BEHIND THE NUMBERS
Quality of Earnings Analysis

May 21, 2021

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

National Instruments Corporation (NATI)
Earnings Quality Update- 3/21 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 beat non-GAAP EPS forecasts by 1-cent coming in at 32-cents. It did pick up $4 million y/y from lower travel costs due to COVID – which added 3-cents to EPS. It also faced a drag from variable compensation increasing $8 million in 1Q21 vs. $3 million in 1Q20. Moreover, all of 2020, the expense was only $8 million. So, NATI was hit for 3-cents there in EPS for the quarter.

One of the bigger drags was simply fewer sales were reported due to a shortage of parts in the supply channel with several end-markets growing at double-digit rates. Normally, backlog is only about one week's sales and after 1Q21, it was more than 2 weeks. One week's sales is $26 million. If we assume that NATI is NOT planning its R&D, G&A, and some other overhead costs on a week-to-week basis, then much of that incremental $26 million would have become earnings – likely at least 50% if not 60%. That is where NATI was probably light by about 7-9 cents in EPS for 1Q21 given how strong demand was that it couldn't post as sales.

We saw some positives here for the company's earnings goals. First, it wants to boost software sales to more than 30% of total revenues, which should be higher margin. Second, NATI has

one of the easiest restructuring plans in process which is focusing on making smaller accounts less labor-intensive and reducing the workforce – which began in 4Q20. Already, NATI reported 60bp of gross margin gain from sales mix (which we believe is primarily more software sales). That helped EPS by just over 1-cent. The workforce reduction already helped costs by $7 million, which was over 4-cents. Those two trends should keep working to boost EPS going forward.

There should be a tough 2Q, but it could set up a sizeable rebound in earnings after that with margin leverage and higher sales. We think NATI will end up realizing strong EPS growth after getting through the current shortage of key inventory parts.

What is strong?

- NATI has addressed several times that its backlog is growing and should continue to grow in 2Q and into part of 3Q. However, its backlog still turns into revenue and is not customers double or triple ordering per management. Also, the sales force continues to sign up more business encouraging customers to get in the queue. It will be delayed. This should create better visibility for sales forecasts as NATI turns the corner on parts. As we discussed above, there should be considerable operating leverage implications for NATI with this where margins may face some pressure in 2Q and start to see larger increases in sales and margins in 3Q and 4Q.

- NATI's restructuring plan appears largely complete. The company is adding back these charges to adjusted EPS and recorded $30 million in 4Q20, $6.3 million in 1Q21, and only expects $3 million more. The plan was expected to be completed in 9-12 months and our estimate was it could add as much as 10-cents to quarterly EPS. This should offset some of the delayed sales in 2Q as well.

- We are not seeing much in working capital to get alarmed about and the company continues to spend on R&D. Only inventory levels are down, which is to be expected in the current supply shortage situation. Rebuilding some of that may also help gross margin in 3Q and 4Q. It is also worth noting that NATI did discuss that it is working to re-engineer some products with fewer parts or available substitutes. This may help resolve this supply issue more quickly and may result in better margins too. Arguably, sales being light, likely made the DSI figure look better at 196. An extra $15-$25 million in sales would have had the DSI at 165-175 days- much closer to what 4Q ended at:

	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19
Inventory	$197	$194	$210	$210	$208	$200
DSI	196.3	167.6	216.4	228.6	231.8	204.8
Receivables	$241	$267	$215	$212	$213	$249
DSO	65.6	66.2	63.6	64.9	62.8	61.8
R&D Spending	$80	$74	$71	$64	$72	$72
% Sales	23.9%	20.0%	23.0%	21.3%	23.1%	19.4%

What is weak?

- NATI missed the size of this supply chain shortage after saying on the 4Q call that it could navigate supply constraints and again – that is why they carry above-average inventories. The size of the rebound in demand coupled with the supply issues led NATI to miss on revenue forecasts for 1Q and indicated that 2Q will also be constrained and 3Q may see a turnaround begin. That will make for a lumpy 2021.

- NATI took a $3.5 million impairment of an equity investment. It didn't give much detail about this. It was added back to adjusted EPS as well.

What to Watch?

- We still expect the spread between NATI's GAAP and Non-GAAP EPS to narrow going forward. Primarily, the integration and restructuring charges should shrink considerably going forward. NATI is simply not capitalizing as much software costs as we have discussed before and that amortization account will shrink. COVID was about 1.5-cents in expense for 1Q21 and NATI guided for that to continue through 2021, but at some point, that should vanish. That will leave stock compensation and amortization of acquired intangibles which NATI at lease expenses very quickly:

	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19
GAAP EPS	$0.03	$0.04	-$0.04	$0.08	$1.01	$0.45
Stock Comp.	$0.13	$0.12	$0.12	$0.09	$0.08	$0.10
Amtz Acq Intang.	$0.06	$0.07	$0.06	$0.01	$0.01	$0.01
Intgration/Restruct.	$0.11	$0.27	$0.10	$0.04	-$0.87	$0.08
Amtz Software	$0.05	$0.04	$0.05	$0.04	$0.03	$0.04
Tax Impact	-$0.06	-$0.03	-$0.06	$0.00	$0.00	-$0.12
Non GAAP EPS	$0.32	$0.51	$0.23	$0.26	$0.26	$0.56

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

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.