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ADI - Q2 2014 Analog Devices, Inc. Earnings Conference Call

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OVERVIEW:

ADI reported 2Q14 revenue of $695m, operating profits before tax, excluding special items, of $220m and diluted EPS, excluding special items, of $0.59. Expects 3Q14 sequential revenue growth to be 1-5% and diluted EPS, excluding any one-time items, to be $0.60-0.64.

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PRESENTATION

Operator

Good afternoon. My name is Doris, and I will be your conference facilitator. At this time, I would like to welcome everyone to Analog Devices' Second-Quarter Fiscal Year 2014 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the opening remarks, there will be a question-and-answer period. Please limit yourself to one question to ensure that Management has adequate time to speak to everyone.

(Operator Instructions)

Thank you, Mr Husain, you may begin your conference.

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

Great. Thank you, operator. Good afternoon, everyone. This is Ali Husain, Director of Investor Relations. Thank you for joining us here for our second-quarter 2014 earnings call. With me today are Vincent Roche, ADI's President and CEO; Dave Zinsner, ADI's Vice President of Finance and

CFO; and Maria Tagliaferro, Director of Corporate Communications. During the first part of today's call, Vince and Dave will present our second-quarter results and our outlook for the third quarter. The rest of the call will be dedicated to Q&A.

If you missed our press release, you can find it and all related schedules on ADI's Investor Relations website at investor.analog.com. Today's conference call can also be accessed from our investor page, and a replay of today's call will be made available within two hours of the call's completion.

During today's call, we may refer to non-GAAP financial measures that have been adjusted for certain non-recurring items in order to provide investors with useful information regarding our results. We've included reconciliations of these non-GAAP measures to their most directly comparable GAAP measures in today's earnings release, which is posted on our Investor Relations website.

Before we begin today's call I'd like to review the Safe Harbor statement. Please note the information we're about to discuss includes forward-looking statements intended to qualify for the safe harbor from liability established by the Private Securities Litigation Reform Act. These forward-looking statements include risks and uncertainties including but not limited to those described in our Form 10-Q filed earlier today.

Our actual results could differ materially from the forward-looking statements made on this call. Subsequent events and developments may cause our outlook to change, and we don't undertake any obligation to update the forward-looking statements made by us today. Therefore this conference call includes time-sensitive information that may be accurate only as of the date of the live broadcast, which is May 20, 2014.

Now before we begin with today's prepared remarks, a couple of housekeeping items from me. First, ADI will be hosting an Analyst Day on June 17 in New York, and I would welcome you all to listen in. Links to the webcast and Management's presentations will be available at ADI's Investor page at investor.analog.com. Secondly, our Third-Quarter FY14 Earnings Call is scheduled for August 19, 2014, beginning at 5 p.m. Eastern. With all that behind us, I'll now turn the call over to Vincent Roche, ADI's President and CEO, for his opening remarks.

Vincent Roche - *Analog Devices Inc - President and CEO*

Thanks, Ali. Good afternoon everyone, and thank you for joining us today for our Second Quarter 2014 Earnings Call. As you can tell from the press release, the second quarter is a very good quarter for ADI. Revenues of $695 million grew 11% sequentially, and our operating model showed very good leverage, converting the sequential revenue increase into a 20% increase in diluted earnings per share, excluding special items. On a year-over-year basis, revenues grew 5%, with a corresponding 13% increase in diluted earnings, again a very strong operating result. Both revenue and earnings in the second quarter were above the high end of our guidance.

During our last earnings call, we spoke about our largest customers becoming more optimistic about their growth prospects, and overall improving order rates on ADI. I'm happy to report that these trends continued in our second quarter. In addition to continued optimism at our largest customers, total orders were higher than in the prior quarter across all our end markets, and we finished the quarter with a book-to-bill that was above one. These trends, coupled with inventories that are in good position and recovering demand for capital goods, we believe are positive signs for our business in the third quarter 2014.

Turning to our performance by end market in the second quarter now, our revenue growth was broad-based, and was lead by seasonal and secular strength in the industrial, communications infrastructure, and automotive markets, which represented 89% of our total sales. Our consumer business grew sequentially, also.

The industrial end markets, which are typically seasonally strong for ADI in the second quarter, turned in an even better performance than we had planned, and grew 13% sequentially, and represented 47% of our total sales.

All of the major application areas within industrial grew sequentially, with the strongest growth from the instrumentation sub-sector, which was up significantly, driven by increased demand across our broad base of instrumentation customers; but also by higher-than-anticipated demand for wireless and semiconductor test equipment, areas which benefit from our very advanced analog and mixed-signal capabilities. Industrial automation, health care, energy, and defense also were up in the second quarter. On a year-on-year basis, our industrial business grew 5%.

By region, industrial sales in Europe and North America, which together account for over 2/3 of our industrial sales, grew in the double digits in the second quarter. Industrial sales in China, Japan, and the rest of Asia also registered strong sequential growth. The industrial sector is indeed the backbone of ADI, with a very diverse customer base of tens of thousands of customers and long-life-cycle products with sustainable profitability. We believe the industrial sector has the potential for above-market growth rates, driven by the need for more intelligent, connected, and energy-efficient products.

Revenue from communications infrastructure customers increased 11% sequentially, and 25% year over year, well ahead of our plan for the quarter. Wireless infrastructure sales surged in the second quarter, driven by strong base-station deployments in China and the capacity build-outs in the US. ADI's technology in these wireless applications is focused on the radio signal chain, where the spectrum is digitized, and where innovation in radio architectures not only leads to higher ADI content per system, but also is critical to improving the coverage, capacity, and efficiency of wireless networks.

The wireless networks are already strained, and the burden placed on them is set to increase with the adoption of more and more 4G-enabled devises. In addition, consumers typically are engaging in very-high-bandwidth applications on their 4G devices, with activities such as video, music, and gaming. Therefore, the demand for data is growing at a much faster clip than the rate of device unit growth. Compounding this issue are newer nodes that await connecting, for example, in the area of machine-to-machine communications, and even in 4G-enabled wearable devices. As a result, carriers continue to invest in their networks, and are benefiting from increased per-user revenue to help fuel that CapEx spend.

Moving forward, we believe that demand in the networks will continue to out-pace supply, and that the limited availability of spectrum will continue to drive the need for more advanced radio solutions, where ADI has been focusing its RF and converter R&D.

The fundamental demand for increased wireless traffic, full-time connectivity, and more and more connected nodes, we believe should drive growth in this business for ADI in 2014 and well beyond. Moreover, several opportunities exist for ADI to leverage this core technology into other areas, such as industrial devices, instrumentation equipment, and health care applications, so that anything that can be connected to the cloud ring will be connected safely and securely.

Our wireline business also grew sequentially, primarily as a result of our strong pipeline of designs in 100-gig optical applications, where customers are benefiting from our precision plucking, timing, and control technologies.

In automotive, revenue increased 9% sequentially, with all three of our focus application areas experiencing growth. A combination of increasing content and vehicle-unit growth helped to fuel our automotive growth this quarter. Safety revenues improved over the prior quarter, as new vehicles accelerated adoption of radar-based advanced driver-assistance systems for collision avoidance.

Power-train revenues also grew, as our battery monitoring technology and start-stop applications continue to gain wider adoption in high-volume vehicles. Recently, Ford announced it plans to offer start-stop technology on 70% of its US model range by 2017. In Europe, start-stop technology is already found in 45% of the latest model vehicles, with demand in that region also set to rise, as consumers opt for the technology, and indeed, government mandates kick in.

By region, demand for premium vehicles in China and the US continue to be strong, and the European vehicle market has also begun exhibiting modest growth, combining to deliver stronger revenue for ADI.

On a year-on-year basis, our automotive business grew 10%, which was the fifth consecutive quarter of year-on-year revenue increases in this business. We see plenty of runway ahead for ADI's automotive business, as we work with the leading OEMs and Tier 1 suppliers, to develop safer, smarter, and more fuel-efficient vehicles, as car manufactures accelerate the use of silicon to further differentiate their offerings.

Finally consumer revenues, which accounted for 11% of total sales in the second quarter grew 5% over the quarter prior, which was the first sequential revenue increase in this sector in five quarters; and is the culmination of a very purposeful shift in the mix of our investment profile. This quarter's sequential revenue performance was largely due to an increase in prosumer audio-video applications, with digital cameras and portable applications flat to the prior quarter in the aggregate.

Overall this quarter, we had a very good performance across the broad diversity of markets we serve, due in large part to the significant investments we are making at ADI, to be well ahead of market trends; but also, as a result of the very purposeful reshaping of our product portfolio over the last several years.

With that I'll turn it over to Dave, who will take you through some of the details of our financial results. After he does that, I'll come back and provide our outlook for the next quarter, and give you some of my thoughts on where ADI stands today. Dave?

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

Thanks, Vince. Good afternoon, everyone. As Vince mentioned, our second quarter was a very good quarter for ADI, with both revenue and diluted earnings above the high end of the guidance. Revenue in the second quarter was $695 million, which was up 11% sequentially and up 5% year over year. Gross margin in the second quarter was 66.1%, up 100 basis points from the 65.1% we achieved in the prior quarter.

Factory utilization in the second quarter increased to the mid-70%s, from the prior quarter's mid-60%s level. Our plan for the third quarter is for utilization to be approximately flat to the second quarter, which on higher expected sales should further decrease our days of inventory. Inventory in the second quarter on a days basis decreased to 115 days from 121 days, and on a dollars basis increased by $8.5 million to $298.4 million, as we positioned our inventory for higher expected sales in the third quarter.

Turning to inventory in the distribution channel, inventory distribution on a dollars basis was modestly higher than in the prior quarter, and weeks of inventory in distribution was at 7.5 weeks, consistent with the prior quarter.

Overall, orders were very strong for ADI during the second quarter. End-customer orders increased sequentially, and our booked-to-bill was above one. Our flexible and robust manufacturing and supply chain operations executed very well, responding to the increase in order flows while maintaining lead times at four to six weeks. Excluding special items, operating expenses in the second quarter increased 5% sequentially, lagging well behind the11% increase in revenue, and in line with our model to constrain the rate of operating expense growth to no more than half the rate of sales growth.

Most of the sequential dollar increase in operating expenses was the result of higher variable compensation, which is paid to ADI employees based on year-over-year revenue growth and operating profit targets, and also due to more days of business in the second quarter. Head count in the second quarter remained essentially flat to the previous quarter's levels. Excluding special items, as a percent of sales operating expenses in the second quarter declined 180 basis points compared to the prior quarter.

During the past 18 months, while uncertainty was the prevailing sentiment in the global economy, we continued to increase investments in areas we believe represent significant growth opportunities for ADI over the long term. We did so primarily by tuning our product and technology portfolio, and redirecting existing spending. With generally improving sentiment and positive signs from our customers, we are prudently increasing our spending in strategic high-performance signal processing markets, while staying true to ADI's financial model. We believe we can make these investments while keeping tight control over expenses, and we expect expense growth to continue to lag sales growth.

Excluding special items, operating profits before tax increased to $220 million, or 31.7% of sales, which is 270 basis points higher than in the prior quarter; and 170 basis points higher compared to the same quarter in the prior year. Other expense of approximately $3 million was flat to the first quarter, and is primarily a reflection of the ongoing run rate of our net interest expense at current debt levels.

Our second-quarter tax rate was 13.8%, slightly higher than our plan, resulting in an adjustment to our anticipated full-year tax rate to 13.5%. We expect our tax rate to be approximately 13.5% for the next two quarters. Excluding special items, diluted earnings per share of $0.59 increased 20% over the prior quarter, and 13% year over year, and was above the high end of our guidance.

Cash flow in the second quarter continued to be very strong. We generated 34% of our revenue or $238 million in operating cash flow. CapEx was $44 million, resulting in free cash flow of $194 million, or 28% of revenue. We returned approximately $138 million to shareholders through dividends and share repurchases. On a trailing four-quarter basis, dividend payments and share repurchases totaled 81% of our free cash flow. And compared to the prior quarter, our share count was approximately flat.

Our 2014 plan is for capital spending to be approximately $180 million, of which about 2/3 relates to ongoing capital equipment spend, and about 1/3 relates to new facilities and upgrades to existing facilities; which is all part of our long-term investing for growth strategy. Our cash and short-term investment balance increased by about $106 million during the second quarter, and now stands at $4.8 billion, with $1.3 billion available domestically. At the end of the second quarter, we had approximately $870 million in debt outstanding, resulting in a net cash position of $3.9 billion.

In line with our capital allocation strategy, our Board of Directors declared a cash dividend of $0.37 per outstanding share of common stock. This will be paid on June 10, 2014, to all shareholders of record at the close of business on May 30, 2014. At the current stock price, this dividend represents an annual yield of approximately 3%. Our total shareholder return, which is calculated as the change in stock price plus cumulative dividends paid on a one-year basis was 17%; and on a three-year average growth rate basis was 12% through the end of the second quarter.

In summary, this was a very successful quarter for ADI. The leverage in our model was evident throughout our results, which were better than planned. On a year-over-year basis, revenue growth of 5% generated diluted EPS growth of 13%. We believe that the investments we have been giving and we have been making, give us a strong design win pipeline that sets us up well for good growth and good profitability going forward. Now I'll turn the call back over to Vince, who will discuss ADI's outlook for the third quarter.

Vincent Roche - *Analog Devices Inc - President and CEO*

Thanks, Dave. While we begin our third quarter with a higher opening backlog than at the start of the second quarter, our order rates remain solid and inventories are in good position. As a result, our plan for third-quarter revenues -- we have planned for third-quarter revenues to grow sequentially in the range of 1% to 5%. We are expecting our industrial and communications end markets to grow, and for our automotive and consumer businesses to be approximately flat to second-quarter levels.

In industrial, we believe the improving macroeconomic picture and more positive sentiment is translating into higher capital spending, which is driving robust order activity throughout our industrial customer base. In communications infrastructure, which is likewise tied to capital spending, we expect the 4G deployments in China and the US to continue in the third quarter, contributing to our plan for sequential growth in this end market. In automotive and consumer, we expect that normal seasonal patterns will prevail, and for revenue from these markets to be approximately flat to second-quarter levels.

Gross margins should increase approximately 50 basis points, as utilization stays at the mid-70%s level, which is flat to the second quarter. Accordingly, we expect gross margin drop-through on incremental sales to be in the mid-70%s, again similar to second-quarter levels.

In line with our model, we are planning for operating expenses to increase at half the rate of sales growth. As margins improve and we grow our revenue year over year, our variable compensation expense will increase. In addition, in the third quarter we will have a full quarter of the annual salary increases which went into effect in April. With OpEx growth lagging our anticipated revenue growth in the third quarter, operating margins are planned to expand to the 32% to 33% range, delivering additional leverage. Based on these estimates and excluding any one-time items, diluted earnings per share are planned to be in the range of $0.60 to $0.64.

In closing, we had a strong quarter in the second quarter of our fiscal 2014, and we have a solid outlook for the third quarter. We can continue to expand margins as factory loading increases and expenses remain under tight control. We will continue generating strong earnings leverage and strong free cash flow, which we will use to further improve shareholder returns. Our investments are well-positioned in signal-processing applications, where we believe we can gain more share of wallet with our customers, as they look to collaborate with ADI to embed sensing, processing, connectivity, and increasing levels of control and monitoring into their diverse products.

Over the past few years, we've made great strides in re-targeting our strategy to focus on industrial, communications infrastructure, and automotive applications, and carefully selecting consumer entry points. We've been redirecting our investments accordingly, all the while increasing investments in advanced technologies to seed our future growth.

We have the highest quality technology and the best people, positioning us very well for the favorable macro trends in energy efficiency, safety, health care, and ubiquitous sensing and connectivity. Now it really comes down to execution, and harnessing the power of our innovation to meaningfully impact our growth rate. We have the talent, the right strategy, the heritage, and the perseverance it takes to be successful, and to continue generating strong financial performance for our shareholders. Thank you.

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

Thanks, Vince. I would like to remind everyone that during today's Q&A period, please limit yourself to one question so we can get to everyone on the line. We plan to run today's call until 6:00 p.m. Eastern. If time remains at the end, we will keep the lines open and give you an opportunity to ask another question at that time. With that, operator, we can now start taking questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from the line of David Wong with Wells Fargo.

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

Noting that you're planning to keep utilization unchanged, even with the expectation of rising sales in July, do you expect to be holding down production in future quarters too, or should we expect production and utilization will rise after the current quarter, if sales keep going up?

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

Yes, I think if sales keep going up we would expect utilization over time to rise.

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

Okay, great. How do you make the decision about when you're going to increase production. Are there specific parameters that you're looking at?

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

Yes, you've got to remember that half our production is actually bought through outside foundries, so some of it is a mix element that the operations guys take into account. Some of it is that we're trying to move our days of inventory down from where we started the year at 121 days and try to get it down to where we would like to be which is 110 days, so that plays into it.

Then there's some anticipation around what distributors are going to do in terms of keeping their inventory carry and how much inventory we have to carry for certain customers that require us to hold inventory for them at their location. Depending on that dynamic it can play into it. There's a lot of moving pieces, obviously David, for this that go into it. We found that the manufacturing team here is excellent. They have a really good bead on this. We've pretty much follow their queue in terms of what utilization should be in any one quarter.

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

Okay. Great, thanks.

Operator

Our next question is from the line of Chris Danely with JPMorgan.

Chris Danely - *JPMorgan Chase & Co. - Analyst*

Can you give us a little color commentary on the sales upside? Was there some sort of a hockey stick during the quarter? Was it just a gradual linear increase? Maybe talk about the geos a little bit? I think you mentioned Europe showed some modest growth. Was that better than expected? Just a little bit of color there?

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

Everyone's sneaking in two questions. Okay, so I'll take the first part. Maybe Vince, you can talk about the geography. I would say in general things strengthened through the quarter. We saw good strength, really pretty much across the board in the areas that we care about, like in the automotive space and the industrial space and in the comm space. I don't think there was any one end market that surprised us. It was pretty much the entire business just performing better than perhaps we anticipated going into the quarter. I'll let you, answer, Vince, the European question.

Vincent Roche - *Analog Devices Inc - President and CEO*

As we said, Chris, we had great strength -- virtually 90% of our business now comes from the core markets of industrial, communications infrastructure, and automotive. Europe has a very strong play in all three of those sectors. We saw good linearity through the quarter, and good strength in all those areas with both large and small customers.

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

Thanks, Chris. I guess we'll move on to our next question.

Operator

Our next question is from the line of Jim Covello with Goldman Sachs.

Jim Covello - *Goldman Sachs - Analyst*

Afternoon, guys. Thanks so much for taking the question. My one question would be around -- you mentioned within industrial, in particular instrumentation and then semi test within that -- that business has been kind of depressed for a while. Some of the customers there saw big order recoveries this quarter. Any visibility on the sustainability and the continued pick-up there, which you have very good and unique exposure to? Thanks.

Vincent Roche - *Analog Devices Inc - President and CEO*

Well Jim, our business and instrumentation has really two sectors to it. It's got the multi-product, multi-customer, which is the classical very distributed instrumentation business. Then we have the many product, few customer business, which is the ATE-related sector. I think we expect to see the first part of the business, the very diverse part of instrumentation, continue to grow pretty steadily, I think, throughout this next quarter.

Who knows on the pure ATE business, which is very lumpy; but it's driven by or has been driven by the automotive and semiconductor test areas. We think as well at some point, there's going to be a rise in the building out of equipment for the mobile space. Very hard to read that piece of it, but I think overall the instrumentation business will be steady in the third quarter.

Jim Covello - *Goldman Sachs - Analyst*

Thanks very much.

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

Thanks, Jim.

Operator

Our next question is from the line of Craig Hettenbach with Morgan Stanley.

Craig Hettenbach - *Morgan Stanley - Analyst*

Yes, thank you. I had a question on business and distribution. I know you guys recognize revenue on sell-through, but it looked like deferred income to distribution was up 9% sequentially. Just trying to get a sense of -- inventory still feels on the lean side, yet that's a decent-size increase sequentially, so what you're hearing from distributors, and what that might suggest in terms of the pipeline of business there?

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

Yes, good question, Craig. As you point out, deferred margin was up 9%. Some times I would point out that moves around, not only because revenue changes, but also because the cost of units change. That does have an impact. We did see a little bit of a rise in inventory in distribution, but it was kind of in line with the revenue growth. As a result, the days of inventory stayed pretty much the same as it did the prior quarter.

There was towards the end a pick up in the shipments to distribution. We did have some amount of distributor revenue that was in transit so isn't counted in our days of inventory, but nevertheless left our docks, and kind of moved over -- or is in process of moving over to the docks of the distributors. That did raise the deferred income a bit higher. Probably it was more a result of holidays and so forth that caused that.

I do think, though, the fact that distributors are growing inventory in line at least with their revenue growth does suggest that there's some optimism about the next couple of quarters in distribution, or at least the next quarter in distribution, and that they do see the next quarter being pretty strong. Outside of the next quarter it's kind of hard to predict what they will do, but I do look at it as a favorable sign.

Craig Hettenbach - *Morgan Stanley - Analyst*

Got it. Thanks a lot for that color, Dave.

Operator

Our next question is from the line of Craig Ellis with B. Riley.

Craig Ellis - *B. Riley & Co. - Analyst*

Thanks for taking the question, and nice job on the quarter, guys. My question is more longer term. When I look at the guidance, it looks like the implications of the end market growth means the communications will be at record revenues. You've been knocking that out pretty consistently with automotive as it drifts higher as a percent of mix. But when I look at industrial, we're still about 10% to 15% below the peaks for that end market. As you look at the different end demand drivers and the products that ADI has, what do you think it takes from here to get that particular end market back to the levels that you saw in the mid-2011 time frame?

Vincent Roche - *Analog Devices Inc - President and CEO*

Well, remember in 2011 there was the whole tsunami situation, which dramatically over-inflated demand, so that was a big factor. But I think -- I've talked with a lot of industrial customers over the past six months, and I think the general consensus is that there's going to be a steady improvement in the spend of CapEx in industrial plant and automation equipment in the years ahead here, because particularly in the US, the age of manufacturing equipment is beginning to really creak. It's getting old, and there's and a natural replacement cycle that is going to -- is starting to take place here, at least in the US and I believe Europe as well.

I think as the macro situation continues to kind of gently improve, that bodes well for the industrial business. I think you've got to look at that business as well over a very long period of time. We're bullish based on the product crop that we have, the customers we're engaging with across the globe, and what we hear, the sentiment we hear and the evidence that we see in terms of increasing CapEx spend.

Craig Ellis - *B. Riley & Co. - Analyst*

Is that really the factory automation and industrial process control part of that business, Vincent, or -- I assume you're not speaking of the medical part of industrial. I'm just trying to narrow that down and understand what sub-segments you're referring to there?

Vincent Roche - *Analog Devices Inc - President and CEO*

Yes, it's really industrial automation. I think the instrumentation business as well will continue to improve. Energy too is a fairly modest business for ADI, but we've seen some improvement in latter months, as well, in that area.

Craig Ellis - *B. Riley & Co. - Analyst*

Thank you.

Vincent Roche - *Analog Devices Inc - President and CEO*

But I'm specifically not talking about health care when I talk about the industrial sector here.

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

The instrumentation and automation pieces of that industrial business clearly take up a good chunk of what we do in industrial. Thank you, Craig. We'll move on to our next question?

Operator

Our next question comes from the line of Doug Freedman with RBC Capital Markets.

Doug Freedman - *RBC Capital Markets - Analyst*

Thank you for taking my question and congratulations on the strong results as well, guys. Dave, a question for you. When we look at the variable comp now starting to kick in, how do I think about the way in which that program works when you're going to probably feel maybe a seasonal decline in the business starting off next fiscal year? Will we see both the OpEx numbers come down? I know you just -- if we look back at the January 2014 quarter there was a small decline, but I don't know that the variable comp was a big part of that?

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

Well, I think the key -- well, there's two components to it. One is -- and it's 50-50. Half of it is driven off of year-over-year revenue growth. To the extent that the sequential decline, if there is one, from the fourth quarter to the first quarter still drove a year-over-year revenue growth, there is probably no impact to that 50%, depending on what year-over-year growth rate we're talking about.

To the other piece, the other 50% is kind of the self-correcting piece that's related to operating margin percentages. That does obviously come down if revenue were to decline, because there would be some pressure on operating margins, thus it would self-correct a little bit on the variable comp. Net-net the variable comp should come down in a situation where we have a sequential decline, which is typical in the first quarter, but it probably won't be to the magnitude you might think of.

Doug Freedman - *RBC Capital Markets - Analyst*

Okay, great. Thank you for that color.

Operator

Our next question is from the line of Stacy Rasgon with Sanford Bernstein.

Stacy Rasgon - *Sanford C. Bernstein & Company, Inc. - Analyst*

Hi, guys. Thanks for taking my question. I wanted to drill a little bit into the communication infrastructure. It sounds like you seem to be seeing both cyclical as well as potentially secular strength in this. I was wondering if you could give us a feeling for how much longer you believe the 4G build-out that we're seeing right now are going to take place? Maybe give us a little more color on the secular aspect of this in terms of content increase? How much is your content per base station increasing as we're migrating, and how much life do you think this common infrastructure lift we're seeing right now has?

Vincent Roche - *Analog Devices Inc - President and CEO*

Let me take your second question first, Stacy. We're seeing about a 20% increase per system, per antenna basically, in terms of the overall content that we ship into these base stations.

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

For 4G systems.

Vincent Roche - *Analog Devices Inc - President and CEO*

For 4G systems. When it comes to what we see in terms of demand here -- as I've said before, the infrastructure business is very lumpy. But I think what we're starting to see in play now is obviously China is very strong, very hot at the present time, but America also continues the densification of the network. We're seeing companies like Sprint up their CapEx and continue to build out the infrastructure there.

There are also trials taking place in Europe now. Europe is at long last beginning to wake up to the need to replace and upgrade it's network to 4G. I think what we're seeing is a major shift towards 4G. In fact, it will be we think towards the end of this year it will probably be 50% of our total unit shipments into those particular base station units. That will likely be the trend. We see continued growth in that business throughout the year, and we'll take next year as it comes. But I think at least from the signs we see at the present time, we have a lot of cause for optimism.

Stacy Rasgon - *Sanford C. Bernstein & Company, Inc. - Analyst*

Got it. That's helpful. My follow-up, I just wanted to ask quickly, you said you were building -- some of your CapEx was being spent on new facilities. Could you give us some color on that? What is that? Is that assembly and test? Is that wafer fab? What are you building out?

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

Good question. There's about -- of the $180 million or so that we'll spend this year, about $60 million is related to plants and equipment, I guess -- or plants, rather. The most significant piece is a new design center in Ireland that we agreed to put in, we're actually getting some assistance from the Irish government, as well. There's another couple of pieces that are -- we have a small building getting built in the Philippines. That is related to manufacturing, so that is back-end test. Then we have an upgrade of a building in Greensboro, which is also design related, so that's more an engineering building.

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

Thanks, Stacy, and we'll move on to our next question.

Operator

Our next question is from the line of Romit Shah with Nomura.

Romit Shah - *Nomura Asset Management - Analyst*

Just want to go back to the April results, which were clearly much better than your comps were reported with the March quarter end. It just seems like a big reversal from what we've seen in prior periods. I'm just curious, how much of this is a one-month lag versus new product traction that could be driving something that's more sustainable?

Vincent Roche - *Analog Devices Inc - President and CEO*

Well, I think it's a combination of many things. Obviously, given that our business is very CapEx-centric, as the macro environment gently improves that helps. I think very clearly in the automotive, communications infrastructure sectors in particular, we're getting a lot of new product growth traction. I think it's a combination of those two things, really.

Romit Shah - *Nomura Asset Management - Analyst*

Okay, thank you.

Operator

Our next question is from the line of Ross Seymore with Deutsche Bank.

Ross Seymore - *Deutsche Bank - Analyst*

Thanks, congrats on the strong quarter and guide. Vince, a high-level question for you. In the last couple years we've seen a good, strong, first half of the year in semiconductors, and then the second half has slowed down, whether for macro reasons or otherwise. You definitely sound a lot more confident about what the growth is looking like this year. Can you give us a little bit more color on why you're confident? Any sort of data points, duration of backlog? Anything along those lines that helps us understand the longer-term confidence that you guys are displaying now? Thank you.

Vincent Roche - *Analog Devices Inc - President and CEO*

Yes, Ross thanks for the question. What we see, I think the facts are we have very little visibility beyond the quarter. That's a fact. But I can tell you that our customers in CapEx areas and the automotive customers are seeing good backlog right through a significant portion of the year coming. I've said before that from talking to customers across the globe, particularly industrial customers who are involved in plant automation and process control -- very specific process-control systems, there's just a general improvement in the sentiment and their confidence to actually lay out CapEx -- or customers to lay CapEx on them.

I think it's a combination of the gradually improving macro environment, the stability there. I think, as we said, our business is so CapEx sensitive that we pay very close attention to what our industrial customers and infrastructure customers tell us. Things are just generally better now than they were last year, let's say.

Ross Seymore - *Deutsche Bank - Analyst*

Great, thank you.

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

Thanks, Ross. We'll move on to our next question, please?

Operator

Our next question is from the line of Steve Smigie with Raymond James.

Vince Celentano - *Raymond James - Analyst*

Thanks, this is Vince filling in for Steve. I was hoping you can go into a little detail as far as what the size and growth of your MEMS business currently is?

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

We don't typically go into more detail than we provide on the earnings release and in the K, or in the Q.

Vince Celentano - *Raymond James - Analyst*

Okay. In that case could you go into a little detail about your front-end solution as far as how much is currently done in house, and what your eventual target would be?

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

In total or related to MEMS?

Vince Celentano - *Raymond James - Analyst*

In total.

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

In total. Okay, so we do about 50% of the wafers internal, and the other 50% we source from outside foundries. That's actually been pretty consistent, almost since I've been here it feels like. I wouldn't say we have a particular target in mind, although we do like to keep our internal fabs as full as possible.

A lot of it's based on the particular process that products have been designed in, depending on whether it's very fine line or CMOS or any that -- in general it usually goes outside. For all the other processes and things that kind of go above 0.18 or 0.25 micron, we generally do inside. The way things have been trending and the way our products have gained traction, it just appears we seem to be on this kind of normalized level of about 50% internal and 50% external. I don't see any reason why that would change.

Vince Celentano - *Raymond James - Analyst*

Great, thank you.

Operator

Our next question is from the line of Vijay Rakesh with Sterne, Agee.

Vijay Rakesh - *Sterne, Agee & Leach, Inc. - Analyst*

Hi guys, good quarter. Just a question on the comm side. It was up nicely, 10% sequentially. But when you look at China, how much of that 400,000, 500,000 base station roll-out is done? Do you see an acceleration -- a re-acceleration of comm going to the second half?

Vincent Roche - *Analog Devices Inc - President and CEO*

Yes, I really can't answer. I just don't have the -- I really don't have the number in terms of how much of the original contract has already been spent. The indications are that we'll have another good quarter in the third quarter in China. That's pretty much, in terms of the evidence I can give you, I don't have any more granularity than that.

Vijay Rakesh - *Sterne, Agee & Leach, Inc. - Analyst*

Got it. On the consumer side, you mentioned strength from prosumer. Is that mostly power management that you're doing in there? What are you driving on to the consumer side?

Vincent Roche - *Analog Devices Inc - President and CEO*

Yes, so it's a mixture. It's actually a mixture of many different things. It's DSPs. We have high-end DSPs in there. We sell a lot of converters, interconnectivity products, linear products, in areas like studio broadcast -- in media systems for enterprises, for example. It's a great mixture. It's a lot like a horizontal business, with lots of customers and lots of different products.

Vijay Rakesh - *Sterne, Agee & Leach, Inc. - Analyst*

Got it, thanks.

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

Thanks, Vijay. We'll move on to our next question, operator.

Operator

Our next question is from the line of Blayne Curtis with Barclays.

Blayne Curtis - *Barclays Capital - Analyst*

Thanks for taking my question. I was wondering if going back to the consumer segment, you saw it rebound off the bottom but then flat. I would assume July and October would be seasonally stronger quarters. Wondering if you could talk about what's going on there and then address the opportunity for some of these -- I don't know, what you call biosensors or heart rate sensors -- obviously a win and a watch, small volume. But can you just talk about the longer-term opportunities there for you?

Vincent Roche - *Analog Devices Inc - President and CEO*

Yes, as we've always said, we pick our entry points in the consumer market very carefully, particularly the portable area. We participate in areas where we can find audio, sensor, and imaging-type applications, where we leverage our core technologies that we re-purpose for those applications. My sense is yes, the back end of the year will be better. Again, that's a business that's very programmatic and very hard to predict quarter on quarter. But overall I think we're playing in the right places, with the right customers and right technologies.

I believe -- as I've said before, I believe we're reaching the bottom of the re-profiling of our consumer business. Things will improve gradually. I think we've got a good base of business now. With some of these newer applications that we're playing in we'll see some decent growth in future, including the vital signs monitoring application, where again, we've developed technology for clinical applications that we have re-purposed for some of these vital signs monitoring in consumer areas.

Blayne Curtis - *Barclays Capital - Analyst*

Got you. Then just a quick one for Dave. I just want to make sure. Your inventory levels, are you going to get to your target this quarter based on the revenue guide that you gave, and then we can think about utilization in terms of revenue for October and beyond?

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

I think it will come down. I'm not quite sure it will get down to the 110-day target. I would say that we're looking for a glide path to 110 days by the end of the year.

Blayne Curtis - *Barclays Capital - Analyst*

Got you, thanks.

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

Thanks, Blayne. Move on to our next question, operator.

Operator

Our next question is from the line of C.J. Muse with ISI Group.

C.J. Muse - *ISI Group - Analyst*

Good afternoon. Thank you for taking my question. I guess specific to the industrial segment, curious what impact recovery in Europe has had on that business? Then if I could sneak in a second question, was hoping you could talk bigger picture about your strategy for power management. You guys clearly a leader in data converters and amplifiers. Curious how to think about your focus on that business? Thank you.

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

I'll take the second one, which is the power management question, and then I'll pass it off to Vince to answer the first one. On the power management side, our strategy is somewhat kind of selective. What we try to do is develop power solutions that fit along side our signal processing solutions, in an effort to provide kind of a complete holistic solution to the customer.

We're not trying to be a broad-based supplier of power. We're trying to pick our spots where we're very strong on an applications basis in signal processing, and then pull along the power. Quite honestly, it's a situation where customers are actually asking us for that. They want a complete kind of out-of-the-box solution and power is an important part of powering the signal processing. In those instances, when they want us to marshal all the resources to bring forth a solution, we leverage our power capability to do that.

Vincent Roche - *Analog Devices Inc - President and CEO*

Thanks, Dave. Yes, so with regard to Europe, the areas of primary strength for us over the last quarter or two really has been -- the areas have been industrial automation, instrumentation. Our health care business is healthy, doing quite well. But the standard performers really at this point in time right now are automotive and communications infrastructure -- not surprisingly, given the strength of Europe in those particular areas.

C.J. Muse - *ISI Group - Analyst*

Great, thank you.

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

Thanks, CJ, and we'll move on to our next question, operator.

Operator

Next question is from the line of Stephen Chin with UBS.

Stephen Chin - *UBS - Analyst*

Hi. Thanks for taking my question, and congratulations on the solid results and guidance.

Vincent Roche - *Analog Devices Inc - President and CEO*

Thank you.

Stephen Chin - *UBS - Analyst*

Vince, I wanted to get some more color on the future R&D, or at least investments in future growth areas. Can you provide some color on how you're prioritizing those investments, and whether you're looking at it more from further enhancing and expanding gross margins, or is it operating margins you're looking at, or is it maximizing the investment you have on the internal wafer front-end fab investments, and so forth?

Vincent Roche - *Analog Devices Inc - President and CEO*

Well, our investment strategy is really is to find as many attractive opportunities as we can in the B2B space, which is industrial, communications infrastructure, and automotive, and very selectively pick spots in the consumer area where we can play and really make a difference. We're a signal processing Company. We think there's a tremendous future for ADI in the signal processing space.

As Dave said, we've increased our OpEx on specifically trying to find ways to increase the strength of our portfolio and converters. We're picking every spot. We're really pushing performance there. Our linear products, we've been increasing spend in areas like RF and microwave, increasing our spend in our MEMS technology, which traditionally has been strong in the automotive area. We continue to see a lot of up side there. We're also diversifying our MEMS technology into industrial applications.

That gives you a sense for how we're viewing things. Number one job for us is to make sure that we keep our core, we defend our core and grow it. That's job number one. We've increased our impetus as well in looking for new waves of growth that can leverage our technology in new and exciting applications, in areas that maybe connect our tech to the real world to the cloud for example. We see signal processing as a great space to be, and we're focusing more and more and more in the B2B area in that technology space.

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

As you mentioned, Vince, that's now about 89% of our total sales. Hope that answered the question, Steven. We'll move on to our next question.

Operator

Our next question is from the line of Ian Ing from MKM Partners.

Ian Ing - *MKM Partners - Analyst*

Yes, thanks. I share in my congratulations. For Dave, you have a nice capital return strategy, 80% of free cash flow returned to investors. Any room to revisit that, or do you have new product investments? It looks like TI is running close to 100%, Maxim's been running above 80%, perhaps, Dave talk about something tomorrow at the Analyst Day?

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

I think what right now we're going to stick with the 80%. We've only been doing it for about a year. Vince, you announced it at this call last year. I want to see how that goes for a while. There is, I think, a desire on our part to put some of the cash to use in other ways -- some tuck-in M&A and so forth. I want to keep something available for that purpose.

Quite honestly, I think 80% is a pretty good return of cash, in my opinion, particularly when a good chunk of that is coming in the form of a dividend, which is consistently paid year in and year out, and actually grows year in and year out. For now we'll stick with the 80%, and we'll revisit it, perhaps, at another date.

Ian Ing - *MKM Partners - Analyst*

Thank you.

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

Thanks, Ian. Another question, operator?

Operator

Yes. Our next question is from the line of William Stein with SunTrust Robinson Humphrey.

William Stein - *SunTrust Robinson Humphrey - Analyst*

Good afternoon. Thanks for taking my questions, and again, congrats on the good quarter and the outlook. Understanding that you have a mix of what you manufacture internally and externally, can you give us an idea at what revenue level and utilization level do you think you're likely to start seeing lead times stretch, and kind of bumping into a point where you need to add more fundamental capacity -- not just design capacity that you've discussed earlier?

Dave Zinsner - *Analog Devices Inc - VP Finance and CFO*

On the wafers we manufacture internally, we're obviously -- we're only in the mid 70%s. We have a pretty decent runway before we run into a challenge, just in a quick capacity. We have actually more clean-room space than that. Equipping it is relatively inexpensive and can be done relatively quickly, such that if you say that right now roughly $350 million or so of our revenue comes from internally sourced wafers, I think we

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could easily double that if not more before we ever have to worry about something on the front end. I'll love when that problem arises, but I don't see that problem coming forth any time soon.

On the external side, we have a pretty focused set of foundries that we use. Because of the volume that we purchase from them, we tend to have a lot of clout. We've been into situations where in the past where things have up-turned quite significantly -- in fact, this quarter being an example of one. We get very good reaction from our foundry partners in order to meet that demand. Again, these are foundries that have very good capacity. We tend to be a lagging-edge node for them. We get -- I don't think we're going to run into an issue there.

On top of that, one of the reasons we carry right now 115, but hopefully gliding down to 110 days of inventory -- which is not an insignificant amount of inventory -- is because we want to make sure we keep lead times short. We have a lot of buffer inventory, both on our balance sheet and with the distributors to make sure we keep lead times very short. I think in the last -- certainly in the time I've been here, which is five years, and I'm going to guess in the last 10 years -- I don't think we've ever had lead types stretch out beyond the four to six weeks we've been operating in. I don't think that's going to be much of a risk for us.

William Stein - *SunTrust Robinson Humphrey - Analyst*

Great, thank you.

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

Thank, Will. Looks like we are a few minutes short of the hour. I look at Christina here and she tells me there's no one left in the queue. With all that, I would like to thank you for keeping very good time. Just a reminder, again ADI will be hosting our Analyst Day on June 17 in New York. I invite everyone to listen in. Links to the webcast and presentations will be available at the ADI Investor.analog.com web page. Secondly, our Third-Quarter FY14 Earnings Call is scheduled for August 19, 2014, beginning at 5 p.m. Eastern. Thanks again for tuning in, everyone. Good night, and we look forward to seeing you on June 17.

Operator

This concludes today's Analog Devices Conference Call. You may now disconnect.
