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# EDITED TRANSCRIPT

ADI - Analog Devices, Inc. at JPMorgan Tech Forum at CES Conference

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## CORPORATE PARTICIPANTS

**Dave Zinsner** *Analog Devices, Inc. - CFO*

## CONFERENCE CALL PARTICIPANTS

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

## PRESENTATION

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

Next up is Analog Devices. It is our pleasure to have the Ben Affleck of semiconductors otherwise known as the CFO, Dave Zinsner, here. They both used to date JLo.

At any rate, so ADI, why do we like ADI? Why do we have an overweight on it? Very similar to our theme on Texas Instruments and Xilinx. We see new all-time highs in margins. Over at ADI we think gross margins could eventually get to 70% operating margins up towards the high 30s and low 40s and how are they doing it? Really getting out of the bad businesses, focusing on the good businesses. There's no real magic there. They had a nice restructuring which is implemented by yours truly sitting right next to me.

And then again, with the payout ratio of 80% they give all you guys the cash.

So, I think you guys are one of the more recent semiconductor companies to report roughly four or five weeks ago. If you could just maybe provide a brief recap of what happened during the quarter and what the guidance was and sort of what you guys are seeing in the semiconductor market.

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**Dave Zinsner** - *Analog Devices, Inc. - CFO*

Okay, sounds good. So I will just preface this by saying I have been off for two weeks. I had to go back and look at even what we did for numbers, quite honestly, after two weeks of being shut down.

It was a little, obviously, a little bit softer than we had expected into the fourth quarter. And I think, based on the guidance and based on what I had heard from some of the expectations, we probably guided a little bit weaker than what everybody expected. There wasn't a ton of momentum in the business going into the quarter.

But I think the good news is our guidance was to be down at the midpoint, 7.5%. If you strip out the microphone business which we sold last year, that would mean we would be up, I think in the midpoint, 3% or 4%. So it is -- we are starting to see that year-over-year growth momentum start to kick in.

The communications business has been one of those businesses where we haven't quite seen the uptick that has long been expected, probably in the beginning from Asia, but probably more broadly after that. I do think that that is going to happen this year. I think the industrial business, which has been a little bit weaker for us because of the automated test equipment business being softer and our defense business being a little softer, I think that is going to pick up.

We do have some pretty interesting design activities or design wins in the consumer business. I think most of that is probably going to be a 2015 story, but we will probably start to see some of the momentum kick in in consumer, which has long been a headwind for us over the last few years in 2014.

And then automotive, which has been probably the crown jewel of the Company over the last four or five years, it has grown in the double digits. I think that business is actually going to have another good year in 2014. So knock on wood, the macro certainly does have to behave for us, but I think there is a reasonable expectation that we will start to see some decent momentum in the business in 2014.

On top of that, as you point out, we had in a -- what we call a tougher environment having been down a couple of years in a row, we managed to, I think, exit the year above 65% gross margins. We did that while bringing our inventory down by \$30 million.

So that bodes well for gross margins on a go-forward basis as inventory depletion is no longer or should no longer be an issue -- a factor. We start to see utilization come back up into fab. I think we have done a very good job on the OpEx side in this softer environment containing operating expenses. Really, they have been generally kind of flattish for the last few years. We are going to continue to really be very careful about where we spend our money.

We told the businesses, the business units, that the pie really isn't -- not going to change that much. They had to re-divide the pie up in terms of where they wanted to invest for growth in the future so, as not to see a big ramp in operating expenses which we hopefully see revenue recover. So that should mean operating margin leverage should be really good.

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

So, I guess just to take a step back and talk about how 2013 went. What went better for you guys? What was maybe not up to expectations and, then, why do you think we are just slogging along in the semiconductor market? What do you think it is going to take to snap us out of this watching paint dry end market?

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**Dave Zinsner** - Analog Devices, Inc. - CFO

Yes. Well, I think -- in reality I have to think back to the plan. We actually were not too far off of our operating plan, maybe 1% or 2% off what we originally thought. I think that every end market had a little bit of unexpected weakness to it, relative to our expectation. I mean even auto which was up, I think, 4% year over year last year. We were expecting, obviously, given the fact that we had not been doing double digits, we actually had expected a little bit higher growth rate even there.

I think in an environment where there is a lot of uncertainty in most of the global markets where capital spending is really being contained, because they just aren't certain about the future and where to invest, I think those things affect us very significantly and maybe way more than what is going on at the end market level in those markets.

So, usually what happens is when it starts to come back, we start to see a way better recovery than those end markets. And that is the expectation. We talked to a lot of customers over the last few quarters in predominantly in the industrial space, but also in the [super] space and the auto space. And I think all of them are more optimistic going into 2014 than they were in 2013.

Now it is marginally more optimistic and I think they are all being cautious because there's a lot of uncertainty, but the little bits of information that have come through over the last few weeks in terms of macro generally have been more positive than negative. So I think there's reason to believe that things are going to be better next year.

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

Do you feel any better about your business now than you did during the report or is it still too early to tell (multiple speakers)?

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**Dave Zinsner** - Analog Devices, Inc. - CFO

Well, I think it is early to tell. You go through -- I like to -- I think like I analogize this to, you're running the race track and there is a wreck up ahead and it is all kind of foggy and you close your eyes and go through it and hope you don't run into something.

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

That is not giving me any confidence on 2014, Dave. (laughter)

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**Dave Zinsner** - Analog Devices, Inc. - CFO

There's a little bit but the last couple of weeks of December like it just kind of -- like, it all slows down which is what you expect and you hope that when January starts, orders start to flow back in. And every year we go through this and we go oh, geez, wow, there was no orders at the end of December.

But I do believe that January will strengthen and we will do fine for the quarter, relative to the guidance; and hopefully, what normally happens is the second quarter is a really strong quarter for us, given the industrial business, see some pretty good seasonal growth. So, hopefully that will be -- we will have some good numbers to report and some good guidance to report.

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

And I don't know if you looked at this, but your revenue growth versus the other large analog companies was a little bit lower. Any reason why? Now, granted you outgrew them the year before, so is it just one year is better, one year is worse, next year will be better? Is there anything you could (multiple speakers)?

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**Dave Zinsner** - Analog Devices, Inc. - CFO

Yes, I do think that in the industrial space, which is one that probably I focus a lot on, relative to the other players who have big consumer -- big industrial exposure, we did seem to do a little bit worse than them this year. And I think partly it is a little bit of classification. We put our defense business in. Not all of those guys put defense in there.

We also have a relative -- when it is actually performing, we have a relatively large automated test equipment business and that sometimes goes through these cyclical -- which not necessarily in tune with the cycles of the overall semiconductor business. It goes through these kinds of cycles and clearly it was really, really soft over the last couple of quarters. And I think that did also provide some headwind for us, relative to the peer group.

But and also on top of that, you have revenue recognition differences. Some of those guys recognize revenue when the product ships into the distributor, depending on what the distributors were doing in terms of inventory levels that may have benefited them. And we recognize revenue when it ships out. So we don't necessarily get that benefit of inventory builds at distribution.

So, I would say you have to take it over like a couple of year period and really see what you are doing. I would tell you that we track -- voraciously track the market share data of data converters and amplifiers, the things that go, that sell into those markets. And if anything we have been growing share in those business -- in those product categories.

So I feel relatively confident that this is not any sort of share loss. It is really just kind of unique, a unique syncretic differences between different companies and over the long term it all shakes out.

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

Just writing all this down. So, let's dig into the end markets. First of all, starting with your largest one -- industrial. So you said last year was a little disappointing because the [ATE] and the defense part was weak. How big of your industrial business are those two categories roughly? And, then, what gives you confidence to expect them to bounce back this year?



**Dave Zinsner** - *Analog Devices, Inc. - CFO*

So, military. We put military and aerospace all in one bucket, but that is in kind of a mid- to high-single digits as a percent of revenue. Our instrumentation business in terms of total revenue is in the mid-teens. And I would say, depending on the quarter a decent chunk of that is automated test equipment. So --.

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

That is pretty big, yes.

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**Dave Zinsner** - *Analog Devices, Inc. - CFO*

Yes, so it is -- these are decent-sized businesses for us and can move the needle for us.

The other thing, if you are looking at us on an aggregate basis, just to touch again on the whole differences between us and some of our other peers, one thing that we clearly have done over the last few years is really refocus our business. And you highlighted it at the very beginning.

Some of that refocus has been moving away from certain parts of the consumer business and shifting those resources into areas that we feel more confident will deliver good returns, like communications and automotive and industrial and then, the portable space within consumer. And so that has driven a lot of headwind and it certainly was a headwind last year as well.

So, I think that that is a consumer -- like, for example, consumer was down what was it 13% year over year (multiple speakers) FY 2013. And so that was a pretty meaningful headwind to our business that, if other peers were not making those kinds of shifts, they wouldn't have experienced that. But, I think, the good news for us on the consumer front is we are kind of -- we have that behind us. And I think a lot of the opportunities that we have going forward are pretty good.

So, we should see a leveling off of consumer. And at some point it is hard to determine exactly when that is, we will start to actually see the other side of this and see a ramp.

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

Why do you think you have had so much volatility in the consumer business over the last couple of years and does that incentivize you to minimize it or what should we see out of that going forward?

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**Dave Zinsner** - *Analog Devices, Inc. - CFO*

Yes. We have minimized it. It is now 15% of revenue. I think it was 25% of revenue a few years ago. It is partly, it's been, I think -- I think the best way to describe it is the way we had been addressing consumers had been a little bit more ad hoc. We heard some things, somebody might come with some idea, an OEM or so forth. We drum up a design for that, maybe get some traction there. It would last a generation and then they would want a cost-down version of it.

It was -- you start to look at the R&D spend and the ROI, and it is no longer there. And so what we did was we didn't really take a specific area and say, we are going to fund those things that are highly differentiated that we think we can maintain over multiple generations and fund those appropriately and make sure we win in those markets.

And making sure we win includes having a really good roadmap for how we get the cost down over time. And that just really wasn't going on in the consumer business. So, I think in a lot of cases that was impacting our ability to perform in the consumer.



The other thing is that there just wasn't a ton of -- in the markets that we had relatively meaningful size, there just isn't a lot of innovation going on in those areas. And so we had to shift away to areas that we were -- that we felt had better opportunities for innovation plus differentiation, thus we could maintain the price discipline and get a decent ROI on the designs.

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

Some of your competitors going after the consumer end market even really high margin competitors like Linear have been seduced by the dark side going after this one, very large high-volume consumer customer that starts with an A, intends to really hop around for their suppliers. Is that -- for you guys, does that part change going forward?

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**Dave Zinsner** - *Analog Devices, Inc. - CFO*

Yes. I think that that is, in those instances where that is going to be the case, we are going to pretty much avoid those as best as possible. I think when -- we know we have got something when we are working with an OEM on a combined basis in almost joint development. And those are areas where I think it is more difficult for the competitors to come in. We are tightly aligned with their design resources.

I think the opportunities are there to maintain it over multiple generations. I think when it is -- when you are in this process where they have got an RFQ out and five semiconductor companies are bidding on things and you know it is dead in the water, and we just are going to avoid those.

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

Yes. You will jump off.

Switching gears a little bit, talk about the automotive market. What would be your thoughts on how the automotive market did for you guys last year? What are you expecting this year? I guess one thing that I have noticed coming to CES at least over the last three or four years is a massive increase in the amount of automotive companies that are here at the floor. So give us your thoughts there.

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**Dave Zinsner** - *Analog Devices, Inc. - CFO*

Yes. So, it was up in an environment where every other business was down. So that you could say is a positive. It wasn't up quite as much as we had hoped. There was one product transition that occurred for us on a lower performing part and so we didn't actually win the socket the second time, and that was okay because what we wanted to do was transition to higher performance. And that created a little bit of a gap in terms of coverage.

So we lose -- the revenue rolled off and we didn't have revenue to roll back on at that moment. But I think in 2014 you are going to find that we have some pretty good design momentum within the automotive space.

We focus in three areas. Infotainment, which I think a lot of companies do; safety, which I think we really have a unique position. We have MEMS technology that is pretty high performance, very advanced. Really our only major competitor in that space is Bosch, which is a good competitor to have. And safety is a good thing because a lot of the safety systems are mandated over time, and so they are required to put them in, and thus we have a really good opportunity to gain a lot of traction in terms of design win activity in the safety space.

And then the last area, which had been, I guess, traditionally maybe a little bit more of a sleeper submarket which is the power train market. Now it is becoming more interesting as hybrid electric, electric, even higher fuel-efficient combustion engines start to roll in, become a bigger part of the [sam] there. A lot of that stuff requires analog sensing capability and so forth. And so we think we have a pretty good opportunity to exploit that and to see some good growth there.

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

And that's interesting with the one area of share loss that dinged you a little bit last year, why did you guys lose the socket? Was it price? Was this a lower margin part? Was it a converter part? Maybe just give us a (multiple speakers)

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**Dave Zinsner** - Analog Devices, Inc. - CFO

Yes. It was kind of a combination of price and performance -- the price and performance kind of where those two intersect wasn't quite the right place for us at that moment. We were a little late getting it out. Like I said, we have another generation that --

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

Was it a converter part?

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**Dave Zinsner** - Analog Devices, Inc. - CFO

No. It is actually a MEMS-based part. But the next generation of that part is on track. If we do it, we are going to get -- I was actually with Vince in Europe as he was talking to some of the leading module guys in the OEM -- or in the automotive space. And they are pretty excited about this technology.

So we roll this out, I think we have a really good shot at some very meaningful growth or revenue momentum within the automotive space.

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

When would that (multiple speakers)

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**Dave Zinsner** - Analog Devices, Inc. - CFO

Well, the design is going to roll out here imminently. We would start to see revenue probably sometime this year and really we will start to see some -- the real ramp of it in later generations as the automotive new models start to come out.

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

Okay. And let's talk about the [condo] market a little bit. A lot of hype, a lot of back and forth, it is it coming, is it going, China spending, they're not spending, they're delayed, they are not delayed, what is your take there and what do you expect in 2014?

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**Dave Zinsner** - Analog Devices, Inc. - CFO

Well, only because I have been wrong so many times on this as anybody else is, I will be cautious about what I say. I --

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

I will put you on my [blacklist], you will feel a lot better about yourself and predictions.

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**Dave Zinsner** - *Analog Devices, Inc. - CFO*

Thanks.

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

And your family.

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**Dave Zinsner** - *Analog Devices, Inc. - CFO*

Yes. Sure. I don't know what to say about this. We certainly think we have a great position in 4G. There has been enough headlines around rollouts, particularly in Asia or China, specifically, that lead one to believe that there will be a lot of radios sold this year. And for us we are really tied to the radio.

I mean, the base station obviously important, but it is the number of radios on the base station that really drives the revenue growth for us. And small sell, every small sell would be a radio too. So the radio count is really what we want to see go up. That has been relatively flattish over the last couple of years, and so that has been the challenge around the communications business.

I personally believe that they have to -- and this is I think, collectively, the ADI belief is that they have to upgrade the radios in order to get the performance they need in order to get 4G performance. There's some things you can do with software, but you cannot get real 4G data rates without upgrading the radios in most cases.

So, when it happens, I don't know. You would think that they would be anxious to do it over the next -- particularly now because they are going to start rolling out 4G handsets out over there and they are going to need -- I think there is going to be some expectation that they get 4G data rates with it.

So, we will have to wait and see, but my expectation, we certainly built in the plan that we would start to see a turn up in this business in 2014.

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

And if you had to write your three biggest end markets, industrial, COM, auto for 2014 how would you rank them? In terms of --

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**Dave Zinsner** - *Analog Devices, Inc. - CFO*

In terms of likelihood of --

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

Let's hope they all grow, but in relative areas of growth --.

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**Dave Zinsner** - *Analog Devices, Inc. - CFO*

In the highest growth to the lowest, you mean?

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

Sure.





**Dave Zinsner** - *Analog Devices, Inc. - CFO*

Tough to say. Automotive, [sit for it] and then industrial would be the way I would rank them. But, again, the way we ranked them last year that was kind of the complete opposite to.

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

Yes, bring the business to predictions. Okay, great.

Switching gears a little bit, power management, this is an area that you have gone back and forth on. Do we focus on it more, do we focus on it less? What are the current thoughts there? Would you ever do M&A there? Any update there?

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**Dave Zinsner** - *Analog Devices, Inc. - CFO*

For us, power management -- I think what we have come to discover over time was that going after power sockets in markets that we don't have a lot of presence with other products doesn't make a lot of sense. Going after the broad line power business, setting up distributors to sell some gigantic portfolio of power parts doesn't make a lot of sense because there are already companies that do that.

So for us, power is really kind of additional kind of quiver that we can use to -- or arrow in the quiver that we can use to augment what we are doing on the data converter or amp signal processing side. And do it when we think we have something unique to provide the customer.

So if it is just a meter regulator and net regulator what every other power company does, if you want to do it, that is probably not one we are going to raise our hand for to just get it there. But if it is laying out on a board something that the power needs to elegantly work with the converter and the amplifier to perform some functions that are really critical for the customers' needs, then I think those are the areas that we want to participate in.

And that is really what probably over the last at least 24 months that has been the way we have been investing in the power space. And we have really cut back a lot of R&D in that space because of that. So, really that business is in decent shape on an expense, relative to revenue basis because I think we have that thing rightsized for what we want it to be.

It is possible that we would buy something in the power space only because there might be some technology that we really need, but I would venture to guess it is unlikely to be some larger scale \$100 million, \$200 million in your revenue company. I would doubt it. If anything it would be something that was pre-IPO relatively small kind of tuck-in type acquisition if we did it. And as you kind of prioritize the opportunities that's probably one of the ones that is lower on the list.

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

So you and the rest of the lucky lucks at 80 I don't feel like you need to have a bigger power management business? Do you ever get customers come in and telling you, hey, we wish you guys had more power management?

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**Dave Zinsner** - *Analog Devices, Inc. - CFO*

No, and I think that is the litmus test for this is the customers were pounding us for more power products then we would certainly think differently about it. But I think in a lot of cases they do think of them a little bit differently and separately. And so for that reason, I don't think it makes a ton of sense to do it unless, like I said, unless there is something that really the customers need very specific around power that's -- uniquely fits with what we're doing.

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

And then it's interesting, you have seen some of your peers, given the low interest rates, some would call it free money, being thrown about there, leveraging up, doing some M&A, this sort of slowing growth in semis and these historically low interest rates, does it make you want to lever the balance sheet up? I mean, you guys have some debt, but lever up a little more? Does it incentivize you? Do you have more conversations about M&A? What would be your thoughts there?

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**Dave Zinsner** - Analog Devices, Inc. - CFO

I would say that we don't look at M&A in terms of when there is cheap money and when there is not cheap money. I mean I think we look at it a little bit more on a cash flow basis as in a strategic basis to make sure it is something that we really need in the portfolio that customers really require. And if so where would we get that. And can we buy it at a valuation that makes logical sense, regardless of what -- if you start using the accretive model for acquisitions, you can make everything accretive. I mean, when cash is free it is not that difficult, but for us we are way more disciplined around valuation. We don't buy something because it is accretive.

I do think that -- and I would argue or agree maybe that we have more cash probably than we need and we could probably operate with more leverage as well. And I think the fact that we got to \$800 million of debt or \$875 million or whatever is kind of the early stages of I think trying to shift the balance sheet around. We talked about this pushing more cash flow to shareholders and I think that we certainly will use some of the cash for M&A.

But I think we also have a priority around dividends and buybacks to further augment the returns of shareholders. And that is a key priority for us as well. And I think over time that will require more leverage as well.

So, we are not afraid of leverage. I think we will do leverage over time. I don't think it's not cheap money that makes us do it, it's that we need lever -- we need to do it for the benefit of what we want to do both from an M&A perspective and from a cash return to shareholders' perspective.

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

Before I dig into a couple more finance questions, I just want to make sure if anybody in the audience has any questions, going once, going twice. In the back.

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**Unidentified Audience Member**

Why don't you dig in a little bit further on your commentary about how April quarters you feel very good about it. Is that based on normal seasonality? Do you think given your commentary earlier about how some of the customers are more optimistic about 2014 than they were about 2013, do you think maybe April can be better than normal? Or just maybe provide some color around that. Thanks.

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**Dave Zinsner** - Analog Devices, Inc. - CFO

To give you any certainty around this is a little difficult. We get orders -- we have four-week leadtimes. So, most of the orders that we are even getting at this moment still are for the January quarter and not for the April quarter. So our visibility is pretty limited.

I am basing it partly on the fact that just seasonally we -- April tends to be a better quarter for us. It was last year, for sure, and has been in the past. And basing it a little bit on the customer commentary that I have heard, although the commentary comes without any orders to back it up or any forecast to back it up. So I caution you there.

I -- there's certainly a scenario where as we get into February and we announce earnings, that we are more optimistic about the April quarter than we have been before. And I think that is one possible scenario. I think it is early to say for certain that that is how it is going to play out. So we will have to wait and see, but I am hopeful.

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

And one two-part question, I guess, on the finance. So, you guys are giving out and 80% payout ratio. I think you were fairly substantially below that for last year. Can you just talk about why and then a good problem to have, you have a large offshore cash position. What is the plan to give that back to shareholders? Do you get a lot of pressure from shareholders to return that?

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**Dave Zinsner** - Analog Devices, Inc. - CFO

Well, I mean the -- we have been behind on the 80%. The idea is we will catch up over time. Our buyback program was a little bit maybe tuned not quite aggressively enough and so, in November, we retuned it to make it a little bit more aggressive and I think, hopefully, you'll start to see more activity around buybacks in the future. And that should at least get us to catch up to the 80%.

I think -- and the 80% was really over a five-year period. I am going to look back and say, did we get at least percent of the free -- of the earnings back to shareholders. And so we'll see. We'll see. But I am pretty optimistic that that is going to turn out great for the shareholders.

You are right. We have a lot of cash. There's not a lot of use -- needs for that, for so much cash. I am hopeful that we do have a backup plan which is to manage through leverage on the US books, but I am hopeful that the US government gets their act together and decides to do a repatriation, and then we would really have a great opportunity to exploit that cash and use it to & up shareholder returns.

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

Absent a repatriation holiday, is there anything you guys can --?

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**Dave Zinsner** - Analog Devices, Inc. - CFO

There are other ways to do it. And I think partly we have held off just because we wanted to be certain because, certainly, the cheapest and most efficient way would be a repatriation. So we are waiting to make sure that that (multiple speakers)

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

Call the White House, man, ask what is going on.

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**Dave Zinsner** - Analog Devices, Inc. - CFO

Yes, talk to Obama myself. And but if that doesn't happen there are other opportunities for us to utilize that cash.

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

Great. With that we are out of time. Thanks, again, everybody and next up is Hewlett-Packard.

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**Dave Zinsner** - *Analog Devices, Inc. - CFO*

Thanks.

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

Thanks, Dave.

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