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# EDITED TRANSCRIPT

ADI - Analog Devices Inc at Raymond James Systems,  
Semiconductors, Software & Supply Chain Conference

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## CORPORATE PARTICIPANTS

**Dave Zinsner** *Analog Devices, Inc. - VP Finance & CFO*

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

## CONFERENCE CALL PARTICIPANTS

**Steve Smigie** *Raymond James - Analyst*

## PRESENTATION

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**Steve Smigie - Raymond James - Analyst**

Thanks, everybody, for attending this session. Today we have Analog Devices with us. My name is Steve Smigie. I am the analog and communications semiconductor analyst here at Raymond James. We have Dave Zinsner who is the Chief Financial Officer, and we also have Ali Husain who is the Director of Investor Relations.

So with that, we will get started. Dave, obviously there was a -- Microchip came out and scared people and then changed their mind. So just curious, just a quick summary of where you think we are in terms of the end markets out there right now.

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

Okay. Yes, I mean when -- we had a few maybe more negative announcements out there in October, and I have to say orders looked good for us, but we did pause a little bit I guess you'd say in our own thinking and thought, well, maybe we're missing this. Maybe things aren't as robust as we are seeing in orders.

But then after a few more weeks of watching the order flow, it just looked like we continued to have strength through the entire quarter. So from our standpoint, everything looked pretty solid. Our guidance has industrial, really all end markets, going down. Communications may be going down a little bit more than the rest, which largely is pretty seasonal for us, maybe even a little bit better than seasonal as far as the first quarter goes.

Of course, this is the semiconductor industry and you only get four weeks of visibility in a lot of cases. But I think for the most part, we feel pretty good about where we are. When you look at inventory, we track obviously inventory at distribution. That looks relatively lean at seven-and-a-half weeks. We do some of our analysis around our larger OEMs and what their inventory levels are, at least from a macro standpoint, and their inventory looks pretty good.

So it's hard for me to predict cycles, but I would say as I stand here today, 2015 looks like it will be a pretty solid year for us.

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**Steve Smigie - Raymond James - Analyst**

Great. And just wanted to touch on telecom a little bit, just because you seem to have doubled down there where you added Hittite. So as I think about that, I guess there's some short-term concerns about that, but maybe it recovers into 2015. So is this near-term dip anything to worry about?

And then more significantly, obviously, (inaudible) Hittite that says you are a big believer in telco infrastructure for the coming years.

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

Yes. So from an organic standpoint, communications was up in the fourth quarter. On a combined basis with Hittite, obviously, it was up, and do expect it to be down. But it's fairly typical for a first quarter for us, in that a lot of times the OEMs in that space tend to work inventory down, get their balance sheet in good standing as they report their annual numbers.



Other than that, I can't say that we've seen a lot of weakness. Certainly, there have been indications that certain geographies are perhaps in a little bit of a pause. But the beauty of our business is we sell globally to every OEM. We are being designed into every geography you can think of. So there's a great balancing effect where if one region is not as strong, a lot of times other regions pick up the slack and they are even stronger.

So that's kind of what we are seeing. And I think as you look into 2015, there will be a lot of buildouts going on throughout the world as all of us who use these smartphones now require more and more data, that requires more and more bandwidth on an already stressed network. So our expectation is that 2015 will be a very solid year for communications infrastructure.

That was the reason we acquired or at least one of the reasons we acquired Hittite, is we had a lot of confidence in that market and the trends that were going to go on over the next 5 to 10 years, and the requirements for higher frequency capability were going to be important for those that wanted to play in the communications infrastructure space. And that's why we got that company.

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**Steve Smigie - Raymond James - Analyst**

Okay. Since we're talking about Hittite already here a little bit, I'll just ask, I think one of the things -- I mean one of the positive surprises about that was after you brought them in you started to get an immediate positive reaction from customers about, hey, now that you are part of ADI, you're much larger and there's more -- you could be a stronger supplier to us.

Just to follow up on that, have you continued to see that roll through in terms of orders and so forth?

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

Well, I think we will -- we won't see any benefit to our actual revenue for some period of time. Hittite is doing really well for us. We were expecting that business to do kind of mid-\$70s million in terms of revenue in the fourth quarter. It actually hit \$81 million in the fourth quarter, so it far exceeded our expectations.

And in the first quarter, we are thinking that the number for Hittite might be around \$80 million again, which was well ahead of where we thought they would be. But I think all of that is just communications infrastructure. The market is doing well, and not so much that it's part of a larger franchise. But the early indicators which aren't revenue, that's more about design win activity and so forth, that already has started to take shape.

There have been several instances where customers either would not have designed in Hittite or would not have designed in the analog piece if not for the fact that we had the combined portfolio to provide to them. We've had at least three or four major wins in the industrial space that hit on that exact point.

On top of that, today is the first day that customers can buy Hittite parts through the distributors. That was a meaningful benefit for us, in that I think somewhere in the neighborhood of 2% to 3% of their revenue came from distribution. So they weren't really well served by the distributors. We're obviously a major line of the two most significant distributors in the world, and a lot of other distributors that are fairly meaningfully size beyond the US.

So now all of those distributors have and can sell Hittite parts, and so are expecting a relatively quick uplift in terms of Hittite's revenue from utilizing the distributor channel.

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**Steve Smigie - Raymond James - Analyst**

Okay, great. One of the other comments I believe that you made on your earnings call was that you expect all of your markets to grow in the next year. One I'd like to touch on briefly -- I know it's not a huge part of what you do -- but it seems even consumer at this point then would grow next year. And just curious, color there on what's changed that's going to allow that to grow.

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

So, obviously, our top line over the last five years has grown, but probably not at the rate we would've liked to have seen it grow. It was a tale of two businesses. The B2B part of our business which is selling into automotive, industrial, communications infrastructure, healthcare accounts, that business actually grew pretty reasonably. What was the rate around?



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

About 10%.

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

About 10%, yes. What unfortunately created a headwind was we really started to exit a lot of the consumer parts of the market, in that we just couldn't find a good return in that space. There's a fair amount of that market that just does not value the high-performance analog that we serve.

And that had to run its course, and it did seem to bottom out kind of in the mid-part of 2014, and we've started to see a little bit of a recovery in the consumer space more recently. Our expectation is that 2015 will be the first year, I think, that we'll see growth for a long time over the last five years. That's just refocusing that business into the areas where we think we can differentiate, where we think we have products that not a lot of people can do, do the really hard stuff that we can maintain over several generations.

So we've obviously been working on that approach over the last few years, and those activities are starting to translate into wins which translate into revenue in 2015. So my expectation is that in 2015, we will see consumer grow around the corporate average.

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**Steve Smigie - Raymond James - Analyst**

Okay, great. Industrial is your largest market. Within that, what drivers -- what are the bigger pieces? Industrial is always kind of a catchall, so what's specific to ADI that will hopefully be decent drivers?

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

Well, it is a catchall. It's 100,000 customers probably in the industrial space. We have five sub segments: factory automation, instrumentation, aerospace and defense, healthcare, and energy management. And really I think in all of those cases, there are opportunities to see growth.

For example, in the healthcare space we've invested in that area for a long time. Most of the semiconductor players have not, so we've been able to find areas where precision and performance matter and where we can differentiate ourselves.

Same holds true in the instrumentation space. Obviously, adding Hittite to the mix for instrumentation helps us. A lot of those customers are looking for microwave capability. In the energy management space, obviously, there's a trend around energy management. So that's another opportunity where we've invested a lot over the course of the last 5 to 10 years in monitoring and control around energy meters and control systems.

But I think this -- I hate the word because it's totally overhyped, but this Internet of things which probably has been going on for some period of time which is just simply trying to sense things, control them, monitor them, report them back to some central cloud or data warehouse; that I think will over time accelerate. So the trouble is that it's 100,000 customers all buying relatively small amounts of revenue -- or small amounts of units, which translates into small amounts of revenue.

And it's really hard for somebody to wake up tomorrow and go, you know, I'm going to be the IOT guy in the industrial space. You have to have built up a network of relationships with those customers over decades. So I think that is going to be a great driver for us on a go-forward basis, really seeing that kind of proliferation of monitoring, controlling, connecting back, sensing what's going on in those systems.

We are in the early stages of that. We already have revenue from that, but I expect it to be somewhat of a tailwind for us on a go-forward basis.

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**Steve Smigie - Raymond James - Analyst**



Great. As we look at it from a product perspective, one of the things that I've always respected about ADI's product set is you guys dominate this analog-to-digital converter business. And I was just curious if you could talk about that a little bit in terms of do you explicitly try to grow share there going forward, or is that not something that you guys care about per se? Is it more just trying to provide the right solutions?

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

I don't think we are fixated on maintaining some certain market share. I think what we try to do is develop parts that are hard to do and that we can differentiate ourselves from the competitors. And in the data converter space since we have such a library of understanding on how to do that capability, and there are always new unique applications that are getting developed that require this connection between the physical world and the digital world, we tend to be the first ones they call with the really hard problem to solve around doing that.

As a result, I think that's how we at least maintain share. I think what's gone on more recently is that this is really hard to do. It takes a lot of investment to stay ahead of the curve in data converters. I think there have been companies that have attempted to get in there that have won a handful of sockets, thinking that that will be the beginning of building out a franchise there; recognized that this is really hard to do and ADI has a moat around this business that's pretty deep. And eventually, they've started to go away.

So I think what we've been doing is capturing back this little bit of incremental share that people had nibbled around the edges on and just couldn't make a real business out of it.

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**Steve Smigie - Raymond James - Analyst**

All right. I was hoping you could talk a little bit about the economics of that. I hear that from engineers (inaudible) that it's order of magnitude more difficult to do analog-to-digital converters versus any other part of analog.

Does that require an excessive amount of investment, or is it roughly the same for your investment there versus say amplifiers or some other type of category?

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

Well, no, I think the investments are relatively similar. And quite honestly, since we've got such a significant portion of revenue coming from data converters, we actually have fairly good scale in that business even relative to some of the others. So as a percent of revenue, we probably spend a little bit less than in data converters than we spend in some of the other areas that we are trying to -- still try to build out the franchise in.

The trick for us is we just have most of the really, really good people that design data converters. And what we do is we augment that with a program where we hire the really brightest out there in the various universities, bring them in and kind of operate more or less as an apprentice -- like an apprenticeship kind of model where over time they figure out how to develop really sophisticated data converters. And then eventually, they are on their own developing the next generation of data converters.

So it's one of these things where you have had to have built it up, built it up over a long period of time to get to a point where you have such critical mass to sustain that kind of business.

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**Steve Smigie - Raymond James - Analyst**

Great. And one of the things you had mentioned was that some folks had come in and tried to pick up some share, maybe picked up a little bit, but then exiting the market. And there was another very strong engineering company that basically backed away from the market, a former number two player. Any sense as to why those guys decided they couldn't keep up with you?

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**



Again, I look back to this is really hard stuff, and you get this brand within the marketplace where customers trust you. And the price of a data converter on a relative basis to the full bill of materials is actually not that significant. So if it's working really, really well, it does everything it's supposed to do, it's in spec all the time, it never fails, that's worth a lot when the total system might be \$50,000.

So I think when you are trying to take share and you don't have much to offer other than price, and price is something that customers within a range of reasons don't really care about, I think you eventually just give up.

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**Steve Smigie - Raymond James - Analyst**

Okay. Turning to the model, you've had pretty nice gross margin improvement since you've been there. Can you talk a little bit about how likely it is that you guys can track and hold at the high end of margin over, say, the next two, three years? Is that something that is feasible?

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

Yes. I think our stated margin range is -- help me out.

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

65 to 68%.

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

See, I knew you'd come in handy, Ali. 65% to 68%. Obviously, we're trying to get to the 68% level over time. We were 66% in the fourth quarter. I think we did 66% basically for the full year on average. So our goal is to kind of steadily improve that over time.

Partly, that comes from utilization. Our utilization ran probably on average at low 70%s probably for the year, and we'd like to see that incrementally get a little bit higher this coming year to give a little bit of lift to the gross margins.

On top of that, I have a team that works both in the pricing side and the cost side to improve the two drivers of gross margins. We've made steady improvement in that space over the last couple of years, and I think we have pretty good visibility into how we can get the gross margins up from here just through a little bit better discipline around pricing.

We put in a system just recently that tracks our pricing worldwide. Believe it or not, we didn't have that visibility before. And I think we have some pretty good line of sight as to how we can bring the cost down over time to continually expand the margin. So I don't know when we will get to 68%. It could be in a couple years, it could be in four years. But I think what you will see is absent some massive downturn that really affects utilization, we should see a relatively steady improvement in gross margin.

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**Steve Smigie - Raymond James - Analyst**

A question I get on you guys is, well, do they have pricing power. And I guess my thought is your solution is more about being a performance leader. That's really what they are paying for, yet you mentioned price.

So as you are discussing this price, you are not saying it's about charging more versus a competitor, something like that; it's the way in which you initially introduce a product and the value [afterward]?

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**



Well, partly it's that. Partly we give it away a little early. We don't fully, or we have had instances where we haven't fully understood the value that we are providing. And have thought about it more in terms of okay, well, this is our target gross margin, so as long as we get that price we are happy. So we have missed out a little bit on some opportunities.

Part of it is, though, you've got to remember this is billions of units of -- or billions of line orders every year. So this is like lots of data coming at us. So there are various people within the Company that are entrusted with trying to make sense of all of that, and making sure that we don't have disconnects in the way we price products.

But in certain cases, we haven't had a good understanding holistically of pricing of our products. So in certain cases, we've probably given it away cheaper than we should have in certain instances, relative to what we would ordinarily have gotten for that part. So just getting a little bit smarter about it on top of that.

And then lastly, I think we have -- there are certain parts that we sell that are 20 years old, and that's worth a lot to the customers. And we probably haven't extracted the right amount of value for that over time. So we are getting smarter about it.

I think, obviously, we want to be fair about it to our customers, but we also want to get the optimal level that those products deserve, given what they are providing, the functions they are providing and what it does to the customers and application. So getting smarter about that I think would be fairly beneficial to us.

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

Steve, I would just point out, maybe making your point, is that we do get paid for the value of our innovation certainly. The things we are talking about here are fairly mechanical in terms of the utilization rates, in terms of things we are doing around pricing.

These gross margins in the range of 65% to 68% are probably the envy of most of the S&P 500.

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**Steve Smigie - Raymond James - Analyst**

Right. And as part of that, in terms of your comment about the products being 20 years old, your point is most people will cut the product off after five years. You guys are saying, we will keep that product for you.

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

We never end-of-life a part. We never end-of-life a part, and we do that because customers value that. So that's -- the idea is to extract that value.

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**Steve Smigie - Raymond James - Analyst**

And as you've moved to these higher gross margins, the typical thing that I see is companies moving gross margin higher, that impacts the customers that they are willing to deal with. It's, well, we don't want that business anymore. That doesn't really seem like that's the approach you are taking.

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

Yes, there was a company out there that's not around anymore that had that kind of approach, where they just unilaterally decided on what gross margin they were willing to accept. And anything that had a margin below that, they kind of turned down. That's not our model.

I think of the gross margins as more a function of the value of our products and the performance of it, and the differentiation of it. But we go after any market where we think there is an opportunity to develop parts that not a lot of customers can do. And certain markets, obviously, can only tolerate certain levels of gross margins. So, obviously, in the consumer space you're not getting 70% gross margins on most cases.

So we are willing to go after different markets that have different profiles in terms of margins, but the idea is to extract the right level of value for the development effort and get the right return on the R&D investment.



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**Steve Smigie - Raymond James - Analyst**

And speaking of R&D, you also improved operating expense quite a bit since you've been there. So just wondering, is there any more magic there on terms of cost improvement? And specifically, one criticism I hear sometimes is people talk about Texas Instruments maybe and they'll say, well, they are not spending enough. And there's some argument there I think between total dollars and percentage of revenue, and it seems like especially, say, like you and [Fergers], you have some scale. So is percentage of revenue the right way to look at that?

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

Yes, although I do agree with you that higher levels of revenue you can scale little bit better, and that's kind of what our thinking is. We did take a restructuring in the fourth quarter. That did on a net basis save about \$40 million of operating expense, although we will have inflationary things. So net-net, we will probably be at the same absolute dollar of OpEx, at least on average per quarter that we saw in the fourth quarter of 2014.

So roughly \$270 million a quarter. First quarter is going to be a little less than that. Obviously, the other quarters will probably be a little higher than that. So I think ideally that I feel like was maybe the last little chunk of OpEx that I felt like we probably should pull out to get things a little bit more efficient.

There will always be opportunities to find cost savings, and we continue to do that. But I think for the most part, OpEx as a percent of revenue is going to be more driven off of leverage with a top line story that's working in the right way.

So ideally after this year, what we should see is revenue hopefully going up at a relatively decent clip. And the idea is to keep OpEx growing at some rate below that, so that ultimately we are in the low 30s as a percent of revenue for our operating expenses.

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**Steve Smigie - Raymond James - Analyst**

Okay, great. We'll see if there are any questions in the audience.

#### QUESTION AND ANSWER

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**Unidentified Audience Member**

On the comms segment, there's been some talk that small cells might be growing out or to be accelerating (inaudible)?

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

We are, yes. Certainly it's in the early stages right now, but what I have heard is that 2015, that certainly is going to be incrementally higher because what carriers want to do is spend about the same in terms of OpEx. And they can get more bandwidth by deploying small cells because the individual units are cheaper.

They can deploy in more radios. And so that's a good story for us, because our dollar content per radio is better in a small cell than it is in a macro station. So for every dollar of CapEx that gets spent by a carrier, we do better when it's a small cell.

So that's part of I think why we're so optimistic I guess, about 2014 in terms of comm infrastructure.

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**Unidentified Audience Member**

Then I have a follow-up on the Chinese portion of that base station build. Do you guys have any good base station thought process (inaudible)?

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**



What China's going to do?

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**Unidentified Audience Member**

Yes, and timing.

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

Timing, I'm probably less good at. I think that there will be a good deployment in China, probably at least to the same level as we've seen in 2014. But timing of it and whether some of that rolls into 2016 or not, I don't know. We will have to see how it goes.

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**Unidentified Audience Member**

And one last follow-up. Last week, Avago talked about their industrial business being down. Is there any overlap on maybe an easy data point from there? Because then they've said Asia was down 9%, Europe down 6%, Japan down 13%. Do they just overlap with you guys or are they just seeing (inaudible) of an issue on industrial?

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

Quite honestly, I don't know what Avago does, with their specific exposure in is. Some of those numbers, actually, are fairly consistent with what we've seen, although not all of them.

So every -- maybe as Steve kind of said the industrial tends to be a catchall for everything you can't define as an ASSP. So in certain instances, certain competitors or certain peers out there have a different exposure to industrial, and so they see different things.

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**Steve Smigie - Raymond James - Analyst**

And just on that note, that would have been the reported quarter. Or let's say we look out to April -- and I know you haven't guided there -- but it seems like you were kind of saying, hey, we had this seasonal drop-off that we maybe saw there. But that as we look out to next year, there's no reason why you wouldn't see seasonal (multiple speakers).

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

Of course, it's hard to predict, but usually the second quarter for us which is the April quarter is a really strong quarter. And usually the first quarter is not, because what we have is the last couple of weeks of December where a lot of manufacturers shut down for at least a week or two. So we always see a little bit less activity in this first quarter. It's fairly typical, and it usually rebounds quite strongly in the second quarter where there aren't as many shutdown opportunities for manufacturing.

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**Unidentified Audience Member**

Dave, another one on the comms side. Beyond China, which you commented about and in the US, we get all the headlines about people cutting CapEx. What do you guys -- and you sell to all the OEMs as you commented on. What are you guys seeing worldwide beyond China, US? Is it real? How long will it last?

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**



Well, one of the -- we actually had a very good -- even organically a very good comp result in the fourth quarter, and quite honestly there was a little bit more weakening or more weakened condition in China. And where we saw the strength was all these other pockets out there besides China and the US which, of course, dominate the press.

So yes, that's the beauty of our model is we sell to every OEM, and our products end up in every region of the world. So that did pick up some of the slack. So it's actually the perfect situation where you have these kind of self-balancing businesses out there.

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**Unidentified Audience Member**

Should we be thinking about EMEA and Brazil and what kind of (multiple speakers)?

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

Yes, right. India.

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

Brazil, Russia, that's where we are building this quarter. To Dave's point, North America and China were pretty -- it kind of slowed down a little bit this quarter. Historically, in the last couple years, it had been driving the growth in our comms infrastructure business. But as Dave pointed out, it speaks to the diversity.

And it's not just 4G; it's 3G, 2G 2.5G in some regions. So it's a diverse business. We are extremely well-positioned from a technology standpoint. I think as we move up here in terms of standards, it just means more radios. That's really where ADI plays. So more macro base stations, particularly with 4G. That's more radios, that's great for ADI. And more small cells, that means more radios, that's great for ADI.

The question becomes with regard to the earlier question, it's just around the timing of all this stuff. And it's harder to call, but I would tell you that the trends clearly are playing in the favor of more and more new deployments that have been happening and potentially will continue to happen.

So I think when we look out to 2015, I mean China is most likely going to continue building its next phase of TD. FD starts to switch on. Europe is in very early phases here of its coverage projects in that region. North America looks like it's going to be deploying some small cells. Those are all great things for ADI.

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**Steve Smigie - Raymond James - Analyst**

We have time for one last question. Okay, my last question is just if I look at the story that you are telling today, you seem more upbeat I think than I've seen you in a while in terms of the revenue opportunity. And on top of that, you've got some nice margin expansion.

Is it fair to characterize that, is you are more upbeat than we've heard you in a while?

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

The lunch was really good (multiple speakers), so maybe that's it.

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**Dave Zinsner - Analog Devices, Inc. - VP Finance & CFO**

I always feel like I'm upbeat, but I don't know. I think that there is no question that you come out of a quarter where the organic business did better, Hittite did even better; the integration is going well with Hittite, way better than we had expected. And we've built a plan where you can really have line of sight into some decent growth for 2015, and we took some opportunity to get some cost out. It's hard not to feel like you're in a pretty good situation for 2015.

Of course, we're not going to be arrogant about it or overconfident about it, and we will be very cautious and see how things go. What I want to make sure is we don't layer in OpEx when the revenue is not real. So we will kind of take it as it goes through the year and see how things develop.



But right now, as I sit today, I feel pretty good. It's even better when you feel good in a quarter in which you know you're kind of down usually, and so -- normally, this quarter we're maybe more pessimistic than usual. So it's a good situation to be in.

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**Steve Smigie** - *Raymond James - Analyst*

Great. All right, thanks a lot, gentlemen. I appreciate it.

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**Dave Zinsner** - *Analog Devices, Inc. - VP Finance & CFO*

Thank you.

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