BEHIND THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers

Companies in this Issue

AT&T Inc. (T)
Earnings Quality Update

We are maintaining our earnings quality rating of T at 5+ (Strong).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

AT&T's non-GAAP EPS of $0.68 beat forecasts in 3Q22 by 6 cents. The company is expecting to hit the high end of guidance for wireless of 4.5%-5.0% growth. The company also held its forecast for $14 billion in free cash flow. The beat looks solid to us:

- There was an unexpected bump from selling $100 million in intellectual property at the Business Wireless unit vs. $20 million the year before – that translates to 0.8 cents.

- While the bad debt reserve was down slightly from 2Q's $655 million to $646 million for 3Q22, bad debt expense was still a headwind, rising $202 million y/y. That hurt EPS by 2 cents.

What to Watch

- There continues several areas for additional growth coming:

    - AT&T expects to reach a run-rate of $4 billion in lower costs by the end of 2022 of the $6 billion goal. Much of this is expected to come from retiring copper lines and moving people to fiber. Also, retiring and taking down 3G infrastructure was a large expense in 4Q21 that won't recur in 4Q22. The additional $2 billion of cost savings they are targeting would ultimately be worth 5 cents per quarter in EPS.

    - ARPU for both wireless and fiber is rising. This is a combination of roaming fees returning, promotional pricing rolling off, and better deals leading customers to transfer to higher-priced unlimited plans.

ARPU	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Post-Paid Phones	$55.67	$54.81	$54.00	$54.06	$54.37	$54.24
Fiber Broadband	$58.63	$57.64	$56.66	$55.96	$55.16	$54.76

    - Also, remember that the fiber broadband sees greater profitability from incremental customer additions as the incremental infrastructure investment is minimal for later adds.

- Bad debt reserves declined slightly from 2Q22's $655 million to $646 million in 3Q22. However, the expense figure rose sequentially by $43 million and y/y by $202 million in 3Q. The $202 million cost AT&T 2 cents in EPS. More importantly, AT&T noted that after rising two days in 2Q22, receivables DSOs did not rise in 3Q22. After the jump in DSOs and bad debt reserves in 2Q, AT&T noted that it is nearing normal pre-Covid levels too. This did not make cash flow worse. AT&T is sticking to $14 billion in free cash flow after reporting $1 billion headwind in 2Q due to rising receivables. If the bulk of the bad debt expense was booked early in the 3Q, 4Q22 sets up with an easier comp as bad debt expense in 4Q21 was $383 million vs. $251 in 3Q21.

- Business Wireline improved, in 3Q, but was helped by a $100 million sale of Intellectual Property. AT&T gave little information on this other than to say these happen opportunistically and are lumpy. This helped both revenue and EBITDA:

Business Wireline	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Revenue	$5,668	$5,595	$5,460	$5,901	$5,938	$6,052
EBITDA	$2,224	$2,023	$2,158	$2,193	$2,306	$2,362

After 2Q22, AT&T lowered forecasts for the Business Wireline unit saying it was cutting costs and transitioning more of the business to fiber and to 5G wireless. There was some delayed government spending too in 2Q22. The forecast for double-digit decay for the unit through the 2H24 when it should stabilize did not change after 3Q22.

For 3Q22, the net gain from the sale was an $80 million y/y increase in sales and EBITDA, which amounts to just under 1 cent in EPS. The $80 million was all of the revenue increase, but with EBITDA up $201 million, some of the cost-cutting is looking effective. AT&T did not change the forecast from continued decline, but it does have some easier comps coming up after 4Q.

Ares Capital Corporation (ARCC)
Earnings Quality Update

We are maintaining our earnings quality rating of ARCC to 4+ (Acceptable).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

ARCC reported core earnings of $0.50 for the 3Q22, which beat by 1 cent. This isn't really the type of company to review for one cent because the balance sheet is so large and the timing of when money is put to work or mark-to-market issues can have an outsized impact. With that said, ARCC noted:

- Core earnings would have been $0.54 had the current interest rates on September 30, been in effect and all loans reset to it for the full quarter.

- ARCC also noted that another 100bp of interest rate increases would add 7 cents per quarter to core earnings. Thus, a case can be made that there is a reasonable line-of-sight to quarterly EPS topping 60 cents.

- ARCC responded with another dividend increase from $0.43 per quarter to $0.48 plus there is still the $0.03 in quarterly special dividend. It noted on the call that it does not take dividend hikes lightly and it ran numerous scenarios to ensure it can support it going forward. At $19, it's over book value again, but the yield is nearly 11% now.

- As we thought, in GAAP EPS, ARCC saw more unrealized losses in the portfolio due to wider spreads with market volatility. This was -$0.36 and resulted in book value declining to $18.56 per share from $18.81 in 2Q22. That was after -$0.29 in 2Q22. If those investments are repaid in full, those unrealized marks will boost book value in the future.

What to Watch

- There remain ample reasons to expect more dividend increases. On the earnings call, ARCC noted that it expects to be able to support the new $0.48 quarterly dividend and would address further dividend plans on the 4Q22 call. Here is some of what could be examined:

    - Spillover income (income that has been earned and not yet paid out) is at $1.36 per share and that is expected to grow further in the 4Q22. Already in 2022, ARCC has been paying out a special dividend of $0.03 per quarter. So another special dividend for 2023 could be announced.

    - Core EPS is likely already at $0.54 per share vs. the $0.48 dividend without additional rate hikes. Just getting to a 90% payout should mean an additional small boost to the dividend and higher rates could push the core above $0.54.

- As we noted last week, the Debt-to-Equity ratio came in at 1.25x (1.24x net of cash). That is the top of ARCC's target range. Management was very clear on the 3Q call that it would focus on lowering that figure. Thus, we would not count on the size of the portfolio rising in the next couple of quarters. Growth may be more heavily tied to interest rates.

- That does not mean there won't be any new loans. Existing loans come due or prepay. The portfolio is $21.3 billion and in any given quarter there is normally $1-$3 billion that is repaid. Even ARCC expects duration to lengthen in the near term, but there should still be a way to remake about 5% of the portfolio in most quarters through repayments:

	3Q22	2Q22	1Q22	4Q21	3Q21
New Commitments	$2,242	$3,109	$2,001	$5,866	$3,110
Exits of Existing	$1,996	$1,085	$2,551	$3,869	$2,263

- A great deal of the focus on the call was – when will bad debts become an issue? ARCC noted the following:

    - It is still lending less than 50% Loan to Value for the bulk of deals – so equity investors in the deals have every incentive to support their investments.

- The companies in the portfolio just posted 13% y/y EBITDA growth for the trailing 12 months, so that is rising as the debt figure is not. On a trailing basis, another 100bp of interest rate increases would still make interest coverage at the portfolio companies about 1.8x. Some further EBITDA growth would boost that too.

- In Covid, they were looking at companies whose businesses were closed, and ARCC did 60 loan modifications in two quarters of 2020. Now, they are doing under five per quarter and have a lower problem loan rate now than they have averaged over the last several years.

- It has a long relationship with the bulk of its borrowers and its equity partners. ARCC is proactive with them and it makes sense for all sides to modify a loan and pay a fee to ARCC who also gets tighter documentation in the event it needs to bridge a period of results. That could translate into higher fee income from ARCC.

- ARCC has $4.1 billion of liquidity and only $750 million of debt due before the spring of 2024. It can still be picky in opportunistically selling down some positions as well as adding new ones at wider spreads and with strong covenants. Banks continue to be sellers of these types of deals so the market still favors buyers at this time.

International Business Machines Corporation (IBM) Earnings Quality Update

We are maintaining our earnings quality rating of IBM of 2- (Weak).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

IBM's 10-Q is available and we can review the 3Q22 more fully. IBM's adjusted EPS of $1.81 beat by only 1 cent and was down y/y from $1.84. We see several areas where IBM picked up some short-lived earnings and past contributors to earnings are now headwinds. We believe IBM picked up a net 4.5 cents in one-time items, 2 cents from the tax rate coming in lower than forecasts, 6 cents in lower depreciation, and it gained EPS from not boosting R&D:

- Depreciation declined at IBM from $1.037 billion to $586 million in 3Q. We know Kyndryl's depreciation from 3Q21 was $389 million, meaning IBM picked up $62 million in earnings from lower depreciation. That was 6 cents of EPS in 3Q22.

- On that same theme, we believe IBM is continuing to under-invest in capital spending and software. These figures continue to decline y/y:

	3Q22	3Q21	2Q22	2Q21	1Q22	1Q21
Capital Spending	$317	$351	$339	$560	$281	$494
Cap. Software	$138	$176	$172	$204	$169	$175

- IBM saw workforce rebalancing charges become a headwind as we predicted, posting $13 million in expense vs. 3Q21's $0, which cost EPS 1 cent. IBM has a big headwind coming in 4Q, the $60 million credit added 6 cents to 4Q21's EPS:

Workforce Rebalance	4Q	3Q	2Q	1Q
2022		$13	$28	$5
2021	-$60	$0	$107	$94

- IBM also saw bad debt expense continuing to rise as 3Q21 was a credit of $17 million and 3Q22 was an $11 million charge. The $28 million swing cost IBM 2.6 cents.

- But, against the headwinds from workforce rebalancing and bad debt expense, IBM cut advertising by $45 million, which added 4 cents, and cut stock compensation by $11 million, which added 1 cent too. Those areas offset the workforce charges and bad debt headwinds for a net 1.4 cents of tailwind.

- IBM boosted the gain on the sale of the health care data and analytics unit from earlier this year from $232 million to $259 million in the 3Q22 – that $27 million added 2.5 cents to EPS.

- IBM saw a big leap in recognizing deferred revenue on extended warranties in 3Q22. This account has been shrinking and has been about a 1-cent headwind for income per quarter, it suddenly became a positive for 0.6 cents last quarter:

Ext. Warranty	**3Q22**	**3Q21**	**2Q22**	**2Q21**	**1Q22**	**1Q22**
New Deferral	$19	$21	$66	$32	$18	$18
Amortized Deferral	-$57	-$50	-$39	-$51	-$44	-$53
Balance	$284	$334	$339	$367	$323	$383

- Other income was up y/y from $74 million to $293 million in 3Q. That includes the $27 million gain from selling the healthcare unit and $39 million in higher interest income due to rising rates. That still leaves a $153 million net increase which is 14 cents of EPS and is largely gains on FX contracts. We're not going to call this out as a major issue other than this is not operating income. Also, IBM carefully calls out every place where FX is a headwind for it, but doesn't spend much time pointing out the hedges offsetting it.

As we noted last week before the 10-Q was available – IBM had virtually flat R&D despite inflation and higher sales. As a percentage of sales, marketing dropped 94bp, which could have added as much as 12 cents to EPS. The only explanation in the 10-Q is that FX offset some of the R&D expense growth. Given that R&D only rose 0.3% against operating revenue growth of 8.4%, we think it is fair to believe IBM is picking up a few cents in EPS by not growing R&D. And as we noted above on FX – here's an example of IBM not calling out gains on FX contracts but it does point to where FX impacted operating items.

Juniper Networks, Inc. (JNPR)
Earnings Quality Update

We are raising our earnings quality rating on JNPR to 4+ (Acceptable).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

JNPR posted non-GAAP EPS of $0.58 which beat results by 8 cents. The biggest driver that made this happen was revenue growth. JNPR has suffered from being unable to fully fill client orders for several quarters and its backlog grew from $420 million in 4Q20 to $2.4 billion in 2Q22. In the 3Q22, backlog actually declined by $100 million and total sales rose y/y by $226 million. That compares to 2Q when revenue only grew $97 million and 1Q by $94 million.

- Guidance is that revenue should be about $1.475 billion in 4Q – up 14% y/y and better than 3Q figures.

- JNPR also sees the supply chain issues starting to moderate. It expects to see backlog remain at elevated levels even in 2023, but then decline and provide incremental sales.

- Guidance for 2023 is only for a minimum sales growth figure of 7% - largely volume based. It seems likely that if more inventory issues are resolved, that forecast could rise when 4Q22 and 1Q21 results are announced.

That incremental $100 million helped leverage operating costs. The beat looks solid as many of the operating costs rose too – and JNPR still picked up some operating leverage:

	3Q22	3Q21	2Q22	2Q21	1Q22	1Q21
Sales	$1,415	$1,189	$1,270	$1,172	$1,168	$1,074
nonGAAP R&D	$247	$228	$227	$225	$231	$229
R&D %	17.5%	19.2%	17.8%	19.2%	19.8%	21.3%
nonGAAP S&M	$266	$243	$258	$238	$256	$231
S&M %	18.8%	20.4%	20.4%	20.3%	21.9%	21.5%

Our concern was that JNPR was cutting back on R&D when sales were impaired by lower inventory availability to help preserve EPS. The first half of 2022 showed this well. One quarter doesn't make a trend, but 3Q22 did see a jump in R&D with higher sales. This is an area we will still watch. In earlier periods, every 100bp picked up by keeping R&D in dollar terms essentially flat was adding about 3 cents to quarterly EPS.

Many of the potential red flags we discussed last month also showed improvement. The biggest change to help JNPR and its outlook is management indicating that supply channel issues are still there but have improved.

- **DSOs fell back to 67 days.** That is after jumping 15 days in 2Q22 as JNPR admitted supply chain issues caused the quarter to be very backloaded. We were not concerned with this explanation and the DSOs are almost to normal levels, which confirms that the backloaded 2Q was a one-time event:

DSO	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Sales	$1,415	$1,270	$1,168	$1,300	$1,189	$1,172	$1,074
A/R	$1,028	$1,048	$849	$994	$774	$768	$759
DSO	66.8	74.3	65.4	68.8	58.6	59	63.6

- **DSIs jumped considerably in the latest quarter.** That is a combination of being starved for inventory in many recent quarters making the levels look low plus the higher purchase prices with higher shipping/broker fees. The cost of inventory may restrain some gross margin gains, but having more inventory is a nice change for JNPR. With the huge backlog still, having more inventory should make it possible to continue boosting sales. At some point, the inventory issues may subside – management sees them lasting into 2023. **The higher inventory means higher sales now – but with FIFO accounting, JNPR may see a period in early 2023 where pricing declines and it has some expensive inventory to expense in COGS which could pressure gross margin.**

DSIs	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Adj COGS	$627	$576	$519	$550	$497	$490	$459
Inventory	$520	$395	$317	$273	$223	$212	$259
DSO	76.3	61.8	55.0	44.6	40.5	38.8	50.8

Already, the higher costs of inventory are pressuring gross margin y/y. The higher sales are mitigating some of that now, but it was still down y/y for 3Q22.

	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Sales	$1,415	$1,270	$1,168	$1,300	$1,189	$1,172	$1,074
Gross Profit	$788	$694	$649	$750	$692	$682	$616
Non-GAAP Margin	57.2%	56.2%	57.5%	59.5%	60.1%	60.0%	59.3%

- **Prepaid expenses also declined from 2Q22 levels.** In 2Q, JNPR attributed much of the increase to making additional deposits for contract manufacturing to obtain more inventory. It dropped to 89 days and has helped inventory levels increase:

Days PrePd	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Adj COGS	$627	$576	$519	$550	$497	$490	$459
Prepaid Exp	$604	$613	$480	$452	$410	$344	$311
Days	88.7	95.8	83.3	74.0	74.4	63.2	61.0

Kimberly-Clark Corporation (KMB)
Earnings Quality Update

We are raising our earnings quality rating on KMB to 3+ (Minor Concern) from 2+ (Weak)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

KMB reported EPS of $1.40 in the 9/22 quarter which was 5 cps below expectations. While lower depreciation and amortization was a 1.8 cps tailwind to earnings, we saw several unusual headwinds that more than offset that benefit including a 2.1 cps in adjusted other expenses, a 1.6 cps increase in non-operating expenses, a 10.5 cps headwind from higher stock compensation against an easy comp from last year, and 2.4 cps from a higher tax rate. Note that the higher tax rate was a function of an unusually low rate last year while the 9/22 quarter's rate was in-line with guidance so this was likely anticipated by analysts' models. Regardless, we see the unusual headwinds more than offsetting the unusual benefit.

Positives

- Inventory DSIs were up to almost 60 from 55.5 a year ago and above the pre-pandemic mid-50 level. Almost 40% of inventories are accounted for under the LIFO method. The company continues to raise prices with more increases going into effect in the fourth quarter. We believe the company will be one of the better-positioned staples to benefit from any downturn in input prices as it will be able to match these lower costs against higher revenues immediately.

- KMB once again refrained from more restructuring charges. While we are skeptical this will continue, given the minimal use of non-GAAP adjustments and the above-mentioned factors, we view the company's earnings quality as having improved enough to warrant an increase in our rating.

Negatives

- Our biggest remaining concern with the company is the degree to which it is cutting costs. In addition to all the restructuring spending, the company makes regular ongoing cost cuts under its FORCE program. There are typically hundreds of millions of dollars in cuts per year and the company has a pattern of announcing increased FORCE cuts whenever profits have disappointed. FORCE savings were $80 million in the third quarter, up from roughly $50 million in each of the first two quarters. The company’s guidance for the full year was $300-$350 million in FORCE savings implying a significant acceleration in cuts in the fourth quarter which the company confirmed on the call as being a key component of its outlook for improving profits. However, the company has been promising profit improvement via cost-cutting for years which makes us skeptical that they can continue without negative repercussions on operations, returns, and/or growth.

- KMB faces the same problems as all the staples companies do- how far can they push prices before volume growth is wrecked? Volumes fell by 5% in the quarter on a 9% boost from pricing. This was led by a 7% volume decline in Personal Care which faced tough comps from a year ago in North America. The company stated in the conference call that promotional spending had recovered from the Covid lows but implied it was still not quite back to historical levels in terms of depth. We remain concerned that promotional spending may have to increase more given the aggressive pricing which could eat into sales growth and margins.

Microsoft Corporation (MSFT)
Earnings Quality Update

We are maintaining our earnings quality rating on MSFT of 4- (Acceptable).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

MSFT reported non-GAAP EPS of $2.35 in the 9/22 quarter which beat consensus estimates by 4 cps. The top line also outperformed by $435 million. Despite this, the stock was punished in part over Azure growth coming in slightly below guidance and negative guidance on future PC growth. It also increased its full-year outlook for negative FX impact and called for operating margin to decline 1% from its previous outlook of remaining flat.

The above issues are beyond the scope of an earnings quality review, but we wanted to comment on a couple of earnings quality items

- MSFT announced after the 6/30 quarter that was raising the estimated useful lives of its server and network equipment from 4 to 6 years. This added 11 cps to earnings. The company documented this well ahead of time and included several references to the change in its discussion of company and segment margins. Our concern is the fact that the company had already extended the useful lives used in calculating depreciation on this equipment from 2-4 years just two years ago.

- Intelligent Cloud unearned revenue days of Intelligent Cloud revenue continues to decline, falling by 9 days YOY in the 9/22 quarter. This continues a multi-year trend of declining unearned revenue days in this key segment. Ordinarily, this would be a significant red flag. However, as we explained in our original review of the company, its larger hybrid contracts contain portions of the deal which are recognized upfront rather than being deferred and recognized over time. As these contracts grow in the mix, the deferred revenue number will be depressed. Deferred revenue could have also been depressed more relative to sales in the last few quarters as it is translated at end-of-period exchange rates while revenues would be translated at the average rate over the quarter. These factors unfortunately make the unearned revenue trend much less informative.

National Instruments Corporation (NATI)
Earnings Quality Update

We are maintaining our earnings quality rating of NATI at 5+ (Strong).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

NATI's non-GAAP EPS of $0.53 met forecasts. Revenue beat slightly with 17% y/y growth, but much of this is overshadowed by NATI's 4Q guidance. NATI reported semiconductor order growth went flat in the last two weeks of 3Q and it is expecting that to continue in 4Q where it also has a tough comp due to large orders in 4Q21. We are not reducing the rating as we do not see the accounting getting worse and, more importantly, many more signs point to operating leverage being unleashed in the near future.

- Backlog declining by $9 million in the 3Q, helped EPS by as much as 4 cents. Without this NATI would likely have missed forecasts. **(See Below)**

- Cash flow continues to be impacted by rising inventories and rising prepaid expenses. Both have supply chain-related causes. YTD cash from operations is down $95 million y/y. Prepaid expenses are up $54 million on insurance premiums and higher freight costs and inventory is up $85 million with higher costs to find and deliver it. **(See Below)**

- NATI sees supply chain issues starting to improve. This positive trend may continue if semiconductor demand growth stalls with an economic slowdown. The important part for NATI is it supplies customers with testing equipment and R&D products, where spending is unlikely to decline. Its orders are still rising. The part of its business exposed more to semiconductor end-markets is its portfolio business which is about 32% of sales, about half of that is economically sensitive, and NATI is not very exposed to consumer devices like cell phones, cameras, etc. It sells more to the production lines developing the new products.

- If supply chain constraints mitigate in 4Q22 and beyond, it should allow NATI to fulfill more of its $240 million in backlog – and those sales would help total growth and margin leverage. Management sees this happening – they are uncertain if it happens in a bigger way in 4Q or early 2023. **(See Below)**

- Supply chain constraints being resolved should reduce inventory costs and prepaid expenses as NATI has been paying 500-600bp of its margin for brokers to locate critical parts and expedited shipping. That should allow cash flow to improve with inventory and prepaid expenses declining. (**See Below)**

- Margin forecasts may be too low, but the timing is unknown and also tied to supply chain issues resolving further. NATI is on pace to reach its goal of 100bp of margin gains in 2022 and has a target of an additional 300bp of improvement in 2023. We see much cushion in these forecasts if the supply chain continues to improve. **(See Below).**

- Reducing brokerage fees and accelerated shipping are 500-600bp of margin to play with already. Pricing that NATI has taken in February and August has not fully shown up in recent results but is already adding about 200bp of margin and offsetting FX. **(See Below).**

- We noted in the past that NATI did one of the quickest and cleanest restructurings we have seen in late 2020 and it has held headcount down and moved more operating costs to align with revenues rather than being fixed. Thus, it is already picking up margin leverage on operating costs while still boosting total dollars invested. **(See Below).**

- The backlog also looks solid and is a cushion against any order weakness. NATI confirmed again it does not see double ordering and less than 1% of its backlog has been canceled over the last 18 months of its building up.

Inventory Levels Remain Elevated

High inventories have been by design. Historically, NATI has wanted to avoid out-of-stock situations and in the last 4-5 quarters there have been shortages of parts and semiconductors in global supply chains that have taken inventory investment to new highs.

	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21
Inventory	$374	$344	$308	$289	$237	$211
DSIs	258.4*	253.6	244.3	222.0	218.0	201.2
Product Sales	$390	$355	$344	$377	$326	$307
Product Sales Growth	19.6%	15.8%	16.5%	15.1%	20.8%	15.1%

We use inventories over product sales cost of goods sold – which omits software. NATI adds back stock compensation, amortization of acquired intangibles, and integration costs to total cost of goods sold. We have used the GAAP figure, except in 3Q22 when there was a larger-than-normal integration charge which we added back to get to 258 days. Without that, DSI would have been 246 days.

Here's what to watch in Inventory going forward:

- **NATI is seeing that the supply chain constraints are improving. They reported receiving a rising percentage of orders in full and arriving on time** in 3Q and 4Q. Also, the slowdown in semi-conductor ordering in late 3Q and early 4Q should make it possible to complete more of NATI's orders. Management is not certain of the timing of meaningful improvement hitting in 4Q or early 2023.

- **Supply chain constraints have led to higher costs to obtain the inventory on hand now. Using third-party brokers has hurt gross margin by over 400bp in much of 2022 (440bp in 3Q22).** Delays also led to more expedited shipping which was a 160bp headwind in 3Q22. If the supply chain sees less demand pressure, there should be more inventory available in the channel without needing to pay these additional costs.

- The higher costs have raised inventory in dollar terms and buying any needed inventory that is available in greater quantity just to be safe has boosted inventory investment. That has been a headwind for cash flow. **It is possible, NATI can reduce inventory DSIs by 40-50 days and still have its historic business model of avoiding out-of-stocks. That would create $58-$72 million of cash flow just on 40-50 days and that could be boosted by lower net costs per unit.** In the first 9 months of 2022 – operating cash flow is -$8.9 million vs. $86 million in 2021. Inventory rose $85 million this year vs. $22 million.

Margin Guidance May Prove Too Low

Coming into 2022, NATI was calling for 100bp of margin improvement, and going into 2023, it expects another 300bp of gain. YTD, the margin gain is 110bp y/y and guidance is they will meet the 100bp target for 2022:

Adj. Op. Margin	4Q	3Q	2Q	1Q
2022		21.4%	15.4%	17.1%
2021	22.9%	18.2%	17.2%	15.3%

- The biggest item is the brokerage fees and higher shipping costs. NATI did not expect that to be a year-long issue for 2022. As noted above in inventory, the reasons behind that higher cost are starting to mitigate. In 2021, gross margin was flat with 2020 levels at 75%. It's running at 70.6% YTD this year vs. 75.0% in 2021. They have had 400-440bp of broker fees and 100-160bp of higher shipping costs this year. That wouldn't even need to completely disappear in 2023 to pick up 300bp of margin. On zero sales growth, 300bp of margin gain is worth 30 cents per year in EPS.

- Backlog may start to decline as supply chain issues subside more. That's a big deal because the backlog is still $240 million or about 7 weeks of revenue. Having that add to current quarter sales will boost total revenue and leverage overhead costs like R&D. In 3Q22, NATI noted that it was able to lower backlog by $9 million in the quarter and recognized it in sales. That added 4 cents to EPS in the quarter. It also added 100bp to operating margin.

- Backlog continues to look solid as well. NATI has highlighted for over a year that its customers aren't double ordering. Plus much of its product isn't going into the new washing machines – it's going into its customers' R&D and testing equipment to design new chips, manufacturing processes, and lowering their unit costs. Thus, orders do not get canceled. NATI noted that less than 1% of its orders are canceled.

- Price increases in February and August are helping revenue growth and margins. On the call, NATI expects this to hold as it is selling systems more than individual parts and is build into the system price to customers. They are already getting some margin leverage in this area too ahead of FX headwinds:

Pricing	3Q22	2Q22	1Q22
Rev Growth from Price	9.0%	6.0%	4.0%
FX hit to Revenue	-5.0%	-2.0%	-1.0%
Margin gain	2.4%	2.0%	1.0%

NATI could see a full period of price hikes in 4Q and beyond at the same time some of its inventory costs start to decline.

- NATI also increased the amount of variable costs that can rise and fall with sales should they suffer a downturn from 20% to 30%. It had a small restructuring with layoffs two years ago and has largely held headcount flat. Plus, it has moved more of its smaller clients to digital ordering and interaction. This is lumpy depending on sales growth and some expenses rising more in a given quarter, but here is some of the margin leverage NATI is already seeing:

Oper Exp growth	3Q	2Q	1Q
2022	$208.4	$218.2	$208.3
2021	$209.0	$199.8	$201.4
Exp. Growth	-0.2%	9.2%	3.4%
Sales Growth	16.6%	14.1%	14.9%
Margin gain	8.2%	2.4%	5.9%

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

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