BEHIND THE NUMBERS
Quality of Earnings Analysis
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Texas Instruments (TXN)
Earnings Quality Update- 3/22 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 rating of TXN at 5+ (Strong).

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

Summary

TXN's adjusted EPS of $2.42 beat forecasts by 23 cents. The beat was solid to us.

- TXN's adjusted and GAAP EPS only differ by 7 cents related to start-up costs for a new plant that has not opened yet. That 7 cents per quarter will disappear in 3Q22.

- TXN reported the 1Q22 had 2 cents of better than expected benefits it did not describe.

- We believe 1.3 cents of the benefit was pension costs declining by $11 million.

- We also note that stock compensation rose $13 million and was a 1.2-cent headwind.

- Gross margin was up 500bp y/y, with 100bp coming from higher than normal utility costs in 1Q21 that did not recur in 1Q22.

The initial negative market reaction was all about revenue guidance coming down for 2Q22 due to Chinese Covid lockdowns. After posting $4.9 billion in revenue for 1Q22, TXN cut its mid-point for revenue guidance by 10% and made its estimated spread $4.2-$4.8 billion. We see this as a short-term hiccup and expect and backlog will grow more. Semiconductor demand is still hot and the lull is more a case of manufacturing plants being closed in parts of China. They cannot accept chips during the lock-down or the trucks are not allowed into those areas.

We see three areas where TXN should still be in a strong position:

- Inventory is rising further. And with a goal of being near the high end of their historical range of 130-190 days, TXN should continue building inventory to meet growing backlogs during 2Q22.

	1Q22	4Q21	3Q21	2Q21	1Q21
DSIs	128	118	114	113	116
Fin Goods DSIs	40	37	37	40	44

- Inventory was 140-150 days for much of 2019 and 2020 by design as TXN seeks to maximize revenues by capturing sales from competitors who are lighter in inventory. If inventory can expand further during 2Q22, it should help TXN boost sales after that by filling current quarter demand and backlog orders in future periods.

- Gross margin should be pressured in 2Q22 based on fewer sales leveraging fixed costs such as depreciation of $200 million. On $4.9 billion in sales for 1Q, that was 408bp of cost, but the same depreciation over $4.2-$4.8 billion becomes 420-476bp.

- Gross margin is still being helped by TXN producing 80%-90% of its own chipsupplies. That enables it to offset some inflation, and as competitors raise prices, TXN can price to the market and see wider margins.

- TXN should still see flat R&D and SG&A in dollar terms despite the lower sales forecast for 2Q22. They have maintained this spending at flat to slightly growing levels throughout Covid in 2020 and 2021. As sales recovered, operating margins

gained 280-350bp of operating leverage (330bp in 1Q22). R&D and SG&A would come in at 17.2%-19.6% of sales vs. 16.5-16.6% of late.

- Revenue is the wildcard, EPS forecasts of $1.84 -$2.26 are assuming a gross margin of about 68-69% vs. the 67.2% posted in 2Q22 and vs. the 70% posted in 1Q22.

We Still See the Order Book as Solid

A common concern among semiconductor bears for the last 4-5 quarters is the possibility that TXN's customers have double-ordered and will begin canceling at a higher rates as chip shortages are cured. The 1Q22 call was no different. Our take on this is TXN is not getting hit much by this issue:

- TXN's commentary for several quarters noted that customers need more chips but are selective in what they order, keeping quantities in line with their current demand. Customers are focused on ordering specific chips they need to complete the full set to finish building their end products. So the overall higher demand is correlated to higher levels of end-market demand with a few exceptions at this point.

- TXN's comment this week was very similar to what they have said for a year now: *"The market environment in the first quarter was similar to what we've observed for the last several quarters. Customers continued to be selective in their expedite requests, focusing on products that completed a matched set, rather than expediting products across the board. This behavior was not specific to any product family, end market or geography."*

- The current Chinese lockdowns make some customers unable to receive new inventory in 2Q. That is why TXN cut forecasts for 2Q, but does not see full underlying demand going down – it may just be delayed, *"Our assessment in early April indicated that revenue would continue to incrementally grow again in the second quarter. However, it just became clear that we were experiencing lower demand, particularly due to COVID-19 restrictions in China. And just to be clear, customers' behavior wasn't changing as it related to backlog or cancellations."*

- We also note that TXN is still reporting chip prices are rising, that they are seeing the need for more capacity, and they still want as much as another 60 days of inventory.

Another 60 days of inventory is over $3 billion in future sales and they reduced sales guidance by $100-$700 million for 2Q22.

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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