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EDITED TRANSCRIPT

ADI.OQ - Q3 2021 Analog Devices Inc Earnings Call

EVENT DATE/TIME: AUGUST 18, 2021 / 2:00PM GMT

OVERVIEW:

ADI reported 3Q21 results with revenues of $1.76b and adjusted EPS of $1.72. Co. expects 4Q21 revenues to be $1.78b, plus or minus $70m, and adjusted EPS to be $1.72, plus or minus $0.11.

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PRESENTATION

Operator

Good morning, and welcome to the Analog Devices Third Quarter Fiscal Year 2021 Earnings Conference Call, which is being audio webcast via telephone and over the web.

I'd now like to introduce your host for today's call, Mr. Michael Lucarelli, Senior Director of Investor Relations. Sir, the floor is yours.

Michael C. Lucarelli - *Analog Devices, Inc. - Senior Director of IR*

Thank you, Shelby, and good morning, everybody. Thanks for joining our third quarter fiscal 2021 conference call. With me on the call today are ADI's CEO, Vincent Roche; and ADI's CFO, Prashanth Mahendra-Rajah.

For anyone who missed the release, you can find it and relating financial schedules at investor.analog.com.

And on to the disclosures. The information we're about to discuss includes forward-looking statements, which are subject to certain risks and uncertainties as further described in our earnings release and our most recent 10-Q and other periodic reports and materials filed with the SEC. Actual results could differ materially from these forward-looking information as these statements reflect our expectations only as of the date of this call. We undertake no obligation to update these statements, except as required by law.

Our comments today will also include non-GAAP financial measures, which exclude special items. When comparing our results to our historical performance, special items are also excluded from prior periods. Reconciliations of these non-GAAP measures to their most directly comparable GAAP measures and additional information about our non-GAAP measures are included in today's earnings release.

And with that, I'll turn it over to ADI's CEO, Vincent Roche. Vince?

Vincent T. Roche - *Analog Devices, Inc. - President, CEO & Director*

Thank you, Mike, and a very good morning to everybody. So ADI delivered a second consecutive quarter of record revenue and earnings. Despite the challenging supply environment, our strong performance was driven by continued operational excellence and insatiable demand as semiconductors power the modern digital age.

Broadly speaking, the economic recovery continues to take shape with demand still far exceeding supply. We, like many others in our industry, will face a constrained supply environment into 2022. Despite this backdrop, our business continues to achieve record results as our investments and design wins over the last few years are matched with strong demand across our end markets. So looking ahead, the combination of robust bookings, lean inventories and ongoing capacity additions position ADI to close fiscal '21 on a high note and continue to grow in the next year.

So moving to our third quarter results. Revenue was $1.76 billion, up 21% year-over-year. All markets increased sequentially with Industrial and Automotive once again achieving records. Gross margin expanded to over 71% and operating margin to over 43%. Adjusted EPS of $1.72 increased 27% year-over-year. Despite elevated capital spending to increase our capacity, free cash flow over the trailing 12 months was $2.2 billion. This equates to a 34% free cash flow margin, maintaining our position in the top 10% of the S&P 500. So overall, I'm very pleased with our performance and our team's outstanding execution.

As you know, at ADI, our ethos of innovation and deep customer engagements ensure that we stay ahead of what's possible. We invest more than $1 billion annually in R&D, focused on strengthening our core franchises and capturing market opportunities presented by secular growth drivers which have accelerated in the economic recovery.

Now let me share some recent highlights with you. Our Industrial business is our most diverse segment across customers, products and applications and feature sticky, long product life cycles. Our largest industrial segment, instrumentation and test, is comprised of automated test equipment, electronic test and measurement and scientific instruments. This is truly a performance-driven market that aligns perfectly to our high-performance precision signal chain, power management and RF portfolios.

Importantly, instrumentation and test is aligned with all secular growth trends from connectivity to EVs, to sustainability. The growing technology complexity of these applications requires more testers with more advanced performance capabilities.

Today, ADI is the leader in communications tests, and we're collaborating with Keysight, for example, to advance the development of O-RAN solutions. This partnership will enable the fastest path for designing cost-effective and power-efficient radio units. Looking ahead, we're already beginning to partner with our customers to test emerging 6G technologies.

Our innovations in the instrumentation market also have a positive impact on human and planetary health. One particular area is our environmental monitoring business, where there is an increased need for highly reliable and accurate instruments to improve the standard of living globally. Our market-leading portfolio of precision converters enables 10x greater measurement resolution of fine particulate matter, better identifying trace pollutions.

The next largest industrial segment is factory automation. Over the last year, many of our customers are rethinking their factory floors and supply chains to make them more resilient, cost effective and flexible through automation and connectivity. To achieve this, our customers will further automate their businesses with intelligent and connected factories and increase their use of robots and cobots.

Specifically, cobots require ADI's precision signal chain and power franchises, sensing technologies and robust wired and wireless connectivity. This new vector of growth increases our SAM opportunity by 3x that of a traditional robot. To that end, our precision motion control business is on track for a record year of design wins, including a recent win at a leading Japanese robotics company for its next-generation cobots. In addition, we're leveraging our domain knowledge and system-level expertise in a collaboration with Universal Robots to design smaller, smarter and easier-to-use robots that help scale tasks safely and transform workforces.

Well, turning now to our Communications business. 5G is beginning to broaden globally, especially in North America, as carriers look to deploy newly acquired C-band spectrum. And O-RAN continues to gain momentum also with several of the largest European carriers setting ambitious 2025 O-RAN deployment targets. This includes Vodafone where our technologies are very well represented.

This quarter, we extended our market-leading position in 5G radio solutions with the introduction of the industry's first software-defined transceiver that includes a fully integrated digital front end. Our innovative radio architecture greatly improves power efficiency, thereby reducing radio weight, size and carrier expenses. This high level of integration eliminates FPGAs to simplify implementation and facilitate the proliferation of these emerging O-RAN networks. Our next-generation transceiver platform is already designed in at a major Tier 1 global supplier that is gaining share in these 5G and O-RAN deployments across North America as well as Europe.

Stepping back, we expect our Communications business to return to growth in 2022. We have strong design momentum, and our geographic mix has shifted with North America, Europe and Korea representing our largest sources of revenue.

Moving now on to Automotive. Over the last 2 years, we've realigned our business to focus on electrification and the in-cabin human experience. We're seeing the benefits of this strategy as we continue to scale our market leadership in battery management, power management, audio systems and connectivity.

Starting firstly with our battery management systems, or BMS. Our wired and wireless portfolios provide unmatched accuracy to deliver market-leading vehicle range and can measure all key battery chemistries, including zero-Cobalt LFP. Additionally, our solutions incorporate ASIL-D functional safety and an ultra-low power continuous monitoring feature that ensures the battery remains stable even while parked, which is a first in the market.

In addition, this quarter marked the first time we recognize revenue for our wireless BMS solution as General Motors prepares to ship its first of 30 EV models powered by the Ultium battery platform. And this is just the beginning for this groundbreaking BMS technology as OEMs realize the power of wireless data in scaling their fleets.

Turning to audio systems and connectivity. As complexity continues to increase, there's very strong demand for our market-leading audio systems with signal processing, A2B connectivity and active road noise cancellation. Our solutions offer the highest fidelity performance in the market while reducing vehicle weight, removing nearly 100 pounds per vehicle.

During the quarter, 2 leading OEMs adopted A2B, and a top 3 European vehicle manufacturer implemented A2B as its audio connectivity standard across its entire fleet. In total, A2B is now designed in at over 30 OEMs, including 18 of the top 20 global automotive companies. Furthermore, interest in our active road noise cancellation feature continues to intensify. We're designed in at 9 OEMs, up from 5 just a year ago, including Hyundai and a leading EV manufacturer. This added capability can more than double the value of our A2B solution.

In all, these are just a few of the countless examples of the tremendous work underway at ADI. We remain focused on delivering breakthrough innovations to stay ahead of our customers' needs.

So in closing, I've never been more confident about ADI's future. Over the last decade, we've built an industry-leading portfolio with unparalleled breadth and depth of capabilities that's aligned with more profitable end markets. And our portfolio and leadership position will only get stronger with the acquisition of Maxim, enabling us to deliver strong returns in the years to come.

And so with that, I'll hand you over to Prashanth.

Prashanth Mahendra-Rajah - *Analog Devices, Inc. - Senior VP of Finance & CFO*

Thank you, Vince. Good morning, and welcome to our third quarter earnings call. My comments today, with the exception of revenue and non-op expenses, will be on an adjusted basis, which excludes special items outlined in today's press release.

ADI delivered exceptional third quarter results, underpinned by our ability to increase production. Revenue and EPS reached all-time highs for the second straight quarter with continued gross and operating margin expansion. If we look at performance by end market, Industrial represented 57% of revenue and increased 3% sequentially and 29% year-over-year. Notably, this business surpassed $1 billion of quarterly revenue for the first time. We experienced broad-based strength across applications and geographies. All subsegments increased double digits year-over-year, except health care, given the elevated pandemic demand a year ago.

Communications represented 16% of revenue and decreased 21% year-over-year while up 4% sequentially with growth in both wireless and wireline. As we outlined last quarter, we believe our Communications revenue has bottomed and will continue to grow as 5G deployments broaden globally, especially in North America.

Automotive represented 16% of revenue and increased 13% sequentially and 80% year-over-year. Strength was broad-based with double-digit growth across every major application. BMS and A2B remain our fastest-growing applications, and both are on track to nearly double in size this year. As Vince shared earlier, ADI has been strategically pivoting resources to focus more aggressively on electrification and the in-cabin human experience. As part of this strategy, we are licensing select radar IP to a large European Tier 1 auto supplier. This resulted in immediate revenue recognition of $24 million in the quarter.

Consumer represented 10% of revenue and increased 16%, both sequentially and year-over-year. Our strategy to diversify and grow this business in fiscal '21 is working as strength across home entertainment, hearables and wearables more than offset a decline in portables.

And now moving to the P&L. Gross margin expanded sequentially and year-over-year, finishing at 71.6%, mainly due to the cost savings from the LTC manufacturing optimization and the IP license agreement. OpEx in the quarter was $493 million, up modestly sequentially, due to a full quarter of merit increases and continued strong variable comp. This netted an op margin of 43.6%, which marks the fifth straight quarter of year-over-year op margin expansion, underscoring the strong leverage in our business. Non-op expenses were $37 million, below our typical quarterly run rate of approximately $43 million due to an investment gain. And our tax rate was approximately 12%, which give us an adjusted EPS at $1.72, including $0.05 of upside attributable to the IP licensing agreement.

Moving on to the balance sheet. We finished the quarter with an ending cash balance of $1.5 billion and a net leverage ratio of 1.2x. Relative to the second quarter, inventory dollars increased $16 million, driven entirely by raw materials and work in process. Days of inventory were unchanged at 118, and weeks of channel inventory remained well below the low end of our 7- to 8-week target as sell-through remained stronger than selling. CapEx for the quarter was $86 million, up meaningfully sequentially as we continue to add capacity to support our robust and growing order book that now stretches into fiscal '22. We will continue to increase capacity in the fourth quarter, resulting in full year capital intensity above our long-term model of 4%.

And turning to free cash flow, we generated more than $2.2 billion over the trailing 12 months, up 23% from a year ago, and this represented a 34% free cash flow margin. Over the same period, we have returned nearly 85% of free cash flow after debt repayment via $970 million in dividends and over $500 million in share repurchases.

And now on to the fourth quarter outlook. Revenue is expected to be $1.78 billion, plus or minus $70 million, up sequentially, as additional capacity comes online. At the midpoint, excluding the automotive IP licensing revenue, we expect each of our B2B markets to increase sequentially, led by Communications and Consumer to be up high single digits. Based on the midpoint of guide, we expect to deliver a record gross margin and for operating margins to be 43.7%, plus or minus 100 bps. Our tax rate is expected to fall toward the upper end of our range. And based on these inputs, adjusted EPS is expected to be $1.72, plus or minus $0.11.

So before moving to the Q&A, I'd like to give a brief update on Maxim. Our discussions with the Chinese regulatory authorities have been productive, and we're working towards closing within the initial time frame. We plan on closing no later than the third business day after China approval has been granted. As we shared before, shortly after the close, we will hold a conference call to provide an update on our capital return plans. Once combined, we anticipate having nearly $4 billion of cash on our balance sheet, a leverage ratio well below 1 and more than $3 billion of annual free cash flow.

I'll now turn it over to Mike to start the Q&A.

Michael C. Lucarelli - *Analog Devices, Inc. - Senior Director of IR*

Thanks, Prashanth. Let's get to our Q&A session. (Operator Instructions) With that, can we have our first question, please?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question is from Vivek Arya of Bank of America Securities.

Vivek Arya - *BofA Securities, Research Division - Director*

Vince, you mentioned demand far exceeds supply. I was hoping if you could help us quantify that. Are you under shipping by 5%, 10%? How much of a demand cushion does ADI have right now? And kind of part B of that is how much incremental capacity are you planning to bring online in the next year? And is that kind of a proxy for what kind of sales growth we should be looking at?

Prashanth Mahendra-Rajah - *Analog Devices, Inc. - Senior VP of Finance & CFO*

Thanks, Vivek. So demand continues to grow across our markets. All end markets are up, and our book-to-bill was above 1.2. Supply is also expanding. We grew 4% sequentially in the third quarter, and we're -- at the midpoint, we're going to be up another 3% for the fourth quarter.

So you look at that math, and it says the supply-demand gap is growing, or said another way, backlog is increasing quarter-over-quarter, and it now extends well into 2022. Our view is this gap is likely to persist into calendar year '22, given the long lead time it takes to add supply in the industry, plus just the broad strength of the demand.

Vincent T. Roche - *Analog Devices, Inc. - President, CEO & Director*

Yes. I think the second part of that question, Vivek, just a little bit of color. So we're layering in investments in CapEx to support our growth objectives, so particularly on the back end of our operations, assembly and test. And we need this capital now to meet the demand. But also in the longer term, we're very, very optimistic about the tailwinds in -- right across our business, from automation to electrification, connectivity and so on and so forth. So the outlook we've just given you is supply feasible, and it is certainly the governor, I would say, right now on revenue for the company.

Operator

Your next question is from Tore Svanberg of Stifel.

Tore Egil Svanberg - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

yes. I was hoping you could just elaborate a little bit more on the Maxim merger. You said that you'd still expect it to happen within the time frame you had announced. I believe you had said the summer of 2021, correct me if that was wrong. And related to that is, again, China the only remaining obstacle before you can close the deal?

Vincent T. Roche - *Analog Devices, Inc. - President, CEO & Director*

Thanks, Tore. So look, our confidence of the closing remains unchanged. And as we said in the prepared comments, our discussions with the Chinese regulatory authorities have been productive -- positive and productive, and we're working towards closing within the initial time frame. So China is the only outstanding regulatory approval need at this point in time. And I will remind you as well that all of the other regulatory bodies across the globe have approved our deal without condition, without remedies.

Operator

Your next question is from John Pitzer of Credit Suisse.

John William Pitzer - *Crédit Suisse AG, Research Division - MD, Global Technology Strategist and Global Technology Sector Head*

Yes. Vince, I wanted to pick up on your prepared comments about your Industrial business. You're now going in the third consecutive quarter of sort of record revenues in that business. You have to go back to, I think, April of '18 before -- which was the last peak. But year-to-date -- fiscal year-to-date, that business is up about 30% year-over-year. And for a lot of investors, they're concerned that perhaps that represents more cyclical excess than sort of structural sustainability. And so I'm kind of curious, as you break apart your Industrial business, what do you think is being driven by the "cycle" versus stuff that's a little bit more sustainable?

Vincent T. Roche - *Analog Devices, Inc. - President, CEO & Director*

Yes. Thanks, John. I think, first and foremost, I'd like to remind everybody that ADI's Industrial business is built on a foundation of many individual market segments like automation, instrumentation that I talked about, health care, our space business and energy as it moves to renewables and charging infrastructure, for example, the whole need for grid efficiency and stabilization. So that's the foundation. It's a highly diverse business. We've got many tens of thousands of customers. And the life cycles in the business are kind of 15 years plus, and it's a very, very, very sticky set of sockets that we've got.

So those of you who have followed ADI for a long time, remember, we -- about a decade ago, we fairly dramatically increased our focus in terms of R&D, go-to-market activities in ensuring that we could really grow that business. And the last few years have shown that we've been gaining market share across the board there.

So I think there's a certain amount, John, of -- there were a lot of programs that were stalled last year, so there's a certain amount of catch-up there. But I do think that the breadth of the portfolio that we now have, the investments we've been making in terms of customer engagement, R&D activities and the secular trends that we've got, all these concurrent secular drivers are propelling that business beyond the markets.

Michael C. Lucarelli - *Analog Devices, Inc. - Senior Director of IR*

Yes. I'll add one thing, John. You're right. As we said in our prepared comments, all the markets did increase double digits year-over-year. Of our 6 applications that Vince outlined, 2 are still below pre-peak levels. We do think fiscal '21 marks a record for all of them, and we don't see why they won't hit another record in '22, given the strong trends that Vince outlined. And with that, we'll go to our next question.

Operator

Your next question is from Stacy Rasgon of Bernstein Research.

Stacy Aaron Rasgon - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

I had a question on the pricing environment. And given the -- just the tight supply and the shortage situation, we're starting to see some hints of some of your peers starting to take prices up. And I was curious what you guys are seeing in the pricing environment. Are you seeing that? Are you able to actually do that? Are you treating your own pricing environment more conservatively?

Prashanth Mahendra-Rajah - *Analog Devices, Inc. - Senior VP of Finance & CFO*

Yes. Thanks for the question, Stacy. So I would say that for the results that we printed, pricing is on net neutral. We're passing on cost increase so that we're not impacting margins, but we've made a decision not to take advantage of our customers by structurally increasing pricing in this environment. Our long-term model is unchanged, and that is 70% plus. So the goal really is to drive the revenue growth and make the trade-offs that are necessary to drive that revenue growth, focusing on delivering on the op margin and the free cash flow.

So you'll see on a -- if you back out the IP license impact, we had a 71.2% gross margin in the third quarter. And while we don't guide to gross margins, if you impute it from the guide that we give you -- we gave you, fourth quarter is going to be -- probably be a record for ADI in terms of gross margins.

Operator

Your next question is from Toshiya Hari of Goldman Sachs.

Toshiya Hari - *Goldman Sachs Group, Inc., Research Division - MD*

I wanted to ask about the Comms business. Vince, you talked about 2022 being a growth year, and you talked about North America, Europe and Korea being the key drivers for you guys going forward. How should we think about the shape of the recovery going forward? Is it going to be a fairly gradual recovery? Could it be sort of a V-shaped recovery over the next couple of quarters? And when you talk about return to growth in '22, what sort of implicit assumptions are you making for China?

Prashanth Mahendra-Rajah - *Analog Devices, Inc. - Senior VP of Finance & CFO*

Okay. Thanks. We're going to split that into 2. Let me just quickly talk about what happened, and then I'll let Vince speak to kind of more broadly. So in the second quarter, as a reminder, we did call the bottom on Comms and said that we would grow on a sequential basis. We delivered that in third quarter, and we are on track to deliver that for the fourth quarter. So we believe we're really well positioned for strong growth into fiscal '22.

And between kind of the 2 subsegments there, wired demand remains strong, and we expect that to continue as both carriers and data centers continue to do the upgrades to their networks. And wireless, while it's always lumpy, growth in the past quarter was really driven by rest of the world, North America. We do think China bottomed in the third quarter so that should also represent some growth momentum for us as we go forward.

And then I'll hand off to Vince to kind of speak more broadly about what we're seeing.

Vincent T. Roche - *Analog Devices, Inc. - President, CEO & Director*

Yes. So Toshi, why do I have the confidence I have about 2022 being a strong growth year? So maybe I can unpack that a bit for you. So I think our Comms revenue mix is seeing a benefit from the rest of world beginning to emerge in 5G. So today, rest of world, outside of China, is 3x in terms of TAM. So that's number one. If you look at then the geographies, North America, the auction, the C-band auction is complete, revenue is really just beginning here. And all the indications are that 5G revenue here will accelerate in 2022 and indeed beyond. Europe, I would say a step behind, but we're beginning to see good signs of life in that region. And -- but I think it will be more a late 2022 driver.

We've talked several times on various calls here about O-RAN, what's happening, but we're beginning to see revenue. We've talked before about Rakuten in Japan. That business continues to accelerate, and European carriers are looking right now to make it also an important part of their 5G offering.

I mentioned during the prepared remarks as well that Vodafone is a major player there, and we happen to be very well represented in their systems. And I'm also having conversations with customers about the use of 5G and O-RAN beyond the classical consumer market.

So it's early days, but the characteristics of flexibility, scalability, quicker time to market, cost savings and so on is enabling private networks to be configured in factory environments, for example. So that's all still on to come, but that gives you a sense for our confidence in 2022 and beyond.

Operator

Your next question is from Ambrish Srivastava of BMO.

Ambrish Srivastava - *BMO Capital Markets Equity Research - MD of Semiconductor Research & Senior Research Analyst*

I had a question on Maxim and -- so my investment case for ADI has now been Maxim. And you have a very sticky shareholder base who have been with you before Maxim. But I get this question a lot, so I think it's a fair question to ask. If Maxim was not to go through, how do you think about capital allocation? Do you then go back to the playbook and say you would be changing how you think about capital allocation or you would continue on the M&A path and look at other opportunities?

Prashanth Mahendra-Rajah - *Analog Devices, Inc. - Senior VP of Finance & CFO*

So Ambrish, let's do this. Let me just remind everyone what the capital allocation policy is today because I think that we have a very shareholder-friendly capital allocation policy, which is that first call is really to invest in the business and that -- although not a traditional definition, we do consider that organically kind of how we spend our R&D, and that is heavily pointed towards the B2B market. And then we think about inorganic really more as it helps the technology portfolio or find other ways to help us become more important to customers.

But our commitment is to return 100% of free cash flow to customers. So we're at a 1.2 level leverage today. We do not need to reduce debt. So on a -- in an environment -- despite the confidence that we have in the Maxim deal closing, in an environment where that was not to have happened, would not look for us to really be changing that view of having all our incremental free cash flow go into -- returned to shareholders, either through buyback or through dividend.

And as a reminder, I think over the past 3 years, we've averaged about a 10% increase in our dividend, so a very healthy commitment for our fixed income-focused investors as well as the repo. I think we're on track this year for an all-time high in terms of our repo activity.

Back to the M&A, I'm going to hand that one to Vince to talk more about the alternatives there.

Vincent T. Roche - *Analog Devices, Inc. - President, CEO & Director*

Yes. So as you know, you've seen, over the years, we've always acquired very, very high-quality assets, and that will remain to be our view on things in the years ahead as well.

Operator

Your next question is from Blayne Curtis of Barclays.

Blayne Peter Curtis - *Barclays Bank PLC, Research Division - Director & Senior Research Analyst*

Just curious on -- if you look at the B2B guidance, it's fairly flattish. I think Industrial probably is flat, given the segment guidance you gave. So I'm just kind of curious as you look at this, obviously, you had strong comments on the bookings. Is that gap really supply? Or are you starting to see demand trends start to settle out at this level?

Prashanth Mahendra-Rajah - *Analog Devices, Inc. - Senior VP of Finance & CFO*

That is purely supply. I think I mentioned in maybe the first or second question that book-to-bill for the quarter was over 1.2, and that's across all markets. So we're seeing very strong interest in products across all markets.

Mike indicated in one of the other Q&As that we're likely to have the industrial markets hit an all-time high collectively for fiscal year '21 and expect that to continue to be on track, to have another record in FY '22. So very much a supply-constrained environment.

Blayne Peter Curtis - *Barclays Bank PLC, Research Division - Director & Senior Research Analyst*

And I just wanted to follow up on the gross margin, Prashanth. So you indicated the gross margin would be up, and I think that's with the license impact as well. So you saw a benefit from the linear. Just curious how much more there is of that as a benefit. And then maybe just talk about utilizations and other pulls on gross margin as you look over the next couple of quarters.

Prashanth Mahendra-Rajah - *Analog Devices, Inc. - Senior VP of Finance & CFO*

Yes. So I presume you're asking kind of with respect to the guide. So in the fourth quarter, we -- and we're not guiding gross margins, but we're pretty confident we're going to hit a new record for gross margins. That is coming from the LTC synergies. We're continuing -- I think we hit the final phase of closing down the manufacturing operation in California. We still have an opportunity, as soon as the supply environment allows us to, to get some additional savings out of Asia because we haven't closed that facility yet because we have no time to ship the tools to their new location.

Utilization is also going to provide some level of increase. I would say mix is a bit of a headwind into the fourth quarter. And fourth quarters typically have some level of challenges in terms of holiday shutdowns, so we need to manage through that, which can provide a little bit of headwind for us as well that we got to work ourselves around.

Vincent T. Roche - *Analog Devices, Inc. - President, CEO & Director*

The foundation for our gross margins being where they are is, number one, innovation. We produce the best forming -- the best-performing solutions between the physical and digital worlds, and we get a premium. We get very, very well paid for doing that.

Also the diversity of our product and customer portfolios, 125,000 customers with, I think I've said this before, 85% of our sales come from products that individually contribute less than 0.1%. And the pricing environment, as we said earlier on the call, has been very, very stable, very steady.

Operator

Your next question is from Harlan Sur of JPMorgan.

Harlan Sur - *JPMorgan Chase & Co, Research Division - Senior Analyst*

Congratulations on the strong results and quarterly execution. Channel inventories continue to remain below your target 7- to 8-week range. You guys can also monitor direct customer inventories, at least for those that are on consignment programs. Any signs that customers have been able to build inventories? I mean, it seems unlikely because the entire value chain appears to be sort of hand-to-mouth from a chip supply perspective. But wanted to get your views. And when do you believe customers will be in a position to start to build back inventories? I'm assuming the soonest is sometime in calendar '22 but wanted to get your views as well.

Prashanth Mahendra-Rajah - *Analog Devices, Inc. - Senior VP of Finance & CFO*

Yes. Thank you, Harlan. So I'll take that. So first, a couple of comments on inventory. Inventory on our balance sheet is up year-over-year and sequentially, but that is exclusively due to raw materials and WIP. We can't keep a finished good in stock. So when it's produced, it either goes to the customer or it goes into the channel, and then it goes out of the channel immediately. So we are struggling to build finished goods inventory, both in ADI warehouses as well as in our channel partners.

Roughly -- well, let's say a significant amount of our Auto business is on consignment, which gives us good visibility for that direct business as to what's happening there. And that is also -- we're seeing that demand kind of pull through pretty quickly and no opportunity for those auto customers to build the inventory within their warehouses, but that's on our books.

So it's still very much hand-to-mouth, and the focus that we have, as we've talked throughout this call and in the prepared remarks, is on increasing our capacity or ability to supply by making some significant investments in capacity. I don't see this balance coming into some sense of normalcy until sometime in calendar year '22.

Operator

Your next question is from William Stein of Truist Securities.

William Stein - *Truist Securities, Inc., Research Division - MD*

Great. Prashanth, you just talked about inventory not coming to sub-level of ability to rebuild anything until sometime in '22. You talked about the supply-demand imbalance lasting well into '22; 1.2, book-to-bill; et cetera. When we look out to the next, next quarter, the January quarter, typically, that's a sequentially down quarter in Automotive, Industrial, Consumer and for the whole business as well. But given these supply constraints and this very significant backlog, should we think about that seasonality as different in the coming year? Should we expect maybe some visibility to sequential growth for the next several quarters?

Prashanth Mahendra-Rajah - *Analog Devices, Inc. - Senior VP of Finance & CFO*

Yes. I think the way to answer that would be to say that seasonality in today's environment is a bit of a meaningless concept because revenue growth is really dictated completely by supply. So the print for Q1 is likely to be driven by what more capacity we can get online between the fourth -- over the fourth quarter to allow us. Again, now we've got a couple of things we need to work through in the first quarter that won't -- that would be a little bit of an offset.

First, there's the holiday season, so we do need to adjust factory capacity for that. And Consumer, fourth quarter is kind of the key quarter for Consumer. That's when they build for the holiday season. So there's always going to be a little bit of seasonality impact for Consumer, just because of the -- they don't need it in the first quarter or our fiscal first quarter as that is the holiday period.

So maybe that's kind of where I'll finish, Mike. Anything you want to add to that?

Michael C. Lucarelli - *Analog Devices, Inc. - Senior Director of IR*

Yes, sure. So I guess if you look back, you're right. I mean, we talked about seasonality not being as meaningful now. But just to give you a bit of a history lesson, if you look past over the past 10 years, you're right. Our B2B markets, I would say, in good times, which I would call now good times, is usually flat to down slightly in 1Q. And Consumer, I would say, in good and even kind of normal times, is down kind of 5% or maybe more in 1Q.

And with that, I want to thank everyone for joining the call this morning. A copy of the transcript will be available on our website, and all reconciliations and additional information can also be found in the Quarterly Results section. Thanks again for joining and your continued interest in ADI.

Operator

This concludes today's Analog Devices conference call. You may now disconnect.