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# Texas Instruments Incorporated (TXN)
# Earnings Quality Update- 9/21/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 coverage of TXN at 5+ (Strong) and maintain Top Buy rating.*

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

## Summary

We are maintaining our 5+ (Strong) rating on TXN after it beat forecasts again by 3-cents. The market was upset largely because TXN did not top the high-end of guidance again. We also believe some of the market's reaction was due to TXN saying that in 2Q customers were buying everything in stock and in 3Q, customers were being more selective in buying product that would help them complete production. Thus, revenue was only up 1.4% sequentially.

This is more of a long-term holding than a quarter-to-quarter company. We think there are still several revenue tailwinds for TXN. However, we can see some headwinds on cash flow and earnings in the near term. The company's accounting quality remains strong in our opinion and the company's biggest problems involve how to fulfill growing demand and rebuild its own inventories.

## Earnings Quality Issues Remain Tame

When we first wrote TXN, we noted it was gaining 2-4 cents per year in EPS from areas such as reducing bad debt expense, gains on investments, and declining pension costs. We considered that tame as EPS was $5-$6 and TXN was routinely beating forecasts by more than what the change in these items was for a year. All would say at this point, is declining bad debt at 0.5% of receivables has likely run its course. The same can be said for total pension costs which should be largely flat in 2021 vs 2020.

Other than those minor issues, TXN adds back the amortization of acquired intangibles to EPS. This has been adding 5-cents per share per quarter. While we don't like this, we gave TXN good marks for effectively amortizing these assets over 7-years.

**There is a new item coming up in 4Q21.** They closed on a deal this month and expect $75 million in wages per quarter through 2022 related to getting production started. TXN is likely to report this $75 million (7-cents per quarter) as a restructuring item. The employees doing this start-up work will not leave so the wages will remain. But adjusted EPS may add these back for about one year.

## Inventory Is a Bigger Problem

TXN's operating model involves carrying a sizeable amount of inventory to avoid out-of-stock situations. The supply chain shortages since last summer as the economy reopened in the late summer of 2020 has caused demand to exceed what TXN could supply. Sales increased 20%+ y/y for several quarters to exacerbate the situation:

| | 3Q21 | 2Q21 | 1Q21 | 4Q20 |
|---|---|---|---|---|
| DSIs | 114 | 113 | 116 | 125 |
| Fin Goods DSIs | 37 | 40 | 44 | 52 |
| | **3Q20** | **2Q20** | **1Q20** | **4Q19** |
| DSIs | 139 | 168 | 147 | 146 |
| Fin Goods DSIs | 62 | 77 | 67 | 66 |
| | **3Q19** | **2Q19** | **1Q19** | **4Q18** |
| DSIs | 140 | 145 | 146 | 154 |
| Fin Goods DSIs | 63 | 66 | 63 | 67 |

The market was concerned that sequential sales growth slowed in the 3Q. TXN noted that customers had switched from ordering nearly anything that was available to asking for more chips in their most critical areas to meet their own demand. They became more selective in

wanting product that would allow them to fully complete their own output rather than build more partially built inventory themselves.

Overall, demand should continue to rise based on that completion of customer inventories, customer output still looking to match current demand, and that the amount of semiconductor content in many product areas continues to increase.

However, TXN's inventory is normally 145-150 days and needs to increase 30-35 days. More importantly, finished goods inventory is only 37 days now instead of about 65 days. They need to fill a higher level of current and future sales while working to rebuild inventory levels. TXN has new capacity coming online so they expect demand and sales to continue increasing. Growing inventory by 30-35 days will consume about $500 million in cash too.

Normally, we would see a $500 million commitment to new inventory as a sizeable headwind – but not really for TXN. The Free Cash flow is running at $7.1 billion for the last 12-months vs. a current dividend of about $3.8 billion. There has since been a $900 million acquisition. However, there is still considerable cash flow available to support higher inventory and repurchase shares. Also, rebuilding $500 million in inventory seems unlikely to happen in one quarter. TXN has been trying to build inventory for four quarters now and demand is still clearing the shelves faster than it can produce it.

## R&D and SG&A Are Not Falling but Could Increase in 2022-23

TXN always says it expects to keep the combination of R&D and SG&A spending between 20%-25% of sales. It has been running at more like 17%-19% of late.

| | 3Q21 | 2Q21 | 1Q21 | 4Q20 |
|---|---|---|---|---|
| R&D | $388 | $391 | $386 | $388 |
| R&D % | 8.4% | 8.5% | 9.0% | 9.5% |
| SGA | $412 | $425 | $425 | $398 |
| SGA % | 8.9% | 9.3% | 9.9% | 9.8% |

| | 3Q20 | 2Q20 | 1Q20 | 4Q19 |
|---|---|---|---|---|
| R&D | $386 | $379 | $377 | $386 |
| R&D % | 10.1% | 11.7% | 11.3% | 11.5% |
| SGA | $407 | $401 | $417 | $412 |
| SGA % | 10.7% | 12.4% | 12.5% | 12.3% |

We think it is important to note that the spending is not falling, the higher sales figures have simply leveraged the cost more and boosted margins and cash flow. We expect TXN to boost

spending more in this area going forward to support more future sales growth. However, it may be difficult for it to reach much higher than 20%-21% of sales in our view based on rising sales.

While that sounds like a headwind for margins and free cash flow – investors should remember that TXN has new capacity coming online – the new 300mm plant in particular, which is expected to lower production costs about 20% and thus gross margin could rise. Also, depreciation is a large expense at TXN and higher production spreads that cost over more output and also helps gross margin. Those two benefits could offset R&D and SG&A rising to more normalized levels as a percentage of sales.

The one thing to watch would be a quarter or two of initial start-up of the new factories when depreciation, wages, and operating costs begin, but production levels need to build up. That could lead to some gross margin erosion during the start-up. We see that as a temporary item that should quickly recover.

# 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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