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ADI - Q2 2016 Analog Devices Inc Earnings Call

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OVERVIEW:

ADI reported 2Q16 revenues of $779m and diluted EPS (excluding special items) of $0.64. Expects 3Q16 revenues to be $800-840m and diluted EPS (excluding any special items) to be $0.66-0.74.

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PRESENTATION

Operator

Good morning, and welcome to the Analog Devices second-quarter FY16 earnings conference call, which is being audio webcast via telephone and over the web.

I'd like to now introduce your host for today's call, Mr. Ali Husain, Treasurer and Director of Investor Relations. Sir, the floor is yours.

Ali Husain *- Analog Devices Inc - Treasurer and Director of IR*

Great. Thanks, Jennifer. Good morning, everyone. Thank you for joining the Analog Devices second-quarter 2016 earnings conference call.

You can find our press release, relating financial schedules, and the investor toolkit, which includes additional information that we believe will be useful for investors, and all that is at investor.analog.com. As usual, I'm joined by ADI's CEO, Vincent Roche, and ADI's CFO, Dave Zinsner.

So before we start, let's get through some disclosures. Please note: The information we're about to discuss, including our objectives and outlook, includes forward-looking statements. Actual results may differ materially from these forward-looking statements as a result of various factors, including those discussed in our earnings release and our most recent 10-Q. These forward-looking statements reflect our opinion as of the date of this call, and we undertake no obligation to update these forward-looking statements in light of new information or future events.

Our comments today will also include non-GAAP financial measures, which we have reconciled to their most directly comparable GAAP financial measures in today's earnings release, which we've posted at investor.analog.com. And with that, let's get started.

Revenue in the second quarter totaled $779 million, which was up 1% sequentially and down 5% from the prior year. On a sequential basis, our business-to-business, or B2B, markets of industrial, automotive and communications infrastructure experienced broad-based demand, growing 9% sequentially and more than offsetting a weak consumer market.

So let me give you a little color on our performance by end market. While overall macro trends were fairly mixed during the quarter, ADI's highly diverse industrial markets grew 11% sequentially and represented 49% of revenue. All of the major application areas within industrial, such as factory automation and industrial instrumentation, grew sequentially in the seasonally strong second quarter. And we also had a particularly strong performance in the aerospace and defense vertical.

The automotive market, at 18% of sales, grew 9% sequentially in the seasonally strong April quarter. Growth was broad based across all of our automotive focus applications of safety, ADAS, powertrain and infotainment.

Turning now to communications infrastructure, last quarter we had talked to you about a nascent recovery in this market, and we're happy to report that this trend continued during the second quarter. Revenue from communications infrastructure customers, at 23% of sales, increased 4% sequentially, with both wireless base station and wireline applications revenues increasing over the prior quarter. After troughing in July of last year, communications infrastructure revenues have grown at a slow and steady pace, and we believe we're still in the early stages of a recovery in this market. So in total, ADI's B2B markets of industrial, automotive and communications infrastructure grew 9% sequentially in the second quarter.

In the consumer market, revenues decreased 37% sequentially. At current quarterly run rates, we believe that our consumer business is at trough levels. In total, consumer represented 10% of revenue in the second quarter.

So, now I'd like to turn the call over to Dave for details of our financial performance in the second quarter. With the exception of revenue and other expense, Dave's comments on our second-quarter P&L line items will exclude special items, which, in the aggregate, totaled $33 million for the quarter.

When comparing our second-quarter performance to our historical performance, special items are also excluded from prior-quarter and year-over-year results. And reconciliations of these non-GAAP measures to their comparable GAAP measures are included on Schedule E in today's earnings release.

So, with that, Dave, it's all yours.

Dave Zinsner - *Analog Devices Inc - CFO*

Thanks, Ali, and good morning, everyone.

Our strategy to focus on diverse products, customers and markets enabled really good performance in the second quarter. We also repurchased $214 million of our stock in response to price volatility, which enabled the third consecutive quarter of share count reduction.

Revenue in the second quarter totaled $779 million, and diluted earnings per share was $0.64, with both results above the mid-point of guidance. Gross margins of 65.8% increased 360 basis points from the prior quarter, primarily on lower inventory reserves and on factory utilization rates that increased to the low 70%s.

Inventory on a dollars basis decreased $5 million sequentially, and on a days basis, increased to 138 days, as we staged inventory for an anticipated consumer revenue ramp and managed Hittite-related last-time buys. We expect both dollars and days of inventory to decrease over the next two quarters. Turning to inventory in the distribution channel, inventory in distribution on a dollars basis was modestly higher than in the prior quarter, and weeks of inventory in distribution decreased to 7 weeks from the prior quarter's 7.5 weeks.

Operating expenses increased 3% sequentially, to $272 million, in line with our plan. Operating profit before tax of $240 million increased 12% sequentially, and as a percent of sales expanded 300 basis points to 30.8%. Other expense in the second quarter was approximately $13 million, and that represents the run rate of our net interest expense.

Our second-quarter tax rate was approximately 12%. We expect our non-GAAP tax rate for the remaining two quarters of the year to be approximately 12.5%. Excluding special items, diluted earnings per share of $0.64 increased 14% over the prior quarter.

Our business franchise forms the foundation of our strong balance sheet. At the end of the second quarter, we had $3.8 billion in cash, net cash of $2 billion, and a leverage ratio of 1.3 times EBITDA. We also have $1.7 billion of liquidity in the US, which we plan to use for investments in our Business and for general corporate purposes, including dividends, share repurchases, and acquisitions.

During the second quarter, free cash flow as a percent of revenue increased 190 basis points from the prior year to 37.8%. Excluding a one-time item, over the last 12 months ADI has generated $1 billion in free cash flow. And over this period, we have also returned that $1 billion to shareholders through dividends and share buybacks, effectively returning 100% of free cash flow over the past 12 months.

During the quarter, we paid $130 million in dividends to shareholders. And earlier this week, our Board of Directors declared a cash dividend of $0.42 per outstanding share of common stock. This will be paid on June 7, 2016, to all shareholders of record at the close of business on May 27. At the current stock price, this dividend represents an annual rate of about 3%.

M&A is a key part of our strategy to accelerate technology leadership and revenue growth. During the quarter, we acquired SNAP Sensor, giving ADI the ability to provide very high dynamic range industrial imaging solutions in smart-city and smart-building applications.

So in summary, this was a good quarter on several fronts. The diversity and breadth of our Business, coupled with strong execution, enabled revenue and diluted earnings per share results that were above the mid-point of guidance, and our capital allocation strategy enabled a significant return of cash to shareholders.

So now turning to our outlook and our expectations for our third quarter, which, with the exception of revenue expectations, is on a non-GAAP basis and excludes special items that are outlined in today's release. We're planning for another quarter of sequential revenue growth in the third quarter.

In our B2B markets, we are seeing stable order rates across the industrial, automotive and communications infrastructure sectors. And as a result, we are planning for aggregate sequential demand in these B2B markets to be largely seasonal in the third quarter. Importantly, we expect our B2B markets, in the aggregate, to grow in the mid- to high-single digits on a year-over-year basis in the third quarter.

In the consumer market, good design traction in the portable sector leads us to plan for sequential revenue growth in this market, although it is likely that this revenue growth will be back-end loaded and occur late in the third quarter. In total, we're planning for revenue in the third quarter to increase sequentially, and be between $800 million and $840 million.

We expect gross margins to remain stable to their second-quarter levels, despite utilization rates in the 60%s range, as we expect lower spend levels and manufacturing efficiencies to offset the lower absorption. We estimate that operating expenses will be up slightly in the third quarter, but that they will lag our expected sequential revenue growth, and we expect even greater operating leverage in the fourth quarter. Based on these estimates and excluding any special items, diluted earnings per share are planned to be in the range of $0.66 to $0.74.

We firmly believe that our future success is within our control. To that end, we are partnering with customers, and innovating with impact, to drive business success and, more importantly, shareholder return. With a strong business model and a focus on the right end markets, we're confident that we can drive ADI's non-GAAP EPS to up to $5 by 2020.

Ali Husain - *Analog Devices Inc - Treasurer and Director of IR*

Great. Thanks, Dave.

All right, folks, before we get to Q&A, let's run through the format. Please limit yourself to one question. If you have a follow-up question, we ask that you please re-queue. And again, we do this in the spirit of fairness so that all callers get to ask at least one of their questions. And we plan to run the call until 11 AM, so I think we've got plenty of time to get to everyone's questions.

And so with that, operator, let's start the Q&A session, and folks on the line can ask questions of either myself, Vince or Dave.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from the line of Tore Svanberg with Stifel.

Tore Svanberg - *Stifel Nicolaus - Analyst*

Yes, thank you, nice quarter. Just a question on your communications business. You said it's been steadily improving since, I guess, almost a year ago now, but that we're still in the early days of some good momentum there. So can you just elaborate a little bit on that? Perhaps maybe both on the wireless and on the wireline side, please?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, so Tore, as you point out, I'll start, and Vince will, I'm sure, finish up. But we troughed around the third quarter of last year, and obviously, a lot of the weakness last year was related to China investigations. That seemed to run its course, and we've been steadily improving up to the levels that I think we saw right around the second quarter of last year. I think our position in the marketplace is quite strong. We literally have any OEM that's building base stations or other infrastructure communication equipment uses our radios. We also expect that over the next few quarters, we'll start to see a more meaningful rollout of small cell activity in China.

We think that will be a good growth driver. We have the lead position, from a technology perspective, in integrated transceivers, which is going to be the technology of choice in that space. So I think we are in great competitive position. The small cell activity is going to help drive some momentum, just aggregately in the marketplace, and then this whole headwind that we saw in China has started -- has run its course, obviously, and we're starting to see the recovery there. So the momentum and the wind is behind our sails at this point in the communications space. Obviously, it can be lumpy at times. But right now, based on the order flow, we're quite optimistic about the com space.

Tore Svanberg - *Stifel Nicolaus - Analyst*

Thank you.

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Operator

The next question is from Ambrish Srivastava with BMO.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Hi, I had a question on the guidance, and I'm just trying to understand the consumer guidance. And we're notoriously bad in trying to predict Apple units, but if you look at the guide, it looks like it could be a factor of either lower units than what most of us were modeling for or lower ASP. Or just the overbuild was so high that it's taking a longer time for all of that to bleed through the channel. What's the right way to think about it? Thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

I think the way to think about -- I guess you're talking about the third quarter. I think, really, the third quarter, as you compare it against the third quarter of last year, is really the dynamics around when the buildup is going to occur this year versus when it occurred last year. I think because we were a new player in that particular application, with a new product, our customer ramped a few months earlier than typical for their semiconductor vendors, in an effort to make sure they had everything in the pipeline they needed. I think now, we're going to be more consistent with most of the other semi vendors out there that supply into this particular application.

And really, that means that we really don't see the demand pick up until the July time frame. So it's probably going to be more of a end of third quarter and more into the fourth quarter this time, versus last year, where it was more of a ramp in the third quarter. I would point out that we have -- that we -- I should say suspect we have more dollar content in that particular application this year versus last year. And so from a BOM perspective, we will actually be in a better position. And so it obviously, at the end, depends on how the demand of the end product goes. But assuming that goes fine, we will actually see pretty good growth.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Okay, thank you.

Operator

Our next question is from Amit Daryanani with RBC Capital Markets.

Garo Toomajanian - *RBC Capital Markets - Analyst*

This is Garo on behalf of Amit. Thanks for letting me ask a question. I guess looking to industrial business, it's been down year on year for a few quarters now. And it looks like given guidance, it might grow year on year in the July quarter. Will we see the growth accelerate as we get into the back half of 2016 and then into 2017?

Dave Zinsner - *Analog Devices Inc - CFO*

Industrial is hard to predict out 4 weeks, so I don't know that we're ready to predict what it's going to do out several quarters. I would say that yes, from our guidance, you can interpret that we suspect the industrial business is going to be up year over year in the mid single digits or so. Ali? Yes. And as a result, we think we're back in a recovery phase there. It had been weak, probably related to the phenomena around oil and gas weakness, and maybe some currency issues.

That seems to have run its course, and as a result, we think we're back on a recovery trend in the industrial space. The one area of that business that's actually beaten the macro headwinds has been the aerospace and defense business. That's done very well for us, even despite the weakness we've seen out there on the macro side. And as it looks out into the future, it looks like that business will continue to be a pretty strong business for us.

Garo Toomajanian - *RBC Capital Markets - Analyst*

Thank you.

Operator

Your next question comes from John Pitzer with Credit Suisse.

John Pitzer - *Credit Suisse - Analyst*

Yes, good morning, guys. Thanks for letting me ask a question. Dave, I want to talk a little bit about the gross margin guidance for the July quarter. If I look on a year-over-year basis, gross margins are going to be down a little bit, year on year, despite the fact that I think you said in your prepared comments that the B2B business should be up, actually, high single digits year over year. Can you just help me square that circle? And help me better understand why margins wouldn't perform better, if B2B is showing such good year-on-year growth?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, it's a good question, John. We're actually going to bring utilization down, in the third quarter, into the 60%s level. It was actually, I think, in the 70%s last year. And that's really, when we looked at our inventory levels, even though most of the inventory build was related to things within our control, like ramping up or the consumer ramp, and also for the buildup related to some foundry transfers that are going to occur related to our Hittite business. We really wanted to keep inventory in check.

And so we thought it would be a good idea to bring the inventory down in the products that get -- or related to the products that get manufactured internally. So that's really why we approached it that way. Now, we're probably going to bring it down -- I don't know -- somewhere in the 10 percentage point range, at least, and that normally would have a 100 basis point negative impact on us. But what we're going to -- what we think we can do is take some of the costs out of the factory in the third quarter, and we think we'll make some improvements, from an efficiency perspective. And those things combined will offset a lot of that headwind, and as a result, we think we'll be generally flat.

John Pitzer - *Credit Suisse - Analyst*

Helpful, thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

Sure.

Operator

Your next question is from Stacy Rasgon with Bernstein Research.

Stacy Rasgon - *Sanford C. Bernstein & Co. - Analyst*

Hi guys, thanks for taking my question. I wanted to dig in a little bit on automotive. Over the last couple of quarters, you talked about expecting a bit of a second half lift in that business. But now, you're talking about seasonal and aggregate for Q3. And frankly, given the rest of the guidance you're talking about, if industrial is up in the mid single digits year over year, and the overall B2B is up in the mid to high.

Like I'm coming our with auto probably flat to down year over year, and probably down decently in sequentially, which I think would be seasonal. But neither of those things seem consistent with a lift in the back half. So are you backing off on that statement that you made previously? Or how should we be thinking about automotive, as we move through the rest of the year?

Vincent Roche - *Analog Devices Inc - CEO*

Yes, Stacy, we've had stellar growth. We've pointed out before that there's one particular area that we've had a headwind. We believe now that headwind has abated. Our -- we've had good growth in areas like infotainment, the events driver assistance in the powertrain area, we've had good growth. Specifically, in active and passive safety, we've had some issues.

And as I said, I believe the headwind is -- has abate there now. So my sense is that with the programs we have in place, we'll start to see -- we've bottomed out in the auto [MEMS] area, in terms of the decline. So we will be back on a growth track over the coming months, and into the -- during Q4. So I think the worst is behind us there, and we'll get back into a decent growth pattern from here on in through FY17.

Stacy Rasgon - *Sanford C. Bernstein & Co. - Analyst*

But is it that your Q3 outlook for auto was probably flat to down year over year then? [Seems to be.]

Ali Husain - *Analog Devices Inc - Treasurer and Director of IR*

(multiple speakers) No, Stacy, let me just point out -- let me just make a slight correction here. I think when Dave was talking about mid to high singles in the third quarter and the year-over-year basis, I think the comment was specific to the B2B market. Industrial, we expect to be up, on a year-over-year basis, in the very low single digits. And so as a result, I think when you look out to the third and fourth quarter, what we're expecting to see in the automotive business is to see some modest year-over-year growth that we think we can accelerate through the back half of the year here. I hope that -- does that help?

Stacy Rasgon - *Sanford C. Bernstein & Co. - Analyst*

Yes, thank you.

Ali Husain - *Analog Devices Inc - Treasurer and Director of IR*

Sure.

Operator

Your next question is from Craig Hettenbach with Morgan Stanley.

Craig Hettenbach - *Morgan Stanley - Analyst*

Yes, thanks. Just a question on the increase in cash returns, just really stepping it up to the last couple quarters. Clearly, you guys are generating a lot of cash, and have a very strong balance sheet. But just wanted to get your sense of how much is opportunistic versus how much may be providing a read on the M&A side? What might be out there, and how you're approaching that?

Dave Zinsner - *Analog Devices Inc - CFO*

We still have $3.8 billion of cash, so it's not like it's massively influential to how we're thinking about M&A. We're still interested in acquisitions, and that's part of our strategy. Obviously, we have a high bar on those acquisitions, so they don't come every quarter. But we do want to have some dry powder available to us, to make those opportunistic acquisitions that A, can be very strategic for us, in terms of driving growth and are very synergistic with what we're doing from a customer perspective. But B, also deliver a very good financial performance, and hopefully accelerate our earnings growth.

As far as just the level of buyback that we had in the last couple of quarters, I'd say it's a couple things. One, it's somewhat programmatic, in that when the stock has these dips in the stock price, we take advantage of that and buy stock back. And so I'd say over the last couple of quarters, there were those periods of time where that happened. And on the average, we bought a bit more back than we had been in the past. And also, we just fundamentally believe that the best is yet to come for us, and we think that $5 target is a doable target for us.

And if that's a doable target, then buying at this price is a pretty attractive price. So those two things combined drove us to be a little bit more aggressive with the buyback over the last couple quarters, in response to both the stock price and our expectations on value.

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

Got it. Thanks for all of the color, Dave.

Dave Zinsner - *Analog Devices Inc - CFO*

Sure.

Operator

Your next question is from Craig Ellis with B. Riley.

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

Thanks for taking the question, guys. I wanted to follow up on the increase on both automotive and industrial. Those businesses, in the outlook, look like they are back to nice year-on-year growth. So my question is, since those are both businesses that have significant application diversity, where are you seeing the strongest year-on-year gains? And where, within those businesses, do you still have sub-segments that would be below last year's level? And what's the prospect for those to reach new highs? Thank you.

Vincent Roche - *Analog Devices Inc - CEO*

Specific to the industrial area, we've seen tremendous growth in the aerospace and defense area over the last number of quarters, and that's been also bolstered through the acquisition of Hittite. That's helped us a lot. We've been able to combine the franchises of both companies and eke more growth out there. I'd say broad based instrumentation, across the globe, has done well. And if you extract oil and gas from the factory and processes automation side of things, we've seen good growth there, too.

And geographically, I would say in the recent term here, both Europe and China have seen particularly strong growth. On the muted side there, I'd say, on the slower growth side of things, the automatic test equipment and energy sectors have been more turbulent. Energy is flatter, but the ATE thing has been quite turbulent. So that's the picture, in terms of the puts and takes on the markets, the sub-sectors and geographies there. As I said earlier, in terms of automotive, we've seen stellar growth in infotainment, in powertrain and advanced driver assistance.

And we've been dealing with this headwind on the automotive safety -- the passive safety and active safety side of things. Geographically, if I look at automotive again, America has been very respectable, Europe has been stronger, and China and Japan have been relatively flat. So that gives you, I think, a picture of both of those sectors, from a sub-segment and geographic standpoint.

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

Thanks for the color, Vince.

Operator

Your next question is from Vivek Arya with Bank of America.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Thank you for letting me ask a question. Just on the Q3 outlook, I think you may have addressed it at different parts of the call, but could you just give us more color on each of the B2B segments? How you expect them to trend on a sequential basis? And more importantly, how that compares to what you thought, say, 2 or 3 months ago about the segments? Thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, sure, I can take a crack at it. So industrial, I would say, sequentially, is probably going to be up in the low single digits. Automotive is likely to be down in the low single digits. I'd point out that's probably better than what they normally see seasonally, given we have July in our quarter and that tends to be a soft month for the automotive market. And then coms is probably close to mid single digits, somewhere in that range.

I'd say it's pretty consistent with where we thought we would be a few months ago. Nothing has changed. The macro is hanging in there nicely. The order flow in all three of these markets has been pretty good. We're obviously always running the business cautiously, in the event that something in the macro gives us a hiccup. But that hasn't happened, and we're, I guess, pleasantly surprised or happy that's how things panned out for us. And so hopefully, this continues.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Okay. Thank you.

Operator

Your next question comes from Steve Smigie with Raymond James.

Vince Celentano - *Raymond James - Analyst*

This is Vince Celentano on for Steve. I had a question. Has there been any more progress in getting your Force Touch technologies [opted] at OEMs, either within mobile or in other end markets? And I guess in general, what's your plan, going forward, with this technology?

Vincent Roche - *Analog Devices Inc - CEO*

That product source is based on a core technology that we use in multiple applications, in industrial, automotive and so on and so forth. So it's not a case -- the product sector is specific to one application, but the technology is useable in many, many different applications. It's based on our precision signal processing expertise that we've been developing for decades. So as I said, we're all the time looking to diversify, be it consumer, be it industrial. But whichever sector, all those products are based upon the core high performance precision signal processing platform that we've been developing for decades.

Ali Husain - *Analog Devices Inc - Treasurer and Director of IR*

Yes, and Vince, just as a point, we don't comment on individual customers or products. So appreciate the question, but we'll move on to the next caller. Thanks.

Operator

Your next question is from Ross Seymore with Deutsche Bank.

Ross Seymore - *Deutsche Bank - Analyst*

Hi, guys. You gave great color on the wireless side of your coms business. Can you just give us a similar update on what you're seeing on the wireline side? And maybe remind us what the split between those two portions of your coms business end up being these days?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, so two-thirds of our business is wireless, and then the other one-third is wired. There's several applications within wired, but probably the most prominent is control that goes into the optical signal. Obviously, that market is doing quite well, because there's a move towards 100 gig, and that's obviously beneficial to. So it's been on a pretty steady -- the good news on this one is, it hasn't had the lumpiness that the wireless business has had, so its been on a pretty steady growth trajectory. It moves around based on seasonality, but year to year, it's been pretty steady and solid.

Vincent Roche - *Analog Devices Inc - CEO*

Yes, we've been successful at moving between the various generations of optical transceivers, from 2.5 gig right up to 100 gig now and beyond. So we've built a nice franchise, again based on our precision signal processing portfolio, where we're providing sophisticated and very, very precise control of the optical signal change. So that's the primary part, as Dave said, of our wireline business. Other aspects in which we have a good position are in the data pats and control pats in cable infrastructure. But by far, wireline is dominated by the optical technology that we -- the optical products that we provide.

Ross Seymore - *Deutsche Bank - Analyst*

Thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

Sure.

Operator

Your next question is from Romit Shah with Nomura Securities.

Romit Shah - *Nomura Securities Company, Ltd. - Analyst*

Yes, thank you. I just wanted to talk about consumer. My understanding is, January 15 was the last quarter before you guys started booking Force Touch revenues. And in that quarter, consumer was about $95 million. This last quarter, consumer was down to $80 million. So it implies that the business overall is down about 16% from that January 15 baseline. And I guess excluding Force Touch, your legacy consumer business is down even more than that. And so I was hoping you guys could talk about the performance of that business, and legacy consumer in particular, and your expectations going forward?

Vincent Roche - *Analog Devices Inc - CEO*

Yes, legacy consumer has been -- it's a huge number of different applications. We have a steady, strong business in areas like high end digital consumer for home, and for Enterprise. And that's been doing well, and continues to do well. It's a very, very modest investment for the Company, so my sense is, that's been growing at the low single digits for many, many years.

My expectation -- again, given that it looks a lot like our B2B business, in terms of design cycles, product cycles -- that will continue to be a modest growth story for ADI in the years ahead. And it leverages. We do very, very little specific product development for that sector. In terms of the remainder of the business, it's lumpier by nature, and we have a good -- as best we can tell, we read the signals pretty well. And we're managing supply and demand on the basis of what we're reading in those more volatile portable consumer applications.

Romit Shah - *Nomura Securities Company, Ltd. - Analyst*

I appreciate the comments. I just -- I don't know that I'm coming away with a clear understanding for why the legacy business has contracted this much over what's been, what, five or six periods?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, it has been a headwind for 6 years or so, 6 or 7 years ago, mainly because of the digital still camera business, which has been a -- obviously, everybody is using their phones to take most of their pictures, and so that business has -- perhaps has waned a bit. It's down, at this point now, as we sit in 2016, a pretty nominal level at this point. And so I wouldn't anticipate it being much of a headwind going forward. There is a certain amount of people that will always buy digital SLR cameras. I'm looking over at Ali, because he's one of them. But -- and so at this point now, it's probably stabilized.

Romit Shah - *Nomura Securities Company, Ltd. - Analyst*

Okay, thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

Sure.

Operator

Your next question comes from Doug Freedman with Sterne Agee.

Doug Freedman - *Sterne, Agee & Leach, Inc. - Analyst*

Hi guys, thanks for taking my question. If I could ask a question regarding the consumer business, as well. When we look at the business coming back in, with handsets contributing materially here, how do we think about the incremental margin? Both up, but as well as when it ramps down? Especially given the actions you seem to be taking, as far as managing the factory, which may be not coincident with the fab -- with the ramp-up that you're going to see in revenues?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes. So this -- all of this product gets manufactured in a foundry, a third-party foundry, so it doesn't necessarily affect utilization levels. So really, it comes down to what we price the product at, and what we pay the foundry in the back end to produce the parts. And the margins are respectable margins, and there's a little bit of mix degradation by having that business, but it's not significant. I think it runs in the tens of basis points up or down, based on whether we have it in a quarter, or we have a meaningful amount in a quarter or not a meaningful amount in the quarter. But other than that, I don't -- wouldn't suspect we have much volatility in gross margins from it.

Doug Freedman - *Sterne, Agee & Leach, Inc. - Analyst*

I guess another way, Dave, just to ask the question. If we were to exclude the impact of this business year on year, would you expect gross margins to be up next year?

Dave Zinsner - *Analog Devices Inc - CFO*

Excluding consumer, would we expect gross margins to be up?

Doug Freedman - *Sterne, Agee & Leach, Inc. - Analyst*

Yes, if I were to exclude the impact of the consumer ramp up and ramp down, would I expect to see some gross margin improvement, year on year?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, yes.

Doug Freedman - *Sterne, Agee & Leach, Inc. - Analyst*

Great. Thank you so much.

Dave Zinsner - *Analog Devices Inc - CFO*

Sure.

Operator

Your next question comes from Chris Danely with Citi.

Philip Lee - *Citigroup - Analyst*

Good morning, guys. This is Philip Lee calling on behalf of Chris. You mentioned just the inventory was down to 7 weeks this quarter. How is this versus maybe last year? And how do you expect it to trend the rest of the year?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, typically, the second quarter tends to be the trough of just the inventory levels, just because it tends to be a really big quarter for ship-outs. And we're, on a ship-in basis, running it pretty consistently. So I wouldn't glean too much from it, other than the fact that it's at a healthy level. 7 weeks is exactly where it should be in the second quarter, and that's very healthy. My guess is that in the third quarter, it will start to trend back up to 7 1/2 weeks, and then stabilize until next year's second quarter.

Philip Lee - *Citigroup - Analyst*

Thanks.

Dave Zinsner - *Analog Devices Inc - CFO*

Sure.

Operator

Your next question comes from Harlan Sur with JPMorgan.

Harlan Sur - *JPMorgan - Analyst*

Good morning guys, thanks for taking my question. On the strength in industrial, you mentioned aerospace and defense as an area of particular strength. Was this segment up year over year? And was it more commercial or defense related programs that are driving the strength? I know that there's some programs both in commercial satellite and radar. There's also some defense program initiatives, like some fighter jet upgrades and so on. What -- and then what's the program pipeline look like for the remainder of the year? Thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

Okay, I'll take a little bit of a crack at that, and anybody can join in. It was up year over year in the second quarter. It likely will be up year over year for the full year, unless something changes significantly. Most of the growth that we've seen has been in high performance RF, specific to military applications. We got a lot of that technology, obviously, when we acquired Hittite. They were already servicing that market in a relatively meaningful way, and their design wins over several years ago are starting to translate into revenue, and that's obviously driven the growth in that business.

The expectation, over the next 3 to 5 years, is quite positive. I think the areas that -- where radar applications are deployed are areas where the military is spending more in. And so as a result that, coupled with the fact that now we have a really commanding position in that marketplace, leads us to assume that this market, for us, is going to be a nice driver of growth over the next 3 to 5 years.

Vincent Roche - *Analog Devices Inc - CEO*

Commercial aircraft is another space where more and more of our technology is being used for all different kinds of signal processing, radio upgrades, control and so on and so forth. And also satellite, commercial satellite, is an area that's becoming more and more dominant, if you like, and particularly for commercial application. So I think overall, when you look at what's been happening and what will happen, that aerospace and defense business will continue to grow for the Company at good rates.

Harlan Sur - *JPMorgan - Analyst*

Thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

Sure.

Operator

Your next question comes from Mark Lipacis with Jefferies.

Mark Lipacis - *Jefferies LLC - Analyst*

Hi, thanks for taking my question. Perhaps for you, Dave. You were successful, in the past, in finding tax efficient ways to use overseas cash for M&A. And I was wondering if you would describe the M&A environment today as being a target rich one? And of the targets that you're looking at, is there a good potential to use overseas cash tax efficiently, like you have in the past? Thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

Good question. There are lots of ideas in the pipeline. It goes through a number of stage gates. And as it gets closer and closer to the point at which we're going to pull the trigger on it, those bars get higher and more difficult to get through. So I think that -- from an ADI perspective, I don't think anything has changed, in terms of whether you'll see us do a ton of acquisitions on a very frequent basis.

I just don't think that's our model. But there are areas that we think make a lot of sense, in terms of acquisitions, and those are the areas we're focused on. And so I suspect we will be doing them, from time to time, to help augment what we're doing organically. From a acquisition -- from a tax perspective, it's always [back] specific as to whether -- which cash we can use depends on where it's located and where their operations are, and so forth. But to the extent that it checks all of the boxes, I'm sure we could do something similar to what we did with Hittite.

Mark Lipacis - *Jefferies LLC - Analyst*

Thank you.

Operator

And your next question comes from Ian Ing with MKM Partners.

Ian Ing - *MKM Partners - Analyst*

Yes, thanks a lot. Had a question on Hittite. What was the magnitude over the last time buys in the April quarter? What are the expectations in subsequent quarters? And as customers start looking at developing 5G infrastructure, are there some opportunities here for Hittite and microwave products? I know largely, microwave is for back-haul at the moment in communications. Thanks.

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, Hittite will help us a lot in the 5G space. And given our strong position in 4G, and our strong relationship with all the OEMs who are developing 5G applications, we think we're in a great position to really take a commanding position in the 5G space. On the -- I don't have the number off the top of my head, unless you know it, Ali, off the top of your head. But the second quarter represented the peak amount of builds that we were going to have associated with Hittite. And so as quarters progress now, it should slowly be coming down.

I'm going to guess it added somewhere between 7 and 10 days to our inventory levels, because of those transitions. And as I said, you'll see a steady improvement. The one thing is, we built up a lot of inventory for stuff that has long life cycles, and so it will take some time for us to get all the way down to zero. It might take 5 years, maybe even 7 years, to get down to zero. But the good news is that the headwind aspect of the inventory build is behind us, and now becomes a tail wind, going forward.

Ian Ing - *MKM Partners - Analyst*

Okay, thank you.

Operator

Your next question is from Steven Chin with UBS.

Steven Chin - *UBS - Analyst*

Hi, good morning, and thanks for taking my question. A question on the communications wireless business. I was wondering, just given some of the comments around small cells, I was wondering if you could talk a little bit about your revenue sensitivity to deployments regarding small cells versus base station? Just given the different level of content and also the unit deployments? And also, do you have any further visibility into, beyond the current quarter, regarding CapEx for either small cells or macro base station?

Vincent Roche - *Analog Devices Inc - CEO*

Yes, I think we're in a very good position in both macro cells and small cells. There's -- as more and more of the usage of cellular equipment is in building, there may be a switch to small cells over time, but it's not going to be a gross switch from macro to small. I think there's always going to be a mix of both. So we're very well positioned, irrespective of whether our customers are deploying macro or small cells.

And in terms of content, obviously, the small cell has less content than the large cell. But we have -- in terms of the radio, we've got almost the entire radio in the small cell, given the strength of our software defined transceiver technologies. So I think what you'll see is the deployment will be -- will continue on the macro side. There will be an upsurge in small cell over the remainder of this year into next year. And we're very well positioned, irrespective of whether it's macro or small. What was the second part of the question?

Dave Zinsner - *Analog Devices Inc - CFO*

CapEx.

Vincent Roche - *Analog Devices Inc - CEO*

CapEx? I think the way to look at the CapEx discussion is, in terms of innovation, the innovation in base stations is really happening at the radio level, to increase spectral efficiency and flexibility. So there's an increasing amount of the hardware spend going into the radio over time. And with the strength that we have in the franchise we've got in terms of mixed signal and RF and microwave technologies, I think we're very well positioned, given the strength of our relationships and the fact that we've skewed R&D, over the last 5 years, more heavily towards wireless applications.

Irrespective of what happens, I believe it will be a fairly stable CapEx environment, in terms of the ratio of services software and hardware. But I think we're well positioned, as a Company, to grab additional share there, given, as I said, the strength of our technology and customer positions.

Steven Chin - *UBS - Analyst*

Okay, thank you.

Operator

Your next question is from Ambrish Srivastava with BMO.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

(multiple speakers) Yes, hi, thanks, I just had -- yes, I'm here. Sorry, Ali. I just had a couple of follow-ups. Just on the A&D strength, is this more primarily a Hittite benefiting from your channel? Or is it more a result of the last time buys? And then a little bit longer term, when do we expect to see jointly developed products between Hittite and ADI? And I realize it takes awhile for that to pan out.

And then a second quick follow-up. Dave, you mentioned that in consumer, you'll have more content. Is that because you are imagine ASD going up? Are you designing out sockets from -- that somebody else had? Thank you.

Ali Husain - *Analog Devices Inc - Treasurer and Director of IR*

That's a lot of questions, Ambrish. Okay. So on the aerospace and defense side, I would characterize the growth as products designed back in the Hittite days, in a lot of cases. Some on our own products, back many years ago that now -- because it takes a while for that stuff to turn around and become revenue. And so that's really what has driven the performance at this point. It hasn't been related to Hittite being a part of ADI yet.

The opportunity pipeline has significantly expanded because of the acquisition of Hittite, and because of our ability to both sell more of what Hittite sells or makes into that market, and also what we make, and try to drive that into that market. And so I think that we'll start to see some revenue synergies next year. And probably be relatively modest next year, but begin to ramp significantly over time. And it's probably on the opportunity side of peak revenues. It's probably $100 million of opportunity, so not all of that we'll close on, but it's a significant amount of synergies that we were able to get by combining Hittite and Analog Devices.

Vincent Roche - *Analog Devices Inc - CEO*

Yes, in terms of your product development question, the combination of Hittite and ADI on the design side of things. We acquired the technology to enable us to broadly apply microwave technology and build a real leadership franchise in the high end of communications infrastructure, general communications, even industrial instrumentation. So we already have very, very good synergy between the design teams, in looking at the next 5G application.

In the 5G application, the next generation of defense driver assistance, where there's a lot of microwave technology needed. So we'll start to see the first combined products hit the market over the coming year. And beyond there, I think you'll see more complete solutions from ADI, the combination of the old ADI and Hittite together, in many, many different markets.

Dave Zinsner - *Analog Devices Inc - CFO*

Okay, so then on the consumer side, we can't comment specifically on whether or not we're displacing somebody, and if so, who. But I can tell you that we have more sockets in the next generation than we did in the last generation, and that's what's driving the BOM to be higher this time.

Ali Husain - *Analog Devices Inc - Treasurer and Director of IR*

And Ambrish, just a slight housekeeping note for me. When you talked about the last time buys, those are last time buys that we made on foundry. So that didn't impact the revenues, really, in the aerospace and defense side. So okay, thanks for the question. Next caller?

Operator

The next question is from Stacy Rasgon with Bernstein Research.

Stacy Rasgon - *Sanford C. Bernstein & Co. - Analyst*

Hi guys. Thanks. One more quick follow-up on consumer. You said that the ramp was going to happen late in Q3, which seemingly would imply, potentially, a fairly big Q4 sequential ramp, as you annualize that. Can you give us some feeling for what the trajectory of that consumer business into Q4 ought to look like? And do you think that it could be -- would it be up or would it be down year over year versus last year? Because I think Q4 of last year was the peak.

Dave Zinsner - *Analog Devices Inc - CFO*

Yes. Definitely, it's hard to predict exactly how the trajectory is going to work out. But I would say it's going to be -- you could -- if we end up shipping in the last, say, 2 or 3 weeks of July, we're going to probably be shipping at that level through the entire fourth quarter. So you can interpret that what you want. But it's going to be a meaningful ramp in the consumer space in the fourth quarter, at least as things have lined up so far.

On a year-over-year basis, I think given the fact that there was probably -- or shipped in -- I think we can safely say in the fourth quarter, versus what was consumed. And that drove a lot of inventory in the channel. I think on a year-over-year basis, we're likely to be down in the consumer space. But I think from a sequential basis, it will look quite nice.

Stacy Rasgon - *Sanford C. Bernstein & Co. - Analyst*

And so just to clarify, so we're talking something like a $30 million sequential increase in Q3, all of which may be happening, potentially, in the last couple of weeks? So if we're annualizing that for 3 months in the following quarter, if you're shipping at that rate, this could be -- we're talking something like $100 million, maybe more, sequentially into Q4, that we could see in terms of increase? Is that the right way to think about that?

Dave Zinsner - *Analog Devices Inc - CFO*

That's -- it's obviously tough to predict, but you're probably in the zip code at this point.

Stacy Rasgon - *Sanford C. Bernstein & Co. - Analyst*

Got it. Thank you.

Ali Husain - *Analog Devices Inc - Treasurer and Director of IR*

And by the way, if that did happen, as Dave mentioned, I think, in the prepared remarks, the operating margin leverage we expect to see in the fourth quarter would be pretty strong. All right. Thanks, Stacy. Next caller?

Operator

Your next question is from John Pitzer with Credit Suisse.

John Pitzer - *Credit Suisse - Analyst*

Just staying on the topic of consumer, and for both Dave and Vince, investors have been somewhat critical about your exposure here over the last two or three quarters, because it tends to be volatile, tends to be commoditized. We always worry about how long you can hold on to the business. You guys have done a great job talking about the trajectory for this fiscal year. And when you initially got this business, I think you talked about 2 years of visibility.

I'm wondering if you could just talk, longer term, how we should think about the consumer bucket? And Dave, you've talked about, in the past, your need just to be strategically engaged with certain customers, to broaden out your footprint. Maybe you can talk about your ability to have broadened out that footprint with this customer, as we go into FY17?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, so obviously, they don't give us a ton of visibility. But next year -- or as much as we can tell, looks to be in pretty good shape for 2017 for this customer. And as I said, we actually got more sockets this time around, and held the prior socket, all of which are high performance parts that -- and that's really what we're trying to focus on with that customer. And with any customer, quite honestly, not only in the consumer space but outside of the consumer space, in the B2B markets.

And that's -- we're going to maintain that strategy, going forward. And I think there's enough to win, at that customer and in the consumer space, to drive growth in the consumer business. And as you would point out, longer term, there -- and it's not even just this particular customer, but there are a handful of customers that have -- certainly have consumer exposure, but that are more broadly focused in other markets, because a lot of this stuff is converging.

And so we want to be attached to those customers, as they think up new ideas that we can come up with new technologies to help define their parts and make them better, and that's what we are going to do. And so that's where we direct our research and development dollars. It worked out for us here, and my guess is there will be other things that we do for this customer and other customers, and other markets, that will help them and help us.

Vincent Roche - *Analog Devices Inc - CEO*

As the user experience becomes more and more sophisticated in these applications, that's in our wheelhouse. We play on the edge of the physical and the digital, so it gives us more opportunity. But as Dave pointed out, we're looking for the really hard to solve problems in these applications, where we can hopefully get multiple generations' worth of momentum, and where we can get the kind of margin performance ratio that we expect.

John Pitzer - *Credit Suisse - Analyst*

Thank you.

Operator

Your next question is from Vivek Arya with Bank of America.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Thanks for letting me ask another question. Just [with] longer term, is the current top line growth rate acceptable to you? And if it is not, do you think it's time to consider larger and more transformative acquisitions? And how do you think about the [various] accretion metrics, or anything else that we should keep in mind? Because the macro environment stays somewhat sluggish, and you managed to navigate through that quite well. But I'm just curious whether even with this navigation, is the top line growth acceptable to you? And if not, what can you do about it? Thank you.

Vincent Roche - *Analog Devices Inc - CEO*

We've said publicly that we are committed to generating over $4 of EPS by 2020. We remain committed to that. And when we first offered that target to the investor community back in 2014, we said that we expected our revenue, our top line, to grow at the rate of 2 to 3 times GDP, whatever that is. And we remain optimistic about that. We're investing at a level, in terms of R&D and field -- customer engagement. But -- and given what we see in terms of the design activity, the customer engagement activity, we remain committed to that top line target.

Another component of, obviously, being able to get towards the EPS target over time is to do careful M&A. And so that is the mix, and we are committed to our targets. We believe in the growth story. And as I said, we will use our balance sheet wisely, to get some more high performance technology that will enable the Company to grow at an even greater rate over time.

Dave Zinsner - *Analog Devices Inc - CFO*

As far as just the acquisition measures, we use -- there's probably 15 of them that we use. Obviously, accretion plays a factor in it. We look at the relative valuations of the cash flow of the business that we are looking at, to determine whether we're paying a good price for it. We want businesses that grow, and that help us drive our growth faster than we are growing today. So that's a key component that we believe that can happen. And obviously, we think we're looking for things where we can get synergies.

Sometimes that's cost, sometimes it's cost and revenue. And so those are things that influence us. Sometimes, when we're doing tuck-ins like SNAP Sensor, which we talked about in the prepared remarks, there isn't much in terms of financials to hang your hat on in the early stages. And so then, it really comes down to whether or not the technology really was going to make a difference in our customers' application, and ultimately the user experience. And that tends to rule the day, when it comes to those tuck-ins.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Is there any push from customers to have more integrated solutions? That's where I was coming from, that if you are the leader in converters, does it help to gain access to other areas because that's what your customers might be asking you to do?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, it's integrating all the time. We're developing, we're moving in more and more to a systems level solution, and so that requires us to have more and more technology. Some of which we do acquire, a lot of which we actually build internally.

Vincent Roche - *Analog Devices Inc - CEO*

Yes, I think what we acquire depends very much on the type of segment we're addressing. The reason we bought SNAP Sensor was to help us move up the stack to make our solution more complete. We've got a very strong DSP high performance signal processing technology platform and product base, onto which we needed to add some algorithmic value in that particular imaging application. So yes, what we acquire, and what customers are asking us to do, very much is application and market segment dependent.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Thank you.

Ali Husain - *Analog Devices Inc - Treasurer and Director of IR*

All right. Next caller?

Operator

Your next question comes from Steve Smigie with Raymond James.

Steve Smigie - *Raymond James & Associates, Inc. - Analyst*

Great, thanks for the follow-up. So last quarter, you mentioned that orders were positive, but that you felt that your customers were a little bit worried about the overall weaker macro. Have you seen any changes in their general outlook since the last call?

Dave Zinsner - *Analog Devices Inc - CFO*

No, I think they are pretty much the same. They are cautiously optimistic. The macro has held in there. The order flow has been good. Customers think they're going to -- I think in aggregate, think they're going to see modest growth this year. And -- but they are obviously very cautious. They're keeping their inventory levels lean. We see, obviously, that at the [Disty] level, as well. So that's -- I think it's pretty consistent. It's been pretty consistent through the whole year, really.

Steve Smigie - *Raymond James & Associates, Inc. - Analyst*

Got it, thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

Sure.

Operator

Your next question is from Ross Seymore with Deutsche Bank.

Ross Seymore - *Deutsche Bank - Analyst*

Hi, guys, thanks for letting me ask a follow-up. Dave, one follow-up to a question you answered earlier on the gross margin side. I know you said you're taking utilization down by roughly 10% sequentially in the third quarter. Can you just talk a little bit about why you're doing that, considering that you said that the coms business is in the early stage of recovery? You're now past the headwinds on the auto side, where you had the design loss on the passive safety, et cetera. If everything in your core is starting to grow year over year, what led you to the decision to cut utilization that substantially?

Dave Zinsner - *Analog Devices Inc - CFO*

I don't know that it's significant, but we had 138 days of inventory, and we want to get that level down. And we felt like we should address it now rather than wait. I would -- like I said in the prior question -- or answer to the prior question, I think a lot of the inventory is related to product that was manufactured in foundry. But nevertheless, we've got to work all of the levers to get the inventories to where we want them to be, and this seemed like an appropriate place to pull it down. The coms one doesn't influence us a ton, because there isn't much of that that gets done in internal foundries -- or internal fabs.

Really, it's in the industrial space, which is plugging along at a low growth rate at this point. So it seemed like we weren't taking a big risk by adjusting the production there. I would say that I think it's a one-quarter event. When you take down inventory levels, and you take down the utilization rates, generally, you shut the factory down. And so we'll be taking, I think, on average, 2 weeks of shutdown in our internal fabs. I would suspect that we will be back to not doing that in the fourth quarter, and so utilization should come back up again in the fourth quarter.

Ross Seymore - *Deutsche Bank - Analyst*

Great, and one other housekeeping one. You were gracious enough to say your content is going up with a specific customer. Relative to what you had in the prior generation, did the tent increase just order of magnitude a similar amount of the prior socket? Half, double? Any sort of color, directionally, would be helpful.

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, I probably have to avoid these kind of pricing things. It's not to the level of the prior socket, let's put it that way.

Ross Seymore - *Deutsche Bank - Analyst*

Perfect, thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

Sure.

Ali Husain - *Analog Devices Inc - Treasurer and Director of IR*

Great, it looks like Ross was our last question, so we'll close out the call. As a reminder, our third quarter 2016 results will be issued on August 17 at 8:00 AM, similar to this quarter, and we'll have the earnings call at 10:00 AM. So that does it for us here. Thanks for joining us this morning. We look forward to talking to you soon.

Operator

Thank you. This concludes today's Analog Devices conference call. You may now disconnect.
