FINAL TRANSCRIPT

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ADI - Q2 2008 Analog Devices Inc. Earnings Conference Call

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PRESENTATION

Operator

Good afternoon. My name is Heather, and I will be your conference operator today. At this time, I would like to welcome everyone to the Analog Devices second quarter 2008 earnings conference call. All lines have been placed on mute to prevent any background noise. After the opening remarks, there will be a question and answer period with our analyst participants. (OPERATOR INSTRUCTIONS) Thank you.

Ms. Kohl, you may begin your conference.

Mindy Kohl - *Analog Devices Inc. - Director, IR*

Thanks Heather, and good afternoon everyone. This is Mindy Kohl, Director of Investor Relations for Analog Devices. If you do not yet have our second quarter 2008 release, you can access it by visiting our website at analog.com, and clicking on the headline on the home page. This conference call is also being broadcast live on the Internet, from analog.com select Investor Relations and follow the instructions shown next to the microphone icon. A recording of this conference call will be available today within about two hours of the call's completion, and will remain available via phone and Internet playback for one week.

Participating in today's call are Jerry Fishman, our President and CEO, Robbie McAdam, Vice President and Head of our Analog business, and Joe McDonough, our Vice President of Finance and CFO. We have scheduled this call for 60 minutes. Jerry Fishman will present our fiscal second quarter results during the first part of the call, and the remainder of the time will be devoted to answering questions from analyst participants. Analysts can press star one on their phone at any time, beginning now to queue up for questions..

We will begin in a moment with Jerry's remarks, but first I would like to take a minute to bring your attention to some new information we posted on the IR section of the website this afternoon. This information has been provided in response to requests from many of you, for historical continuing operations data, which reflect the divestitures of both the wireless handset modem chipset, and PC voltage regulation thermal monitoring businesses.

The schedules we provided present both quarterly and annual historical information of product revenue from continuing Operations, by end markets and product type. Additionally, we posted historical quarterly and annual summary P&Ls for Continuing Operations.

Next, please note that the information we are about to discuss includes forward-looking statements for purposes of the Safe Harbor Provisions under the Private Securities Litigation Reform Act of 1995. Such statements include risks and uncertainties. The Company's actual results could differ materially from those discussed herein. Factors that could contribute to such differences include but are not limited to, those described in the Company's SEC filings, including our most recent quarterly report on Form 10-Q, which was filed earlier today.

The forward-looking information that is provided by the Company in this call represents our outlook as of today, and we do not undertake any obligation to update the forward-looking statements made by us. Subsequent events and developments may cause the Company's outlook to change. Therefore, this conference call will include time sensitive information that may be accurate only as of the date of the live broadcast, which is May 20th, 2008.

With that, I will turn the call over to Jerry for opening remarks.

Jerry Fishman - *Analog Devices Inc. - President, CEO*

Well, good afternoon. As can you tell by our press release, our second quarter of 2008 was a very strong quarter for ADI. Our revenues grew 6% sequentially to $649 million, we were up 9% year-over-year. And that was certainly well ahead of the plan that we started with at the beginning of the quarter.

During my comments this afternoon I will be from time to time referring to the information on our Investor website that Mindy just mentioned, which provides a pretty good analysis of our revenues for our Continuing Operations over the past five years, segmented by both end market, and also by product type. We believe this data will help investors better understand the most important trends in our business, and we expect and hope that you will find it useful, because it took plenty of work to get it all done.

Revenues from our industrial customers grew about 8% sequentially in Q2, and 10% year-over-year. We enjoyed very good sequential growth in Q2 in most industrial applications, with the largest increases in instrumentation, automatic test equipment, or ATE, automotive products, and medical products. In aggregate for the quarter, industrial end market, which includes all of those different subsegments, comprised approximately 50% of our revenue during the quarter.

Industrial revenues have been growing significantly at Analog now for many years. The 5-year compounded annual growth rate for industrial products is about 13%, and as a result revenues have grown over 80% during this period. The industrial market, which I mentioned is now about half our sales, really does represent the backbone of ADI.

It is our most diverse customer base with many different application areas, including industrial instrumentation, process control, power meters, security products, automatic test equipment, medical products, defense products, and automotive products. These applications generally require our highest performance technology, support very long life cycles, and earn gross margins above the Company average.

Our brand is extremely strong amongst those customers, and we often receive the first call from designers at leading industrial customers to help them design their new systems. Also emerging are new industrial applications in Southeast Asia, and in greater China, which represent very high growth potential for ADI, in addition to our traditionally strong industrial base in the United States and in Europe. This quarter, we also continued our penetration of fast growing automotive and medical applications, which are very analog and DSP intensive, and we also call part of our industrial product category in all the data that we present.

In automotive, ADI continues to drive innovation in safety systems, in powertrain electronics, and in entertainment applications as well. We have now expanded our safety system focus beyond air bags, to such new areas as electronic stability Control Systems, which use our iMEMS Accelerometers and Gyroscopes, and advanced driver assistance systems for accident avoidance, which use our highest speed converters and amplifiers, our radio frequency products, and in many cases our DSPs.

Our high performance analog products are also being used to devise new battery monitoring systems and braking sensor interfaces, while our SHARC and Blackfin DSPs are being used in new entertainment systems in high end automobiles. In the medical market, we have focused on furthering our lead in the most advanced CT imaging and ultrasound systems, which utilize highly integrated high speed converter technology from Analog Devices. We believe that continued strength in the more classical industrial applications, and new growth opportunities in automotive and medical applications, should keep industrial revenues growing at solid rates going forward.

Revenues from our communications customers in Q2 grew about 10% sequentially, and 20% year-over-year. The sequential growth in the communications market was principally driven by very strong growth in revenues from base station applications, and we also saw growth from optical and networking infrastructure products. In aggregate communications applications represented about 25% of our sales last quarter.

Our wireless base station revenues grew significantly, both sequentially and year-over-year, with leading base station manufacturers around the world that are producing GSM, 3G, and TD-SCDMA equipment in the China market. We have long enjoyed very high market share in high performance data converters in base stations, and we are now gaining share in the bill of materials with our end components, such as mixers, variable gain amplifiers, modulators, plot controls, phase-locked loops, and more recently, digital power controllers. These new functions have significantly increased the size of the opportunity available to ADI in base stations, and is the source of a lot of our very significant revenue growth this quarter.

Our analog revenues from handsets declined sequentially in Q2, in-line with industry trends, but were up substantially year-over-year. We have been very successful with leading handset manufacturers in supplying highly differentiated, high value-added audio, power management, camera control, and display and also sensor products. This business represents substantial opportunities for ADI, as design-ins move to high volume production.

Consumer revenues experienced small sequential and year-over-year declines in Q2, not surprising, given the slowdown in consumer spending in response to the uncertain economic environment. Consumer revenues represented about 20% of our revenues in the second quarter. Our market position in consumer products remains very strong, in both digital cameras and advanced digital TV, particularly with the largest market shareholders and top brands in Japan, who continue to garner a premium price in the market, by creating the better user experience.

In both of these applications areas, we continue to expand the market available to ADI by creating new functionality, that gives our customers a competitive edge and also commands premium prices. For example, in cameras, we now provide new stereo sound chips, as digital cameras now often include motion video, and we also sell products that are lens drivers to control focus on cameras.

We are also now beginning to sample a highly integrated power management solution to our leading camera customers. These new functions complement our very high market share in the analog front ends that we have been supplying for many years. In addition, we are nearing the end of our capacity constraints in supplying MEMs motion sensors for Consumer Electronics. We continue to execute on our plan to supply the first real production quantities of consumer MEMs sensors manufactured by TSMC this quarter, with volumes increasing through the rest of the year.

Now looking at our product revenues, our analog products increased 6% sequentially last quarter, and 8% year-over-year. By any standard, this was a very solid performance, and certainly it is a solid performance relative to the market and many of our closest competitors. Our converter products grew 6% sequentially, and 9% year-over-year.

Converters remain our largest and most diverse product family at ADI, and contributed 46% of our revenues in the quarter. Our converter revenues have grown now at a compounded growth rate over five years of 13% per year, which is well ahead of the market, and as a result we have continued to gain share during this period.

Very recent statistics published in March by the GartnerGroup, or Dataquest, indicate that ADI's share in converters increased to approximately 37% in 2007, over 2 times that of our closest competitor who actually lost some share in 2007. Other industry analyst data which utilizes a much broader definition of what a converter product is, indicates the ADI share in 2007 was between 43 and 47%. But by any measure, even though there are competitive shifts among smaller converter competitors, ADI continues to be the company that customers most often choose, for the essential functions of analog to digital and digital to analog conversions.

Amplifiers grew about 10% sequentially in Q2, and were up 10% year-over-year as well. This is a very solid performance of these products relative to the market, and other competitors who have reported their amplifier sales over the last couple of months. Amplifiers contributed 23% of our revenues in the second quarter. Industry analysts estimate that our share of the overall amplifier market, which includes both high performance and commodity amplifiers, is approximately 20%. We don't participate very much in the commodity amplifier category.

With respect to the high performance category, we estimate that our share is approximately twice that, or approximately 40%. Our amplifier products have grown at a compounded annual rate of about 10% per year over the last five years. The category of what we call other analog, includes specialized signal processing solutions, such as MEMs, and RF products, or Radio Frequency products.

Revenues from the Other Analog product category grew slightly in Q2, and contributed 16% of our revenues in the quarter. Our Other Analog product category has grown very significantly over the past five years. The three product categories of data converters, amplifiers, and what we call Other Analog, which in aggregate provides analog signal processing functionality, represented about 85% of our sales last year.

In aggregate, those signal processing categories have grown at a compound annual rate of about 13% per year for the last five years, and 8% per year for the past three years, despite difficult industry conditions in the market over the last two or three years.

Paramanagement products make up the balance of our analog portfolio. We have focused our product development on industrial, communications and consumer applications, where we can leverage our position as the leading supplier of converters, amplifiers, and other signal processing functions, to customers who already know and who already respect ADI's technology, and also our ability to help them through very complex new designs.

We are focused on providing the industry's smallest high performance linear regulators, and switching regulators for portable applications, high performance switching controllers for industrial applications, and precision monitoring products for infrastructure, and for networking applications. In fact during Q2, we introduced the first digital power controller for mission critical IT and communications applications, including cellular base stations, and we plan to introduce a number of new products through this year. To date we are very pleased with our customers' response, and their desire to consider power as an adjunct to our signal processing products.

In the second quarter, our paramanagement revenues grew 4% sequentially, and were up 16% year-over-year, and represented about 5% of our total revenues. Our general purpose DSP revenues also grew well in Q2, it grew 6% sequentially, and 18% year-over-year, and represented about 9% of our total revenues. During the second quarter, we experienced strong demand for both our SHARC and our Blackfin product families, across a diverse set of end applications, and many thousands of customers. Gross margins for our general purpose DSP products approximated our corporate average gross margins in Q2, supporting our view that customers do value our technology, as evidenced by the high gross margins in that business.

In addition, we continue to see advantages of having DSP technology in our product portfolio. For example in many new designs, customers typically select the DSP or the microprocessor early in the design cycle, which gives us a very early look into their total system design, which is an important strategic advantage relative to our analog-only competitors. As we have noted in previous calls, having completed the divestiture of the more commodity-like DSL products, and the cellular base band modems and product lines, which were both R&D intensive and lower margin, our full focus now is on our general purpose DSPs, where we can exploit synergies with our analog portfolio, in applications such as communications automotive and home entertainment products.

Recent industry data indicates that ADI holds a leading market share of the overall general purpose DSP market, and we believe this business fits well with our current business model, and presents a good growth opportunity, particularly amongst the many thousands of customers that ADI has served over many years. As I mentioned earlier, our revenues grew 6% in aggregate to $649 million, and our gross margins were about 61%, or about flat to last quarter.

The positive impact of a favorable mix of industrial and communications revenues, was partially offset by very strong sales of automotive products, which carry somewhat lower gross margins, and also the impact of lower margin consumer MEMs products. As I mentioned earlier, we are on plan to open up additional capacity for our consumer MEMs products through our relationship with TSMC in Taiwan. More business transferring to TSMC should provide us with significant cost reductions, and much greater scale for these products later this year.

Our operating expenses grew about 4% sequentially, which was directly in-line with our plan for the quarter. Expense increases were mostly the result of annual salary increases, which we implemented early in the quarter. The headcount at ADI remained approximately flat to Q1 levels, in-line with our plan to modulate expense growth for the remainder of 2008, to achieve good operating leverage as sales increase.

Our operating profits increased to $157 million, or 24.2% of sales, which was up about 40 basis points sequentially. Our earnings from Continuing Operations were $0.44, which was up 10% sequentially, from the $0.40 we reported in Q1 on the same basis. On a year-over-year basis, operating profits increased 17%, and earnings per share increased 19%, representing significant up leverage on a 9% year-over-year increase in revenue.

In addition, our balance sheet and our cash flow continued to be very strong during the quarter. Our operating cash flow was $154 million, after a reduction of $67 million of taxes on gains of last quarter's sales of businesses. Combined, the $221 million that we generated last quarter, represented 34% of our revenues. Capital expenditures were about $31 million, or about 5% of sales.

Inventory declined by $11 million sequentially, or 3% in Q2. Days in inventory as a result decreased from 127 days last quarter, to 115 days at the end of this quarter, which is beginning to approach our target levels. Accounts Receivable at the end of the quarter also decreased by 2% compared to last quarter, while Days Sales Outstanding declined by 4 days from 51 to 47.

During the quarter, we repurchased 5.8 million shares of our stock, or 2% of the outstanding shares for approximately $165 million. Since our program began, we have repurchased almost 30% of our outstanding shares, for $3.9 million, and the average cost of all the shares we repurchased was approximately $34.00. During the quarter, we also paid out $53 million in dividends, and the Board has authorized an increase in the dividend, from $0.18 per quarter to $0.20 per quarter per share, which now represents 45% of second quarter earnings from Continuing Operations.

We ended the quarter with about $1.2 billion of cash and no debt. Approximately $1 billion is held outside the United States in various foreign subsidiaries. Orders remained very strong for ADI during the second quarter. End customer orders on our distributors, and OEM orders increased sequentially by 4% and 6% respectively, from first quarter levels. We continue to experience a very strong turns environment where many customers are placing orders for delivery during the quarter, and our backlog entering the quarter was approximately flat to the backlog that we had entering last quarter.

Our operating plan for Q3 is for revenues to be in the range of about 650 to $665 million, or about flat to up 3% sequentially. Gross margins are estimated to be approximately 61%, and operating expenses will increase only very slightly. However, our plan does not factor in any potential effects of ongoing financial market uncertainty, which could translate into a more cautious stance from our customers, we will just have to wait and see how that materializes during the quarter.

If the operating plan is achieved, the earnings from Continuing Operations is expected to be in the range of about $0.43 to $0.45, and the earnings from Discontinued Operations is expected to add another $0.02 to $0.03 to that. Clearly, ADI enjoyed a very strong quarter in a tough economic environment. Important ingredients in our success in Q2, are the good returns that we are getting on the significant investments that we made over the last few years, and also and equally important, the reshaping of our product portfolio to focus on high growth, very profitable segments, where customers value innovation, because it really does change the user experience.

As you will observe in all the schedules that we have now put on the website, our product portfolio is now focused on end markets, and products that have grown faster than the market and produce above average returns. And by keeping our focus on innovation, we believe we can continue to grow our sales and earnings at very attractive rates going forward.

In addition, we have increased the returns to shareholders, by using our strong balance sheet and cash flow to repurchase now almost 30% of our stock in the open market over the past few years. We have also increased our dividend per share, which now represents 45% of our earnings, and a yield of about 2.3% at current stock prices.

So I think in summary when investors look at ADI now, I would suggest that there are really five important things to consider. Number one, ADI has had a 40 year history of innovation in signal processing, which has provided strong growth at very attractive margins, and is now better focused than in our recent past with a stronger portfolio than we have had before. While industry growth rates have certainly modulated in the past few years, signal processing is growing much faster than the semiconductor market in general, since new generations of electronic equipment are more dependent on signal processing than ever before. ADI's unique technology and strong market position, should continue to provide the foundation for attractive growth rates going forward as a result.

Number two, ADI is holding or gaining share in product areas where we're strong, namely converters, amplifiers and general purpose DSPs, and gaining share in new product categories, such as Radio Frequency products and MEMs products. Other initiatives such as Paramanagement could provide further upside beginning in 2009.

Number three, ADI has a stable, diversified base of industrial customers, which provide solid growth and exceptional margins, and now represents approximately half our revenues.

Number four, ADI has the opportunity to achieve 3 to 4 points of sales operating leverage, as we make progress towards our model of 27 to 28% operating margins, which includes 2 to 2.5% of expense for stock options.

And lastly, ADI's exceptional cash flow provides the opportunity to further enhance shareholder returns, and I think as an aside, also demonstrates the quality of our earnings.

Mindy Kohl - *Analog Devices Inc. - Director, IR*

Thanks very much, Jerry. During today's Q&A period, we ask you to please limit yourself to one primary question, and no more than one follow-on question. We will give you an opportunity to ask additional questions if we do have time remaining.

Operator, we are now ready for questions from the Analyst participants.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). We will pause for just a moment to compile the Q&A roster. Our first question comes from the line of Craig Hettenbach with Goldman Sachs.

Craig Hettenbach - *Goldman Sachs - Analyst*

Thank you. Jerry, you mentioned qualifying TSMC for the MEMs product. Can you give a little more color in terms of some of the applications over the next 12 to 18 months, particularly within consumer that you think will drive some growth within MEMs?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

Yes, sure. Well, with our supply being very limited, most of our consumer MEMs products were going towards video games, and we have talked about that quite a bit in the past. And we have only really been able to sample other applications for some of those products. I think as we go forward, we first of all have an opportunity to use that with another broader spectrum of motion sensing consumer games with other game producers, that we have been sort of short on supply to be able to do.

But there is a myriad of other applications for MEMs products and microphones and switches, and just a whole raft of other things that we believe that we are going to be able to really get scale on now to be able to do. So I think, getting clear on the capacity and the scale that we can produce these products at now, with what I think to be a very important site benefit, that we will be able to access a much lower cost structure at TSMC, where we can build those in a large, modern fab that has large scale will help us.

So I think it is really the combination of we will be able to expand into other applications, and we will be able to make higher margins on the MEMs products than we have been making on the consumer side. So we are looking forward to that transition, I can tell you.

Craig Hettenbach - *Goldman Sachs - Analyst*

Great. Just as one follow-up you spoke that orders were strong in the quarter. Can you give us a sense of linearity as you went through the April quarter, and then into the beginning of May here?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

I think it was pretty linear during the quarter. We always experience a little softness around the Chinese New Year at the very beginning of the quarter, but we anticipated that because it comes every year. So I would say the first approximation, one of the things we were most excited about during the quarter is the quarter was quite linear.

Craig Hettenbach - *Goldman Sachs - Analyst*

Great. Thank you.

Operator

Our next question comes from the line of Romit Shah with Lehman Brothers.

Romit Shah - *Lehman Brothers - Analyst*

Jerry, on the last call you took a decent haircut to your guidance to account for the macro environment. Do you have the same mindset this quarter? Do you feel like you have got a more clear view of how the quarter is going to trend?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

There is always a lot of risk out there. We try to put out some guidance on what our plan that we are operating the Company under. Certainly we did better than our plan last quarter and we were able to respond to it, even though we had planned for numbers that were below what we actually achieved. So I think we have good production levels in our factories, I mean, we have to operate the Company under a plan, and that is what we indicated the plan is. If it turns out that it's better than that, we will be able to respond to it. If it turns out worse than that, we will have to respond to that too.

There is a lot of uncertainty out there so I think getting ahead and being very aggressive on the guidance isn't a very smart thing to do for us, or anybody else right now. We have seen good strength in our business last quarter. The order rates were higher than we thought. We captured a large portion of those orders. So we haven't really seen any weakness as a lot of people have been anticipating, based on what is going on in the financial markets. But who knows?

I mean, in that sense you probably have a better guess at that than we do. What we are trying to communicate is basically what the plan is that we are going to operate the Company under for the quarter. If it turns out better we will be able to respond it.

Romit Shah - *Lehman Brothers - Analyst*

It seems as the year progresses you are going to be more dependent on your consumer business to grow the top line. Can you give us some feedback from some of your larger consumer customers?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

Well, I think, by and large, we had a reasonably good consumer quarter. We expected to get more revenues on the consumer side, a little bit less revenues on the industrial side when we started the quarter. Still plenty of cameras being sold and TVs being sold, and video games are jumping off the shelf. So I mean, we will see.

We haven't taken a very aggressive stance on that for next quarter. Whereas typically you would see more, a stronger third quarter for us in the consumer business. So our guys in the product groups tend to read the newspapers and they are cautious on that. So we will have to see. And I think all that is wrapped up in the plan that we put together for the quarter.

Romit Shah - *Lehman Brothers - Analyst*

If I could just lastly, you guys did a good job reducing your internal inventories. Did you lower your production rates as well?

Joe McDonough - *Analog Devices Inc. - VP Finance, CFO*

The production rates during the quarter were pretty similar to last quarter, nothing dramatic.

Romit Shah - *Lehman Brothers - Analyst*

Okay. All right. Thanks a lot.

Operator

Our next question comes from Craig Ellis with Citigroup.

Craig Ellis - *Citigroup - Analyst*

Thank you and the first question is really just a clarification. Jerry it sounds like some of the upside in the quarter was driven by industrial. Does that mean that communications were in line or was that also a little bit better than what you had expected?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

I think both the industrial and the communications were a little bit better than we thought. Typically in our second quarter, we generally see a good lift in the industrial business, because there are more sales days, and there are not a lot of holidays and that tends to drive the sales of that up. We were a little bit more cautious going into the quarter about that business than we typically would be, and that is the result of what guidance that we put out for the second quarter was. Turned out that there was no reason to be cautious about either of those businesses, because they both did what we would typically see in our second quarter.

Craig Ellis - *Citigroup - Analyst*

That is helpful. And then switching gears to the industrial business, that is one that is typically seasonally strong in the first half, less so in the second half. But a lot of the infrastructure development globally is dependent upon infrastructure or industrial related products. How should we think about the seasonality of that business in a year like this?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

I mean, I think the guidance that we put out is sort of our typical guidance. As you go back and look at a lot of years, in our third quarter we usually see a few percent up, and sometimes a little higher than that, sometimes a little lower than that. But that's in-line with, we will get some growth in the industrial business, we will get a little growth in the consumer business, so it tends to be a quarter that we don't see extraordinary ups and downs in any business in a normal year.

Where we have excursions from that, it is typically due to the economy, or just the whole world moving strongly one way or the other. So I think what our guidance represents for this quarter is a sense that third quarter is going to be about a typical quarter for Analog, and that is what our plan is based on.

Joe McDonough - *Analog Devices Inc. - VP Finance, CFO*

One point on the industrial business that's worth noting is that in aggregate, industrial represents 50% of the revenues of the Company, but about half of that or 25% or 26% of the revenues of the Company is in the core classic industrial space. The rest of it is in medical, automotive, automatic test equipment, and military. So those are the subsegments that are categorized as industrial in aggregate for the company.

Jerry Fishman - *Analog Devices Inc. - President, CEO*

Those by the way tend to be a little less seasonal than the industrial, the core industrial business, which tends to be related to how many days you have in the quarter as much as anything.

Craig Ellis - *Citigroup - Analyst*

Got it. Thanks, guys.

Operator

Our next question comes from the line of Sumit Dhanda with Banc of America Securities.

Sumit Dhanda - *Banc of America Securities - Analyst*

Yes, hi. A couple of questions. Jerry I wanted to dig a little deeper into your gross margins and the reported quarter. Now you indicated that production levels had stayed pretty flat, and that the better mix of industrial in comm, have been offset by auto and consumer MEMs. I guess what I am having a little trouble with is industrial and comm are two-thirds even X auto. I am assuming Auto and Consumer management are no more than 15% of the business, so why was the drag as much as it was, in terms of offsetting any benefit from what is obviously a very high margin industrial and comm business?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

I think there are a lot of different aspects of the gross margin. The automotive business, which had a significant amount of growth, we don't make the corporate margins in that. Partly because just automotive products are a little bit lower in margin, but also because the MEMs products are below the margin also, and that turned out between the MEMs stuff and the automotive stuff, to drag our gross margins down a little bit. So I think the way to look at it is 61% is a pretty good gross margin.

It is going to vary a little bit based on a lot of different things, but overall, 61% is good, particularly given the fact that we had as many or some tailwinds and some headwinds there that moved that. I think without the headwinds it would have been higher, but you always have some headwinds. So in aggregate, we have been reasonably consistent in saying that we thought that 61%, maybe it would go up a little bit from there, is a good gross margin for the Company, and that is the mix that we are investing towards.

Sumit Dhanda - *Banc of America Securities - Analyst*

I had a second question, a different question. On the operating margin side, clearly the target is to get them up 4 or 5 points from current levels. You had some annual salary increases this quarter. I mean really, how should we think about you getting there? Is it that the OpEx structure from here on out until your next annual raise is going to be relatively flat no matter what the revenue line does, or is there a specific revenue target level you think allows you to get to those operating margin targets, given the fact that your gross margins are going to be roughly flat from here, per your earlier comment?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

I think the way to think about it is we had a jump on the expense line, mostly related to salary increase as you mentioned. We are going to keep the headcount by the way last quarter was relatively flat to the quarter before, so I think that in the coming quarters, that is still our plan and therefore, the expenses, if the revenues grow at the kind of rates that we are planning for, the expenses will grow at rates well below the revenue growth rates, and as a result of that we expect to get good operating leverage going forward.

Sumit Dhanda - *Banc of America Securities - Analyst*

I guess my question--

Jerry Fishman - *Analog Devices Inc. - President, CEO*

I don't have a number. All I can say is that the expenses are going to grow at a rate lower than the sales growth rate. That is our plan. And we will modulate that as the circumstances determine we should. But I don't have a number for you saying when we get to $700X million, we will be at that target, we're going to make steady progress toward getting to that target.

It is one of the highest priorities in the Company now. We know how to do that. We have done it many times before, and a large part of doing that is mostly under our control. We are spending a lot of money on R&D, a lot of money on sales and marketing, and I think we are going to grow into those expenses as the revenues grow, and once we say we are going to do that, it is a good bet we will, because we control a lot of those variables.

Sumit Dhanda - *Banc of America Securities - Analyst*

Let me just ask a quick follow-up on that. You have invested in power, obviously the salary increases happen every year. Are there other areas where you think you need to invest above trend line, or do you think, or do you feel really comfortable about the fact that most of the investments are behind you, and you can reasonably grow the OpEx line at half or a third of the rate that the revenue growth is going to come in at?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

We have really upped the expense levels in the Company in the last year in some of these new areas to get some more sales growth, and I think it is good to see that we are getting sales growth in those areas, which is why our revenues were so much better than most of our competitors this quarter. I don't think there is another sort of increment that we are thinking of, that we are not already investing in at pretty high levels. So I think that the challenge for us, and what we are planning to do is get the benefits of those investments in the sales line, without raising the investment levels very much from where we are. So we don't have another category where we raise the expense levels considerably in last year, that we are going to raise them again this year.

That is just not within our plan now. So I think it is a reasonable expectation that we can grow the revenues a lot faster than we can grow, than we are going to grow the expenses. I mean, that is discipline that we have in the Company. We as a management group have made that determination, and that is the way we are going to run the Company going forward.

Sumit Dhanda - *Banc of America Securities - Analyst*

Okay. Thank you.

Operator

Our next question comes from the line of Tristan Gerra with Robert W. Baird.

Tristan Gerra - *Robert W. Baird & Co. - Analyst*

In power management, what type of gross margin should we expect near term as you continue to [run] the business, and what product line specifically are you focusing on right now?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

We are not going to make a projection on the gross margins in any particular product area but it is an analog product, the kind of markets we are addressing we think in aggregate can support the kind of gross margins that we are running in the Company, and that is certainly the objectives that we have for that business.

Tristan Gerra - *Robert W. Baird & Co. - Analyst*

Okay. And you reiterated that last quarter the utilization rates were pretty much in-line with the previous quarter. Given the trend, what should we expect in terms of utilization rates for this quarter?

Joe McDonough - *Analog Devices Inc. - VP Finance, CFO*

This is Joe McDonough. You should expect the utilization rates to remain about the same. There is no significant effect on the gross margin that is likely to be caused by a significant change in the way that we run the factories.

I think one of the points that we tried to make in putting up some of the schedules that you will see on the website is, and we have broken the revenues over a long period of time of Continuing Operations between the different product types, the different end markets, and what you will see there is that 85% of the Company's revenues are derived from converters, amplifiers, and analog signal processing, excluding the power management part of the business, and so a substantial portion of the investments that we make in engineering and other operating expenses, are going toward that 85% of the business. It is the other 15% of the business where there is an opportunity for growth.

There is a little bit of a disproportionate engineering spend in the other 15%, but it is not terribly significant, and that is the portion of the business that does have an opportunity, if we can get it right to grow the revenues, since the power management revenues are a small portion of the business. But there is nothing now that we have disposed of some portion of that business, there is nothing in that power management business, that is substantially different at the gross margin level from the Company as a whole. It is a little bit less but it is not substantially less anymore.

So the gross margin I think as Jerry said, the 61% gross margin is the gross margin that we believe is a very good gross margin in the semiconductor industry, it is slightly above the gross margin model for the Company, and from quarter-to-quarter it will vary a little bit above or below 61%.

But for a change from 61.2 to 61% to try to find out the root cause of it, we have tens of thousands of products across a whole lot of different end markets, and there are a lot of different gross margins in that mix, so there is not any one item that has caused a 0.2 of a point change in the gross margin.

Tristan Gerra - *Robert W. Baird & Co. - Analyst*

Thank you.

Operator

Our next question comes from the line of Chris Danely with JPMorgan. Your line is open.

Chris Danely - *JPMorgan - Analyst*

Yes, can you hear me.

Jerry Fishman - *Analog Devices Inc. - President, CEO*

Yes.

Chris Danely - *JPMorgan - Analyst*

Sorry about that. Just another question on gross margins, and this is more looking into the second half of the year. In general, the industrial market is a little bit stronger in the first half, and that is your higher margin area.

As we get into the second half of the year, in general the MEMs and the consumer which is lower margin tends to be a little bit stronger. You've said the gross margin should oscillate around 61%. Is it fair to expect a little bit of potential weakness in gross margins in the second half of the year?

Joe McDonough - *Analog Devices Inc. - VP Finance, CFO*

We don't know that to that degree. The core industrial business, which is the portion that you are talking about is 26% or so of the total sales of the Company. That business has been growing quite nicely over the past couple of years. There is nothing terribly unusual about it from quarter-to-quarter, I mean we had some pretty good growth this quarter in base stations. There is reason to believe that business continues to be pretty good.

The automatic test equipment business is another business that turned out to be okay this quarter. And I think it is kind of hard as we look out through the second half of the year, to try to estimate exactly what the gross margin impact will be, as a result of the slightly different mix in the overall business. But we do believe that we have a good mix of businesses. We have got them aligned in a way that we think we can produce 61%, 60% to 61% type of gross margins, maybe a little more than that from time to time.

It is just a very good portfolio of businesses.

Chris Danely - *JPMorgan - Analyst*

Then Joe, one thing that Jerry mentioned was moving the MEMs production to TSMC. How much should that benefit the margins, and then when do you expect that to be a material impact to your model?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

Well, I mean, it is important to realize that the MEMs products are sort of 8% of our sales. I think roughly. So I think all of these are just normal things that go on in the context of trying to run our business. We transfer production, it gives us scale, it is going to help us on the gross margin. There are so many moving parts as Joe was saying, when you are selling 10,000 products to 100,000 customers, what happens to one product line in the quarter might change the gross margin, 10, 20, 30, 40, 50 basis points but that is what really happens.

So I mean, I think the way to think about analog is that 61% is a good number. Like Joe said, maybe it will go up a little, maybe it will go down a little any particular quarter, because of the mix or because of yields, or because of any problems or opportunities that we might get, and that the leverage we are going to get is on the operating expense level, and the way I would describe it is, I would take all the business I could get at 61 points of gross margin.

Because it is an enormously profitable business. And the challenge and the opportunity for us is to get the operating expense ratios down, so we can get the operating margins moving, and that is the way we are trying to plan and run the Company right now.

Chris Danely - *JPMorgan - Analyst*

Okay. Thanks, guys.

Jerry Fishman - *Analog Devices Inc. - President, CEO*

Yes.

Operator

Our next question comes from the line of Steve Smigie with Raymond James.

Steve Smigie - *Raymond James & Assoc. - Analyst*

On the MEMs capacity you have, can you say on a dollar basis what that is, and could you remind me, would there be any potential back end constraints?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

I didn't hear the second part.

Steve Smigie - *Raymond James & Assoc. - Analyst*

Are there any back end constraints on manufacturing capacity for MEMs?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

Well, I think I mentioned, MEMs is about 8% of our sales, so that runs about $50 million plus or minus a quarter. The consumer MEMs products are the ones that have been the most capacity constrained because that is the place where we have seen the most steep revenue inclines that we have had. There is not much more we are going to say about that, other than certainly if we had more capacity, we would have got more sales out of that this year, and I think that we do have capacity, it is going to really help us on both the front of scale and costs. So at the margin it gives us a little tailwinds on the margin.

But like I said, on $50 million of sales, you don't get a lot of tailwinds on any particular thing. You need everything moving right to get the gross margins up from here. The thing, because it seems like there are a bunch of questions on this margin thing, I think the way I think about it is that we have a business that even at these margins, it is generating 33% of our sales in cash every quarter. That is a pretty attractive business.

We think we can constrain the expenses, to get the margins up by 3 or 4 points, which will make it an even more attractive business. I think that the concept of running 60-plus-odd percent gross margin makes it a pretty attractive investment, given the returns that we are getting below that. The gross margins will go up and down a little bit.

It could be that in a quarter or two we come back and say the mix has shifted, and the margins will be a little higher because of this or that, or we successfully executed some cost reduction programs that combined with all the other things we are doing around the Company, we will move the margins up, and we hope that happens. But I want to reemphasize that the primary leverage we have is on the expense line, which is mostly in our control.

Steve Smigie - *Raymond James & Assoc. - Analyst*

Okay. Great. And just you did a nice job increasing the dividend and buying back shares. Can you talk a little bit about what that looks like over the next year, in terms of more buybacks or increasing dividend? Is there a certain percentage per year you want to be increasing the dividend?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

Certainly, we have bought a lot of stock back. As I mentioned earlier a large portion of our cash balance is overseas, in-line with the cash generation capability over many years of our Irish subsidiary. So given that, in order to execute a lot more buybacks, we would have to borrow some money which we are certainly quite willing and able to do, given the strength of our balance sheet.

It is a little bit unsettled out there to borrow money so we are being a little bit cautious about that, but I think over a long period of time, certainly we have the opportunity to keep deploying our cash to raise shareholder returns in both dividends and buybacks, and we will continue to, depending on the conditions out there in the market, that might either go up or down from where it is. We will have to wait and see how credit conditions are out there. We still have (inaudible) cash, it is just right now most of that resides offshore.

Steve Smigie - *Raymond James & Assoc. - Analyst*

Okay. Thank you.

Mindy Kohl - *Analog Devices Inc. - Director, IR*

I just want to say we still have a few people in the queue waiting to ask questions. We are going to try and get as many as we can in, and go a few minutes over. But if we don't get to everyone's call, we ask that you please give us a call at 781-461-3282, and we will follow up with you tonight. We will go back to our queue now.

Operator

Our next question comes from the line of Uche Orji with UBS.

Uche Orji - *UBS - Analyst*

Thank you very much. Two questions. First, on the comments you made on the base station market being strong. Do you have any color as to what region or what type of products that is driving the strength at the moment, and any insight as to how sustained that has (inaudible) has remained in the current quarter?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

Well, I think what I said in the earlier comments I believe is that we saw pretty good strength from some of the older GSM base stations, some of the new 3G base stations, and of course we have a very, very strong position in China on TD-SCDMA base stations, and the way to really think about the strength that we are seeing, it is really a combination of just the strength we've had on the converter side, which is one of the primary product areas that we serve base stations with, but all the new RF products that I mentioned in the opening comments that we put out into the market, which is one of the areas that we have significantly increased our spending rates on last year, are really adding to that.

So it is not just the unit volumes of base stations that we are seeing good growth in, it is the fact that we are getting a lot more dollars per base station that we sell into, because the product mix we have right now is much broader than it was a year or two ago. So I mean, that is a place that really is a market that requires the highest performance products that we make throughout the Company in virtually every area. So a lot of our products are defined with that end market in mind, because it is the most performance hungry market that we serve.

So we have good positions with virtually every base station manufacturer around the world. In one quarter it might be stronger in China, the next quarter in Europe, the next quarter in the U.S. But we are well-positioned with the largest base station manufacturers in virtually every geography.

Uche Orji - *UBS - Analyst*

All right. Just one more question, I know you said your operating rates were the same as last quarter but is there any way for us to quantify what the utilization rates were in your factories, and related to that also, is I know you have been in a mode of bringing your inventory level down to a target. As you mean that, that will mean lowering your operating rates. If you are above target and start to increase your operating rates, is it possible that this could be a factor that could influence gross margin in the future? I don't mean to(inaudible), but I'm trying to see this at another angle, to this gross margin comments that maybe a little bit better to clarify.

Joe McDonough - *Analog Devices Inc. - VP Finance, CFO*

Well, this is Joe McDonough. The utilization rates are somewhere in the 65 to 70% range within the factories, probably closer to the 70% number, but our factories produce about 55 or 58 or some number of our sales. The rest of it is produced in external factories.

I think that you should not assume that there is a meaningful change in the utilization rates or the gross margin as a result of our inventory goals of getting from 115 days, to say 110 days, or 105 days. Our primary purpose in running our factories is to have product available for the customers when they want to buy it, and we manufacture thousands of different products, and our primary objective is to have them available, because we make a large profit every time they say they would like some of them.

So there is nothing about this gross margin, that there is a point here or a point there that is some sort of a magic bullet, but there is an awful lot about it that's very complicated in running the business, in order to achieve a 61% gross margin. I think the growth of the Company and the earnings, and most of the actions that we take within the Company, in terms of investing in R&D and other things that we do and disposing of businesses, is focused on the growth of the revenues and analog signal processing, which is our converters, amplifiers, RF and the MEMs, and some of the other analog signal processing products.

Last year in 2007, they grew 10%. That is 85% of our revenues grew 10%. Over the last three years, it grew 8%. Over the last five years, it grew 13%. So we believe we have a portfolio that has some pretty good growth characteristics, that exceed the growth opportunities in semiconductor industry as a whole, and that is where most of the focus and attention within the Company goes. At the same time, we try to produce gross margins that are above 60% which we are doing.

Uche Orji - *UBS - Analyst*

I just wanted to know if, I don't know what your theoretical upper limits had been with your utilization rates, but let's say it was 70 or 75%, if you got back to those levels would that be a material contribution to gross margins was simply the question?

Joe McDonough - *Analog Devices Inc. - VP Finance, CFO*

No, I don't think you should assume that.

Uche Orji - *UBS - Analyst*

Okay. Fair enough. Thank you.

Jerry Fishman - *Analog Devices Inc. - President, CEO*

I think we have said in previous quarters that we are consolidating our two wafer fabs in Ireland, to one (inaudible) fab that will start showing some results and some momentum on that in 2009, as we finalize that transition. That is a complicated transition, because there are so many products there, but that ought to give us a little bit of a tailwind on the margin line as well.

Uche Orji - *UBS - Analyst*

Okay. Great. Thanks, Jerry. Thanks, Joe.

Operator

Our next question comes from the line of Doug Freedman with AmTech Research.

Doug Freedman - *American Technology Research - Analyst*

Getting in under the wire. Thanks for taking my question. Can you talk a little bit more about what you are really seeing out in the marketplace? I mean, we have recently heard from probably your largest competitor, Texas Instruments, about their aspirations to grow the analog business 20%. They overlap with you probably the most of anybody. What are you seeing out there in terms of ASP trends, and just what you are seeing as far as just the competitive nature of the marketplace?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

I think the analog category itself is a very non-descript category, because there are very many different segments in there. There are product segments. There are performance segments. And so it is not a homogenous market, even though a lot of people describe it as that.

Our sense is in the commodity part of the analog market, which is sort of half of it or 60% of the market, depending on how you count it, that is probably as good a place to be as making logic. The performance doesn't matter. It is a commodity product. People primarily buy that on price. The aggregate market doesn't grow at nearly those rates because of the continuous price pressure, and the fact that the products are not worth that much to the customers. I think in the high performance part of the market, you can still differentiate the customer's products by what you do.

We can change the sound or change the image or whatever, change the new video game with motion or whatever, that to me is probably one of the most attractive segments in the semiconductor market, because you can get paid for what you do, because our customers can get paid for what they do. If they pick a better product, they can get incrementally more money from the customers. If Sony goes in, or any of the premier brands of TVs, they get more money for the TVs because the picture is better, or at least the brand is better.

Our sense is in that part of the market where performance really matters and differentiation really matters, you get paid for your products, and you can earn a very good return on them. Now what the market growth rate is going to be, there are as many theories about that as there are people making theories, and we think that the signal processing or the high performance part of that, will outgrow whatever the semiconductor market is. There are varying opinions on what that growth rate can be, but our sense is for the kind of products we make in analog, growth rates are 10 to 15% a year on the average are credible.

I think for the commodity analog market, I would be surprised if that market grew more than 5% a year. Because you can't get paid for the products. So without commenting on what any competitor thinks or not, our sense of the market is that in the high performance area, if you do your job right you can build a business that grows 10 or 15% a year, you can make extraordinary returns at it, you can generate tremendous amounts of cash, and relative to most businesses that is pretty attractive, which is why we spend all the money we do in getting those products out.

So beyond that, I mean, we will see what the growth rates are. I think our belief is that like I said, if we do a good job, get 10 to 15%, other people have different views of that. We will have to see which one comes out right.

Doug Freedman - *American Technology Research - Analyst*

Sort of a little bit of a follow-up along a similar theme. You guys have been really good at sort of divesting those businesses where you couldn't capture the value you were looking for.

What is your thought now about taking the cash flows that you have and moving, swinging the pendulum in the other direction and start acquiring some of those other companies that are coming to market with things that do have high value in them? What is your take on your role there?

Jerry Fishman - *Analog Devices Inc. - President, CEO*

Certainly that is an opportunity for us. We think we have a good hand now, a good portfolio, but there are lots of smaller companies that have products that can enhance our portfolio, and we look at a lot of those companies. You have got to be careful on these acquisitions because they are hard and they are complicated. Most of them don't work so well when you get all done with them, but there are such opportunities and we look at a lot of them. We certainly have the financial structure to do that if we find one we like.

Doug Freedman - *American Technology Research - Analyst*

All right. Great. Thank you.

Operator

Our next question comes from the line of John Pitzer with Credit Suisse.

Stephanie Sun - *Credit Suisse - Analyst*

This is [Stephanie Sun] for John Pitzer. I was just wondering how you are viewing the strength in your comms business just relative to the Beijing Olympics? Are you worried that some of the strength is driven by pre-build ahead of the Olympics, which could lead to worse than seasonal trends in the second half of the year? Thanks.

Robbie McAdam - *Analog Devices Inc. - VP Analog*

Robbie here. No, I think that certainly we did, Jerry mentioned TD-SCDMA and an increase in our CDMA base station business, but that is, we already have a very broad base station and communication infrastructure business, so that really don't move the dial significantly. It helped last quarter, but certainly the strength is much more broad based than that across all the regions.

Jerry Fishman - *Analog Devices Inc. - President, CEO*

I think the thing I mentioned before is really the most important thing to take away, is what we are trying to do, and what we have been successful this year in doing is vastly expanding the bill of materials that is available to us in those products. So that is at least, if not more of a driver, than unit volume of base stations right now.

Stephanie Sun - *Credit Suisse - Analyst*

Understood. Thank you.

Mindy Kohl - *Analog Devices Inc. - Director, IR*

Okay. Well, thank you very much to everyone for your participation today, and we look forward to talking with all of you again during our third quarter conference call, scheduled for Tuesday, August 19th, at 5:00 Eastern. Thanks again.

Operator

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