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ADI - Q1 2012 Analog Devices, Inc. Earnings Conference Call

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OVERVIEW:

ADI reported 1Q12 revenue of $648m and diluted EPS of $0.46. Expects 2Q12 revenue to be $655-675m and diluted EPS to be $0.48-0.53.

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CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good afternoon, my name is Natalie and I will be your conference facilitator. At this time, I would like to welcome everyone to the Analog Devices first-quarter fiscal-year 2012 earnings conference call. All lines have been placed on mute to prevent any background noise. After the opening remarks, there will be a question-and-answer period with our analyst participants.

(Operator Instructions)

Thank you. Ms. Tagliaferro, you may begin your conference.

Maria Tagliaferro - *Analog Devices, Inc. - Director of Corporate Communications*

Thank you, Natalie and good afternoon, everyone. This is Maria Tagliaferro, Director of Corporate Communications for ADI. Here with me now are Jerry Fishman, our President and CEO; Dave Zinsner, Vice President of Finance and CFO; and Vincent Roche, Vice President of Sales and Strategic Market Segments. We appreciate you joining us for today's call. If you haven't yet seen our first-quarter fiscal-year 2012 release, or the release announcing an increase in the dividends, you can both find both on our IR website at Investor.Analog.com. A recording of this conference call will also be available on the website within about two hours of the call's completion.

I would like to point out that there were 14 weeks of activity in the first quarter of fiscal 2012, that compares to a typical 13 weeks in a quarter. From time to time, during today's conference call, we will point out the impact of this additional week on historical and projected trends. The 14-week quarter occurs because ADI follows the fiscal year calendar of 52 weeks per year. As a result, there is an extra week approximately every fifth or sixth year, and to adjust for that one day difference between our fiscal year and the typical 365 day calendar year.

Finally, I'd ask you to please note that the information that you're about to discuss includes forward-looking statements, intended to qualify for the Safe Harbor from liabilities established by the Private Securities Litigation Reform Act of 1995. These forward-looking statements include risks and uncertainties, and our actual results could differ materially from those we will be discussing. Factors that could contribute to such differences include, but are not limited to, those described in our SEC filings, including our most recent quarterly report on Form 10-Q, which was filed today. The forward-looking information that is provided on this call represents our outlook as of today, and we do not undertake any obligation to update the forward-looking statements made by us. Subsequent events and developments may cause our outlook to change. Therefore, this conference call will include time sensitive information that may be accurate only as of the date of the live broadcast, which is February 22, 2012. With that, I'll turn the call over to opening remarks from our CEO, Jerry Fishman.

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

Well, good afternoon to everybody. As you can tell from our press release, our revenues in the first quarter totaled about $648 million, which was a decline of 9.5% sequentially and 11% year-over-year. And although within the range we provided last quarter, it was at the lower end of that guidance range.

Continuing inventory reduction by both our customers and distributors in November and December, coupled with lower capital spending by many of our customers reduced orders on ADI, and that continued a trend that began about six or nine months ago. Nevertheless, and happily, our order rates and orders began accelerating in January, and have continued strong into February, which leads us to believe that our first quarter may represent the sales, gross margin, and operating margin trough of this cycle for ADI.

And we expect to resume growth in our second quarter, which began in early February. We believe that customer and distributor inventories are reaching levels commensurate with their now-revised outlooks, and many of our larger customers have become marginally more optimistic, and are beginning to free up some of their capital budgets. I'll provide a few more specifics on the short-term outlook towards the end of the call.

In the first quarter, our sales into virtually every end market except automotive declined sequentially and year-over-year. In the first quarter, automotive sales actually increased 6% sequentially and 26% year-over-year, as ADI continued to benefit from increased ADI dollar content per vehicle, and increased vehicle unit sales worldwide. We would expect our automotive sales to remain strong in our second quarter. Industrial revenues declined 8% sequentially in Q1, for the third consecutive quarter of declines. The decline was very broad-based across customer tiers and geographies, and across industrial automation, energy instrumentation, and healthcare applications.

As has been the case now for several quarters, order rates from industrial customers appear to be well below consumption rates for our products, for the first two months of our first quarter, but have recently been showing some good signs of improvement, which of course is very welcomed news for us, since the industrial market represented 45% of our revenues in Q1 and remains our highest margin business. Based on these trends, we expect that industrial revenues will increase in the second quarter after now three quarters of sequential decline.

The communications infrastructure end market also declined in the first quarter. Continued economic uncertainty, some country-specific regulatory issues, and disruption from the failed AT&T and T-Mobile merger, all contributed to widespread deferral of orders for new systems, in favor of temporary improvements, mostly software and network capacity. Communications was 19% of revenues and declined 13% sequentially. While at this point in time, we're not currently forecasting much improvement in communications infrastructure revenues in our second quarter, our customers in many geographies are now beginning to signal that we should expect a resumption of growth in the second half of this year.

The consumer end market decreased 21% sequentially, a little bit more than our seasonal expectations, but also due in part to customer production limitations caused by the floods in Thailand, which limited our customers' ordering patterns for many of our products. We're currently forecasting some growth in consumer sales in the second quarter, in line with what we normally see seasonally from first to second quarter. So I think really the summary comment, with few exceptions, is the two things that seemed to play out during the first quarter were inventory reductions at most of our customers, and delays to long-term capital expenditures at many of our customers, and I think for the most part, we now believe that both of these trends seem to have run their course, at least for ADI, by the end of December.

On a regional basis, only North America experienced any sequential revenue increase in Q1. And even in North America, the growth rate was very modest. It was only up about 1% or so, and that was the result of strength in automotive and wired communications markets in the US. Revenue in Japan declined by 23% due to consumer inventory seasonality, and also the supply chain limitations that I mentioned earlier. Revenues from Europe decreased 12%, as increases in automotive sales were more than offset by declines in industrial and communications revenues. Revenues in China decreased 11%, as declines across the industrial end market overshadowed good growth in other markets. The ROW or rest-of-world decline of 6% was largely due to reductions in consumer revenue. So now, Dave will take you through some of the details of the first-quarter financial results, and I'll come back after Dave's comments and talk a little bit more about the outlook.

Dave Zinsner - *Analog Devices, Inc. - VP Finance and CFO*

Thanks, Jerry. As Jerry mentioned, first-quarter revenue declined 9.5% sequentially, and 11% year-over-year to $648 million. Our gross margin was 63.2% in the first quarter. This was down from the 64.3% we reported in Q4, primarily as a result of our decision to decrease factory utilization. Lead times for our direct OEM customers remained similar to last quarter, and are in good control with virtually 100% of our shipments to OEMs occurring within six weeks, and in 99% within four weeks. Operating expenses for the first quarter were approximately flat from the prior quarter, at $226.1 million, a great result given an extra week of expenses. Holiday shutdowns and tight control of discretionary items helped keep expenses in check.

Operating profits for the fourth quarter were $183 million, or 28.3% of sales, compared to 32.9% of sales in the prior quarter. Operating profits were down both in dollar and percentage terms, as a result of the lower revenue and reduced factory absorption in the first quarter. Other expense was $3 million in the first quarter, compared to $4 million in the fourth quarter, and reflects the ongoing run rate of our net interest expense. Our tax rate for the first quarter was 22.6%, in line with expectations we communicated for a 22% rate in fiscal 2012. We expect our effective tax rate, excluding discrete items, to be approximately 21.5% for the remainder of fiscal 2012. Diluted earnings per share of $0.46 in the first quarter was slightly lower than the midpoint of our guidance, as tight control of operating expenses provided some relief against lower revenue and gross margins.

Cash flow in the first quarter continued to be strong. We generated 33% of our revenue, or $215 million in operating cash flow. Capital expenditures were $25 million, resulting in free cash flow of $190 million, or 29% of revenue for the quarter. Our accounts receivable balance decreased from the prior quarter by $46 million due to lower sales, and our days sales outstanding increased by 2 days from the prior quarter to 46 days. Inventory was carefully managed and increased by only $2 million, or less than 1%, despite lower sales. Inventory at distribution also declined by approximately 7%, and is at the lowest point since 2010.

During the first quarter, we repurchased $78 million of our stock, and we received $49 million in proceeds from stock option exercises. We also distributed $74 million in dividends to our stockholders. Our cash balance at the end of the first quarter was approximately $3.7 billion, of which approximately $1.1 billion is available domestically. At the end of the first quarter, we had approximately $870 million in debt outstanding.

On February 21, our Board of Directors declared a cash dividend of $0.30 per outstanding share of common stock, up from $0.25 last quarter, which will be paid on March 28, 2012 to all shareholders of record at the close of business on March 9. At current stock prices, this dividend represents an annual yield of about 3%. This significant dividend increase represents our strategy to improve returns to our shareholders, and also our confidence in our continuing ability to generate significant free cash flow in the future.

In summary, our operating model includes significant variable costs that have helped ADI achieve record-high margins during the upturns in recent industry cycles, and equally as important, during the inevitable downturns. Our results in the first quarter continued to demonstrate the strength of our model, as tight expense controls, variable compensation, and a highly-responsive manufacturing infrastructure have ADI well positioned for the emerging recovery. At current operating margin levels, we have significant operating leverage as sales increase and we begin to reload our factories while keeping very tight control of operating expenses. So now, I'll turn the call back over to Jerry to discuss the recovery in terms of ADI's outlook for next quarter.

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

Thanks, Dave. Although we're certainly in a challenging business environment, we do see improvement on the horizon. We now believe that our inventory levels at both OEM customers and distributors are below consumption rates, and we're pleased to report that our order rates have improved and increased significantly over the last six weeks.

For the second quarter of 2012, we believe revenue could be in the range of $655 million to $675 million, or up 1% to 4% sequentially. Considering that we're going from a 14-week quarter to a more normal 13-week quarter in Q2, the sequential revenue growth at these levels is significantly higher on an apples-to-apples basis. We're planning for higher sales and a higher mix of industrial products, which leads us to a gross margin plan of somewhere between 64% and 64.5% for the second quarter.

While utilization will increase in Q2, compared to Q1, it's expected to still remain below 70%, which indicates that we still have significant remaining gross margin leverage as sales improve in future quarters, and as utilization expands. We anticipate that operating expenses will remain flat in Q2 to Q1 levels, and also to Q4 2011 levels, at about $226 million. Given that the macroeconomic environment still remains uncertain, as Dave mentioned, we will continue to aggressively monitor and control our expenses in Q2 and for the balance of the year. Based on these estimates, and excluding any one-time items, diluted earnings are planned to be in the range of $0.48 to $0.53 in our second quarter.

So in summary, the fundamentals of our business remained strong during the cycle. And as growth returns, we believe our customer relationships, our technology portfolio, our better market focus, our terrific service levels, and our financial model will all contribute to higher profitability, and we believe, increasing shareholder returns.

Maria Tagliaferro - *Analog Devices, Inc. - Director of Corporate Communications*

Great. Thank you very much, Jerry. During today's Q&A period, please limit yourself to one primary question and no more than one follow-on question. We'll give you another opportunity to ask additional questions if we have time remaining. And we're going to run this call to 6.00 PM Eastern time. Operator, we are now ready for questions from our analyst participants.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). And our first question comes from the line of Jim Covello, from Goldman Sachs.

Jim Covello - *Goldman Sachs - Analyst*

I guess first question, Jerry, can you give us some sort of idea of how much you think we can grow revenues here, just from customers going back to consuming at their own shipment levels? So in other words, if production and consumption levels come back in line, how much can we grow? And then beyond that, we're going to need sales growth. How much do you think catching back up can give us some growth here?

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

Well, that's a very complicated question to answer, so I can only really speak qualitatively about that. One way to think about it, I think, is that if you look at our industrial revenues, from the peak of where they were before the cycle collapsed, to where last quarter wound up, our industrial revenues are down 20%-plus.

If you look at our customers' results in the industrial business, none of our customers' results are down anything like that. In fact, many of our largest industrial customers, particularly customers in the United States, Europe, and China, most of their industrial revenues are up. So there's been a pretty significant inventory reduction at our customers.

When you couple that with their most recent outlooks, and after I finish, I'll turn it over to Vince, who just came back from another long week on the road, talking to a lot of those customers, I think most of our customers are really not pessimistic about the next couple of quarters.

I say they're not jumping off the table and saying everything's great, but they expect to get some growth, and some a little sooner, some a little later. I think the early adaptors in this business to what's happened will be the industrial business, but I think soon after, it could be followed by the communications business.

So it's very hard to put a crisp number on it, but some of the largest customers have had enormous inventory reductions. Well beyond what would be indicated by any potential slowdown in their sales, so I think there's a reasonable amount of snap back just to get back to normal consumption levels, but Vince, you --?

Vincent Roche - *Analog Devices, Inc. - VP - Sales, Strategic Market Segments*

Just a couple of points for color here. I think it's true to say that the first -- let's say the second and third quarters of the year just gone, customers were trying to get ahead of the supply issues, and a lot of over-inventorying was done. I think the second half of the year was very much dominated by the debt crisis in Europe to a large extent. A lot of our business was done in Europe with the industrial customer base, particularly in the areas of automation.

I think the conference is generally good with our customers out there, that this is going to be a pretty good year, maybe modest growth. But I think also some customers still believe that they're burning off inventory, and it will take probably another couple months to get the inventory out of the pipe. Certainly second and third quarters, we're expecting to see some positive movement in terms of industrial customers, based on their confidence, and certainly the order rates that we're seeing from them.

Jim Covello - *Goldman Sachs - Analyst*

That's terrific. Thank you. If I'm allowed a follow-up, I guess I would ask, how much margin expansion should we see for every $50 million of incremental revenue growth from here, assuming mix stays the same, with industrial being a little bit higher of a percentage than it was at times in the past? Thank you very much.

Dave Zinsner - *Analog Devices, Inc. - VP Finance and CFO*

This is gross margins you're asking?

Jim Covello - *Goldman Sachs - Analyst*

Correct.

Dave Zinsner - *Analog Devices, Inc. - VP Finance and CFO*

We're obviously, first off, I think the gross margins, if this is indeed the trough, were pretty stellar, relative to previous troughs. In fact, I think now our previous peaks are much like our current troughs, so we've done a lot to fundamentally improve the gross margins from where we were, say, a few years ago. Going forward, clearly, I think the utilization we're down to, a lot of this can be driven off utilization, were down below 70%. When we were at our peak at 67%, a little over 67%, our utilization was up past 80%.

So really, the fundamental driver to getting the margins up I think will mostly be a function of getting that utilization up, and as Jerry said, we're still even next quarter operating at relatively low utilization, and I think our expectation is that we ramp back into the levels that we saw in prior periods, where the margins were up into the high 60s.

Jim Covello - *Goldman Sachs - Analyst*

Thank you so much.

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

Jim, the other comment I'd make is we're working hard to really manage the inventory very carefully here. And we want to make sure that we have enough, because in these kind of cycles, you can get a very quick snap back or change in customer sentiment and everybody starts loading you up again. You've got to be careful that you don't see both ends of the seesaw here.

We're trying to keep the inventory levels at reasonable levels, so that number one, we'll get expansion on the gross margins when we really do load the factories, but also that when customers do decide to make changes, and history shows they make those changes very quickly, that we can be responsive in this cycle, as we were in the last cycle. We still think that's the best policy for ADI.

Operator

Our next question comes from the line of Shawn Webster.

Shawn Webster - *Macquarie Research - Analyst*

Just a little bit more on the gross margin question. Dave, could you quantify what your utilizations were in the January quarter? And is full utilization rate for you guys north of 80%? And did you have any one-time markdowns or inventory effects impacting gross margins for your last quarter?

Dave Zinsner - *Analog Devices, Inc. - VP Finance and CFO*

Utilization in the first quarter was 67%. Like Jerry said, we're expecting it to be north of that, but below 70%, so hard to pick the exact point. But somewhere between 67% and 70% we're expecting utilization. We did have a little bit of an inventory write-down, more so than we normally have in the first quarter. It's probably what contributed about 50 basis points of the decline in gross margins, certainly will help us, because we don't think that's going to repeat again in the second quarter.

As far as maximum utilization goes, I guess theoretically you could get to 100%, rarely do you get to that level. So something in the high 80%s probably -- or 90% is probably where we'd like to -- where we feel comfortable and think we can keep our lead times to the place we want to keep them.

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

We've operated our manufacturing facilities very well at 90% utilization, and then just by adding small amounts of incremental capital, we can get the overall capacity up quite quickly, so 90% is quite comfortable for us.

Shawn Webster - *Macquarie Research - Analyst*

Okay. Great. And then on the inventory question, it sounds like some areas, from your perspective, if I heard it correctly, are getting lean and some areas are still some -- what your customers are communicating to you is they're digesting inventory. What are the areas that still seem like they're in the process of burning down inventory?

Vincent Roche - *Analog Devices, Inc. - VP - Sales, Strategic Market Segments*

I think particularly in the small customer base, which is largely industrial, and some of the larger industrial customers themselves, but I think it's very much industrial and possibly healthcare as well.

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

All the signals we're getting is that's really winding down, so we're seeing -- when the inflection point on the bookings occurs, broadly, as we've seen, that's usually an indication that there still might be a little inventory out there in a couple of the customers, some of these end markets that Vince mentioned. But that's going to not affect the results nearly to the extent that has affected them over the last three quarters.

So I think even if they are still burning off a little inventory, the net results that we can achieve is quite a bit better than where they were, where the mentality six to nine months ago was, just get inventory down as fast as you possibly can, and we had many of our largest customers that went through a quarter or two and didn't order anything. Because they just didn't want any more inventory. And that really accelerated what we got into November and part of December, when they were safe in year-end.

We monitor our customers' inventory in aggregate pretty carefully, and when you look at the inventory levels of some of our large industrial customers, are carrying in aggregate, this doesn't necessarily talk about ADI products specifically, it's quite lean right now. So there might be some more to go, might take another month or two in some of the accounts, but I believe, and what we're seeing in the order rates is most of that's behind us.

Shawn Webster - *Macquarie Research - Analyst*

Thank you.

Operator

The next question comes from the line of Tristan Gerra from Robert Baird.

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

Could you talk about the segments this year you think are the best growth opportunities? And also on a geographic basis, do you expect to catch up in Japan over the next couple of quarters as the supply chain comes back?

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

I didn't get the first part of your question. Could you repeat that?

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

The first part of the question was just to talk about some of the segments that you think are for the best growth opportunities for ADI this year, any color by end market?

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

China? Was the question?

Vincent Roche - *Analog Devices, Inc. - VP - Sales, Strategic Market Segments*

I think in general. Yes, so your question is the best growth opportunities across the globe. So clearly, automotive has been a stand-out growth contributor to the Company over the last couple of years, and I expect that will continue this year, and for the next few years at least, anyways.

Demand is very strong in all the geographic markets and particularly in America, we saw strong growth in the quarter just gone. In fact, I read a statistic in the last couple of days that the average age of a car now in America is over 10 years. So there's a replenishment cycle going on there very clearly.

And we're expecting in Japan and China as well, growth in the region of 9% to 12% for this year. Again from China, there's a lot of demand for mid- to high-end cars that we're very prevalent in supplying products to. And Japan as well, there's a very strong replacement activity going on there. So I think automotive will be strong. Communications infrastructure, I believe in the second half of the year, as we start to see --

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Maria Tagliaferro - *Analog Devices, Inc. - Director of Corporate Communications*

Calendar

Vincent Roche - *Analog Devices, Inc. - VP - Sales, Strategic Market Segments*

The calendar year. As we start to see the continued data explosion and the need to put hardware in places, Jerry said earlier, there's been an optimization cycle in the past quarter or two, but the operators who have the cash are going to start putting hardware into place over the next two, three quarters. So I think we'll see some decent growth there, and industrial, as I said, it could be modest, but at least we expect some growth during the remainder of this year.

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

Okay. Thank you. And then a quick one. Could you give us a breakdown of your communication revenues?

Vincent Roche - *Analog Devices, Inc. - VP - Sales, Strategic Market Segments*

Well, it's roughly two-thirds of the revenue comes from the wireless infrastructure sector, and one-third from the wired infrastructure sector. And wired is really the composite of optical and cable infrastructure and some enterprise business.

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

Great. Thank you.

Operator

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

John Pitzer - *Credit Suisse - Analyst*

Quickly, Jerry, the first question I have is relative to the January quarter. You guys came a little bit light at the low end of guidance. Was that all Thailand? And the reason why I ask, is a lot of chip companies actually saw some strength in December, beginning of January -- just kind of curious as to why you guys came in at the low end of your guide for the January quarter? Then I have a follow-up.

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

Well, it's hard to say whether people what other people did one way or the other. We weren't even around the last two weeks in December. We had most of our factories closed, and not much of our sales guys out there.

But we began to see the increases in very early January, starting with the first week in January that we came back, and we've seen that to be relatively strong since then, so it's very hard to say why somebody's orders were stronger one week versus another, it's hard to get to that level of granularity, I am just happy to see that our orders began to pick up in early January and continued strong into mid-February. That's the best I can tell you.

John Pitzer - *Credit Suisse - Analyst*

Just going back to the utilization, with below 70% for both the Jan and April quarter, can you help us remind for every hundred basis point increment of utilization, what that might mean for gross margin? Given the strong mix of industrial in the April quarter, does mix come into play and perhaps dampen cyclical leverage beyond April?

Dave Zinsner - *Analog Devices, Inc. - VP Finance and CFO*

Clearly the second quarter will have a strong industrial component to it, and that will help gross margin from a mix perspective. But we think, or we're assuming that industrial's at a low point in the first quarter, and that we will see recovery beyond the second quarter. So my guess is mix is not a headwind going forward, if we're right that we're in the early stages of our recovery. Maybe the best way to describe the utilization to gross margin ratio, is back when we were operating in the 67% gross margin, we were running high 70%s to 80% utilization.

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

It's not a strictly linear relationship. X number of basis points for each point of utilization, that's not the way the factories run, that's not the way the costs are generated. I think Dave's comment is illustrative of the kind of gross margin leverage that's out there. As utilization improves. But we can't model it linearly for you.

Maria Tagliaferro - *Analog Devices, Inc. - Director of Corporate Communications*

Do you have a follow-up, John?

John Pitzer - *Credit Suisse - Analyst*

That was my follow-up.

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Maria Tagliaferro - *Analog Devices, Inc. - Director of Corporate Communications*

Oh, sorry. Thank you for keeping track. All right. Next person, please?

Operator

The next question comes from the line of Craig Ellis, from Caris & Company.

Craig Ellis - *Caris & Company - Analyst*

The first question is just a follow-up on the communications business. Vince, can you talk about the types of projects that you're hearing about for the back half of the year? Are those 3G products, or are those LTE projects? And the color that you're getting, can you provide some insight on whether that's based on OEMs in particular geographies, or on projects in particular geographies? Or is it more broad-based?

Vincent Roche - *Analog Devices, Inc. - VP - Sales, Strategic Market Segments*

Well, I think all of the major players in the wireless space are attacking the market with a broad range of technologies. Some are more heavily focused on 4G, some of them got out of the starting blocks earlier on 4G, but I think everybody has some level of offering across 4G, 3G, and even 2G.

In India today, we still the see deployment of 2G, but my sense is that this year and next year we're going to see largely a move out of 2G into 3G, and I think most of our sales over the next three or four years will be dominated by 3G and particularly 4G. I think it's true to say that in the more-developed economies, the deployment is really 4G at this point in time. It's to get the data into place that people need to be able to move all of these massive quantities of mobile video and high-bandwidth data.

Craig Ellis - *Caris & Company - Analyst*

Okay. And then switching gears in the question for Dave, real nice increase on the dividend, 20%, $0.30 a share. As we think about the dividend-generative capacity of the firm and the balance that you want to strike as you think about the right level of pay out and the cash that's available in the US to fund that dividend, how do we think about an upper control limit for what the dividend payout might be, as we think about ADI's business?

Dave Zinsner - *Analog Devices, Inc. - VP Finance and CFO*

How do we think of a what?

Craig Ellis - *Caris & Company - Analyst*

The upper control limit? Is there a free cash flow payout that you wouldn't want to go over? Or what are some of the parameters that you're looking at as you think about what the potential payout is on your dividend?

Dave Zinsner - *Analog Devices, Inc. - VP Finance and CFO*

The issue with using payout ratios on cash flow is every quarter it can be up and down depending on one-time tax payments, things like that. So generally, we historically I think someone mentioned that we've been -- we paid out around 40% of our net income in the form of dividends. And what we'd like to see is that number be higher.

We don't have a rule of thumb for every quarter, but we're trying to push the dividend to be more and more compelling to shareholders, return more and more of our cash flow to shareholders, and that's really the way we think about it versus some sort of scientific ratio that we apply.

We think that investors, at least that we've talked to, particularly over the last, say, six months have been really interested in dividends as a means of returning cash to shareholders, vis-a-vis buybacks. So we've taken the approach to really put a little bit more emphasis on the dividend.

Craig Ellis - *Caris & Company - Analyst*

Thanks, guys.

Operator

The next question comes from the line of Uche Orji from UBS.

Uche Orji - *UBS - Analyst*

Jerry, can I just ask you a few sub-segment questions? So my first question is on the infrastructure area. You did mention about the event last year that led to a slowdown in the wireless infrastructure. As we go in through this year and you talk to your customers, what is the expectation for recovery there, particularly in North America and in China? Is there any comments on why infrastructure would be helpful?

Vincent Roche - *Analog Devices, Inc. - VP - Sales, Strategic Market Segments*

Yes. Because of the situation in the US there, with the whole situation surrounding AT&T and T-Mobile, there was obviously a great lull in procurement of equipment, or deployment of equipment and procurement of product. But my sense is, some point in the next number of months, we're going to see as I mentioned earlier, some level of deployment of hardware, because there just aren't enough base stations deployed, particularly in America and Europe, to handle the data requirements that are in place.

The operators and our customers have been trying to optimize the equipment that's already there through pretty much software techniques, just to get the capacity to where it needed to be, but I think we're going to see a pretty strong deployment of new hardware, particularly in Europe and America in the area of 4G, in the second, third, fourth quarter of this year. But I think in Europe and America, it will be pretty much 4G, Japan 4G, and in China, to be a mixture of 2G, 3G, and 4G.

Uche Orji - *UBS - Analyst*

In terms of the leverage you have as we go into -- as we deploy 4G, I know that from all that competent suppliers do have high leverage, do you think as we go into 4G, two questions here, one is how much more leverage do you think you will have within in that segment? And also, in terms of the base of that over 3G, I'm just trying to see if there's any way to understand how ADI can leverage this growth just 4G deployment. I'm not sure it has any more incremental leverage for you.

Vincent Roche - *Analog Devices, Inc. - VP - Sales, Strategic Market Segments*

I think it's actually a very good for ADI. The more complex the problem becomes, and the problem does become more complex in terms of delivering performance when you get 4G levels, that's good for ADI. We participate in pushing the performance envelope in all these radio systems across the globe with all the major players, so the move into 4G is very good for ADI.

Of course, it won't stop there either. There will be more generations coming on top of that in the years ahead. In terms of being able to put a specific quantity in there in terms of leverage all I can tell you is that the content increases for ADI in terms of ASP per system, the higher level of system, that is certainly through in terms of 4G from 3G, for example.

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

I think the other part of it is that not only does that require higher performance components, as Vince said, but we have a much wider spectrum of products that we supply in newer systems. We have talked previously about our RF portfolio, which I think in the early generations of wireless infrastructure was quite minimal. But in the more recent and most advanced deployments, our RF products are very important, and very often the differentiator in the system that differentiates our product offerings to our competitors.

We also have many other new products, like clocks and other types of things that go around converters that we never had, really, in the early 2G, and in some cases, 3G deployments. So I think that we're getting the benefit of, number one, that you need higher-performance components, number two, in many of the new systems, there were more cards per box than in the older systems.

And thirdly, the product offering is much broader in the newer systems than it was in the older systems. So the combination of all those three things happening simultaneously does give us a lot of leverage on the upside, as newer systems get deployed.

Vincent Roche - *Analog Devices, Inc. - VP - Sales, Strategic Market Segments*

There are two dimensions to the products that we supply to these systems. We have the data path products that allow the performance, the speed and the bandwidth performance requirements to be realized, but also, there are control and observation circuits that are required to become more and more sophisticated, as the standards continue to increase in performance levels.

So it's good on both sides of -- on both those dimensions for ADI, both in terms of the data stream itself, but also the sophistication of the components required to keep these systems stable and secure.

Uche Orji - *UBS - Analyst*

Perfect. Thank you very much.

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

I would just make one final comment on that, that when we visit all the large infrastructure accounts, we're one of very few competitors that can offer the breadth of products they really want. And as you look forward, the deepness of the relationship that's going to be required between the suppliers, in this case, like ADI and the manufacturers, who are well-known in this business, is getting to be much tighter every year.

And the strategic rationale of buying one part from one vendor, another part from another vendor, and picking the rest of them out of a catalog in that business, I think is more indicative of what it's been, than what it's going to be in the future. So I think that the deepness and the strategic engagements that are required to really penetrate new applications in that business is much greater than it's been.

And in that sense, the breadth of the portfolio, the reputation of the vendor, the share that the current vendor has of the bill of materials, the technology roadmaps, in terms of not only single products, but very integrated products that integrate analog technology and RF technology, and a bunch of other things on either the same chip or the same package, is going to be a very important differentiator going forward. And in that sense, we think that's one of ADI's long-term very significant competitive advantages.

Maria Tagliaferro - *Analog Devices, Inc. - Director of Corporate Communications*

Great. All right. We'll take our next question now, operator.

Operator

The next question comes from the line of C.J. Muse, from Barclays Capital.

C.J. Muse - *Barclays Capital - Analyst*

I guess first question, I was hoping to maybe get some color on whether you saw any changes in order patterns post-Chinese New Year? Whether any business performed better or worse? I would love to hear color on that.

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

I don't think so. I think what we typically see is business was very good for quite a while, the Chinese New Year came, the business in Asia weakened for a week and then it came back very strongly the week after, so I don't think we saw any trends in the Chinese New Year that are not very typical to what we'd see normally.

C.J. Muse - *Barclays Capital - Analyst*

Okay. That's helpful. And then I guess as my follow-up, I was hoping maybe you could talk a little bit about some of the recent acquisitions, Lyric, Audio Asics, et cetera. Any contribution there that's noteworthy that we should be thinking about in terms of future growth?

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

Well, I think the second one you mentioned, it's been long ago integrated into long ago as an important part of our product offering. Lyric is much more of a longer-term play, where we really believe that the kind of technology they have really enables performance that without that type of technology just isn't possible on many, many dimensions that are very critical in signal processing. We're just now beginning to embed that type of technology in our products. We have a couple of areas that we have picked out that we think it's the most relevant.

So I think as we get out towards the end of this year, and into 2013, we'll begin to see Lyric technology deployed in a wide number of ADI products that will really -- that technology will really make a huge difference in power anticipation and other characteristics, size, that people really care about.

So the proof is in the pudding, and it's always hard to predict exact quantitative numbers long in advance. But everything we've seen so far substantiates the value of that technology ultimately to analog devices in our customers.

C.J. Muse - *Barclays Capital - Analyst*

Thanks, guys.

Operator

Next question comes from the line of Steve Smigie, from Raymond James.

Steven Smigie - *Raymond James & Associates - Analyst*

Jerry, you mentioned that you would expect a quick snap back on the industrial side. I was hoping you could talk a little bit about the piece of how that would look. Is it you get the bulk of that recovery in one quarter, or it would take place over a couple quarters?

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

I think it will probably -- if history is a good example -- it will be a gradual recovery, eventually gets to the point where people's psyche changes a little bit, and they start saying, oh my God, there's not enough supply out there, and then we can see a more rapid acceleration.

At least from the data that we're getting from the customers and -- Vince, as I mentioned just visited a bunch of our large industrial customers in the last week or two -- I think we're expecting -- or at least what we're planning for is a gradual recovery in our industrial business, as we've seen in many other cycles. Vince, do you have anything else?

Vincent Roche - *Analog Devices, Inc. - VP - Sales, Strategic Market Segments*

I think, just to add a little bit more color to what Jerry said, we have -- we characterize the industrial sector across the areas of automation, energy instrumentation and mil/aero, and we have seen, since this time last year, pretty much all of those sub-segments are down, just about the same level from the peak.

And the indications are that they're all going to pick up -- as Jerry said -- they're down roughly about 25% over the past year. But we're expecting that the recovery will be fairly gradual, and I would say the next two, three quarters we'll see the recovery gather speed.

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

Of course. Vince is saying that because he doesn't want me to raise his sales plan, but our experience is that is typically what happens.

Steven Smigie - *Raymond James & Associates - Analyst*

Right. And as my follow-up, with regard to the telecom recovery you are talking about for the second half, is there a particular geography you expect to see a sharper or more meaningful recovery?

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

I don't know. My own sense, I'd be curious to hear Vince's views on that. It will come up where it went down the most first, because some of that recovery is just going to be the end of the inventory reduction.

I think longer-term everyone can make their own prediction about which economies are going to grow faster, what's going to happen in Europe, what's going to happen in the US as the election gets closer. What's going to happen in China in terms of government policy.

So there's a lot of unknowns about what the macro issues are going to be in each of the regions. But I think right now, what we expect is that the places that have had the most significant reductions will have the most significant increases at least in the short-term.

Vincent Roche - *Analog Devices, Inc. - VP - Sales, Strategic Market Segments*

Yes. So the industrial business that we've talked about a lot is very intertwined in Europe and America in particular. Those two regions have seen the sharpest declines over the last few quarters, and they're the regions that I would expect to see improve -- see the benefit of the improvement over the next number of quarters, most compared to the others.

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

I think just to try to quantify that just a little bit, if you go back to the fourth quarter, our peak quarter, in industrial revenues which is about a year or 15 months ago, we were doing -- we did $350 million in the industrial area that quarter. Last quarter we did below $290 million.

In a business with probably 10,000 or more different customers, in virtually every geography in the world, that's a massive decline in a short period of time. That's a market that tends to move at glacial speeds. So that's what gives you a sense of what it is that is possible for us over the next couple of quarters. But we'll have to just wait and see how that happens.

Steven Smigie - *Raymond James & Associates - Analyst*

Great. Thank you.

Operator

The next question comes from the line of Stacy Rasgon, from Sanford Bernstein.

Stacy Rasgon - *Sanford C. Bernstein & Company, Inc. - Analyst*

I had just a quick one, first on the effect of the fourteenth week. As I recall from last quarter, you had suggested that holiday shutdowns, and I guess the Asia holidays as well, would mitigate or eliminate any potential upside from that fourteenth week, but you don't seem to be suggesting that now when you're giving color on the seasonal growth embedded in your guidance.

Can you give us some feeling for how much additional revenue in this quarter that you just reported that fourteenth week actually provided, so we can get some better feeling for what the apples-to-apples seasonal growth comparison ought to be?

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

It's purely a guess is what I'd have to say. We believe that probably we lost at least a week, and maybe a week and a half of revenue last quarter, due to the holidays. Some people think it's two, some people think -- there were a lot of different analyses of that. Of course it's very hard to be specific about that, but I'd say if you took a number of a week and a half or something, that probably wouldn't be a bad number.

Stacy Rasgon - *Sanford C. Bernstein & Company, Inc. - Analyst*

Wouldn't you usually have that same loss of revenue in this quarter every single year? So that would be normal, wouldn't it?

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

Yes, partially that's absolutely true. But when you have a year where the economy is really in the tank and virtually every company that we sold to, including us, was closed for at least a week and maybe in Analog's case, two weeks, and many of our customers, that tends to be exacerbated from what would normally be -- people take three extra days over Christmas off.

So I think when times are good, we see periods where we get through that with almost no change in the Christmas period. And when times are bad, we get a whopping big change. So I think this was more in the latter category, than the former.

Stacy Rasgon - *Sanford C. Bernstein & Company, Inc. - Analyst*

Okay. For my follow-up, I want to touch a little bit on this peak-to-trough decline in industrial revenues. So there you see, right? They're down 20%-plus from the peak. Was it fair to say that peak itself was potentially elevated as the customers were probably overbuilding inventories? Any sort of feeling for how elevated it might have been and what -- how far below are you what would tend to be sort of a normalized level of typical inventories? What would that decline be if it was off of a normalized level?

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

You're asking very challenging questions that we really don't have.

Stacy Rasgon - *Sanford C. Bernstein & Company, Inc. - Analyst*

I do try.

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

I know you do, and you succeed. It's very hard because when we were shipping at those levels and we went to the customers and went to our sales folks and said this looks pretty overheated and is this really sustainable? What's going to happen when inventories rebalance?

We got a lot of comments that was very specific with the consumer customers, and I'd say the communications customers, that this one probably took $10 million too much, this one took $20 million too much. And we did see a long line-up in the lobby of those kind of customers that were desperate for product.

We didn't see that much in the industrial area, because the customer tends to be smaller and more diversified. So with the communications area, it's a little easier to try to be quantitative about that than the industrial area. But I don't know -- if you say, added 350, how much could that be? It could be $10 million, it could be $20 million. I don't know.

It could be $5 million. I don't think it's more than $20 million. But I don't know. I just don't know. There's just too many customers, too many different ordering patterns to be real specific about that.

Vincent Roche - *Analog Devices, Inc. - VP - Sales, Strategic Market Segments*

I think a couple of things that might have helped us through the upswing through the cycle, I think our lead times were very healthy as the tsunami crisis hit last year, and we've kept our lead times very healthy as a Company over the last 2.5 years. And also, we paid very close attention to the demand rates as per the end customer, rather than factoring in the channel demand. So I think those two things help us to some extent manage both the upswing and the downswing.

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

I think the other thing that we look at, Stacy, a little bit, to try to smooth this out, is we look at what the growth rate of the industrial business has been. Over the last couple of years. On the average -- there's always supply or demand issues on either side of that. And the kind of numbers that we're planning for our industrial business are commensurate with an industrial business that's grown about 8% a year. Now, I think 2011 was a little overheated, the year before was underheated.

But the sequential numbers are harder to try to predict because of all the things you're saying, then what's the long-term growth rate of that business? And I think with the success we are having in some segments of the industrial business, which are growing at quite strong rates, we think long-term that's a good grower for us, and it's going to grow at a rate that's higher than most people believe, and that we even believe when we looked at it three years ago, on the average. Some years will be better, some years will be worse.

But the question you're getting at of trying to predict how much industrial revenue you're going to get based on the bounce back, is just -- we just don't know enough to be quantitative about that. I mean, there is something there. I just can't pinpoint exactly what it is.

Stacy Rasgon - *Sanford C. Bernstein & Company, Inc. - Analyst*

Got it. Thank you, guys.

Operator

Next question comes from the line of Chris Danely from JP Morgan.

Chris Danely - *JPMorgan Chase & Co. - Analyst*

Just a quick clarification, if we take out the 14- to the 13-week transition, do you guys feel like demand or your revenue this quarter is back to normal seasonality?

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

I don't know. I don't know what normal is in this world anymore, frankly. But I think the range of guidance that we put out is indicative of the order rates that we are now achieving. That's the best I can say.

Chris Danely - *JPMorgan Chase & Co. - Analyst*

That's fair. And then in terms of the increase, Jerry, do you think that it's all inventory replenishment or all demand improving? Or a little bit of both?

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

Well, your guess on that's probably as good as -- if not better than mine. I think some inventory replenishment, as Vince said earlier, many of the large industrial customers are indicating that they're planning to grow this year. And so, I think there's probably some of that in there. It's probably a combination of those two. The ratio between those two -- I just don't know.

Chris Danely - *JPMorgan Chase & Co. - Analyst*

And one last clarification if I may, on the reported quarter, the reason you guys came in at the low end of guidance, was that because consumer and/or industrial was a little bit lower than you thought?

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

Well, I think November and December were worse than we thought.

Chris Danely - *JPMorgan Chase & Co. - Analyst*

Okay.

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

At the onset. And then we were worried going into January that we missed the lower end of the guidance. I think we had some people around believe that was the case going into the Christmas period. But January was a better month, and you could really see the inflection point in the orders as soon as we came back, so that was very encouraging. And the fact that it stayed strong in the early part of the first couple of weeks of February, which we've now seen, is encouraging to us. And we're hopeful that continues.

Chris Danely - *JPMorgan Chase & Co. - Analyst*

Great. Thanks a lot.

Maria Tagliaferro - *Analog Devices, Inc. - Director of Corporate Communications*

Well, we just came up on the 6.00 hour, and unfortunately we have quite a few people still in the queue. So I'm going to ask folks to give us a call to the Investor Relations line. And we'll schedule a time and get back to you today, this evening. The number there is 781-461-3832. And we also have a record of who is still in the queue, and we'll be sure to reach out to you. Thanks again for joining us on today's call.

Just for your information, our call for the second quarter's financial results is scheduled for May 22, 2012, beginning at 5.00 PM. The release will be out at 4.00. Thanks very much for joining us. Operator, you can now disconnect callers.

Operator

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