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ADI - Q1 2016 Analog Devices Inc Earnings Call

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OVERVIEW:

ADI reported 1Q16 revenue of $769m and diluted EPS, excluding special items, of $0.56. Co. expects 2Q16 revenue to be in negative 2% to plus 4% range sequentially and diluted EPS, excluding any special items, to be $0.58-0.66.

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PRESENTATION

Operator

Good morning, my name is Jennifer and I will be your conference facilitator. At this time I would like to welcome everyone to Analog Devices' first-quarter and FY16 earnings conference call.

(Operator Instructions)

I would now like to turn the conference over to your host for today, Mr. Ali Husain, Treasurer and Director of Investor Relations. Please proceed.

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

Good morning. Thanks, Jennifer, and good morning, everyone. Thanks for joining ADI's first-quarter 2016 conference call. You can find our press release, relating financial schedules, and our investor tool kit at investor.analog.com.

As usual I'm joined this morning by ADI's CEO Vincent Roche, ADI's CFO Dave Zinsner. The format for today's call will be slightly different. Today's prepared remarks will be relatively short because we want to devote most of the call to Q&A.

Before we start let's get through some disclosures. Please note the information we're about to discuss, including our objectives and outlook, includes forward-looking statements.

Actual results may differ materially from these forward-looking statements as a result of various factors, including those discussed in our earnings release and our most recent 10-Q. These forward-looking statements reflect our opinion as of the date of this call, and we undertake no obligation to update these forward-looking statements in light of new information or future events.

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

So as you've likely seen, revenue in the first quarter totaled $769 million, which was about even to the same period in the prior year. Compared to the prior quarter, revenue decreased 21%, but this sequential revenue performance masked what was really a tale of two narratives.

While weakness in the consumer portable sector exacerbated what is typical seasonal weakness within the consumer market, our business to business, or B2B markets, of industrial, automotive, and communications infrastructure combined to perform in line with our expectations. So let me give you a little color on our performance.

The industrial market at 45% of revenue decreased 5% sequentially during the seasonally weaker first quarter, which was a good result in a challenging macro environment. Compared to the prior year, the industrial market was stable.

The automotive market at 16% of revenue decreased 4% sequentially, with all sectors flat to down and in line with seasonal patterns. As compared to the same period in the prior year, revenue from ADAS, or advanced driver assistance systems, increased 22%, power train sector revenue grew 8%, and infotainment sector revenue increased 6%.

Turning now to communications infrastructure, revenue in this market increased 4% sequentially, which was well ahead of seasonal patterns. Revenue from both wireless and wireline infrastructure customers increased sequentially, as we believe the trough in the wireless market turns into a nascent recovery.

As compared to the prior year, wireless revenues decreased while revenue from wireline customers increased. In total, ADI's B2B markets decreased 3% sequentially.

Now in the consumer market revenues decreased 60% sequentially to $126 million, and this market represented 16% of sales. While prosumer audio video applications decreased in line with seasonal patterns, revenue from portable consumer applications declined significantly as a result of weaker than forecasted customer demand in this sector after a prior-quarter performance that had far exceeded expectations.

Now I'll turn the call over to Dave for details of our financial performance in 1Q 2016. With the exception of revenue, Dave's comments on our first quarter P&L line items will exclude special items which in the aggregate totaled $22 million for the quarter.

When comparing our first-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 release. So Dave, over to you.

Dave Zinsner - *Analog Devices Inc - CFO*

Thanks, Ali. The first quarter was a challenging quarter as we executed through weaker economic conditions and significant weakness in the portable consumer electronics sector. Nevertheless, our B2B markets combined to perform in line with our expectations, and we repurchased $132 million of our shares in response to stock price volatility, which helped reduce our share count by approximately 1%.

Revenue in the first quarter totaled $769 million, and diluted earnings per share was $0.56. Gross margin of 62.2% decreased 350 basis points from the prior quarter, primarily on higher inventory reserves and lower utilization rates.

Inventory on a dollars basis decreased $7 million sequentially, and on a day's basis was 128 days on lower sales. Utilization rates in the first quarter were in the mid 50%s, and we are planning to increase utilization to the high 60%s in the second quarter.

Weeks of inventory and distribution were approximately seven and a half weeks, consistent with the prior quarter. Operating expenses of approximately $265 million declined $27 million, or 9% sequentially, and were flat to the prior year as we continued to carefully manage expenses.

Operating profit before tax of $214 million, or 27.8% of sales, decreased from both the prior quarter and the year-ago period. Other expense was approximately $10 million, as we raised $1.25 billion in 10-year and 30-year notes.

We expect our net interest expense for the remainder of FY16 to be approximately $15 million per quarter. Our first quarter tax rate was approximately 13%, which we expect will be our tax rate for the remainder of FY16.

Excluding special items, diluted earnings per share was $0.56, which was a decrease of 11% as compared to the prior year on higher inventory reserves and interest expense. Nevertheless, our strong financial model continued to generate solid cash flows, which we used to enhance shareholder returns.

Excluding a one-time payment relating to the conversion of our Irish pension plan, over the past 12 months ADI has generated free cash flow of $1 billion, or 30% of sales, and we have returned $800 million to shareholders through dividends and share buybacks. The first quarter was also a strong working capital quarter, during which free cash flow as a percent of revenue increased to 26% up from 19% in the prior year, which is an increase of approximately 700 basis points.

Capital additions in the first quarter were $23 million, or 3% of revenue, and we are planning for capital additions in 2016 to be in the range of $130 million to $150 million. In line with our capital allocation strategy, our Board of Directors approved a $0.02 increase in the quarterly dividend to $0.42 per share, which is payable on March 8, 2016.

This dividend represents the 13th dividend increase in the last 12 years. At the current stock price, our dividend yield is approximately 3.2%.

Our Board also increased the authorization under our stock repurchase program to $1 billion, as we plan to continue to repurchase our stock during periods of stock price volatility. We ended the quarter with a cash and short-term investment balance of $3.8 billion, with approximately $1.2 billion available domestically.

We had approximately $1.7 billion in debt outstanding, which resulted in a net cash position of $2.1 billion. Now turning to our outlook for the second 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.

While we are cautious about the macroeconomic environment, current order trends in the industrial, automotive, and communications infrastructure markets suggest combined sequential revenue growth in these B2B markets to be in the mid- to high-single digits in the second quarter. In consumer, we are expecting another quarter of sequential weakness within the portable sector of this market.

In the aggregate, we are planning for revenue in the second quarter to be in the range of minus 2% to plus 4% sequentially. Gross margins are expected to increase to approximately 65.5% in the second quarter on higher utilization, a more favorable mix, and lower expected inventory reserves as compared to the first quarter.

We estimate that operating expenses will be up slightly in the second quarter, and as a result for operating margins to expand sequentially. Based on these estimates and excluding any special items, diluted earnings per share are planned to be in the range of $0.58 to $0.66, which at the midpoint would represent an 11% sequential increase in EPS.

We are currently operating at the lower end of our financial leverage model range, and we are carefully managing production levels and operating expenses. As business conditions improve, we should drive better operating leverage.

Overall, we estimate that we have approximately 800 basis points of operating leverage remaining on our financial model based on our first-quarter exit rates. While near-term market headlines warrant caution, we believe our future prospects remain strong.

We have been deepening and broadening our customer engagements while investing in our most critical technology vectors to support our long-term growth. And together with our operating model, these place ADI on a strong platform to achieve up to $5 in non-GAAP earnings by 2020. And so now I'll turn the call back over to Ali.

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

Great. Thanks, Dave. So folks, before we get to Q&A let's run through the format. Please limit yourself to one question.

If you have a follow-up please requeue. And again, we do this in the spirit of fairness so that all callers get to ask at least one of their questions. We plan to run the call until 11.

I think that's plenty of time to get to everyone's questions. So with that, operator, let's start the Q&A session. Folks on the line can ask questions of either Vince, Dave, or myself.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Ambrish Srivastava with BMO Capital Markets.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Thank you, good morning, folks. I had a long-term question on the automotive segment for any of you gents who could answer. Autos has been a great business for you long term. Last year didn't grow.

Can you help us -- sorry. I'm in a hotel room. Can you please help us understand where the business' position in some of the newer areas such as ADAS, self-driving push, safety -- so in a sense what drove the business in the last five years, and what should we be looking at in the future? Thank you.

Vincent Roche - *Analog Devices Inc - CEO*

Yes, well Ambrish, as you know our automotive business has three major components to it. One is the infotainment sector, which is largely built around audio and media products.

We have a strong power train business, which in the past number of years has been driven really by our strength in battery monitoring and control. And last but not least the safety business, which has three major components; passive safety and active safety, which are largely MEMS based activities, and advanced driver assistance.

I can tell you that all those sectors grew over the last several years. The infotainment area has grown in the high single digits, same thing with the power train business. And where we run into headwinds really is on the MEMS side of the safety business.

The advanced driver assistance piece in fact has been growing at a rate of about 20% over the last two or three years. And in the MEMS area specifically, we have been very careful to exit parts of the business that we're commoditizing and focusing our R&D in areas where we can get the returns on performance-driven products.

That's where we've suffered the headwind, and it provided a dampening effect over the last year in particular. My sense is based on what I hear from customers, what I hear -- what our business units are predicting, is that in the latter half of this year we'll be back into I think a pretty solid growth pattern with regard to automotive in general across all those three sectors.

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

Great. Thanks, Ambrish, and let's get to our next caller.

Operator

Our next question comes from Tore Svanberg with Stifel.

Tore Svanberg - *Stifel Nicolaus - Analyst*

Yes, thank you. You talked about order rates in your B2B business being stable in spite of the macro climate.

Could you talk a little bit more about the linearity of those bookings? Are they coming in in line with seasonal patterns, or is there any trends for strengthening or weakening as we look forward?

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

Tore, thanks. This is Ali, I'll take this one. If you look at the order patterns throughout the quarter, I think they generally trended -- again ex the consumer business, I'm talking about the B2B business here.

They generally trended as we would have expected them to. I think November and December were pretty stable. January saw some pretty good strength.

I'd say part of that is just the natural cycle there. January tends to be a stronger order flow month than December just because it has less holidays.

Part of it could be there is -- our first and second quarters had the effect of the lunar new year. Part of that could be that as well. But I'd say overall as we now look into February, orders continue to maintain themselves.

I'd say when you look at the various businesses, the industrial businesses hanging in February to January rates, the comms business is off a little bit from its January rates. Again, January is a very strong month for the comms business, particularly as you think about some of these wireless infrastructure build outs in China.

There is likely some ordering that happened in the month of January that was likely going to be consumed in February. I think overall I'd say it's probably tracking to where we would expect it to be around this time of year, and I think that's certainly implicated in the guidance that we gave for the B2B markets to be in the mid- to high-single digits sequentially in the second quarter.

Operator

Our next question is from Stacy Rasgon with Bernstein Research.

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

Hi, thanks for taking my question. I want to actually follow up on that. So you're guiding the B2B at mid- to high-single digits, you're calling that seasonal.

I think industrial and auto are typically up in the low double digits sequentially in Q2. So is there something else going on for example in comm that's offsetting?

I mean can you give us some feeling for variation across the three B2B businesses above or below that average? Because it does seem overall you're a bit below normal seasonal for industrial and auto.

Dave Zinsner - *Analog Devices Inc - CFO*

Right. Yes, so we actually went back and looked at the B2B in total and by piece. Communications tends not to have as much seasonal effect, and it's more a cycle effect.

But when you look at the industrial and automotive, you're right, Stacy, sometimes it's in the double digits. Sometimes it's in the high-single digits, kind of depends on the year.

I think partly it depends on where lunar new year falls, and sometimes lunar new year is in the first quarter and sometimes it's in the second quarter. And so I think a little bit of the effect of perhaps us being on the lower end to seasonality in those businesses is the fact that lunar new year shows up in the second quarter this time around.

Part of it's just you have to pay attention to what's going on in the macro environment, and I think we're being prudently cautious given some of the perturbations out there, things going on in China, things going on with our customers who sell into the oil and gas space. I think there's a little bit of prudence there.

And then partly I think comm has had a pretty good quarter in the first quarter. It's going to probably have a more flattish to up slightly kind of quarter in the second quarter, and that would mute the B2B sequential growth rate as well.

Overall I would say we're pretty pleased with how the B2B business has been operating. It had a better than expected first quarter, and so to have the second quarter be a little bit on the lower end of seasonality is I think a pretty good outcome.

Operator

The next question comes from Chris Danely with Citigroup.

Chris Danely - *Citigroup - Analyst*

Okay, thanks. Just some more color on the consumer end market. How do you expect that to trend this year?

Have you seen any change to your forecast recently? And do you think consumer revenue in the second half of calendar 2016 will be above or below what it was in the second half of calendar 2015?

Dave Zinsner - *Analog Devices Inc - CFO*

Tough to call the year-over-year growth rates, Chris. Obviously we have a good position I think in the consumer space, particularly in the portable electronics space.

We obviously had a really good second half last year, but as the first half of this year has shown, looks like some of that was not real in demand. And so there might have been a little bit of build of inventory, some inventory build in the second half of last year that we're now feeling the effects of this year.

So clearly on a sequential basis the second half should be quite strong relative to the first half. I'm not sure how things will work out year over year given that inventory build.

Operator

Our next question comes from John Pitzer with Credit Suisse.

John Pitzer - *Credit Suisse - Analyst*

Yes, good morning. Thanks for letting me ask the question. I want to go back to the non-consumer or B2B business.

If you look at that revenue over a longer period of time, it peaked out in the October 2014 quarter at about $720 million. And even again your guide for April, you're still going to be $30 million to $40 million below that level.

And Vince, I think in a prior question you did a good job talking about the puts and takes in autos. I'm assuming industrial military is really a reflection of a lackluster macro.

I guess my question is more on the comm side of the business, which is still down the most over that period of time. Wondering where you think we are in the comm cycle. Do we get back north of $200 million in revenue at some point?

Are there structural barriers to get there, and importantly if you can give us an update on how Hittite is performing within that division that would be helpful. Because I believe October 2014 was the first full quarter of Hittite revenue.

Vincent Roche - *Analog Devices Inc - CEO*

So I think the situation in the communications infrastructure market is really about -- last year it was driven by -- the downturn was driven largely by what was happening in China with regard to regulatory issues, if you like. What we're seeing -- we came off a very, very low bottom at the very early part of 2015, but my sense is now with the -- we're seeing some bookings momentum.

My sense is that we'll see a pretty good growth year overall this year in communications infrastructure. There's a lot of innovation still taking place, and we are I believe gaining share across the board.

Our customers are still driving hard in the wireless area, for example, to increase spectral efficiency, reduce power costs and so on and so forth in the radio systems, and we're right at the heart of that. The combination of ADI with Hittite makes us the, if you like, the supplier of choice when a customer is thinking of that physical interface between the air and the bits, if you like.

So we're very, very happy with what we're seeing in terms of the revenue contribution from Hittite. In fact in the past quarter Hittite was up over the same quarter in the prior year. So I think overall that's going well, in terms of the revenue and profit contribution, in terms of the contribution in improving ADI's capacity to innovate in these radio systems in 4G.

And we're also now starting to get involved in producing, if you like, the architectures for 5G; but my sense is there's still a lot of legs in 4G. And from our perspective what we're doing is driving technology and product leadership at key customers.

And so I think this year will be about what the market does, and the indications are that the market is getting back into a pretty modest buy mode, I think. And the -- as I said we have some very, very good momentum in terms of design ins across the globe, which should bode well for 2017 and beyond.

Operator

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

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

Thanks for taking the question. I wanted to follow up on the industrial end market.

It looks like it's performing seasonally, but from some of the other companies in the sector we've heard about some weakness in certain geographies like China. So can you address the trends that you're seeing across your major geographies in that key end market? Thank you.

Vincent Roche - *Analog Devices Inc - CEO*

Well, from a geographic perspective, I would say the -- if you talk with the industrial space specifically, we actually had -- the strongest growth we had was in China last quarter. And Europe was the area of slowest growth.

So I think it's a case of the macro, the situation in regard to oil exploration has really impacted the situation in America and to some extent Europe. But from our perspective China was the area of strongest performance in the first quarter.

Operator

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

Amit Daryanani - *RBC Capital Markets - Analyst*

I have a question on the gross margin line. I fully understand you had a fair bit of deleverage sequentially.

But I'm wondering if there were any other factors that played into the margin shortfall that you had on a sequential basis? And if you could specifically maybe quantify the inventory reserves you had to take on the consumer side?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes. So as you point out, we -- I think we exited the fourth quarter around 66% gross margins. It came down to a little over 62%.

About half of that was the fact that we lowered utilization in the fab, and obviously when we do that, that has a pretty meaningful effect to the gross margins. And then the other half was inventory reserves. And the inventory reserves were specific to the consumer portable electronics business.

We built up inventory to meet what we thought would be backlog in the first and partially second quarter. And as that forecast was taken down by the customer, we were left with more inventory than we needed in the short term. And so we elected to reserve that inventory for that reason.

Operator

Our next question comes from Blayne Curtis with Barclays.

Blayne Curtis - *Barclays Capital - Analyst*

Hey, thanks for taking my question. I just want to follow up on that, Dave. When you look at the consumer business it's obviously down a lot more than others levered to that customer.

Can you just talk about within the supply chain, you mentioned writing off some of your own inventory, but when you look at the supply chain was there inventory in that supply chain that you're working through? If you could talk about yields within the modules that your product goes into, and is that cleared up as you look at April such that you could see an uptick in July as you saw last year?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, I mean, I think that we were a relatively new product, and I think when that happens the whole supply chain probably adds a bit of cushion along the way to make sure that they can all meet the demand. And of course the end customer doesn't have absolute certainty in terms of what they're end demand might look like, and so I'm sure that they add a little bit of cushion there.

As it turned out, that cushion across the whole supply chain, including the cushion we had on our own balance sheet, wasn't necessary. And so as a result you have the effect of an impact to our top line and the need to reserve some of that inventory for a possible disposal.

So I think based on what we saw in the first quarter and based on the fact that there was a bit of demand expected in the back half of the second quarter, a resumption to the order flows, we think that this will be behind us by the end of the second quarter and we'll be back to shipping with consumption.

Operator

Our next question comes from Steve Smigie with Raymond James.

Vince Celentano - *Raymond James - Analyst*

Thanks, this is Vince Celentano on for Steve. I had a question about the defense business. So the DoD recently released their 2017 proposal.

They expect R&D to increase by about 4%. How closely does this tie into your own defense business, and what are the badges that determine whether it grows above or below this amount?

Dave Zinsner - *Analog Devices Inc - CFO*

I think what we have seen is that the defense business actually has been performing quite well. I think in the first quarter we were up double digits.

So we continue to get maybe a disproportionate amount of, as it trickles down to us the capital spending that the government allocates to defense. Obviously I think anything where the government is adding expense or capital expense to the budgets of defense is going to be a good answer for us.

In particular because I think a lot of what they're doing are these military systems that require a lot of semiconductor, a lot of electronic content. And that obviously is beneficial to us. We've been very pleased with the performance of the defense business.

Obviously the Hittite acquisition just super charged it for us and has helped us do even better in that market. We're seeing all kinds of opportunities for our military components into that space.

But not only that we're actually figuring out ways to take things in the rest of our business that maybe were more commercial in nature and addressing those -- that content to the military business to even grow it faster. So the pipeline looks great in that space, and I think we'll do very well over the next few years in that market.

Vincent Roche - *Analog Devices Inc - CEO*

You know, one of the things that's happening in that area is the mass digitization of a lot of old radio and microwave systems. So there's a huge cycle of upgrades that is in play and that will continue we believe for the next several years.

So as Dave said, the combination of ADI's mixed signal technology combined with Hittite's microwave prowess puts us in very, very good stead. And we're certainly seeing that in terms of the business growth in aerospace and defense over the last 12 or 18 months, and we expect it to be a good contributor to the industrial story over the coming years as well.

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

Next question, operator.

Operator

Our next question comes from Harlan Sur with JPMorgan.

Harlan Sur - *JPMorgan - Analyst*

Good morning, thank you for taking my question. Great job on the OPEX controls over the past few quarters. How should we think about OPEX beyond fiscal Q2?

Dave Zinsner - *Analog Devices Inc - CFO*

As we indicated in the prepared remarks, we do expect it to go up a little bit in the second quarter. The second and third quarter gets the impact of salary increases, and so there's a natural lift.

Although it's not significant in the second and third quarter it will happen. After that I think we're going to be very cautious about how we deploy capital and operating expenses until we're really clear on what the macro environment looks like.

And so as we came into this year, Vince really set the edict that we basically are going to keep the pie the same, and we'll divide the pie differently based on the markets and product areas that we think are -- have the best opportunity for a return. And I think that's going to be the mind set for us for the foreseeable future, unless things change dramatically on the macro side.

Operator

Our next question comes from CJ Muse with Evercore ISI.

CJ Muse - *Evercore ISI - Analyst*

Good morning, thank you for taking my question. I guess a follow-up question on the inventory reserve and gross margins. Did you take reserve for your inventory or for inventory at ODMs?

Part B I guess, is that inventory now obsolete, or could that be a tailwind to gross margin in the back half of the year? And then lastly in terms of getting back to prior peak gross margin last year of 66.5%, what kind of step up in utilization do we need to see? Thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

Okay. So a three-part question, good. Yes, so first of all, the -- on the inventory side, that inventory is not necessarily obsolete.

So it's possible it could be used in the future. What was the other part of that specific question on the reserves?

CJ Muse - *Evercore ISI - Analyst*

Were you taking reserve for your own inventory or inventory at your ODMs?

Dave Zinsner - *Analog Devices Inc - CFO*

Once it ships out it's not our inventory anymore. We don't take reserves on that. This inventory was on our balance sheet.

It was in our supply chain, so that's the inventory reserved. It is possible like you said, if demand were to change in the back half of the year, it's possible that inventory does get sold. I wouldn't rule that out.

In terms of the gross margins getting back north of 66%, I think we actually have a great shot at that. We're in -- certainly in the first quarter we were artificially low because of where utilizations were and because of these inventory reserves.

We don't expect the inventory reserve situation to repeat itself in the second quarter, but even the utilization is not up to prior peaks. We're thinking it's going to be in the low -- the high 60%s rather, and in fact we've been in the high 70%s in prior periods.

And that's at least 100-basis point improvement to the gross margins. So I think we have a good path towards getting our gross margins back north of 66%, and actually probably in relatively short order.

CJ Muse - *Evercore ISI - Analyst*

Very helpful. Thank you.

Operator

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

Vivek Arya - *BofA Merrill Lynch - Analyst*

I'm wondering if you could give us a sense for how large was your largest customer? And broadly can you talk about diversification in your consumer business?

It's obvious the results and the stock has been extremely volatile, and from our perspective its very hard to see whether you can or even want to maintain that socket. You might have it this year but we don't know what the situation will be next year.

Could you just give us some color on how we should think about modeling that volatility in your results? Thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, so in the first quarter I don't have the number right in front of me, but I think -- I'm fairly certain it was below 10%, our largest customer. And then it's a long tail after that. So we're pretty diversified from a customer perspective.

I think it's a valid question as to do we want this business or not. Sometimes we think about that ourselves based on the street reactions. I would tell you this has been one of the single most successful products we've ever developed in terms of its return on investment.

It was a relatively small amount of R&D investment. We were able to utilize technology that was highly proprietary that really was at the cutting edge of technology, and we were able to redeploy it and customize it to a given customer.

That really made a difference in their application, and that's our philosophy in consumer, and it has always been our philosophy in consumer. And so we're going to continue to do that.

There will probably be several different things we will do in the consumer space that will have characteristics like this that require -- that leverage our existing technology and drive great returns. And quite honestly I think the long-term shareholders of ADI want us to do that.

They want us to drive good return on investment. There may be some volatility that happens from quarter to quarter, but over the long run I think we'll be very happy.

One of the things I think we cited was that excluding this pension fund changeover that we had in the fourth quarter, we will have generated $1 billion in the last 12 months in cash flow. We wouldn't have gotten there without this thing.

So we're all about driving cash flow and maximizing that and helping to maximize return on shareholders. And I think that this piece of business and business like this do that.

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

And I would just add, not only did we generate the $1 billion but we return $800 million of that. And given where the cash flows are, the yield on the free cash flow is somewhere around 6% or 7%, which I think is 1.5 times what the S&P is yielding. All right, let's get the next question.

Operator

Our next question is from Craig Hettenbach with Morgan Stanley.

Unidentified Participant - *- Analyst*

Hi this is [Denai] calling for Craig. I had a quick follow up on the comm business.

You saw some good growth in the last couple of quarters in the communication side, and now from your earlier comments it sounds like the business is taking a pause in April. What visibility do you have in that business, what are you hearing from customers, and if you can touch upon the trends you're seeing by geography for that segment?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, so I wouldn't say it's taking a pause. We do expect it to be flat to up, and so I think it's -- certainly as I think, and Ali mentioned in his prepared remarks, it's in the nascent part of a recovery.

We have a pretty good visibility into the pipeline here, because the design cycles tend to be a lot longer, particularly in areas like the consumer space. And so we understand where our traction is in this space.

And as Vince mentioned earlier, based on the way we read how things are going to transpire given the newer technology that we're -- technologies that we're bringing out into the wireless comm space, we think we're going to gain share over the course of the next couple of years. In addition, I think that the market has paused as well.

Clearly it paused significantly in China, and there is a real need for higher bandwidth, and as all these devices that we all hold dear to ourself require more and more data, video driving a lot of it now. And so our expectation is that there will be some capital spent in the wireless infrastructure space.

That's what our customers are telling us. That's what their customers are telling them. We're excited about our position in that space. We think it will only strengthen.

My guess is, it's hard to call this for sure, but my guess is we'll be in a pretty consistent recovery phase over the next 18 months or so. And then who knows when 5G comes around, but when 5G comes around I think we're even in better position, particularly given that a lot of the technology requires millimeter wave, which is one of the key reasons we acquired Hittite.

Vincent Roche - *Analog Devices Inc - CEO*

I think it's a market you've got to take a very long-term view to. It's a space that we've been innovating in for the last 15, 18 years as technologies became more and more digital in terms of their communications modalities across the various generations.

So we are getting strength every year in terms of technology and customer penetration. We know for sure that there's going to be more and more demand for spectral efficiency as people use more and more and more mobility, higher bandwidth data streams required.

So there will be oscillations quarter on quarter, but overall we believe it's a terrific space to be in. We're investing to win in that market in the radio space, and as I said our position gets better year by year in terms of customer penetration and technology and product quality and availability.

Operator

Our next question comes from Ross Seymore with Deutsche Bank.

Ross Seymore - *Deutsche Bank - Analyst*

Vince, one for you on the automotive market. That was very helpful earlier when you gave some of those splits of your business. If I summarized it a different way, investors seem to be a little bit concerned that the automotive market from a SAR perspective is peaking.

Could you give us any details on if you're seeing any evidence of peaking behavior? And then probably more importantly, how do you think of your business being unit driven as far as the unit build in the market versus content driven going forward?

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

Ross, let me take part of that, and then I'll turn the rest over to Vince. I think from a SAR perspective really what we saw towards the end of our fiscal year was China, particularly the premium vehicle market there weakening.

I think what we're seeing at this stage is that North America is still continuing to be pretty strong. The European vehicle registrations are continuing to be up.

And I think very importantly for ADI is that the premium vehicle market in China seems to be stabilizing right now. So that's sort of a macro view in terms of the SAR.

And then secondly I'd point out from another -- if you take it from another macro view, is that when you look at the dealer inventories out there, those are in good shape. When you look at again, the average age of vehicles they're above their historical norm.

That would suggest that there's still some pent up demand from the SAR perspective. That's I guess our sort of 30,000-foot macro view of what's going on with the SAR. I'll let Vince take the second half.

Vincent Roche - *Analog Devices Inc - CEO*

Maybe just one other piece of additional information, light vehicle sales were strong. As Ali said, the luxury part of the market seems to have at least stabilized, maybe stalled a bit.

But light vehicle sales have been stronger than expected in both certainly North America and Europe. So part of our -- we were talking earlier just about the diversity of our business.

Our business continues to become more diverse as we penetrate Asia more aggressively than we have in the past, building on the strength that we've had traditionally in Europe and America. So I think from our perspective, we've got a stronger portfolio than we've ever had.

It's really going to be a case of, from an ADI perspective, how well we penetrate the socket. So irrespective of what happens in terms of SAR, we actually have some good momentum in terms of products and technology which will enable us to get share. I think it will be a tale of those two pieces.

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

If I could just add some examples of the technologies we're bringing to the market. ADAS systems, as we mentioned in the prepared remarks were up 22% year over year.

That today is largely a 24-gig solution, and over the next couple years we'll be in 77-gig solutions as that modality rolls out, puts us in very strong position to grow. Power train systems continue to be strong again as car makers want to make cars more efficient. And finally on the infotainment front, that's been a good market for us.

I don't know if you noticed, but last month we announced a release with Ford Motor Company announcing what we call an A to B bus, which is basically taking very high-end audio fidelity in cabin, takes a bunch of weight out of the car, still keeps fantastic audio quality within the vehicle, and at the end of the day is a cheaper solution for the car manufacturer. Those are some examples of the things that Vince was talking about. Here we go, next question, operator.

Operator

Our next question is with Ian Ing with MKM Partners.

Ian Ing - *MKM Partners - Analyst*

Good morning, my question is on the comms business, 20% off of the prior peak at this point. Alex talked about their comm segments not liking achieving prior peaks in the near future.

They talked about FTD in China being a smaller deployment than TDD. For ADI, do you have the potential to reach prior peaks with some different exposure perhaps more on the microwave side? And in what sort of time frame do you think that could happen?

Vincent Roche - *Analog Devices Inc - CEO*

We've got a bigger footprint now than we've ever had. Just the combination of the investments that we've been making for the last several years to make sure that we have the most complete solutions in the radio space, combined with the microwave technologies that we've acquired through Hittite. So I think there are three parts we should think about.

One is the macro, the macro sell, the small sell. We believe, for example, that we will see growth this year in macro sales. It will be relatively modest.

We're also very well-positioned in small cells, and I think it's becoming pretty clear that in China, China mobile is going to deploy small cells this year. We have a very strong competitive moat that we've built in the area of software defined transceivers that specifically addressed the small cell arena.

And the point-to-point space has been modestly growing. It seems to have slowed as of late, but there are the three components, and we've got a bigger footprint. We're getting more penetration.

I believe it will be more about market adoptions and what the carriers do in terms of CapEx on hardware versus other things, more so than what we do. I think we're well positioned as growth continues to gain momentum here in that market.

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

Not that I'm keeping score, but we're 19% off our peaks, not 20%. All right. We'll get to our next caller. Thanks.

Operator

Our next question is from Steven Chin with UBS.

Steven Chin - *UBS - Analyst*

Hi, thanks for taking my question. Vince, I want to drill down a bit on the distribution channel. Can you discuss the sell in/sell through rates that were lineary through the quarter, and what your expectation is in the current April quarter as well?

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

Well, I'll take a first stab at that and then I can let either Vince or Dave come in. When we look at the distributor channel this quarter, inventory on a weak space is, as I think Dave mentioned in his prepared remarks, were 7 1/2 weeks, which was pretty consistent over the last several quarters.

Deferred revenue, which is a pretty good proxy for inventory in the channel at revenue dollars, was down 1% sequentially. So the channel I'd say is behaving itself.

I think a lot of the inventory is on the supplier balance sheets, and I think folks are doing a good job at managing the actual channel. I think when you look at some of the outlooks painted by some of the larger distributors out there, it appears to be a pretty mixed environment.

And of course if you look at that as a proxy for our industrial business, as Dave mentioned earlier, if you back into the guidance, we're guiding industrial to be in somewhat of a seasonal range, but likely to be at the lower end of that seasonal range. I don't know if, Vince, you wanted to add anything to that?

Vincent Roche - *Analog Devices Inc - CEO*

I think what you said is correct in terms of you can take our industrial business as a good proxy for what's happening in the channel. So that the book-to-bill is positive at this point in time. As Ali said, we've got modest expectations based largely by the fact that the macro backdrop is to say the least volatile at this point in time.

Operator

Our next question is from Mark Lipacis with Jefferies.

Mark Lipacis - *Jefferies LLC - Analyst*

Hi, it's Mark Lipacis. Dave, you mentioned you're cautious and that there's perturbations in China, but the orders in the non-consumer businesses seem seasonal given the timing of the lunar new year. And Vince noted that the China industrial market was the strongest industrial market.

So I'm trying to reconcile what appears to be seasonal order patterns with your cautiousness. Are customers or distributors throwing up flags, or is there some other analysis or signals that's driving your cautiousness? Thank you.

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, only the -- and when I say perturbation I mean what you read in the Wall Street Journal and see on CNBC more than anything. But certainly in our -- what we see from an order flow perspective that leads you to be -- feel pretty good about the situation from a macro perspective.

But I just think we've got to be -- we've got to recognize that there is uncertainty in the market. I think our customers generally feel the same, feel this uncertainty and just aren't sure of what the outcome will look like for this year.

And a result, I think when those situations arise it's best to be on the cautious side of things. If things turn out to be more positive, that will be great.

We'll put the money to work at that point. If it doesn't, we'll have protected our income statement.

Vincent Roche - *Analog Devices Inc - CEO*

If you look at what our customers are predicting for this point this year versus the same period last year, it was a lot more caution. I think all the big industrial companies are projecting very, very low-single digit growth or flatness through the year. So you've got to take all that into account when you're trying to run your business here.

Mark Lipacis - *Jefferies LLC - Analyst*

Great. Thanks.

Operator

Our next question comes from Doug Freedman with Sterne Agee.

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

Hi, thanks for taking my question. It really relates to your M&A strategy.

We've seen in the markets taking a little bit different tact towards deals in the semiconductor space, those guys that have chosen to lever up and do things have not been received as well. Does this weigh into your thinking at all, and can you give us an update on how you view M&A and what the opportunities you see out there today?

Dave Zinsner - *Analog Devices Inc - CFO*

I think that for us we have a pretty high bar. We have a high bar in terms of it's got to add innovation that's core to what we do. It's got to hit all the -- it's got to hit the customer base.

It's got to be something that the customers turn around and say well that was a good idea. We really needed you to have that technology.

And then it's obviously you got to check the box on all the financial parameters that we have. And like I said, the bar is pretty high in terms of what we'd like to see from that perspective.

And so I think that in that regard we take a pretty systematic disciplined approach to it. That's the reason we did Hittite, and that's the reason we haven't aggressively tried to find other deals just to fill the coffer with an M&A pipeline.

What we've done is we've been carefully looking -- I would tell you that we've kicked the tires on a lot of different ideas over the last year or so, and not one of them has reached the high bar that we've set. That's not to say that there won't be one down the road, and I think when that happens, we'll go to our shareholders and I think given the bar we set, we'll give them a pretty compelling reason as to why we want to utilize their precious cash to go do that acquisition.

And so I think it will end up being positively received in that case. I think when you're doing M&A for the sake of M&A, that's when things tend to turn on you.

Operator

Our next question comes from Tristan Gerra with Baird.

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

Hi, good morning. A follow up to a prior question, what's your sense of the timing for the initial ramp in 5G, and what's the percentage content increase ADI has relative to 4G? And also what geographies are for the highest gross opportunities for the remaining leg of 4G growth?

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, so I mean usually when you go transition from generation to generation, it's easily into the double-digits volume increase when those transitions. I can't tell you when exactly 5G will roll out. I'm going to say it's a few years away at this point.

There might be little pockets of early adoption, but most of that is a couple years away I think for us. But when it comes, we're well-positioned for that. 4G is pretty well certainly deployed in North America, although I think there are areas where it needs to be densified.

China still has a few things to roll out, you know. They have -- they changed I think sometimes what they're -- the way they want to deploy that technology. But over time, over the next couple of years I think they'll be in a good position.

The rest of the world is actually outside of maybe a few areas like Korea or something, are actually in pretty old generations, particularly in Europe, and so I think there's a lot of room for 4G deployment before we even get into where the 5G takes us.

Vincent Roche - *Analog Devices Inc - CEO*

4G still has a lot of legs. As Dave said, it will be multiple years before 5G comes into play. And you might be surprised to know that if you take the typical customer that we have in the bay station area, the macro bay station area, the product replenish rate of the radio is very frequent.

There are many new radios developed every month for different regions, different spectral usage, and so on and so forth within 4G. So there's a lot of innovation and at lot of edge that we can still bring in terms of technology to 4G. That's what we're doing.

When we make the steps to 5G the frequencies increase, the data rates increase, it's got to be much more spectrally efficient than 4G. It needs lower latency, and so on and so forth, and all to drive the improved coverage and the quality of service.

So when that happens, we will have been at the forefront of helping our customers architect what 5G looks like in terms of the radio. So it will be multiple years, but I'm still bullish on 4G and what we can do in that area in terms of bringing ever-increasing levels of innovation and increasing our footprint there.

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

Great. Thank you.

Operator

Our next question is from Deepon Nag with Macquarie.

Deepon Nag - *Macquarie Research Equities - Analyst*

Dave, the dividend increase that you did is probably the lowest you've done since 2009, but repurchases in Q1 were at a very high level. So is there a change in the way you view your mix of returning capital? And then on fiscal Q2, are you going to take any more inventory return, because the gross margin leverage is a little bit lower than I would have thought given the mix and the ramp in utilization risk?

Dave Zinsner - *Analog Devices Inc - CFO*

No, philosophically at the top we really want to deploy 80% of our cash back to shareholders. And I think the way we look at it is we try to maintain a balance.

Clearly the stock has weakened a bit since its peak, and so we recognize that the buyback is probably going to be fairly active for at least some period of time. And so I think that was really the primary reason why the dividend increase was smaller.

Because we're trying to maintain the balance to get the return to 80%. I wouldn't read into anything more than that. We do have a stated target that will stay between 5% and 10% a year increases in the dividend.

This still stayed within that range, but as you point out was on the lower end because we think the buyback will be a bit stronger. From an inventory reserve perspective, we think we've taken care of that situation and that we don't expect that to repeat in the second quarter.

I'd say the primary reason why the gross margins haven't -- I think they got up to north of 66% probably in the second quarter of last year, and the reason they're about 100 basis points below that is because of the utilization levels. We aren't ramping the utilization up quite as much this quarter versus last year at this time, and fundamentally it's just I think a mix.

There's certain things that get done internally, certain things that we leverage outside partners for, and the way the revenue is going to fall out I think for the second quarter is going to be a little bit more disproportionately to the outside waivers that we get from foundry. And so as a result we won't be cranking the factory up as much in the second quarter.

On top of that, we do -- we are focused on the inventory levels of the product we build internally, and we didn't want that to get too high. So hopefully in the third and fourth quarter this momentum that we think we have in the B2B space continues. That certainly has more wafers manufactured internally, and so we'd expect to see the utilization come up over the course of the year and that will -- should be a pretty good tailwind to gross margins.

Operator

Our next question comes from Tore Svanberg with Stifel.

Tore Svanberg - *Stifel Nicolaus - Analyst*

Yes, thank you. I just had a quick follow up. Could you talk a little bit about the thinking behind carrying $1.7 billion of debt?

THOMSON REUTERS

Dave Zinsner - *Analog Devices Inc - CFO*

Yes, good question, Tore. So when we -- as we came into like that December month, we knew that we had a $375 million bond that was coming due in April of this year. We also thought that we might be using some of the US cash in the near term for an acquisition, and the rates were pretty attractive.

The market was pretty excited, and we were particularly excited by the fact that we could get 30-year debt in some cases, or in some amount at rates that on a tax affected basis would be less than the dividend yield. So we thought that those things combined meant that it'd be a good idea to go into the market, get the cash, and be ready.

As it turned out, the acquisition that we were thinking about we didn't end up consummating. We did refinance the bond, so that utilized some of the cash that we raised.

The rest of it does sit on our balance sheet in the US, but I think we will over time find very good accretive uses for that cash. It was relatively cheap money. We will look to use it in situations that -- where we need US cash for M&A.

As I mentioned, we're using some of the cash for buybacks, and so that will obviously be an accretive use of the cash as well. So in terms of net cash, which is the number we're most focused on, we think we'll find ways to bring that down over time.

One of the disconnects we have is we generate two-thirds of our cash offshore, but a lot of our uses like some of the M&A and some of the -- and certainly the buyback activity utilize US cash. And so we sometimes need to add leverage to the US balance sheet in order to make those happen, and the cash accumulates offshore.

Operator

Our final question comes from John Pitzer with Credit Suisse.

John Pitzer - *Credit Suisse - Analyst*

Yes, I was going to ask a debt question but I'll ask another one. Vince, can you talk a little bit just about within the consumer space how we should think about pricing over time and your ability to bring down cost on your solutions that you bring to the consumer market, especially as you go into second and third generation products from your customer?

Vincent Roche - *Analog Devices Inc - CEO*

Well, John, we're very discriminating in terms of how we play the game everywhere, not just in consumer, everywhere. But particularly in consumer we've been very clear that we need to have a strong grasp of the complexity of the application and the quality of the solution that we're bringing.

So we're playing really at the high performance edge. There are many, many things we can do.

We are very discriminating about the things we take on, and we are -- that's the basis in which we're playing. So we're leveraging if you like precision core technology that we -- that we sell into many, many different sockets and many, many different applications.

And I think it was Ali said earlier that we're -- if we hit the right places, we get terrific ROI on a technology that we customize in a particular application space and consumer. So, I mean that's the pieces. That's how we play within that space, and when we hit it, we hit it very, very well.

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

Great. Well, thank you, John. Thanks for all our callers this morning. I have to admit I do like this morning call.

As a reminder our second-quarter 2016 results will be issued Wednesday May 18, 2016 at 8:00 AM Eastern. And the earnings call will begin two hours later at 10:00 AM Eastern.

So thanks for joining us this morning. We look forward to speaking with you soon. And for those in Massachusetts, enjoy the school vacation week. Thanks.

Operator

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