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GNTX - Q3 2017 Gentex Corp Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Gentex Reports Third Quarter 2017 Financial Results. (Operator Instructions) As a reminder, this conference call may be recorded.

I would now like to introduce your host for today's conference, Mr. Josh O'Berski, Investor Relations Manager. You may begin.

Josh O'Berski

Thank you. Good morning, and welcome to the Gentex Corporation Third Quarter 2017 Earnings Release Conference Call. I'm Josh O'Berski, Gentex' Investor Relations Manager. And I'm joined by Steve Downing, President and Chief Operating Officer; Kevin Nash, our Vice President and Chief Accounting Officer; and Neil Boehm, Vice President of Engineering. This call is live on the Internet by way of an icon on the Gentex website at www.gentex.com.

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Now I will turn the call over to Steve Downing, who will give the third quarter 2017 financial summary.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Thanks, Josh. For the third quarter of 2017, the company reported net sales of $438.6 million, which was an increase of 2% compared to net sales of $429.6 million in the third quarter of 2016. The 2% quarter-over-quarter growth in net sales was driven by an increase of 12% in international auto-dimming mirror unit shipments. The underlying light vehicle production in Europe, Japan and Korea was up 7% overall in these markets, which comprise the majority of the company's international shipments. The growth in international auto-dimming mirror unit shipments was partially offset by a quarter-over-quarter decrease of 7% in North American auto-dimming mirror unit shipments, which in large part resulted from an 8% quarter-over-quarter decline in North American light vehicle production.

During the third quarter of 2017, North American light vehicle production schedules decreased by approximately 3% as compared to the company's original estimates for production, primarily due to intermittent plant shutdowns, which negatively impacted the company's net sales growth on a quarter-over-quarter basis by approximately the same percentage. When compared with the third quarter of 2016, the gross margin declined from 40.5% to 39% in the third quarter of 2017, primarily as a result of annual customer price reductions that were not fully offset by purchasing cost reductions, as well as the company's inability to leverage fixed overhead costs due to the lower growth in sales on a quarter-over-quarter basis. However, the gross profit margin improved sequentially from 37.7% in the second quarter of 2017 to 39% in the third quarter of 2017, primarily as a result of improvements in product mix and manufacturing efficiencies.

Income from operations for the third quarter of 2017 decreased 4% to $129.1 million when compared to income from operations of $134.2 million for the third quarter of 2016 due to the lower quarter-over-quarter gross profit margin percentage, which was more than offset -- which more than offset the quarter-over-quarter increase in net sales.

Other income increased to $1.8 million in the third quarter of 2017 compared to $0.1 million in the third quarter of 2016 due to an increase in investment income during the most recently completed quarter as compared to the same quarter last year.

Net income for the third quarter of 2017 decreased 2% to $90.2 million compared with net income of $92.1 million in the third quarter of 2016. Earnings per diluted share in the third quarter of 2017 decreased 3% to $0.31 compared with earnings per diluted share of $0.32 in the third quarter of 2016 as a result of the decrease in net income.

During the third quarter of 2017, the company repurchased 3.2 million shares of its common stock at an average price of $17.51 per share. As of September 30, 2017, the company has approximately 14.9 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, depending on macroeconomic issues, market trends and other factors that the company deems appropriate.

During the third quarter of 2017, the company paid down $8.1 million of debt on the company's term loan, which, in combination with its normally scheduled principal repayment of $1.9 million, resulted in a total repayment of $10 million during the quarter. The company expects to continue at its discretion, based on previously disclosed factors, to pay additional principal towards its debt in the future in anticipation of such debt maturing on September 27, 2018.

I will now hand the call over to Kevin with third quarter 2017 financial details.

Kevin C. Nash - *Gentex Corporation - CAO and VP of Accounting*

Thank you, Steve. Automotive net sales in the third quarter of 2017 were $428.2 million, an increase of 2% compared with automotive net sales of $419.8 million in the third quarter of 2016, driven by a 5% increase in auto-dimming mirror unit shipments on a quarter-over-quarter basis. Other net sales in the third quarter, which includes dimmable aircraft windows and fire protection products, were $10.5 million, an increase of 6% compared to other net sales of $9.8 million in the third quarter of 2016.

The tax rate during the third quarter was 31%, which varied from the statutory rate of 35% primarily due to domestic manufacturing deduction as well as favorable discrete items related to newly adopted accounting guidance impacting the tax treatment of share-based compensation. Excluding future impacts of the new accounting standard, the company expects its tax rate to be approximately 31% to 32% for calendar year 2017, but the impacts of the standard may cause further variability in the overall company's effective tax rate.

Quickly for some balance sheet items. These balance sheet items represent a comparison versus December 31, 2016, which is also included in today's press release. Cash and cash equivalents were $562 million, up from 15 -- up $15.5 million from $546 million -- $546.5 million, primarily due to cash flow from operations during the 9 months but was partially offset by share repurchases, accelerated debt repayments, capital expenditures and dividend payments. Short-term investments were $178.7 million, up from $177 million, and long-term investments were $51.6 million compared to $49.9 million.

Accounts receivable was $240.5 million, up from $211.6 million primarily due to timing of sales within the quarter. Inventories were $206.6 million, up from $189.3 million. Accounts payable was $80 million in both of the periods. Accrued liabilities were $185 million, up from $69.9 million primarily due to the reclassification of the company's long-term debt to short-term debt as a result of the September 2018 maturity in addition to increases in accrued salaries and wages.

Some cash flow highlights. Third quarter cash flow from operations was $89 million, down from $101.2 million in the third quarter of '16, and year-to-date cash flow from operations was $352.5 million versus $356.4 million for year-to-date 2016, both of which were primarily driven by changes in working capital and fluctuations in net income.

Capital expenditures for the third quarter were $29.9 million compared with $36.7 million for the third quarter of 2016. And year-to-date capital expenditures were $86.1 million compared with $91.5 million year-to-date 2016.

Depreciation and amortization for the third quarter was $24.4 million compared with $23.1 million in the third quarter of '16. And year-to-date depreciation and amortization was $74.9 million compared with $68.9 million year-to-date 2016.

And based on estimated completion dates for the company's current and planned capital expenditure projects, the company has lowered its capital expenditure guidance in the range of $110 million to $120 million for calendar year '17 and is also lowering its estimates for depreciation and amortization in the $95 million to $100 million range for calendar year '17.

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

Neil Boehm - *Gentex Corporation - VP of Engineering*

Thank you, Kevin. In the third quarter of 2017, there were 20 net new nameplate launches of our inside and outside electrochromic mirrors and electronic features. During the third quarter, approximately 60% of the net auto-dimming mirror launches contained advanced features. As we have noted previously, when net launches of advanced features are greater than 50%, this is a bullish indicator of strength of our product portfolio. We are also encouraged at the levels of launches in our base auto-dimming products as this growth provides evidence of the relevance of mirrors globally but more importantly helps us secure a geography in the car to deliver other technologies to our customers.

Gentex continues to work on the development of -- and launch of our Full Display Mirror products for our initial-launch customers. With the recent announcement of the 2018 Buick Enclave offering our Full Display Mirror product, we are currently shipping on 8 vehicle models for General Motors, and we continue to believe that we will see additional program launches for Full Display Mirror over the next several years at GM.

During the second quarter, we announced our Full Display Mirror system launch on the Subaru Levorg in Japan. And now during the third quarter, the company is pleased to announce we are now shipping our FDM system on the Subaru Levorg for the European and Australian markets as well. We're excited about the Subaru launch because we believe it points to the global acceptance of our digital mirror technology and why we believe our product is a security offering in the marketplace.

Additionally, during the third quarter, the company began shipping for Nissan, our third OEM customer. Nissan's interest in our display technology began a few years ago and ultimately became one of Gentex' first engagements with an OEM race team. We pushed our technology very hard to meet the performance requirements of NISMO, Nissan's race team, and that hard work and development for Nissan ultimately paid off in the form of a production award of our FDM system. We're excited to announce that during the third quarter, the 2018 Nissan Armada debuted with our Full Display Mirror system.

In addition to these specific OEM updates, we would like to update the overall status of our business development activities for Full Display Mirror. As we have discussed publicly, we have received program awards with 5 different OEMs for our Full Display Mirror and are in advanced talks with other OEMs who we believe will make decisions to add the Full Display Mirror into their product road map for future vehicles.

And for a quick update to the new products that we debuted at CES in 2017. We continue to see interest from several customers on our camera monitoring system, Integrated Toll Module system, iris-based biometrics solution as well as our HomeLink home automation technology. As we look forward to CES in January 2018, we're excited to showcase improvements and new generations of these technologies as well as introducing new products to our customers.

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

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Thank you, Neil. Based on the October 2017 IHS Light Vehicle Production Forecast, which concurrently shows an approximate 2% increase in production in the company's primary regions for the fourth quarter of 2017, our current forecasted product mix and expense growth estimates, the company estimates that revenue will increase between 5% and 10% versus the fourth quarter of 2016. When combining the actual results for the 9 months of calendar year 2017 with our current forecast for sales, product mix and our expense forecast, the company continues to believe that the gross profit margin will be between 38.5% and 39% for calendar year 2017 and operating expenses will be between $165 million and $170 million for calendar year 2017.

Lastly, based on the most recent IHS Light Vehicle Production Forecast for 2018 and current forecasted product mix, the company is making no changes to its previously announced revenue estimates for calendar year '18, which continues to be estimated to be over and above the foregoing 2017 revenue estimates in the range of 6% to 10%.

As Neil mentioned in his product discussion, we are very excited about the product offering we'll be showing at CES in January of '18. And as always, please know that you're welcome to come see us at the show. If you are interested in visiting us at CES, please feel free to contact Josh O'Berski to schedule a time.

Thank you, and we can now proceed to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from David Leiker from Robert W. Baird.

Joseph D. Vruwink - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Associate*

This is Joe Vruwink for David. I wanted to start, can you just provide more color on the product mix that benefited gross margins sequentially?

Kevin C. Nash - *Gentex Corporation - CAO and VP of Accounting*

Yes. Some of our newer-featured, advanced-feature mirrors did well in the quarter, but our traditional and what we call advanced features, the older ones, didn't do so well. And it's really a function of, if you look at our -- the D and E segment in North America, you saw a lot of weakness in that sector, and so you saw a lot of product weakness there. In addition to that, our regional mix was strong. As you saw, our international shipments do very well. So it was a combination of both of those.

Joseph D. Vruwink - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Associate*

I think what we're trying to reconcile is, it seems like similar corporate ASPs Q3 versus Q2, similar exterior versus interior mix Q3 versus Q2, and yet the gross margins had a pretty healthy increase. So that's all explained by just the difference between those new versus the legacy features. Anything else?

Kevin C. Nash - *Gentex Corporation - CAO and VP of Accounting*

Well, it's a combination of a couple of things, right. I think we talked about historically Driver Assist kind of going away, the Mobileye integration moving away from us. And that's a high ASP, but it's a low margin for the company. I could talk about also the improvements in the new features. But then also, we tend to get better follow-through in the third and fourth quarter from our purchasing cost reductions. And while, on a year-over-year basis, it's not as good, sequentially, it's better than it was in the second quarter.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

And like Kevin mentioned, you're replacing the Driver Assist features with lower gross margin profile with some of our newer FDM launches at a better gross margin profile than the Driver Assist features.

Joseph D. Vruwink - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Associate*

Okay, that make sense. As you think back to July and how you are viewing Q4, it seems like a lot of the P&L items are pretty much intact, the top line down a little bit, though. And I know within the IHS forecast, North America is expected to be a bit weaker, foreign markets a bit stronger. So is it as simple as saying you're highly penetrated in North America, and the change in schedules for Q4 are what's causing the Q4 revenue revision?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Well, I think when you look at Q4, one thing we always discuss December especially is incredibly hard to predict with plant shutdowns in the holidays and the number of Tier 1s that we have as customers now both with HomeLink and outside mirrors. And so we tend to be cautiously optimistic about the fourth quarter. And so we tend to look at it and say, okay, what do we know for the last couple of years? And the last couple of years in particular, Q4 has missed what we had planned due to the -- really the December shutdowns and Tier 1 inventory adjustments. So we're looking at what we see and what we forecast and then kind of also looking at it through the eyes of what is a likely or what has been likely scenario the last couple of years in terms of inventory adjustments from those Tier 1 customers. And that's how we come up with that net forecast. If you look at -- like you said before, if you look at the full year and then you look at where production is supposed to be, North America is going to continue to struggle a little bit. And so that is also one of the optics that we view our forecasts.

Joseph D. Vruwink - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Associate*

Okay. And then last question since you touched on HomeLink. Can you maybe provide an update on growth around some of the initiatives, the international certifications and product rollouts? And has that grown enough where it's beginning to have an accretive impact on your margin mix for the overall business?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

No. If you look at international shipments for HomeLink, those are really just beginning right now. It's not materially changed any of our financial performance. We believe it's going to take a couple of years before foreign shipments of HomeLink would have any type of real impact on the company's financial performance because like we've mentioned previously, you're creating a marketplace. So not only are you creating a product, but you have to create the need and the customer awareness. And by customer, I mean consumer awareness. But then ultimately, the OEMs buy in into that product offering. So that is going to be a long-term business development strategy of the company.

Operator

And our next question comes from Christopher Van Horn from FBR Capital Markets.

Christopher Ralph Van Horn - *FBR Capital Markets & Co., Research Division - Associate*

I just want to -- I want to jump into the Full Display Mirror because you have a bunch of new data points here, and congrats on all these wins. Can you just give us an update on what's happening from the OEM perspective of their response to the product? Is it just that the take rates are performing very well? Or are they just getting really good response from the product? Because these are a number of new launches that are pretty good for the product here.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Yes. Thank you for noticing that. One of the things we struggle with is when you're launching a new product like that, you're trying to wait for the OEMs' announcements and trying to honor their ability to control how they go to market. And so we watch carefully and try to watch what's publicly available before we announce anything. And really, this is a function -- these first awards that we're talking about are really a function of just the OEMs' direction and decision that they made. Most of these were made 2 to 3 years ago. And so -- because that's about what the launch cadence was and the launch timing to get these products to the marketplace. So really, there isn't -- we haven't seen any of the positive -- other than GM, you haven't really seen the product in the market enough yet for OEMs to say, "Wow, this is really popular with the consumers. This is something that we need to do because consumers want it." This is really about OEMs' strategy. And so we're excited because as we launch these programs, as they get into the marketplace, we hope that this will create some of the pull effect based on consumer demand.

Christopher Ralph Van Horn - *FBR Capital Markets & Co., Research Division - Associate*

Okay, got it. And then on the international shipments, we've had a strong couple of quarters here. Could you just update us on the marketplace there? Are you taking share? Is it further penetration of advanced features? Is it better pricing? What's the dynamic on the international side?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Yes. So it's really about the penetration play of the product. So there's not really any takeover business that's material in terms of that growth rate. It's primarily all about just the penetration and take rates of our products accelerating in the international markets.

Christopher Ralph Van Horn - *FBR Capital Markets & Co., Research Division - Associate*

Okay. And then last for me. I mean, you cited price concessions. I know that's pretty typical for the industry. But anything out of the ordinary going on there? Is it the magnitude or the frequency of them? Or is it just the continued kind of state of the industry that you're seeing?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Yes. I'd say it's pretty much a continuation of the normal industry standards. This year was a little higher for us than it was last year, which is why it's having a little bit more of an impact on the financials. But that's primarily driven typically for us based on future awards. So in other words, the price concessions typically move ahead of the business growth because they are linked. In other words, obviously, as you're working through new program awards for 2 to 3 years from now, it's part of the concession you have to make as pricing on your current product portfolio to help drive that growth in the future.

Operator

And our next question comes from Richard Kwas from Wells Fargo.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

What was the base advanced feature mix in the quarter for shipments?

Kevin C. Nash - *Gentex Corporation - CAO and VP of Accounting*

It was actually about the same as it was last quarter. So that was about 55% base. But like I said, some of the newer features drove that revenue growth to be better than it would have otherwise been. So yes, we're still seeing a strong base of those mirrors on a year-over-year basis.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Which is -- which honestly makes the gross margin improvement from last quarter to this quarter all that more impressive when you look at the feature mix. Advanced feature versus base mix did not change from Q2 to Q3, and yet the margin did improve 130 basis points.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Right. No, that -- I mean, that was good performance. I guess I'm getting at longer term, do we think of this as kind of the more normalized rate between base and advanced feature? Or is this kind of just a pause in terms of the growth of some of the advanced features, and you expect to get to 50-50? I guess any -- I know you're back in the 6% to 10% revenue growth guidance for '18, but what's entailed in that?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Well, what I would look at if I would -- probably the primary factor that's going to impact that is how does North America perform. So the real reason why we were at a 55-45 this quarter is because of the -- was because of the growth in international. A lot of that tends to be base mirror, to begin with. It's new programs that you've never been on before, and that begins with base auto-dimming. And the counter of that is in the North American market, the primary losses in production were in D and E segment where we have a disproportionate amount of advanced features in that segmentation. And so the reason why it happened in Q3 was because of that 8% decline, and most of that decline in North America happening on D and E segment vehicles.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Right. So then, Steve, as we think about '18, do we think of this as normalizing? Or is this kind of the new run rate in terms of North America? Or do you -- based on the trim take rates, what you're launching here recently, et cetera, et cetera, what's your best guess around that, whether we go closer to 50% or we're going to be at -- it's going to be closer to 55% on the base?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

It's tough to predict, honestly, because it's really -- I mean, it's a fairly -- you're talking about less than a 10% swing basically in feature volumes versus base volumes. So it's really tough to predict on a quarter basis because it's a fairly short time period. If you look over a longer period -- a longer time frame, we would continue to think that it would be more in the 50-50 range. The upside to all of this, though, is that we're talking about -- and one of the things that Neil mentioned in his comments was really that growth in base auto-dimming is a bullish indicator of the business. I mean, one of the bare cases against the company has been that auto-dimming or mirrors themselves aren't going away, and what we're seeing now, we're having discussions around, why is the base business growing fast? We view that as a good thing because it does pave the way longer term for us to increase that outside mirrors, auto-dimming mirrors and then also advanced -- other advanced features.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Okay. And just another one for me on -- just on -- as we think about margins, so this year, the gross margin was disappointing relative to initial expectations. You've talked about a number of different factors. But as we think about '18 -- and I realize volume and mix and all that can have an impact. But if you look at the stuff you can control, how do you feel about improving the gross margin with the metrics you can control, the initiatives you can control versus this year? Because I know you've had some headwinds that -- besides the market and the mix, et cetera.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

I think you -- when we look at '18, I mean, primarily what we've been talking about is gross margins roughly in line with this year's gross margins. And what we're really focused on is, in next year and then the next several years, creating that ability to continue to grow inside of the income statement that we've worked really hard on over these last 4 years. So we're not looking at -- and not forecasting a gross margin expansion in '18. Really, what we're focused on is the discipline it takes to maintain what we believe to be one of the best-in-class income statements.

Operator

Our next question comes from Brett Hoselton from KeyBanc.

Brett David Hoselton - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Looking at your guidance, I'm kind of struggling on the tax line. And I may be miscalculating it here, I'm not sure, but as I look across your taxes, I mean, you did 27.7% in the first quarter, 30.8% in the second and 31% in the third. And to get to a 31% to 32% for the full year, I'm calculating you need to get to hit 35% tax rate in the fourth quarter, which is kind of -- that's a significant step-up from the previous 3 quarters. Am I misunderstanding this? Or am I miscalculating this? What the -- can you help me rectify it?

Kevin C. Nash - *Gentex Corporation - CAO and VP of Accounting*

No, I think the guidance excludes what we call discrete items, so onetime items. The first quarter had quite a few discrete onetime events. And we also have, on a quarterly basis, some new accounting regulations that are impacted by our stock-based compensation and the value that people are realizing versus what we're expensing. And so that can make it vary. And so that rate is exclusive of that. So this quarter, it was on the bottom end of that because we had favorable benefits, but you can have variability there. So I wouldn't expect it to be 35% by any means. But the rate that I was talking about doesn't include those discrete items because they are pretty hard to forecast.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

One -- and remember, the 27.8%, those were -- that was largely a much lower rate than what the company has experienced really in its history. And that was like Kevin mentioned, those were due to discrete onetime events that we are working on to try to help with the tax rate. If you look at really the company's history on a tax basis, it's really been between 31.5% and 32.5% for most of its history. So we've actually been working that down to the lower -- to that kind of 30.5% to 31% range over the last several years.

Brett David Hoselton - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

So I guess I'm thinking about modeling kind of 31%, 32% or -- in the fourth quarter. Does that seem unreasonable?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

No.

Brett David Hoselton - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Okay. And then switching gears. As we think about the Full Display Mirror product, can you talk about its competitive positioning in the marketplace and particularly talk about the proprietary nature of it?

Neil Boehm - *Gentex Corporation - VP of Engineering*

Yes, absolutely. I think one of the things that's important with the product that we have, one of the key items is how the display comes through trends like the device or 2-way mirror sorts where you have thin-film coatings that we perform internally, and we are able to take a display and, on demand, make it shine through, have the product look like a mirror and then have it shine through the displays to have an excellent-looking product either direction and either a mirror or a display. We do all those coatings internally. And what's important is we're always evolving between the coatings and the chemistry side of our business and evolving how to improve the product and how to continue to stay ahead of where the competitors are trying to get to. With 5 OEMs that we've talked about, by the time we get that OEM, we're not working just on one generation of product. We're working on multiple generations for years from now. So I think we have a great competitive advantage just being in the market first. But with our core competency in coatings as well as our chemistry, we're able to, I think, move the bar really quickly from a competitive side.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

And we -- and if you look at -- one of the things we point out there, Brett, is if you look at the 5 OEM awards, we believe that's indicative of the strength of our product offering. So when you -- like Neil mentioned, the technology behind that in terms of the applied materials in the chemistry and what -- and the light management and how we manipulate light in order to make that product effective, that's part of what makes Gentex very unique. And the strength of our product offering, we believe the best evidence of that is not us talking about it but looking at the number of OEM awards and the program launches that we're experiencing currently.

Brett David Hoselton - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

As I think about your competitors, outside of Magna, it seems like there's a limited amount of automatic-dimming mirror capabilities. And so correct me if I'm wrong, but it seems like one of the major advantages you have, again outside of Magna International, is the ability to combine the Full Display Mirror features with the automatic-dimming mirror features. Is that a correct understanding? Or am I mistaken?

Neil Boehm - *Gentex Corporation - VP of Engineering*

No, that's absolutely one of the foundational advantages of it. Absolutely. That's the chemistry and the coating side is -- being able to produce this and shine it through a reflective surface with electrochromics in front of it is really difficult. And we've been able to do it really well, and it's a competitive advantage.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

And I think, Brett, one of the things you were hitting on there is that, in combination with our other advanced features, makes that product offering truly unique.

Neil Boehm - *Gentex Corporation - VP of Engineering*

Right. Combining it with HomeLink and other products.

Brett David Hoselton - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Yes. I just -- I talked to investors who were thinking that a third party is going to come in and just kind of knock you off. And I'm asking how do they replicate the -- what gives them the advantage on the automatic-dimming mirror portion of it. So okay.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

I think the other part of that product offering is very unique, and really seeing it at CES helps explain it because you can see tangible -- the product tangibly. But FDM is really the starting point for a camera monitoring systems. So when you look at that, that whole system, it starts with the building blocks of a single camera, some type of display, so in our case, Full Display Mirror, ultimately moving into additional cameras located in outside mirrors. What that allows you to do from a styling and design perspective, to change the size of the outside mirrors. And so it's really not just about this one product; it's about the evolution of the whole product. And that's where we believe Gentex has a unique product offering and a distinct advantage in the marketplace.

Operator

Our next question comes from Ryan Brinkman from JPMorgan.

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

I'll start with just one more question on the Full Display Mirror. Can you remind us of, the vehicles that you're on, how many are you standard on versus being an option? So for example, I think on the Chevrolet Bolt that it might be a standard. And then on the vehicles where it is an option, how does the consumer take rate track relative to your expectations? And does that make you feel any differently, more positively or negatively, about the potential for the product?

Neil Boehm - *Gentex Corporation - VP of Engineering*

This is Neil. I'll talk to the -- some of the packages. It's a variable across all of these vehicles, but I'll give you some snapshot of where they are today with the current vehicles. So if you look at the Buick Enclave today, there's 4 trim packages on a Buick Enclave. We're standard on the highest trim level, the Avenir package. We're optional on the mid 2 packages. Those packages, when you're -- we are optional on this Buick Enclave, for $825, you get the Full Display Mirror product and surround view. So 2 technologies come together. The base trim level of the Enclave, it's not available. So that's kind of the starting vehicle. So on that one, optional on 2, standard on the top trim. If you look at the CT6 All-Wheel Drive version, there's

5 packages that are available on that platform. Out of the 5, we're standard on 2 and optional on 2. The 2 that we're optional, we're part of a $2,500 package. If you look at the CTS -- and I'm not going to read through all these because there's a lot of data here, but on the CTS, there's -- the top 2 trim levels, we're standard. The mid 2 trim levels, it's part of a -- it's a $475 stand-alone feature. And then if I roll into -- take the Nissan Armada, which is the most recent one we announced, it's got the top 2 trim levels, the Platinum and Platinum Reserve, where we're standard, and it's not available on the bottom 2 trim levels. So it's very...

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

It has pretty similar...

Neil Boehm - *Gentex Corporation - VP of Engineering*

It's pretty variable. Usually, the top 2 trims, depending on how many trim levels are, we are standard. And then usually, it's available on an option -- if there's, let's say, 4 or 5 trim levels, usually, we're available on the mid trims as an optional content.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

And usually not available on the entry base level...

Neil Boehm - *Gentex Corporation - VP of Engineering*

Typically, that base vehicle, we are not available on.

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

I presume you prefer to be available as a stand-alone feature. How does it work with the $475 option? Is there a strong appetite for that?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Yes. We believe -- I mean, based on the volumes that we're seeing, it'd seem -- it would appear to us that there is. Obviously, it's very early in this. And so GM hasn't shared a lot of that data with us yet in terms of how it's being bought. But if we just look at the overall volumes versus our forecasts and how it seems to be performing, I mean, we're pleased with what we believe to be consumer sentiment. The other thing that we tend to look at is owner boards and forums and customer -- direct consumer feedback as best we can get it. And 2 weeks at SEMA is one of our great opportunities to solicit input directly from consumers about what they like about that product and what we need to do going forward to help continue to improve the product offering.

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

Okay, great. And then just the last question for me. Relative to the softer-than-expected IHS North America production, it seems that the incremental shortfall in the back half of this year relates primarily to the passenger cars. I heard you saying earlier, calling out the softness in the D and E segments. But are you able to remind us specifically of your relative exposures to passenger cars versus light trucks in North America?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Yes. If you look at -- I mean, as a high level to your statement, I believe the IHS data for the quarter was that passenger cars were down almost 20% in North America and trucks and SUVs, I believe, were relatively flat. And if you -- but if you break that up a little further and you look at segmentation of passenger cars, most of our exposure in North America is on D and E segment pass cars, B and C, we do not have as much exposure on, and on trucks and SUVs, obviously, it's much more -- very similar to D and E segment. So if you look at that overall volumes, we're probably have -- we probably have content on about 70% of the D and E segment vehicles in North America today.

Operator

Our next question comes from David Whiston from Morningstar.

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

Wanted to switch gears on the topics, go back to an article you guys have featured on, in one of the news that was talking about how you haven't had to reduce your headcount despite a lot more automation in the plants. And I was just curious where are you reassigning these people? And ultimately, at some point, do you run out of ways to reassign people? And would a headcount reduction ultimately have to happen if you keep automating?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Well, if you look at -- no, and the reason why, how the people are getting reassigned is to the growth of the business. And that's really -- the part of that story that we were excited about sharing is if you can automate, become cost-effective and globally competitive out of the North American operational footprint, and the advantage of that and what it offers for us is the ability to have people move from very manual production efforts to more computer maintenance to line management, to kind of higher-end skill sets and job performance. And how you equate that and how you make those numbers work is -- obviously is driven by our growth of the business. And one of the things -- reason why we talk about what the future looks like for the business is not only maintaining that income statement, but it's driven by how do we enlarge the funnel of growth into our business and continue to use that same philosophy of production and manufacturing efficiency to do more things.

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

Okay. And on 2018 revenue guidance not changing, I was just curious, are you basically waiting to see 1 more quarter to see how things play out especially in the North American market because once we get past this hurricane bounce, it could get softer again? Or are you just really confident it's not going to be weak in 2018 relative to your original expectations, of course?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Yes, sure. So I -- it really -- I mean, if you look at the IHS data for '18, it hasn't changed that much since last quarter. So we continue to be cautiously optimistic that '18 is going to be pretty similar to '17 in terms of vehicle production levels, and hopefully with the one difference being that we won't see that drop off in Q3 of next year, like we experienced in Q3 of this year. So if you look at our product offering and where we're at, we've always said that if we can get into a pretty stable production environment, so flat to up 1% or 2%, that we feel like, with our product offering, we continue to outpace that underlying growth in those markets and get to that kind of 6% to 10% growth range.

Operator

Our next question comes from John Murphy from Bank of America Merrill Lynch.

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

Just a simple first question. On inventory, it looks like inventory spiked up a bit in the quarter relative to sales. And I was just curious if that was just relative to this sort of this disruption or volatility in North America or if there was something else going on in the inventory levels.

Neil Boehm - *Gentex Corporation - VP of Engineering*

A couple of things. One is continuing to fill the pipeline with ocean shipments, one for our European distributions. But then also, it's kind of a leading indicator. We built ahead a little bit a few weeks for that fourth quarter. And so it was nothing out of the ordinary from that perspective.

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

Okay, that's very helpful. Then a second question. When we look at the guidance of plus 6% to 10% for 2018, could you split that up by region or just give us sort of some direction there? Because it seems like markets outside of North America have a lot less risk in them, and there's that -- maybe a fair amount of risk in the North American market. So I'm just trying to understand how much of that is comprised of international and how much of it is North America.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Yes. I mean, right now, we're forecasting growth in all of those regions. Now I would say that international over the last couple of years has outperformed the North American market. And that's primarily because of the lower take rates, and where our content has been historically is a little more weighted to the North American market. So what we're seeing in those international markets is continued growth in our base auto-dimming features and also -- base auto-dimming mirrors and also on the advanced features. Now what's going to help the North American market and the reason why we're bullish there is a lot of the FDM launches that we're talking about are going to be focused on the North American market, to begin with. They're not only in North America like with the Subaru announcement, but many of them are, especially with OEMs like GM leading the forefront there. So we continue to see the FDM and some of the advanced features will help us drive content and growth rates in that North American market.

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

So would it be fair to characterize it as similar growth international and North America, international growing a little bit more on units, North America growing a little bit more on content? Is that a fair statement?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Yes, that would be a pretty -- at least from a forecast perspective, that would be a fair statement.

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

Okay. And then just lastly, when we think about the Full Display Mirrors, and it's very interesting, you're talking about sort of coatings and chemistry being unique, which I fully appreciate. How much of that technology in those processes do you have patented and that you could defend going forward and could be of a similar level of uniqueness and proprietary nature as what you have with the regular self-dimming mirrors?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Yes, it's a great question. From a strategic standpoint, the company has always taken a stance that we patent products, not processes. And the reason why is that once you patent a process, you're then time-limited by how long that patent will protect you obviously for the normal patent life versus intellectual property and know-how associated with their manufacturing continues to evolve every day. And so we're actually, we believe, better protected by not patenting or trying to patent that production process because once you patent it, you've now let the world know exactly how you're accomplishing those. What's worked really well for Gentex historically has been able to invest in that process, keep that as a trade secret, continue to invest in it over a long period of time and outpace our competition through investment.

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

Okay. But on the actual product on sort of coatings and the products themselves, sort of are these sort of uniqueness and these patents sort of as defensible and as big a moat as what you have with the self-dimming mirrors? Because obviously, self-dimming mirrors, nobody's been able to crack that and won't apparently. So I'm just trying to understand if this is basically -- if we're looking at the sort of the same level of sort of defense and huge competitive moat that you have on that side.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Well, if you look at our Full Display Mirror, everything we're shipping today is combined with electrochromics. So it has all the strength of our auto-dimming portfolio of patents plus the new patents that we have focused on the Full Display Mirror application.

Operator

And we do have a follow-up from Rich Kwas from Wells Fargo.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Just now that taxes up is starting to get a little more discussion and who knows what happens, but just remind us, in terms of tax as we think about the forward years given your high tax rate, what that potentially could do if actually a 20% corporate tax comes through.

Kevin C. Nash - *Gentex Corporation - CAO and VP of Accounting*

Yes. Well, you know the -- like you said, thanks for rubbing it in, we are at about 32% tax rate. We don't really see a scenario where we're a loser in this situation. Going down to a 20% tax rate saves you somewhere in the $50 million to $60 million range. But I'm sure there's going to be some obvious negotiations before this is all settled out. In addition, the territorial tax system benefits us. So we're not here -- we don't want to speculate. We're just here to run our business. And like Steve mentioned several times before, if they don't do something, we have strategies on the back burner to help move that down, albeit not to 20%, but over time start to look at that more strategically.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

But hypothetically, if 20% actually went through, would you get kind of a one-for-one benefit or close to one-for-one?

Kevin C. Nash - *Gentex Corporation - CAO and VP of Accounting*

The only thing that would be in question would be, currently, we have -- what's bringing us off that 35% rate is the manufacturing deduction. So assuming that goes away, you go from, just call it, 32% to 20%. Potentially, there's not really any other...

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

And assuming there were some -- maybe some other offsets that need to happen, so you maybe don't go to 20% in total, but it would be -- I wouldn't say it's dollar for dollar, but you have to assume that we would probably be the benefactors of -- the difference between our current tax rate and down to 20%, you'd probably get at least 70% or 80% of that benefit.

Kevin C. Nash - *Gentex Corporation - CAO and VP of Accounting*

The only other one that's a big one is interest expense, which is very little for us, too. So I mean, if they disallow that, that doesn't hurt us.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Right, okay. And then just quickly on the Japanese shutdown of the factories, seems like that should be fairly short-lived. But just any impact factored into the fourth quarter with things that we should worry about?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

No. I mean, if you look at most of that's accounted for inside of our guidance. Obviously, the length and severity of those are what's hard to predict, and then which vehicles -- what all is actually affected and how does that change overall production levels is probably the primary factor. It's hard to predict at this stage given the amount of data that's out there. But if you look at it, we believe our Q4 forecast encapsulates most of the known plant issues.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

And then what do you have for Tier 1? Because last year, you had a bad quarter in terms of shipments to Tier 1. It was down. That was down, but it was the headwind certainly to the mirror shipments. You're comping against that. What's the assumption embedded in the fourth quarter for that piece of the business?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Yes. The assumption is, like we said earlier, we're kind of viewing Q4 out of the optics of saying, hey, the last 2 years have been a struggle on -- especially in December, and it's primarily about the Tier 1s and inventory adjustments that they have. So that -- and really, the amount of business -- or the book of business that affects is our outside mirrors and our HomeLink shipments are the 2 primary pieces of the business that shipped through Tier 1s. That's been an increasing percentage of our business because of the HomeLink acquisition and the growth in HomeLink and the growth in outside mirrors. And so we're looking at it, and like you mentioned, we do have favorable comps in Q4 because of last year's issues. But we're going into this quarter assuming that there's going to be probably some type of inventory adjustment that'll take place. And that is why we are probably a hair cautiously optimistic about the Q4 guidance. We feel confident in that range, but there's obviously -- the ability to look at and predict what a Tier 1 is going to do is very difficult. And so at this stage -- and I honestly don't publish much information. I don't share a lot of that. They pretty much just changes. And really, about the first week of December, you start seeing orders change pretty significantly. So we really won't know that impact until we get to early to mid-December.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Okay. But you've taken a more conservative approach relative to prior years.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Yes, absolutely.

Operator

(Operator Instructions) And we do have a follow-up from Brett Hoselton from KeyBanc.

Brett David Hoselton - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Gentlemen, wondering if you could talk about that cash, cash deployment in 2 things. First of all, can you give us an outlook as to M&A, what you're seeing in the marketplace and what are your expectations in terms of maybe making an acquisition at some point in time? And then secondly, share repurchase. The amount that you repurchase kind of bounces around some and -- from 3 million shares this quarter versus, let's say, 1 million in prior quarter -- I guess you were 3 million in the prior quarter. As we kind of look forward, what should we think about in terms of the pace of the share repurchase? What do you think we should model? How do you think that 14.9 million leftover rolls out?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Sure. Well, first of all, on the M&A front, obviously, it's something that we continue to look at very carefully and study. One of the things that we're focused on is primarily looking at technologies that dovetail well with our existing product portfolio that help create a growth story longer term, primarily looking in the areas that we've discussed. Some of those are going to be pure M&A-type efforts. Some of them are going to be partnerships and license agreements. ITM is a prime example of that. Our relationship with TransCore and what we've worked on with them to bring that type of tolling technology into the automotive segment, those in our mind are the same type of thought process. And how they end is dependent on who you're partnering with and what their interests are and ours as well. So when you look at this, the company's been very active. If you look at the ITM deal, if you look at some of the other, the iris biometrics solution, these are all either minority equity stakes or partnerships that we've put in place. So we continue to be very interested in that. What we're not trying to do is we're not trying to find growth or subsidize growth purely through M&A in that we're not trying to cover up for a lack of growth rate by buying something. What instead we're focused on is the strategic merits of how that product or those potential products would work well or dovetail with our existing portfolio. On the share repurchase side, really, what we talk about is the consistency or the baseline on a quarter-to-quarter basis will be in that $25 million to $30 million per quarter range. Above that is when you see us become opportunistic based off of market valuation of the company. So obviously, in Q3, we are able to average at $17.51 or $17.52 a share. And so we took advantage of that price. Obviously, the market price we didn't believe accurately reflected our value, so we used that as an opportunity to go a little faster on the share repurchase side.

Brett David Hoselton - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

All right. And then on the M&A front, financial criteria, I'm wondering, are you willing to make a dilutive acquisition if the technology is compelling enough? Or is there a financial discipline that says, "No, we're not going to do that"?

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Oh, yes, absolutely. Especially when we talk about the fact that when we're looking at technologies, many of these are pre-revenue. I mean, we're not necessarily looking -- we're not posting necessarily an income statement play. But really, when we look at the pure technology side and what Gentex does really well, it's how you bring a product to the marketplace, especially in automotive. And so in a perfect world, we're finding a technology or a start-up that at the beginning is probably going to be dilutive to earnings, albeit, obviously we would love something to be very modestly impacting that income statement, and we believe true value is found there. It doesn't mean that you can't find a more expensive acquisition that may be on the cutting edge that you need to make to help round out the product offering. But our focus is -- our focus more is on kind of early start-ups pre-revenue or very early on in their revenue stream-type targets.

Brett David Hoselton - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

I would think that those targets would be -- given pre-revenue would be fairly inexpensive.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

Yes, most of them tend to be. However, they are -- regardless of their expense level, they are by definition dilutive to earnings because they are pre-revenue. They are not material necessarily to earnings but nonetheless somewhat dilutive.

Operator

Our next question comes from David Stratton from Great Lakes Review.

David Michael Stratton - *Great Lakes Review - Research Analyst*

When we look at the Subaru Levorg and the Buick Enclave, these expanded Full Display Mirrors, is that the same content as others? Or are you getting both the camera and the display? Or can you kind of walk us through how that compares to what you're seeing currently?

Neil Boehm - *Gentex Corporation - VP of Engineering*

The -- yes, absolutely. The Buick is similar to the other GM platforms that we've launched towards the Full Display Mirror only, and we do not do the camera on the General Motors product. But the Subaru Levorg is a system. So we supply the display mirror as well as the camera.

David Michael Stratton - *Great Lakes Review - Research Analyst*

All right. And then when we look -- talk about the new products, TransCore, biometrics, HomeLink, has anything changed regarding the tempo that you see these coming to market as you further engage in conversations with customers? Just any update on where -- when you see these hitting would be helpful.

Neil Boehm - *Gentex Corporation - VP of Engineering*

Yes. I think we mentioned this maybe a little while ago about, on the ITM side, our target was -- to get a customer onboard by the end of this year was our target, I think we announced early this year. And we're still on target for that in directional for that. We've got one customer that's very close and a couple more that are coming behind it. And then on some of the other technologies like the HomeLink home automation, we're hoping at CES, as we expand on that technology, that we'll be able to get into some greater details of how we see that product rolling out in the future because the customer interest on that has grown significantly in the last 6 months since CES. And the same thing for the CMS product that we showed at CES in 2017. When we get into 2018, we're -- there will be expansions on that technology. And I think probably sometime in '18 would be -- I'd be expecting that we should have some customers that would want to go down that direction more formally.

Steven R. Downing - *Gentex Corporation - President, COO, Interim CFO & Treasurer*

And if you look at ITM, I think what we had said probably about early this year when we announced it was probably SOP for that, our first-launch customer will probably be in the '19 timing.

Neil Boehm - *Gentex Corporation - VP of Engineering*

'19.

Operator

Thank you. And I'm showing no further questions from our phone lines. I would now like to turn the conference back over to Josh O'Berski for any closing remarks.

Josh O'Berski

Great. Thank you for your time and questions, everyone. We look forward to seeing some of you at SEMA in a few weeks and more at CES in January. Have a great weekend.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a wonderful day.
