million for the third quarter of 2020, which compared to net income of $111.9 million in the third quarter of 2019. The increase in net income was accomplished despite the quarter-over-quarter reduction in sales when compared to the third quarter of 2019. This increase in net income was driven by increased gross and operating profits, which were the result of the positive product mix in the quarter, operating efficiency and structural cost savings that were put in place during the second quarter of 2020.

The company had earnings per diluted share for the third quarter of 2020 of $0.48, which compared to earnings per diluted share of $0.44 for the third quarter of 2019, primarily as a result of the increase in net income as well as a lower diluted share count when compared to the third quarter of 2019 as a result of share repurchases.

During the third quarter of 2020, the company paid down $50 million of debt on our revolving credit facility. We currently anticipate that we will pay the remaining balance on our credit facility during the fourth quarter of 2020.

During the third quarter of 2020, the company repurchased 1.2 million shares of its common stock at an average price of $26.93 per share. As of September 30, 2020, the company has approximately 11.9 million shares remaining available for repurchase pursuant to its previously announced share repurchase plan. The company intends to continue to repurchase additional shares of its common stock in the future in support of the previously disclosed capital allocation strategy. But share repurchases may vary from time to time and will take into account macroeconomic issues, including the impact of the COVID-19 pandemic, market trends and other factors that the company deems appropriate.

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

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

Thank you, Steve. Automotive net sales in the third quarter of 2020 were $464.7 million compared with $464.3 million in the third quarter of 2019. Automotive net sales were strong during the quarter of 2020 despite the 3% quarter-over-quarter decrease in auto-dimming mirror unit shipments, primarily driven by revenue growth of the company's Full Display Mirror product. Other net sales in the third quarter of 2020, which includes dimmable aircraft windows and fire protection products, were $10 million, a decrease of 26% compared to other net sales of $13.5 million in the third quarter of 2019.

Dimmable aircraft window sales decreased by 52% for the third quarter of 2020 when compared to the third quarter of 2019. The company expects that dimmable aircraft window sales will be impacted until the recovery of the aerospace industry begins and the Boeing 787 aircraft production levels improve.

In terms of the balance sheet. During the third quarter, the company continued to focus primarily on maintaining high levels of liquidity in order to remain well positioned for multiple economic scenarios. As previously mentioned during the quarter, the company began repurchasing shares but also paid down approximately 2/3 of its debt. I'll mention a few key balance sheet items as of September 30 as compared to December 31 of 2019.

Cash and cash equivalents increased to $400.5 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 $52.3 million, down from $140.4 million. The company had approximately $88 million of investment maturities, the majority of which were not reinvested during the second and third quarters of 2020.

Long-term investments were $159 million, up from $139.9 million. Long-term investments include FDIC-insured CDs, treasury notes as well as corporate and municipal debt. The portfolio continues to be well positioned, with over 90% of the corporate and municipal holdings invested in A-rated or better institutions.

Accounts receivable increased to $268.5 million from $235.4 million. The increase in AR was due to a significant increase in sales during the quarter and more significantly the timing of the sales within the third quarter. As of September 30, all the company's Tier 1 and OEM customers continue to be in good standing.

Inventories were $233.3 million, down from $248.9 million as a result of lower raw material inventory and finished goods inventory levels. As production and sales levels have increased, raw material inventories that built through the second quarter have moved down to a more normalized level.

Our purchasing and supply chain teams have continued to manage through certain supply chain stresses and supplier issues and have done an excellent job of making sure operations have not shut down as a result of component shortages.

Accounts payable decreased to $90.2 million, down from $97.6 million, and accrued liabilities were $146.2 million, up from $74.3 million. Increases were due to increases in accrued salaries and wages, accrued income taxes as well as increases as a result of the draw on the company's line of credit.

Third quarter 2020 cash flow from operations was $138.6 million, up from $110.5 million in the third quarter of 2019. The company was able to realize a year-over-year increase in operating cash flow as a result of the increase in net income during the quarter and fluctuations in working capital.

Year-to-date cash flow from operations was $329 million, which compares to $383.9 million for year-to-date cash flow in '19, driven by the lower net income in the second quarter of 2020. Capital expenditures for the third quarter were $8.2 million compared with $12.9 million for the third quarter of 2019. And year-to-date 2020 capital expenditures were $37 million compared to $58.3 million year-to-date in '19.

Depreciation and amortization for the third quarter of 2020 was $25.1 million compared to $26 million in the third quarter of '19. And year-to-date depreciation and amortization was $78.5 million compared to $79.3 million for year-to-date '19.

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

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

Thank you, Kevin. For the third quarter of 2020, there were 23 net new nameplate launches of our interior and exterior auto-dimming mirrors and electronic features net of previously disclosed feature headwinds. Of the total launches, approximately 50% had advanced features. Advanced feature launches in the quarter were led by new launches of HomeLink, Integrated Toll Module and Full Display Mirror.

We're excited to announce that during the third quarter of 2020, we began shipping Full Display Mirror to our 8th OEM customer, FCA. Developing and launching the FDM technology for FCA was a great cooperation between both organizations to bring an exciting technology to market. During the third quarter, we began shipping FDM on a total of 4 new nameplates. These nameplates are as follows: the Jaguar I-PACE, the Ram 1500 TRX, the Ram ProMaster and the Toyota Venza. The variety in these nameplates helps to show how broad the use cases are for the FDM product, and we're excited to see them come to market. For 2020, we have launched Full Display Mirror on 18 new nameplates.

Our final launch update for today is in regards to Integrated Toll Module. During the third quarter, we made our first production shipments of ITM on 6 new platforms for Audi. Currently, we are shipping ITM on 9 platforms for Audi, and they are as follows: The A4, A5, A6, A7, Q5, Q7, Q8, e-tron and e-tron Sportback. We're excited with the progress of the ITM launches, and we continue to see great interest in this technology from our customers.

The third quarter of 2020 was a strong launch quarter for the company, and the Gentex team has done an incredible job keeping these launches moving forward, even with the adverse conditions we've had to deal with in the second quarter of this year.

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

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

Thank you, Neil. The company's current forecast for light vehicle production for the fourth quarter and full year 2020 and 2021 is based on the mid-October 2020 IHS Markit 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 are expected to be down 2% for the fourth quarter of 2020 versus the same period last year. For 2020, light vehicle production in the company's primary markets is expected to be down 16% when compared to 2019. For 2021, light vehicle production in the company's primary markets is expected to be up 12% when compared to 2020.

Based on this light vehicle production forecast and the structural changes that the company has made over the last several months, we have updated our previous guidance estimate for the second half of 2020 to the following: revenue of $940 million to $960 million; gross margin between 39% and 40%; operating expenses between $95 million and $100 million; tax rate between 16% and 17%; capital expenditures between $25 million and $30 million; and depreciation and amortization of $50 million to $55 million.

Given the magnitude of changes this year, the company continues to believe that providing updated second half guidance will provide a more accurate representation of the new cost structure and financial performance of the company for the remainder of 2020. Also based on the mid-October 2020 light vehicle production estimates for 2021, the company is reintroducing revenue guidance for 2021, despite the fact that there continues to be significant uncertainty regarding macroeconomic conditions, underlying overall consumer demand for light vehicles worldwide and the continued impact from the COVID-19 pandemic.

We currently estimate that revenue for calendar year 2021 will be approximately 15% to 20% higher than estimated revenue for calendar year 2020. While we have enjoyed a very rapid recovery in light vehicle production over the last several months, we remain cautiously optimistic about the trends in the economy heading into 2021.

We adapted very quickly in the second quarter to the COVID-19 pandemic to adjust our cost structure because we were estimating that global light vehicle production, and therefore, our total addressable market was likely to be much smaller over the next few years than it was from 2017 to 2019. Despite the cost changes we made during that time, we remain focused on further developing and adding to our product strategy and launch execution to help us maintain our history of growth that outperforms the underlying market. We believe that our focus on both cost control and new product innovation will provide above-market returns for our shareholders over the next several years.

Lastly, I don't do this very often on earnings calls, but my last comment today is for the team at Gentex. I realize the last 7 months have been unbelievably difficult on you. What has made it even more difficult is that we haven't been able to hold any of the large meetings that we usually have each quarter so that we can communicate what is happening, our plan and why we believe the future is bright for Gentex. But despite the challenges and the changes, you delivered again. You've already read this in letters and business updates from me, but I believe that you deserve to hear me say it out loud. Thank you.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from James Picariello with KeyBanc Capital Markets.

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

Congrats on a really great quarter here. So if we scrub the run rate this second half to next year, you'll have the 50 to 100 basis points impact on SG&A, right? Maybe that trends toward the low end of the range. Just assuming travel and trade shows spend in the first half of '21 isn't much higher, right, than the current run rate? And then for gross margins, you're guiding the second half at 39.5%. You mentioned some purchasing cost reduction benefit. But -- so that likely picks up, but you also have, call it, $10 million to $11 million in incremental COGS savings, right, from the restructuring effort this year into next year. So what's the right run rate for gross margins as we think about next year? And can you just help bridge both of those buckets?

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

Sure. If you look at the overall gross margin, I think the one thing that did help in Q3 that we mentioned in our press release was some help from white collar employees who were helping build parts. So gross margins were a hair higher than what we'd expect going forward. But that total is probably only 25 to 50 basis points impact on margins. So honestly, as we stand here today, probably somewhere between 38.5% to 39.5% would be the range we would give for next year.

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

38.5% to 39.5%?

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

Yes.

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

Yes.

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

Okay. Yes. So that's very encouraging. And then for FDM, how should we -- what's the right target for this year's shipment number?

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

If you look at -- yes, I mean, we lost -- if you look at -- if you take Q2 out of it, we were right in line with our original annual guidance. We probably made up a little ground even in the back half, made up a little bit of what we lost in Q2 in the back half of this year. So we're going to be down from our original target for this year, but definitely not a full 25% down.

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

Got it. And then just last one. As we think about your strong free cash flow from here, right, clean balance sheet. Is there a targeted total cash and investments number as we think about what your potential cash deployment is towards buybacks? Is there a targeted number you have in mind?

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

For total cash?

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

Yes. Total cash and investments like previously you had $525 million?

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

Yes. If you look at it, I mean, total cash and investments, I mean, we're going to be somewhere in that $550 million to call it, a little over $600 million range is kind of where we're comfortable. So what we're focused on right now is, as you saw in Q3, and we waited till we were pretty far into the quarter and we started to see customer orders respond and then cash flow build, that's when we started repurchasing. So that's kind of what we're watching as we move through the last quarter here and then into early next year. As long as cash generation continues like it has been in Q3, you'll see us get active on repurchases again.

Operator

Our next question comes from David Kelley with Jefferies.

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

Just maybe starting with the ITM launches with Audi and just lighting feverishly to keep up with the number of the models you mentioned. How are you thinking about kind of the go-forward trajectory for ITM? Just trying to get a sense of the size of that contribution into 2021 would be great.

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

Yes. So from the Audi perspective, you'll see it continue to roll out. The vehicles, the multiple models that were read off were mostly the 2021s. So as the 2021s continue to come out, you'll see ITM show up as a standard feature in those products. Late this year into the beginning of '21, we'll begin also shipping on our second OEM for that product as well. So it continues to grow. It's not as fast as some of the other technologies, but we continue to see the interest and expansion of it.

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

And the nice part about that in terms of contribution, really, given that we're still with our launch OEM, you're looking at -- like Neil mentioned in his comment there, we're basically standard on most Audi vehicles in North America. And so you can get a sense of total Audi volume and sales in North America. It will give you a pretty good estimate of like what our volume is currently. And typically, we're in that kind of $50 to $65 price point for ITM.

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

Okay. Great. That's super helpful. And then maybe switching to cost in the quarter. Were there any onetime costs such as overtime to meet the significant ramp-up in production volumes you noted? We were just trying to get a sense for if there might be any offsets to the lower trade show and travel cost and the implications of the move forward, I'd assume reversal of those 2 as going end of the year here?

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

Yes. We've been pretty busy. As Steve mentioned, it started a little slow, but orders ramped up pretty heavily. So yes, our teams were stretched a little bit, working significant amount of overtime. And we would expect that, that would abate as you move through and things start to normalize and may offset it, but you have to continually balance that with wage growth and expense management. So I think...

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

But nothing on the SG&A side that would have been higher that would have -- that would be a natural offset to trade show marketing expenses.

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

Okay. Got it. Perfect. And maybe last one, just if I could squeeze one in. Dimmable aircraft sales, you noted down 52%. Do you expect any further sequential deterioration? Or are we pretty much bouncing along the bottom from here?

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

No. it could go lower. I mean, honestly, when you look at Boeing making announcements about changing production footprint of where they're going to be building the 787 and the fact that they've made some pretty drastic cuts to their estimates for plane production, it could go lower. The good news is it's basically 1%. Before the reductions, it was 1% of revenue. So it wouldn't have a material impact on the top line. Obviously, it can impact the bottom line a little more significantly than that. But it could move lower from -- it's run about half -- last quarter, it ran about half of where it was prior year. It could go lower than that, yes.

Operator

Our next question comes from John Murphy with BoA.

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

I just wanted to actually follow up real quickly on the prior question. So you had white collar workers working the line, but you're saying that actually didn't create incremental costs. So I'm just curious, it just seemed like kind of that scramble would create some temporary inflation in costs that would disappear over time. That just wasn't the case?

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

Well, what you'd see is that our -- actually, our scrap rates and our yield losses were down in the quarter. So those savings actually offset some of the inefficiencies of what we had going on with what Kevin mentioned on the overtime side. So I would say that these are very, very high levels of gross margins. So I don't think there's anything -- there's not a whole lot of upside to that just based off the fact that we are working overtime and some of the scrambling that we had to do. The teams are incredibly efficient during that period despite the chaos.

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

Okay. And then just a second question on mix. It seems like it was very strong in the quarter for both Full Display than added electronic features. Just curious how sustainable you think that is? I mean it seems like this was a quarter where the automakers were producing very high-end vehicles. So just trying to gauge what you think is going to happen with mix going forward? And what kind of impact that specifically may have had on gross margins?

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

Yes. So I mean, if you look at the strong North America rebound, I mean, that obviously plays very well into our feature set with FDM being the primary driver. Outside mirror sales were very strong in the quarter as well catering into that North American launch. But as Neil talked about, the continued launches of the new vehicle platforms, that's what's going to continue to sustain the strength of product mix as we go into the next -- rest of this year and into next year.

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

What I would say product mix itself was probably only -- on a year-over-year basis, it was probably only 50 to 100 basis points. The rest of it was operational efficiency, cost structure improvements, things that we did deliberately and that's what helped the margin improve.

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

Okay. That's extremely helpful. And just a follow-up on that also. Just the FDA versus ITM, I mean when you look at these -- those sort of newer features or newer products, I should say, is there a big delta in the margin you're getting on those versus traditional sort of electronic adds? I mean, is there in-house IP that you guys have developed that you're getting paid for as opposed to some of the electronics that will pass-through in the past. So I'm just trying to understand as these come through -- how much higher those margins are than like base margins?

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

Well, if you look at -- yes, like, so our base mirror margins, as we've kind of talked about in the past, are usually in the high teens, low 20s from a base auto-dimming inside mirror standpoint. Almost all of our advanced features, the new things that we've launched in the last couple of years are all at or slightly above corporate average margin. And so that's what's really helping. As those products that were base mirrors transition to advanced features, that's why we really get the margin uplift because you not only get the incremental dollars, but you're also improving the core mirror itself from a low -- high teens to, call it, mid-30s kind of gross margin profile?

Operator

Our next question comes from Ryan Brinkman with JPMorgan.

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

Congrats on the quarter. Thanks too for the preliminary outlook on 2021 revenue today, I don't think many other suppliers are going to venture to guide to next year just yet given the still high macro uncertainty. As of now, that seems to imply, I think, that the 15% to 20%, about 1.2 to 6.2 percentage point growth over market, just simplistically looking at IHS is 13.8% growth next year. I haven't tried to wait that for your geographic exposures or anything, but I think historically, you've targeted more like a 5% plus. Just curious what your growth over market assumptions are next year, what might be baked into that?

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

Well, if you look at our guidance of 15% to 20% on IHS data that we are looking at, it was about 12.5% vehicle production for next year -- what, at 12%, I think. What you're seeing is that midpoint would be at about 5.5 points better than production in our key markets.

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

Okay. Very helpful. That is helpful. And then just last question on the $35 million annual structural cost reduction target. Is that, in any way, volume dependent? So if the industry continues to outperform, would you maybe look to curtail that some? How should we think about that?

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

No, that $35 million was executed in Q2. So that's the annualized savings, but it was all executed completely in Q2.

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

Okay. So none of that needs to layer back on or anything if volume comes back faster?

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

No. I mean, it already has in Q3. If they continue to come up even faster, obviously, we'll scale the business to what orders are, but then it would be in line or proportionate to the revenue growth. So it shouldn't deter from the margin performance that you've seen.

Operator

Our next question comes from Mark Delaney with Goldman Sachs.

Mark Trevor Delaney - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

Congratulations on the good results, especially on gross margins. I was hoping to dig into the gross margin outlook a little bit more. Within that commentary of potentially 38.5% to 39.5% gross margins next year, any more details you can provide as you're thinking about that number in terms of factors like how mix and volume and pricing and potentially absorption, some of those other factors. What are some of the puts and takes within that 38.5% to 39.5% deal?

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

Thanks for the question. So the biggest puts and takes going into a new calendar year, obviously, are annual customer price reductions. Our team works really hard to offset those. But historically, we've talked about that being between 200 and 300 basis points headwind starting in the first part of the year. But as Steve also mentioned, we have a carry-through of the cost -- the structural cost savings that we have, mix is going well. And we would expect that our purchasing teams -- purchasing and supply chain teams will be able to continue to offset much of the annual customer price reductions with purchasing cost down. So depending on the revenue growth, the efficiencies, product mix, all those things really are the same factors that we talk about it every year when we give that -- and it was more of a back of the envelope, where things are not structurally changing, but we know that we do have APR typically starting in January again.

Mark Trevor Delaney - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

Got it. That's helpful. My follow-up is just on the content environment more generally, and I understand you already talked about what you're expecting in aggregate as you think about the growth over production for 2021. But wondering if you could share any more details on what you may be hearing from your customers on the content environment. And I think the mix of vehicles has been trending towards the high end for the whole market, which should be very good for Gentex. But then you also talked about some so factors like in this current macroeconomic environment and what sort of content there may be in certain vehicles, especially premium features like auto-dimming mirrors. So just kind of any more details you can share on some of the tailwinds and maybe potential constraints as you hear out from your customers?

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

Sure. If you look at -- yes, I mean, the Q3 was very solid in terms of average content per vehicle. We know as OEMs were working to rebuild inventory levels, they were starting with the higher-end feature sets as would -- anyone would do. And so that's been really positive. When we look at releases, so far in October and heading through the end of the year, we really don't see that changing drastically from what the third quarter was. And so when we look at -- a lot of what we get from data from our customers is we're sourcing programs and we're working on launching.

We know what their estimated take rates are and how they're packaging. Something drastic would have to change at the beginning of next year, let's say, for that mix to adversely impact kind of the forecast that we just gave. I think the bigger risk factor is overall number of vehicles sold, what is the consumer, what's consumer sentiment, average price of a vehicle, what are borrowing rates. Really macroeconomic type trends would be the biggest thing we would be worried about. Micro kind of decisions that are made about packaging will not have nearly as big of an impact as large-picture macroeconomic issues would have.

Mark Trevor Delaney - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

That's helpful. If I could ask one last question. Just and the longer-term outlook for the easier products and electric vehicles, and there's proposals for some battery electric vehicles to use either smaller outside mirrors or cameras in order to maximize the potential range that a battery electric vehicle can travel. But again, these are also high-end vehicles and typically -- and maybe those are actually a really good opportunity for Gentex. Maybe you can talk a little bit more on what you're seeing on design for your products for mirrors within the battery electric vehicle market in particular?

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

Yes. I'd start at high level first. I'd say on BEV vehicles, we do really well on content. If you look at the consumer, if you look at the average price of those vehicles, what you'll see is a trend towards technology, which suits us really well, whether it's with FDM or other advanced electronic features. You look at the Audi, for instance, in the e-tron, and that was our launch vehicle for our Integrated Toll Module product. And so we feel very well set up to be a part of that trend and take advantage of those trends.

When you look at what's happening in the space as it relates to cameras replacing outside mirrors, the talk and a lot of the movement that happened over the last couple of years has actually slowed down a little bit, primarily because of the cost structure, the difficulty engineering and getting those products in the space and the cost once you do. We still believe we have a superior offering in that space, and we're excited about what opportunities that will bring. We think it's just going to be a few years longer than what everyone estimated it will be before you'll start to see. And it requires a lot of legal changes to happen in various parts of the world before it becomes mainstay or even a larger portion of the market.

Right now, you're talking tens of thousands of vehicles sold globally with this type of technology. And primarily because it's multiples more expensive than existing auto-dimming technology. And so we continue to be excited about the opportunity it represents, but we think it's going to be a few years out versus how fast the market seemed to think it was going to happen.

Operator

Our next question comes from David Whiston with Morningstar.

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

First, a question on unit shipments. The one positive outlier here was North American interior was actually up. I was just curious why?

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

Yes, it's really driven by that increase in light vehicle production from the first part of the quarter to the end of the quarter where OEMs are really trying to fill that pipeline, get vehicles on dealer lots. And then as Neil talked about, right, some of the vehicle launches, FDM launches, have been very strong and the strong mix towards high-end vehicles contributed towards that.

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

And just how would you gauge -- I don't know how much insight you can get into your customers -- your OEMs customers' state of minds on supply chain and whatnot. But I imagine in April, it is extremely frantic, and it's -- inventory is still quite thin, as you know. So do you think it's a little bit less frantic for them than it was 3, 4 months ago or about the same?

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

I would say it's a little less than it was then. I mean, if you look at what was happening then, you're dealing too with government intervention at the time, telling you what you can, when you can and cannot work, how much and so that added a whole layer of chaos that fortunately, right now, we're not having to deal with.

In terms of trying to get back up and running, the hardest part OEMs had then was trying to make sure you could staff each plant that you could get -- make sure your supply chain with secure. And so that's happening now, but for a different reason. Before it was -- did everyone get started. Could everyone make sure or guarantee they were started back up. Now it's do you have the right number of people? Do you have the capacity in place? And can you keep up with demand?

And so that's really probably what the next month or 2 looks like as what -- all of September was, was really dealing with constraints and trying to make sure that your entire supply chain is operational and able to produce the capacity that's needed. And that's a similar problem that we had in the quarter and where the Gentex team really stood up well was making sure that we are supplementing where needed and people volunteering to change buildings, change lines, whatever needed to be done to make sure we kept up with customer demand.

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

So you have not had any customers say, well, we need these mirror units by tomorrow or next week, but then say, well, never mind, we had too many people call in sick or we have to stop the line or slow the line, nothing like that?

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

No. I mean, what's happened is you have customers changing orders a lot, like on this side, usually, it's canceling orders when you're coming into a bad time. This time it's can we get 10% more than what we said or 15% more than we said.

Typical to Gentex, we try our best to honor those. If we can't, we just give them an applicable time under which they can get those parts. And typically, given the supply chain, there's flexibility from the OEMs. So if they have a request and if you give them a reasonable response, you can usually find a way to make sure you get them the parts they need and enough time for them to build the vehicles they want.

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

Okay. And on the guidance, the second half operating expenses are higher despite the structural cost reductions. So I was just curious about what's the dynamic there, what's increasing versus the decreases from Q2?

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

It's really driven by the fact that margins improved, and our corporate profitability improved, which then ultimately our profit sharing bonus, which is really for the employee level, all employees share in that, that drives a little bit of increase there. Options expensing, things that we're estimating based on the performance and our expectations of what stock price will happen. Obviously, that moves options expensing and there's a few others and like Neil mentioned, there's a lot of launch activity going on. And so you're going to see a lot of that flow through the R&D line items.

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

So it most like comp and launches. Is that fair?

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

Yes.

Operator

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

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

First question I want to ask is maybe a little bit more of a hypothetical. And that is if there were to be a change in administration, I mean, who knows, of course, but if there was, we could maybe see a softening in the U.S.'s stance towards China. And I'm just wondering if you could walk through the potential benefits to the company, if that did happen, both in terms of gross margin as it relates to tariffs and perhaps more importantly, just the ability of the company to compete in China more broadly.

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

So the obvious is -- let's just assume for a second, there were a change in administration and then the trade war were to slow down or stop. There's upsides and downsides to that as well. Number one on the upside would be, obviously, our duties and tariff rates would drop on incoming components, but also on our exports. Hopefully, they would drop on our exports into the China market, hopefully making our price point a little more competitive for shipping into the China market. On the flip side of that, though, you haven't -- you would expect to have increased competition from copycat type suppliers in the China market.

So there's -- obviously, there's pros and cons, and you would expect that you're not going to get much help from the Chinese government, if that were to change, in terms of support for representing and forcing and helping imports into the China market from U.S.-based suppliers. So I think it's hard to determine what the net of that is of the pros and cons, but those would be the 2 common kind of areas that we would see and expect if that were to happen.

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

And then one other item to consider and there's not a lot of details coming out, but I think if there's a change in administration, a lot of the talk around increases in corporate income tax rates is certainly one of the primary agendas there in that camp. So you would expect a negative impact there.

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

And very concerning, as you can imagine.

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

Yes. Right. Okay. Those are some good things to consider. And then second, just looking out a little further into 2021 in terms of the FDM. Just any very high level guardrails you can give us around the pace of launches? Is 200,000 units still a good starting point? Or maybe could that get squeezed a little bit higher if we see this trend towards sort of the higher-end vehicle mix that we're seeing currently continue?

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

In terms of launches or annual volumes?

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

In terms of the launches, yes.

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

I don't think launches will change. I mean, if you look at the engineering function and the time lapse it takes to get them queued up and ready, we feel pretty comfortable where we're at for the rest of this year and into '21. I don't think that will change a whole lot.

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

Okay. Actually, yes, makes sense. I actually meant to ask in terms of just the unit numbers.

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

Yes. If you look at -- if you kind of -- like we said, we lost a little bit because of Q2 and not being able to ship there for a while, but if you look at that trajectory, we were on from the last couple of years, what we expected this year and then that trajectory we expect it to continue into next year. So factor out that we lost a good portion of Q2, but the trajectory itself hasn't changed. In other words, what the growth rate was and the total number of units we expect to add on an annual basis. We expected that would continue and build through '20 and into '21.

Operator

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

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

Clearly, an exceptionally strong quarter here. Looking here, great to see the North American interior mirror market actually up 4%. I'd assume that that's bolstered by the growing dominance that we're seeing in some of these higher-value truck and SUVs. Have you seen a material increase in some of these markets for penetration rates for the interior or exterior mirrors as far as like dimmable glass? And is there significant opportunities to further push that forward over the next like 12 or 24 months?

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

If you talk about penetration, that's a pretty steady as we go. We've seen about 1% a year if you look at the -- across the landscape. And again, the nice part about North America is we are getting a ton of foothold with the new vehicles, the FCA programs, GM truck, as you mentioned before, a lot of the platforms there really were in heavy launch and the OEMs really trying to get dealer inventory to an acceptable level to the level that they were hoping for. So I don't think the penetration necessarily has increased on a step function, but we continue to work vehicles and platforms that we don't have exposure on.

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

And then just looking at the Full Display Mirror. Great to see such a sharp rebound in the third quarter. I know next year, if you're guiding 15% to 20% sales growth, fair to assume, I would think that FDM piece of the business would be growing like materially faster than that as far as what you have planned for launches. Any detail you could provide around that?

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

No. Your assumption is right. What I would say and what we've been consistent with that couple of hundred, 250,000, 300,000 kind of unit growth rate that we are expecting for this year on FDM. We had expected initially for that to happen in '21 as well. And so that's kind of the trajectory we're still on.

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

Great. And then I guess -- what's the ability, I guess, to address a larger percentage of the market here to really bring down costs for the Full Display Mirrors so that the penetration rate can expand a little bit more bountifully over the next couple of years to a more material percentage of the overall market.

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

Yes, we've been working on that. And a lot of the customers that we're launching with now, there's a much wider variety of price points that we execute Full Display Mirror with. So at the beginning, everything was kind of in that $225 to $250 per unit. That's come down because that was 4 years ago. That's come down 3% to 4% a year in essence. So you're really kind of in the $200 to $225 range now for most products. We also have lower-cost versions, smaller displays, not all the bells and whistles, certainly not all the graphics processing capability in every product, depending on what the OEM wants.

And so you can see price points as well as $150 to $180, depending on the size of display and what type of graphics processing the OEM wants done. And so we do have a wide variety that we offer our customers that you start to see these on multiple OEMs. Sometimes you can notice a difference in those products. Certainly when you drive them or how the OEM chooses to handle that graphics processing can lower our cost to them if they choose to do it at the camera or a video processing block.

So there is already a wide variety of price points. That's what has allowed us to continue to grow the number of OEMs and the units.

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

Great. And then last question for me. Is there any real material difference? I know that you have relationships with pretty much all the automakers as far as penetration rates for the company's products amongst the various OEMS, particularly the larger OEMs. Are there any opportunities to improve with one or 2 manufacturers specifically?

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

Yes, there's a lot of opportunities. If you look at the high end or luxury builders, we tend to have very high penetration rates of our core auto-dimming technology. Where our real opportunities start to come from are you look at volume producers and does our core auto-dimming technology get packaged in such a way that offers the most upside. I mean, if you look globally, right now, I think we're still only on about 32% of vehicles produced with our inside mirrors and sub -- probably 15% -- 14%, 15%, I would guess, penetration rate on our outside mirrors. So there's still a significant amount of upside potential for us to continue to grow our core auto-dimming technology.

In addition to that, if you look at Full Display Mirror, you're talking just a very small percentage of the total global production that has that type of technology. So we're still excited about the upside potential. Not to mention the things that we've been showing at CES, things like Integrated Toll Module and some of our newer technologies that we've been working on that haven't even really begun to hit the market yet.

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

I guess one more, I guess, if we want to talk a little bit about more broadly, like how material could the ITM opportunity be? I know that's still a relatively nascent offering. But if you could elaborate on that a little bit, that would be helpful.

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

On FDM?

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

ITM.

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

ITM. Okay. Yes. I think if you look at it right now, the fall in market potential right now is just the North American market. The product itself is specific to North America. So if you look somewhere between, depending on what you think SAAR is somewhere between 15 million and 17 million vehicles, that's the obvious cap.

Beyond that, you have to deal with how does an OEM want to package this. Luxury segment only. Geographically, obviously, there's a bent towards where this is more useful today. Obviously, on the coast and the south, those are very high. The -- some parts of the Midwest, like Chicago, but there's definitely pockets of places in the North American market where vehicles sold in those spaces will be much more useful product for them than it would be in other places where tolling isn't as common.

So when you start looking at that, though, when we look at car sales spread out over North America, the estimates are anywhere from 40% to 60% of vehicles are sold in areas where tolling is either very common or at least available. And so when we look at that, we would say 50% to 60% of the total North American market is absolutely right in the strike zone for a key market for us.

Operator

I'm not showing any further questions at this time. I would now like to turn the call back over to Josh O'Berski for closing remarks.

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

Thank you, everyone, for your time and questions. This concludes our Q3 quarterly call. Have a great weekend.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.