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ADI - Analog Devices Inc at Citi Industrials Conference

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PRESENTATION

Amanda Scarnati - *Citi - Analyst*

All right, good afternoon. Welcome to Citi's Industrials Conference. My name is Amanda Scarnati and I'm here with Ali Husain, the Director of Investor Relations for Analog Devices; and Mark Martin, the VP of the MEMS division for Analog Devices. We're going to start off with a brief presentation, just to introduce you to the industrial side of Analog Devices, and then we'll break it out into the question-and-answer session after that.

So just to start off, Analog Devices has about 66% of their revenue tied to the industrial and auto segments versus the specialty semiconductor segment, which has about 36% of their revenue. So ADI is very focused on industrial and auto, with about 20% auto, and 47% tied to the industrial market.

When we look at Analog Devices' revenue, we look towards US ISM and global PMI in order to forecast revenues, because there's a net 0.92 correlation, with a one-quarter lag to both of those measures. So it's a good indicator, one quarter ahead of time, whether ADI's revenues are going to be up or down using those measures.

ADI has favorable margins to both the industrial segment and S&P 500. And we're looking at the top 30 or so industrial companies, based on revenue. There's a 30% advantage in gross margins for ADI, and about a 15 point advantage in quarterly EBITDA margins.

ADI also generates a significant amount of cash. Looking at quarterly free cash flow to sales, there's about a 12 point advantage for ADI. ADI then returns a lot of that cash to shareholders. There's a target to hit 80% return of free cash flow to shareholders over a five-year period. Currently, over the last three years, ADI has been north of 70%; whereas the industrials segment, those same 30 companies, have been roughly around 60% returns.

And then, finally, ADI has a very strong dividend yield. A big portion of their return of free cash is in that dividend yield. And there's about a 2 point difference between the industrial group and ADI in terms of dividend yield.

Now I'm going to pass it off to Ali to continue on.

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

Great. Thanks, Amanda. That was a great introduction. And thank you, everyone, for being here today. So what I will quickly do is run through an intro at a primer on ADI at a very high level. And then I'll throw it over to Mark who will run us through some of the interesting things we're doing in the industrial and auto space. And then we'll open it up to Q&A.

So, the requisite forward-looking statements slide that I have to put up. So, Analog Devices, we're a $3 billion-a-year, high performance, analog semiconductor company. Our technology really focuses on bridging the gap between the real world of analog, where we all live, and the world of digital. Really more sensors getting deployed out there represent unbelievable opportunities for ADI's signal processing technology. So there's a stat out there that says by 2020, they are expected to have 2 billion sensors deployed throughout the world.

Each one of those sensors represents an opportunity for signal processing. ADI has supplied the high performance edge of signal processing. So keep that in the back of your mind as we go through today's presentation.

We're really focused on sustainable innovation to drive profitable growth. So to that end, we've actually been refocusing the mix of our business over the last few years. Much more of our business used to come from the consumer end market. We have refocused that R&D spend to really target industrial, automotive, and communications infrastructure; what we call the B2B space. We just like that market a lot better: long life cycles, sustainable profitability, and markets that truly do value innovation. And that's what really ADI is: a very innovative company.

So what that's done in the near-term is that has impacted our overall topline growth, but the core business of the B2B space has actually been growing quite nicely. And in a few seconds, I will show you a chart that outlines that. Our sense is that with consumer now being only about 10% of our total sales, that the mix of our markets is right-sized. And going forward, the hope here is that the great revenue growth that we've been seeing in the core markets here continues without this drag on our top line.

The second bullet here is talking about diversified growth, and so we have a very diverse business in terms of the markets we participate in, our customers, and our products. So, for example, we sell over 20,000 SKUs to over 100,000 customers. No one customer accounts for more than 2% or 3% of our total sales. In the case of some of our largest industrial customers, both that you might be familiar with, we can sell over 1,000 different SKUs to those customers. So, a very diverse business.

And in terms of cash returns to shareholders, as Amanda mentioned in the introduction, our free cash flow model is to generate 28% to 32% of our total sales in free cash flow, and to return 80% of that to shareholders, primarily in the form of dividends. So, on a trailing 12-month basis, ADI has generated $2.7 billion in sales. On an end-market basis, two-thirds of our sales are from industrial and automotive. And if you add the infrastructure segment, what we call communications infrastructure, now you're talking about almost 90% of our total business.

Within industrial, it's noteworthy, particularly at this conference, that our industrial business has five subsegments. The two largest subsegments are industrial automation and instrumentation, and those both combine to form about half of what we're doing in industrial. We also have, within our industrial business, an aerospace and defense line; we have an energy line; and we also have a healthcare business.

So it's pretty clear: when ADI talks about industrial, we're not talking about white goods; this is really an industrial bent to our Company. And we, frankly, do business with a lot of the companies that you are familiar with, as you can see here.

Now, from a product or technology standpoint, 72% of our total sales are for products where ADI leads the market. And when you think conceptually about bridging that gap between the real world of analog and the world of digital, these two product categories really form the pillars of that bridge, or really the concrete blocks that form that bridge. So I think from an economic moat standpoint, we're very, very well protected and positioned.

I mentioned earlier the diversity of our business. This is a chart that shows our quarterly sales, broken out by year of product release. And as you can see, these products have very, very long life cycles. In some cases, we're selling products from the early 1970s. And at the same time, we have new products that come in to fill in our product pipeline. And so one-third of our sales are for products released over 10 years ago' but one-quarter of our sales are from products released within the last five years, because you have to continually be refilling that pipeline.

Interestingly enough, many of these products are slow to ramp; as you would imagine in the industrial space, they tend to be. But once they do ramp to revenue, you will see revenue from those products for many, many years, as you can see from this chart. And in some respects, it's actually like a bond portfolio, where you put the value of your innovation out there, and the innovation produces a steady stream of revenue for -- and cash for extended periods of time.

As I mentioned earlier, over the past few years we've been refocusing the mix of our end markets. On a trailing 12-month basis, both on a five-year CAGR and on a year-over-year basis, you can see the core business -- the B2B space of industrial, auto, and communications infrastructure -- has grown at 9%. And some of the exits from the commodity areas of consumer have actually masked our overall topline growth. But the core business has been doing quite well.

And as I mentioned earlier in the introduction, our sense is that the consumer business, at 10% or 12% of sales here, is right-sized for the opportunities we see ahead, and that we're now starting to finally see the benefits from re-steering all that R&D away from consumer into the B2B space, in terms of topline growth and profitability.

So while we were actually refocusing the business, we've actually been returning a lot of cash to shareholders. We've returned, since our fiscal 2004, over $7 billion to shareholders in the form of dividends and share repurchases. And our stated goal is to return 80% of our cash -- of our free cash flow generation -- to shareholders.

And so, here are the financial targets that we laid out this summer: gross margins in the range of 65% to 68%. Our most recent quarter had gross margins at about 66.5%, so we're firmly within that range. Operating margins and cash from operations in the range of 32% to 36%; and free cash flow, as I mentioned earlier, at 28% to 32% of sales. On the leverage side of the house, what this model can generate, then, is annual earnings growth of 8% to 15%, followed by dividend growth of 5% to 10% annually.

And so what we did is really lay out a target for what we think our business can do in terms of earnings growth. And so we believe that the way our business breaks out today, in terms of the growth profiles and the profitability we see for our business, that we should be able to generate $4 to $5 in earnings by the end of fiscal 2020.

Now, as of the most recent year, or the estimate for fiscal 2014, our earnings are estimated to be about $2.40, or in that range. So we have some work cut out for us to get there, but I think we're firmly on the path towards executing towards that goal.

So, overall, we really believe that our innovation is going to drive profitable growth for ADI. We play in diverse markets with diverse products. And the combination of that, we believe, will continue to drive shareholder returns.

Now I will just turn it over to Mark, who will take you through just a couple slides.

Mark Martin - *Analog Devices, Inc. - VP of Sensor Products and Technology Group*

Okay, so my name is Mark Martin. I'm responsible for MEMS and sensors at Analog Devices. And going to talk about two markets, which are certainly relevant for my business in MEMS and sensors, and highly important for Analog Devices.

So, first of all -- and this is just to do some context-setting before we get into the question-and-answer. So automotive, as Ali said, is a critical market for us. We've been growing very successfully. And that business, for us, really breaks down into three areas: the safety business, which is where MEMS and sensors plays a very large role, and that's a business that I have a lot of experience with.

Powertrain -- start/stop technology is an example of products that we do within the powertrain domain. A great example of technology and products that, 10 years ago, nobody was really even talking about. Today we are finding them more and more in today's vehicles, and that trend will continue.

And then, infotainment: this is another sector for us in automotive in which Analog Devices is very well established, primarily in audio head-in units. But just like in safety, there's a lot of new technology going into not only comfort -- in cabin comfort, more of a classic consumer experience inside the vehicle -- but also safety aspects inside the cabin, as well.

So, safety, powertrain, and infotainment -- these are three key markets for us, and also synchronize very well with some of the macro trends who are pushing for energy conservation, safer examples.

So, the other business for us is industrial; as Ali said, automation, instrumentation, military, healthcare, and energy. These are major segments in industrial that we participate today. 46% of our overall business, so we are well established in industrial. But what I wanted to share with you is from that industrial base, ADI is very much looking to the future and how we can deliver more value going forward. And we see this is a very exciting space.

One of the things that excites me is this whole Internet of Things, Internet of Everything. Call it whatever you want; it's a great opportunity. There's a huge push now to really rethink and reengineer the whole ecosystem here around industrial.

We see customers rethinking their businesses, where they spend their resources. They are looking to us to step up and deliver new kinds of value, new kinds of solutions. And the way we brought the value to this market so far is in -- we'd like to think about it in terms of sensing, monitoring, control, and connecting. And when you think of the Internet of Things, those are the foundational elements going forward. And this is not something that's a million miles away in the future; we're actually already delivering solutions that are enabling this Internet of Things concept.

For example, we're selling devices, the sensor devices that are supporting concussion detection. That kind of application lends itself very naturally to big data analysis. We're selling solutions into drilling apparatus to help monitor these drills that are way down in the ground, and it's very, very costly to have to stop drilling. So our sensors help detect if there's a problem, and protect the drilling element before they have a major problem. This is one of the fundamental ways that you save -- through machine health -- you save costs. So we're already participating in this new trend, and it's a major focus going forward.

I often talk about, it's about -- for us, we see the opportunity in the instrumenting of people, and we certainly see the opportunity in the instrumenting of things: creating better sensor dashboards, and then communicating that information to the cloud so that companies can mine that data and address whatever challenges they may be trying to address.

And then probably not speak about it too much today, but a lot of people view this universe -- you can't forget about the communications infrastructure. This is a major part of ADI's business today. We're a market leader in communications infrastructure; have been a supplier in 2G, 3G, 4G; and we expect to be absolutely there when it comes to 5G, which many people talk about and how that fits into the so-called Internet of Things.

So, long-standing presence in the industrial market. We're very excited about the future opportunity, and very excited about playing a major role in delivering added value to our customers going forward.

QUESTIONS AND ANSWERS

Amanda Scarnati - *Citi - Analyst*

All right. Thank you, Ali and Mark. Just moving into competition, you had mentioned that around 70% of your products are in markets where you have a leading market share. How hard is it for new entrants to come in, or how hard is it for existing competitors to take share away from ADI?

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

Yes, I think it's a competitive business, for sure. We've been in business now almost 50 years. And I think what's happened over the course of time here, as we've done this, is that companies have gotten particularly good at doing what they are particularly good at. In our case, that is really fundamentally that bridge between a sensor that captures a real-world signal and a processor that actuates or makes a decision based on that signal.

It's actually very, very hard technology to do. We are the only company out there that really solely focuses very, very hard on that particular challenge. Certainly, we have competitors where there is a bit of overlap. But for what we are doing, and particularly with our market share position where, as you mentioned, Amanda, 72% of our sales are from products where we lead the market; but, at the same time, when we talk about leading the market, we have about half the market in both of those product categories.

In terms of new entrants, then, I think it becomes increasingly difficult for new entrants into the space. As I mentioned earlier, you've got to have a whole host of technologies. It's not just about a data converter anymore; it's about the entire conversion process. So, particularly when you go into these larger customers, larger OEMs, even in the industrial space, we're having conversations about, what is the world going to look like? What is my business going to look like, 10 years from now? Those are very hard conversations to have; very tough technology type of challenges for companies like ADI and other broad-based suppliers that have a whole host of technology already in their hands.

I think for new entrants to come into this space, not to say that it can't be done, but we have a very good market share position. We've built that up over time, and we control about half the market there in each one of our focus product categories. And I think that positions us extremely well from an economic moat perspective.

Amanda Scarnati - *Citi - Analyst*

Great. In terms of growth drivers, looking towards 2015, what segments of your business do you expect to be the largest growth driver?

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

Well, hopefully all of them, and we won't have this conversation. But I'm sure it won't work that way. I think our best sense is 2015 will be another year of growth. 2014 is turning out like it will be a year of growth, and so 2015 would be a great follow-up. I think there are trends in each one of our major end markets that would suggest that I'm not off-base. But I guess we'll have to see; the proof will be in the pudding. But I think with half of our sales coming from industrial, a lot of that market tends to ebb and flow with global PNI and GDP and global CapEx. You can look at OECD capital formation, for example, as examples of things that can drive that business.

I think our best sense is that we've been through a few years here where CapEx was fairly constrained. That seems to be turning modestly, and so our industrial business has responded this year in kind. And our sense is that next year, the capital spend will continue. There's a whole host of technologies that are being rolled out. There's a whole host of conversations that are taking place with our industrial customers around the areas of energy efficiency, more and more connectivity. For example, Mark was talking about that in the introduction. I think a lot of that stuff turns.

But really in the near term, it's going to be a question of the global macro and CapEx, which seems to be, I'd say, marginally more positive than it was then maybe last year at this time.

We also, in the automotive space, there's clearly a push to have more and more content going into vehicles. I think we're very uniquely positioned in the areas that we play in. It's very, very hard technology to do. It's very hard to get qualified to partner up with the customers in the automotive space. And I think our stated goal is that if vehicle unit growth averages 3% or 4%, for example, that we should be able to grow our automotive business, which today is probably around 18% or 20% of our sales, at about at least twice that rate of vehicle unit growth.

And you might get into a period where maybe that grows three times, but our stated goal is to grow that at least two times the rate of vehicle unit growth. And I think there's every indication that the fiscal 2015, for us, could be another good year of growth for automotive, as it was in fiscal 2014 -- or as it's shaping up to be in fiscal 2014 here.

On the comms infrastructure side, that's about 23% of our sales today. It has been a good year on the communications infrastructure front. A lot of what we're doing centers around the radios that go up on macro and small-cell base stations. We are, I think, fairly uniquely positioned there as well, in terms of the technologies that we bring.

So really it's a question of the refreshes that are happening; it's a question of more and more infrastructure that's being put up there that will house these radios. What we've also done, then, in advance of all of these base station deployments -- which clearly there seems to be a push to continue in 2015, based on deployments throughout the world -- but what we've done is we've also invested ahead of that trend.

We've invested in integrated transceivers, which were, frankly, ready for the market two years ago when the market wasn't really ready for them. But our best sense now is that the market is ready for them. We're actually seeing very good growth from that particular technology. So I think we're going to be in good shape next year.

I think the biggest hindrance, in a sense, over the last few years in terms of topline growth has been our exit from the commodity areas of consumer. And I think you saw that in the chart that I flashed up, that if that drag is behind us, then I think -- which the thesis would suggest that it is -- I think fiscal 2015 should be a good year of growth for ADI.

But when we get there -- I'm sure you'll be here next year, Amanda, reminding me one way or the other.

Amanda Scarnati - *Citi - Analyst*

I'll hold you to it.

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

You'll hold me to it.

Amanda Scarnati - *Citi - Analyst*

Moving into the automotive segment -- Mark, you touched on this a little bit during your introduction -- but how will ADI benefit from increased system requirements and enhanced regulatory standards in the quote-unquote car of the future?

Mark Martin - *Analog Devices, Inc. - VP of Sensor Products and Technology Group*

Sure. Yes, so certainly, of the three categories of infotainment, powertrain, and safety, both powertrain and safety are -- the mandates are driving brand-new requirements, are driving the addition of sensors, this whole trend of electrification of the vehicle. So that's what, as Ali was talking about, why ADI sees the opportunity to grow well above the natural vehicle growth rate, is that additional requirements going forward.

So there's examples out there today. There's new mandates pushing for an enhanced rollover detection in vehicles in the case of safety; pushing for pedestrian detection. This will drive additional sensors into the vehicles; pushing new standards that are encouraging companies like Analog Devices; working with our customers to come out with advanced driver assistance; and then, eventually, likely moving on to semiautonomous and then eventually autonomous vehicles, perhaps. We'll just have to see on that. But the trend and the direction is clear, to continually push to make safer and safer vehicles.

In the case of powertrain, I mentioned intelligent battery monitoring, this so-called start/stop technology. Analog Devices has a major position in that technology today, and it's driving material energy conservation in vehicles, reduced emissions. The same thing in hybrid electric vehicles. So these are key areas in the automotive market where ADI is well positioned, well established. We're a 20-year-plus automotive supplier. We have demonstrated a brand and reputation in that market, all the quality systems you need. So very well positioned, as new technology is demanded by that industry, we are in a great position to deliver that to the market.

Amanda Scarnati - *Citi - Analyst*

Great. Moving towards the MEMS segment.

Mark Martin - *Analog Devices, Inc. - VP of Sensor Products and Technology Group*

I think we have a question in the audience.

Amanda Scarnati - *Citi - Analyst*

Sure.

Unidentified Audience Member

Can you just clarify? The sensors that you are selling, are you competing in the automotive segment? Would you be competing with the Sensatas or Bosch in any of those? Or is it an entirely different -- I know you are doing the semiconductor technology; but could you just clarify where you come into the competitive picture, versus those types of companies and the subsystem suppliers?

Mark Martin - *Analog Devices, Inc. - VP of Sensor Products and Technology Group*

Sure, absolutely. So our primary play in sensors in automotive today is in what we call inertial sensors: so, motion sensing, this would be accelerometers and gyros, and then putting those together. Our strength is that we have the full portfolio, so from crash satellite sensing, which is simple high G accelerometers, but very high-performance; and then in stability control systems, with combined accelerometers and gyros. We compete against Bosch. We have a few other suppliers, but Bosch I would say is the one who has the full portfolio of capability when it comes to inertial sensing.

But Bosch also has the interesting characteristic that they are also a competitor to most of our customers today, because they supply electronics. We don't compete with Bosch at the electronic subsystem level; we compete with Bosch in the sensor components. Sensata is another sensor company, but they don't do the kind of sensors that we do. And in fact, Sensata is a customer of Analog Devices, where we sell some of our signal processing solutions to Sensata. So that's how the competitive landscape looks.

Unidentified Audience Member

And are you usually selling to someone like a Sensata, or to the OEM, in terms of your route to market?

Mark Martin - *Analog Devices, Inc. - VP of Sensor Products and Technology Group*

So I think we have really good relationships with the OEMs. I think as being a major automotive supplier, we spend a lot of time talking with the lead OEMs that are driving the technology innovation curve, attracting the government mandates.

Our major suppliers are what's often called in the automotive industry the so-called Tier 1s. Companies like Delphi, like Autoliv, who I think are two companies that are at this conference -- those would be the kinds of customers that we would normally sell to. Certainly, that's where we would sell sensors to.

Sensata, in some markets, would be a component -- a so-called Tier 2 supplier like Analog Devices. But as I said, where they can't meet all of their needs, ADI can supply some of our signal processing, which they would embed and combine in their solutions.

Unidentified Audience Member

Sorry, if I can just throw in one more on that. And then who would you compete the most within? Would it be Linear Technology? Would it be Texas, as it relates to auto sensors, or do they not compete in that space?

Mark Martin - *Analog Devices, Inc. - VP of Sensor Products and Technology Group*

So, I think once you get into providing just the signal processing, I'm not sure that there's any real one competitor that stands out. I think depending on the -- if it's a pressure sensor, or if it's some other kind of sensor, I think you really have to get into each one of those markets. And we probably face different competitors in those spaces. So there's not any one person that stands out, in my mind.

Amanda Scarnati - *Citi - Analyst*

Any other questions at this point? Moving into the MEMS business, most of what semiconductor companies compete in the MEMS business is in the consumer space. ADI has chosen not to focus on the consumer space. Can you discuss where your areas of focus are and what led you to this strategy?

Mark Martin - *Analog Devices, Inc. - VP of Sensor Products and Technology Group*

Sure. So Analog Devices, we've been in -- we were one of the pioneers in MEMS. It was -- for a long time, it was all about automotive. We shipped the first accelerometer to Saab in 1991. And for at least 10 years, although we imagined all kinds of uses for the technology, it was really automotive that was the focus. We actually participated very actively when the consumer wave kicked off in MEMS in approximately 2006. We shipped many units to companies like Nintendo. We were in the very early days, when you had accelerometers going into handsets. We shipped in high volumes there.

But what we ultimately realized is that we needed to make some important business decisions about where we were going to focus. And the technology integration, drive for cost, that you see in consumer with performance as a secondary parameter, led us to -- particularly in MEMS -- to conclude that we were going to focus on automotive, industrial, and healthcare. And our strong market presence in the auto, the kinds of requirements that you see in automotive and industrial, are of very synergistic.

To win in automotive, you have to support long lifecycle products. We launch a product; we know we're going to have to support that product for 10 to 12, maybe even 15 years.

Industrial, exactly the same way. What both customers value is high quality and high reliability. And not just liability, but also robustness -- the ability for you to make these complex sensors and have them work in very harsh environments. It's not an easy thing to do. It's very complex technology. And you've got to engineer these devices in a particular way in order to satisfy those very rigorous requirements. And so, the kinds of technology and the kinds of solutions you need in consumer -- absolutely, Analog Devices -- we have all that you would need to be able to do that.

But at the end of the day, we decided to put our attention to the markets that best suit the Company and best suit the use of our MEMS technology. And so automotive, industrial, and healthcare is the focus.

Amanda Scarnati - *Citi - Analyst*

Okay. And what percentage of ADI's business is the MEMS business?

Mark Martin - *Analog Devices, Inc. - VP of Sensor Products and Technology Group*

So I think we reported in terms of other analog, Ali, do you --?

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

Yes, so we -- the MEMS business is not a separate category when we disclose it externally. It's part of what we call other analog, which runs at about 12% of sales. And I'd say a good chunk of what we're doing in that is the MEMS business. But there's also other things that we do there. It's kind of a catch-all category.

Amanda Scarnati - *Citi - Analyst*

And how big is that market that you're targeting, and how should we think about growth rates and growth opportunity in the near-term?

Mark Martin - *Analog Devices, Inc. - VP of Sensor Products and Technology Group*

Sure. So I think one of the really nice attributes of the inertial MEMS market and our other sensor types that have similar characteristics is, yes, there's a very large consumer market. So, for inertial MEMS, accelerometers, and gyros, there's various estimates; but generally speaking, a $2.5 billion market if you look out a couple years in that consumer space. But the really good news for Analog Devices is, if you look to automotive, industrial, and healthcare, our estimates are that market has the potential for $2 billion as well. So, large consumer market, but a very solid, $2 billion, high value, performance-oriented market in automotive, industrial, and healthcare.

And there are other sensor types that are very, very closely -- very dominated by consumer. Microphones would have been an example, which was a product and technology that, no matter you looked at it, 85%, 90% is about the consumer market. Optical is another sensor type that Analog Devices has reported products and plans on. And this technology looks a lot more like the inertial MEMS, with of course a consumer market, but a very broad opportunity space in automotive, industrial, and healthcare.

Amanda Scarnati - *Citi - Analyst*

Are there any questions at this point? Moving back into the industrial space, industrial sales was up about 7% in the July quarter, stronger than expectations. What were the key drivers of this strong July quarter, especially given 13% growth in the April quarter?

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

I'm glad you asked that question, Amanda. I was hoping you would ask that question. Yes, so, from -- by the way, if we had this conversation last year, you would've been asking why the business wasn't growing as strongly; and so I'm glad that we're having this discussion. But in any event, the July quarter for ADI industrial sales grew 7% sequentially, about 11% year-over-year, which I think was a great result. It was certainly better than we were expecting.

Now, there's really two cuts at the industrial business. One is the long tail of the business, with tens of thousands of customers, 20,000 parts, and that's the kind of business that jibes with overall PMI and GDP. That piece of it grew well, but it only represented about half the growth. The other half of the growth actually came from more programmatic areas within industrial; for example, in the areas of aerospace and defense, in the areas of energy.

And so, the overall growth rate for industrial looked a little stronger than maybe the base business was. The base business probably sequentially grew 3% or 4%. So, interestingly enough, when we look out to the fourth quarter, we actually guided industrials down somewhat, and I think that had some tongues wagging in our industry a little bit. Well, what's going on?

And really I think there's a couple things. One is, we're heading into a period that is seasonally weaker for a certain portion of our business. That's the area of semiconductor test equipment. And also, we had a particularly great quarter in the third quarter from some of the more programmatic areas, and we expect that to be a little weaker in the fourth.

But there's two key points that I'd like to make. One is the broad base of customers are doing quite well. They have been doing well. The broad base of customers we expect will continue to do well in the October quarter, and I think they'll grow. The revenue from those customers will grow. But there is going to be a little bit of seasonality there. We expect it to be down a little bit. But year-over-year, the expectation is that it will still be up.

And importantly as well, the big thing in semiconductors I guess is, you look at inventories out there -- and what are inventories doing? The inventory in our distributor channel, which is about 55% of our total sales, and is a great proxy for what the industrial business is doing, because most of what we're doing in industrial is service through distribution.

Inventory in the channel is at 7 1/2 weeks. It's right in line with our model, and that number actually hasn't wavered much over the last few quarters. It's been at 7 1/2 weeks. Our best sense is that this is a modest recovery. Things are improving; they are improving slowly; inventories are still in good shape. So, I think the best is still to come.

Amanda Scarnati - *Citi - Analyst*

Great. And then the final question on the cash return strategy: it's been about a year and a half since announcing the 80% buyback -- or return of free cash flow. What are the current priorities between dividends, buybacks, acquisitions? I know you mentioned a 5% to 10% increase in the dividend on a yearly basis. In the recent acquisition of Hittite, how has this priority changed?

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

I'm a musician, so I think it's going to be second verse, same as the first, to be honest with you. Because we've committed to returning 80% of our free cash flow to shareholders, and I think when you look at the -- how that breaks out, two-thirds of that is going to be most likely in the form of dividends that will grow in line with earnings. Earnings growth is 8% to 15% annually; dividend growth is 5% to 10% annually. We'd like to lag the earnings growth a little bit. And then the balance of the 80% will come from share repurchases.

We've actually been very methodical in our approach on the share buybacks side. In the old days, we'd sit around in our offices thinking about the right time to buy stock. And it always turned out that we were the worst timers of the market. So we've actually decided that -- and this has happened over the course of the last couple of years -- we've decided that we have a programmatic approach to the buyback. When the stock breaches certain rolling averages of the stock, it goes out and buys stock. And to the extent it breaches longer-term rolling averages of the stock, it buys back more.

So, at current stock prices, we're actually out there buying stock at probably our max daily capacity here, because we think this is a great value for the stock.

And then in terms of the way that splits out -- so the priority being the dividend; secondly being of the share buyback; and then M&A would be obviously the third leg to that stool. And we've been very -- which might be new for some of the industrial investors in the room -- but we haven't had a huge focus on acquisitions. Our focus has really been on returning a lot of cash, because we generate a lot of cash.

We just recently closed a deal -- as you mentioned, Amanda. We purchased a company here in Massachusetts, really driven by technology that a lot of our customers in the areas of industrial, automotive, and comms infrastructure were looking for. And so really for us when it comes to the M&A, it's really a question of customers pushing us, or really looking for an area for us to invest in. We look at the buy-versus-make decision, and then we make a decision based on that.

So, I think like I said in the introduction -- you probably could have cut out everything I said in the middle -- but second verse, same as the first.

Amanda Scarnati - *Citi - Analyst*

Excellent. Well, thank you, Ali. Thank you, Mark. Enjoy the rest of your day.