BEHIND
THE NUMBERS
Quality of Earnings Analysis

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National Instruments Corporation (NATI)
Earnings Quality Update- 9/21 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).

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

Summary

NATI reported adjusted 3Q21 EPS of $0.42 which beat forecasts by 3-cents. NATI benefitted from a drop in the effective tax rate from 21.5% to 15.7% y/y. Last year, there were higher state taxes and officer compensation that was non-deductible. This added just under 3-cents to EPS. However, we still believe NATI had a solid beat because its backlog grew again in 3Q21 to five weeks up from four in 2Q21 and against the more normal one week. That represents sales that were pushed into next quarter and it causes deleveraging of Operating Costs that are often budgeted based on the higher level of business. We believe that cost NATI more than 9-cents in EPS in the quarter.

- 2Q's four-week backlog grew to five weeks in 3Q. NATI is budgeting its overhead spending (R&D, Selling, and G&A) based on order rates so the expenses are deleveraging on the income statement when sales are lower than orders. These expenses totaled $230.3 million in 3Q21. NATI's adjusted EPS removes stock compensation, intangible amortization, and restructuring from these costs – that makes them $209.0 million. Sales of $367.6 million means these costs were 56.8%. However, had the extra week of backlog been sales, revenues would have been $28 million higher

at $395.6 million. Then the same $209.0 million would be 52.8%. This cost NATI about 400bp of margin or $14.8 million – net of tax that is 9-cents in delayed EPS.

This could also be looked at as $28 million of extra sales at the product gross margin of 70% is $19.6 million in delayed gross profit – net of tax that is 12-cents in delayed EPS. So as good as adjusted EPS of 42-cents looks – NATI has some built-up future earnings that should start flowing in as the backlog normalizes. At 9-12 cents per week, the backlog is five weeks now. That won't all flow in for one quarter – but it should give 2022 quarters a push. We think that is why NATI expects to top its 2023 goals for 20% operating margins in 2022.

- NATI expects the backlog to grow to six weeks for 4Q21. It also noted that some of the lower sales in 3Q were due to freight issues. It is also important to remember that the Four weeks of backlog at the end of 2Q21 was largely filled during the 3Q. It does not sound like NATI is short of many raw materials to have any products on a very long delay.

- Inventory is starting to increase again. NATI still must build back more, but this is a good sign that backlog growth may slow and convert into sales and EPS.

	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Inventory	$237	$211	$197	$194	$210	$210	$208
DSIs	218.0	201.2	196.3	167.6	215.4	228.6	231.8

- Variable compensation is still higher year-over-year. NATI did not quantify it in the press release but that remains a headwind for EPS too. NATI did say on the call that it expects this expense to level out in 2022 so it should leverage also in 2022 for higher earnings if sales continue to grow.

- An acquisition plan that makes sense is nice to see as well. NATI announced it has two deals that will serve the battery market for electric vehicles. One for the US closed October 19 and another for Europe should close in 1Q22. There aren't many other details about them other than they will be accretive to 2022 EPS and will be about 3%-4% of NATI's 2022 revenues. Here is what we found positive about these deals:

  - NATI bought companies that are posting large organic growth rates of 30%-40%.
  - They are not banking on synergies to justify the purchases.
  - Both deals expand NATI's presence in a market it already serves and enable NATI to post higher profits sooner than building it themselves.

- NATI will pay for one with cash on hand and tap the credit line for the other and repay that quickly.

Compare that to many purchases these days where neither the purchaser nor target have much top-line growth, the purchase price multiple looks outlandish until they promise that margins can improve 700bp with synergies they will find and the balance sheet gets destroyed with a large amount of debt.

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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