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EDITED TRANSCRIPT

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OVERVIEW:

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CORPORATE PARTICIPANTS

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PRESENTATION

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

Great. I think we can get started. So very privileged to have Analog Devices today, and honored to have the CFO, Prashanth Mahendra-Rajah. Prashanth is the CFO of Analog Devices. He's responsible both for financial strategy, oversees the company's global finance organization with responsibility for financial management, planning controls and reporting. Prior to Analog Devices, Prashanth was the CFO of WABCO Holdings and he previously served as Division CFO and other financial leadership roles at Applied Materials, Visa and United Technologies. So Prashanth, thank you for coming. Welcome.

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

Thank you, Mark. Pleasure to be here.

QUESTIONS AND ANSWERS

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

Great. So Prashanth, I want to start out. You made an announcement on your earnings call that you intend to leave the company at the end of the fiscal year. As you look back over the last 6 years at the company, can you share with us your view as to what accomplishments are you most proud of? And what surprised you most about the industry and ADI as you kind of hit the ground running?

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

Yes. Thanks, Mark. So on a personal level, I would say that I am very proud of the team that we have built in finance at ADI. And the growth that we've seen in that finance leadership team. Several of them have already gone on to become company CFOs, and I would expect several of the -- of my current staff at some point in their career to also become company CFOs. So it's great to see that type of talent development. On the business side, I think that the discipline that we, as a finance team, brought to ADI in focusing on how to deploy our capital is something that I'll take with me as I go to whatever opportunity I take on next.

ADI is a unique organization in that the ideas that we have on where to invest our money vastly exceed what our financial model would normally allow. So the role of finance has been really in culling that list and ensuring that the best opportunities rise to the top, and they get funded, and good ideas, while still good, stay on the shelves perhaps for another day.

Your question on the -- latter part of your question on over the last 6 years, what has changed or surprised me? I actually think about, Mark, and if you guys haven't read this, I would encourage you to, there was a research piece that Mark wrote a long time ago called -- I think it was called the renaissance of Analog. Am I getting the name right?

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

Analog Renaissance. Thank you for remembering.

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

Analog Renaissance. and it turned out to be relatively prescient that how the industry has evolved and how semiconductors went from when you used to tell people you're in the chips business. If you're in the U.S., they would think potato, if you were in London, they would take French fries to now people really understanding and becoming a national security priority for many governments has been quite a change and the role that Analog has played in its revival, whether it be in electric cars or advanced automation, health care, I mean there's just been so much growth in the application space that requires Analog technology to enable the digital processing that we've created.

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

Right. And the change has kind of played out a lot faster than I had expected in ways I did not expect. And I think what has happened over the last 3 years with tightness in the supply chain and geopolitical dynamics. Has ADI -- can you talk about how ADI has changed how it is -- engaged with customers and your suppliers. And how do you think about the supply chain?

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

In some respects, COVID has been disproportionately beneficial to companies like ADI. And I say that because our customers became very acutely aware of the important role we play in their products, capabilities and features. And they learned that during a period where there was a shortage of supply, and therefore, executive leadership were getting briefed on who are the suppliers that are causing some of their production challenges.

It opened up doors of engagement with ADI's leadership. And we used those -- that engagement to actually build a deeper partnership with many of our customers. And if I think about where we are today in terms of our access to senior leaders at companies of much, much larger scale than ADI compared to when I joined the company, it is vastly different. I mean truly there are CEOs who now will have my boss, Vince on speed dial. And actually, he gets invited to Board meetings too to educate the directors of our customers about the semiconductor industry. And all of that, I think, is an evolution of how our customers learn the importance of what we bring to them.

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

Great. That's very helpful and insightful. I am sorry that you're leaving ADI. I think I appreciate and grateful for the help that you have given me as -- to help me understand more about the company. And when a CFO leaves a company, it usually raises a flag for investors. Whether it's a yellow flag or a red flag or a green flag is not clear, and I hope you don't mind me asking why are you leaving ADI? And where is ADI in a search process for your replacement?

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

Yes. Absolutely. Yes. So I've had 6 amazing years at this company. When I joined, we were printing $3 billion of revenue. This year, we'll do just a little bit under $13 billion. It's been a phenomenal growth story, tremendous value creation for the company's owners, and I'm ready for a different challenge. So it's a conversation that Vince and I have been having, which is why you see a very long transition period here. I gave the company 6 months' notice to work through, allowing them time to start a search, which will evaluate some internal candidates as well as external. And then I'm in the chair through the end of the year. And at that point, we'll see what interesting opportunities there are out there for me. So I know I leave the company in great hands with that finance leadership team that I just referred to is any good organization is always much, much more than an individual.

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

Great. All right. That's very helpful. Thank you for answering that question. Can we talk a little bit about what's going on in kind of a shorter term? On your earnings call, you provided a revenue outlook for the July quarter that was 5% below the April quarter. Your book-to-bill was below parity in all markets. You said the lead times are under 13 weeks for 70% of your products. That's versus 50% in the January quarter. Backlog you had mentioned was returned to its typical coverage range. And total backlog continued to decline. And perhaps most importantly, you noted a quick deceleration in demand from Chinese customers that led to lower channel sell-through. So the question is, what's going on? What's happening with this quick deceleration? Is that deceleration accelerating? Where do we go from here?

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

Great. Yes. So let's do that in two pieces. Let's do China and then rest of the world. So China specifically, we were optimistic as I think many people were that after years of lockdown or rolling lockdowns and various challenges from COVID or the Zero COVID policy in China that once that was behind them and the country reopened, we would see sort of a resurgence in activity as we did in the U.S. and Europe. Therefore, we were expecting the second half to be better than the first half. This is after we've had a couple of quarters of decline in China.

That did not materialize. We saw a spike in order activity sort of early on in the quarter in our second -- fiscal second and then it faded and it has stayed relatively muted since then. Now our team on the ground who I know and trust to be very close to customers is also struggling with this challenge of there was an expectation that there would be more fiscal stimulus in China, and that is not materializing to the level that people were expecting, though there was a little bit of good news last week. Some of you may have heard that there are some EV subsidies being reintroduced. I think, towards the later part of last week, they made an announcement on that should be, in general, constructive for EV sales. Most Chinese car buyers know that subsidies are always around the corner, so you just sort of wait until there's a little bit of help before you make a big capital purchase like that.

But on the industrial side, it certainly is continuing to soften. So I think China is going to remain challenged for the balance of this calendar year unless we see some more government intervention. Broadly, when I speak to the rest of the world, I think, Mark, an important point is something that you said that we have brought our lead times down drastically, down to 13 weeks. It has been a hard-fought battle for us with manufacturing to build out our die bank to add capacity to get us back to a business model where customers can, for the most part, place an order for what they need at the start of the quarter and get delivery before the end of the quarter.

What is good about that service model is that now you're getting true demand signal, you're really reading it from the market because folks aren't anticipating what they might need 2, 3 quarters out and making forecasts on you that then change over time. So when you compare my comments to what you might hear from others on this stage or other semiconductor companies you track, I think it's important that you look at where their lead times are versus ADIs and there's one large competitor to ADI that also has done a nice job with lead time improvements. We are getting the signal. I think some of our competitors are still hearing a little bit of the noise.

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

Got you. And there is a heightened sensitivity about exposure to China. Can you talk about what your exposure is on the consumption side versus the supply side?

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

Sure. Yes, yes. So we are -- in a normal year, we would have been about 20% of our business in China and 20% for us will be defined as revenue where the engineer who designed the product, the customer sits in China. So we do it on a design basis, not on a destination or ship-to basis. So if you're a U.S. manufacturer, but your products are assembled in China, we consider that a U.S. revenue versus Chinese revenue. Because of the growth in Europe and U.S., that China mix has probably fallen to 16%, 17% because we've had such strong growth in U.S. and Europe versus China.

On a supply side, we do not do any manufacturing in China. So -- or almost no manufacturing in China. So we serve China from our operations outside of China.

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

And you talked about auto being a little weaker in China. Was the auto weak outside of China also? Or is that...

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

No, no, that's very much a China-specific comment. I think that we will continue to see some pressure on auto. I met with a very large investor yesterday and their model is that they're expecting SAAR to be down 5% next year. They're the first ones I've heard start calling for a down SAAR number. Our outlook remains consistent that in a flat SAAR environment, we have strong content growth from BMS where we are the market share leader. Our A2B, which is the most advanced audio technology for audio distribution and GMSL, the most efficient way to move data in the car, the secular trends the design wins for those 3 portfolios give us confidence that in a flat auto environment, we can do high single-digit revenue growth. So I -- that does not change from an economic standpoint, high single digits in a flat environment. But if SAAR does come down, then we'll adjust that outlook accordingly.

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

Got you. Okay. And this cycle, when we think about the supply chain, there's a particular disconnect between what a lot of semiconductor management teams are saying on the earnings call about channel inventories that is that the channel inventories are lean. And then -- but if you look at the balance sheets of some of the largest distributors that shows days of inventory at near all-time high levels. Can you help us just give us a state of the union on your channel and like how might investors reconcile those 2 diverging kind of commentaries?

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

Sure. Yes. So to be a distribution partner with Analog Devices, you have to agree to a data exchange where you're providing us, on a weekly basis, information about how our products are moving through your company. So you'll be letting us know the destination, the pricing, your inventory levels and so forth for ADI products. That allows us to run our business really on sell-through. And for the large -- for the most part, our management team does not look at sell-in. Sell-in is an accounting construct that the SEC requires us to abide by, but we really think about the business on sell-through. .

On a channel inventory level for ADI, we target 7 to 8 weeks. We are below that today, a little bit higher in China, which I mentioned on the earnings call, and we will undership China for the next quarter, maybe one more quarter to bring that back down. But our plan is knowing that our fourth quarter and likely first quarter are going to be seasonally -- are going to be sequentially softer as we go forward here in time. We are keeping our channel inventory extremely tight, and we'll get to 2024 and then determine what's the right level. I know that some of our distribution partners are working through some inventory levels that they've received from other companies that they're -- they need to figure how to move through.

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

Okay. Excellent. That's a very helpful insight about how your -- you insist your channel is tied to your systems. And then when we think about the semiconductor cycle, how would you kind of characterize how things are playing out differently? Or what's different about this cycle, how is ADI handling the whole dynamics around tightness versus previous cycles?

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

Yes, yes. A couple of points. Point number one would be that as a company, we are meaningfully more diverse than we ever have been. And that diversity gives us a great buoyancy to our business that is resistant to some of the peaks and valleys that we have seen as a much smaller company. Point number two is our businesses have different cycles within the larger enterprise. So our consumer business has already bottomed, and we expect that to start to improve sequentially for the third quarter and into the fourth quarter. Our communications business has bottomed. I expect that to stay flattish for the balance of the year, and then we'll see what 2024 brings. Our automotive business, as I said, is largely going to be a function of auto production. So flat auto production and that business will grow because of the secular drivers on that.

50% of our revenue is industrial. Within that industrial, 50% -- 40% of the 50% are segments that we believe are highly recession-resistant. That's aerospace and defense; health care, which is now in its eighth year of double-digit growth; and our sustainable energy businesses. So those also will be more resistant to sort of the peaks and valleys that you get from these economic cycles. So as a mix of the business, I think we have different parts of the business that are in various stages of their reset, but we've had 13 quarters of growth. So it's probably time for a little bit of a pause.

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

Got you. Okay. You discussed the ADI hybrid manufacturing model. Over the past 15 years, there had been -- there has been a movement in semis to move to more of a fab-light model. And I think that started during the time when the industry was flushed with capacity, and there was kind of a movement globally for various governments to take steps to integrate into the world economy. And today, it seems like the setup is the exact opposite with tighter capacity and geopolitical tensions rising. Can you just remind investors what's the hybrid model? And how do you think about it in the context of this changing backdrop?

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

Sure. Yes. So there's 2 elements to ADI's manufacturing strategy. There is the hybrid manufacturing model and there is swing capacity. And then you have to take them together. The hybrid model is simply our philosophy that we need access to a very wide range of technology. And it is not possible for us to own internally that breadth of technology. Today, we have products that are shipping it 28 nanometers. We are taping out at 7 nanometers. We would never have enough volume to be able to own a 7-nanometer fab ourselves. So we will always rely on partners. And because we are a performance-driven company, we need access to technology that solves the performance challenge and that can come in different forms, which require that breadth of process chemistry experience.

So that's the hybrid model. There are processes we run internally and then there are processes that we rely on our foundry partners for. The swing capacity, which comes with that is the arrangement that we have with certain foundry partners that allow us to run their proprietary process within our four walls and it's an arrangement that they've given us and the benefit of that arrangement is that when our volumes start to fall due to macro conditions, we have the ability to bring more production internally, keep our foundries, keep our internal fabs at a higher utilization rate. And you see that in our investor model where we've committed to a 70% gross margin floor. That gross margin floor is because we have this swing model that allows us to keep our fabs at a higher utilization than they otherwise would be during normal peaks and valleys.

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

Got you. And are you -- in light of the fact that the supply chain has gotten quite tight, and you can make the argument that the industry had underinvested in capacity, which is one of the reasons that things got so tight, and combining that with increasing geopolitical tensions, are your customers coming to you with a different set of requirements about diversifying your supply base or becoming more vertically integrated or less sourcing of materials and raw materials?

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

Right. By the -- when you think about some of the things that have happened in the past, the earthquake and fire in Japan, the freeze in Texas, which shutdown a couple of fabs, customers are clearly more aware of the importance of having resiliency in their supply chain. The challenge, as you know, with Analog, Mark, is that when you solve a high-performance Analog problem, it is very hard to dual source that. And therefore, the customers are asking the suppliers to be able to create that dual sourcing optionality for them. And by the end of 2024, we will be able to source 90% of our SKUs for more than one location, and that is how we are addressing that concern for our customers.

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

Got you. And you brought up the target operating margin 70% floor. You -- so this is just 14 months ago, you had your Analyst Day, which was quite a good Analyst Day. Thank you for hosting that. And then you also have a bogey of operating margins between 42% and 50%. So last quarter, you reported 74% gross margins and 51% operating margins. So you are above your target model. So is if you're not resetting the model, is the implication that it should revert back to those ranges?

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

I think that when you're a company that has extraordinarily high profit levels, the benefit is on the upside, you get great operating leverage and the negative is when you have periods of contraction, you also have operating leverage. So there are things that we do. I mentioned the swing capacity. There are some very specific features in our OpEx spend that are also variable in nature that allow us to minimize some of that pain.

But over the next couple of quarters as we see a little bit more pressure on the revenue, I think you can expect our margin numbers to stay sort of in that model range. I want to remind investors that we did -- we do have a thesis out there -- or a statement out there that says in a peak to trough decline of 15%, we are extremely confident we can still maintain a 70% plus cost gross margin in sort of north of -- in north of 40% operating margin, which -- if that's a company that you would own in tough times then imagine how good it is when you own it in the good times.

Mark John Lipacis - *Jefferies LLC, Research Division - MD & Senior Equity Research Analyst*

Great. Well, I think we are -- the clock is ticking down right now to the last second here. I think that's a great statement to wrap up the presentation with. So Prashanth, thank you very much for joining us today and for the great presentation. Really appreciate you coming.

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

Thanks so much, Mark. It's been great to work with you.
