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November 13, 2020

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National Instruments (NATI) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
5+	5+

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

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

The company beat forecasts for adjusted EPS by 2-cents. We also see that the decline in interest rates plus borrowing money for the Optimal Plus deal was a 1.5-cent headwind y/y. The primary driver pushing down EPS has been weaker sales during COVID. We are keeping the 5+ rating as NATI is expecting sales much closer to normal levels in 4Q – rising $25-$50 million compared to 3Q. That should be worth about 9-18-cents in quarterly EPS.

While NATI borrowed money to complete its acquisition, cash and securities still exceed borrowing by $200 million. It also has $95 million on its revolver available and much of the working capital investment to grow sales may already be in place. A/R are up about 3 days but within normal ranges and Inventory levels remain at high levels, which is normal for NATI.

What improved?

- The first restructuring is essentially complete to reduce redundancies and lower headcount. It was a very small deal at about 1.5% of sales in any given year.
- Improved sales guidance to more normalized levels should leverage the lower cost structure and help EPS going forward.

What deteriorated?

- Gross margin declined about 300bp. We can account for the bulk of this due to an accounting change moving costs from SG&A to COGS, divesting AWR, and COVID. The remaining change is within historical ranges of fluctuation.
- A second restructuring was announced that is expected to be largely expensed in 4Q20 and completed within a year. We don't want to see more of these.
- Adjusted EPS is adding back several ongoing expenses such as stock compensation, amortization of capitalized R&D, and amortization of acquired intangibles which just jumped as a result of the Optimal Plus deal in July.

What to watch

- Will the Optimal Plus deal drive sales going forward and justify the price?
- An increase in tax valuation allowance of $15 million in the quarter may become a source of EPS if it declines in the future.
- The structure of the acquisition is expected to allow NATI to use the goodwill as a tax shield if income grows, it is too early to confirm that yet.
- We expect NATI to retire the debt incurred for the acquisition quickly which could limit share repurchases and allow for some share dilution.

Inventories Still Look Fine

We have talked in the past that NATI carries higher inventories as a conscious decision. The rationale is the company wants to work more on larger contracts, availability of some supplies is not always assured, inventory needs to be available worldwide, and the company

wants to avoid out-of-stock situations which can cost it current and future sales. Inventory levels have held at relatively flat levels for several quarters even with COVID:

Inventory	3Q20	2Q20	1Q20	4Q19	3Q19
Raw Materials	$110.8	$112.2	$113.5	$110.1	$107.3
Work in Progress	$12.2	$10.9	$10.8	$10.6	$11.6
Finished Goods	$86.6	$86.8	$84.1	$79.7	$87.9
Total Inventory	$209.6	$209.9	$208.4	$200.4	$206.8

Sales and thus Cost of Goods dropped with COVID, which had impacts on the DSIs for inventory. The drop in Cost of Goods was about $6 million in both 1Q20 and 2Q20 as sales slowed and it accounts for about 15 DSIs, even though inventory was largely flat:

Inventory	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18
Total DSIs	216.4	228.6	231.8	204.8	224.3	231.1	251.7	206.0
Fin. Goods DSIs	89.4	94.5	93.5	81.4	95.2	104.7	114.1	91.8

Gross Margin Decline Can Be Explained

We have been impressed that NATI has essentially held flat gross margins +/- 20-30bp in most periods despite carrying so much inventory. Thus, we considered the traditional red flag of high DSIs a false positive if people are running computer screens. The margins did decline in 2020 by a noticeable amount as seen here. The adjusted margin is down about 300bp:

Gross Margin	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18
Reported	70.1%	71.5%	72.9%	75.2%	74.8%	74.9%	75.5%	75.6%
Adjusted	74.1%	74.4%	75.7%	77.6%	77.3%	77.4%	78.2%	77.9%

- $3 million per quarter in 2020 represents costs that were accounted for as SG&A previously that are now in Cost of Goods. This cut 100bp off of gross margin.

- Divesting AWR in January cost sales and margin. This cut 50-60bp off gross margin.

- COVID costs and higher logistical costs due to COVID have been 70-80bp of gross margin change.

- FX worsened and was 20-40bp of lost gross margin too

Gross Margin	3Q20	2Q20	1Q20
Adj. Year Before	77.3%	77.4%	78.2%
Adj. Current Year	74.1%	74.4%	75.7%
Difference y/y	**-3.2%**	**-3.0%**	**-2.5%**
Divesting AWR	0.6%	0.5%	0.5%
Moving $3mm from SG&A to COGS	0.9%	1.0%	1.1%
COVID/Logistics costs	0.7%	0.8%	0.3%
FX	0.2%	0.4%	0.2%
Total	**2.4%**	**2.7%**	**2.1%**

- For 3Q, the addition of Optimal Plus cost another 20bp from a change of sales mix.

In our view, adjusting for all these items – gross margin is only down 30-60bp on an apples-to-apples comparison. That minor amount of movement has been happening for years and is often due to sales growth leveraging some fixed costs more, or the reverse if sales are weaker along with changes in raw material costs. **These minor movements in margin are about 0.6-1.2 cents in EPS per quarter, based on 3Q20's sales which are still depressed.**

The company is making the trade-off of more inventory to avoid lost sales. If they lose 1% of sales at a 75% margin – it costs them about 1.4 cents per quarter. NATI continues to see stronger sales growth for orders > $20,000 than those below that figure too – that also factors into this.

The GAAP gross margin fell further in 3Q20. This is due to the increases in amortization of acquired intangible assets that began in early July 2020.

A New Acquisition but Still Conservative Accounting

As we noted in our original report, NATI is not growing through an endless series of acquisitions. It just made a $353 million acquisition in July for Optimal Plus which will support its new push into selling more software. Total assets are $1.6 billion so the deal is

not a monster purchase either. Prior to that, the last major deal was in 2015 for $126 million when total assets were just under $1.5 billion. We see several positives for NATI here:

- Deals are infrequent and relatively small.
- NATI can pay for these purchases largely out of cash on hand. It currently has debt of about $89 million against $290 million in cash.
- The sale of AWR produced $160 million in cash too.

In addition, of all the companies in our universe, NATI is among the most conservative in accounting for acquisitions. Of the $353 million in purchase price, $227 million went to goodwill or 64%. That's still higher than we would prefer as it is not being amortized. However, the other $128 million assigned to intangible assets are being amortized. The amortization schedule is very similar to the asset lives assigned to internally developed assets too. **Many companies we see depreciate tech equipment over 5 years and capitalized R&D over 3-5 years. But, with an acquisition, suddenly they use 10-20 years to expense the purchased assets. That is not happening at NATI.** All the tech is being amortized over 6 years and customer relationships over 5 years. NATI's equipment and software developed/purchased for in-house use is expensed over 3-7 years.

The goodwill is expected to provide a tax shield for US taxes based on how this acquisition was structured, which could reduce costs in the future.

Restructuring Remains Conservative at NATI

NATI continues to keep the restructuring small and to the point. As they have begun moving toward more software applications, they have sought to streamline a bit. In early 2017, they announced a plan to reduce headcount by about 2%, redesign processes, eliminate job duplications and focus on higher ROI activities.

The actual size of this plan has been very small:

	3Q20	2Q20	1Q20	2019	2018	2017
Restructuring	$0.7	$1.6	$11.3	$20.1	$14.1	$17.1

While NATI adds this back as one-time items in adjusted results, this restructuring is only about 1.2-1.5% of sales in any given year. Also, the plan wrapped up and the charges became smaller.

In October after working on the integration of Optimal Plus, NATI announced another reduction in workforce plan that will cost $22-$28 million and be mostly expensed in 4Q20. We can understand that after an acquisition. We have three reasons to give NATI high marks in this area:

- The 2nd restructuring is not larger than the prior one. So many companies do a 5-year plan for $2 billion and they announce they will find $4 billion more in savings in a follow-up plan.

- Both restructurings are very small as a percentage of sales.

- Both restructurings have had modest and achievable goals – that are not based on synergies but merely some cost-cutting.

Adjusted EPS vs GAAP EPS Is a Mixed Bag

The gap between reported and adjusted EPS is widening. A large part of that is the lower sales pushing down income in recent results as other adjustments remain flat. NATI is primarily trying to add back non-cash expenses to adjusted earnings. While the company calls out some of the COVID items such as $2.2-$2.4 million in quarterly costs in the form of more expensive logistics and $8 million in quarterly savings from lower travel/entertainment spending – these are not removed from adjusted EPS.

We have a problem when a company adds back obviously recurring costs such as stock compensation. This is basically 8-9 cents of adjusted EPS every quarter. We also do not like adding back amortization of internally developed software. We're fine capitalizing the investment and amortizing it – but this cost cash to build. This is basically 3-cents per quarter of adjustments in normal sales periods.

EPS	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
GAAP EPS	-$0.04	$0.08	$1.01	$0.45	$0.39	$0.22	$0.17
Stock Comp.	$0.09	$0.09	$0.08	$0.09	$0.09	$0.07	$0.07
Amortiz Acq. Intang.	$0.05	$0.01	$0.01	$0.01	$0.01	$0.01	$0.01
Restruct/Integration	$0.09	$0.04	$0.07	$0.06	-$0.09	$0.02	$0.02
Amortiz Software	$0.04	$0.04	$0.03	$0.03	$0.03	$0.03	$0.03
Gains	$0.00	$0.00	-$0.94	-$0.08	$0.00	$0.00	$0.00
Adjusted EPS	$0.23	$0.26	$0.26	$0.56	$0.44	$0.35	$0.30

We applaud the short amortization period for acquired intangible assets. The latest deal for Optimal Plus is why the amortization per share jumped from 1-cent to 5-cents in 3Q20. However, we believe this deal consumed cash - $353 million. They are only expensing 36% of the price, which already keeps much of the cost out of the income statement as it is goodwill. We would not adjust to add back this amortization.

The restructuring charges will be larger in 4Q20. However, those adjustments should be vanishing going forward and lower operating costs with lower payroll should translate into higher EPS on a GAAP and adjusted level. If the restructuring is essentially over in 4Q, that alone should narrow the gap between reported and adjusted EPS. Also, NATI is noting that backlog and orders are growing in 4Q. The drop in sales with COVID was a big reason for lower EPS in 2Q and 3Q. Current guidance is that higher sales could translate to about 9-18 cents in higher EPS that will help both GAAP and adjusted EPS.

Further, NATI effectively has a valuation allowance against all its net deferred tax assets – the bulk of which is in Hungary. The valuation allowance jumped by $15 million from 2Q to 3Q. There is no discussion about this, but the effective tax rate in 3Q20 was -11% on GAAP earnings. The various components of foreign tax provisions are shown as huge negatives on the effective tax rate in 3Q and drove this drop. Boosting the allowance by $15 million is about 11-cents in EPS. Given the lack of discussion about it, we are not comfortable saying NATI had an 11-cent headwind for the quarter. We do think, some portion of this had a negative impact on EPS. Going forward, should NATI be able to realize some of its operating loss carryforwards, this allowance could decline and be a tailwind over time for EPS.

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 Concerns"	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 may 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 the next quarter. 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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