BEHIND THE NUMBERS
Quality of Earnings Analysis

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National Instruments Corporation (NATI)
Earnings Quality Update- 12/31 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

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

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

Summary

NATI's 60-cents in adjusted 4Q21 EPS beat forecasts by 5-cents. Much of this came from what we were pointing out in the operating model concerning growing backlog. A shortage of inventory and booming demand caused backlog to rise throughout 2021, reaching 6 weeks in 3Q21. NATI emerged from 4Q21 at 5 weeks of backlog. That means it filled 13-weeks of sales and 1 week of backlog. Essentially, they had a quarter with 14-weeks of sales and 13-weeks of overhead costs. That extra week of product sales at a gross margin of 69% is 12-cents in EPS. What we like is demand remains very strong and is pulling revenues higher, but inventory for NATI has recovered significantly, which may prevent future quarters where backlog rises due to lack of supplies and reduces net sales. To be clear, we are talking about the number of days/weeks of backlog – not the dollar amount. Rising sales should lift the dollar value of both revenues and backlog even if the days/weeks of backlog stays flat.

NATI's tax rate dropped y/y from 17.7% to 13.3%, which has been the case in other 2021 quarters too as foreign sales grew back at lower tax rates in some cases. That added 3.0 cents to EPS and may not provide the same level of EPS gains going forward. Offsetting that was a swing in"other income" from a profit to a loss which cost NATI 4-cents in EPS. We know much

of the change came from interest expense on the NH Research acquisition in October and FX losses have been running higher too. Variable compensation such as stock options and bonus pay also jumped $20 million y/y in 4Q21 with the improved sales. NATI adds back stock compensation to non-GAAP earnings, but that only rose $1.1 million, so much of the higher bonus payments are still a headwind in non-GAAP EPS. That's 12-cents, and NATI guided to this, but it looks like it still came in higher than forecast especially in terms of cash wages. The overall 5-cent adjusted EPS beat looks solid to us.

What is strong?

- Inventory levels have continued to rise. This is quite a feat in our view given that sales are also rising rapidly at the same time.

	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Inventory	$298	$237	$211	$197	$194	$210	$210	$208
DSIs	227.1	218.0	201.2	196.3	167.6	215.4	228.6	231.8
Product Sales	$377	$326	$307	$295	$328	$270	$266	$274
P Sales Growth	15.1%	20.8%	15.1%	7.7%	-1.4%	-11.6%	-11.2%	-1.3%

Historically, NATI likes to hold a large amount of inventory- between 200-240 days. That helps it fill orders by avoiding out-of-stock situations. Look at how poor sales growth was against easy comps when inventory was low and backlog was building from the traditional 1-week to as high as 6-weeks by 3Q21. NATI is forecasting 19% sales growth (that includes software too) for 1Q22. It still sees a few components in short supply and expects some higher costs in that area for 1Q22 too that should impact gross margin. However, it appears many of the issues have been resolved. NATI is not guiding to the backlog in weeks declining much in 1Q with demand being so strong.

We conclude that investors should see this as an inventory situation that can still improve further, with strong sales growth continuing because demand remains very high, and sales growth can further accelerate as backlog works back closer to 1-week over time.

- NATI continues to invest in the business and lets the sales be the wildcard. With strong sales growth and the backlog not expanding, the margins start to leverage:

	4Q21	3Q21	2Q21	1Q21	4Q20*	3Q20**	2Q20	1Q20
Sales	$421	$367	$347	$335	$368	$308	$301	$309
SG&A	$122	$117	$111	$117	$135	$110	$105	$116
R&D	$92	$82	$81	$80	$74	$71	$64	$72
G&A	$33	$31	$30	$33	$37	$37	$29	$26
adjustments					$30	$5		
Costs % Sales	58.7%	62.7%	64.3%	68.7%	58.5%	69.1%	66.0%	69.0%

*In 4Q20, NATI took $30 million (mostly severance) for a small restructuring that impacted SG&A and G&A which we removed.

**In 3Q20, NATI had some option adjustments that totaled $5 million which we removed.

The main point of this table is to show that NATI is running this business with a longer-term outlook and is keeping up its investments in R&D, salespeople, and other overhead while letting sales be the wildcard. The restructuring took some fixed cost out of the mix, but as sales recovered with inventory on hand, NATI has picked up 10-percentage points in margin. Note – these are not non-GAAP expenses, which we will discuss more below.

What is weak?

- The spread between NATI's GAAP EPS of 30-cents and non-GAAP EPS of 60-cents is fairly large. We never like to see stock compensation added back as we consider that a real, ongoing cost. It will either dilute EPS, or the company will spend cash repurchasing shares. Stock compensation is nearly half the difference between GAAP and non-GAAP so we will let readers decide.

  The other adjustments tend to be actual one-time items in nature or they tend to decline fairly quickly:

	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20*
Stock Comp	$16.5	$16.1	$16.2	$13.9	$15.4	$11.4	$12.3	$10.6
Amortiz Intang	$9.6	$6.6	$6.9	$6.7	$8.6	$6.3	$1.1	$1.2
Restructuring	$9.6	$1.9	$1.8	$11.7	$33.4	$11.3	$4.7	-$114.8
Amortiz Sftware	$3.7	$3.8	$4.5	$5.3	$4.5	$5.5	$4.7	$4.1

*Restructuring 1Q20 includes a pretax gain of $159.7 million, 3Q20 includes a $5 million option charge, 4Q20 includes the $30 million severance charge.

The amortization of acquired intangibles happens quickly, often over less than 6-years. When there is not a new deal, the cost actually starts dropping fairly quickly as assets are fully amortized. So, while this is a recurring expense, it does vanish.

Restructuring includes transaction costs, payments to integrate a deal such as closing a property and canceling a lease, and retraining. We like that this account does have actual one-time items and it becomes immaterial when there isn't a deal happening.

Amortization of capitalized software is another small item. Also, NATI has sped up software releases, which reduces the amount of software that can be capitalized so that line item has been falling.

What to Watch?

- We gave NATI high marks on earnings quality for its acquisition accounting. Primarily, this was due to the company using a very short amortization period. Its last big deal was Optimal Plus in July 2020 for $352 million. NATI allocated $129 million to intangibles that will be amortized over 3-6 years. In our view, too many companies act like an acquisition is free and investors should ignore the costs as being non-cash even though they wrote a check for the deal. Had they built the assets in-house, the company would have had cash outlays for wages, training, contractors, and equipment that would have been expensed and not added back to adjusted earnings. Why should the cost of an acquisition be ignored? What limits the erosion in quality for NATI is even though it adds back the amortization in non-GAAP results, the rapid amortization period quickly removes this adjustment.

  There are two new acquisitions for NATI, one closed in October for $200 million and the other is expected in 1Q22. The amortization schedule for these deals is not known yet, but we hope to see its conservative policy of short amortization periods repeat.

- Variable pay has increased with higher sales. This is due to higher bonuses and stock compensation. In the first half of 2021, it was only a $7 million increase and it jumped to $18 million in 3Q21. NATI guided to this expense leveling off at the higher cost figure. The y/y increase was $20 million in 4Q21. It may have come in a bit higher than forecast in 4Q, and we will want to watch this for 2022. NATI's guidance is that this will leverage with higher sales.

It is also worth noting that in the last two quarters, this has further improved earnings quality. NATI adds back stock compensation to adjusted earnings. In the first half of 2021, the $7 million increase in variable pay came entirely from stock compensation. In the 3Q, the $18 million increase had $4.7 million come from stock compensation. However, in the 4Q, the $20 million rise only had $1.1 million from stock compensation. Thus, more of this higher pay is not being adjusted out of non-GAAP results.

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.

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