BEHIND THE NUMBERS
Quality of Earnings Analysis

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National Instruments (NATI)

Update after 3/22 Quarter Results and 10-Q Review

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

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

Summary

NATI's 1Q22 saw non-GAAP EPS of 41 cents, missing by 2 cents and revenue was light by $17 million. We have not had many issues with NATI from an earnings quality standpoint. The largest differences between GAAP and non-GAAP (22 cents) are adding back stock compensation (13 cents) and amortization of acquired intangibles (7 cents). While we don't like adding back amortization, NATI does use a rapid amortization period and only capitalizes a small fraction of software development costs.

Business and orders remained strong but the backlog grew as NATI was unable to fulfill orders and book the revenue. We have already seen a similar period in early 2021 due to inventory shortages. The timing of when sales normalize again is the unknown and NATI reduced 2Q revenue guidance to $370-$410 million vs. the $385 million booked in 1Q22. Here is what we view as the key points:

- NATI's revenue is the wildcard. It continues to invest in R&D, and marketing. When sales are impaired, those costs deleverage on margins.

- Backlog grew to 8 weeks, up $56 million – indicating business was stronger than what they could fill beyond the Shanghai shutdown.

- NATI attributed $15 million of lost revenue to the China shutdown – that would be almost 7 cents in EPS vs. the 2-cent miss.

- The backlog grew from the normal 1 week in 4Q20 to 2 weeks, 4 weeks, and 6 weeks before dropping to 5 weeks in 4Q21. Those extra sales did not create additional overhead costs and 4Q21 posted record sales and margin gains.

Positive – Broad Inventory Is Up

In early 2021, backlog was growing because NATI was low on inventory. That is now corrected and arguably the Shanghai issues at the end of 1Q helped NATI reach the inventory levels it prefers. Its operating model relies on avoiding out-of-stock situations.

	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Inventory	$308	$289	$237	$211	$197	$194	$210
DSIs	244.3	222.0	218.0	201.2	196.3	167.6	215.4
Product Sales	$344	$377	$326	$307	$295	$328	$270
P Sales Growth	16.5%	15.1%	20.8%	15.1%	7.7%	-1.4%	-11.6%

- We estimate that DSIs would be about 232-235 if the additional $15 million of sales had occurred
- In early 2021, shortages were more broad-based and that started backlog growing
- NATI is blaming both Shanghai's shutdown and one supplier that has underperformed for the backlog growing to 8 weeks
- Low-end guidance of 12% revenue growth for the year assumes neither situation is resolved this year – we consider that a place where NATI could outperform
- NATI is adding new suppliers, raising prices, and redesigning products to use available parts – but sees the supply constraints for some key parts impacting 2Q – that is the big risk near term.

Positive – Margins Can Quickly Expand as Revenue Recovers

In 1Q22, NATI noted gross margin declined by 400bp. This was the result of using more brokers to procure hard-to-find parts for 4%, higher freight costs for 1% offset by 1% price increases. As noted above, NATI is redesigning some products to reduce hard-to-find parts and adding new suppliers as well as boosting prices more to offset these headwinds. It is still forecasting 100bp of better gross margin for 2022 overall.

We think the hidden power of margin leverage comes from the overhead costs. NATI spends a consistent amount on SG&A, R&D, and G&A expenses. When sales are light (or the backlog is growing because orders could not be fulfilled), these flat costs hurt margins:

	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Sales	$385	$421	$367	$347	$335	$368	$308
SG&A	$120	$122	$117	$111	$117	$135	$110
R&D	$82	$92	$82	$81	$80	$74	$71
G&A	$33	$33	$31	$30	$33	$37	$37
adjustments						$30	$5
Costs % Sales	61.1%	58.7%	62.7%	64.3%	68.7%	58.5%	69.1%

Sales were impaired for 1Q-3Q21 and the overhead expenses saw deleveraging of margins by 10 percentage points. 1Q22 would have been essentially flat on margin sequentially (58.8%) had NATI had the extra $15 million in sales that were delayed due to lockdowns in Shanghai.

Guidance for 2Q22 is for revenue of $370-$410 million. That would make these costs 57.3%-63.5% of sales. The $370 million assumes Shanghai sales are lost for the full quarter. Both figures would likely see backlog grow further too. But 4Q21, when backlog dropped a week, shows how quickly margins expand here while NATI keeps its investment level up. NATI did say it expects 2Q22 to be the peak of expenses for the year.

The backlog and the higher sales despite the problems in Shanghai point to very strong demand and NATI pointed several times on the earnings call to demand exceeding their forecasts. Here is what they said about Shanghai for 2Q22:

> *"We do anticipate Shanghai opening up within the quarter. What's hard to predict is what happens after that in China. But what's helpful is that it's region by region and not broad-based overall China. The situation we had at the end of the quarter is Shanghai is our main hub for customs. The in and out that goes through there was a significant impact at the end of the quarter. What we aren't able to size is what might happen in Q2, if anything, extends there or has an impact in a different way."*

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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