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ADI - Q3 2017 Analog Devices Inc Earnings Call

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OVERVIEW:

Co. reported 3Q17 total revenue of $1.46b and diluted EPS (excluding special items) of $1.26. Expects 4Q17 revenue to be $1.45-1.55b and diluted EPS to be $1.29-1.43.

CORPORATE PARTICIPANTS

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

Vincent T. Roche *Analog Devices, Inc. - CEO, President and Director*

CONFERENCE CALL PARTICIPANTS

Ambrish Srivastava *BMO Capital Markets Equity Research - MD of Semiconductor Research & Senior Research Analyst*

Amit Jawaharlaz Daryanani *RBC Capital Markets, LLC, Research Division - Analyst*

Craig Andrew Ellis *B. Riley & Co., LLC, Research Division - Senior MD & Director of Research*

Craig Matthew Hettenbach *Morgan Stanley, Research Division - VP*

Harlan Sur *JP Morgan Chase & Co, Research Division - Senior Analyst*

Ross Clark Seymore *Deutsche Bank AG, Research Division - MD*

Tore Svanberg *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Vivek Arya *BofA Merrill Lynch, Research Division - Director*

PRESENTATION

Operator

Good morning, and welcome to the Analog Devices Third Quarter Fiscal Year 2017 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 Head of Investor Relations. Sir, the floor is yours.

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

All right. Great. Thank you, Jennifer. Good morning to everybody on the line here. Thanks for joining the Analog Devices Third Quarter 2017 Earnings Conference Call.

First, I'd like to get through our disclosures. Note that the information we're about to discuss, including our objectives and outlook, includes forward-looking statements. Actual results may differ materially from these forward-looking statements as a result of various factors, including those discussed in our earnings release and our most recent 10-Q. These forward-looking statements reflect our opinion as of the date of this call and we undertake no obligation to update these forward-looking statements in light of new information or future events.

Today's commentary about ADI's third quarter financial results will include non-GAAP financial measures. When comparing our third quarter results to our historical performance, special items are also excluded from the prior quarter and year-over-year results. Available reconciliations of these non-GAAP measures to their most directly comparable GAAP measures and additional information about our non-GAAP measures are included in today's earnings release and in our web schedules, which we've posted under the Quarterly Results section at investor.analog.com. Our web schedules also include a historical view of what the combined ADI and Linear Tech would have looked like by end market, by quarter for the last 3 years.

And lastly, please note that ADI's first quarter of fiscal '18 will be a 14-week quarter so you should adjust your models for an additional week of revenue and additional week of expenses for that quarter.

And so with that, I'll turn it over to ADI's CEO, Vincent Roche. Vince's comments are on a non-GAAP basis and exclude special items outlined in today's release. So with that, Vince, it's all yours.

Vincent T. Roche - *Analog Devices, Inc. - CEO, President and Director*

Thanks very much, Ali, and good morning, everyone.

Well, this is another very successful quarter for ADI, and I'm pleased to share our results with you this morning. Not only were our third quarter financial results stellar, we're also making excellent progress in integrating Linear Tech from an organization and a synergy capture perspective.

So let's start with our financial results for the third quarter. Total revenue was above the high end of guidance at $1.46 billion, primarily on broad-based strength in the highly diverse industrial markets. And this strong revenue growth, coupled with disciplined operational execution, delivered gross margins of 70.5% and operating margins of 40.5%. Importantly, the combined company has generated $1.9 billion of adjusted free cash flow over the past 12 months with associated margins of 34%, which are among the highest in the S&P 500.

Now, I'd like to give you some details on our performance by end market during the quarter. The industrial market represented 49% of sales and demand across all industrial sectors and regions was strong. ADI's industrial business is now nearing a $3 billion annual run rate and we see numerous opportunities to drive additional dollar content and revenue growth as customers increasingly rely on ADI to make their applications more intelligent, more connected and more efficient. For example, in factory automation, our software configurable I/O solution is making the factory floor more flexible and configurable. The value creation opportunity is highly compelling. Customers have the potential to save more than $2 million per typical installation and factory downtime during line changeovers can be reduced by more than 8 weeks. As the factory floor further automates, ADI's opportunity in the area of robotics doubles with the addition of sensing, signal processing, power delivery and connectivity. A new application such as in collaborative robotics expand our available market by around $300 million over the next 5 years.

Switching now to automotive. This market represented 16% of revenue and increased over the prior year. ADI's dollar content opportunity in a vehicle today is approximately $250, but we believe we can more than double this by 2025 from emerging megatrends such as autonomous driving and the electrification of the powertrain. For autonomous and semi-autonomous vehicles, ADI's 77 gigahertz radar solution delivers the highest levels of resolution and sensitivity, increasing spatial accuracy by a factor of 8 while making the radar 3x smaller. In addition, the desire to make cars more energy-efficient is driving the electrification of the vehicle powertrain. Here, ADI's battery management products are 3x more accurate than competing solutions, enabling more miles per battery charge.

The communications infrastructure market totaled 18% of sales in the third quarter. By application area, sequential strength in wireline offset a slower wireless sector. ADI's portfolio of RF and microwave and high-speed signal processing, coupled with power, is unmatched in breadth and depth with products that span the entire frequency spectrum to 100 gigahertz and beyond. For example, our software-defined radio transceivers dramatically simplify the base station radio card through aggressive integration and software configuration. This solution enables higher channel density and reduces our customers' time-to-market. Today, ADI solutions are pervasive in 5G field trials and we are well-positioned to benefit from the wave of 5G deployments that we believe will begin in 2019.

The consumer market represented 17% of sales in the third quarter, increasing both sequentially and year-over-year across prosumer and portable consumer applications. We've built a strong consumer franchise that focuses on solving our customers' toughest engineering challenges, providing them with a high level of differentiation and, in turn, driving very strong profitability and free cash flow for ADI.

So in summary, this was an excellent quarter and we believe that we are better positioned than ever to drive long-term profitable growth and free cash flow.

So with that, I'd like to turn the call over to Ali for details of our financial performance in the quarter.

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

Okay. Thanks, Vince, and good morning, again, everyone.

Before we move to the quarterly results, please note that with the exception of nonoperating expense, my comments on the P&L line items exclude special items outlined in today's release and our web schedules can be found on the IR page.

Okay. So as Vince just outlined, this was another really solid quarter for ADI with all line items of the P&L exceeding the high end of our guidance range on very strong business performance and operational execution. So total revenue increased to $1.46 billion with a $393 million contribution from Linear Technology. ADI's standalone revenue increased 6% sequentially and 23% over the prior year and this reflected strong and broad-based demand, particularly in the industrial market.

Gross margins in the third quarter were 70.5%, above our guidance range, primarily on a higher industrial revenue mix and cost synergy capture.

Dollars of inventory increased $40 million sequentially as we ramped production to match strong demand, but on a days basis, inventory was stable at around 106 days.

Deferred revenue for shipments into distribution increased 11% sequentially and weeks of inventory in distribution were, again, at 7 weeks, which has been very consistent over many, many quarters now.

Operating expenses in the third quarter were $437 million or 30% of revenue and, as a result, operating margins expanded to 40.5%, which was above the high end of guidance.

Nonoperating expense in the third quarter was $68 million, reflecting a full quarter of interest expense with the financing related to the Linear Tech acquisition in place. Our expectation is for nonoperating expense to be approximately $65 million, both in the fourth quarter of 2017 and in the 14-week first quarter of 2018, and to decrease to $55 million to $60 million per quarter for the remainder of fiscal '18.

Our third quarter non-GAAP tax rate was 10.8%. We expect our fourth quarter non-GAAP tax rate to be approximately 10% and for it to be approximately 15% in 2018.

Diluted share count increased to 371 million shares in the third quarter, primarily due to the equity consideration relating to the acquisition. Excluding special items, diluted earnings per share in the third quarter of '17 was $1.26. That was $0.05 above the high end of guidance.

During the quarter, we completed a restructuring of our legal entities related to the Linear Tech acquisition. This resulted in a onetime cash payment of $750 million. Excluding this item, ADI generated $322 million of adjusted free cash flow in the quarter and $1.9 billion for the combined company on a trailing 12-month basis.

During the quarter, we paid down $600 million of the debt associated with the Linear Tech acquisition, which helped reduce our net debt-to-EBITDA ratio to 2.9x. We expect to pay down our debt at a rate of approximately $1 billion per year and are planning to achieve a 2x net debt-to-EBITDA leverage ratio by the first half of fiscal 2019. Once we achieve this leverage ratio, we plan to reinstitute or reinstate our share buyback program and target an overall cash return to shareholders of 80% to 100% after debt service.

So moving on to fixed asset additions, which in the third quarter were $64 million for the combined company and are planned to be approximately $200 million for fiscal '17. And this is probably a good opportunity to also point out that our model is for CapEx to run at approximately 4% of revenue on an ongoing basis.

During the quarter, we also paid $166 million in dividends and, earlier this week, our Board of Directors declared a quarterly cash dividend of $0.45 per outstanding share of common stock payable on September 19 to shareholders of record at the close of business on September 8. And that dividend payment now represents $1.80 per share annualized dividend payment.

Okay. So with that, I'll turn it back over to Vince for our outlook for the fourth quarter of '17, which exclude special items outlined in today's release.

Vincent T. Roche - *Analog Devices, Inc. - CEO, President and Director*

Thanks, Ali.

After a strong third quarter, we're planning for revenue in the fourth quarter of 2017 to be in the range of $1.45 billion to $1.55 billion. By end market, we're planning for the industrial and communications infrastructure sectors to be approximately flat sequentially and for the automotive and consumer markets to grow from their third quarter levels. Gross margins are expected to remain stable at approximately 70.5% as cost synergies offset the anticipated mix of revenue. Operating expenses are estimated to be down 3% to flat sequentially. At the midpoint of this guidance, these inputs translate into an operating expense ratio of approximately 29% and operating margins of approximately 42% in the fourth quarter. Based on these estimates and excluding special items, diluted earnings per share are planned to be in the range of $1.29 to $1.43.

As you likely saw as well, we recently announced our new CFO, Prashanth Mahendra-Rajah, who will be joining us at the end of September. I'm really looking forward to Prashanth's arrival and getting the benefit of his strategic insight and strong operational focus as we continue our long-term customer and shareholder value creation journey.

We believe that our organization, portfolio and customer relationships have never been in better shape and our technology never more essential to an ever more connected and intelligent world. Our operating model calls for some of the highest margins in our industry and, indeed, in the S&P 500. Operating margins that are in the range of 39% to 45% and free cash flow margins in the range of 34% to 42%. And we're only getting started.

So with that, we will take your questions.

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

Okay. Thanks, Vince.

So let's get to our Q&A session. (Operator Instructions) So operator, can we have our first question, please?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Tore Svanberg with Stifel.

Tore Svanberg - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

My first question is perhaps a bit more longer term for you, Vince. But as we now look at ADI, Linear and Hittite combined, can you give us any examples on how that combination really strengthens your barriers to entry? I mean, I know you're obviously working on a lot of new products with the 3 combined, but if you can give us any insight into how that positions ADI from a competitive perspective, that would be great.

Vincent T. Roche - *Analog Devices, Inc. - CEO, President and Director*

Yes, Tore. Well, if you look across the analog sector, we've now got all the building blocks focused at solving the toughest challenges that our customers face across every facets of -- whether it's sensing, measuring, interpreting, powering the signal chains. And that's the brand that we've been building for several years at ADI, that's the brand that both Hittite and the RF and microwave space and LT and the power and mixed signal space were building as well independently. So under one roof now, we can tackle our customers' toughest challenges, whether it's in communications infrastructure, in autonomous driving, in making our customers' installed factory automation and process control machines more intelligent, more connected. And clearly, that's the brand that we convey to our customers, that's the brand that our customers are buying and engaging with across all these different areas.

So we are investing around now $1 billion of combined R&D across the 3 enterprises under one roof. So we're all the time looking to broaden and deepen our competitive mold and we believe we're in a better position now than ever across all these various markets and with larger customers. And with the addition of LT as well, we now got the chance to directly address more medium-sized and smaller customers directly.

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

Tore, did you have a follow-up?

Tore Svanberg - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Yes. So there's -- I have a follow-up on the communications bucket. So obviously, that's been more mixed here the last few quarters. I assume that's more related to wireless infrastructure, but you mentioned 5G coming online and it seems like maybe it's coming online sooner at least than I was thinking. So maybe you could elaborate a little bit on when you start to -- when you expect to start to see more material growth in the communications part of the business?

Vincent T. Roche - *Analog Devices, Inc. - CEO, President and Director*

Yes. Well, Tore, we are playing in the field trials with virtually everybody today in the 5G area. My sense is that China and perhaps Japan will be first to market with 5G systems. And there are lots of definitions for what 5G really means, but I think the early systems will be massive MIMO-based, more like 4.5 plus, moving up to much higher frequencies over the next 5 years or so into the -- well into the gigahertz, the 20-, 30-gigahertz arena. So my sense is that 2019 is when we're going to see the first deployments in Asia in particular, and Europe and America a little bit longer, I think, to figure out exactly what standards and what frequencies they're going to target and to get into the field trial area.

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

Yes. And, Tore, I'll just to add, from a positioning standpoint, ADI's particularly well-positioned to benefit from these 5G deployments. Inherently, when you're enabling more bandwidth, you're going to need more radios, and that's really where we focus is on the radio. So the more radios that are out there, the better it is for ADI.

And secondly, as you're moving faster -- to faster speeds and higher standards, you need to move up the frequency spectrum. And so with our addition of the Hittite portfolio, we're particularly well-positioned as we move up the frequency spectrum in areas like microwave and millimeter wave.

Operator

Our next question is from Harlan Sur with JP Morgan.

Harlan Sur - *JP Morgan Chase & Co, Research Division - Senior Analyst*

In automotive core ADI, I think the team has been driving sort of solid year-over-year growth over the past few quarters. And I think, combined with Linear, you guys drove sort of mid-single digits year-over-year growth in Q3. And then, if I look at Q4, right, that typically tends to be stronger. You guys are guiding for growth, but that would imply sort of a range of sort of anywhere from low single digits to mid-single digits year-over-year growth in Q4. Just given the momentum that you guys have, rising content on new model deployments, should we anticipate that -- embedded within your guidance that auto is probably growing kind of more towards that mid-single digits year-over-year growth range?

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

Okay. Let me take part of that and maybe for the longer-term piece, I can let Vince answer that.

Okay. So in the quarter, automotive revenues were pretty stable sequentially. They were certainly ahead of the guidance range that we provided investors with. And it really was a tale of 2 cities in the automotive space or 2 businesses, frankly, because while the ADI standalone automotive business did, in fact, decrease in line with seasonality, again, on a sequential basis, the LTC automotive business recovered very, very strongly on a sequential basis. I call that because of a recovery in the powertrain sector specifically in China. So I think when you look at the tale of those 2 businesses combined, you see a pretty stable third quarter result.

On a year-over-year basis, the ADI standalone revenue did grow in the high single digits, but as we point out in the schedule that we provided you, it appears to look like a mid-single-digit growth rate. And again, it's because of the Linear Tech business that's lower on a year-over-year basis around this powertrain business. Again, we're seeing a pretty good recovery in that space right now. So that -- I just want to give you a little bit of color on how the quarter turned out.

In terms of the guidance for next quarter, all we can tell you, Harlan, is what we see in the order book and the order book supports a pretty seasonal fourth quarter. So it could be, on a year-over-year basis, anywhere from kind of the mid-single digits to high single-digit rate.

The one thing I would point out is there's obviously been a lot of noise around SAR and we obviously look at all that information as well and we have access to that data as well as you do. And I'd be perfectly candid with you to tell you that for -- we are Tier 2 suppliers into Tier 1 suppliers who are supplying to OEMs. I think if any semiconductor company sits around and tells you that SAR has a direct impact on their revenue, it's frankly very, very hard for us to tell. All we can tell you is what's in the order book and the order book supports a pretty seasonal quarter in the fourth quarter.

Harlan Sur - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Great. And then, just a quick follow-up. Same question I had last quarter, which is obviously you guys talked about distribution inventory still being very disciplined on lead times. Again, looking at some of your peers, there appears to be some pockets of products that are seeing tightness of supply. Last quarter, you guys talked about being very comfortable satisfying customer demand within your normal 4 to 6-week lead times. I'm just wondering if that's still the case?

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

Yes. Good question. We obviously pay a lot of attention to that particularly because it is a customer service commitment that we have. And so absolutely, the lead times have remained very stable at 4 to 6 weeks and really not a whole lot of change there. We do have about 3.5 months worth of inventory on our own balance sheet. We have 7 weeks of inventory in distribution. And I'd say those metrics have been very, very stable.

Operator

Our next question is from Ambrish Srivastava with BMO.

Ambrish Srivastava - *BMO Capital Markets Equity Research - MD of Semiconductor Research & Senior Research Analyst*

My question is on the Linear integration. And it looks like some of the synergies, especially on the margin front, are showing up earlier, but if I were to pick something that, at least to me, doesn't looked that positive is the free cash flow. And I'm not judging you on a quarterly basis. But even if I x out the onetime payment, free cash flow margin looks on the lower side. Could you please address that?

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

Yes. No, sure. And again, that's a metric that we look at very, very closely as well because even though we're at 34% free cash flow margins on a trailing 12-month basis -- and again, that is probably at the very high end of the S&P 500 -- I think the combination of these 2 businesses and how we think about the future here would suggest that we can really get these free cash flow margins really humming. So even though we're kind of at the high end of the free cash flow spectrum on the S&P 500, in terms of our free cash flow model, we're certainly at the lower end of that, which is 34% to 42% is the range.

So yes, I would just point out, as you mentioned, Ambrish, the -- looking at free cash flow in any one quarter is -- obviously has a lots of puts and takes to it. The third quarter tends to be a quarter that's a seasonally weaker quarter for free cash flow generation. We tend to have a couple of things that go on in the third quarter. So really the compare is to last year. And I think we were at 25% last year and we're probably around 22% this year.

There's a couple of items that are incremental, I guess, this year relative to last in the third quarter. One is we're obviously in a better business environment. And so when you do that, you tend to build inventory and ship inventory to customers, your accounts receivable goes up. Of course, all that converts into cash in the following quarter. But in any event, in the third quarter, we basically saw a use of cash in the working capital section of the free cash flow statement as a result of really better business conditions.

The other item I'd point out relative to last year is we are obviously carrying a debt load related to the acquisition. And related to that debt load, there are 2 really semiannual payments that we need to make related to that debt load. One of those payments falls in the third quarter. So I think you saw a depressed free cash flow number this quarter. It really was kind of the perfect storm for cash flow this quarter. But I think over the longer term, we're very well-positioned to drive our 34% to 42% free cash flow margin model range.

Did you have a follow-up?

Ambrish Srivastava - *BMO Capital Markets Equity Research - MD of Semiconductor Research & Senior Research Analyst*

Yes, I did. And you addressed the auto question that Harlan asked of you. But similarly on industrial -- and on industrial, we don't have any SAR number that we can look at and say, "Hey, look, SAR is at this and so your business should be doing this." How would you characterize what you're seeing in the industrial end market because there's obviously a whole bunch of cross currents there as well?

Vincent T. Roche - *Analog Devices, Inc. - CEO, President and Director*

Yes. I think, Ambrish, at this point, it's true to say -- I've talked with a lot of our -- the executives at our industrial customers over the last several months. I'd say there is generally optimism. I think people are pragmatic in terms of the CapEx environment, but what I will tell you is that there's a general sense that there's a better -- obviously a better economic environment in America, in particular for laying out CapEx and improving, I would say, the efficiency of the machinery, the installed base. So there's what our customers would call a brownfield upgrade in place. I think as well, China is on the track of mass automation, what they call China 2025, and that's having a huge effect obviously in our business in China and Japan.

So I think, overall, there's strength across all the various sectors, whether it's automation, aerospace and defense or ATE, and all the geos are doing well at this point in time. And I think there's a good balance between the consumption of our products and the supply of our products at this point in time.

Operator

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

Craig Andrew Ellis - *B. Riley & Co., LLC, Research Division - Senior MD & Director of Research*

Vince, I wanted to follow-up on a comment that you made in your prepared remarks regarding the automotive business and the potential for ADI content to double from now to the 2025 period. As investors look ahead to the next one to 2 years, where should they expect content to start to increase towards that $500 level from what is $250 now? What are the early signposts that they can look to for an increase in content?

Vincent T. Roche - *Analog Devices, Inc. - CEO, President and Director*

Yes, Craig. Good question. So obviously, autonomous driving, there are various levels of autonomous driving, but we're moving steadily towards a car that is using predictive safety more and more. So our radar solutions are doing well today and we have a great crop of new products at the very, very high-frequency level with tremendous spatial accuracy and very, very high channel count, so highly integrated. So that's one area where we will get a lot more penetration.

Obviously, we're able to attach the power solutions as well of LT into those areas. So that probably -- between the radar solution itself and the combination with LT, that probably doubles the available market, bringing LT doubles the available socket value for ADI, if you like, in the radar area.

We're starting to trial a solid-state LIDAR solution that will start to -- hopefully, in that period of time, over the next 5 years, we'll start to see some significant contribution in terms of revenue there. We've already announced new products that, A2B, for example, that move information around the car very efficiently and very cost-effectively. And we've more generations of that plus new variants of that coming.

On the electrification side, we've built a very attractive sensor portfolio -- magnetic sensor portfolio, for example, for controlling movement in the car and measuring movement in the car with a lot of attached precision signal processing. So those are some examples. And obviously, with the -- on the electrification theme as well, the addition of LT's battery controllers is very exciting to our customers across the globe. And again, there are many ongoing sockets that we've been supplying for many, many years in areas like infotainment, audio, video interface. So all those areas we're building a very, very nice pipeline, which gives us tremendous confidence.

Craig Andrew Ellis - *B. Riley & Co., LLC, Research Division - Senior MD & Director of Research*

Great. Ali, the follow-up question is for you. I appreciate the heads-up on the extra week in the fiscal first quarter of next year. As a backdrop to that, can you just help us, as you look at the combined business, what would normal seasonality be for the fiscal first quarter with Linear Tech in the portfolio?

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

Yes. No, I'd say it's -- that's a good question, Craig. I'd say the ADI B2B markets and the Linear Tech B2B markets probably are pretty similar in terms of how they would behave seasonally. We've also, by the way, put a schedule up on our IR page, which shows 3 years worth of data of what the combined company would have looked like by quarter. So we're also -- you guys can go and calculate the seasonality based on that data as well.

The way to think about the first quarter is, generally speaking, it's a pretty weak quarter. It's a January quarter for ADI so not only do we get the December holidays, but we also get the January holidays that impact that quarter. And generally speaking, it's weaker for industrial and automotive and communications infrastructure as well.

On the consumer side, I think if you kind of back into the fourth quarter guidance that we've given you for consumer, the year-over-year growth rate is down actually. So it's -- and I'd expect that weakness to continue in the first quarter and into the second quarter as well of next year.

But coming back to the point about seasonality in the first quarter, because we are expecting an additional week of revenue in the first quarter, I just tack in an additional week of revenue, additional week of OpEx. And then, the second quarter, generally you see a recovery in the industrial and automotive markets sequentially, although this time my sense is that recovery will probably be a little bit more muted just simply because you get the additional week in the first quarter. And consumer, generally you see a bit of a leg down from its first quarter levels. And then, the third and fourth quarters are, again, seasonally pretty stable for the B2B markets and consumer tends to recover. So that's probably the way to think about 2018 and the impact of the extra week and the 14-week quarter of 1Q '18.

Operator

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

Vivek Arya - *BofA Merrill Lynch, Research Division - Director*

First question on the consumer segment. It's good to see that it's now less than 20% of sales. But do you think it's at a point where your large portable customer have sort of stabilized somewhat on a content basis so we don't have to worry about any big fluctuations that are content-related? I understand the seasonal swings in consumer, but at what point can we start to finding normal seasonality and not have to worry about content swings at large customers?

Vincent T. Roche - *Analog Devices, Inc. - CEO, President and Director*

Yes. Well, as we talked about at the Analyst Day there a while ago, we are -- our sense is that our position in the portable space is strong in the areas that we care about. Obviously, the adoption cycles and the life cycles are shorter than in the areas like industrial, for example. So we have to -- there is a dynamic there where we have to fight for sockets continuously. But I think as we pointed out at the Analyst Day, we're expecting a level of stability at a lower run rate, perhaps down, in the portable area, of 20% in the coming year. That's what we're planning for and we're shooting for. And obviously, there may be upside to that, but that's how we think about it at this point in time.

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

Yes. I'll just add, Vivek. It's obvious. We have really no visibility into what 2018 is going to do in consumer, although we do have a good sense that our content in these devices is pretty platform-specific. And our sense is that, that mix is going to be weaker next year.

As Vince pointed out, frankly, we were asked at the Analyst Day as well, it's just very hard to model that business. And so I've heard estimates from analysts to be down, that business, 20% to 30%. Our sense is that 30% is probably a worse case scenario in the consumer space for next year.

Vivek Arya - *BofA Merrill Lynch, Research Division - Director*

Got it. Very helpful. And as my follow-up, now that you have achieved your 70%-plus kind of gross margin target, what are the next few milestones? And how should we think about the impact of mix versus utilization versus call synergies from here?

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

Yes. No, that's a good question. I think, Vivek, it's -- these 70.5% gross margins, 70-plus percent gross margins that we're putting up right now are a function of -- obviously, we're pretty well-utilized in our fabs given the current business conditions. In addition, the industrial market is really driving a lot of growth for us right now and that tends to drive pretty solid margins as well. In addition, we moved pretty early this quarter to capture some cost synergies in the gross margin line and that obviously helped as well.

I think, as we look into next year, if business conditions remain in there, if business conditions are led by the industrial market, we do have more synergies on to come on that gross margin line. We should do better. But again, it's all going to be very much specific to the environment that we're in next year.

Vivek Arya - *BofA Merrill Lynch, Research Division - Director*

Got it. So even if consumer declines next year, that should be helpful for gross margin line?

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

Well, I mean, I would say our margins across all of our businesses are actually quite good. So I don't expect that to be a big needle mover.

Operator

Our next question comes from Ross Seymore with Deutsche Bank.

Ross Clark Seymore - *Deutsche Bank AG, Research Division - MD*

Vince, one for you back on the industrial side. If I look at your growth year-over-year, I think the combined mix that you guys talked about has it up 27%. I think your guidance is up 10% to 20%, 25% year-over-year. That's really impressive, but almost so much so that I wonder if there's something company-specific going on. Is that -- that number is really about 2x what your competition is doing and much higher than anything you have done yourself in the last 5 years. So, I guess, given that, what's driving such strong growth? And how sustainable do you view that growth rate?

Vincent T. Roche - *Analog Devices, Inc. - CEO, President and Director*

Yes, Ross. I think there are a number of factors in the response here. Firstly, '16 wasn't a strong year, in particular on the industrial side of things. We have a strong play. We made a pivot as a company several years ago. We pivoted R&D and focus into areas like aerospace and defense. Hittite, obviously, has helped us a lot in the penetration of that space. Our automation business is strong across the globe. We've seen -- China has become a bigger part of what we do in the industrial area. So I think those things have helped us a lot. And obviously, with LT's focus as well, the mix of LT's business being skewed towards heavily B2B applications and particularly industrial, that helps everything. So I think there are a number of factors that are related to just a stronger market and ADI's position within the market.

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

Yes. And I'd just add to that, Ross. On a year-over-year basis, aerospace and defense and automated test equipment were up very, very strongly. And so we do have this broad base of customers and they've certainly done well as well, but we've also got a couple of these more programmatic areas like I just mentioned that really we're very strong on a year-over-year basis. And we look at these growth rates as well and we say, "Boy, this is really good growth. I would love to keep this going." But our sense is, at least from a supply chain perspective, that things are pretty stable, at least for the things that we can see. And I tend to look at the distie channels, see how that's doing, and that's been like clockwork at 7 weeks every quarter. And we did that again this quarter. So it's the best that we can tell you at this stage.

Ross Clark Seymore - *Deutsche Bank AG, Research Division - MD*

Great. I guess, as my follow-up, switching over to the Linear Tech side. I believe last quarter, you talked about having $20 million out of the original $100 million in OpEx synergies already captured. Can you give us an update on what you've captured so far?

And then, at your analyst meeting, a similar follow-up. You had -- you added $100 million with a longer time frame and made it a $250 million synergy target. Is that $100 million incremental more on the COGS side or more on the OpEx side?

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

Okay. Good question. So on the initial $150 million synergy that as, Ross, you point out, there was $20 million of public company costs that came out in the second quarter when we combined the companies. In the third quarter, there was an additional $20 million of synergies that we realized. And in the fourth quarter guidance -- and again, all this is embedded in the guidance -- there's an additional $45 million of cost synergies.

So the way to think about it is by the end of the fourth quarter, we would have realized $85 million of the $150 million. And of that $85 million, the split on the P&L would be approximately 2/3 in the OpEx line and about 1/3 in the cost of sales line. Now, there's still an additional $65 million remaining that we expect to start recognizing ratably in the first quarter of '18 and ending by the fourth quarter of '18. And displayed on that, we expect to be about 2/3 cost of sales and 1/3 OpEx. So that's $150 million locked and loaded. We are obviously recognizing and realizing those synergies a little faster than we perhaps pointed to in the past, but I'll take it.

And then, the $100 million of additional synergies that we talked about in the 3 to 5-year time frame, I would say we've identified those areas. I think, naturally, when you put 2 companies together, you're going to have efficiencies that take place and some of those are earlier, some of those are later. And in the 3 to 5-year time frame, we've got those synergies identified. It's just a question of communicating it to The Street and once we have that planned, we'll certainly do it.

Operator

Our next question comes from Craig Hettenbach with Morgan Stanley.

Craig Matthew Hettenbach - *Morgan Stanley, Research Division - VP*

Yes. I wanted to follow-up on the automotive side, particularly for BMS. Now that you have Linear's business in-house, just want to get a sense of just kind of design pipeline and how you're viewing that market over the intermediate to longer term.

Vincent T. Roche - *Analog Devices, Inc. - CEO, President and Director*

A lot of the activity, Craig, over the last couple of years for LT in that space has been in China and Asia in general. There has been an aggressive shift to penetrate the market as well in the U.S. and merging in Europe as well. So I would say given the pipeline, given the products that we have and given the penetration that we've got into some new areas as well, I think over the next 5 years it would be a significant growth contributor for ADI.

Craig Matthew Hettenbach - *Morgan Stanley, Research Division - VP*

Got it. And then, just want to follow-up on the CFO hire. Understanding Prashanth will be starting at the end of September, but just maybe just taking a step back and, Vince, if you could just shed light on kind of your process, how you evaluate different types of candidates and why you think he was the best fit for you?

Vincent T. Roche - *Analog Devices, Inc. - CEO, President and Director*

Yes. So first and foremost, I was looking for a very seasoned CFO with an understanding of the technology environment. In fact, Prashanth ticks all of those boxes. He's been in the world of technology for a quarter of a century. He's a chemical engineer by background. So I think -- and his track record has proven that he can run complex financial operations. And what I'm looking for is somebody to obviously run the financial operation of ADI flawlessly, make sure that we integrate LTC flawlessly and as well work with myself and the leadership team here at ADI to look for areas of trapped value that we can unlock in the years ahead. So I think as well Prashanth will be -- he will be a great cultural fit for ADI. And so we're obviously very excited to have him come on board in the next few weeks. And I think we have a world-class CFO now coming on board and with a great future ahead of us that he would help us unlock.

Operator

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

Amit Jawaharlaz Daryanani - *RBC Capital Markets, LLC, Research Division - Analyst*

I guess, a couple of questions. One, on the automotive side. I realize you guys are guiding for a seasonal recovery or improvement in the upcoming quarter. But given the improvement you're seeing in the powertrain side at Linear, which is a legal part of the revenue, why do you think growth is not better than seasonal trends in the upcoming quarter on automotive?

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

Yes. Amit, I would just point out all we can tell you is what we see in our order book and the order book supports the kind of guidance that we provided.

Did you have a follow-up?

Amit Jawaharlaz Daryanani - *RBC Capital Markets, LLC, Research Division - Analyst*

I do. I guess, just on the gross margin side, you guys had really impressive upside on gross margins this quarter in July, but as I look at October, you guys are kind of guiding flat gross margins despite revenues improving and the potential of Linear benefit. So beyond mix, I guess, what are the headwinds that might be there for gross margins in October?

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

Yes. So I think Vince mentioned it in his prepared remarks. We expect our growth in the fourth quarter to be led by the automotive and consumer markets. And those 2 markets tend to carry, again, very good gross margins, but they're slightly dilutive to the overall company. And so as a result, actually I think the great result that we can keep gross margin stable next quarter despite the mix or the anticipated mix. And the way we're going to do that is to realize more of the cost synergies like we talked about before.

All righty. Thanks, Amit.

Okay. So everybody, thanks for joining us this morning. A copy of this transcript will be available on our website and all available reconciliations and additional information can also be found on the Quarterly Results section of our Investor Relations site at investor.analog.com.

So thank you very much for dialing in and have a great Labor Day, everybody.

Operator

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