BEHIND THE NUMBERS
Quality of Earnings Analysis

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National Instruments Corporation
(NATI) Earnings Quality Update- 6/21 Qtr.

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

We are raising our earnings quality rating of NATI to a 5+ (Strong) and maintain our Top Buy rating.

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

Summary

NATI's 2Q21 non-GAAP EPS of 35-cents beat forecasts by 7-cents. Revenue also came in above forecast. Guidance is for 20% growth in revenue for 3Q and non-GAAP EPS of 31-45 cents that may top 2Q's results. In our view, the beat was very solid as the company faced several headwinds:

- **Covid costs were 50bp or 1.1 cents in 2Q21**. We know that **2Q20 had a $9 million decrease in travel expenses which helped EPS a year ago by 5.4-cents**. It was not mentioned on the call, but that lower expense item likely did not recur in 2Q21.

- **Variable compensation was $10 million higher in 2Q21. That is a 6.1-cent headwind for 2Q21 EPS.** We do know that the workforce reduction plan in 4Q20 to cut headcount by 3% produced $7 million in cost savings in 1Q21. **Assuming 2Q21 saw the same benefit, the net increase in wages was a 1.8-cent headwind for 2Q21**.

- Tax rate was a small tailwind in the quarter of 0.7-cents.

- **Strong order demand and continued supply chain issues pushed the backlog up again**. Normally backlog is about one week. At the end of 1Q21, it was over two weeks. It finished 2Q21 at four weeks. A week's sales are just over $26 million and **NATI says the figure grew $50 million for 2Q.** In normal times, those higher backlogs would have been reported as $50 million in higher sales. This has several implications for margin headwinds:

    - R&D rose to $81.4 million from $64.2 million y/y. Adjusted for stock compensation and restructuring in non-GAAP earnings – R&D was 74.7 million vs. $59.6 million. Even on the higher sales, this was 21.6% of sales in 2Q21 vs. 19.8% the prior year. Thus, **higher R&D was a 3.7-cent headwind to EPS. However, assuming the backlog was $50 million of higher sales - that would have made the higher R&D only 18.8% of sales in 2Q21. It would have come in at a 2.3-cent tailwind.**

    - **G&A costs already reflect the quick cost-cutting plan** NATI implemented in 4Q20. Costs were basically flat on the higher sales at $30.3 million vs. $29.4 million. Adjusted figures were $23.6 million vs. $22.6 million, and we would surmise some of the higher variable compensation is in the 2Q20 figure. **On actual figures, this was a 1.5 cent tailwind to non-GAAP EPS. It could have been a 3.7 cent tailwind if the backlog had not grown.**

    - **Gross margin also leverages with higher sales as fixed costs are spread over more units.** The higher sales already moved gross margin up to 74.8% of sales compared to 74.4%. We know the company is increasing software as a percentage of sales which is higher margin to begin with at over 90%. **If backlog had been higher sales in 2Q, gross margin may have come in higher too. Every 25bp is worth about 0.5-cents in EPS.**

- NATI is forecasting that the backlog will grow $30-$40 million in 3Q21, and they will finish the year at 3-5 weeks of backlog. That could be some margin expansion in 3Q21 simply due to higher total sales. However, the margin gains could really show up when the backlog starts to decline again. That sounds like it could begin in 4Q21 and a return to one week of backlog could be a strong boost to 1Q22 and 2Q22.

- We think NATI could be successful in reaching its longer-term goals of a 9% CAGR on revenue by 2023 – especially since backlog shrinking should become higher sales. Also, it wants to have a 20% operating margin. With the goals of growing software as a percentage of sales, and higher sales leveraging costs like R&D, COGS, and G&A, that

looks doable. Margins were 17.2% in 2Q21 and there was 250bp of lost margin from having the backlog grow.

- A restructuring program that ends? Long-time clients know that we grew tired of companies that restructure for 25 years and always add back the costs to non-GAAP figures. NATI's 4Q20 restructuring was expected to have only $3 million left in spending coming into 2Q21, it used $2.1 million. The add-back was only 2-cents to non-GAAP. The short duration and the falling number boosts earnings quality in our view.

- Inventories are still lower than where NATI wants to be, but they are building again. That should also help signal that the backlog growth will slow and decline in the future. It is also worth noting on both the 1Q and 2Q call – NATI was very clear that their backlogs become sales. They do not have a history of customers double or triple ordering.

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

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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