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PRESENTATION

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

Good afternoon, everyone. Welcome to the ADI session, or Analog Devices session, at the 2023 Stifel Cross Sector Insight Conference. My name is Tore Svanberg. I'm the senior analyst covering semiconductors, with particular focus on analog and connectivity.

And it's my honor to introduce ADI management this afternoon. So with us from the company, we have Prashanth Mahendra-Rajah, who is Executive Vice President of Finance and Chief Financial Officer; and also Mike Lucarelli, who is Vice President of IR and FP&A. The format for this session is a fireside chat. But I will start asking Prashanth to just give us a 2- to 3-minute overview. I think most people know about ADI, but there might be a few that don't know the company that well. So just a 2- to 3-minute overview, and then we'll get into the details.

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

Yes. I can keep it shorter than that. So Analog Devices is a $12-plus billion revenue semiconductor company with a focus -- we are the premier player in analog, mixed signal and power.

Global footprint, we've been in existence -- I think this is our 58th year, and we have profitability levels that even software companies dream of. Maybe I'll leave it there.

QUESTIONS AND ANSWERS

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

Okay. Very good. Simple enough. So maybe I can still start a little bit higher level and then I'll dig deeper eventually, Prashanth. But we've had the presence of other -- of your peers here today. Everyone's talked about the infamous cycle that we've gone through the last few years.

And I just wanted to hear your take. I think we kind of all know how it's playing out. I think that's the easy part. I think the tougher part is how did the pandemic truly change the industry? How should we think about cyclicality for the industry beyond this period of inventory digestion that we're seeing right now?

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

Yes. Great question. Right. So I think there's a few things to consider there. The -- let me maybe start with ADI specifically, right? The company today is far more diversified than we ever have been, just in terms of the end markets that we operate in, our global operations.

And as we think about how the -- just the economic cycles will play through our business, we have pretty strong conviction that we won't see the types of troughs that we have thus seen in prior cycles just given the diversity of the business provides a great buffer against that.

And as an example, I would say that our consumer business, we believe, has already bottomed and is likely to start improving. Our communications business is also very likely at its trough levels. It may stay there for another quarter or 2 as inventory digestion continues, but it's hard to see that continuing to see further weakness.

Our industrial business, which represents about 50% of our revenue, we have a solid 40% of that business that is tied to end markets that have great resiliency to sort of the recessionary pressures or the impact of higher interest rates, like aerospace and defense, health care and our sustainability or our energy business.

And then lastly, automotive, for us, has been largely a content story. So that's the one I have the least visibility on because it's hard for me to get a sense of what is happening to auto production or auto sales with the higher interest rates. As I'm sure everyone knows, autos are very much subject to consumer finance rate.

So as those higher rates weigh on auto sales, we might see some pressure. But the offset for that -- for ADI is we have a terrific content game story. So for us, it feels more like it's going to be a rolling impact through ADI than I think we've seen in prior periods where we were more concentrated to a particular sector or market.

This morning, I was having a conversation with our CEO who reminded me that during the dot-com bust, ADI had almost 25% of its revenue for the coming quarter tied to one networking company in California. And they canceled orders on us. So we felt it. Those days are long, long gone for us.

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

Right. That's -- it's a great point. And I was around back then so I remember it very vividly. What about some other things that could have perhaps happened with the pandemic? I'm thinking about close relationships with customers because, obviously, when you have a supply and demand imbalance the way we did, it really brings chip companies closer to the end customer.

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

Right. I think the supply chain -- I don't know that I'll call it the pandemic. Let's talk about it as the supply chain imbalance that we had. The supply chain imbalance that we had proved a few theses, right?

First, it proved the thesis that everyone has been saying that analog sockets are not replaceable, right, that if they were, you would have seen switching, and you didn't. Customers waited for the suppliers that they had already designed against to be able to serve their products. We introduced this term called the golden screw, which I think has run around the industry.

And it verified that our business is incredibly sticky, and it is simply not -- even when a customer's line is down, it's still not worth the engineering effort to redesign the product in order to substitute out. So it just again proves how challenging it is to replace analog sockets when you have the win.

The second thing that it demonstrated was you had customers who were not truly aware of where their supply chain came from. And that has been quite a helpful revelation, I think, for us because we now have -- I'll name a -- we've got a semi-cap company that is a customer of ours, a European semi-cap company, so you guys can probably figure it out, who we have a certain amount of revenue to on a direct basis.

And I would not have thought of them as a large customer. But through our engagement with them, we learned, okay, this is how much you buy from us. But here are Tier 1s to you that are also buying from us, and your actual procurement volume from us is bigger. And now there's Tier 2s that are buying from you, and our procurement volume is bigger.

So it turns out that the semi-cap company is actually a fairly important customer to ADI, but it was the pandemic that showed them, hey, we didn't realize how we were connected to you through multiple levels. And that helps elevate our relationship with you because a traditional purchasing manager is going to look at his or her list of the top procurements and say, "All right, these are my big suppliers, but you're not getting the full picture."

And in automotive, I think that's probably where you've seen the most kind of inversion for the industry. And that is, you go back, I don't know, 4 or 5 years ago, when -- I joined ADI 6 years ago, so let's go back to then, we -- our most important automotive customers were Tier 1s.

And it would be hard for an OE to really know who we are. And today, our CEO can readily get meetings with the CEOs of OE customers because they have such an appreciation for how semiconductor and, particularly, ADI's technology is instrumental to the performance of their vehicle.

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

To stay on the topic of ADI uniqueness, especially compared to some of your peers out there, so the one thing that I really appreciated is the 3 acquisitions you made, right, Hittite, Linear, Maxim.

I mean I think some people say, "Oh, those are expensive assets." But when you think about the timing of those assets, even going through the supply chain issue, right? I mean, how did the dynamics change having those 3 assets under the ADI umbrella during the supply chain years as far as selling more to your more than 100,000 customers?

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

Yes. Yes. I don't know that I would say it was different during the pandemic years than just a commitment to the general strategy, which is we are an innovation-led company and our approach, which is different from, I would say, the overwhelming majority of our peers out there, is it's about finding the hardest problems for our customers and solving those problems in a way that we get richly rewarded with the gross margins that you see.

And having more in that portfolio allows us to solve more complicated problems. It's also made us the clear magnet for analog talent. I mean if you are an engineer who wants to work in analog, you can choose to work for a company that is focused on cost reduction or you can choose to focus -- to work for a company that is focused on innovation. So we know we get more than our fair share of great talent because you come to us looking for hard problems to solve.

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

And staying on the topic of uniqueness. And I apologize for bringing these 2 companies off, but they were here today. So -- and they're maybe the closest I can get to ADI, which is your friends in Texas and your friends in Arizona, Microchip and TI, respectively.

So you have a hybrid model, manufacturing model. I think Microchip, they also shared that view of that strategy. I do understand you have different businesses. But obviously, Texas Instruments is very, very different, vertically integrated, investing a lot of CapEx these days.

Help us understand why you chose the path that you did and especially when thinking about the use of capital because the way they position is just like, look, they have this money, then they got to make a decision where to use that capital, and they are deciding to spend it on manufacturing.

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

Right. Right. I would summarize it in 3 words, it's volume versus value. And both can work quite well in the marketplace. We are very value-focused. We do a very large number of SKUs in small quantities at a high ASP.

And the companies that Tore mentioned, they pursue a different strategy. And there's room for all of us in the marketplace. The analog market, if you look at kind of that top tier of the profit pool where you're solving the real challenging problems, that's our playground.

And that's where we take value. We solve the problem the first time around, we lock the socket, then we enjoy the socket for 10, 15, 20, 30 years. And we're not worried about price competition once you've won the socket. And we're in the business of making markets, right, that -- there's a product that we've been -- it's come out now, but it's just -- the technology behind it is so amazing. I love talking about it.

It is using our heritage of noise cancellation, along with our automotive heritage of our audio to bits platform. And allows us to sense road noise when it hits the window of your car. The microphone picks it up, the processor figures out what's the countervailing noise, and then the speakers that are in your head rest give you the opposite noise, so you don't hear the road. I mean it's the art of our ability to do that. And now we have that in Hyundai, and there's a California company, I believe.

Michael C. Lucarelli - *Analog Devices, Inc. - VP, IR and FP&A*

Nine companies, 4 EV companies. One is based in California.

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

Yes. There we go. So it's amazing technology that nobody else, who's come up on this stage, can even begin to create. And it's -- is it going to be -- is it going to benefit from a large 300-millimeter fab that's pumping out high-volume chips? It's not. That's not the game.

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

Right. Right. By the way, there's 2 in California. So we still have to guess.

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

There you go. Good luck.

Michael C. Lucarelli - *Analog Devices, Inc. - VP, IR and FP&A*

Tore, one thing I'll make a point on to -- on the hybrid model, others have the hybrid model. What makes us unique is our ability to swing the capacity.

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

Thank you, Mike. Yes. Yes.

Michael C. Lucarelli - *Analog Devices, Inc. - VP, IR and FP&A*

Hybrid just means internal external foundry. Many do that. But what we're doing is cross-qualifying those technologies at different foundries or internally such that gives us more resiliency and optionality where to produce the products. And that is very unique.

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

That is worth asking other companies to talk about hybrid because, swing, we believe, is a lot more unique. Swing requires you to have that very trusted relationship with a foundry partner, where they're willing to teach you their processes and license you right to run their process in your own fabs. So that is -- that -- not all foundries want you running their recipe in your kitchen.

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

And I think one of your peers, the one in Arizona, they talked about doing more manufacturing in the U.S., but I think they realized that some of their foundry partners are actually willing to invest in lagging capacity because I think that was a big concern, right, during the last few years is that everything is going to go into a leading edge and lagging is going to fall behind. But -- did you see that same dynamic there?

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

I feel pretty confident that the foundry partners -- the large foundry partners are investing in lagging. I think you'll hear a relatively big announcement in the next quarter or 2 from one in particular about making some of the lagging edge capacity available in another country.

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

Right. The -- some of the other things that have come up is sort of the different strategies when it comes to distribution. And I'm just also wondering, again, if any of that changed during the last few years because the analyst in me tells me that, hey, if I can go direct to my customer, I get more money. I mean, yes, I need my distributor to get to thousands of customers. But hey, at the same time, if I can go direct, I go direct.

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

Yes. Yes. Yes. So I think what happened with ADI, specifically, is that when we acquired Maxim, we got scale that allowed us to rethink how we use our distribution partners. And there's a cutoff as to when is a customer large enough for you to handle directly.

When does it make worth the investment of you calling on them with your own sales organization? So when you took Maxim's revenue and our revenue and put it together, more customers were above that water line. So that allowed us to go to more customers directly. That's point number one.

Point number two is our distribution partners serve a valuable role for us in fulfillment. So there are plenty of customers, including large customers who have a preference to get their product through distributors because distributors will do kitting, distributors will provide certain commercial terms that are -- that customer asks for.

And from my perspective, distributors handle a lot of the KYC risk plus the credit risk. So there is a value to running that long tail through them. But you will see more -- given that we are doing more solution and system selling, you are going to see us doing more interface with the customers on a direct basis, but that doesn't mean that we will ship to them from our warehouse. It may still ship to them from a distributor.

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

Okay. And another topic that's come up, especially lately, has been this whole idea about LTSAs. And I'm probably going to ask you a question a different way than what you're thinking.

So there are some suppliers that say, "Hey, you know what, we want the customer to pay for that capacity." Right? I mean it's kind of like you're guaranteeing it, but you've got to pay up for it, right? But then you have the TI way, which is, well, you know we're going to build it ahead. We'll pay for it, we'll carry the cost and then eventually you will come. Where does ADI stand on that? I mean I assume maybe somewhere in between because I don't think you're a big fan of LTSAs, but...

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

Actually, were violently opposed to LTSAs. And our philosophy on that is a few things. First, we are deeply customer-focused, deeply customer-focused and oriented. And we know this to be a differentiation because whenever we have employees who join us from our competitors, they're stunned at how much energy we put on that customer orientation and that customer focus.

And in our view, an LTSA is disadvantageous for a customer because you're requiring them to commit a volume to you that they don't know about. And at some point, you're going to get into an uncomfortable conversation with them on to a take-or-pay. And when you get to that take-or-pay conversation, any goodwill that you built up is going to evaporate on you as you try to either force them to take product or you can see that they don't have to take it.

And perhaps more importantly is the comment I made early on is once you design ADI on to your board, you've already given us an LTSA, right? I mean you are -- you have agreed that we are your supplier of that component for as long as you're making that model.

So we don't need it contractually, and we don't need to give you a price agreement. You're going to pay the price we ask you to pay every year for the next 10, 15 years. And if we want to charge you more, you're going to pay more because you made that decision when you designed us in.

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

Right. No, that makes sense. So maybe I can move on to some financials. And Prashanth, you've said in the past that you kind of draw a line in the sand and 70% gross margin is a trough in the cycle. I assume what gave you that conviction is what you said before, which is the diversification of the business, right? Because...

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

And the swing capacity.

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

And the swing capacity.

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

Right. When you think about cycles and semiconductor companies and where do they feel that pain, you feel the pain because semiconductor companies tend to be higher-margin businesses.

And when your factories are running underutilized, you're sucking up a lot of fixed costs without volume to attribute it to. Our swing capacity allows us to moderate that because we can shut down the foundry partners, bring that demand internal and keep those fabs running at a higher utilization than we otherwise would have.

That's the -- there's a terrific chart in our investor deck from last year that shows that as we've gone through each one of these acquisitions, and we reset our model range, the prior peak margin becomes the new trough of the company. So 70% we talk about as the floor of ADI. Before Maxim, 70% was sort of our peak-ish margins.

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

Right. And from a CapEx perspective, I know you're running a little bit higher now than your long-term target. But as we think of the next, let's say, 10 years, is mid-single digits you think an okay number to use for this flex capacity model?

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

I do. I do. I would not rule out that just given how the industry changes, 10 years is a long time that we may need something different at some point in the future. But I can say with confidence for as far out as we can see, and certainly to meet our 2027 investor model, we are quite comfortable with mid-single digits.

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

Okay. And moving on to operating margin. And -- I mean you know I've covered Analog for a long time. And I remember seeing linear technology get to like -- I think it was like 52% operating margin back in the days. That's when that big California networking company was buying a lot of product from them. And I thought to myself, that's probably not going to happen again, right?

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

But it did.

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

You guys got there. I mean how sustainable is a 50%-plus operating margin? I mean I understand scale plays a big role here, right? But at the end of the day, you also want to grow your business. So you've got to spend in R&D and SG&A, right? So like, I mean could we get to sustainable 60% at some point and then the revenue is still growing a few percentage points?

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

No. No, I'm just -- we like it. I think the way to think about it for us is that we have our gross margin model, we'll call it, low to mid-70s. And then we have our OpEx spend, which is basically our SG&A and our R&D. Our G&A is fixed.

We are going to always continue to find ways to be more efficient with that G&A spend. On the sales side, I did mention that this is an area we're willing to invest more in because we do believe that the opportunity pipeline is so great and the engagement from customers is at such a strong level, we want more field resources to help support that customer engagement.

For the R&D portfolio, it's really about shifting the mix. So for R&D, I don't want to say that it's going to be flat, but you're going to see that grow at a much lower rate because we're going to continue to find ways to pivot the resources into the areas that we want and continue to take advantage of.

We have a phenomenal footprint in Asia where it's a couple of big R&D centers. And as a matter of fact, I was reviewing some numbers today for our industrial business, where industrial R&D spending has not moved as a percentage much but the headcount has been quite significant because Martin Cotter has done a nice job of pushing more talent into some of our overseas locations where you get a better salary arbitrage.

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

And how do you keep that in -- because you said the culture of the company is to fix the most difficult problems, right? But now you're a $12 billion company, right?

So I mean it must get harder and harder to be that innovative. And so -- again, going sort of back to the R&D spend, but also maybe more culturally there, because your peer in Texas, to your point, they sell volume, right? So if they're a $20 billion business, well, you're selling volume and who cares, right? But when you're $12 billion and you're selling a lot of innovation, does it get harder?

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

Yes, it does. It does, but I would say that what it allows us to do is it allows us to run bigger teams on truly innovative areas. And those bigger teams can -- we have an internal terminology that we use in the company call TTR, time to revenue.

And the focus is -- and Vince talks about it in terms of sort of simple math, which is it's a function of scope, resources and money, right, is -- you can get your revenue as soon as you want if you're willing to adjust one of those levers.

And the scale allows us that flexibility. But there's still no shortage of ideas. I think that is what's been amazing to me over these 6 years with ADI is one of the hardest jobs for the CFO and for my successor when they come in will be how do you know where to cut the line because the engineers come in with such a long list of brilliant ideas and you can't fund all of them, right?

You can't fund all of them. You've got to spread your bets. You got to do a couple swing for the fences and you got to do a couple of singles and doubles because you need coverage, right?

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

And I think the previous CEO of Maxim called it man months of engineering, which I guess today would be politically incorrect to say, but I get it. I had 2 more questions. So for those that have...

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

Anyone from the audience, please jump in.

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

Well, I know people have been waiting for this question, so I'm going to ask it. Just an update on the near term, right? I mean, you've had very strong bookings for multiple years.

You're now seeing the other side of that coin. We've also talked about still have a lot of backlog that keeps getting pushed around a little bit, but still in aggregate, it's it still gives you so much demand out there that you can grow out.

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

It does. Yes. Yes. I mean I think the -- I'll go back to what we said on the call, right? Our third quarter is down sequentially from our second. I think we expect our fourth quarter to be down sequentially from our third, and then first quarter for us because of our unusual calendar year-end is going to be seasonally down from fourth.

So we have reasonably good visibility to that. I think what could upset that to the negative, I think, would be if the turns business, the book and ship business, does not resume at the levels that we expect. Customers have not relied on book and ship, and we have not relied on customer book and ship for 2 years.

Michael C. Lucarelli - *Analog Devices, Inc. - VP, IR and FP&A*

Yes. Yes.

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

At least 2 years. And we've had so much backlog. We haven't relied on orders in the quarter for delivery in the quarter. Lead times are now at a level where you don't have to give us an order until the quarter starts, then you can still get your product. So it makes sense for that to be the case, but we still need to see that come through. And I think what could surprise us to the positive is fiscal stimulus in China.

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

Yes. And I know a lot of management teams are saying, we need turns back. We need turns business back. Whatever what happened last year is not sustainable, right? So I get it.

And then the last, last question, and I know you're a diversified business, but AI is the big thing these days, right? So when I say AI, what does ADI say as far as how that impacts your business? I mean, I think there's some direct impact but perhaps more importantly, indirect?

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

Yes. So I would do it in 2 ways. First, the more common question we get from investors is how should we think about the revenue growth that might be attached to some of the spending that's going on in the ecosystem for AI?

And for us, you're going to see it in our wired business, basically power for servers, and our optical businesses. But as Tore said, given our huge diversification, I don't know that it's going to be a meaningful growth item at our level.

It will be big for that business. But when it gets washed out in all of ADI, I'm not sure that it's going to be meaningful enough for us to continue calling out. The other area is actually within the company where we're using it and we're deploying pilots all across the company. I think the one that we're most excited about now is we've got some very interesting progress being made with our field application engineers where customer queries can be handled up to a certain level, not the depth that you would get from an expert, but certainly up to a certain level, the FAEs can rely on an internal tool to get the -- kind of the first -- we'll call it the first-line answers.

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

So 60% operating margin? Well, on that note, we're running out of time. So thank you so much, everyone, for attending the ADI session. And Prashanth, Mike, thank you so much for coming. I appreciate it. Thank you.
