BEHIND THE NUMBERS
Quality of Earnings Analysis
January 29, 2021

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Texas Instruments Inc. (TXN) Earnings Quality Update 12/20 Qtr.

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

We maintain our earnings quality rating of TXN of 5+ (Strong).

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

Summary

TXN posted EPS of $1.80 for 4Q20, beating forecasts of $1.55 by 25-cents and TXN's guidance of $1.20-$1.40. The market was disappointed by 1Q21 guidance of $1.44-$1.66, but it actually looks solid to us and the $1.80 was helped by some short-lived items. The company reported that it saw 16-cents in the quarter that was not in prior guidance related to a large inflow of royalty income. Demand recovering rapidly with a y/y increase in sales of 22% helped leverage some costs as well. Revenue came in at $4.08 billion vs. TXN's guidance of $3.41-3.69 billion. R&D coming in flat y/y against the 22% jump in sales added 4-cents and SG&A leveraged more than planned and added 5-cents to 4Q EPS. Also, TXN has a tax forecast of about 14%. In 3Q, it was 15% and a small headwind. In 4Q it came in low at 12.4% and that was 3-cents in EPS. Adjusting for that, TXN's reported EPS of $1.80 becomes $1.52 against high guidance of $1.40 and against a range of 1Q guidance of $1.44-$1.66. We can see some small headwinds coming in 2021 as a result of this, but much of this fits within TXN's normal operating plan. 4Q20 shows some of the lumpiness that can occur at TXN on the upside.

What is strong?

- Beating so much on revenues should have created operating leverage. Based on guidance, SG&A should have come in closer to 11.0% of sales but finished at 9.8%. That likely added about 5-cents to EPS. SG&A had an easy comp from 4Q19 when it was 12.3% of sales so some EPS pick-up should have been expected already. Also, R&D leveraged as it was essentially flat y/y and guidance would have had it between 10.5%-11.4% of sales, but it came in at 9.5%. 1% of margin is equal to 4-cents in EPS.

- Discussing operating costs (SG&A + R&D) on the call, TXN reiterated that it expects to stay within a band of 20%-25% of revenues all the time and has been between 21%-22% for much of the last several years and that was true in 2020 at 21.8%. TXN just had an easy comp from 4Q19 when costs were 23.8% of sales and 4Q20 came in at 19.3% with the jump in sales. So returning to about 20%-21% will be a headwind in early 2021, offset by more earnings from higher sales.

- Gross margin also rose and sales also benefited from the TXN operating model of producing higher volumes, which spreads fixed costs over more output and lowers unit costs and carrying more inventory. When sales demand turned rapidly in 4Q, TXN had inventory on hand produced at lower cost. Having inventory on hand when competitors did not, meant TXN picked up more sales. We think this quarter really showed the strength of TXN's plan. TXN expected sales to be up less than 10% and they grew by 22% instead creating the operating leverage for SG&A and R&D. Plus, by having the inventory on hand and sourcing most of their own intermediate products – TXN saw gross margin rise by over 200bp.

- Inventories fell noticeably in 4Q with the jump in sales. Inventories finished the period at under $2 billion or 125 days. That's down y/y from 147 days and it was as high as 168 days in 2Q20. We would expect TXN to produce at full capacity to boost inventories going forward, which should help maintain gross margin. Historically, DSIs are normally in the 140s.

What is weak?

- TXN picked up EPS from a lower tax rate too. The effective rate was expected to be about 14% and it came in at 12.4% in 4Q20. This added 3-cents to EPS and should return to 14% going forward.

- TXN expects Capital Spending to be about 6% of revenues. In 2020, it was down y/y in every quarter except 4Q. Spending was only 4.5% in 2020 and 5.2% in 4Q20. TXN said it would get closer to normal in 2021 so we expect capital spending to be a $200-$300 million headwind for free cash flow in 2021.

- The inventory also could be a headwind in 2021. Had DSIs held at normal levels in 4Q, inventory would have been about $300 million higher. With rising sales, TXN may see a $300-$400 million headwind on free cash flow for 2021.

- TXN wants to pay out 100% of free cash flow as dividends and share repurchases. In 2020, FCF was $5.5 billion and TXN returned $6.0 billion to shareholders. The company has liquidity, but if there are headwinds on inventory and capital spending, offset with higher earnings. The level of share repurchases may drop in 2021.

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.