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ADI - Q4 2016 Analog Devices Inc Earnings Call

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OVERVIEW:

Co. reported 4Q16 revenue of $1b and diluted EPS, excluding special items of $1.05. Expects 1Q17 revenues to be $840-900m and non-GAAP diluted EPS guidance excluding special items to be $0.68-0.78.

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PRESENTATION

Operator

Good morning. Welcome to the Analog Devices fourth-quarter and 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. Thank you, Jennifer. Good morning, everybody. Thank you for joining ADI's fourth-quarter and FY16 earnings conference call.

You can find our press release, relating financial schedules and the investor tool kit at their usual spot at investor.analog.com. Specifically about the investor tool kit, it's something we post on our website two hours before the earnings call and it's actually a pretty good summary of our prepared remarks. For those that are interested in kind of getting the early scoop, that's probably a good place to go as we file our press release.

With me on today's call are ADI's CEO, Vincent Roche, and ADI's CFO, Dave Zinsner. Before we start, let's do our disclosers. Please note, the information we're about to discuss, including our objectives, outlook and the proposed acquisition of Linear Technology Corporation, 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-K. 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 few information or future events.

Our comments today will also include non-GAAP financial measures, which we've reconciled to their most directly comparable GAAP financial measures in today's earnings release, which we've posted at investor.analog.com. With all that behind us, let's get started. I'd like to turn the call over to Vincent Roche, our CEO.

Vincent Roche - *Analog Devices, Inc. - CEO*

Thank you, Ali, and good morning, everyone. By almost any measure, ADI had an excellent fourth quarter. To put it in perspective, we achieved record revenue of $1 billion, expanded operating margins to a record 38% of sales, and we generated record free cash flow margins of 44%.

Throughout FY16, as you know, caution and uncertainty were in norm across the world. Nevertheless we executed well in a tough business environment, investing and positioning ourselves for future growth while remaining disciplined and making smart investment tradeoffs. All told, the actions we took during the year drove free cash flow margins to 33.7%, a 520-basis point improvement over the prior year, and I'm very proud of the stellar execution by our entire team.

For ADI it starts with an obsession for our customers' success and I personally spend, as you know, a lot of time talking to and listening to their needs. It's obvious to me from these conversations that ADI is an exceptional Company and we are more relevant to our customers than ever before. What is also clear is that our customers are seeking true innovation partners as they grow and evolve their businesses in the midst of unprecedented levels of complexity.

At the same time, our customers' hardware engineering talent is stretched thin. As a result, they're increasingly focusing their design efforts on systems and software, while turning the analog design challenge to ADI, where we have economies of scale and of scope. With the analog design challenges set to become even more complicated and critical in the area of IoT and industry 4.0, for example, helping our customers bridge the physical and digital domains in mission critical applications will, we believe, create tremendous opportunities for sustainable, profitable growth for ADI long into the future.

Customers choose us because we've been at this craft for over 50 years now and in our industry, brand matters. The ADI brand is synonymous with high quality and high performance and our customers rightly have full faith that ADI will support them today and well into the future. We have demonstrated an unwavering commitment to innovation that creates economic value for our customers by investing strongly in our own business.

Since the Great Recession, ADI has invested $4 billion in research and development alone, primarily in the B2B markets of industrial, automotive, and communications infrastructure. We've also made investments in quality, manufacturing, supply chain, and field operations, because being able to effectively and efficiently deliver high reliability innovation and customer support is just as important as the innovation itself.

In addition to these organic investments, we've been acquiring capability that not only builds our technology base but also enables ADI to move up the value stack. During the year we announced the proposed acquisition of Linear Technology, which, once complete, will create a high performance analog leader with the combined Company having a top-two market share position across all the key building blocks of the analog market, namely data converters, power management, amplifiers, interface and high performance RF and microwave. Once the transaction closes, we will have the ability to meet all of our customers' analog and mixed signal needs in sticky, long-life cycle, high-value applications in the industrial, automotive, and communications infrastructure markets.

During the year we also acquired some very interesting early stage technologies which we believe will help ADI move up the value stack, as we say, over time. The acquisition of SNAP Sensor gives ADI the ability to provide our customers with very high-dynamic range imaging capabilities important in smart city applications, as an example. For smart factory applications, we acquired Innovasic, a developer of the Deterministic Ethernet switching and software solutions to extend our reach in this core market.

We also acquired the cyber security solutions business of Cypress, giving ADI the ability to provide customers with a trusted sensor-to-cloud solution with security right down at the node. Just recently we announced the acquisition of some exciting lidar technology from Vescent Photonics that will enable ADI to develop a true solid-state scanning lidar system complimenting our existing radar-based ADAS offerings. These things are very important in autonomous driving applications.

The investments we've made and continue to make are helping create economic value for our customers and I'd like to share a few examples of where ADI's technology is making a real difference. In the automotive space, our recently announced A2B Audio Bus structure provides vehicle manufacturers with high-end, in-cabin audio fidelity while reducing vehicle weight. We estimate that our solution helps save car manufacturers approximately $30 per vehicle in combined CO_2 taxes and fuel efficiency.

In the area of factory and process automation, our software configurable input/output solutions are solving significant channel density, physical space and terminal challenges while reducing system complexity and installation and wiring costs. In the healthcare arena, ADI's vital signs monitoring products are bringing clinical-grade care into the home, enabling high-quality remote patient monitoring that reduces or even eliminates the need for, and of cost of, a hospital stay.

Ours is a customer value creation journey, 51 years in the making. We have the intellectual capital and more importantly, we have a talented, passionate and engaged team at ADI to help serve our customers' needs today and well into the future. The combination with Linear Technology represents the next phase in this value creation journey. With our market-leading product portfolios tied to attractive markets, we believe we can create a free cash flow engine that will be unmatched in our industry and help provide investors with an attractive combination of growth and shareholder value for many years to come.

With that, I'd like to turn the call over to Ali for details on our performance by end market in the fourth quarter.

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

Thanks, Vince. Digging deeper into our results by end market, the industrial market, at 39% of revenue, increased 6% sequentially, a very strong result in what is typically a weaker period for the industrial business. Revenue from our broad base of small- and medium-size customers was better than seasonal and in fact increased sequentially. The expected rebound in the aerospace and defense sector was also pretty strong. Our healthcare business also posted record quarter, as we are now beginning to see the early returns from our investments in the healthcare sector.

Compared to the prior year, the industrial market showed actually pretty considerable strength, growing 8% over the prior year and it was broad-based strength across all of the industrial sectors as we compare the year-on-year performance. The automotive market, at 14% of revenue, increased 5% sequentially and that was broad-based growth across really all sectors within this market. I'd say more importantly, automotive revenues increased 7% compared to the prior year.

Communications infrastructure sales, at 17% of revenue, decreased slightly from the prior quarter. Both wireless and wire line application revenues decreased slightly sequentially but increased compared to the prior year, led by growth in the 100-gig-plus optical networking applications. The consumer market, at 29% of fourth-quarter revenue, increased 58% sequentially and decreased 7% compared to the prior year, with both sequential and year-over-year results largely due to portable consumer application sales.

Now I'd like to turn the call over to Dave for details of our financial performance in the fourth quarter and in FY16. With the exception of revenue, Dave's comments on fourth-quarter and FY16 P&L line items will exclude special items, which in the aggregate totaled $39 million for the quarter. Reconciliations of these non-GAAP measures and our calculation of free cash flow are on Schedules E and F in today's release.

With that, Dave, it's all yours.

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

Thanks, Ali. The fourth quarter was once again a very strong and profitable quarter and we set records for revenue, operating margin, free cash flow generation and earnings per share. Revenue in the fourth quarter totaled $1 billion and diluted earnings per share was $1.05. Gross margins of 66.6% increased 60 basis points from the prior quarter and included a 120-basis point benefit relating to the sale of previously reserved portable consumer application inventory. Excluding this item, gross margins were in line with guidance, decreasing 60 basis points from the prior quarter due to mix.

We continue to tightly manage inventories, and as a result, inventory on a dollars basis in the fourth quarter decreased $16 million sequentially and inventory on a days basis decreased 17 days to 105 days. Weeks of inventory in distribution were slightly below seven weeks and were at the leanest level in six years. Operating expenses increased 3% sequentially, lagging well behind the 15% sequential increase in revenue. As a result, operating profit hit a record 38.1% of revenue, expanding 400 basis points sequentially and 220 basis points over the prior year. Other expense in the fourth quarter was approximately $20 million.

Our tax rate in the fourth quarter was approximately 10% as we adjusted our full-year tax rate to approximately 11%. Excluding special items, our business delivered strong operating leverage, even with low utilization rates and diluted earnings per share grew 28% sequentially to the $1.05 per share, which was almost twice the rate of sequential revenue growth. We had a record cash generation quarter, with free cash flow margins of 44%, expanding 600 basis points compared to the year-ago period.

Capital additions during the quarter were $41 million and we expect FY17 capital additions to be in the range of $125 million to $145 million. During the quarter we paid $130 million in dividends and our long-term financial model incorporates annual dividend increases of 5% to 10%. At the current stock price, ADI's dividend yield of $1.68 represents a dividend yield of approximately 2.5%, although it may be a little bit lower now that the stock rose today.

Now I'll take a moment to talk about our performance in 2016. Revenue of $3.4 billion was stable to the prior year and non-GAAP diluted earnings per share decreased 3% from the prior year, primarily due to lower gross margins and higher interest expense ahead of the Linear Tech deal close. The lower gross margins for the year were primarily the result of a very deliberate and disciplined inventory management program that reduced inventory on a dollars basis by $36 million, or 9%, and on a days basis reduced inventory in the fourth quarter by 9 days to 105 days.

Nevertheless, gross margins remained relatively stable to the prior year as we minimized the impact of lower factory utilization rates through pricing and cost efficiencies. The good news is that inventory levels are now in excellent shape. All told, FY16 free cash flow margins expanded by over 500 basis points to 34%, setting a new Company record. During the year we also returned almost $900 million, or 77% of free cash flow, to shareholders via dividends and share buybacks.

Of course, the biggest news of the years was the proposed acquisition of Linear Technology. To date, we've received regulatory clearances in Israel, Germany, Japan, and the United States. We now expect the transaction to close by the end of our second quarter of FY17. Our integration planning teams are hard at work and we're very pleased with their progress. Vince has put me in charge of the integration effort and I'm confident that our combined Company will be greater than the sum of its parts.

We expect the transaction to be immediately accretive to non-GAAP EPS and free cash flow and for accretion levels to increase as we begin realizing the planned $150 million of annualized run rate synergies within 18 months of the transaction close. During the quarter we also made good progress on financing the transaction, locking up a $5 billion term loan facility. Based on our current expectations, we anticipate the all-in coupon rate related to the financing to be approximately 3%.

Now turning to our outlook and expectations for the first quarter of FY17 which, with the exception of revenue expectations, is on a non-GAAP basis and excludes known special items that are outlined in today's release. Order rates are currently stable across our business as we enter the seasonally slow January quarter. As a result, we expect revenue in the first quarter to decrease sequentially and be in the range of $840 million to $900 million, but to grow 9% to 17% over the prior year. With inventory levels and utilization rates in good shape, we anticipate gross margins in the first quarter to be between 65.5% and 66%.

We expect operating expenses in the first quarter to increase slightly sequentially and for operating profit before tax to be well north of 30%. We're planning for our tax rate to be approximately 11%, which is our planned non-GAAP rate until we close the Linear transaction. In total, excluding special items, we expect diluted earnings per share in the first quarter to be between $0.68 and $0.78, which would represent year-over-year earnings per share growth of 21% to 39%.

This was a great quarter for the Company and we're very proud of our achievements, but as Vince always says, we should be often pleased, but never satisfied. It is our job to make sure that we continue to exceed expectations. Our customers, employees, and shareholders would expect nothing less, and neither do we. With that, operator, let's open up the floor for questions.

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

We'll get to the questions in a second. Just a reminder to folks on the line, please limit yourself to one question. If you have a follow-up I'd ask that you please requeue. We do this in the spirit of fairness so that everybody who wants to ask a question gets to ask at least one of their questions. We're running this call until 11. I think that's plenty of time to get to everyone's questions.

Jennifer, I think you've got the instructions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Ambrish Srivastava with BMO.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Thank you. I know the rule, but I had a quick fact check for Dave and then I had a longer term for Vince. Dave, I apologize if I'm missing it. Usually in your prepared press release you do give the end market breakdown for the coming quarter. I don't think I saw it this time.

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

Maybe we ordinarily do. We'll give you two questions, Ambrish, (technical difficulty). I would say just kind of directionally the B2B businesses, which we would consider industrial, automotive and communications, will roughly be down mid-single digits and of course consumer I think would be roughly in the 30% down range.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Okay.

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

What was your other question, Ambrish?

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Thank you. For my other one was a bit of a longer term for you, Vince. This is going back to a conversation you and I had a while ago. I know you've been on a path to transforming ADI and you've talked about inorganic as well as organic and thinking more of value creation as opposed to what we are used to, design in, design out. You've kind of showed it in the consumer side so far that you're not a one-socket win.

Give us a perspective of where we are. I know baseball season is over and I love cricket, but cricket is a bad analogy. There's only two innings. Where are we in the transformation, Vince? Just help us with that perspective. Thank you.

Vincent Roche - *Analog Devices, Inc. - CEO*

Thanks, Ambrish. Good question. Look, we're on a journey. We believe, we said several years ago, we believe that there's enough impetus in our business and that we have the balance sheet as well to help us get this Company towards $4 billion to $5 billion in sales in a reasonable period of time. We're well on track. I believe over the next several years we will be updating obviously when we integrate LTC. We'll be updating all the benchmarks around what we expect our revenue to be over time, profits, free cash flow and so on, so forth.

I don't know -- I'm not a cricket fan at all, Ambrish. I don't know cricket. I'm only an amateur in terms of understanding baseball. I would say we're still in the probably the first quarter of the transformation. We have --

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Okay, that's football.

Vincent Roche - *Analog Devices, Inc. - CEO*

We have many, many years of upside. As I said, what makes me very optimistic about this business is that the analog domain essentially sets the performance for all the systems that make up this massive information communications technology sector. It's one of the foundational technologies. Our customers are asking us for more, more, more, and we're getting to the point now where we can be very, very choosey about the problems that we solve and we can solve those problems across the board from microwave to mixed signal to digital signal processing to power sensor technologies.

I think there's a huge innovation upside. That's the root of this Company. We're in a better and better position with our customers. I'm very optimistic that we can get this business well beyond $5 billion in a reasonable period of time.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Okay. Thank you. Happy Thanksgiving, guys.

Vincent Roche - *Analog Devices, Inc. - CEO*

Many happy returns.

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

Thanks, Ambrish. Next question, please.

Operator

Your next question comes from Tore Svanberg with Stifel.

Tore Svanberg - *Stifel Nicolaus - Analyst*

Yes, great execution, guys. Dave, can you remind us where utilization is right now and what are your plans for the next quarter? Obviously, you've done a great job bringing the inventory days down, but kind of as we look forward from here on, how should we think about utilization and inventories? Thanks.

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

Good question, Tore. Utilization was in the kind of high 60%s in the fourth quarter. I would expect it to be roughly in that range in the first quarter, which is somewhat atypical for us for a first quarter because generally we're working our inventory back down in the first quarter and with industrial usually having a sequential decline in the first quarter as well, that generally drives our utilization down a bit. Given that we have done so well, the operations group has done so well in terms of managing inventory this year, we can keep utilization a little bit higher going into the first quarter.

Tore Svanberg - *Stifel Nicolaus - Analyst*

That's great. Happy Thanksgiving, guys. Thank you.

Vincent Roche - *Analog Devices, Inc. - CEO*

Thank you.

Operator

Your next question comes from Tristan Gerra with Baird.

Tristan Gerra - *Robert W. Baird & Company, Inc. - Analyst*

Hi. Good morning. Related question on the gross margin guidance. When we adjust for the sale of previously reserved product, you had a sequential trend in gross margin guidance that's better than seasonal and you just mentioned the utilization rate being better than what you would see typically in the fiscal quarter. Is there anything else in terms of mix that also had an impact on the gross margin, maybe some weakness in base station or anything else that you could give us color on?

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

I think it's generally utilization that's going to drive it. Because in reality, mix on a year-over-year basis is actually a little bit worse, because if you remember the first quarter was a pretty difficult quarter for us with regard to consumer, came down quite a bit. This year it won't haves as dramatic a decline. Mix is a little bit negative but utilization will offset.

I would say the other thing just anecdotally is the operations group has done a very good job on the spending side, just really managing the expenses there. We've incrementally, I'd say, every year been doing a bit better in terms of spending. On top of that, there's obviously, as I think I mentioned in the prepared remarks, we've been focused on pricing as well. I think those things have just had an incrementally little bit of a benefit every quarter and then of course utilization drives a lot of it and the offset would be mix sequentially.

Tristan Gerra - *Robert W. Baird & Company, Inc. - Analyst*

Great. Thank you.

Operator

Your next question comes from Craig Hettenbach with Morgan Stanley.

Craig Hettenbach - *Morgan Stanley - Analyst*

We've had cricket, football, baseball. We had some game, set, match with tennis in there. On industrial, and I understanding there's a macro of (inaudible) to industrial, but nice to see the broad-based strength. Can you talk about, Vince, just maybe some of the applications or product that you're excited about in terms of where you're seeing some investment by your industrial customers?

Vincent Roche - *Analog Devices, Inc. - CEO*

I mentioned in the prepared remarks there, Craig, for example in our core businesses, like robotics, for example, there's a need to be able to push the speed and the accuracy of these robots to ever-higher levels. That's a tremendous digital signal processing challenge and we've been building complete solutions that are only coming to fruition now for that area to enable much higher speeds in the operation of the robot with lower power, much greater accuracy. It's a complete signal chain of digital signal processing technology and mixed signal technology.

I mentioned in the prepared remarks as well some of these software-defined input/output structures that are enabling our customers to deepen the penetration of sensors into their environments and to dramatically reduce the complexity of installation and the cost. Energy's another area. It's a slow-burn market but it's an area where we have tremendous technology in transmission and distribution and also in the metering of energy. Those are just a couple of areas.

I should say as well, we combine -- we just lump healthcare into the industrial sector as well and we've seen -- this is a market where we've been investing, I would say modestly, but very determinedly, over the last seven or eight years and we're beginning to really see the returns come good there in terms of revenue and profit. I'll give you an example. Using integrated silicon photonics and signal processing technology, we've changed the way our customers can implement CT scanning and digital x-ray. We're bringing clinical-grade vital signs monitoring beyond the hospital into the clinic and the home.

Those are all things that are making a big difference to ADI. I should point out, by the way, as well, that we're on a $0.25 billion run rate now with our healthcare business with very, very good profits and a good outlook. Again, it's a slower burn business but it's a terrific bet for the future for ADI.

Craig Hettenbach - *Morgan Stanley - Analyst*

Great. Thanks for all that color.

Vincent Roche - *Analog Devices, Inc. - CEO*

Thank you.

Operator

Your next question comes from Chris Danely with Citigroup.

Chris Danely - *Citigroup - Analyst*

Hey, thanks, guys. I'm going to ask the Trump question since I get it five or six times a day. Who knows what this guy's going to come up with policy wise, but maybe if you could share with us your sort of thoughts on how you think this impacts you, what your concerns are, what you think any positives could come out of it for ADI and the industry? Any thoughts there would be appreciated.

Vincent Roche - *Analog Devices, Inc. - CEO*

It's a good question. We're getting into our 52nd year now as a Company, so we've gone through many regime changes across the world and many, many -- how many American presidents is that? I think it's just wait and see. We don't know.

We hear -- like everybody else, we hear the rhetoric. We've yet got to see what the policy's going to look like. Maybe on the margins, it will be good at least for the American business environment.

Chris Danely - *Citigroup - Analyst*

Thanks.

Operator

Your next question comes from Amit Daryanani with RBC Capital Markets.

Amit Daryanani - *RBC Capital Markets - Analyst*

Thanks. Good morning, guys. Congrats on a really nice quarter here. I just want to go back to the Linear transaction for a second. You've had more time to go you through this and review this.

I'd say the number one question we tend to get is how much of -- what sort of manufacturing optimization savings could you get from the transaction over time? What sort of upside would that yield versus $150 million you've talked about? Anything you can talk about just manufacturing integration optimization you can do and if that would be incremental to what you've talked about?

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

Thanks, Amit. That's a good question. Let me start though, since you opened up the Linear question, why don't we just start at the top here. We've actually spent the last several months really focusing on how the integration will goes as of day one. I would tell you that where we have gotten a lot more optimism is around the revenue side.

We were already coming into this, and this is the reason you do an acquisition like this is to get revenue synergies, we were already coming into the acquisition thinking that we would get hundreds of millions of dollars of revenue upside over time. Of course, it takes a while to get that revenue upside, but eventually.

I would say that we're even more optimistic about getting revenue synergies. The teams have sat a number of times and talked through where there might be opportunities for the combined Company to really address markets and deliver products that we hadn't in the past. The fruits of that, those conversations have been very, very positive.

On the manufacturing side, I think that right now we're going to go in with the footprint that we have and what we do and what we've always done is optimize that to our needs. We'll continue to look at it. I don't know beyond -- I think we had roughly thought that there's about $50 million of manufacturing synergies through purchasing power and so forth. Whether there will be more several years down the road we'll just have to wait and see. For now, I would call it $50 million.

Then we expect there's probably another $100 million of OpEx synergies. There's a lot of early wins that we've identified through the efforts and planning the integration with obviously the public company expenses but there's a lot of things that we spend in terms of outside services and so forth that we don't need to spend two of and so I think we'll get some very quick cost savings out of that activity. If anything, I think we're very positive.

I would tell you that the other thing we talked about when we announced the acquisition was that we thought our tax, blended tax rate would be 19.5%. I think today now we believe that's more like 15%. That actually pushes up the near-term accretion number from about 10% to probably about 15%. If anything, we're more optimistic about the near term and incredibly optimistic about the long term.

Amit Daryanani - *RBC Capital Markets - Analyst*

Perfect. Thank you guys.

Operator

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

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

Thanks for taking the question and congratulations on the excellent execution, guys.

Vincent Roche - *Analog Devices, Inc. - CEO*

Thank you.

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

Just looking the model bottoms up and going back a bit to Ambrish's question, if my model's correct not only did you have record margins in the quarter but auto and industrial also had record quarters. As I look at the outlook, the 13% midpoint year-on-year growth relative to ADI's history and global GDP growth, I think we would typically look at the analog industry growing at a 2 to 2-1/2 times multiple, you're growing at 4 times that. As we look at the business and where it is now and the early payoff in some of the platform investments the Company has made, are we seeing the Company start to move into a phase where its growth rate relative to its own history and relative to the industry is now at a nice premium to what we would have seen in the post-Lehman and even pre-Lehman periods?

Vincent Roche - *Analog Devices, Inc. - CEO*

I think firstly, you've got to take growth over a longer period of time. It's a longer integral. Yes, as I've said, what makes me very optimistic about things is that we're innovating like never before and our -- we're solving big, meaningful problems of greater impact and our customer relationships are such that I think we're very, very well positioned to be able to partner with them, to really uncover what they believe to be the most intractable challenges both in terms of their innovation and their commercial impact.

So yes, I think we're innovating in a way that gives us tremendous opportunity for growth and as I said, we've got the customers with us. I think I would expect -- we've said that our long-term growth model is 2 to 3 times GDP. I think we're well positioned to at least deliver that organically and as I said when Ambrish asked the question earlier, we will be updating our models over the coming couple of quarters once we integrate LTC here. We'll give you more color and visibility.

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

All right. Thanks, Craig. Next question.

Operator

Your next question comes from Stacy Rasgon with Bernstein Research.

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

Hi, guys, thanks for taking my question. I guess I also had a housekeeping question. Dave, you mentioned that you thought consumer would be down in the ballpark of 30% sequentially next quarter, but just mathematically that doesn't give me the B2B down mid-single digits. B2B, to fit the guidance, would be down more than that. Were you just sort of rounding on the consumer number or is there something else going on with the math?

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

I was rounding on the consumer number.

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

You expect it to be down more?

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

A little bit more.

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

Got it. That's the housekeeping question. If I could ask the real question now. Just last year you gave us a little bit of color on content increases for Apple and obviously the businesses, consumer was down a little bit this year but not much with the content increase offsetting the inventory reduction. What do you guys see for content increase on the next cycle for that product?

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

I think it's too early to tell right now. I think we feel good about our content right now. Whether there will be any additional items is, I think, difficult to say right now.

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

Got it. Thank you, guys.

Operator

Your next question comes from Blayne Curtis with Barclays.

Blayne Curtis - *Barclays Capital - Analyst*

Hey, guys, thanks for taking my question. Actually just a follow-up there on the consumer side. The 30%-ish decline seems fairly normal, so just wondering if you could compare and contrast this year versus last year. You have additional components. Are you seeing any yield issues or anything like you saw in (inaudible) this year or is it fairly smooth?

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

We don't -- it's fairly smooth. I think what you saw kind of on a year-over-year basis is we came down a little bit while increasing content. The driver of the opposite kind of force here was obviously the inventory build that happened last year that doesn't appear to be happening this year. It's kind of tracking as you would normally expect.

Blayne Curtis - *Barclays Capital - Analyst*

Great. Thanks.

Operator

Your next question comes from Ross Seymore with Deutsche Bank.

Ross Seymore - *Deutsche Bank - Analyst*

Hi, guys. Thanks for letting me ask a question. On the OpEx side of things, I realize you only have a couple quarters left before Linear comes into the equation. Dave, can you walk us through why you're guiding at up sequentially? If I look historically I can't find a quarter in the last four, five years where it was actually up. How do you plan to manage the organic OpEx up until that Linear integration?

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

Well, I'll take the second question first, which is very carefully. We're not looking to build or add a lot of resources right now because we're going to inherit a lot of resources from Linear Tech.

We want to optimize that combined workforce that we're going to have going forward. We're very, very, very cautiously managing OpEx. I would say for the most part keeping headcount flat. Maybe there's one or two people here or there that we need to add for one reason or the other.

There is a dynamic within our compensation plan, variable compensation plan, that makes this phenomenon happen every so often. That's a situation where on a year-over-year basis we have pretty meaningful growth, which is a component of our variable comp and so while as you point out, we do a pretty good job with the fixed expenses, bringing them down in the first quarter on a sequential basis, and generally the same thing happens with the variable compensation. In this particular quarter, that's not going to be the case because of the year-over-year component is going to actually drive a higher bonus payout.

That's really the dynamic there. Otherwise, it would have been kind of largely as you would have expected it to be managed in the first quarter.

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

I think as you mentioned, Dave, in the prepared remarks, the operating margin in the first quarter is still going to be I think at the midpoint around 32%, which is pretty strong. I think you'd have to go back five or six years to see those kinds of operating margins in the first quarter.

Good question. Next caller, please.

Operator

Your next question comes from David Wong with Wells Fargo.

David Wong - *Wells Fargo Securities - Analyst*

Thanks very much. Your B2B segments, industrial, automotive comps, they've all swung from year-over-year declines a couple of quarters ago to solid 6% to 7% growth in October. Sounds like your January comp guidance assumes about the same. Are you seeing any sub-segments of these accelerating or actually strengthening from that very good October level?

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

I think they're all pretty much behaving as you might expect. There are areas that we're obviously seeing just strength in general. Vince mentioned the healthcare space. Clearly the aerospace and defence business has been good. Areas around IoT that we focused on have done well.

There are sub-segments of the auto space like ADAS and powertrain and so forth. Vince mentioned the A2B platform that we have in auto for infotainment area. All those things are doing probably on the margin a little bit better. I would say it is a very, very broad-based situation with the B2B space and pretty much every sub-segment is doing well.

David Wong - *Wells Fargo Securities - Analyst*

Great. Thanks very much.

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

Thanks.

Operator

Your next question is from Steve Smigie with Raymond James.

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

Great. Thanks a lot, guys. Just was hoping to get some quick color on lidar opportunity. What do you see that opportunity for you guys, as in what does your acquisition bring to the table versus some of the competition out there?

Vincent Roche - *Analog Devices, Inc. - CEO*

Good question. Basically, the technology we've acquired is liquid crystal optical wave guide technology and it's a solid-state approach to a very, very difficult problem, basically using a solid-state approach to optical beam steering. That's critical if you're going to really push the resolution of lidar in the future. In contrast to other beams theory methods, for example, like MEMS mirrors, the spinners that you've seen running around highway 101 there are optical phased arrays.

The technology we've acquired doesn't have any sensitivity to vibration, for example. Technically, we get great frame rates, no blind spots and we can randomly steer the beam as well. This technology, we believe, puts us firmly on the lidar roadmap and combined with our radar-based advanced driver assistance technology at 24 and 77 gig, really gives us two of the very critical technology modalities to enable not only greater safety, which everybody craves in transportation, but also it puts us well on the path to enabling our customers to get closer to realizing autonomous driving as a major trend in the transportation sector.

That's essentially what we see. It's a potentially beyond $1 billion semiconductor TAM for this thing for us, so it could be potentially a wave. That's why we've bought the technology. It is reasonably early stage, but the technology is working. Now we've got to get it installed and make it work in the application.

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

Thank you.

Operator

Your next question comes from William Stein with SunTrust.

William Stein - *SunTrust Robinson Humphrey - Analyst*

Great. Thanks for taking my question. I'm hoping you can address the reasoning behind the greater optimism for revenue synergies. Specifically, is this more of an inside-out view when you sit down with engineers and think about the products that you might be able to deliver or is it more customer driven where you're hearing feedback that requests a combination of products, let's say? Thank you.

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

I would say it's a combination. Vince can add color if he wants. I would say it's a combination of clearly the business units, call it the engineering portion of the business units, do see opportunities for products that they could make that would be special. I think a lot of it comes from just the sales force of the combined Company looking at the other Company's portfolio and licking their chops at what they could do with that, those products in their geographies, their customers and so forth. I think that's really where we see a lot of the kind of near-side opportunities.

Vincent Roche - *Analog Devices, Inc. - CEO*

I think maybe as well in some -- particularly of the larger customers, there's an open door invitation to do more together with the portfolios that we have on hand as well as getting our engineering teams together to figure out how to create even more value and future together, in terms of how we invest in R&D and apply it.

William Stein - *SunTrust Robinson Humphrey - Analyst*

Thanks and congratulations.

Vincent Roche - *Analog Devices, Inc. - CEO*

Thank you.

Operator

Your next question comes from Vivek Arya with Bank of America Merrill Lynch.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Thanks for taking my question and congrats on the great execution and the recovery in the B2B segment. My question, though, is related to the consumer segment. What is the right way to model that segment for the next two years?

If you were in our shoes, would you model that segment to be flat, up or down? Just given the large influence of one of your customers in that segment, it's really hard to model that. I was just wondering how you would be modeling it if you were in our shoes. Thank you.

Vincent Roche - *Analog Devices, Inc. - CEO*

From a top-line perspective, I'd say if we could get 10% growth compounded for the next few years in that business, we'd be very, very satisfied.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Do you see -- do you have visibility for that, Vince?

Vincent Roche - *Analog Devices, Inc. - CEO*

Well, look, do you really have visibility into anything? I mean, we work hard on building great products. We're working very, very hard on deepening our penetration, not just in one customer but in several customers.

It's a rapid cycle business as well and things can change. Markets can change. Applications or products can hit, not hit. Products get -- can even at the customer level be brought to market or canceled.

As best we can tell, we're happy with the position we're in, in terms of the products and technology we have, the relationships we've got with the critical customers in this space, so I'm optimistic that we can grow this business at the level I've said. Time will tell. We don't know. We can't predict because also it's a market with relatively fickle customers on the other side of things. I think we're well positioned to pick the upside. That's pretty much what I've got to say about it.

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

One thing I would add is that we do track kind of the opportunity set and we certainly have the opportunities to do what Vince said and it is a matter of markets and applications taking off and so forth. From an opportunity perspective, we're optimistic about what we can do in the consumer space.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Thank you.

Operator

Your next question comes from John Pitzer with Credit Suisse.

John Pitzer - *Credit Suisse - Analyst*

Thanks for letting me ask the question. Congratulations on strong results. I guess, Vince, an earlier questioner rightly pointed out that within your B2B business, industrial and auto kind of established new all-time quarterly highs in the October quarter.

I was hoping you could talk a little about the communications sector, still about $40 million below kind of peak revenue run rate a few years ago. I know not all of Hittite gets wrapped up in the coms, but especially given the success at least on a design side from the Hittite acquisition, I'm just kind of curious how you view the outlook for the coms business. Why is that the business that's still kind of struggling relative to past ties and what are kind of the growth drivers you see from here?

Vincent Roche - *Analog Devices, Inc. - CEO*

I think you've got to take a very long-term view to the consumer space. We have been playing in this business from 1G into 4G. We're helping our customers with 4.5G. We're at the early stages of helping them architect 5G technologies as well.

It's an important market for ADI. With Hittite, we're able to bring a level of completeness to our customers' solutions. We're seeing the growth we expected out of Hittite that we had thought was there. We're getting the growth.

We're well positioned with our customers and we're grinding out results in 4G. I think we are getting share in 4G. In some of the older technologies, some of the 2.5, 3G technologies, clearly there's price erosion, which offsets to some extent the growth we get in 4G.

I think the customers are facing increasingly difficult challenges in this space. We're helping them solve them at an ever-increasing level of sophistication. It's a wave for the future and we'll grind out the results quarter by quarter, year by year.

I think, as I said, we are in an increasingly good position to gain share in the space, particularly as we begin to push our products as well towards single-chip radio solutions in the future. I think there are very few companies standing in the radio who can build a sustainable business for the long term and ADI will be right at the top of that stack.

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

Thanks, John. Next question.

Operator

Your next question comes from Chris Caso with CLSA.

Chris Caso - *CLSA - Analyst*

Thank you. Good morning. Wonder if you could talk about what you consider to be normal seasonality for the April quarter. I ask because last year was the first quarter of the substantial revenue from the consumer segment but that was undergoing the inventory adjustment. If we normalize for that inventory adjustment, what would your expectations be for a normal April?

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

That's a good question, Chris. We're kind of in new territory, so I'll take a crack at it but don't hold me to it. I would expect, as is typical, the industrial and automotive sectors to have pretty good sequential growth. I think the industrial sector usually has about 10% and usually the automotive sector is a little bit below 10% but they're both pretty strong.

Coms will do what it does. It's more cyclical than seasonal, I think, in most cases.

The consumer business, which is the big wild card, I'm going to guess that it's down probably the same kind of level sequentially as it was in the first quarter, probably in the 30% plus or minus or something like that in the second quarter again. Then of course we'll have a rebound after that in the third and fourth quarter as it seasonally does. Hard to say, but that would be my guess.

Chris Caso - *CLSA - Analyst*

That's helpful. Thank you.

Operator

Your next question comes from Toshiya Hari with Goldman Sachs.

Toshiya Hari - *Goldman Sachs - Analyst*

Great. Thanks for taking my question. Congrats on a very strong quarter.

I had a question on your incremental gross margins. I think for the October quarter on a year-over-year basis most of your revenue growth dropped through to the gross margin line and also for the January quarter, if we take the midpoint of your revenue and gross margin guide, again, I think close to 90% or 100% of your revenue growth is dropping through the bottom line. I guess I'm curious, is this just product mix or are there other factors at play here? Thank you.

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

Drop-through works when there isn't a lot of changes going on around working capital and so forth. I think that's kind of masking things a bit.

For example, in the fourth quarter, as I talked about, and we had this inventory release which drove up the gross margin, so you have to kind of strip that away before you even look at it. Then in the first quarter we are -- because we normally have this kind of utilization decline in the first quarter. We're not going to have that because the really good discipline we had through the year this year in terms of inventory management, it's instead of the utilization level that's kind of atypical for us.

I'm not sure drop-through is the best way to look at it. It's more a function of -- at least in the first quarter it's more a function of utilization levels. They're going to be in the kind of mid- to high-60%s. That's going to be really beneficial relative to where we were last year at this time, which is kind of unusual for us.

Toshiya Hari - *Goldman Sachs - Analyst*

Okay. Great. Thank you.

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

Sure.

Operator

Your next question comes from CJ Muse with Evercore.

C.J. Muse - *Evercore ISI - Analyst*

Thank you for taking my question. I was hoping to revisit earlier comments regarding a 10% CAGR for consumer. If you look at your top customers in that bucket, I think 13% of your total revs in FY16, that would imply your other consumer business declined about 25% year on year. Curious, the 10% CAGR is that a reflection of your vision to rising content at your very large customer there or is it a reflection of seeing greater breadth with other consumer customers as you look out over the next one, two, three years?

Vincent Roche - *Analog Devices, Inc. - CEO*

I think it's a combination of all of the above. It's a long-term prediction. We have, as I said, we've certainly got the customer engagements. We have the -- we've got the technologies and products and I think we're solving problems that really matter.

What I'm indicating is that to my mind it's probably more about how the market performs than individual, if you like, dynamics around engagement and individual customers. It's really more about the market.

I think what we're talking about is a long-term expectation. We're investing at a rate that should enable us to get those kind of growth rates.

I will say as well that we have funded our B2B businesses. We're spending more than [90]% of the Company's R&D on our B2B businesses to make sure that we drive growth and capture the opportunity that's available to us in those sectors. We're all the time making tradeoffs in investment between the various applications in the B2B area and we're very carefully picking out the vital few opportunities in consumer, where we think our technology makes an enormous difference to the user experience.

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

Just a clarification. The outside of the portables business within consumer, outside of portables, consumer was up sequentially and was about stable to the prior year. Okay. Next question.

Operator

Your next question comes from Romit Shah with Instanet.

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

Yes, hi. Just regarding the merger, it sound like early indications are good but one of the things that's come up is just employee retention. Something to that extent was mentioned in the proxy and one of the -- for some of us who have followed Linear over the years know that it's kind of a different culture, West Coast company. I'm just curious how are you guys incentivizing the Linear people to stay at the organization? Dave, as we put our merger models together, should we assume that OpEx and stock comp sort of step up on a like-for-like basis after the deal closes?

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

Well, we do have -- we have a retention plan in place for them, so near term we're not too worried about it. I would tell you that my own view on this, Vince can probably opine, is that engineers stay with a company or come to a company based on what they're doing and whether they're doing exciting things and are granted the opportunity to work on really difficult problems and do amazing things. That's the environment we intend to create for both the ADI and Linear Tech engineers.

I'm not particularly worried about it. No, our compensation plan in the near term for ADI and Linear Tech people is to maintain what both of them have. Over time they'll be homogenized but I think a way that -- a manner in which we wouldn't see a negative impact.

Vincent Roche - *Analog Devices, Inc. - CEO*

Just a little more color to what Dave has said, Romit. I've spent a lot of time, as many of our leaders have, with the LTC engineering community, the business community, the operations community and we share a very similar view of the world. We understand each other's businesses very, very well.

We share a very similar value system, how we believe value gets created and captured. I think there's tremendous excitement, by the way, all through both companies, incidentally, about how we can combine the complementary technology suites of both companies to do really marvelous things in the future.

As Dave said earlier, that our sales forces are really chomping at the bit to get the two bags, for the ADI people to get the LT power bag and the LT salespeople to get the ADI mixed signal bag and really capture the opportunity that we think is available to both of us over the next three or four years.

I think as Dave said, a part of retention is a sense of equity and fair treatment in terms of compensation and we pay a lot of attention to that. The soft side of the adventure that people can undertake here and work together to do amazing things into the future, solving really critical, meaningful problems with the world, that's what people want to do. I will tell you as well, we pay a lot of attention to retention and I'm pleased to say that things are very, very stable on both sides of the fence.

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

All right, thanks. Next question.

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

Thank you.

Operator

Your next question comes from Ian Ing with MKM Partners.

Ian Ing - *MKM Partners - Analyst*

Thanks for fitting me in. You mentioned pricing efficiencies helping gross margins year over year, looking for color on that. You have a pretty capable team in place now for a while. I've been assuming you have been pricing by value of solutions.

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

It's basically that. As Vince mentioned, I think in one of the questions, we're increasingly putting more and more robust technology in the products, some cases algorithms, some cases other software, some cases it's just hardware. It's just solving a really challenging problem and what we do is work to try to get commensurate price for that value that we create. Not surprisingly, in a big organization sometimes a little bit of that slips through the cracks and what we've been doing over the last few years is plugging those holes.

We're not looking to gouge our customers, by any means. We're looking to find the optimal level of price per value and that's what we do every day. I think we've done an increasingly better job at that over time.

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

Thanks, Ian.

Ian Ing - *MKM Partners - Analyst*

Thank you, Dave.

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

Next question.

Operator

Your next question is from Harsh Kumar with Stephens.

Harsh Kumar - *Stephens Inc. - Analyst*

On that answer you gave, there seems to be some trend among semiconductor companies that they can actually get paid very well for what they're doing. Historically it's always been downward pricing, but now I think some of the companies are trying to raise prices and maybe get paid fairly. I'm curious, you mentioned, you touched upon it in the previous answer, but I'm curious where your philosophy is as a company with that and how much of an impact did pricing have and margins for the last quarter?

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

I think, Harsh, I would say that some companies who have been drifting into the 40%s and maybe very low 50%s in terms of gross margin, they got to get a whole new kind of philosophy in place for pricing. We already had 60%-plus gross margin, so we were actually pretty good at executing a strategy around this. It was more just cleaning up a little bit around the edges where we probably weren't executing as well.

Hard to put a number on it for the quarter. I would say, though, that on the average over the last, say, four years, our ASPs are probably up 30%, 40%, probably. It's obviously been a pretty big impact in terms of our gross margins.

Harsh Kumar - *Stephens Inc. - Analyst*

Great. Congratulations, guys.

Vincent Roche - *Analog Devices, Inc. - CEO*

Thank you.

Operator

Your next question is from Cody Acree with Drexel Hamilton.

Cody Acree - *Drexel Hamilton - Analyst*

Thanks for taking my question and congrats on the progress. Any more color you could give on the wireline business? You made some comments about strength you're seeing in the 100 gig.

Vincent Roche - *Analog Devices, Inc. - CEO*

Yes, so, we've a reasonably significant business in the optical space and providing precision measurement and control for the various parts of the optical system. It's grown well for the Company over several years and I think as the need for data center infrastructure build out continues, medium and long haul, back haul connectivity continues to be pressured, we see it as a good bet for the future and probably at the higher end of the spectrum of growth that we have put into our model.

Cody Acree - *Drexel Hamilton - Analyst*

Thank you.

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

Thanks, Cody. We'll get to our last caller.

Operator

Our last question comes from Steven Chin with UBS.

Steven Chin - *UBS - Analyst*

Hi and thanks for squeezing me in. I had a question on wireless infrastructure. I know that was down in the quarter. Was that broad-based softness in that business or were there any pockets of positive demand? Also related to that, how would you characterize the current, I guess, level of rollout for 4G and 4.5G overall? Are there any more greenfield or upgrade opportunities left around the world in the next couple years? Thanks.

Vincent Roche - *Analog Devices, Inc. - CEO*

I guess in the quarter, the macro base station and the back haul were down for the quarter. Our small selectivity was up. I think China's reasonably strong.

Our transceiver pipeline, by the way, across the board, not just in base station technology, but across the board, is continuing to build a nice pipeline of opportunity and also we're converting the pipeline into decent revenue. I think we're still in the reasonably -- I mean, 4G is going to be around for a long, long time to come. The largest part of the world, by the way, is still on 2, 2.5 and 3G networks. 4G will have a long life ahead of it and as I said, we'll be grinding out share gains there in an increasingly thinning atmosphere here, if you like, in terms of suppliers.

5G is on its way. As I said, we're in the earlier stages of helping our customers to architect 5G solutions, but I think it's going to be many, many years out yet. I think it will be -- I don't expect to see capital deployments from the carriers change an awful lot. I think it will be a slow and steady increase in the build out of 4G and I think that will be the environment until we get to 5G and see another specific step function ramp here.

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

All right. Thanks, Stephen. That looks like it's the end of the call.

We had a good quarter. The deal here for Linear Tech continues to stay on track, progressing well here for a close. Inventory, as Dave has talked about, is in great shape, gives us good gross margin leverage going into 2017.

Our business is now showing some really good momentum, especially in the B2B markets. You guys saw the results of some pretty strong operational execution this quarter, with our free cash flow margins up pretty significantly.

We appreciate you guys calling in and we'll look to talk to you soon. Thanks.

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

Happy Thanksgiving.

Vincent Roche - *Analog Devices, Inc. - CEO*

Thank you.

Operator

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