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ADI - Analog Devices Inc at BMO Capital Markets Technology & Digital Media Conference

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PRESENTATION

Ambrish Srivastava - BMO Capital Markets - Analyst

Thank you for joining us. We have Ali Husain from ADI. So, I'm assuming everybody is familiar with the ADI story. So we go straight into the Q&A, Ali. I'll put you on the spot.

Ali Husain - Analog Devices, Inc. - Director, IR

The good stuff, yes.

Ambrish Srivastava - BMO Capital Markets - Analyst

Maybe we can just start off with -- we'll start off with capital structure, shareholder return. We always view and I think most investors view ADI as a very shareholder friendly Company.

So you made an acquisition now, not something you do typically. So just help us understand, has anything changed with you think about capital allocation post-Hittite?

Ali Husain - Analog Devices, Inc. - Director, IR

Yes, I think it's second verse, same as the first, to be honest with you. I mean I think what we're doing is returning 80% of our free cash flow to shareholders. The lion's share of that will be from the dividend. We are focused on increasing the dividend. In fact, we have a goal to increase our dividend by 5% to 10% every year, and I think you'll see ADI committed to that.

What gets us up to the 80% is the share buyback. And you know what we do is a fairly programmatic approach, and it really looks at rolling averages for our stock price.

So to the extent our stock price breaches the various rolling averages for our stock, the program essentially on its own goes and executes. Over the last year or so, our stock price has been fairly up and to the right.

So we did take advantage about 10 odd months ago to make the buyback program more aggressive so that when it does trigger, it does by a meaningful amount of stock.

In the last quarter, there was some volatility, particularly in the semiconductor market, and we were able to purchase back a fairly meaningful amount of stock. We bought back about 4 million shares in our prior quarter, and really that's what the program is designed to do is, when the stock goes a little lower, that the program executes. And we think that's a good way to get cash back essentially to shareholders and be a good way of returning capital basically essentially to shareholders.

The third, I guess, leg to the stool of capital allocation is what Ambrish asked about, it's about M&A, and historically ADI hasn't been very acquisitive on a larger scale. We tend to do kind of smaller deals where you pick up some very good engineers and add some capability to what we currently are already doing on the signal path, signal conditioning.



What we did on the Hittite deal was pretty unique for us. It's a larger deal, and it's really a question of customers looking for more and more microwave and millimeter wave capability. ADI was able to scale up to 6 gigahertz on the frequency spectrum, and now we basically go from 6 gigahertz that ADI had, all the way up to 110 gigahertz.

Now, we were building our capability, with Hittite we get that ability right away. We get the ability to convert the entire frequency spectrum. So as more and more things get connected, as more and more things move up the frequency standards, for example 4G moving up to 5G in the communication space or in the area of radar-based ADAS systems in automotive moving upwards from 24 gigahertz up to 77 gigahertz, these are all things that we can now do. And I think it's a meaningful differentiator for us versus the competition.

So, now looking forward, I think really at the end of the day for ADI when it comes to M&A, it's going to be driven by what our customers are asking us for. In the Hittite case, like I said, the customers were asking us for more and more microwave and millimeter wave capability. And I think that's really going to be kind of the strategic driver for M&A for ADI going forward.

That said, you know the numbers still have to work. So in the case of the Hittite transaction, we got some pretty good financial synergies.

In the first quarter here, the fourth quarter that we just reported, it was our first quarter with Hittite, we had 8% EPS accretion. Our estimate is that we will be able to accelerate that to about 10% in our fiscal 2015, and further accelerate EPS accretion in FY16 to about 15%.

And so that's kind of how we think about capital allocation as a whole. ADI isn't the most acquisitive company. I don't think we'll ever be the most acquisitive company, but I think we are open to it when our customers are pushing us to get a certain type of technology, and we make the buy versus make decision, and when it makes sense to buy, we do.

Ambrish Srivastava - BMO Capital Markets - Analyst

So maybe we could just stay with Hittite. You recently turned on the Hittite catalog to broader ADI salesforce. I think it was a release that went out yesterday or a couple of days ago.

So what's the feedback you're getting from customers, initial feedback, and when you think about the top-line synergies that you can get before you turn on the actual jointly developed products, which probably comes a couple of years from now, so what's the initial response you're getting?

Ali Husain - Analog Devices, Inc. - Director, IR

Yes, so the press release that Ambrish is talking about was issued yesterday, and we at ADI have now switched on the Hittite parts, and we are able to stock them at our distributors - we are talking the major players in the US, Arrow and Avnet, and also internationally.

And so historically, Hittite's products, they have about 1,000 standard products that are actually quite well-suited for the distributor channel, and yet they were basically underutilizing it. They had about 2% or 3% of their sales running through distribution.

ADI has about half of our sales running through distribution. So I think by virtue of a better and more efficient use of the channel, and a wider scale, I think we are going to be able to get some synergies there.

In addition, as Ambrish also mentioned, we do have a salesforce that's probably 7 to 8 times larger than the salesforce at Hittite. So I think that's again another tool that we have in our toolbelt to accelerate some revenue synergies there.

That said, I think we've been fairly conservative. This is our first major transaction, and so part of it is just to kind of see how things go. But to your point, we have turned on the distributor channel, we do have our salesforce now out there talking to customers, and the feedback has been absolutely phenomenal.

I mean my first answer to your first question about M&A was, the customers were really pushing us for the technology. So we've gotten unbelievably good feedback in the area of comms infrastructure, in the area of industrial, even in defense and aerospace, which is an area Hittite has been very focused on as well.



And even with automotive customers, with ADI we were pretty strong at 24 gigahertz, ADAS systems, and now with the Hittite capability, we can really scale up the frequency spectrum. So I think that's again a meaningful differentiator for us.

To your point, it's early days yet, but we've only been together as a company for about four or five months, and we've already started to win designs.

And you know, there's a couple of scenarios: one is ADI was potentially -- we were fighting to keep a design, and by virtue of having the entire signal chain and the entire frequency spectrum, we won the entire design. So that was one thing.

The other thing was there have been cases already where Hittite was struggling to enter a particular customer, but because of the scale and ADI's signal processing technology, we now have the entire design.

So to your point, Ambrish, it takes a couple of years for these designs to ramp to revenue, but we're pretty confident that they will ramp to revenue. You'll probably see it starting in kind of the -- I think it will start in earnest in 2016 and accelerate further from there.

When we think about the revenue synergies, I think we haven't really modeled much in terms of revenue synergies for 2015 and 2016, just given the designs -- just how long it takes for the designs to ramp. But I think when you look out from 2017 and onwards, we expect to see pretty meaningful revenue synergies from the deal.

Ambrish Srivastava - BMO Capital Markets - Analyst

So then maybe you can zoom back up to the \$4 to \$5 EPS target that you laid out at the analyst day?

Ali Husain - Analog Devices, Inc. - Director, IR

Yes.

Ambrish Srivastava - BMO Capital Markets - Analyst

That is -- it's a pretty decent EPS growth, and so I have two questions on that. And you and I had some discussions from that. The first one was it is very unusual for a chip or an analog company to be able to target that far out. So what was the the guiding principle behind that?

And the second question is embedded in that, what are the assumptions that you have for top line or synergies with Hittite and for core analog?

Ali Husain - Analog Devices, Inc. - Director, IR

Sure. So you are absolutely right. This was actually pretty new for analog semiconductor companies to lay out an earnings target. Your colleagues on the sell side I think most of them didn't appreciate the EPS target. But I was actually at an industrial company conference just last week here in New York. As I think the industry is maturing, I think we are finding traction with more generalist type investors that are kind of open to our story.

And one of the comments I got back was we love the fact that you have this annual EPS target of 8% to 15% growth every year, which is kind of unheard of for the industrial space, and yet we're perfectly capable of delivering that. And secondly, we're kind of speaking the language of \$4 to \$5 and giving out an EPS target. And I think that's pretty meaningful as well for kind of a larger investor base.

Now in our most recently reported fiscal year, we did non-GAAP EPS of \$2.39, so \$4 to \$5 is effectively doubling it. And to your point, Ambrish, I agree that is a meaningful increase in the earnings.

Now the reason we actually gave the target wasn't, frankly, for investors, although clearly it was, but it was really more for our internal folks at the Company. It was really for "how do we want to run the Company for the next four or five years?"



And I think what it does, it really does instill a discipline in the folks that are managing our Company. It's great that we are putting out fantastic products, which we are. It's great that we are thinking about topline growth. It's great that we are focused on that, which clearly we are, but it's also a lot about what does that mean in terms of earnings growth.

And so putting this target out, I think, and having the Company driving toward it, I think is really what we were both focused on when we laid out those targets.

Now, we have, like I just mentioned, a target to increase our annual earnings per share by 8% to 15%. If you run that math through the model, you get to essentially \$4 to \$5 by the end of fiscal 2020. And I think the drivers are going to be topline growth. We have a model of driving growth of 2X to 3X that of real-world GDP. And I think there's tremendous trends in the markets that we play in that will drive growth for ADI.

There's also leverage in the model. We have a model to convert our sales at 65% to 68% in terms of gross margins. We are currently around 66%. So I think there's some leverage there. We are going to be very watchful on our OpEx. So I think there is a good amount of leverage in the model. We are still focused on buying back shares to at least keep the share count flat. So I think that will get us to earnings per share growth per year, and then that gets us to kind of the \$4 to \$5 by the end of 2020. But, Ambrish, to your point, certainly we live in a cyclical industry, although to be perfectly candid, we think the cyclical nature recently has been a little more muted.

So if there's a cycle in 2020, then all bets are off. But to my earlier point, it's about instilling a discipline within the Company and how we run the Company and focus a little more on our earnings growth.

Now, I like the way you intro'd that question because it is a target. It's not a roadmap, and I think there's a meaningful difference between the two. A roadmap means that you're going to do whatever it takes to get to \$4 to \$5, even if it means cutting into the muscle, which that's not what we are about. We want to grow this Company profitably, and that's really the key.

Now again, like I said, if there's a cycle in 2020, all bets are off. But I think based on the discipline we have in the Company, to get to that target, based on the markets we are levered to, I think we are going to grow. I think we are going to grow profitably, and we are going to hit that target.

One last point that I'd like to make before my time is up: the biggest headwind to growth for ADI in the recent past has been the transformation. It's been a fundamental transformation of our business. 30% or 40% for sales, just about three or four years ago was from the consumer end market.

We've really refocused our R&D spend, and what ends up happening is in the consumer space, when you pull away, particularly in the commodity areas, your customers, they leave you tomorrow. And if the thesis is that you take those dollars and you invest them in industrial, automotive and comms infrastructure, there is a design ramp, and it takes a while for revenues to ramp.

So I can tell you in the near term, certainly our topline has been impacted. But if you look at the core growth rate, it's been very good. High singles kind of 10% growth, and our expectation is that we're levered to the right market, and that we are not going to have this drag from consumer on our topline going forward. So I think we feel really good about 2015 and beyond, frankly.

Ambrish Srivastava - BMO Capital Markets - Analyst

Good long-term stuff on how you're running the business. Just a point --

Ali Husain - Analog Devices, Inc. - Director, IR

You didn't ask me about bookings trends (laughter).

Ambrish Srivastava - BMO Capital Markets - Analyst

We all know what visibility is, right? It's not a lot. So just on consumer, consumer actually could be a driver for growth in 2015, right?

Ali Husain - Analog Devices, Inc. - Director, IR



Yes.

Amrish Srivastava - BMO Capital Markets - Analyst

Great. So my point is that -- so that's what was a headwind could turn into a tailwind. Is that a curse? Is it just something I like to use the word ephemeral, which is fleeting, or it is something you think is a little more sustainable than what you had last time?

Ali Husain - Analog Devices, Inc. - Director, IR

Well, what I'd tell you about the consumer market overall, Amrish, is we play in areas where quality matters for the customer and ultimately for the end customer. So if it's an area that is fairly commoditized, we don't tend to play in that space.

That said, over the last few years, we've actually narrowed down our portfolio and our offerings in the consumer space to really focus on the areas that are high quality, and of strategic benefit to the customer.

So obviously that's brought a lot -- our consumer business, like I said, was a much bigger piece of our business. That could really come down.

So really what's left in consumer at about 10% or 11% of our total sales, half of that, these are very kind of long lifecycle type products in the area of very, very high-end audio/video applications. We're talking about high-end broadcast systems, authoring systems, where the lifecycles are quite long. Profitability levels are actually quite good, but the growth rates are actually quite slow.

So that's one piece of it. And I said probably half of the 11% total consumer is that market.

The other half then is kind of the more exciting stuff, and that's in the area of portable applications. So we're talking about tablets and wearables and smartphones.

And I think looking forward into fiscal 2015, we do have some designs across the areas of consumer in all areas that we play that should convert to revenue. The question becomes: the designs that you're in, how successful are they out in the marketplace? That will obviously kind of depend. For us, I tell you that, like I said, we are in the areas that provide a real strategic benefit to our customers. And I think given that the bleed from the drawdown of consumer, the other parts of consumer behind it, we were doing a lot of sales in the digital camera area, for example. Those sales are essentially gone.

So I think on a percentage basis, I think we should grow in 2015. On a dollars basis, given that it's 10% or 11% of sales, I can't really speak to the magnitude of it. But I would tell you that on a percentage basis, our goal is to grow consumer this year.

Amrish Srivastava - BMO Capital Markets - Analyst

Okay. Maybe you can turn a little bit to the medium-term. And I think if you -- a couple of months ago, there was either a canary or a boy crying wolf, I don't know what it was. Your latest earnings seemed to indicate things were kind of seasonal in most of the end markets.

So to the extent that you can talk about it, just remind us what are you seeing in your business as we are heading into, not just on the quarter, just thinking about 2015 and the various drivers that we should be thinking about. And I know the business is very broad-based, but how should we think about automotives, industrials and comms?

Ali Husain - Analog Devices, Inc. - Director, IR

Sure. Frankly, we didn't really see much volatility in the last quarter in terms of orders. Certainly week to week there are things that happen, but it's all pretty much within a narrow band. Our results, I think, speak for themselves. We did really well this quarter. On an organic basis, we grew better than we thought we would.

And I think looking forward, you know, we are in the first quarter. It's a tough quarter for a lot of folks. That's the January quarter for ADI. We get the holidays in December, and again we get the holidays in the first part of January, which our competitors don't. So it tends to be a quarter where things are weaker because that's just how it is. It's just slower.



But on the flipside, the second quarter is a good rebound for ADI. There's more days of production, and that really benefits our industrial business. The margins tend to be better because industrial is fabbed primarily internally in our fabs. It tends to carry better gross margins. So it tends to be a pretty good quarter.

And then, you know, looking forward in the third and fourth quarter - obviously I have, by the way, no visibility into the second quarter. So I'm just -- if the macro hangs in, I think we will do great.

Ambrish Srivastava - BMO Capital Markets - Analyst

And, if you said, you have visibility, I'll call you and talk, let's say, you know.

Ali Husain - Analog Devices, Inc. - Director, IR

(laughter) Well, given that we deliver almost all our product within four to six weeks, that's a fact, and I have no visibility beyond that.

But I think the trends are good. I think in industrial in 2015, again, all these comments are macro as long as the macro hangs in. But in 2015, I think there are designs on the industrial side that we think should kick into revenue. In the areas of industrial automation, for example, there is a tremendous desire for industrial customers to make their equipment more energy efficient, to make them more connected.

In fact, like I was just saying, I was at this industrial conference last week, and just the theme of more and more connectivity is just so pervasive now over at the industrial companies, and I think we are going to play really well there.

On the automotive side, I think it's going to be a little weaker in 2015 than it has been historically, although I believe it will still be a year of growth. You know, we actually had some investor meetings this morning, and I was explaining the reason for that.

The design wins and the platforms run generally on kind of a five-year period, and we are nearing the end of the five-year period in 2015, and then the new ramps start in the 2016 model year. So when that happens, I think you're going to see a meaningful improvement in our automotive revenues.

That said, I tell you, our goal is to grow automotive at least 2 times the rate of vehicle unit growth. We certainly did that in fiscal 2014. It might be a little slower than that in 2015, but it will accelerate in fiscal 2016 and beyond.

And on the comms infrastructure front, we had a great year this year. Our business grew on an organic basis, I think it grew about 20%. And I think there's unbelievable trends I think for fiscal 2015 in the area of comms infrastructure, specifically wireless base station deployments I think in North America, in China, in emerging regions like Brazil, Russia, Middle East.

Even in Europe, they've already started kind of the coverage phase of 4G LTE. So I think those are going to be great trends. They are also going to be adding in small cells. That's our best indication here yet that the small cell market is going to take off in fiscal 2015.

And so I think, you know, we're really -- I would tell you, Ambrish, for the first time in a long time, we're actually feeling -- we are in the Northeast, we tend to be a little more conservative, and we tend to try to see the world with glass kind of half empty.

Ambrish Srivastava - BMO Capital Markets - Analyst

Are you implying Californians don't? (laughter)

Ali Husain - Analog Devices, Inc. - Director, IR

I don't live in California, so I can't speak for you guys. But I can tell you for us, it's -- we tend to start the year thinking, well, there's all these risks out there, and we will see how things go. I think this is the first year, particularly with the consumer crosswinds behind us here, that we are feeling pretty good about 2015. And as long as the macro hangs in, I think it's going to be a very good year for ADI.



Amrish Srivastava - BMO Capital Markets - Analyst

Good. I'll pause and see if there are any questions from the audience. I'll go back to my list.

Then going back to the big chunks of the business and focusing on automotive and something you said, that sort of should explain we saw the deceleration as we exited the year, right, on a year-over-year basis?

Ali Husain - Analog Devices, Inc. - Director, IR

That's probably fair, although I would tell you the interesting thing about the automotive market is that one quarter doesn't tell the real story. It is just based on kind of how the designs roll off and on in a particular quarter. But for the year, we grew 9%. That's kind of the way you want to look at it is over a longer term.

Amrish Srivastava - BMO Capital Markets - Analyst

Yes, your three-, four- or five-year CAGR is very strong or (multiple speakers) better than anybody you look at.

Ali Husain - Analog Devices, Inc. - Director, IR

Sure, yes.

Amrish Srivastava - BMO Capital Markets - Analyst

And then the point there that you're making about the new ramps coming, so when we think about next year, that's the older -- there's a five-year window kind of rolls down and then you start to see the ramp after that, right?

Ali Husain - Analog Devices, Inc. - Director, IR

Yes, I think that is a fair statement, Amrish. I think 2016 is going to be a really good model year. We've got the design wins. We've got the visibility. There is an unbelievable desire to fit more and more electronic content into vehicles. We're seeing that. We've seen that in our automotive business. I think it's a step function basically improvement then in 2016 and beyond with more and more government mandates kicking in in the area of safety and fuel efficiency and, frankly, manufacturers responding to consumer demand for having more and more electronics in the cabin.

The other thing that I think is a little bit interesting for ADI is that historically our automotive business has been much more focused on the high-end premium kind of European vehicle manufacturers and North America. But it really hasn't had much traction in Japan and Korea, but that does switch on in 2016. And so I think certainly there's this content story playing out overall, but then specific to ADI I think in 2016, we start to see more regions contributing to our growth.

Amrish Srivastava - BMO Capital Markets - Analyst

Interesting. So the mix is changing. And what's the -- if you compare the last big tranche of designs you had versus what you're getting into, what is the total content, and how would you compare the content that ADI gets versus what you had before?

Ali Husain - Analog Devices, Inc. - Director, IR

Yes, I think I don't want to throw out a broad -- it might be an overgeneralization. But I think the sense that we get is that in order to play in the automotive space, you need to do two things. One is you've got to be able to deliver at a very, very high quality and reliability levels, which ADI does. You've got to have a heritage in this



space. We've been delivering products into the automotive space 1991. And so we've been playing in the space for a long time. We've delivered the quality levels that the automotive folks require and we do that. There was one more point that I wanted to make, which I --

Ambrish Srivastava - BMO Capital Markets - Analyst

Zero ppm requirement?

Ali Husain - Analog Devices, Inc. - Director, IR

Yes. But there was another point I was going to make, but I can't remember what it was.

Ambrish Srivastava - BMO Capital Markets - Analyst

Right.

Ali Husain - Analog Devices, Inc. - Director, IR

But in any event, I think you know from the automotive space, I think we're super well-positioned. I think it's going to be a great grower for ADI.

I think 2015 is going to be fairly anomalous. I think it still grows. Maybe it doesn't grow as much as it has the past, but then it accelerates into 2016 and then going forward, I think we'll do great.

Ambrish Srivastava - BMO Capital Markets - Analyst

Thanks for the transparency, and thanks for your time.

Ali Husain - Analog Devices, Inc. - Director, IR

Sure.

Ambrish Srivastava - BMO Capital Markets - Analyst

Appreciate it. Thank you very much.

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