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TXN - Q1 2015 Texas Instruments Inc Earnings Call

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OVERVIEW:

Co. reported 1Q15 net income of $656m or $0.61 per share. Expects 2Q15 revenue to be $3.12-3.38b and 2Q15 EPS to be $0.60-0.70.

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PRESENTATION

Operator

Good day. Welcome to the Texas Instruments 1Q 2015 earnings release conference call. At this time, I would like to turn the conference over to Dave Pahl. Please go ahead, sir.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Good afternoon and thank you for joining our first-quarter 2015 earnings conference call. As usual, Kevin March, TI's Chief Financial Officer, is with me today.

For any of you who missed the release, you can find it and relevant non-GAAP reconciliations on our website at www.ti.com/ir. This call is being broadcast live over the web and can be accessed through TI's website. A replay will be available through the web.

This call will include forward-looking statements that involve risks and uncertainties that could cause TI's results to differ materially from management's current expectations. We encourage you to review the notice regarding forward-looking statements contained in the earnings release published today as well as TI's most recent SEC filings for a more complete description.

Revenue growth of 6% from a year ago was within the range of expectations we provided in January. Automotive and industrial markets were strong as we expected they would be. However, revenue was in the bottom half of the range for two reasons. First was weak demand in the last month of the quarter in our personal electronics market, particularly PCs, and in our communications equipment market, particularly wireless infrastructure equipment. We believe these market-specific issues were due to delay of investments by carriers and capacity upgrades for wireless infrastructure equipment and a weaker-than-expected refresh cycle for Windows XP.

The second reason was a steep decline in the currency exchange rate for the euro relative to the U.S. dollar. The euro dropped about 10% during the quarter, and even though only about 5% of TI's revenue is transacted in euros, it was a sharp enough drop that it negatively impacted our revenue by about $20 million more than we had anticipated. Even with these pockets of weaknesses, our core businesses of Analog and Embedded Processing turned in their 7th and 10th consecutive quarter of year-over-year growth, respectively. Combined, these business grew 9% and were 86% of our total revenue.

Earnings per share were $0.61, reflecting our continued attention to cost controls. Although the vast majority of our revenue is transacted in U.S. dollars, ROE negatively impacted revenue by $20 million, which translated to only about $5 million of impact to earnings and, therefore, cash flow. This is due to a partial natural hedge against negative currency fluctuations due to our non-U. S.-based operations. It is nice to have a position to be in this when you have almost 90% of our revenue comes outside of the U.S. With that as a backdrop, Kevin and I will move on with our report on business performance that we believe continues to represent the ongoing strength of TI's business model.

In the first quarter, our cash flow from operations was $609 million. We believe that free cash flow growth, especially on a per-share basis, is most important to maximizing shareholder value in the long term. Free cash flow for the trailing 12-month period was $3.6 billion, up 17% from a year ago. Free cash flow was 27% of revenue, consistent with our targeted range of 20% to 30% of revenue. This is a 2 percentage point improvement from a year-ago period and we believe reflects our improved product portfolio and the efficiencies of our manufacturing strategy, which includes our growing 300 millimeter output, and the opportunistic purchases of assets ahead of demand.

We also believe that free cash flow will be valued only if it is returned to shareholders or productively invested in the businesses. For the trailing 12-month period, we returned $4.1 billion of cash to investors through a combination of stock repurchases and dividends.

In the first quarter, TI revenue grew 6% from a year ago with growth in both Analog and Embedded Processing. Analog revenue grew 11% from a year ago, primarily due to Power Management and High Volume Analog & Logic. Silicon Valley Analog and High Performance Analog also grew. As we mentioned earlier, this is the 7th quarter of year-over-year growth for Analog.

Embedded Processing revenue grew 2% from a year ago due to microcontrollers and connectivity. Processor revenue declined, which was impacted by the weakness in wireless infrastructure. And again, as I mentioned earlier, this is the 10th consecutive quarter of year-over-year growth for Embedded Processing.

In our Other segment, revenue declined 10% from a year ago primarily due to custom ASIC products, which also are heavy in wireless infrastructure, as well as DLP products.

In distribution, resales increased 11% from a year ago. Weeks of inventory remained at historically low levels of just under four and a half weeks, which is a decrease by more than a week from a year ago and is even with the fourth quarter. This level has decreased over the past few years because we have structurally changed how our inventory is managed in the distribution channel with our consignment program.

From an end market perspective versus a year ago, automotive grew with most sectors inside this market growing at double-digit rates. Industrial had broad-based growth. Personal electronics grew, although growth in PCs was lower than we expected. Communications equipment declined due to wireless infrastructure, and enterprise systems grew. Kevin will now review profitability, capital management, and our outlook.

Kevin March - *Texas Instruments Incorporated - CFO*

Thanks, Dave, and good afternoon, everyone. Gross profit in the quarter was $1.82 billion, or 57.7% of revenue. Gross profit increased 13% from the year-ago quarter, and gross margin was up almost 4 points. Gross profit reflects higher revenue, increased factory loadings and benefits from our efficient manufacturing strategy as we build more Analog chips on 300 millimeter wafers.

Moving to operating expenses, combined R&D and SG&A expenses of $777 million were down $68 million from a year ago. The decline primarily reflects the targeted reductions in Embedded Processing in Japan that were previously announced. As we have said, that restructuring was essentially complete at the end of last year.

Acquisition charges were $83 million, almost all of which were the ongoing amortization of intangibles, which is a non-cash expense.

Operating profit was $958 million or 30.4% of revenue. Operating profit was up 39% from the year-ago quarter. Operating margin for Analog was 35.4%. Operating margin for Embedded Processing was 18.3%, more than doubling from a year ago as we executed our restructuring plan to better align resources with the opportunities that we are pursuing as we benefit from our investments for growth. Net income in the first quarter was $656 million or $0.61 per share.

Let me now comment on our capital management results starting with our cash generation. Cash flow from operations was $609 million in the quarter. Inventory days were 124, about three days more than planned due to revenue coming in at the bottom half of our expectations. Capital expenditures were $123 million in the quarter.

On a trailing 12-month basis, cash flow from operations was $4.04 billion, up 16% from the same period a year ago. Trailing 12-month capital expenditures were $431 million or 3% of revenue. As a reminder, our long-term expectation is for capital expenditures to be about 4% of revenue, which includes our $8 billion 300 millimeter Analog plan discussed in our recent capital management call.

Free cash flow for the past 12 months was $3.61 billion, or 27% of revenue. Free cash flow was 17% higher than a year ago.

As we said, we believe free cash flow growth, especially on a per-share basis, is most important to maximizing shareholder value in the long term and will be valued only if it is returned to shareholders or productively invested in the business. As we've noted, our intent is to return 100% of our free cash flow plus any proceeds we receive from the exercise of equity compensation minus net debt retirement.

In the first quarter, TI paid $356 million in dividends and repurchased $670 million of our stock for a total return of $1.03 billion. Total cash returned in the past 12 months was $4.14 billion. Outstanding share count was reduced by 3.2% over the past 12 months and by 39% since the beginning of 2005. These returns demonstrate our confidence in TI's business model and our commitment to return excess cash to our shareholders.

Fundamental to our commitment to return cash are our cash management and tax practices. We ended the first quarter with $3.30 billion of cash and short-term investments. TI's U.S. entities owned 82% of our cash. Because our cash is largely on shore, it is readily available for a variety of uses including paying dividends and repurchasing our stock. TI orders in the quarter were $3.21 billion, up 5% from a year ago.

Turning to our outlook, we expect TI revenue in the range of $3.12 billion to $3.38 billion in the second quarter. This represents continuing weakness in our communications equipment and personal electronics markets, particularly for wireless infrastructure equipment and PCs, respectively. We also do not expect a near-term rebound in foreign currency exchange rates.

We expect second-quarter earnings per share to be in the range of $0.60 to $0.70. Acquisition charges, which are non-cash amortization charges, will remain about even and hold at about $80 million to $85 million per quarter for the next five years. Our expectation for our annual effective tax rate in 2015 remains about 30%, and this is the tax rate you should use for the second quarter and for the year.

In summary, we believe that the first quarter demonstrates the strength of TI's business model. While we are not immune to demand and currency changes, their effects are softened by the diversity of our portfolio and our markets. With that, let me turn it back to Dave.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Thanks, Kevin. Operator, you can now open the lines up to questions. In order to provide as many of you as possible an opportunity to ask your questions, please limit yourself to a single question. After our response, we will provide you an opportunity for an additional follow-up. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

We go first to Jim Covello with Goldman Sachs.

Jim Covello - *Goldman Sachs - Analyst*

Thanks so much for giving me the chance to ask a question. There's so much controversy in the industry today about whether the industry is as cyclical as it used to be, less so, et cetera.

I look at your year-over-year growth rates, the June quarter represents the first time you have had a year-over-year decline at the midpoint of your guidance in a long time. How do you think about that in the context of an industry where many are arguing that we're not cyclical anymore?

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Yes, Jim, we're, as you know we've been pretty guarded at trying to predict the cycle. It's not something, obviously, that we can control. We really just go to what we can look at and what we can measure.

So if you tick through the things that you typically look at from a cyclical standpoint, we look at channel inventories are down a week from a year ago. They're lean at just under four and a half weeks.

Lead times are remaining consistent, our cancellations and reschedules are very low. In addition, we're continuing to deliver on time and very consistently with that.

So we've got a couple of pockets of weaker-than-expected demand as we talked about specifically in wireless infrastructure and PCs. At the same time, we're seeing automotive and industrial continuing to be strong as we expect.

So, that's what we know. That's what we can see. The debates will continue on how cyclical our industry will be or won't be.

Kevin March - *Texas Instruments Incorporated - CFO*

I might just add that we do have several significant competitive advantages, the combination of which we believe is pretty difficult for anybody else to replicate, and it helps us deal with any notion of cyclicality or noncyclicality. Those advantages include that we've got the broadest portfolio in the industry, which really means engineers start their design work by looking at us first.

We enjoy very low-cost manufacturing for all the reasons that you've heard us talk about for the last few years, including our 300 millimeter wafer fabs. We have the broadest sales channel, in fact probably 3 to 4 times larger than our nearest competitor.

We play in an extremely diverse set of markets with long-lived products that enjoy significant cash returns to our shareholders for a long time. We think that's what's really important to deal with, whatever may be happing in market cycles and just really make sure that we're a lot more competitively advantaged than everybody else.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Do you have a follow-up, Jim?

Jim Covello - *Goldman Sachs - Analyst*

Yes, thanks for that. It was helpful. Obviously you're talking about some weakness in PCs and comms.

In the industrial segment, we're starting to see some negative news flow from the customers. Do you see pockets of weakness but there's just other pocket of strength that are offsetting those industrial customers that may be weak? I know it's a very broad-based customer base.

Or do you just not see any weakness at all in that segment at this point? Thanks very much.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

I will just say that like you were hinting to, it's very broad based. So we service over 100,000 customers, most of those who reside in industrial. And again, I think it's probably helpful for me to just go through, and when we say industrial, it means something different than I think the investment definition of industrial.

So it will include things like factory automation and control and medical, healthcare, fitness products, building automation, smart grid, energy test equipment, motor drives, display, space avionics, appliances and other segments. So again, very, very broad.

Of course, we will always see pockets of strength and weaknesses, but overall, industrial is doing well. We've seen growth in almost all those sectors that I have described.

Okay, thank you. We will go to the next caller, please.

Operator

And we will go now to Chris Danely with Citi.

Chris Danely - *Citigroup - Analyst*

Dave, you did a good job of outlining the relative areas of weakness in Q1 from currency and comm and PC. Can you just give us which you think would be a bigger drag in terms of company sales from PC versus communications?

And then do you guys expect a negative impact from currency in Q2 as well? And if you could give us the magnitude of that negative impact.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Yes. So the one that is pretty straightforward to identify, because it's really just math, walking through the numbers, is that on a year-on-year basis, we will probably see about a $50 million headwind due to currency exchange rate. Obviously we're not assuming that we see a rebound in those rates. We will still see and expect to see the weakness in PCs and wireless infrastructure, and in the balance of the business as you know, there's always puts and takes. As an example, second quarter a year ago, DLP was very strong, if you remember. It was benefiting from several world events, one of them like the World Cup.

That won't repeat, so that will be weaker than it was a year ago and will continue for the rest of the year. But inside of that bucket, we will continue to have puts and takes.

Do you have a -- and the other comment that I would just make on that, although we see those pockets of weakness, if you look at the core businesses of Analog and Embedded, we do believe that those will continue to perform well. Do you have a follow-up, Chris?

Chris Danely - *Citigroup - Analyst*

Yes, actually just a couple of clarifications. Would you expect that PC or the wireless infrastructure to have a bigger drag on your revenue in Q2? And then it almost seems like, do we need the dollar to weaken again for that to -- for that impact to go away, i.e. if the dollar remains strong, is that going to be a negative impact for you guys every quarter?

Kevin March - *Texas Instruments Incorporated - CFO*

Chris, I would say that we probably don't have enough detail to tell you whether wireless infrastructure or PC, which is going to be more of a drag. We just don't expect them to be recovering in the second quarter.

As it relates to ROE, certainly with -- if you take a look at just the euro alone versus a year ago, it's down 23%. The yen is down 14%. We roughly average about 5% of our revenue in euros and around 3% in yen.

So clearly with that kind of weakness, on a year-over-year compare, that's going to continue to be an issue that's going to just affect that kind of math. It doesn't affect our ability to sell in those markets.

We continue to remain very competitive in those spaces as we do have a lot of design wins. Unless the ROE moves back and the dollar weakens, then certainly with that kind of dramatic decline in those two major currencies, that will be, at least on the fringes, a year-over-year compare headwind for us.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

And I will just add to that, that like we saw in the first quarter where we had an impact of about $20 million, because of the natural hedging we've got the impact to operating profit and free cash flow is really only about $5 million. So fairly small on that front.

Okay, thanks, Chris, and we will move on to the next caller, please.

Operator

We now go to John Pitzer with Credit Suisse.

John Pitzer - *Credit Suisse - Analyst*

Good afternoon, guys. Thanks for letting me ask a question.

I don't want to beat a dead horse, but just on the outlook, when I look at the Q1, it looks like you guys are only missing the midpoint of your guide by about $50 million, and you explained $20 million of that on currency. As I go to Q2, if I just anchor against seasonality, you're kind of missing it $150 million to $200 million.

I guess sequentially, are you expecting any more headwinds from currency? I understand the year-over-year compare. I'm trying to figure out the sequential compare.

And when I look at PCs plus comm infrastructure, help me understand the percent of the business that represents. I'm thinking around 15%, maybe I'm wrong with that. I guess I'm trying to get a sense as to why you think that the miss in Q2 is going to be so much larger in those two buckets than the miss in Q1.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Yes, John, let me -- I will take the first part of the question, and Kevin can add in if he would like to. The first, if you look at our PC revenues as a percentage of our total is around 5%, if you were to include hard drives into that. That will add a few points. So you will be just under 10%, in upper single digits.

If you look at wireless infrastructure, last year it was about 10% of our revenue. So obviously combined there, you're in the mid-teens. So that will give you an idea of what that impact is.

Again, as Kevin walked through the math -- like the euro is an example. Last year, 18% of our revenue was done in Europe. About a third of that, so 5%, 6%, is transacted in euro. Again, sequentially, I don't know if you have any additional comments on the impact of the euro.

Kevin March - *Texas Instruments Incorporated - CFO*

I think 1Q to 2Q is what you're trying to ask for there, John. The average ROE that we experienced on our billings in 1Q for the euro was about 1.13. And for planning purposes, we're using 1.06 going into 2Q.

So there's going to be a little bit of quarter-over-quarter ROE impact just from that standpoint as it relates to the euro. Right now, we're anticipating the yen to be pretty flat.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Do you have a follow-on, John?

John Pitzer - *Credit Suisse - Analyst*

I know that within the comm section specifically you guys were doing a little bit of pruning with the product portfolio. I'm wondering if any of the pruning that you have done is being reflected in either sequential or year-over-year growth rates. Or do you feel like that's not a factor as you look at the June guide?

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Yes, we don't believe that that is a factor, John. I think if you look at the impact that wireless infrastructure has, we sell more Analog product than we do Embedded or the custom ASIC products.

So it actually hit both Analog, Embedded and Other. Of course, you can see the impact more significantly in Embedded and Other because it is a higher percentage of that revenue.

But again, we've got a good position really across most of the major OEMs there. So what we're seeing is really a change in chips in demand.

Thanks John. We will go to the next caller please.

Operator

We go now to Stacy Rasgon with Bernstein.

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

Thanks for taking my questions. First, I was wondering if you could give us a handle on where you see OpEx going next quarter given the revenue shortfall.

Kevin March - *Texas Instruments Incorporated - CFO*

Stacy, OpEx was up about as expected fourth quarter to first quarter. And recall that in the fourth quarter, we typically are down a bit on OpEx because of seasonality for holidays and so on.

And the absence of those holidays in the first quarter, along with our annual pay and benefit increases, traditionally drives our OpEx up quarter-over-quarter. Those pay and benefit increases kick in in February, so there is really only two months worth inside the OpEx right now in first quarter, so we will have the full three months. So you will see a very slight increase going into the second quarter.

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

Got it. Thank you. That's helpful.

For my follow-up, again on currency, I know you guys are pointing to direct translation effects. We've had other players who have pointed to demand destruction from currency.

I was wondering if you could give us your point of view on what you are seeing more broadly in the market, not just for your revenues but also for your customers? Are you seeing any broad-based TAM destruction because of the currency movements that we've had?

Kevin March - *Texas Instruments Incorporated - CFO*

Stacy, we've talked about that, but there's no way for us to really point to something and demonstrate evidence that that's actually occurring. Given that the entire industry tends to price in dollars for the preponderance of what's being shipped, there's not a lot of other alternatives it would seem for customers from a demand standpoint.

But that's not to say there might not be a second order knock-on effect like what you are alluding to. We don't see any way that we can quantify that with any confidence.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

There's always pluses and minuses with currency moves. So it's really impossible for us to be able to quantify that.

Thank you, Stacy. We will go to the next caller, please.

Operator

We go now to Harlan Sur with JPMorgan.

Harlan Sur - *JPMorgan - Analyst*

Good afternoon and thank you for taking my question. Given the timing of when you started to see the weakness that you talked about in the March quarter and just given the softer than seasonal Q2 outlook, would you have to ratchet down your wafer fab manufacturing activity or wafer starts here in Q2?

Kevin March - *Texas Instruments Incorporated - CFO*

Harlan, yes, we will be lightening up the wafer starts in 2Q. I would caution you, though, that pulling back on the wafer starts doesn't necessarily mean that that will have a direct impact on our inventory as the work in process in 1Q will become finished goods in 2Q. So we would expect our inventory probably still goes up a bit in 2Q even though we will pull back on the wafer starts a little bit.

Harlan Sur - *JPMorgan - Analyst*

Thanks for that. And then Analog was up nicely 11% year-over-year despite the headwinds.

Embedded was up only 2%, which is a pretty significant deceleration year-over-year versus the prior quarter. I'm assuming that the Embedded weakness was primarily driven by DSPs given the muted wireless infrastructure spending environment.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

That's correct. It was impacted by the wireless infrastructure. And, in fact, if you look at the businesses inside of Embedded, we had good growth in microcontrollers and connectivity both, but processors were down for the exact reason that you identified.

Okay, thank you, Harlan. We will go to the next caller please.

Operator

We now go to Ross Seymore with Deutsche Bank.

Ross Seymore - *Deutsche Bank - Analyst*

Thanks for letting me ask a question. One other avenue to get at the broad-based demand trends. Are you seeing any sort of difference in demand patterns from your distributor customers relative to the OEM customers?

Are they getting any more nervous or excited and willing to carry inventory? I realize the weeks of inventory data that you gave before, but from a bookings perspective, any color would be helpful.

Kevin March - *Texas Instruments Incorporated - CFO*

I think all I'd offer on that, Ross, is that on a year-over-year basis, bookings were up 5%. 60% of our revenue does go through disty, so clearly we're seeing a lot of the bookings coming through the disty channel.

The inventory levels they're carrying are about four and a half weeks, which is down about a week from a year ago. So they continue to carry lean levels of inventory. And I think largely that's because they know that we carry inventory in consignment. We also maintain very short lead times as we have for a number of years now, so their ability to get inventory quickly is pretty reliable for them when they order with us.

So I don't -- from those kinds of elements inside that space, there's no real signs that we can look at that says -- gee, there's demand destruction going on because of ROE. You really can't glean anything there.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

I would add, Ross, if you look at our resales overall, that was very consistent with our combined Analog and Embedded sales, so it was in the upper single digits, very close to the same number. Do you have a follow-on, Ross?

Ross Seymore - *Deutsche Bank - Analyst*

Yes, a quick one. Just to make sure that I have all the moving parts.

It sounds like in an answer to a prior question, Kevin, you said OpEx would be up a little. You also said utilization will be down. It seems like putting that together with your earnings guidance, it implies gross margin is going to be down a bit sequentially.

One, is that math directionally correct? Two, is the cause of the gross margin simply utilization, or is there some mix effect that I also need to appreciate?

Kevin March - *Texas Instruments Incorporated - CFO*

You may be missing the mix effects inside there, Ross. I don't expect much change in the margin.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Thank you for that question Ross. We will go to the next caller, please.

Operator

We go now to Joe Moore with Morgan Stanley.

Joe Moore - *Morgan Stanley - Analyst*

Great. Thank you. In the markets that you are seeing weakness in PCs and wireless infrastructure, do you think, is it an inventory or a demand problem?

We've seen other suppliers in the PC sector talk about a return to better than seasonal second half as you get past inventory correction. Where do you stand on that?

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Joe, I'd just say first of all that the wireless infrastructure market has notoriously been very choppy as you look at demand over the number of years. So there's usually a significant build as OEMs are planning to bid for the operators' spend and then typically surprises us, and there's an overbuild that occurs. So one kind of begets the other. We think the wireless infrastructure market obviously long term is a good market for us, and we've got a good position in. And just as the numbers come down, though, they will come up again one day.

On the PC side, that's only a couple of percent of our revenue, so I don't think we really have any unique insight on that. We believe that that weakness is due to the inventory that is created because there wasn't as much demand in the XP refresh cycle, but really nothing beyond that.

And we will see how the rest of this quarter goes before we start making predictions on the back half. We will just take it one quarter at a time. So do you have a follow-on?

Joe Moore - *Morgan Stanley - Analyst*

Specifically, John Pitzer had mentioned the restructuring you did, but just specifically you did cut back on R&D and macro base stations. I'm wondering if there is anything directly that would point to that decision versus the revenue you are seeing now or is that completely separate from that.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Again, I think that when we look at those markets, they're very long tailed and product cycles. We continue to make investments. They're just not at the same rates that we were making 5 and 10 years ago.

And that's not unlike what we've done in other markets as they've begun to mature. So there's other areas of wireless infrastructure that looks like it will be very promising growth like small cells. And we continue to invest very -- at very high levels there while we have very little revenue today. So we just believe that we've got to throttle that investment based on the opportunity overall.

So thanks for that question. We will go to the next caller.

Operator

We go now to Timothy Arcuri with Cowen and Company.

Timothy Arcuri - *Cowen and Company - Analyst*

Thanks a lot. I had two questions. First of all, I had a question about the channel.

Did you see any meaningful cancels this quarter? And then I had a follow-up on the inventory.

Kevin March - *Texas Instruments Incorporated - CFO*

No, we saw cancellations continue to run very, very low as we've seen for a number of quarters now. The same is true of reschedules, too, by the way, also very, very low. So no patterns indicating change in demand there.

Timothy Arcuri - *Cowen and Company - Analyst*

Okay, great. And then, Kevin, you said inventory is going to be up I think again in June despite loadings being down. I guess my question is, what do you think is the -- now that you've had a couple of quarters to think about the mix, what do you think is the right normalized level of inventory? And do you think that we're going to come back down to that more normalized level during the back half of the year?

Kevin March - *Texas Instruments Incorporated - CFO*

Tim, we are going to use 2015 to really monitor the effect of all the changes we've been doing with the portfolio and with our operations to model what we think is a more appropriate overall level of average inventories to carry. What we did conclude was that the prior model which had worked for us quite well of 105 days to 115 days was appropriate given the mix that we had. But clearly as we move to more and more consignment, as we move to keeping lead times very short across the vast abundance of our portfolio, that dictates that we've got to carry more inventory than we have in the past.

So we will be using 2015 to run various tests on what the appropriate levels of inventory are to meet the service metrics that our customers have come to expect of us. Probably by the time we get to early next year when we do our capital management update, we will go ahead and articulate a new model at that point in time.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Tim, thank you. We will go to the next caller, please.

Operator

We now go to Romit Shah with Nomura.

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

Thank you. Kevin, Dave, I just -- I wanted to clarify how these two segments that comprise 15% of revenue are driving what I estimate is a 500 basis-point miss relative to seasonality. Are you guys just being conservative in anticipation of maybe a fallout in some of your other end markets, or am I just not fully incorporating other parts of the equation here?

Kevin March - *Texas Instruments Incorporated - CFO*

So I will go ahead and just -- I think Dave attempted last time. I will give it a try. There are several moving parts going on there when you look at 2Q.

The best comparer is on a year-over-year basis. Just the ROE alone impacts us about $50 million from a year-over-year compare from a growth rate.

Then you go beyond that and you've got continuing weakness in wireless infrastructure and PCs, and then you've also got the absence of the benefit that DLP had a year ago, which was meaningful due to the World Cup and other large sporting events. In fact, we saw some of that impact of DLP already begin to occur in first quarter as we mentioned DLP was down quite a bit in first quarter.

So you've got those kinds of headwinds. ROE, wireless infrastructure, PC and DLP, then we've got the rest of the portfolio basically doing fine, consistent with what we've been seeing in the economy for the last few quarters.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Do you have a follow-up, Romit?

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

Thanks for the clarification, Kevin. I just wanted to ask you about M&A.

There's been, as you guys have seen, a lot of activity over the last year. When I think about TI, M&A has certainly been part of your DNA over the last 10 years to 15 years. Can you just talk about how you're thinking about M&A specifically in this environment relative to buying back your own stock?

Kevin March - *Texas Instruments Incorporated - CFO*

Romit, the -- our M&A posture hasn't changed at all meaning the most important thing to the extent that we consider an acquisition, it has got to be something that fits into our strategy that's consistent with our portfolio interests and something that we can generate long-term returns on and therefore excess free cash flow for our shareholders. If it passes the strategy test, then it has got to pass the numbers test. And frankly, we have a hard time with many of the companies that are out there today making those kind of numbers work.

Contrast that to when we bought National back in 2011 at a time when all semiconductor stock prices were considerably lower. You can certainly see in retrospect that was a very good return for our shareholders.

So we tend to be very disciplined on that. We will continue to be disciplined on that. Buying back our own shares right now especially as long as they trade below the intrinsic value of the company also continues to be a good return for our shareholders, especially from a free cash flow perspective.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Thanks, Romit. We will go to the next caller, please.

Operator

We now go to Ambrish Srivastava with BMO.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Hi, thank you. Kevin, you mentioned if you look at the portfolio, the rest of the business is doing fine outside of the factors that you highlighted.

If you go back to history and look at such a sharp destruction, to use that word, on the exchange rate, when do you expect that to manifest itself in other parts of the business? For instance, the distributors in Europe and other pieces that semis go into, for instance, in industrials and autos, what does past currency issues tell us on that front? Then I had a quick follow-up.

Kevin March - *Texas Instruments Incorporated - CFO*

Ambrish, I wish I had some clever insight on that, but I'm afraid I don't just from an experience standpoint. I actually do not recall in my experience in this capacity, and I have been in this role for a very long time now, seeing currency drop this sharply in this short a period of time.

So I have no history from which to try to get a reference point to answer a question like that. I think we're all going to have to wait and see where this takes us.

I think the encouraging part is, especially in industrial and automotive, is that the silicon content going into those spaces continues to increase year-over-year. And so despite ROE impacts, I don't think that's going to slow down the silicon content increases in those spaces. And frankly if you look at the pricing of those end equipments, the cost of a $0.50 Analog chip going to $0.55 is pretty irrelevant to an automotive customer I think.

If you look at the more macro effects and especially where we see growth for semiconductors in auto and industrial, it doesn't seem likely that we would see a sharp impact in demand caused just because of ROE. There may be other factors that may lead to that kind of difference.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

I would just add that as many arguments as putting pressure on demand, there's as many arguments that it could help demand on the other side. It's really tough to be able to quantify each of those impacts. Ambrish, you've got a follow-up?

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Yes, I did. Thank you. And this is a clarification in response to Ross's question.

Kevin, did you say gross margin will be flat? And if so, the way to think about is that factory loading goes down in the non-300 millimeter, and 300 millimeter is continuing to ramp so that offsets that lower factory loading?

Kevin March - *Texas Instruments Incorporated - CFO*

That's a safe way to think about it, Ambrish. There's mix going on inside there, but clearly we continue to ramp up 300 millimeter, which is much more cost-effective for us. In balance, we don't expect much change in margins.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Thanks, Ambrish. We can go to the next caller please.

Operator

We go now to Doug Freedman with RBC Capital.

Doug Freedman - *RBC Capital Markets - Analyst*

Thanks, guys, for giving me an opportunity to ask a question. Just a follow-on to that mix shift that you're seeing. Kevin, can you possibly give us the utilization on your overall factory base and the utilization that you are seeing in 300 millimeter, then I have a follow-up.

Kevin March - *Texas Instruments Incorporated - CFO*

On the utilization, we typically will just talk about that if something drastic has occurred, so I won't go into that right now. I will remind you that on the capital management call, I did discuss for RFAB in particular that we have the majority of the equipment necessary to support the buildout of that factory to a $5 billion revenue level.

And that in 2014, we had achieved about $2 billion worth of build of revenue in support of that. So call that roughly 40% utilized. But at the same time, we're also converting DMOS6 from its exclusive use by Embedded Processing to also be able to be used by Analog, and that will add another $3 billion of 300 millimeter analog capacity in DMOS6.

So you could say in a sense that our utilization of 300 millimeter may actually decline, but that's not because of loadings. That's because of increasing our capacity.

Doug Freedman - *RBC Capital Markets - Analyst*

And the question really that I have as my follow-up is when you look at the year-on-year growth last year, clearly we had a nice year. But with the guidance you've just offered, we're actually down year on year. If we look at the long-term growth rate of your business, is there a point in time at which you might adjust what you think your long-term growth rate would be such that you felt factory consolidation would be part of the equation to drive higher efficiency?

Kevin March - *Texas Instruments Incorporated - CFO*

No, Doug, factory consolidation isn't on our radar. What we're really interested in is very inexpensive factory acquisition with extremely low carrying costs that allows us to grow into it in a very efficient manner.

As we have been talking about, Analog and Embedded Processing combined for an extended period of time now have been growing at about a 9% compound annual growth rate. In fact, even combined for this 1Q that we just closed out, they grew another 9% year-over-year. So they continue to grow quite healthy.

I would expect that as we move forward in time, we will look at those factories that provide us the best cost efficiency and cash flow delivery and keep those operating and loading those. That's probably going to be biased toward 300 millimeter.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

I would just add too that if you look at the growth rates in time and just look at what's happened in second quarter, the overall numbers are very strong. If you look at our gross margins, you look at where our OpEx levels are, our operating margins, with that 9% Analog and Embedded Processing growth, this quarter we turned in 27% free cash flow.

So our financial performance isn't predicated on having to hit a certain growth level. We can do very well in a low-growth environment, or if things pick up, we're in a good position to be able to support that as well.

Okay, thank you, Doug. And we can go to the next caller, please.

Operator

We will now go to Blayne Curtis with Barclays.

Blayne Curtis - *Barclays Capital - Analyst*

Hey, guys, thanks for taking my question. Maybe just looking back at the weakness in the PC market, you clearly had a fairly seasonal December.

I don't know if you saw any PC slow down there. Intel sure didn't. But then looks like you took a correction in March.

So, one, if you could -- I apologize if you already answered this, but within Analog was your High Performance and Silicon Valley still up in March, and really it was the PC dragging it down. If so, it would be down probably double digits. Is that the right way to look at it?

As you look to June, Intel is up, PC channel is starting to turn around. Is it just that you are working through some inventory, or is there any way you can quantify that and then just help me with the math as to when you really start to see this?

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Let me take a shot at it, then I will let you ask a follow-up. Some of that I think we've touched on.

Again, the weakness that we saw, Blayne, was really -- had manifested in March. And it was both in PCs and in wireless infrastructure.

Obviously I don't know how that played out at some of our competitors, but we do expect to see that weakness in second quarter. Obviously our guidance is reflective of that. So I don't know if that helped or if there's part of that would you like to ask a clarification or a follow-up.

Blayne Curtis - *Barclays Capital - Analyst*

Maybe I will ask -- obviously I could sign up for a full-year forecast, but when you look at the businesses of PC and comm, clearly they've been down for several quarters here, or will be with the June guide. To get full-year growth would require a substantial pickup in the second half. Do you see these as headwinds this year for you, and if so, how much?

Kevin March - *Texas Instruments Incorporated - CFO*

Blayne, I will just take that. We will go ahead and forecast the balance of the year in front of each quarter when we get there, so we would just give you a guide one quarter at a time. Obviously I think you guys are probably better equipped than we are to come up with analysis to help figure out what the year might be, and we will leave it at that.

Dave Pahl - *Texas Instruments Incorporated - Director of IR*

Okay. And that -- we are now out of time, so I would like to thank you all for joining us today, and a replay of this call is available on our website. Good evening.

Operator

This concludes our conference. Thank you for your participation.
