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ADI - Analog Devices, Inc. at Wells Fargo Tech Transformation Summit

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CORPORATE PARTICIPANTS

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

CONFERENCE CALL PARTICIPANTS

David Wong *Wells Fargo Securities, LLC - Analyst*

PRESENTATION

David Wong - *Wells Fargo Securities, LLC - Analyst*

Well, we are delighted to have with us today Ali Husain of ADI to tell us a little bit about ADI.

So, Ali, maybe you could just start off by telling us a little bit about the Company. I mean, what are the wonderful things about ADI?

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

Sure, absolutely. Thanks, David, for having me and thanks for everyone being here today.

So I will just quickly position ADI for those that are new to the story. And since we are at the Tech Transformation Summit, David, I will touch upon some of the transformations that have been taking place at ADI over the last few years.

So, if you look at the analog piece of the semiconductor industry, that is about a \$30 billion a year industry and if you bucket that out, you really have power management, which is where most of our competitors play. And you have the signal path or signal conditioning which is really where ADI plays. And when you really look at that signal path, the real backbone of that signal path are data converters and high-performance amplifiers. And those are both product categories where ADI, we lead the market. We also derive over two thirds of our sales from those two product areas.

And one of the reasons why we are able to get that kind of a brand or that kind of a market share position is because in this space, brand does matter. At ADI we have been in business now almost 50 years, really working at this very, very tough technology, getting it right.

But over and about the technology aspect of it, we offer very high levels of service to our customers. For example we don't end of life parts. We carry pretty good levels of inventory pretty much regardless of what the semiconductor industry is doing.

And so what that ends up doing in terms of the model is that we generate pretty good cash flow so we very easily run our operating cash as a percentage of sales in the 30% plus range. Our capital intensity is quite low and so our free cash flow generation is also quite strong.

And what we have been committed to doing is really taking every dollar of free cash flow that we generate and returning \$0.80 on the dollar to shareholders in the form of dividends and buybacks. And now that almost 90% of our sales are from industrial, automotive and comms infrastructure, we feel pretty good about the mix of our end markets.

It is this process that we kind of embarked on a few years ago when consumer was about 25% of our sales. We really get out of some of the commodity areas, consumer, take those investment dollars, put them into the more B2B spaces like industrial, auto, and comms and, given how the markets are splitting out personnel with almost 90% of our sales coming from the B2B space we feel pretty good about the setup here going into 2014 and hopefully beyond.



David Wong - Wells Fargo Securities, LLC - Analyst

Great. Thanks, Ali. So, all of those things you are in many end markets, but you have chosen your end markets. What does that add up to in terms of growth rate? What have you seen in the past, compared to your peers? What do you expect going forward?

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

Yes, absolutely. I think you know and by the way I get asked this question a lot, especially in the recent past. I think one thing to keep in mind is that there are a lot of differences in how ADI -- we account for our review, particularly in the distribution channels. We are very conservative, we only recognize the revenue when distributors sell through to the end customers. Our fiscal quarters are offset by a month versus the calendar quarter.

So looking at any kind of a growth rate versus peers on a quarter to quarter basis, I think, is fraught with peril.

I think the better thing to do is really look at it over a multi-quarter basis. And when you look at ADI versus the peers on a four-quarter basis, including our guidance for next quarter and their guidance for next quarter, we are all kind of in the same ballpark in terms of topline growth. Now I wouldn't say that anyone -- ADI included -- is setting the world on fire in terms of the growth rates, and I think that has really been a function of a fairly constraint CapEx environment over the last little bit here.

I would say, though, that things seem to be turning a little bit. Our second half of 2013 grew 6% over the first half. If you strip consumer out the second half actually grew 8% versus the first half. We had a bit of a seasonal lull there in the first quarter, but things seem to be turning as well. Some of the sentiment readings out there are fairly positive as well.

Although I am not here to update the guidance that we provided, kind of in the middle of February, all I can speak to obviously is what we were seeing at the time. But the sentiment out there is improving and I think that is a good sign for ADI going forward.

David Wong - Wells Fargo Securities, LLC - Analyst

But on that subject, Ali, sentiments generally improving. If this uniformly across all end markets? Are there some -- some things that seem to be picking up? First, what are you saying?

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

Yes, I would say the market for us that's most finally attuned to sentiment would certainly be industrial. Those customers are very reactive to macro shocks. And so, to the extent that sentiment is improving certainly I think that is a good sign for our industrial business.

I think overall for ADI we are a very CapEx-sensitive business so to the extent that the CEOs and the CFOs of the world out there are feeling better about their businesses. They are feeling better about the world economy at large. I think that is a good sign because that tends to translate into higher CapEx which then does benefit our business.

Our first quarter was down seasonally. Our second quarter, you know, when we were giving the guidance, the order flows looked really strong. They were better or stronger I guess than they were last year at the same point. Our book to bill coming out of the first quarter was slightly above one whereas the last two years coming out for the first quarter book to bill had been below one. So I think that is another good positive sign. And then certainly the sentiment improving as well, I think those are all good signs for ADI going forward.

David Wong - Wells Fargo Securities, LLC - Analyst

Can you talk a little bit perhaps about the competitive landscape? In say industrial and any of the other segments, who do you come across most, who do you reckon (multiple speakers)?

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

Yes. Sure. The way ADI's business splits out, earlier I had mentioned in the introduction there, about 71% of our sales come from data converters and high-performance amplifiers. And those are both product categories that we leave the market pretty substantially in those two product categories. On the data converter side we have about 50% of the market. On the high-performance amplifier side, we have about 48% of the market.

That is really what we are doing a lot of at the Company. That is a lot of what goes on in particularly the industrial space. There are a lot of these catalog type products.

So, it would be hard for me to sit here and say we [appear less]. Certainly we have competitors that have pieces of that signal chain, but in terms of what we are doing in the space, I think we are very well positioned in terms of the technology. We have a very good brand. We do right by our customers. So I think that -- put all of that together and I think what we are doing in industrial, I think we are well-positioned certainly from a technology standpoint.

That business is, obviously, about half of our sales and it buckets out into five sub-businesses essentially. We have an automation business. We have an instrumentation business. We also have healthcare, military, we have energy under the industrial umbrella. And I think going forward, there are some pretty good trends in that market that I think should drive good growth for industrial business.

You know, themes around more and more connectivity, for example. It is not just something relegated to the consumer devices of the world. You are going to see industrial machinery equipment all being equipped with pretty advanced signal processing with RF capabilities to have all of that data aggregated moving up into the cloud brain, so to speak.

Themes that are on energy efficiency for example in industrial, we have the stat, David, we use which is 40% of the world's power goes to basically powering up industrial motors. So any kind of incremental savings there, I think, in terms of the efficiency, that is really good for our customers. That saves them money, makes them more efficient and certainly it is better for the planet as well.

So I think those will be some of the themes going forward that really require some very advanced signal processing. And I think we do a good job with that.

David Wong - Wells Fargo Securities, LLC - Analyst

Cool. And thinking a bit about some of your other end markets. You talked about CapEx cycle, and something that has investors all excited about these days is base stations in China and base stations in general which (multiple speakers) lead to 4G. So what are you seeing in terms of wallet base stations in China? Did that investment CapEx in Europe for comms infrastructure?

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

Sure. I think it is a good growth opportunity for ADI. Comms for us as a business is about 20% of our sales. But two thirds of that is wireless infrastructure. And when we talk about wireless infrastructure, we are really talking about the radios that go on base stations. It could be macro base stations, it could be small cell base stations, what have you.

Unfortunately for us the last couple of years, the radio count has been flattish and I think you have seen that in our results in the communications infrastructure business. It is a market that really, really values technology so we are putting out some very cutting edge radio technology right now,

integrated transceivers in some cases at 65 nanometer, wideband radio, software defined, what have you. I think we are well-positioned from a technology standpoint, we are very well-positioned at all the major OEMs in this space, and I think the big trigger there are the deployments which is really your question.

And I think we started to see some benefit in the first quarter, so that is our January quarter from the China TD-LTE build. Our expectation was for that to continue in the second quarter, and that is why we got in communication infrastructure up.

We also in the first quarter started to see a little bit of benefit from the US carriers who have now voiced this thing. They are moving from the coverage phase to the capacity phase of their 4G LTE deployments. And that also requires more radios. So I think that is a good opportunity as well for ADI.

I think Europe, that is an interesting region. It is underinvested, I think, over the last few years in their network. I think there are signs that the market is going to percolate at some stage. We haven't seen it yet, I think it is probably the back of 2014, early 2015 type of event. But I think like I said it is a market that really hasn't been investing in the network and with the proliferation of more and more of these 4G LTE type devices, I think they will have to spend. There have been some announcements for some of the European carriers that they will do that, loosen the purse strings a little bit and I think that should benefit us as well.

But it is an inherently very, very lumpy business and -- but we like playing in the business because for ADI what we are pretty good at doing is figuring out what the trends are going to be and then aligning our investments and our technology to make sure we hit those trends. So this theme of trying to do more with less certainly applies to the comm space.

There's more and more devices that are being connected up but inherently they are all limited by spectrum. And so, our radio solutions do help parse out the spectrum more efficiently. And I think it's -- at the end of the day resources are not infinite. Everything is finite and you have got to do more with less and I think our radio solutions have really helped do that.

David Wong - Wells Fargo Securities, LLC - Analyst

What about automotive? I mean, one thing that a lot of investors are thinking about is that more electronic and automotive. ADI is doing more in automotive, isn't it? Can you run through some of the things you guys are doing and show (multiple speakers) dollar content is going from and to?

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

Sure. Obviously automotive has been a very exciting space for ADI. We have been playing in automotive since the early 1990s. We have been in automotive long before I guess it was popular.

But, again it is a great spot to be in. We are doing some pretty cutting edge technology their peer for us automotive really splits out into three sub businesses. So we do infotainment applications, powertrain and safety.

It's a market that really craves technology. We are putting out every last square inch of technology at ADI essentially is being used in the automotive space. From DSPs to MEMS, converters, amps, RF.

In many cases that technology is being integrated onto 1 IC, which I think is pretty neat. And other cases we are integrated in it, but we are also embedding things like arm microcontroller. So again it is a very kind of interesting place to be playing. You have got to have a really big toolkit full of tools to service the trends in this space.

So for ADI, let me step back. I think first of all, there is a huge appetite from the vehicle manufacturers to really differentiate their cars, their product. I think silicon is certainly a way for them to be able to do that.

Beyond that, then, for ADI we are historically more tied to the European premium vehicle manufacturers. And they tend to be kind of the early adopters of technology. And what then happens is that technology either because there is a desire for differentiation by other car manufacturers, or it is aided by government mandates, for examples in the areas of safety and fuel efficiency, for example, that technology tends to cascade down to the mid tier brands. So I think that represents a good opportunity for ADI.

And lastly, for ADI, again, Asia has been a region that has been historically underpenetrated by us. And so we have got some very good designs particularly in Japan and in Korea that should start converting to revenue starting in about the 2016 model year or so. So I think, overall, there is this arching trend for more and more content in vehicles.

But you have got to have the technology, but you have also got to have the capability to integrate that technology, to really offer a very good value proposal proposition for the automakers, the car manufacturers as well to be able to help them differentiate their product. So I think that will be a good spot for us going forward as it has been in the past. Those three sub businesses have been growing at a double-digit CAGR for ADI for several years now.

David Wong - Wells Fargo Securities, LLC - Analyst

Indeed. And you also mentioned that ADI is the leader in [Quebec]. You got some new market share, it is about 50%. So you have got more Quebec than anybody else. Are there -- what are the new application converters? Are you able to expand the reach of converters? Are you able to build your market share further or (multiple speakers) margins (inaudible)?

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

Well, we hope so. Data converters are very important to ADI. They are essentially call it the lifeblood of the Company. Half of our sales are coming from data converters. We lead the market with about 50% share in data converters. It is a great spot to be in.

I think in terms of the investments we are making, it is clearly to maintain and grow that position over time. So it is really looking at higher speed, higher speeds for data converters. Lower power, lower signals to noise ratios, things like that.

But increasingly, David, the conversation is turning not just from the data converter and what can the data converter do, it is turning to the entire conversion process which is essentially all the way from the sensor that captures the signal all the way down to the processor. But in some cases, I would say the investments are around how do you integrate all of that functionality? In other cases it is about just owning the signal change. And our investments are really going into that to make sure that we do that and we continue to do that.

David Wong - Wells Fargo Securities, LLC - Analyst

Great. And we moved a step up, we can look at the financials. Actually I think of the bigger analog companies, you guys have the second highest gross margin. It's at the moment around 65% (inaudible) and that is with underutilization. Can you talk a little bit about what the trends are there? Where do you think gross margins go to? Where do you think operating margins go to? (multiple speakers) how does this [take out]?

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

Hopefully good. Hopefully it all works out well. But as you mentioned we did about 65% gross margin this quarter at fairly low levels of utilization I would say. ADI we are a very technology-centric copy. We are very innovation driven. And I think you tend to see that show up in the gross margin. I think going forward, really, utilization clearly will be the biggest driver for the gross margin. I think we topped out at 67% plus range for gross margin's back in 2011. And there is nothing fundamentally there I think that would suggest we can't rescale those peaks at the equivalent utilization rates.

There are things that we are doing on the gross margin side, both on price and cost to get a little bit more efficient about how we do it. So there is a scenario under which we can possibly do better than our prior gross margin piece as well. And on the OpEx side we have been pretty good at controlling the OpEx and so I think the operating margins should be pretty good as well. We tend to run in the high 20s, low 30s as a percentage of sales. And we -- the peaks for the operating margins were in the high 30s.

So I think again there we should be able to get back to the prior peaks if the gross margins are slightly better, the operating margins should also respond. And I think that will be good.

But, it's interesting. I get this question a lot from investors about gross margin and operating margins and how high can you drive them. But for us really it is about the model, and the financial and the operating model for ADI is the topline growth combined with the leverage on the gross margin combined with the operating leverage really gives us some pretty good earnings leverage. And so we have been in this period as we talked about in the intro there of fairly muted topline growth. But the model has worked which is that even in the muted kind of topline growth rate environment, we have been able to generate some pretty good earnings leverage.

And I think going forward, I think that map should hold true as well. We get some decent sized topline growth. That should all flow through the model and generate good earnings leverage. And then really the second derivative of the model then is that we generate a lot of cash and we talked about that in the introduction where we basically take a lot of cash, 80% of it or so of the free cash flow and we return it to shareholders in the form of dividends and buybacks.

David Wong - Wells Fargo Securities, LLC - Analyst

And of course, related to margins and capital use of this manufacturing, so can you run through that? ADI used to do all of its own manufacturing, but it has increasingly moved to mix model, what percentage is outsourced, now what is the target for [foundry]?

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

Sure. On the manufacturing side, on the front end we do about 50% of our wafers internally and about 50% of our wafers externally at foundry. We own two fabs, front end fabs there. We own them, we have one in Wilmington, Massachusetts, and the other one in Limerick, Ireland. So when you get to about 0.18 micron and above, we tend to do that internal. I think once you get below that we tend to do that at foundry.

It is interesting. For a company like ADI in the analog space, a lot of the differentiation that we bring in our product is a virtue of what happens in the backend. The testing, the packaging. So we own our own test facility. We do a lot of our own packaging internally and that is because a lot of what we are doing, the products are going into very rugged environments. They have to work in these harsh environments.

The functionality that they are providing in our customers' end system is so critical that they just have to work. Otherwise the entire system will be a failure. So what we are doing is obviously investing in the backend in the testing, in the packaging to make sure that the quality of the products is there. And that is really how we drive the differentiation for ADI.

David Wong - Wells Fargo Securities, LLC - Analyst

So, Ali, as a higher percent of your product then packaged by ADI than is actually manufactured on the wafer side or is it about the same?

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

I would have to go test the math on it, but I know that we do a lot of our tests internally. The differentiation when it comes on the packaging side to the extent that we could do it internally to really differentiate our product, that is how we do it.



David Wong - Wells Fargo Securities, LLC - Analyst

Okay. Perhaps we could open this up a little bit to the audience. Does anyone have any questions?

QUESTIONS AND ANSWERS

Unidentified Audience Member

Could you maybe talk about what your strategy is for future mergers and acquisitions, potential candidates or segments that you are actively looking in?

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

Yes. I think we are -- I think on the M&A side we are very selective in terms of the companies we would be looking to acquire. I think a lot of what we are doing internally, I think we are investing in what we believe are the right clicks for very good organic growth. I think when we look at any M&A opportunity it is really to try and fill in some of the gaps that we might have on the signal path. Something off the technology side that you can bolt on to your signal chains and really differentiate your product.

We acquired this company actually right here in California a couple of years ago that does very high-speed clocking. We took that clocking technology and we put it into our integrated transceivers on the call side. So that is really the theory behind how we will do it.

Is there anything else I can add on the M&A side? I think that's really -- one interesting point that I will make on M&A is the supplier/customer relationship in certain cases is changing where we are being asked to do a lot more.

So again you have to have a lot of tools in your toolbox. In some cases the hardware engineering is essentially being outsourced to ADI. And so in those cases absolutely you'd have to look and see what gaps you have and whether you can grow that internally. Obviously that would be the priority to the extent that you can't, you would be looking to make an acquisition. But like I said it would be mostly about technology, tuck-in, bolt-on acquisition if we did one, yes.

David Wong - Wells Fargo Securities, LLC - Analyst

Any other questions? Perhaps one more from me while we are waiting. Capital -- you talked about capital allocation, so you said 80% are payback to shareholders. Can you give us any numbers as to dividends versus share repurchase? What percentage do you target for dividend payout and does that change over time?

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

No, sure. So we have committed to returning 80% of our free cash flow to shareholders. We said that again on the earnings call in February. I think the way it will all kind of play out is two thirds of that 80% will be from the dividend and that will grow at some rate equal to normalized earnings growth. On the other one-third then will be the buyback, and we have been pretty opportunistic in terms of when the buyback triggers, it is a program, it is an algorithm that basically triggers when the stock rolls below historical rolling averages for the stock.

And, again, we are pretty opportunistic. So you might go a quarter to where the buyback doesn't do much, but then it is designed to really take advantage of the volatility in the stock and we are committed to returning 80% of the free cash flow. One third of that will be the buybacks.



David Wong - Wells Fargo Securities, LLC - Analyst

Anybody else? Any other questions?

Unidentified Audience Member

Could you maybe talk about the pricing environment and if you have any initiatives, ongoing initiatives to improve pricing?

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

Yes, I think -- I get asked this question a lot about ASP's and things like that. For us at ADI we definitely play at the higher end of the analog spectrum. So certainly in any business, pricing is an issue, but I think we see a lot less of that on the high-performance analog side of the spectrum.

One thing I would say is there are certain efficiencies that we are trying to get as part of Dave's gross margin council there. And things that we might be looking to do for example would be step pricing, for example, where a customer might ask for 100,000 piece price and they only buy 10,000 pieces and so I think one thing that we can do at ADI is get a little better about well if you buy 10,000 pieces here's the price and if you buy 10,000 more, then you step down a little bit. And over the course of the 100,000 pieces you blend in to the 100,000 piece price.

So I think those are some initiatives, an example of some of the initiatives that we are doing on the pricing side. But this overarching question about are there a lot of ASP pressures? Certainly we are like any other business, there are ASP pressures, but when you play at the high-performance analog into the spectrum, Dave, they tend to be a lot less than the commodity area.

David Wong - Wells Fargo Securities, LLC - Analyst

Anyone else?

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

Is a noisy crowd here today.

David Wong - Wells Fargo Securities, LLC - Analyst

That's right, yes. Maybe one final one for me. One of the questions being for all chip companies overseas cash prices (multiple speakers). Can you tell us a bit about your situation and what your plans are for overseas cash?

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

Sure. So we have got about \$3.8 billion of total net cash. About two thirds of that is overseas and so we have about \$1.2 billion here domestically in the US, we have about \$500 million as a revolver that we can use. So I think to be perfectly candid with you we have got plenty of liquidity for the things that we want to do domestically.

We have been adding some debt on the US balance sheet to try and take advantage of the low interest rate environment. So we have got about \$870 million of debt and we have some capacity there to borrow a little bit more. So I think you will probably see us doing that going forward as well.



But with regards to the overseas cash, it is going to be overseas until I guess we have some tax reform or some certainty in the tax policy. And then we can figure out what we want to do. But I think as an overarching statement, I would say that for the things that we want to do with \$1.2 billion onshore plus \$0.5 billion revolver I think we have got plenty of liquidity.

David Wong - *Wells Fargo Securities, LLC - Analyst*

Anyone else? Any other questions? Well if nobody has got any other questions, thank you very much for joining us.

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

Thank you. Great. Appreciate it, David, thank you.

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