BEHIND THE NUMBERS
Quality of Earnings Analysis
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National Instruments (NATI) Earnings Quality Update

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

We are lowering our earnings quality rating on NATI to a 5- (Strong).

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

Summary

NATI's 4Q20 of 51-cents of non-GAAP EPS beat forecasts by 8-cents. It also saw revenues rebound. EPS was hurt by a higher tax rate which was a 2.5 cent headwind. EPS was helped by other income rebounding from a $2 million loss in 3Q to a $1.8 million positive income figure. That was a 2.4-cent tailwind. Overall the company's operating model of carrying high inventories worked well as it was able to take advantage of a rapid recovery in market demand.

We are moving our rating to a 5- because we see a few areas of concern regarding margins and receivable balances which we will discuss below. We still view NATI's accounting for acquisitions and restructurings to be conservative on estimated lives. Our primary negative issue is adding back recurring items to non-GAAP EPS like stock compensation and amortization of acquired assets. In both situations, we believe these are cash expenses.

What is strong?

- **The revenue model worked as intended. Holding higher inventory balances allows NATI to capitalize on surges in demand as was seen in 4Q**. Sales rose 19% from 3Q. This also worked down the inventory balances:

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Inventory	$194	$210	$210	$208	$200	$224	$231	$252
DSI	167.6	216.4	228.6	231.8	204.8	224.3	231.1	251.7

NATI was asked if there are supply constraints in the market, and management said there are some risks of that – which is why it carries high inventory levels to avoid that as much as possible. We would expect NATI to grow the inventory levels back above 200 days of sales, which should be a modest hit to cash flow. Based on guidance, that would likely mean inventory of $220 million vs. the current $194 million.

- **We believe equity-method investments saw the surge in demand as well.** NATI has a line item on the income statement of Other (Expense) Income. It is broken down as follows:

	3Q20	3Q19	thru 9/20	thru 9/10
Int. Income	$414	$1,930	$3,724	$6,187
Int. Expense	-$973	$0	-$1,115	$0
Loss Eq. Inv.	-$627	-$239	-$2,559	-$406
FX	-$676	-$378	-$2,019	-$1,623
Other	-$139	$936	-$615	$1,221
Total	-$2,001	$2,249	-$2,584	$5,379

For 4Q20, Other (Expense) Income was $1.8 million vs. -$2.0 million in 3Q20 and only $0.6 million in 4Q19. We know interest income is down due to lower interest rates and lower cash balances. We know debt is up from the OptimalPlus deal in July and that interest expense was likely flat for 4Q20 vs 3Q. It sounds like FX was a small tailwind in 4Q. We will need the 10-K to see the breakdown it but seems likely that Equity-Method Investments posted a positive income for 4Q. As noted above, the total swing was about a 2.4-cent benefit to EPS in 4Q.

- **NATI continued to invest in R&D during 2020 even amid weaker sales in 2Q and 3Q.** Only 2Q saw a drop in dollars, and this has been a drag on operating margins. As sales recover, this should leverage the spending and allow NATI to regain some margin:

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	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
R&D $	$73.7	$70.8	$64.2	$71.6	$71.5	$66.6	$68.3	$66.2
R&D % Sales	20.0%	23.0%	21.3%	23.1%	19.4%	19.6%	20.4%	21.3%

Based on sales guidance of $325-$355 million for 1Q and an 18% tax rate, if R&D is $72-$74 million – leveraging this over higher sales could add 2-5 cents to EPS for 1Q21.

- Less software is being capitalized. That should mean more of the expense is cash and incurred in the current period going forward and less will be an amortization figure. We think this will improve earnings quality too. As noted in the last 10-Q:

> *"Due to the shorter development cycle and focus on rapid production associated with agile development, we expect that for a significant majority of our software development projects the costs incurred subsequent to the achievement of technological feasibility will be immaterial in future periods and* ***we expect to record significantly less capitalized software development costs than under our historical software development approaches.*** *Consequently, a larger portion of our software development expenditures are being recognized as operating expenses in the future.* ***We also expect amortization of previously capitalized software development costs to steadily decline as previously capitalized software development costs become fully amortized over the next four years. "***

NATI was not amortizing software over a long period and was conservative there. In 3Q, there was already essentially zero capitalized expense and the amortization was already declining from $7.1 million to $6.9 million.

What is weak?

- **Gross margin is under some pressure. There are some obvious reasons for this such as selling AWR in January 2020, which was a higher margin unit.** This accounts for about 60bp of margin compression. There was also a change in accounting policy that saw $3 million in costs that were part of operating expenses moving to Cost of Goods Sold. That is about 80bp of margin lost. Covid costs cut another 60bp off gross margin too. We know from 3Q, that OptimalPlus resulted in lower margin sales that cost about 20bp in margin too. That is 220bp of lower gross margin that is easily explained as one-time items or apples-to-oranges comps that will soon lap. The problem is non-GAAP gross margin is down 335bp in 4Q from 77.57% to 74.22% So NATI lost another 115bp in 4Q. There are some FX impacts in there that have not been quantified yet. In 3Q, before FX, NATI lost about 80bp of margin after adjusting for these other items.

We were less concerned in 3Q as it was the first period of owning OptimalPlus. Also, sales declined y/y in 3Q by 9% and could have unwound some operating leverage. With sales rising 19% sequentially in 4Q and inventories falling, we would expect a bit more operating leverage. Also, software was a slightly larger percentage of sales and that should be help margins too.

Keeping this in proper perspective, a gross margin above 74% is still very impressive and the AWR change will lap after 1Q. Also, a 50bp move in gross margin is worth 1-cent in EPS per quarter, so that is fairly minor for a company that just earned 51-cents. Finally, there is some cost-cutting coming that may offset this situation too as we discuss below.

- **NATI has started a new restructuring program. This one actually sounds fairly limited in scope as it will lay-off 9% of the workforce.** We think some this is aligned around the company's efforts to serve smaller customers more fully on-line as opposed to with the same labor used for larger customers. They took a $30 million charge in 4Q, which will cover this plan and it is expected to be completed within 9-12 months. There has been no estimate of what this will generate in savings. Just a rough-guesstimate – we have seen this will cover 650 employees. At at $50,000 per employee – that would reduce costs by 5-cents per quarter, at $100,000 – EPS would benefit by 10-cents per quarter. That has the potential to help on the gross margin side. It should also offset SG&A growth as travel and entertainment costs return (that has saved about $8 million per quarter with Covid – or 5-cents in EPS). We are listing this as a weakness because NATI is adding this back as a non-recuring charge as part of non-GAAP EPS. Also, they have not given much guidance on the how much savings may occur.

- **Adding back recurring charges continues as well.** As we have noted, it's one thing to spell out more detail about the cost structure by breaking more items out. It's another to treat many items as though they are not part of the cost structure at all. Also, we don't mind singling out one-time items like Covid or an impairment to explain why income rose or fell. We do mind when recurring costs that will remain recurring costs are adjusted out as non-GAAP EPS. This is something investors need to accept if owning NATI. There remains a wide-gap between GAAP and non-GAAP EPS:

	4Q20	3Q20	2Q20	1Q20	4Q19
GAAP EPS	$0.04	-$0.04	$0.08	$1.01	$0.45
Stock Comp	$0.12	$0.12	$0.09	$0.08	$0.10
Amtiz. Acq. Intangibles	$0.07	$0.06	$0.01	$0.01	$0.01
Integration/Restructring	$0.27	$0.10	$0.04	$0.07	$0.08
Amtiz Software	$0.04	$0.05	$0.04	$0.03	$0.04
Tax Impact	-$0.03	-$0.06			-$0.12
Gain on Sale	-	-	-	-$0.94	-
NonGAAP EPS	$0.51	$0.23	$0.26	$0.26	$0.56

We will agree that the gain on selling AWR in 1Q20 is a one-time item as is the $30 million restructuring charge in 4Q20 to reduce the workforce. The fact that capitalizing software is becoming less prevalent means the amount being amortized should largely vanish in the next 2-3 years and it won't penalize GAAP EPS. Before the OptimalPlus deal – adding back the amortization of acquired intangibles was a minor issue. While we applaud NATI for using reasonable amortization lives, they spent $335 million on the deal. It was clearly a cash cost they are adding back.

- Stock compensation definitely appears to be a recurring and a cash cost. Even with Covid, NATI was still repurchasing shares to limit share dilution from this process of paying people with stock. Plus, when is stock compensation going to end? This is not a one-time item. NATI still spent almost the same amount on repurchases $49 million as it reported in stock compensation in 2020 $58 million. In 2019, NATI bought $171 million in stock which more than covered the stock compensation for the several prior years combined.

What to watch

- **Were sales boosted by late quarter business and declining deferred revenue?** We are looking at this from the standpoint that Covid had impacts on results through the year and one quarter does not make a trend. Thus, we are not calling this a red-flag at the moment, but it is worth watching. DSO's bounced up in 4Q and Deferred revenue down. Both of which should have helped revenues:

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Receivables	$267	$215	$212	$213	$249	$224	$223	$215
DSO	66.2	63.6	64.9	62.8	61.8	60.1	60.8	63.1

Normally, sales and receivables rise in 4Q. Plus, in 2018, NATI often had DSOs of 65-70 days. Thus, we're not seeing 4Q's figure as a red-flag at this point. But a $52 million jump in receivables is not routine for NATI. So this bears watching.

Deferred revenue days also decreased in the 4Q, but again it has a history of being in the ballpark of the current number of days:

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Def Rev Days	41.8	44.7	44.3	44.4	41.0	41.9	44.2	47.7

Deferred revenue actually went up in 4Q to $168 million from $151 million in 3Q. The sales were simply so depressed in 3Q that the days outstanding was higher. This is worth watching to see how it develops. This looks like a case where Covid depressed sales more than the deferred revenues are showing a red flag.

- **Sales guidance for 1Q is for $325-$355 million. That would be up 5%-15% over 1Q20. Normally, there is a seasonal drop-off from 4Q to 1Q. We are somewhat surprised to see a forecast that was not stronger.** In 2Q and 3Q 2020 – sales fell $66 million y/y and were flat in 4Q on the rebound. It would seem there should still be more pent-up demand.

- **We also noted on the call that NATI announced it added a new distributor in January. Farnell sells electronic components and NATI said it would add NI software to its mix.** We are not certain from that note if Farnell will start selling components as well. With software, we don't worry about some initial channel stocking that may help near-term revenue. With components, we could see a small tailwind for revenue due to stocking.

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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