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ADI - Q3 2016 Analog Devices Inc Earnings Call

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OVERVIEW:

Co. reported 3Q16 revenue of \$870m and diluted EPS, excluding special items, of \$0.82. Expects 4Q16 revenue to be \$910-970m and non-GAAP diluted EPS to be \$0.84-0.94.



CORPORATE PARTICIPANTS

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

Dave Zinsner *Analog Devices Inc - CFO*

Vincent Roche *Analog Devices Inc - CEO*

CONFERENCE CALL PARTICIPANTS

Ambrish Srivastava *BMO Capital Markets - Analyst*

Tore Svanberg *Stifel Nicolaus - Analyst*

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

Craig Hettenbach *Morgan Stanley - Analyst*

Chris Danely *Citigroup - Analyst*

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

Amit Daryanani *RBC Capital Markets - Analyst*

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

Blayne Curtis *Barclays Capital - Analyst*

Ross Seymore *Deutsche Bank - Analyst*

Harlan Sur *JPMorgan - Analyst*

Cody Acree *Drexel Hamilton - Analyst*

David Wong *Wells Fargo Securities - Analyst*

John Pitzer *Credit Suisse - Analyst*

William Stein *SunTrust Robinson Humphrey - Analyst*

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

Shankar Iyer *BofA Merrill Lynch - Analyst*

Kristen Shak *Nomura Securities - Analyst*

Ian Ing *MKM Partners - Analyst*

Steven Chin *UBS - Analyst*

C.J. Muse *Evercore ISI - Analyst*

Toshiya Hari *Goldman Sachs - Analyst*

PRESENTATION

Operator

Good morning and welcome to the Analog Devices' third-quarter FY16 earnings conference call, which is being audio webcast via telephone and over the web. I'd like to now introduce your host for today's call, Mr. Ali Husain, Treasurer and Director of Investor Relations. Sir, the floor is yours.



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

Thank you, Jennifer. Good morning, everyone, and thank you for joining the Analog Devices' third-quarter FY16 earnings conference call. You can find our press release, relating financial schedules, and our investor toolkit, which includes additional information that we believe will be useful for investors. You can find that at investor.analog.com.

As usual I'm joined by ADI CEO Vincent Roche and ADI CFO Dave Zinsner. Before we start, let's get through some disclosures.

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 statement as a result of various factors including those discussed in our earnings release and our most recent 10-Q.

These forward-looking statements reflect our opinion as of the date of this call, and we undertake no obligation to update these forward-looking statements in light of new information or future events. Our comments today will also include non-GAAP financial measures, which we have reconciled to their most directly comparable GAAP financial measures in today's earnings release, which we've posted at investor.analog.com. And so with that, let's get started.

So revenue in the third quarter totaled \$870 million and exceeded our revised guidance. Revenue increased 12% sequentially and increased 1% from the prior year. Our B2B markets of industrial, automotive, and communications infrastructure in the aggregate were slightly down sequentially, but grew 4% over the prior year.

Now let's talk about our results by end-market. The highly diverse industrial market represented 43% of revenue in the third quarter. All industrial subsectors were stable to up sequentially in line with expectations, but the timing of customer orders in the aerospace and defense vertical led to a weaker than anticipated performance in this sector in the quarter.

The automotive market at 15% of revenue decreased 2% sequentially in the seasonally slower July quarter, but importantly returned to year-over-year growth increasing 3%. We believe the headwinds from the passive safety market have largely abated, and we're in fact very excited about our prospects for automotive revenue growth going forward.

Turning now to the communications infrastructure market, at 20% of revenue, sales to our hundreds of communications infrastructure customers were stable sequentially and grew 23% year over year. On a sequential basis, wireless infrastructure decreased while wireline infrastructure applications revenue increased, as customers continued to build out metro and inter-data center network infrastructure for 100 gig and 100 gig-plus optical networking.

Turning now to the consumer market. The consumer market typically drives significant ROI and free cash flow for ADI, and this market represented 21% of total sales in the quarter, increasing 131% sequentially. This strong sequential performance was due to better-than-anticipated portable consumer application revenue.

So now I'd like to turn the call back over to Dave for details of our financial performance in the third quarter of FY16.

With the exception of revenue and other expense, Dave's comments on our third-quarter P&L line items will exclude special items, which in the aggregate totaled \$28 million for the quarter. When comparing our third-quarter performance to our historical performance, special items are also excluded from prior-quarter and year-over-year results, and reconciliations of these non-GAAP measures to their comparable GAAP measures are included on Schedule E in today's earnings release.

So with that, Dave, I'll turn it over to you.

Dave Zinsner - *Analog Devices Inc - CFO*

Thanks, Ali, and good morning, everyone. The third quarter was a very good quarter for ADI, with revenue increasing to \$870 million and diluted earnings per share growing to \$0.82, with both results exceeding our revised guidance.

Gross margin of 66% increased 20 basis points from the prior quarter, as cost savings and lower spend in the fabs offset lower utilization rates and mix. Inventory on a dollars basis decreased \$7 million sequentially, and on a days basis decreased 16 days to 122 days. We're now expecting days of inventory to decline further in the fourth quarter and to be the range of 110 to 115 days, in line with our model.

Inventory in the distribution channel on a dollars basis was modestly higher than in the prior quarter, and on a weeks basis remained at seven weeks, consistent with the prior quarter.

Operating expenses increased 2% sequentially, lagging well behind the 12% sequential increase in revenue, as we continued to manage our expenses very tightly and gain operating leverage in our financial model. As a result, operating profit before tax of \$296 million increased 24% sequentially, and as a percent of sales, operating profit before tax expanded 330 basis points to 34.1%.

Other expense in the third quarter was approximately \$12 million. Given our recently announced acquisition of Linear Tech and related financing costs, we expect that our net interest expense will be approximately \$20 million in the fourth quarter, and remain at that quarterly run rate until we close the transaction.

Our third-quarter tax rate was approximately 10%, as we adjusted our full-year tax rate down slightly to 12%.

Excluding special items, our business delivered strong operating leverage, with diluted earnings per share of \$0.82 increasing 28% sequentially on a 12% increase in revenue. Diluted EPS increased 6% over the prior year.

At the end of the third quarter, our cash and short-term investment balance was \$3.8 billion, with \$860 million available domestically. We had approximately \$1.8 billion in debt outstanding, which resulted in a net cash position of \$2 billion.

Our business strategy and consistent financial execution enabled strong free cash flow generation, which supports investments in our business and the return of cash to shareholders.

Excluding a one-time item, over the past 12 months ADI has generated \$1.1 billion of free cash flow, effectively converting each dollar of revenue into \$0.32 of free cash flow, at the very high end of our free cash flow model range. In the third quarter alone, free cash flow margins expanded 600 basis points as compared to the prior year.

In terms of cash returns to shareholders, over the past 12 months we have returned approximately \$1 billion to shareholders through dividends and share repurchases, which represents a 90% free cash flow payout.

I want to now take a minute to talk about our capital allocation philosophy in light of the recently announced Linear Tech acquisition.

As we mentioned when we announced the deal, the combined Company's pro forma free cash flow on a trailing 12-month basis ending April 2016 would have increased from \$1 billion to \$1.7 billion. After the deal closes, we plan to use our combined cash generation to rapidly pay down the debt associated with the transaction.

As a result, we anticipate our net debt to EBITDA to go from 3.8 times at deal close to approximately 2 times net debt to EBITDA within three years of the transaction closing, which translates into an approximate \$1 billion per year expected debt paydown schedule.

In order to facilitate this rapid deleveraging, we have suspended our share repurchase program. That said, the dividend remains a cornerstone of our capital allocation philosophy, and we intend to maintain our dividend policy.

So in summary, this was a solid quarter on several fronts. We executed well in our business, and the diversity of our customers, applications, and markets, coupled with the sustainability of our innovation, enabled both revenue and diluted earnings per share to exceed our revised guidance. We are also very excited about the acquisition of Linear Tech, which we announced during the quarter, and I'll invite Vince to come on and say a few words in a minute.

Now turning to our outlook and expectations for the fourth quarter, which, with the exception of revenue expectations is on a non-GAAP basis and excludes special items that are outlined in today's release.

We are planning for another quarter of sequential revenue growth in the fourth quarter. In the B2B markets of industrial, automotive, and communications infrastructure we are planning for aggregate demand to remain stable sequentially, and on a year-over-year basis to increase in the low- to mid-single digits. In the consumer market, strong customer demand and increasing dollar content in portable applications leads us to plan for continued sequential growth in this market.

In total, we are planning for revenue in the fourth quarter to grow sequentially, and be in the range of \$910 million to \$970 million. We expect factory utilization in the fourth quarter to be similar to its third-quarter level as we manage our days of inventory, and so we are planning for gross margins in the fourth quarter to decrease approximately 50 basis points to 65.5% on the expected mix of business.

We are planning for operating expenses in the fourth quarter to increase slightly sequentially, but to significantly lag our expected sequential revenue growth in the fourth quarter, and for operating margins to expand from their third-quarter levels. Based on these estimates and excluding any special items, diluted earnings per share are planned to be in the range of \$0.84 to \$0.94.

Now before we move on to Q&A, I'd like to invite Vince to say a few words about the recently announced Linear Tech combination. Vince?

Vincent Roche - *Analog Devices Inc - CEO*

Great, thanks, Dave. As you know late last month we announced an agreement to acquire Linear Technology Corporation. This is a transformative acquisition that brings together the two best franchises in the analog industry, and once we combine our highly complementary portfolios, will make us a market leader across all major analog product categories.

Following last month's announcement, I've personally heard from many customers, from employees, and shareholders and the response has been overwhelmingly positive.

Our customers are excited to gain access to a comprehensive portfolio of the best brands in high-performance analog, the industry's best design engineers and FAE support, and the best-in-class supply chain all under one roof and with our continued commitment to the long-term support of our customers.

Our employees as well are very excited by the opportunities created by combining our two complementary suites of high-performance analog products and technologies. Beyond that, both companies have long admired the technical expertise and acumen of the other, and our teams are looking forward to the collaboration and innovation possibilities when combining two of the best engineering teams on the planet.

ADI and Linear are two amazing companies with very storied histories and vibrant cultures, and we plan to take the best of both companies to create something much greater than the sum of the parts. We have many ties that bind us. We both believe that innovation and a passion for our customers' success drives superior business results, and we share an intense focus on operational excellence across quality, reliability, supply chain, and of course financial returns.

As a result of this combination, our financial profile is expected to be among the best in the industry with strong margins and free cash flow, which we expect will increase over time as we realize the financial synergies and cross-selling opportunities inherent in this transaction. And as Dave mentioned, ADI's anticipated free cash flow generation is expected to increase significantly from current levels.



We believe that this combination is good for all of our stakeholders. For customers it will create a true innovation and support partner that is unmatched in the industry. For employees it will create a tremendous opportunity for professional growth and the ability to help redefine an industry. And for shareholders this acquisition will further diversify our end-market exposure and strengthen our business and financial profile. Notably, we expect this transaction to be immediately accretive to earnings and free cash flow, and anticipate non-GAAP EPS accretion of 10% right out of the gates.

There is no other team of people out there who could accomplish what we believe Analog and Linear will accomplish together, and I'm very excited to get started on the next phase of our journey together.

And so with that, we'll now start taking your questions.

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

Thanks, Vince.

(Caller instructions)

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Ambrish Srivastava, BMO Capital Markets.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Thank you very much. I had a quick clarification and then my question. Clarification, Dave, you mentioned on the dividend policy, you have been raising dividend consistently for as long as I can remember. You did mean to imply that you would be raising dividend consistently like you have in the past?

And then my question on autos, good to see the headwind from MEMS kind of abating. What are the areas that you are excited about as you alluded to that you should expect to see growth in that segment? Thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

Okay, I'll take the dividend question and I'll let Vince comment on the areas of automotive that we're excited about. On the dividend policy, as you know our model is to grow our dividend over time at a rate of 5% to 10%, and that continues to be our model.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Okay, thank you for that.



Vincent Roche - *Analog Devices Inc - CEO*

So okay on the automotive side, we play in three I would say premier spaces where innovation really matters. We play in powertrain, and there for example we have new sensor technology. We have an ongoing stream of growth in the battery management area.

We have new modalities such as AMR, for example, managing or measuring very, very accurately sensing measuring torque, for example, which is an important modality in the car. Also, our audio infotainment solutions are becoming more and more adopted across many, many platforms across the OEMs in the global market.

For example, recently we saw that -- you probably saw Ford announced our -- we've talked to you before about this A2B bus, a very, very efficient high integrity bus that's being used in the car to move media, audio media. Ford just announced with our brand the inclusion of that technology in two of their particular car models.

We've talked before as well about the growth of ADAS. We have a very strong position on 24 gigahertz radar solutions, microwave to bits, and we are starting to move with some very attractive solutions as well in the 77 gigahertz radar area. So I think we've a good spread of technologies across the various car platforms using our underlying strength in sensing, measuring, and interpreting in both the precision signal processing area as well as the very, very high speed signal processing area.

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

Thanks, Vince, and thanks, Ambrish, for the question. I think, Ambrish, you do highlight a good point which is if you actually look at our automotive business, excluding the passive safety area, we've actually grown that business in the high-single digits year over year in the quarter.

And I think that really speaks to the additional content that we're getting into vehicles now, as Vince mentioned. And that we are really excited about going forward as well.

So thanks for the question, and we'll get to the next caller please.

Operator

Tore Svanberg, Stifel.

Tore Svanberg - *Stifel Nicolaus - Analyst*

Yes thank you, great numbers. My question is on the consumer business. So up 130% sequentially.

Could you just talk about the dynamics there, how we should think about that business here in the back half of the year? Clearly a very volatile business, but yes, if there's anything you can add on the actual trends in the second half, that'd be great. Thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

So Tore, you mean trends in terms of how it's going to do next quarter you mean?

Tore Svanberg - *Stifel Nicolaus - Analyst*

Well, just obviously 130% is not the actual growth of that business.



Dave Zinsner - *Analog Devices Inc - CFO*

Right.

Tore Svanberg - *Stifel Nicolaus - Analyst*

How should we think about the volatility?

Dave Zinsner - *Analog Devices Inc - CFO*

I would say in the fourth quarter it's certainly going to be up again. That's going to be the driver of the sequential growth. Probably in the high 20%s, low 30%s sequentially. Then the next quarter, last year we declined about 60% I think sequentially.

But that was partially -- partially it's due obviously to seasonality, and then the other part of it is that there was a build of inventory last year in the fourth quarter and we had that kind of consumption of that inventory in the channel that affected demand for us. This year I think we have a closer linkage between supply and demand here on the consumer side.

And so I would expect us to decline seasonally in the first quarter, but only seasonally. I don't think we would have this ramp down due to overbuild in the inventory side of things in the supply chain. So it's probably going to be roughly half the rate of what we saw last year sequentially.

Vincent Roche - *Analog Devices Inc - CEO*

I think the way to look at this market overall, Tore, we take a long-term view to the consumer market like we do to all the markets in which we participate. We're picking out with our customers, we're picking the hardest problems to solve, we're pointing our technology at these problems, and we look for areas where we can get sustainability from generation to generation.

So we take a long-term view and then the market will do what the market does in terms of gyration. But I think in the areas that we're playing we're executing well and we've got some very, very exciting technologies in the pipeline as well for the future here.

Tore Svanberg - *Stifel Nicolaus - Analyst*

That's great color. Thank you.

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

Great, thanks, Tore, that was a great question. And then I just want to point out, as I think I mentioned in the prepared remarks, that business for ADI drives very strong ROI, very strong free cash flow business for the Company, and if you note that certainly consumer grew 131% or so sequentially, the operating margins for the Company also expanded -- for the entire Company expanded well over 300 basis points as a result. So great business to be in if you pick your spots. All right, we'll get to our next caller please.

Operator

Tristan Gerra, Baird.



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

Morning. Just a quick follow up on these consumer question. You've talked about some content increase, can you quantify this a little bit? Is it a mid-single digit content increase relative to what you had last year?

Dave Zinsner - *Analog Devices Inc - CFO*

It's about 30%.

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

Okay. Thank you.

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

Thanks for the question. Next caller please?

Operator

Craig Hettenbach, Morgan Stanley.

Craig Hettenbach - *Morgan Stanley - Analyst*

Yes, thank you. As you work towards the Linear Tech deal, can you give us an update on the Hittite integration, how it's going versus initial expectations a couple years ago. And then also just from a cross-selling perspective how that's performed and the opportunities that you have?

Dave Zinsner - *Analog Devices Inc - CFO*

Okay, so I'll talk about it from an operational standpoint and then Vince can talk big picture about how it's gone. Just operationally I would say we're pretty much fully integrated. We had expectations to get synergies that would drive the accretion up into the high teens, and we've actually been successful with that.

In fact we're actually a little bit ahead of where we thought we would be from an expense perspective. From a revenue pipeline perspective, we have seen a lot of activity in terms of design ins and in some case design wins where we have been either able to take products that Hittite sold and bring them into our customer base, or actually vice versa.

For example in the case of the military business they've actually been able to bring ADI parts into their customer base, and that's going quite well. I would say that's exceeding our expectations. I wouldn't say that it's shown up significantly on the revenue line just yet, nor did we expect it to.

This is -- these are markets that have long design schedules, but from everything we can tell just looking at how the activity has transpired from the time we closed to where we are today, we think we are ahead of where we thought we would be. I don't know if you have anything to add?

Vincent Roche - *Analog Devices Inc - CEO*

That's good color, Dave. I think we're approaching the LTC combination very much as we did with Hittite. We -- I think with both Hittite and LTC we share the same values essentially.



We're very innovation centered with very, very high standards in terms of how we execute in supply chain, quality, and financial returns. And that's not negotiable. That's what we strive for in these combinations.

Obviously the cultures are different, but I view the cultural diversity as an opportunity to improve both companies. When you get world-class companies who have been doing this very, very well as they were independently, you've got to listen very, very carefully to and understand what each side has been doing and do your best to combine the entities to create something greater than the sum of the parts.

We did that with Hittite, and that's the approach we're taking as well with LTC. When I look at the combination of Hittite with ADI for example with our customers in communications infrastructure, broad-based communications activity, in the instrumentation the aerospace and defense areas it's really exciting to see how we are now solving big problems from end to end.

We've got unique capabilities. I think we are probably the only high performance microwave to bits supplier out there that can run the gamut of technologies and solve big footprint radio problems for our customers.

So I think obviously with LTC, we get the real strength that they bring in the power area, and some of the mixed signal areas in the little niches. So my sense is we will take the very same approach as we did with Hittite, we've learned a lot as well through the process, and we will, as I said, listen very, very carefully to making sure that we understand the best practices and that we use them across technology, product development, supply chain quality, and customer support, of course.

Craig Hettenbach - *Morgan Stanley - Analyst*

Got it. Thank you.

Operator

Chris Danelly, Citigroup.

Chris Danelly - *Citigroup - Analyst*

Thanks. So if we incorporate your guidance for the individual product segments for the fiscal Q4 for FY6, I think comms, industrial, and auto are all essentially flat. So what growth would we expect for those three segments?

And you can just do relative if you want for FY17. And then how much would consumer be up -- would be expected to be up for FY17?

Dave Zinsner - *Analog Devices Inc - CFO*

Difficult to say at this point how all this stuff is going to transpire. We actually haven't done our plan or annual operating plan for 2017 yet, which is due to happen in the next couple of months. I would say that our expectation is that the industrial market grows normally in the mid-single digits GDP plus a little.

So I think that's how we're building it. Whether that happens in 2017 probably has more to do with how the macro does than anything, but I think it's a good rule of thumb to think about that growing and those rates. Automotive I think over time should be back into the levels that Ali talked about at the subsegments, which is to grow in the high single digits.

It's been way down a bit obviously by this passive safety business coming off. But that's running its course. It ceased to be the driver for automotive to stay flat. It's still going to be a little bit of a headwind, although a smaller headwind into next year.



But I think automotive has a chance to start to move. I think it grew a few percent or it will have grown a few percent this year. Probably grows mid-single digits next year and probably goes up to the high-single digits the following year, given all of the exciting opportunities we have that Vince talked about.

In the comms space it's anybody's guess I think. Over time we think that our technology, which is ahead of competitors, will allow us to drive share gains in that market. And so even if the market itself, the CapEx environment or the comms infrastructure market, is really low single digit CapEx increases year over year, we think we will grow faster than that because of our position in that marketplace.

And in the consumer market, obviously it was down, or should be down most likely year over year this year as we won't have the same inventory build we had last year, which kind of hit us this year. But I think next year has an opportunity to have a pretty decent year because this year was actually weighed down by the fact that they were digesting inventory in the first half of the year.

Next year that won't be the case. On top of that we'll get the full-year effect of the dollar content improvements that we got at the end of this year. So we're cautiously optimistic about the consumer business having a decent year next year.

Chris Danelly - Citigroup - Analyst

Great, thanks a lot, Dave.

Dave Zinsner - Analog Devices Inc - CFO

Sure.

Operator

Craig Ellis, B. Riley.

Craig Ellis - B. Riley & Co. - Analyst

Yes, thanks for taking the question. Dave, I was hoping you could just comment on the ends of the outlook range on revenues. Is the gap between the low end and the high end just allowing for still uncertain macro, or is it related to allowances in any of the segments for different types of build plan assumptions? And any color on what would swing things to the low end or high end would be greatly appreciated. Thank you.

Dave Zinsner - Analog Devices Inc - CFO

Good question, Craig. A part of it is the fact that consumer tends to have a little bit of uncertainty built in. We come in with quite a bit of backlog, but sometimes that backlog can shift around towards the end of the quarter a little bit, and that can affect the quarter number even though it doesn't affect the full build plan over time.

The other piece was you just have to build a little bit of cushion in for a macro uncertainty that might hit us at some point. We don't expect that, which is why the middle of the range is a pretty decent increase. But we did build in some cushion just in case something surprised us.

But I would tell you that we come in in a very good position from a backlog perspective, and with a wide range. We feel pretty good about them hitting the middle part of that range, and if things go better than that, we could hit the higher end of the range.



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

All right, Craig, thanks. Next question.

Operator

Amit Daryanani, RBC.

Amit Daryanani - RBC Capital Markets - Analyst

Thanks, good morning. Just a question on the industrial side. Sounds like part of the year where your decline was driven by this aerospace and defense orders getting pushed out of the timing and getting pushed out (technical difficulty), can you just talk about what sort of revenue did you end up missing in July quarter because of that? And is it logical to assume that you pick this back up in the October quarter and we would see better growth in the industrial segment in that case?

Dave Zinsner - Analog Devices Inc - CFO

Yes, so the industrial weakness was really, as Ali actually mentioned, it was really specific to the aerospace and defense. That's programmatic; sometimes in certain particular quarters they may not take as much as we have forecasted just by the timing of the programs. We do expect that to resume in the fourth quarter, come back in the fourth quarter.

And that was really the most significant impact. We didn't really expect industrial to have significant improvement sequentially. So it's not altogether surprising that we were down \$10 million. But it was in that range that -- where the miss occurred.

On the automotive side, I would say we hit where we thought we would. We thought we would be down around 3%, I think we're down sequentially down 2%. So we did actually do marginally better than we expected in the automotive space. So that is going I would say better than expected.

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

And let me give you a little color on the industrial segment, if I can. Really everything within the industrial space performed as we had expected. Everything was stable to slightly up sequentially.

Let me give you a little more color then. In North America, we had a good quarter in factory automation. We believe that's driven by a stabilization in the oil and gas space.

In China renewable energy did particularly well, and as Dave mentioned the aerospace and defense area hit a bit of an air pocket this quarter, but I think if you look at it on a trailing 12-month basis, that business has actually done very, very well for ADI. And really the acquisition of Hittite has really, as Vince mentioned earlier, reinvigorated that business for us.

We've got a guy who is running that business who's doing an amazing job with what I think is a pretty expensive portfolio in that area. So we think A&D is actually a growth market for us going forward. And there, customers are really looking at these old mechanical systems that are expensive and they're looking to replace them with higher performance, cheaper silicon solutions, and that really increases our content meaningfully in those systems over time.

I think looking at any of these markets in a quarter, particularly in the lumpy markets, can be fraught with peril. I think if you take a longer-term view I think these markets are doing pretty nicely for ADI. So, well, appreciate the question and next question.



Operator

Stacy Rasgon, Bernstein Research.

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

Hello, thanks for taking my questions. I guess in the current quarter you're mentioning about \$10 million offset from the aero, but you had originally guided the B2B business up in the mid to upper single digits.

\$10 million differential still wouldn't quite get you there. So I'm wondering what other areas in the quarter were potentially weaker than you thought? And I was also hoping if you could give us a little more color on a segment basis for what you would expect for next quarter beyond just the aggregate (technical difficulty)?

Dave Zinsner - *Analog Devices Inc - CFO*

Right. Well the other area that was a little less than planned was the communications market. It declined about 1% I think sequentially. We expected that business to be up this quarter.

I would say that was customer specific. There was one particular customer that did quite a bit weaker than expected.

Vincent Roche - *Analog Devices Inc - CEO*

On the wireless side.

Dave Zinsner - *Analog Devices Inc - CFO*

On the wireless side. And there was some color around India pushing out some of their infrastructure build outs that may have contributed to that. That was the other area that surprised us.

And then your other part of your question, Stacy, is how I expect the end markets to play out in the fourth quarter. I would think that -- we mentioned B2B was likely to be flat. I think the combination of industrial and auto is likely to be up a bit, and I think communications might be marginally weaker.

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

Thank you.

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

Next caller.

Operator

Blayne Curtis, Barclays.



Blayne Curtis - *Barclays Capital - Analyst*

Thanks for taking my question. Dave, you got interest income up throughout -- until the close of the deal. Could you just talk about what debt you're adding and at what interest rate? And does that come off the \$7.3 billion that you are planning on raising to acquire Linear?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, it's really just the -- so when we executed the agreement with Linear Tech to purchase Linear, we had to enter into an underwriting commitment with a set of banks so that the funding was essentially guaranteed. We haven't drawn any of the money, but banks don't agree to do that without you agreeing to pay them something.

So the step up from what was about \$12 million a quarter up to what is going to be around \$20 million, give or take, is really that cost of them providing that commitment, even though we haven't borrowed anything. That then goes away once we enter into the agreement with, or rather close the deal with Linear Tech. And then there'll be a new financing cost obviously, which is actually the drawn down amount, which as I indicated was going to be around 3% pretax on what will start out being \$11 billion but quickly pay down to about \$7 billion, \$7.5 billion.

Blayne Curtis - *Barclays Capital - Analyst*

Perfect. Thanks.

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

Thanks, Blayne.

Operator

Ross Seymore, Deutsche Bank.

Ross Seymore - *Deutsche Bank - Analyst*

Hello, just wanted to ask you a question on the communications area. That -- in past calls you've been pretty bullish about the expectations there. I know you talked about the wireless being weak in both the quarter and it seems like even in the guide you're talking comms being a little bit weaker. Can you talk about any confidence or what level of confidence you have in that communications segment growing going forward?

Vincent Roche - *Analog Devices Inc - CEO*

That's a good question. So we look at the comms infrastructure market in general as -- it's a very important market for ADI, and as always we take a long-term view to how we invest, how we pick our spots and how we invest there. So we're solving radio problems for our customers I believe with a level of completeness that is quite unique.

And with the addition of Hittite to our portfolio, we're very well positioned in microwave to bits, and of course with the addition of the Linear portfolio we're able to attach the high-performance power products, which will enable us to even offer more complete solutions to our customers. So I think the way to look at this market whatever happens with the short-term gyrations, the challenges that our customers are facing are really immense.

The problems are getting harder and harder from generation to generation. They're trying to solve the ongoing problem of spectral efficiency, information integrity, power efficiency. And those problems will persist, and we're in a better position than ever to solve these problems.

So the markets are going to gyrate, it's very, very hard to predict, it's quite a lumpy business as we always say, it's hard to predict quarter to quarter what's going to happen. But we view the whole comms infrastructure area as really the electricity of the modern economy.

The things that are under our control, how we innovate, how we engage with our customers, we're doing better there than ever. We continue to make improvements, and I believe we're poised to take share. So whatever the market does, we're poised to take share as the years move on here. So I think that's the way to view communications infrastructure.

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

All right, Ross. Thank you, good question. Next caller.

Operator

Harlan Sur, JPMorgan.

Harlan Sur - *JPMorgan - Analyst*

Morning, thanks for taking my question. Within your broad-based industrial business, can you just talk about the geographical demand trends you saw in Q3?

I know you touched upon some specific product drivers in certain geographies, but maybe just touch upon the broad geographical trends, particularly China, since I think your industrial business in China has been a strong driver over the last couple of quarters. And then maybe touch upon what's implied within the fourth quarter industrial guidance again, from a geographical perspective? Thank you.

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

Sure. Good question, Harlan, let me take that one. So by region I'd say North America and Europe were a little bit weaker sequentially. As I mentioned earlier, even though factory automation was quite strong in North America, our A&D business tends to be more focused in North America. So as a result of that being weak, North America ended up being a weaker region for us in the industrial space.

China was very strong again. As you mentioned it is a key area for us in the industrial space. That was strong on instrumentation applications, smart city, and energy type applications. Then as I mentioned earlier in North America factory automation was pretty strong on stable oil and gas.

As we look forward to the fourth quarter, it's actually an interesting question that you pose, because generally speaking the fourth quarter for industrial tends to be down in the mid-single digits. This time we're expecting industrial to be pretty stable to the third quarter levels. And there's a few reasons for that, why we're feeling I guess relatively bullish on that market in the next quarter. The aerospace and defense sector we expect to come back a little bit in the following quarter.

And frankly if you look at the orders in distribution, they are currently pretty strong. And I think if you compare that to some of the outlooks painted by some of the larger distributors out there, their book to bills are trending at parity or at above parity. So that would support the strong flows we're seeing in distribution.

So as a result I think when you package up all those disparate points, we come up with a view that next quarter the industrial market should be pretty stable to its third quarter levels here. So hopefully that answered the question, and we'll get to our next caller.



Operator

Cody Acree, Drexel Hamilton.

Cody Acree - *Drexel Hamilton - Analyst*

Thanks for taking my questions. With the Linear acquisition, what are your long-term thoughts on your capacity needs and how that might impact margins?

Dave Zinsner - *Analog Devices Inc - CFO*

Well, we'll have four fabs on a combined basis, and so we'll have plenty of capacity for the future demand of the business. We've had utilization down this quarter, expected to be down next quarter, probably will be down again in the first -- at this level in the first quarter again.

And then it steps up a bit. Their utilization is actually pretty good. So I think that for the foreseeable future, I think we feel pretty good about what our capacity looks like.

Vincent Roche - *Analog Devices Inc - CEO*

I think job number one when you think about fabs and foundry and so on, job number one is to make sure that across the huge breadth of SKUs that we've got that are very, very important to particularly our industrial and B2B customers, job number one is to make sure we have no supply chain disruptions whatsoever. Both LTC and ADI have -- we got very, very high scores for being able to supply a huge diversity of products over very, very long periods of time.

And that's a tremendous value to our customers. So job number one is to make sure that we don't diminish that value in any way. And as Dave said, we manage utilizations on a dynamic basis to make sure that we match supply and demand, and that will continue to be the way.

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

Yes, and I think it's worthy of mentioning here this transaction is to better serve our customers. So let's not lose sight of that. Okay, good question. We'll move on to our next caller.

Operator

David Wong, Wells Fargo

David Wong - *Wells Fargo Securities - Analyst*

Thanks very much. Can you give us some idea in the longer run how 5G might affect your content opportunity in comms infrastructure? Is there any additional opportunity, or are the systems essentially the same?

Vincent Roche - *Analog Devices Inc - CEO*

Well, apparently the demand for spectral efficiency is going to increase several orders of magnitude. And one of the methods that they're going to use to get there, obviously the bandwidth has got to increase, but we're going to be moving well into the microwave area. So the complexity of the problem is going to significantly increase in terms of all the things that we've been talking about in terms of spectral efficiency, power management, power efficiency, obviously cost per bit, and so on and so forth.

With each successive generation, there has been more pressure on the technology to deliver ever increasing levels of, as our customers would say, productivity, innovation productivity. So our belief, David, is that we're looking at orders of magnitude of complexity increase, which will continue to put pressure on our technology.

But that's in our wheelhouse. That's what we like. We like hard problems to solve. That's what we build our business on.

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

Great, thanks, David. Thank you. Next question.

Operator

John Pitzer, Credit Suisse.

John Pitzer - *Credit Suisse - Analyst*

Good morning, thanks for letting me ask a question. Dave, I wanted to go back to the consumer business. If I look at a year-over-year compare, July quarter consumer was down about 10%, the midpoint of your guidance is down close to 20% year over year.

And notwithstanding the inventory issues last year, I would have thought the July quarter would have been a more difficult compare quarter. Because my understanding was that July last year benefited from builds beginning early in the quarter throughout the quarter, and this year the July quarter really only benefited from the month of July builds for handsets. And so I'm hoping you can help circle, or square the circle there for me as to why year-over-year growth would be so much worse in the October quarter than the July quarter in the consumer business?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, simply put, John, we just had an inventory build that was pretty significant in the fourth quarter, and we do not expect hopefully to have that happen this time around. It'll be more closely aligned with demand.

I would say that we do have a range, and as you get to the higher end of the range that would suggest a lower, or I guess a lower year-over-year decline would be the way to describe it. So that's obviously a possibility, but not what we built into the plan or the midpoint of the forecast.

John Pitzer - *Credit Suisse - Analyst*

And Dave, did the July quarter only benefit from builds in the month of July, or did builds happen earlier in July quarter than we thought? Or than you initially thought on the last conference call?

Dave Zinsner - *Analog Devices Inc - CFO*

No, it was definitely more of a July ramp in the third quarter. I would say that probably on a weekly basis, it was probably at a higher level than it was last year on a direct compare of the months of July for this year and last year.

John Pitzer - *Credit Suisse - Analyst*

Thank you.



Dave Zinsner - *Analog Devices Inc - CFO*

Sure.

Operator

William Stein, SunTrust.

William Stein - *SunTrust Robinson Humphrey - Analyst*

Great, thanks for squeezing me in. Quick one around Linear acquisition. First, can you remind us of the timing, expected timing to close? And Dave, can you also relate your early experiences coming to ADI, and then also your experiences working to help integrate Hittite, and maybe string a narrative as to the types of things we should expect to hear around integration when that begins?

Dave Zinsner - *Analog Devices Inc - CFO*

Okay. I'll let Ali talk about the timing piece.

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

Sounds good. Yes, I realize that question is top of mind regarding timing, but we're not going to comment on the regulatory approval process at this stage. You'll see the conditions to the closing the transaction, including required regulatory filings.

They're all going to be in the form S4 registration statement and the proxy statement that ADI and Linear are going to be filing in connection with the merger in the upcoming weeks. So that takes care of the timing. Dave?

Dave Zinsner - *Analog Devices Inc - CFO*

Good lawyered up comment, Ali.

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

I'm a good reader. (laughter)

Dave Zinsner - *Analog Devices Inc - CFO*

On the integration side, obviously this is going to be different. It's bigger. It's on a different coast, so it's not quite as -- it's not in our backyard. So we have that aspect to things. But I would say fundamentally it's going to be similar.

What I think we do is we buy really good companies, and really good companies don't need to be fixed. And so what we try to do is take the best aspects of each company and leverage them in the combined company to make something better than the sum of the parts. That's really what we intend to do.



We're just in the initial planning stages as we speak. We'll probably have a more formalized plan as we work with our compatriots over there at Linear Tech to help form a good integration plan together. And I think that will take the better part of the rest of our fiscal year to really come to conclusion on.

And then once we do have I think a more clear plan, we'll definitely communicate that to investors and to analysts. But at the moment, I think just our fundamental premise is take the best of both companies and make a better company is really how it's going to -- the main ethos of the integration. I think it's going to go well.

I think we did a great job at Hittite doing those same things, and every integration is different, but I think the elements of that process are pretty much going to be the way we approach it this time. And so I suspect it's going to be a really great combination.

Just the early reads from every customer we've heard from, our employees, as we've been able to talk clearly to the Linear Tech, we haven't gotten to every Linear Tech employee yet, but the ones we have talked to I think they get the excitement of what this could mean. And so I think it's going to be a tremendous combination.

William Stein - *SunTrust Robinson Humphrey - Analyst*

Thank you.

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

Thank you. And I saw Dave dropped a "tremendous" a la Donald Trump. (laughter) Good question.

Operator

Steve Smigie, Raymond James.

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

Great. Thanks a lot. Vince, I was hoping you could maybe give a high-level strategy comment? ADI has obviously been very strong over the years in analog to digital converters, good amplifier portfolio with Linear adding as you mentioned fantastic power.

So it seems you've got pretty much the soup to nuts great stuff on analog. As we think about increasing IOT applications out there, which I know traditionally hasn't been a big market for you, but as we think about that does starting to invest more in digital make sense, maybe ramping up investment in DSP? I was curious your high-level thoughts on where you go after you've got the complete analog portfolio here?

Vincent Roche - *Analog Devices Inc - CEO*

Yes, great question. Good question, Steve. So we view the IOT, it is the great latest marketing buzz in the world of semiconductors today, but we view IOT as really an extension of the things we already do. So there's a need for precise sensing, precise signal conditioning, and conversion at ultra low power levels.

And our customers are asking us for -- to be able to take some of the bits we generate and develop information to interpret the bits and give them information, which we do in areas for example like reliable healthcare monitoring. So I think the way to view it is we've got a platform of technologies that we apply to industrial applications. Take industrial automation for example. So we've got the conversion technology, signal conditioning, amplification, we've got processing, both on the DSP side.

We've fixed function processing that we developed. We're quite a large user of ARM technologies, for example. A lot of our products now use MCUs, very, very low power MCUs which we tailor for our applications. The RF technologies that we can bring to bear for the conductivity, and obviously power management is a core part of the overall solution as well.

So the underlying foundation of silicon technologies will be supplemented over time with more algorithmic technology, and Lyric, for example, that we acquired several years ago, is a key player in enabling us to bring algorithmic technology to bear. We're looking at how we make each -- anything that gets connected needs security.

So as connectivity in the IOT sector is synonymous, it needs security. So that's something that we're actually experimenting with. We're looking at possibilities to acquire some technology there as well.

So that's -- what I've described to you is we've got a very, very broad base of technologies that are enabling ADI in our traditional markets, these more connected IOT markets, where sensing, measuring, and interpreting is very, very important. And we're looking for token technologies and organic developments to move ADI further up the stack for example into the interpretation using algorithmic technology as well as security and communications.

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

Thank you.

Vincent Roche - *Analog Devices Inc - CEO*

Hopefully that helps you.

Operator

Vivek Arya, Bank of America

Shankar Iyer - *BofA Merrill Lynch - Analyst*

Hi, thanks for letting me ask a question. This is Shankar on behalf of Vivek. Lot of good questions asked about the segments, but I just want to ask about the OpEx side of things.

You mentioned you're having a tight OpEx control right now in Q3, and Q4 is [just skyerd] to flat to up. But given Linear deal, are you going to be focused on keeping the OpEx at current levels until the deal close? Could you just talk about the trends from Q4 to middle of next year, and then how you think about the business long term?

Dave Zinsner - *Analog Devices Inc - CFO*

Okay. I think when history is written on 2016, we will have been roughly flat year over year in OpEx. I think I concur with you, that's pretty good OpEx control. I think our goal is really to be largely flat next year at the ADI level, and what we'll do is in certain cases reprioritize our investments into areas that we're more confident around the growth levels and shift things around as appropriate, and not seek to add a lot of resources, particularly as we're going to get a whole bunch of resources hopefully by the middle of next year in the form of Linear Tech employees.

So that's the goal. It's likely, that likely means that OpEx normally comes down in the first quarter just because the revenue comes down, and then it pops back up in the second quarter if revenue is seasonal. But roughly in these zip codes, plus or minus \$10 million from where we are today.



Vincent Roche - *Analog Devices Inc - CEO*

Needless to say we're operating as two independent businesses until we close. So we're all the time, we're very opportunity rich as a company, and we are all the time looking to pick the best opportunities, make sure they're properly funded, and we are always looking for talent. So within the boundaries of an OpEx model that is spending 18% or 19% in R&D, that's what we intend to do and scale it with revenue growth over time.

Shankar Iyer - *BofA Merrill Lynch - Analyst*

All right, thank you.

Operator

Romit Shah, Nomura.

Kristen Shak - *Nomura Securities - Analyst*

This is [Kristen Shak] in for Romit. Congrats on the great quarter. Just to go back to the consumer segment for a little bit, how did your consumer business outside of your largest North American handset customer perform?

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

Yes, I can take that one. I would tell you as we enter the back half of the year for ADI, the consumer business has some positive seasonality. And so it actually performed quite nicely on a sequential basis, and was about stable to the prior year. So hopefully that's helpful and we can get to the next question.

Operator

Ian Ing, MKM Partners.

Vincent Roche - *Analog Devices Inc - CEO*

Ian, you there?

Ian Ing - *MKM Partners - Analyst*

Yes, thanks a lot. I believe at one point you gave a full-year CapEx target of \$140 million to \$150 million. You're running below that. Is that because of the Linear deal, perhaps getting access to some equipment and factory output and maybe there's some spending you won't need here?

Dave Zinsner - *Analog Devices Inc - CFO*

No, we just generally send a budget that we're going to spend at 4% of revenue, and I think coming into the year we thought -- we didn't suspect this air pocket we'd run into on the consumer side. And so we had a higher expectation on CapEx.

But given that the revenue was a bit lower, we lowered the CapEx too so we could maintain the 4%.



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

So that new number is somewhere in the range of \$130 million to \$135 million for the year. Thanks, Ian. Good question. Next caller, please.

Operator

Steven Chin, UBS.

Steven Chin - *UBS - Analyst*

Thanks for taking my question. Just given some of the color earlier on some of the growth in your wired infrastructure business because of the 100 gig optical, I was wondering if you could provide some more color on whether that's primarily driven by hyperscale data center customers or if there's some telco carrier CapEx driving that as well?

And related to that, looking forward is that pretty much running in line with demand, or is there some big element of capacity build ahead or build out for consumption later on this year? Thanks.

Vincent Roche - *Analog Devices Inc - CEO*

Yes, good question. It's driven by demand. I think there's a very, very good balance between what we're seeing in terms of demand and supply. There's obviously a huge amount of activity in the inter-data center connectivity, and we're participating in that with our customers.

Also long haul and metro build outs, and I think there's a good balance between the three, but it seems that the data center is hotter at this point in time, and it looks like it will be a wave for several years to come. So I think it's a good mix and very good balance between demand and supply here.

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

All right, Steven, thanks. Next caller.

Operator

CJ Muse, Evercore.

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

Yes, good morning. Thank you for squeezing me in. I guess a quick question around the Linear merger. Curious what kind of conversations if any you've had in terms of locking up talent there? And as you think about your compensation plan versus theirs, what are the implications to OpEx going forward?

Vincent Roche - *Analog Devices Inc - CEO*

We're operating as two separate companies until we close. Obviously when you look at both companies actually we've had tremendous -- we've got tremendously long tenure in both companies, and the attrition rates run very, very, very low in both companies. And I expect that to be -- that will maintain its pace for many, many years to come.



People remain with these companies because we do exciting things. We solve big, big hard problems, we've got very strong cultures, and I believe that just as it was so with Hittite and ADI, it is our goal to make sure that we win the hearts and minds of all of our engineers who really create the value for both companies. And I'm very confident about that based on the conversations I've so far had with LTC leadership, and I see that as being a tremendous value and strength of both companies.

Dave Zinsner - *Analog Devices Inc - CFO*

I would say that from an OpEx management perspective, we run into this every time we integrate a company. There are always slight differences in terms of how the compensation works, and I think we're pretty good at figuring out a way that we can do it that works for employees and keeps them energized and engaged and simultaneously doesn't have an impact on our total OpEx and our ability to manage our OpEx appropriately.

So we haven't worked out the particulars of that; that will also be done over the coming months. But I feel pretty confident that we'll be able to address employees' concerns and shareholders' concerns and come up with something that's optimal.

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

Thanks, CJ. Okay, so we're past 11 AM here Eastern, so that means we have time for one last caller.

Operator

Toshiya Hari, Goldman Sachs.

Toshiya Hari - *Goldman Sachs - Analyst*

Good morning, and thanks for squeezing me in. I was hoping you could talk a little bit about your content win and consumer. Where are you seeing the design wins?

How fast is content this year growing relative to last year, and how sustainable is that rate of growth going into next year? Thank you so much.

Dave Zinsner - *Analog Devices Inc - CFO*

As I said, the content increase is 30%. We can't get into the details. We have confidentiality requirements with our customers that don't allow us to go into any more detail other than that.

Vincent Roche - *Analog Devices Inc - CEO*

The wins are consistent with our stated strategy. We play in really, really high quality problem areas in the user experience. And the wins we've had are very, very consistent with that stated strategy.

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

Okay, great. That was the last question. As a reminder, our fourth-quarter and FY16 results will be issued on Wednesday, November 22 at 8 AM Eastern, and the earnings call will begin two hours later at 10 AM Eastern.

So that's it from us from Norwood, Massachusetts. Thanks for joining us this morning. We'll talk to you soon.



Operator

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

Editor

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In connection with the proposed transaction, Analog Devices and Linear Technology intend to file relevant information with the SEC, including a registration statement of Analog Devices on Form S-4 (the "registration statement") that will include a prospectus of Analog Devices and a proxy statement of Linear Technology (the "proxy statement/prospectus"). INVESTORS AND SECURITY HOLDERS OF LINEAR TECHNOLOGY ARE URGED TO CAREFULLY READ THE ENTIRE REGISTRATION STATEMENT AND PROXY STATEMENT/PROSPECTUS AND OTHER RELEVANT DOCUMENTS FILED WITH THE SEC WHEN THEY BECOME AVAILABLE, BECAUSE THEY WILL CONTAIN IMPORTANT INFORMATION ABOUT ANALOG DEVICES, LINEAR TECHNOLOGY AND THE PROPOSED TRANSACTION. A definitive proxy statement/prospectus will be sent to Linear Technology's shareholders. The registration statement, proxy statement/prospectus and other documents filed by Analog Devices with the SEC may be obtained free of charge at Analog Devices' website at www.analog.com or at the SEC's website at www.sec.gov. These documents may also be obtained free of charge from Analog Devices by requesting them by mail at Analog Devices, Inc., One Technology Way, P.O. Box 9106, Norwood, MA 02062-9106, Attention: Investor Relations, or by telephone at (781) 461-3282. The documents filed by Linear Technology with the SEC may be obtained free of charge at Linear Technology's website at www.linear.com or at the SEC's website at www.sec.gov. These documents may also be obtained free of charge from Linear Technology by requesting them by mail at Linear Technology Corporation, 1630 McCarthy Blvd., Milpitas, CA, 95035-7417, Attention: Investor Relations, or by telephone at (408) 432-2407.



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Linear Technology, Analog Devices and certain of their directors, executive officers and employees may be deemed participants in the solicitation of proxies from Linear Technology shareholders in connection with the proposed transaction. Information regarding the persons who may be deemed to be participants in the solicitation of Linear Technology shareholders in connection with the proposed transaction, including a description of their direct or indirect interests, by security holdings or otherwise, will be set forth in the proxy statement/prospectus when it is filed with the SEC. Information about the directors and executive officers of Analog Devices and their ownership of Analog Devices' common stock is set forth in the definitive proxy statement for the Analog Devices' 2016 annual meeting of shareholders, as previously filed with the SEC on January 28, 2016. Information about the directors and executive officers of Linear Technology and their ownership of Linear Technology common stock is set forth in the definitive proxy statement for Linear Technology's 2015 annual meeting of shareholders, as previously filed with the SEC on September 17, 2015. Free copies of these documents may be obtained as described in the paragraphs above.

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