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EDITED TRANSCRIPT

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OVERVIEW:

Company Summary

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CONFERENCE CALL PARTICIPANTS

Stacy Ras *Bernstein - Analyst*

PRESENTATION

Stacy Ras - *Bernstein - Analyst*

I guess we can get started. If we get any stragglers. Is it still morning? I guess it's sort of morning. Yeah, late morning, everyone. I'm Stacey Raz. Sorry, I cover the US semiconductor sector here at Bernstein. And it's my great honor to introduce our guest today, the CFO of Analog Devices, Mr. Rich Puccio.

Before I start, I want to mention if you have questions you'd like to ask during the presentation or have asked, you have a link to our pigeonhole form where you can submit them, and we will have time for Q&A at the end.

So all the companies that I cover, Analog Devices is probably one of -- if not the most respected, an extremely high quality franchise in the analog space, particularly as it relates to signal conversion and processing.

And they've really transformed over the last, it's probably 15 years now. I mean they rationalize their product portfolio way back in the days focusing on high value applications like whatever the market. They've executed on a really well done hybrid manufacturing strategy that's offered flexibility as well as supported margins in downturns.

They've not been shy to take advantage of inorganic opportunities where available to boost the franchising growth potential, and they're now, embarking on more aggressive capital return than we used to see a few years ago, which is good. And just tell us all about it. It gives me great pleasure to introduce.

So thank you so much for being here today.

Richard Puccio - *Analog Devices Inc - Chief Financial Officer, Executive Vice President*

Thank you, Stacy.

QUESTIONS AND ANSWERS

Stacy Ras - *Bernstein - Analyst*

So you were here last year too, and I think you said that was your sort of very first sort of public appearance as a CFO of Analog Devices. So you've been in the job about a year, like I'm just curious like what have you -- what surprised you? Any regrets?

Richard Puccio - *Analog Devices Inc - Chief Financial Officer, Executive Vice President*

So certainly no regrets. And I think when I sat here a year ago, I talked a little bit about one of the surprises to me, even though I did a ton of research before I joined the company. One of the surprises was, digging in to see how sticky and how long the products are, and Stacey talked about the

analog franchise. When you get inside and look and see that we have products that are still producing revenue 25 years after they launched. Do you show that chart with the sediment chart, I think, is what we've gotten to calling that is showed.

The thing that became even clearer over the last 12 months to 15 months as we continued through what was, for us the second worst downturn we've ever experienced as a company was the resilience that our business model demonstrated. And a big piece of that is what you just described is our hybrid manufacturing process which gives us a level of flexibility as we go up and down in the cycle to manage the utilization of our factories.

But at the same time, the other thing that was happening, and I think this also speaks to our resiliency, is our sales teams and field teams were cranking on generating new design wins across our portfolio. So you know if you go back to the prior years where we were generating peak amounts of revenue and then followed that with two straight years of very strong double digit growth in design wins.

And for us that's a really good indicator of the potential for growth in the three year to five year out period. So seeing that resiliency in the face of what was a very challenging. I think Vince has been quoted a number of times saying it's the worst inventory correction he's seen in his entire career. And for the company to manage through that and hold the line pretty well considering the severity from a margin perspective. I thought that was an incredible testament to the business model.

Stacy Ras - Bernstein - Analyst

Maybe it's worth jumping ahead then to that margin question. So I remember when I first started this job, I think the peak margins of the business were -- maybe upper 50s. And then there were some actions taken around the financial crisis. I mean there were some business exits. You think you're one of the few guys to actually get paid to sell a cellular modem business.

I don't think anybody else has managed and there some other businesses -- and then there was some portfolio manufacturing footprint rationalization back in the days. There was Ireland and Santa Clara, I think, and Cambridge in Massachusetts.

And I remember we came out of the financial crisis and all of a sudden now the trough margins were higher than the peak margins used to be. They were kind of like high 50s to low 60s. And there was sort of further improvement and then you did some fairly creative acquisitions. You bought Linear, which I think had the highest gross margins like bar none in the space like mid to upper 70s and then maxim which had 70s.

You sort of talked about gross margins probably holding in that 70% range. It didn't quite get there, but high 60s for the 67 I think is where bottom maybe ish -- for the magnitude of the revenue to decline that we had around the cycle, I think is pretty damn impressive personally.

So maybe you could talk a little bit about that manufacturing, the hybrid manufacturing strategy. How does that work? My understanding is you're licensing processes from TSMC and the capacity is fungible. Like how does that actually work because there aren't a lot of other companies that have been able to pull something like that off at scale.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Yes, so great points on the margin and yes, we were disappointed in defense of my IR team that built the long term model in '22. I think they contemplated some downsides. I don't think they contemplated the severity. So for us to hold pretty close to 70, we felt really pretty good about that. So what the company has done -- what we've done from a flexibility perspective is what you described, we have the ability to produce at this point -- the majority of our products can be produced in our own factories or in our external --

Stacy Ras - Bernstein - Analyst

What percentage of the of revenue.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

So by end of this year we expect about 70% of our -- 70% of our products to be able to be manufactured internally or externally, and I always caveat this. That's not a statement that we would move 70% of our stuff out. We still tend to run about 50/50 internal external.

Stacy Ras - Bernstein - Analyst

Is that 70% of revenue as well, or?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Yeah, it's 70% of revenue as well. So if you think about that, what it means for us is when things were going crazy in the upturn coming out of the pandemic, we were able to go external with and get extra capacity from our founding partners. And so that helped us mitigate our factories during the peak of the comeback were running way above normalized utilization rates. I think even getting to 100%-plus at one point theoretically, but significantly above the sort of ideal utilization rates. So then you look at the trough, peak to trough drop across any of our market.

Stacy Ras - Bernstein - Analyst

How much was it? It was more than 30%.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Right? It was about -- I think it was about 31% or was it, did it go to 34% in the last quarter? So it was north of 30 peak to trough. And for us to be able to maintain a margin in the high 60s, part of that was our ability to bring capacity back in.

Now you can't do it overnight, but with some notice period, we can bring back some of the products that we might be using at an outside foundry into our factories to help keep the utilizations from going down because you talked about this before, right? If you look at the peak margins that you were talking about, say you go back even the most recent peak margins in the '22, '23 time period, where we got operating margins up in the 50s.

You look at the revenue drop from then, there were sort of two primary drivers to the margin hit. One was underutilization in the factories and the variances that got thrown off was a very significant headwind for us because we were well below utilization levels that we would be at historically.

The other piece of that was at the same time. The industrial was feeling it pretty hard. And so if you go back and look and I think in '23, our industrial business was about 53% of the overall business. It's also our highest margin business.

So now you go back and look at the last quarter, it's down to 44%. And so that is those two items were pretty significant downward pressure on the margin and to hold other than I think one quarter we should dip below to hold greater than 40% operating margin at the bottom of the trough. That is attributable to that factor.

Now the other piece that because it will come up eventually when you talk about OpEx. The other thing is we have a variable comp plan. It's in our proxy, so I'm not disclosing any state secrets. Our variable comp plan is driven by operating margin percent and revenue growth.

So in the trough, there's zero revenue growth and that 40-ish operating margin, there's not a lot of variable comp. We're now in a period where we're moving up a little bit in the operating margin but significant year-over-year growth. So you saw it actually because it was in we just talked about it in my prepared remarks.

The impact of variable comp was the entire growth in our sequential growth in our OpEx. So we've been talking about this since -- I think we did guidance in Q4. For fiscal '25, we expected to see less operating leverage than you would normally see in a year with this much revenue growth because we're going from paying very low variable compensation to a pretty significant step up.

But if you think and you move out a little bit longer term or even a year later, the step up in variable comp, even if we continue to grow in '26, doesn't look like it did in the current year. So we would expect the margin operating margin expansion to improve as we get into outer years. So but if you go back to your original question, that ability to swing because we have qualified those products, gives us an advantage over many of our competitors.

Stacy Ras - Bernstein - Analyst

It must be difficult to measure. You have what 100,000 different products? I mean --

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

I think the last count is 125,000, but in fairness, a much sorry. I said what I say?

Stacy Ras - Bernstein - Analyst

As customers, okay, 70,000 products.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

75,000 SKUs and got it backwards. But anyway, if you break it down, a much smaller percentage of the 75,000 SKUs generate the majority of the revenue. So yes, it is. But at any given point there is a subset of subset of our SKUs that are not moving. And the fast movers make up a bigger piece of that. So it does make it a little bit. But yes, kudos to our operations team for their ability to manage that with our external foundries and our internal factories. Got it.

Stacy Ras - Bernstein - Analyst

I do want to talk about growth. So you guys have had -- maybe long term is not quite there, but you give likeivity like three year targets for growth, and it's 7% to 10% at this point off of. I can't remember what the base was the base 23%? I can't remember.

In '22. Okay, so we're almost through it, but maybe you could give us a little bit of color on like where does that growth actually come from and the question is you said something on the earnings call which I think that was a statement for this year, but you felt confidence in that target. But what are the drivers behind those targets?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Sure. Actually I'll do a little bit of a recap of how we actually built out the model when they're doing it because I spent a fair amount of time in my first month at the company trying to make sure I was comfortable with the long term models.

So if you think about the historical growth in the space, and say it's a 5% kind of CAGR business, and then we looked at it and said, what are the things that differentiate us, whether it's from an idiosyncratic driver or other things that will allow us to grow it faster than that, sort of cager that we've seen historically.

So one, the pricing dynamic for ADI has changed. If you think about the historical Moore's law world where every year semis went back and gave back big slugs of their savings to customers. That changed, right? Things became very inflationary that model did not continue to work and we've been pretty disciplined.

So one of the things we haven't been doing is giving back large slugs of the price increase. So if you go back again '22 when we did our analyst we had pretty significant portion of our growth, and I think we talked about it was driven by price increase.

We saw a pricing tail within '23, and as I've talked about '24 was pretty stable pricing for us. We expect '25 to be pretty stable. So if you just think about not giving back that pricing gain, we think that's worth at least a point of growth off of that 5% baseline.

The second piece we've talked about is when we acquired maximum. We set a target out there to get a billion dollars of synergy -- revenue synergies by 2027. Okay, so if you think about the progression we're on, in the '24 we did sort of the tens of millions of synergy revenue. In '25 we'll do hundreds of millions, and we are on track to do a billion dollars worth of revenue synergies for maximum. So if you go off of a \$10 billion dollar base, that's another point.

And the third point is that -- because the industry tailwinds where we participate across a number of the sort of biggest trends whether it's automation, electrification, robotics, think about all this and the other pieces the idiosyncratic parts of the business where we've got specific design wins and our end markets that are now producing revenue.

So if you think about and we've talked a lot about this this year, AT our test business has been growing gangbusters and that's being driven by the -- as are many of these being driven by the AI boom, right? You think about the high performance compute, the high bandwidth memory, those all require more testers. That's been a big benefit for us. So that has been growing significantly for us.

On -- also on the AI side, if you think about what's going on from a power and connectivity perspective, we see we have winds in in both of those areas that show up in our wireline slash data center business, that's strong growth.

In our auto end market, we've got GMSL, which is a fantastic technology. What is that for the audience. The it's the connectivity for video inside of an automobile. So for us it's a chip at the at the edge, which is at the microphone of the camera and excuse me at the camera and then back at the central com compute. So that that GMSL has been powerful and that's actually one of our big synergy drivers is GMSL.

If you look at aerospace and defense, we've got a number of design winds in there, and that's a market we expect to continue to grow given defense budgets everywhere in the world are being increased. So we think that's a good piece of a tailwind for us.

And then the other piece is, over the last number of years we've significantly diversified our consumer business. And we have a number -- we've talked about this a number of new design winds that are ramping, and we're seeing growth across the portfolio whether it's in handsets, whether it's in hearables, wearables, gaming. So those are all areas continuing to grow and I think we've grown where you see that in our consumer business, we've grown consumer, I think 30% in three straight quarters.

So I feel really good about those, and those from an aggregate just in '25, we think those are \$500 million worth of incremental revenue. So we think in total the idiosyncratic and the markets is worth another billion. That gets you sort of above the midpoint, right around in the 7 to 10 above the midpoint.

And then we think that the additional areas just is better execution across the Board in those areas can get us to the high end. And so we -- like we said, we feel pretty good about where we're going, and I did make a comment on the call.

Stacy Ras - Bernstein - Analyst

I wanted to ask you about that.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

You going to ask, I'll let you ask that.

Stacy Ras - Bernstein - Analyst

Well, the question is you said you felt for the year, you felt increased confidence about hitting the high end, which is 10%. But I mean that would actually put Q4 down a ton. Like did you just kind of -- did you speak there or like what?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

So in hindsight, I would call it a misspeak at the time. I'll tell you what I was really just trying to do was express confidence that I had more confidence in the year '25 than I did 90 days ago. Because if you just take a normal seasonal quarter for us in the fourth quarter, we will be well above 10%, more or like 12%.

Stacy Ras - Bernstein - Analyst

If we unfortunately us, like we do --

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

You all went he just soft guided the quarter down the fourth quarter down 7%, which is not what I intended do. In fact, a seasonal quarter would put us above the range. That was a confidence statement, not a guide.

Stacy Ras - Bernstein - Analyst

Got it.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Okay. So sorry for the confusion for anybody who heard that comment, but that was just me being more confident. And look, the confidence stems from we started saying in Q2 last year that we had to hit the bottom and we were going to start seeing growth. We saw sequential growth in Q3 and Q4. We had our -- we're almost flat in Q1, but a slight decrease in Q1. And then one of the things that happened in Q1 is what we've been waiting for is to see some of the broad market industrial start to grow.

Stacy Ras - Bernstein - Analyst

We've been in a downturn there, I don't know, 8 quarters, 10 quarters for you guys, however long it was.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Yeah, two years. So to see some broad market growth to us was one of the first signs that we were starting to see the industrial, maybe a start of a cyclical. Well, that trend continued into Q2. We delivered very strong results in Q2 and we're guiding a Q3 with 10% growth, at some level coming out of that quarter for us, we were waiting for the because typically you see a bit of an upturn like this when you're starting the cyclical upturn because the question has been for a number of quarters, when will we see a more familiar looking upturn.

Now do we know the exact slope of that upturn line? No, but does it look like it's getting a little steeper for us right now? Absolutely. And so that's important. Tie it back to the first part of this conversation is if industrial starts to, outgrow the rest of our business, that's a margin, a creative thing for us because at the standard at the gross margin line that's the highest gross margin business we have.

Stacy Ras - Bernstein - Analyst

That makes sense. I guess with with that recovery, and it sort of ties to the auto piece as well, right? So auto was pretty strong in the quarter, but you used sort of the dreaded p word on the call. It's funny like you sort of look at the stock that evening, it was kind of good until we said pull forward.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

I might have gotten a few snap screenshots of the ticker, after that session pointing out my commentary, yeah, but thank you, Stacey, for pointing it out again.

Stacy Ras - Bernstein - Analyst

Look, but I mean, to your credit, like we were talking earlier, I mean you call it like you see it and try to be honest with yourselves and with us, and so I can appreciate that, but I guess what did you see there that suggests that it was pull forward and like what are you seeing now and then I guess the follow on is the upside in industrial. How would you know that that's not also pull forward versus just like broader cyclical recovery.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Two great questions. So we obviously track very closely, we run our whole business on POS, right, how things are selling through and we look at

Stacy Ras - Bernstein - Analyst

is the report sell through actually like versus --

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

We won't comment about what the accounting folks have done to us. But we do run the business on the POS signals, but we also -- so we're looking at POS bookings pretty regularly. And as we watched the quarter progress, we were seeing what we expected as we had forecast of the quarter and growth in bookings across our end markets.

And then what we saw was right around the time of the introduction of the auto tariffs, we saw a spike in automotive bookings. We also started to see increased turns business in the automotive space. And that lasted through liberation day and for about another week. But after about three weeks of that anomalous behavior, it sort of normalized back down into the weekly ordering patterns that we would have expected.

So when we looked at that -- first we didn't see that kind of anomaly in any of the other end marks. So we don't have perfect visibility that what we said was Poland was all Poland. We don't have perfect visibility that we called no Polands might have had some. But we didn't see any of the significant anomaly that we saw in automotive. So we talked about on the call that we thought, the Polands could have been half of our beat, from an overall perspective and seeing it normalized back down was one of the signals for us that it was likely to pull and it was hard for that to just be a coincidence.

And I understand we had lots of discussion and debate about this, but ADI and this predates me ADI has always been as transparent with the facts as they can, so we continued that trend. Now I think, one of the things we've been super focused on is Q3's guide. I'll just talk about automotive, right?

Q3's guide we guide it down, but largely we guide it down because of the pull-ins. We don't actually think the pull-ins came from Q3, which is why if you factor out the pull-ins in Q2, we're essentially guiding a seasonal Q3 in auto.

Now what we're focused on, and as you and I were talking before we started, our industry is plagued by the lack of longer term visibility on where things are headed, but we are actively monitoring and tracking what's the backlog build looks like in the out quarters. Because our suspicion is that the pollen is likely from Q4, Q1. And so we will watch that, which is why we think that the Q3 is -- today as we're forecasting it doesn't really factor in any incremental polling activity now.

The rules change every day. They may have changed again last night. Three federal judges, right? So at this point we're staying very close to our customers, matter of fact, we just had our teams out and met with all of our top 100 customers to talk about how things are going and what the rest of the year looks like. And we're not seeing a lot of unusual behavior yet because of the suspension of the tariffs and we're still in potentially a pause here.

So that's the wildcard here and for us the impact of tariffs and the thing we worry most about is just the overall macro impact and the potential demand disruption, right, because you think about the number of places our products go that will wind up getting tariffs if those new tariffs go into place and then the reciprocal tariffs hit, and that could cause some demand destruction. We haven't seen that yet based on the results. But that's the variable we're all planning for.

Stacy Ras - *Bernstein - Analyst*

Yeah. I mean that's been my bigger worry. It's not so much the risk of direct tariffs on semis, even if they're 25% away. It's semi-ASPs over the last five years are up 50% anyways. We can probably handle something like that, but demand destruction and everything else, I don't have any way to get a handle on it, doesn't sound like you guys.

Richard Puccio - *Analog Devices Inc - Chief Financial Officer, Executive Vice President*

No, and look, we're doing all the things that you'd expect, and I actually I had a conversation with a group of economists at the end of last week, and we're paying attention to how they're forecasting GDP and what that might do and how the various economies might be impacted, and unfortunately, at least everything I've seen and heard is that the economy that GDP is likely most affected by this is the US. Right, China is still forecasting 4% GDP growth, so we're continuing to watch that and that will be an important factor for us.

But right now we're most focused on serving customers today, making sure we deliver on our promises because, things could change, but we've got to serve today.

Stacy Ras - *Bernstein - Analyst*

So we'll watch auto into Q4, Q1, please. Maybe that's a good segue actually into sort of your geographical footprint. I'd love to learn a little bit both about your manufacturing footprint as well as your demand footprints. So maybe if we started manufacturing you have internal and external. Just like how are you organized like in terms of where the wafers are actually coming from and packaged.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Sure I'll do the quick tour. So I'll start on the left part of the United States, right? We've got manufacturing capacity, out in Oregon and Washington. You come back to the east, we've got manufacturing in Wilmington, Massachusetts, where our corporate headquarters. We also have manufacturing in Chelmsford, Mass, which is large -- largely in our aerospace and defense manufacturing.

And then we've got a factory in Limerick, and those are the -- in Ireland, yes sorry, Limerick, Ireland. And then most of our back end is in Asia. Our internal back end capacity is in the Philippines, Thailand and Malaysia, and then we've got various partners on the front end from a foundry perspective, obviously our largest foundry partner is the big one in Taiwan, and we have Multiple OSATs across the Asia pack region. So if you think about, and assembly and test is largely outside the US and wafers are spread across US, Ireland.

Stacy Ras - Bernstein - Analyst

Pretty diversified like in terms of a global footprint.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Yes, and that will -- that potentially could be critically important as we move forward depending on how things shift in the macro and the geopolitical. And I guess what about like from an in demand standpoint, so your China revenue, if I was out of 20% something like that it's lower I think than some of your peers. It is -- I think our China revenue is -- China revenue is about is about 20%. We ship in headquarters -- headquarters is 20% by shipping it's about 30s.

Stacy Ras - Bernstein - Analyst

That makes sense. Do you guys have -- there's a lot of that talk about like a China for China strategy. Do you have anything like that or how do you think about that?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

I said I didn't. We have design and sales teams in China and then we have some manufacturing capacity in China. The majority of our stuff is not manufactured in China, but we do have China manufacturing capabilities with a partner, not our manufacturing.

Stacy Ras - Bernstein - Analyst

Okay. So like you have like -- do you have like local foundry partners in China?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Yes. Okay.

Stacy Ras - Bernstein - Analyst

Got it. What are your broad thoughts just on the current like China demand situation, because it seems like -- we seem like, I think auto strength has been pretty good in China, not not so strong in auto like elsewhere industrial maybe is like hit or miss, although maybe that's what are your broad thoughts on that and have you seen any impact just given everything that's going on?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

So interesting. China was the first to go into the downturn for us. It's been the first to come out. We have posted very strong results in China for three straight quarters. A big chunk of that has been the auto demand in China, but one of the interesting things in which I think is an important part of this recovery is we saw a pick up in all of the end markets in China in the second quarter.

So when we look at that, that is a big change because we were still at least 50% off our highs in all of the end markets in China except for auto. So now starting to see some growth in the broader market. Our footprint in China is very similar to our global footprint.

So seeing growth in the industrial in China. Good strong signal that we're, still at the highs, still off the highs, but a good signal that we're starting that cyclical upturn that we talked about. And the other thing is when we looked at it, if you just look at the broad macro demand. We exited the quarter with book to bills above one.

In all the geographies and essentially almost all of our end markets, I think we were slightly below on auto but almost at parity. So really strong exiting the quarter from a demand perspective and what we're seeing.

Stacy Ras - Bernstein - Analyst

Got it. Your larger peer in China has been rumored to be being very aggressive on price. I think there's a view that ADI is maybe less exposed to pricing and competitive pressures, particularly in China, given the nature of the portfolio and the value of the -- would you agree with that statement? And I said, what have you been seeing regarding the competitive environment both with local competitors as well as the multinationals in China?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

So I would say from a pricing perspective China is clearly the most competitive place.

We are not exempted from that competition. I do think that what gives us the ability to withstand some of that competition, is one. We tend to play at the -- we play more at the higher end of the spectrum from a performance and value perspective.

We tend to try to be first into a solution where we can leverage our domain expertise and on top of that, we had our local knowledge and our analog knowledge which we have a significant amount of history on, to be able to capture that high end. And the other thing that we're doing is getting more of the system value or driving system value. So that's that's a place where we play a ton.

Stacy Ras - Bernstein - Analyst

What does that mean? Is that like software or like what is that?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

So it is software. It's also the ability to help integrate into various systems and allow them to perform better because of the Jeff like this where the elegance of our solutions. But the other piece of it is, I guess two other pieces to back to how we're protected on this is. One, our footprint there is very similar to globally, so it's, 70%-plus is industrial and auto, highly fragmented, very -- in the industrial in particular, very sticky life cycle products. So that's a hard area to attack and certainly the design in phase, the price competition is significant, but we do continue to win there and we're also still continue to capture about ForEx, the industry ASPs.

Stacy Ras - Bernstein - Analyst

Now part of what happens. What are the industry ASPs now?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Rough number \$0.40. And so the other piece of it is if you go to the other end of the spectrum, a lot of the capacity that's being built both locally and in Texas by -- in China by the local Chinese companies and also what TIs that they're building over there is much more of the higher volume SKUs. Our game, as we've talked about, has not been to try to pump out as much silicon as we can. It's to go after the value capture. So you look at the Catalog type parts, that's just not a place that we're equipped to compete with somebody like TI given their manufacturing model and their efficiency. So we don't tend to play a lot in that space.

And where you're starting to see, the local Chinese competitors pick up is in that space, but we're relentlessly paranoid because they move fast and they're very aggressive and they will continue to try to work their way up into the higher functions. So our continued drive, and you see this in how we spend our money is to continue to drive innovation and maintain our leading analog franchise.

Stacy Ras - Bernstein - Analyst

How much of what you sell into China is maybe replicable by current Chinese skill sets and capabilities? It sounds like you think that those skill sets are evolving and advancing. I'm curious what that might look like in 5 years or even 10 years because clearly. They're being forced into it, right? The Chinese are putting a lot more resources. They have no choice. They're building a lot of capacity. They're going to have to fill it with something. How do you think like longer term and again, there's a perception at least that ADI may be more insulated from it because of the thing.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Well. I think that I always carefully to use insulation because I think the threat is real for everybody. I think it is our technological performance advantage and our service advantage that helps protect us. I think that we have a lead of some amount because of our long history and experience, and designing an analog is hard and just building capacity doesn't mean you can supply everything that folks need.

But I think we have to continue to invest to stay ahead of that, or they will continue to take more and more of that market away from us. But I think we have a lead. I think it's hard for them to replicate where we've seen them take take business in China has tended to be in areas where the performance requirements aren't as high.

And if it gets into a -- it's just okay. Then you might pick China, but, and this applies around the world, if you want the highest performance, you're going to still pick the analog. And we even in this super price competition, we are still accelerating growth in our design wins.

Stacy Ras - Bernstein - Analyst

It makes sense. I presume even with price competition you're coming in above, right? So there's been a bigger push. Vince used to talk about this push toward value pricing. Reversed more than where we were years ago.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Yeah, and we are -- like I said, we are super super focused on capturing what we get from that innovation and being first.

Stacy Ras - Bernstein - Analyst

Got it. Now I guess the same question on the US side, so again you've got a competitor's building an absolute ton. Of capacity here in the US and while that competitor I believe actually is actively losing share in China they've kind of admitted it. They've suggested that like in the US they think it'll sort of like more than make up the difference and how much of a threat is just like and they're building, I don't know what it is, six death stars or whatever it is in Texas and you tell like -- how do you think about that and is there a need over time for ADI to actually be more aggressive about actually even building out here in the US?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

I would say in the near term building incremental fab capacity is not on the table. If you think about what we've done over the last weaverton a bit well, we essentially will have doubled by the end of this year. We'll have doubled our internal factory capacity from where we were. And so given, if you do an outlook on where our revenue is headed and from a growth perspective we feel very comfortable about the factory footprint we have today.

Obviously we only build, at a certain lithography in our internal factories, but today based on the demand we see going forward, we feel very good about where we are from a capacity perspective. And same thing, the US that I said about China is going after the hardest problems to solve. And one of the things that happened during the pandemic is we got really close to customers.

And so what we find now is they come to us very early in their process and say we have this really hard problem, we need you to solve it. And one of the things we hear pretty consistently from customers is you're doing an amazing job. We love all the work you're doing for us. We want you to do more. Because they're hard, complex problems, and they want to get them solved.

And so that has helped us tremendously get out in front of some of these, future design designs and design wins because they're bringing us in early because we have my old boss and I think I said this before, my old boss said there's no compression algorithm for experience. We've got 60 years of Analog experience, so we can solve the hardest problems.

Stacy Ras - Bernstein - Analyst

Is that basically the simple answer to the question of like how do you compete? Because, most of the others, I mean the big US guys would sort of say similar TI has been around. What is it that ADI does differently even from like the large established guys that would probably try to make the claim?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

I think if you look at them, I think from a relative spend perspective we invest more of our money in R&D.

Stacy Ras - Bernstein - Analyst

What's your R&D for 20% this year it's about --

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

It's running about 17% right now. Right, so we tend to run, it's a little bit different. Our first call on capital is R&D versus hardcore capital assets. Now we had a run here for a couple of years that we've spent a ton on on capital, but --

Stacy Ras - Bernstein - Analyst

You went to what 8% or 10% or revenue?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

We might have tweaked close to 10% at one point, but and we've told everybody we expect to get back down into that 4% to 6% range, not 30% right now. No, it is not. No, and our team is very prudent in the way they deploy capital. But this three year period was significant for us. Our customers wanted resiliency and at some level, they're willing to pay for that resiliency and we and we see that. So it's been an important thing, but it goes back to how much we spend.

We have a significantly higher number of engineers than we had three years ago, right, and we have more engineers in more disciplines, so we've hired lots of software people, lots of digital people, and we are ramping up hiring around AI. We've been hiring for a while because we think that the ability to extract more value out of the core Analog franchise comes from having the right digital and software companion.

Stacy Ras - Bernstein - Analyst

So when you say you're investing in AI, is that investing in like AI from a product standpoint or AI from like you're using it for yourselves?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

So you think about we're using it at the enterprise level, we're using it at the engineering level from a use of it, but we're also deploying it into product right because if you think about the current big AI build this infrastructure and its data centers, and we're benefiting from that. Lots of companies are benefiting. And what do you do there, by the way? So for us today, our primary exposures is obviously our test business benefits for all the testing around the high performance compute and high bandwidth.

But if you go into the data centers, they have our hotspot power products in there, and then we've talked about the new winds where we've got vertical power that's coming online, excuse me, at one of the hypo scalars and it starts shipping for us in the fourth quarter and then we're already shipping an optical module that's going to go into one of the large high performance compute companies.

So those are the primary areas today in the infrastructure exposure for us, but as we think forward to AI at the edge, right? So that's the transition from large language models more to small language models out at the edge. So being able to do compute closer to where the physical signals meet the digital.

Stacy Ras - Bernstein - Analyst

What would you be selling into that?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

So for instance, think about it. I'll give a couple of examples. One that we're already doing is noise cancellations for hearing aid. That sound is incredibly dynamic. If you have a fixed algorithm in the earpiece, you don't, you can't react as well. We are now shipping with dynamic algorithms, mini AI in the -- say again,

Stacy Ras - Bernstein - Analyst

Neural nets.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Neural nets. So that you can dynamically react to get better noise cancellation. Another example, if you think about where factory automation is moving and robotics and the increased need for that. Of course, as we build more and more factories, there's not enough people to fill in. You need more robotics. But you think about some of the challenges you face with robotics is power consumption. Right, it's latency, right, if you've got a robot that's got to react, that's got to, you want to end security.

Well, so having the compute at the edge on the device reduces power consumption, reduces latency, and increases security. So the opportunity to build those things into our chips so that in a robot you can do the compute at the edge where the sensing and the physical data is gathered. So I think that is and you've heard Vince talk about this. I think that is a really big opportunity for us in the next gen of AI is getting. AI into our products out at the edge edge.

Stacy Ras - Bernstein - Analyst

So that's interesting like, on each earnings call Vince, like he picks a topic and he kind of goes into it a little more depth, and I heard him talking about space and he talked about robotics and AI and healthcare. What are the areas that you guys I guess collectively would be most excited about? I just go back and listen to the last call.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

I think Vince does a great job calling things out. If you think about some of the broad global trends, our ability to help with the energy transition is super exciting. Think about some of the products we've developed in the automotive space for battery management, grid management potential, right? The grids around the world are old and in need of --

Stacy Ras - Bernstein - Analyst

Technology, by the way, the battery management systems auto that you're doing versus grid. Same concept.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Yes, but it's also, we're looking at other ways to help them do more intelligence of the sensing on the grid, right. So that they can better manage what they have. So that's a tremendous opportunity. We've talked a lot about robotics, but for us that continues to be significant one because of the need for incremental robotics, and two, the change, right? We're moving from -- we move from fixed and now we've got the autonomous and now we're going to have the humanoid robot.

Every move that way is more content for us. So that is super exciting from us -- for us as we look forward. And then one of parts of the business that has been slow and we've started to see it finally grow is automation and going forward again following those trends of factory automation. We think that's a huge opportunity for us going forward.

Stacy Ras - Bernstein - Analyst

Is that sort of where the incremental R&D dollars are going right now?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

So we spend our -- it's interesting, we spend a significant amount of our R&D just on our core Analog portfolio, and then we're looking across what are the most impactful areas and where do we spend our R&D and we're targeting our incremental R&D across these mega trends to make sure we're capturing that going forward.

Stacy Ras - Bernstein - Analyst

What do you guys do on the digital side, if anything? I know you used to have a DSP business. You never talk about it. I don't even know if it's there anymore, but is there anything you do like on the digital? I mean, a lot of what you do also be like maybe it's not pure Analog, maybe it's like more what people call mixed signal. I don't know.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Well, so we're continuing to actually on the digital and software side to develop products to go on to -- go into our enhance our existing chips. We do have the mixed signal stuff that you mentioned, but we're also working on more compute type products I would say. Okay, yeah, you don't talk about it anymore, but it's -- it's harder to move the needle when you get to be over 10 billion, Stacy.

Stacy Ras - Bernstein - Analyst

I hear you, I hear you. Can you talk about the shift, ADI was one of the few companies that actually did attempt to be a consolidator in Analog, and I think there was a lot of hesitancy to believe that there was value to be added to this idea that like we can't get cost synergies because you don't want to fire the engineers.

I think you guys have kind of proven over the years that this can work and you've bought at least in my history at least at least three companies that we know that it was Hittite, which was more of a bolt on at the time, but reasonably sizable and went well.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

And then amazing technology. I actually worked on their IPO. Oh really. It looks like it's done very well and then linear clearly which was -- that was sort of the first really big swing and then more recently Max. I mean even the timing on Maxson was really interesting when it was 2020. I think in hindsight that was good timing.

Stacy Ras - Bernstein - Analyst

But I guess, how was that decision made? Like why was the decision made to go out and be a consolidator and I guess the other side of that, why is M&A now no longer needed? Is it just that you can't? Or that you don't want to.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

So I'll go back to the beginning. I don't think we've made a decision. I know we haven't made a decision to move away from M&A.

Stacy Ras - Bernstein - Analyst

Well. I mean there was a decision that like you post maxim maybe this doesn't hold 100%.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

We did say post maxim we would over the long term try to return 100% of our free cash flow and I talked a little bit about we didn't do that last year. That was pretty conscious given all the turmoil we were trying to make sure we had a little bit of liquidity.

We are very happy with our analog mixed signal and power franchises. However, we've talked about investing significantly organically on digital software and AI. We are also continuing to evaluate opportunities from an M&A perspective in those spaces.

And as you know from watching our history, we're pretty selective about what we do from an M&A perspective. So we are out looking for opportunities that either help us advance time to market with something we're working on or identifying technologies that could broaden our portfolio and give us, ability to solve more complex customer problems. So they're not mutually exclusive, I guess, is my point, because we have not done a large acquisition in a long time in multiple years.

Stacy Ras - Bernstein - Analyst

Is it possible to do large acquisitions?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

I would say in the current environment it would be very difficult to do a large acquisition just given the regulatory climate and the current level of discord among some of the folks that would have to approve a deal.

Probably easier to do, smaller deals that are domestic or less cross border, but we will continue to evaluate states because I do think that's an important part of one of the things we've done well. And we see it as op opportunistic.

Now what's more likely near term is, and I hate this word, but everybody uses it more tuck in type acquisitions that can help accelerate things for us.

Stacy Ras - Bernstein - Analyst

Why do you hate that word? What's wrong with that.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Because everybody's got a different definition of a tuck in.

Stacy Ras - Bernstein - Analyst

I guess, I don't know if I want to ask you what your definition is. I guess on the cash that's on the balances, so you're right, you didn't and I totally understand wanting to build a little bit of liquidity last year. What are your thoughts on that use of cash now? You historically had like a 1.5 X like leveraged target which you've been running well below. Does that target still make sense, especially given where interest rates are now?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Yeah, I think that you know when we go through and we do a pretty significant refresh and update and look at what the right balance is from a weighted average cost of capital, over the long term, I still think that 15 is a good target. It's maybe probably a little bit lighter than what you might see across some of our peers from a leverage perspective.

But what we've shown in the past is we're willing to up the leverage a bit in times of a big acquisition and then, work our way back down. Given, as you said, it's been a few years since we've done a major acquisition we're running a little bit lighter. But that I still think that that long, longer term is the right sort of benchmark for us from a leverage perspective.

Stacy Ras - Bernstein - Analyst

I guess within the long term 100% cash flow return. You want to remind the audience like what your thoughts are on the dividend growth versus buybacks.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Yeah, so we've continued to grow our dividend, and I think what we TRY to tell people is you know we want to grow our 10%, through cycle. And so that in our typical target where we try to stay as the dividends roughly 40% to 60% of our free cash flow, depending on how it shakes out, and then the remainder we'll use for buybacks.

So those of you that are watching, obviously the first half of this fiscal year has been a little bit lighter than the 100%, but that's largely just timing of Q2 is a tax payment quarter, all those things. So we don't do a ton of buyback in Q2. We did about [100 million] more in Q2 than we did Q1. We would expect an acceleration of the buyback in Q3 and Q4 to get us to the 100%.

Stacy Ras - Bernstein - Analyst

Any chips act like impacts on free cash flow coming up or we talk.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

We talked about this in a couple of our calls. This quarter just pasted Q2 was the first time we saw a real cash flow impact from the chips, so we had about \$100 million of tailwind which we've been talking about. And that's the biggest in the near term biggest cash flow impact so far we're still only seeing minor impacts on our P&L just given, the grants we've received are not huge.

We've publicly talked about we had a preliminary award for chips act money. We're still going through the finalization process with the new administration, which is progressing, is it? Yes. Yeah, we actually feel reasonably good about where we're headed. Okay, from it. Now part of that is we're continuing to invest in building in the states.

Stacy Ras - Bernstein - Analyst

Yeah, you can build it anyways.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

I think there's some of it, that's been is continuation, but there's some new things that we probably wouldn't do if we weren't if we weren't getting the funding.

Stacy Ras - Bernstein - Analyst

We got about one minute left. We got a room full of folks here. I mean, I'll give you your soapbox. Like why should everybody here buy your stock?

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

So I think it's a great question. So first and foremost, one of the things that ADI has been able to demonstrate over the long term is the ability to grow and to generate profits and to generate free cash flow. And as we start to look at the signals that are starting to show up in our business, really important for us to grow industrial, and what we wanted people to take away from our Q2 call was industrial seems to be back on a growth pattern, which is a significant needle mover for us.

We are continuing to lead from an innovation perspective and you know our our customers want us to do more. So the opportunity for continued growth is significant, so profitable, lots of free cash flow, and we think there's opportunity to continue growing.

Stacy Ras - Bernstein - Analyst

Fantastic. I think we'll close it out there, Rich. Thank you so much. All right, appreciate it.

Richard Puccio - Analog Devices Inc - Chief Financial Officer, Executive Vice President

Thank you, Stacey.

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