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TXN - Q3 2014 Texas Instruments Inc Earnings Call

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OVERVIEW:
Co. reported 3Q14 revenue of $3.5b and net income of $826m or $0.76 per share. Expects 4Q14 revenue to be $3.13-3.39b and EPS to be $0.64-0.74.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Welcome to the Texas Instruments third-quarter 2014 earnings call. At this time, I would like to turn the conference over to Dave Pahl. Please go ahead, sir.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Thank you. Good afternoon, and thank you for joining our third-quarter 2014 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 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 Safe Harbor statement contained in the earnings release published today, as well as TI's most recent SEC filings, for a more complete description.

The third quarter was another quarter that marked strong progress. Our core businesses of Analog and Embedded Processing grew again, with combined revenue up 10% from a year ago. Revenue of $3.5 billion came in solidly in the upper half of our expected range we had communicated to you in July. Earnings per share of $0.76 was at the top of our range, as profitability was strong in the quarter.

Our cash flow from operations was $1.4 billion. We continue to believe that free cash flow growth is most important to maximizing shareholder value in the long term, especially on a per-share basis. Free cash flow for the trailing 12-month period was almost $3.5 billion, or 27% of revenue, consistent with our targeted range of 20% to 30% of revenue. This is a 300-basis point improvement from a year-ago period.

We believe this reflects our improved product portfolio, and the efficiencies of our manufacturing strategy, which includes our growing 300 millimeter output and purchasing assets ahead of demand at distressed prices. We also continue to believe that free cash flow will be valued only if it is returned to shareholders or productively invested in the business. Over the past 12 months, we've returned $4.2 billion of cash to investors through a combination of stock repurchases and dividends paid. In the third quarter, TI revenue grew 8% from a year ago, with growth in both Analog and Embedded Processing.

Analog revenue grew 11% from a year ago, led by power management. High Volume Analog & Logic, High Performance Analog, and Silicon Valley Analog also grew. Embedded processing grew 6% from a year ago, due to microcontrollers, connectivity and processors, each of which grew by about the same amount. Embedded processing delivered its eighth quarter in a row of year-on-year growth. In our Other segment, revenue was about even from a year ago, as a decline in legacy wireless products was mostly offset by growth in DLP products.

Turning to distribution, re-sales increased 10% from a year ago, consistent with our combined revenue growth in Analog and Embedded Processing. Weeks of inventory were unchanged, at a historically low level of just over 4.5 weeks. This level is low because we have structurally changed how inventory is managed in the distribution channel with our consignment program. This quarter, we continue to convert more of our distribution sales to consignment, and now support about 55% of our distribution revenue on consignment, up about 10 percentage points from a year ago.

With this program, inventory sits on TI's balance sheet and revenue is recognized when distributors pull products from our consignment inventory that is stored at distributors' locations. This program minimizes changes in demand due to distribution of inventory channel inventory, and most importantly, allows us greater flexibility to meet customer demand. From an end market perspective, TI revenue growth from a year ago was due to communications equipment, industrial and automotive, each of which grew by about the same amount. Enterprise systems was also up, while revenue and personal electronics declined due to legacy wireless products.

Now Kevin will review profitability, capital management and our outlook. Kevin?

Kevin March - ***Texas Instruments Incorporated - SVP and CFO***

Thanks, Dave, and good afternoon everyone.

Gross profit in the quarter was $2.04 billion, or 58.4% of revenue. Gross profit increased 15% from the year-ago quarter, and gross profit margin hit another new record. This gross profit reflects higher revenue and an improved product portfolio, focused on Analog and Embedded Processing that benefits from our efficient manufacturing strategy. Moving to operating expenses, combined R&D and SG&A expense of $795 million was down $38 million from a year ago.

The decline primarily reflects the targeted reductions in Embedded Processing and Japan that were previously announced, as well as continued cost discipline across TI. Acquisition charges were $83 million, almost all of which were the ongoing amortization of intangibles and non-cash expense. Restructuring and other charges were a $9 million benefit, primarily due to the gains from sales of assets. Operating profit was $1.18 billion, or 33.6% of revenue. Operating profit was up 39% from the year-ago quarter.

Net income in the third quarter was $826 million, or $0.76 per share. Let me now comment on our capital management, starting with our cash generation. Cash flow from operations was $1.38 billion in the quarter. Inventory days were 108, consistent with our model of 105 to 115 days. Capital expenditures were $103 million in the quarter. On a trailing 12-month basis, cash flow from operations was $3.82 billion, up 17% from the same period a year ago.

Trailing 12-month capital expenditures were $367 million, or 3% of revenue. As a reminder, our long-term expectation is for capital expenditures to be about 4% of revenue. Besides inexpensively adding capacity ahead of demand, we have focused on delivering higher levels of customer service. By combining this capacity with continued improvements in how we manage inventory, we're able to keep our lead times consistently low, while continuing to deliver on time. Free cash flow for the past 12 months was $3.45 billion, or 27% of revenue.

As we've said, we believe strong cash flow growth, particularly free cash flow growth, is most important to maximizing shareholder value in the long term that would be valued only if it is returned to shareholders or productively reinvested in the business. In the third quarter, TI paid $319 million in dividends, and repurchased $670 million of our stock, for a total return of $989 million. As we've noted, our intent is to return all of our free cash flow, plus any proceeds that we receive from the exercise of equity compensation, minus net debt retirement. Total cash return in the past 12 months was $4.16 billion, which was 9% higher than a year ago.

In the quarter, we announced a 13% dividend increase in our quarterly cash dividend, from $0.30 to $0.34 per share, or $1.36 annualized. This marked our 11th consecutive year of increasing dividends, and our 52nd year of continuous dividend payments. Outstanding share count has reduced by 3.5% 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 third quarter with $3.19 billion of cash in short-term investments, up from $2.80 billion at the beginning of the quarter.

TI's U.S. entities own 81% of our cash. Because our cash is largely onshore, it is readily available for a variety of uses, including paying dividends and repurchasing our stock. TI's orders in the quarter were $3.34 billion, up 6% from a year ago, and our book-to-bill ratio was 0.95. This ratio would have been a bit higher, except for the impact of the conversion to consignment of some products sold to distribution. While book-to-bill still would have been below one, this is consistent with the pattern that we have seen for the past four years. Turning to our outlook, we expect TI revenue in the range of $3.13 billion to $3.39 billion in the fourth quarter.

At the middle of this range, revenue would increase 8% from a year ago. We expect fourth-quarter earnings per share to be in the range of $0.64 to $0.74. Restructuring charges will be essentially nil. 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 effective tax rate in 2014 remains about 28%. This is the tax rate you should use for the fourth quarter.

In summary, the third quarter demonstrates the growing strength of TI's business model. Our strategy is anchored in Analog and Embedded Processing, and is bolstered by an efficient manufacturing operation and a broad sales channel. The result is diverse and long-lived positions in many markets. We remain intent on excellence and execution, disciplined in allocating our capital, and firm believers that free cash flow per share is the best long-term indicator of shareholder value.

With that, let me turn it back to Dave.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Thanks, Kevin. Operator, you can now open the lines up for 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. Danny?

QUESTION AND ANSWER

Operator

(Operator Instructions)

John Pitzer, Credit Suisse.

John Pitzer - ***Credit Suisse - Analyst***

Thanks for letting me ask a question. Kevin, I guess my first question will be on OpEx. Clearly you're well ahead of your expected annualized savings of $130 million with the restructuring actions. How do think OpEx will trend sequentially into the December quarter?

And if you look at R&D as a percent of rev now below 10%, is that just a structural change in the model? And how worried should I be at what scale level you should be investing on R&D for future growth? I understand that you are still spending absolutely a lot more money than most of your peers, but tough to see someone with your gross margins and R&D as a percent of revenue below 10%.

Kevin March - ***Texas Instruments Incorporated - SVP and CFO***

Okay. John, I think there were a couple in there, so let me see if I can remember them all.

Starting with OpEx and trends, the -- clearly, OpEx was down quarter-over-quarter, largely as a result of some of the restructuring actions we previously announced, as well as just ongoing cost discipline in all the various businesses across TI. As you look into the fourth quarter, if you just go back and take a look at a year ago, that is probably your best gauge to take a look at, fourth quarter, and even in first quarter for that matter. We typically see that OpEx is lower in the fourth quarter due to holidays and vacations.

In addition, this fourth quarter, we expect a further benefit of another $15 million of cost to come out as a result of the restructuring that we announced on Embedded Processing. That is part of that $130 million of annualized savings that you were mentioning, John. And in fact, we're probably running ahead of that $130 dollars of annualized savings right now. We are probably -- come out beyond that. From the total R&D spend, as a percent of revenue, again, I think what is more important is not how much you spend, but how well you spend it.

And I think the best indicator of how well you're spending it is what is happening to your market share as a result of the products we are introducing into the market. In our case, if you take a look at 2006 through 2013, the last full-year periods that we have reported on, our total R&D spend is up 77% over that period. But most importantly, that R&D has resulted in products where we have continually gained share. So again, I think, John, it is less a question of how much you spend it, and a lot more how well you spend it, and spend it on things that customers really care about.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

That's good. John, do you have a follow-up?

John Pitzer - ***Credit Suisse - Analyst***

Yes, guys, quickly, I know you don't give segment guidance for revenue. But when I look at the embedded business in the September quarter, it was up only about 1.1% sequentially, which is a little bit weaker than I had been modeling. And I am curious as to what you think might have driven that?

And given that some of your peers have talked about sort of a slowdown in the second half of September, from a macro perspective, did any of that play into the embedded business in the September quarter? Thank you.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Okay. So let me take that, John.

I think if you look at the growth rates between Analog and Embedded Processing, you can see a lot of quarters, they won't grow the same. And I think if you look at both of those businesses, they have different end market exposures. And really, it is those end market exposures that will explain most of the differences in those numbers.

So -- and the second part of your question was, yes, just -- basically, is the overall environment impacting the growth that we have seen there. And I just say no, that really isn't in those numbers. I -- basically, that forecast is given off of the orders that we receive from our customers.

Thank you, John. Can we go to the next caller, please?

Operator

Ambrish Srivastava, BMO Capital Markets.

Ambrish Srivastava - ***BMO Capital Markets - Analyst***

Hi, thank you very much. Just on the overall demand environment, there is a lot of confusion out there, but it seems like things have slowed down. So just wanted your perspective. In the past, you guys have given us certain things that you look at, such as cancellations and so on and so forth.

So -- and also within the frame of reference, Dave, if you could please just walk us through your [disty] consignment versus non-consignment? And then, how would you compare it to somebody who claims that they are sell-through, so they see a slowdown before -- a quarter or so before others. And then I had a very quick follow-up.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Okay. So a couple of points in there, Ambrish.

The first is, is that -- I would just point out that all of our distributors provide us with a point-of-sale reporting, and we get that information on a very regular basis. So regardless of how the revenue is recognized, we see what is going on from a distributor resale standpoint.

The second thing is, you touched on the current environment. And we really want to be guarded on trying to take a position for the industry on where that is going. But we can really point to just what we see.

So if I step through those, our inventory on our books is at 108 days, is within our target model. If you look at our channel inventories, those were essentially unchanged from last quarter. They are at a very lean level, at just over 4.5 weeks.

Our lead times have been consistent, and I'd say low. Our cancellations and reschedules remain very low. So nothing changing on that front. And then probably, as we have grown over these last few quarters, we have been able to support that growth, and keep delivering our products on time at very, very high service levels.

So our operations continue to execute at that high level. So -- and then I will get to -- the last part of your question was, what percentage of our revenue goes through distribution? And what percentages is supported by consignment?

So the first one is, about 55% of our revenues go through the distribution channel, and about 55% of that is supported on consignment. And as we pointed out in our prepared remarks, that has increased by about 10% from a year ago, as we have had a couple of conversions go on this year. And I would say that we're not done with that.

We actually expect that additional conversions will happen over the next year or so. So we expect that percentage will actually increase. So Ambrish, you have a follow-up?

Ambrish Srivastava *- BMO Capital Markets - Analyst*

Yes, quick follow-up, Dave. On the embedded operating margins, you guys have had a steady increase.

What is the right way to think about, how do you get to North of 20%? Is it just a matter of focusing on the right product mix, and getting that ramped up? Or is it something beyond that? Thank you, Dave.

Dave Pahl *- Texas Instruments Incorporated - VP and Head of IR*

Sure.

Kevin March *- Texas Instruments Incorporated - SVP and CFO*

Yes, Ambrish, I'll take that one. On Embedded Processing, clearly, the margins have been continuously improving over these last few quarters, and we would expect further improvement. Recall, I just mentioned earlier in the call that we expect another $15 million or so of cost to come out of the fourth quarter. And most of that will come out of Embedded Processing.

I would add that, from this point going forward, and we have talked about this the last couple of quarters, the amount of spend inside Embedded Processing is sufficient. It doesn't need to increase anymore. What, really, the focus is, is revenue growth. And that is what it is really all about. And that entire team has been very focused on that.

I believe they just recorded their eighth quarter in a row of year-over-year revenue growth. So they clearly are working on the right metrics to really make that business start to deliver profitability at the levels we expect it to at TI.

Dave Pahl *- Texas Instruments Incorporated - VP and Head of IR*

OK. Thank you, Ambrish. We'll go to the next caller please.

Operator

Stacy Rasgon, Sanford Bernstein.

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

Hi, guys. Thanks for taking my question. First, I want to dig into the embedded processor margins again just a little bit. You had about $26 million in OpEx come out from Q2 to Q3. You had revenue in the group up a little bit, but mostly flat. Margins were only up a little bit.

Given all of that cost, in theory, I would have expected to come out of Embedded Processing. Why weren't the Embedded Processing margins up more? It doesn't seem like all of those cost savings actually flowed through the margins this quarter.

Kevin March - ***Texas Instruments Incorporated - SVP and CFO***

Actually, they all flowed through the margin, Stacy, but not all through Embedded Processing. Recall, those actions incorporate both Embedded Processing, as well as actions in Japan, which flow through our [margins] as well.

Even with that, at the EP level, you did see about a 72% fall-through on that delta revenue. So you are seeing it come through. But do keep in mind that the Japan stuff spreads around some of the other business, as well.

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

Got it. That's helpful.

For my follow-up, if I can dig into the gross margins a little bit, I think both for this quarter and next quarter. So for this quarter, you came in a little bit high. I guess, was that only the revenue upside? Or was there something else, in terms of mix or other cost savings, that pushed it up?

And then for next quarter, depending on how far you're guiding OpEx down, it feels to me like you're guiding gross margins implicitly flat to up in Q4 in a quarter where revenues are down. And typically, your gross margins would be down in Q4, as well. So if you could give us any sort of feeling for what the gross margin drivers for next quarter ought to be, in terms of mix offsetting revenue declines, that would be very helpful.

Kevin March - ***Texas Instruments Incorporated - SVP and CFO***

Sure Stacy. I think that, clearly, the extra revenue came through, and it was quite rich. We also had a slightly better mix of overall products that were shipped in the quarter. So that combined gave us that new record gross profit margin of 58.4%.

As we look into fourth quarter, I would not characterize our guidance as suggesting that margins go up. We will be reducing loading some of the fourth quarter on a seasonal basis. And so you can expect that margins will be down a bit, not very much, but down just a little bit. So depending on how you are building your model there, I wouldn't assume margins increasing in the fourth quarter.

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

Got it. (multiple speakers)

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Thank you, Stacy, and we'll go to the next caller.

Operator

Harlan Sur, JPMorgan.

Harlan Sur *- JPMorgan - Analyst*

Thank you for taking my question and congrats on the solid quarterly execution. The markets have been focused on Europe and China as sources of potential weakness. At the same time, the team has done a solid job on diversification. And maybe that is what it is, the diversity of 4G, a more stable revenue profile.

But at the margin, can you just talk about the overall health by geographies? Have you seen any signs of weakening above the normal seasonal trends that you would normally expect here in Q3 or Q4?

Dave Pahl *- Texas Instruments Incorporated - VP and Head of IR*

Yes. Sure, Harlan.

I would say, if you just look at what happened regionally, year-over-year, Asia and Europe were both up, while the U.S. was even, and Japan was down a little bit. And sequentially, all the regions were up, with Asia and Europe up the most.

And if you look specifically inside of China, and how re-sales had done there, we had looked into that. And I'd just say that re-sales really just continue to be solid as we closed out the quarter. So that is basically what we saw.

Do you have a follow-up?

Harlan Sur *- JPMorgan - Analyst*

Yes, absolutely. Thank you for that. You gave us some trends in OpEx into the fourth quarter. How should we think about OpEx as we move into the first half of next year?

Kevin March *- Texas Instruments Incorporated - SVP and CFO*

Harlan, I won't comment on first half, but I will give you some thoughts on first quarter. And your best way to analyze that is just go take a look at what happened from fourth quarter to first quarter of most recent year, coming out of 2013 and 2012.

We do have seasonal increases in OpEx as we go from fourth to first, typically because of an absence of vacations that we have in fourth, and the partial implementation of our annual pay and benefit increases that occur in first. So they will -- you should expect those to be up, and you can take a look at, again, this past year to get a rough idea as to about how much that increases by in percentage terms.

Dave Pahl *- Texas Instruments Incorporated - VP and Head of IR*

Yes. And I would just add, Harlan, that the -- as we indicated before, Kevin pointed out that we're expecting about $15 million more of savings in fourth quarter at that point we'll be essentially complete on those announced actions. So we will basically be -- just have those seasonal impacts that Kevin had mentioned.

Thank you, and we'll go to the next caller please.

Operator

Craig Ellis, B Riley.

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

Thanks for taking the question. I will start off with a bigger picture question, Kevin. The Company has done a very good job of looking forward and being proactive, taking action to either prune lower margin revenue streams, such as wireless, or identifying opportunities for cost savings, such as the optimization program this year.

As you look ahead, how much further room is there for similar such optimization efforts? Are we really at a point where the TI model is getting very close to being optimized?

Kevin March - ***Texas Instruments Incorporated - SVP and CFO***

Yes, Craig, I think that, as we look forward from an optimization standpoint, I think the ones you have talked about so far have been more about where we might have trimmed in areas that had opportunities, perhaps not quite as attractive as other areas.

I think perhaps one of the areas least appreciated, as people look at TI on a go-forward basis, is the impact that continued Delta revenue on 300 millimeter Analog is going to have for us. The cost structure to build on 300 millimeter is very attractive. And so incremental revenue going forward on 300 millimeter, we expect to produce not only higher margins, but also higher levels of total cash on that Delta revenue.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Do you have a follow-on, Craig?

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

Yes, I do. Thank you. Dave, you mentioned the strength in Analog power management on a year-on-year basis. Was it similarly strong sequentially? And what specifically is driving that strength?

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Yes. So on a sequential basis, if you look at our Analog business, it was up primarily due to High Volume Analog & Logic, as well as Power Management. Though we did see growth, really from all four businesses. High Performance Analog and Silicon Valley also grew.

So you see a little bit of difference there, sequentially. But again, power continued to be strong in both comparisons.

OK. Thank you, Craig. We'll go the next caller please.

Operator

Steven Chin, UBS.

Steven Chin - ***UBS - Analyst***

Thanks for taking my questions. I just wanted to drill down a little deeper on the Embedded Processing segment. In particular, between microcontrollers, and I guess DSPs, and application processors. Could you talk about some of the trends that you saw in Q3, especially from any communications equipment exposure that you have?

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Okay. So Embedded Processing, as you know, grew 6% from a year ago. That was driven by microcontrollers, connectivity and processors, each growing by about the same amount. And again, as Kevin pointed out, that was the eighth quarter in a row of year-over-year growth.

Sequentially, revenue was a little better than even, connectivity was up, and processors and microcontrollers were about even sequentially. Do you have a follow-up, Steven?

Steven Chin *- UBS - Analyst*

Yes. In terms of gross margins, I was just wondering if this year, there is an opportunity for you to take advantage of building any strategic inventory for certain products that you know have good turnover? And hence, maybe further optimize gross margins a little bit in the seasonally slower quarter? Thanks.

Kevin March *- Texas Instruments Incorporated - SVP and CFO*

Yes, Steven, we do that on an ongoing basis. That is one of the ways that we are able to keep, for the lead time, for the overwhelming majority of our parts to six weeks or less. Because that, in fact, we build to stock, not necessarily build to order, meaning we maintain a stock of inventory such that we can always have short lead times for our customers.

So from a strategic standpoint, that is done. It does have a little bit of ebb and flow. As you point out, we only have lower loadings in certain quarters.

It gives us a chance to build up on a few extra parts on that. But I don't think there's a whole lot of opportunity to do that, just to impact the gross margins. I think we're really doing that to impact customer service.

Dave Pahl *- Texas Instruments Incorporated - VP and Head of IR*

Yes. And I would also add, Steven, that if you take the combined way that we are managing inventory now -- and we are being very intentional with specific targeted programs, depending on how quickly that inventory turns. But you take that, plus the open capacity that we have got, and the combination of those two things, and we've really been able to execute at very high levels, and deliver our products on time to customers. And so we think not only having low lead times, but also delivering product when you make a commitment to a customer, the combination of those things are what customers would like to have.

OK. Thank you. We'll move on to the next caller please.

Operator

Joe Moore, Morgan Stanley.

Joe Moore *- Morgan Stanley - Analyst*

Great. Thank you. Can you talk about where your fab utilizations are now, just qualitatively? And if there is still an underutilization charge to -- as part of these numbers?

Kevin March *- Texas Instruments Incorporated - SVP and CFO*

Joe, on the underutilization charges, the answer is yes, there are. But we're not really talking about those anymore. And the reason is really straightforward.

We found that analysts and some investors were drawing the conclusion that, because we had underutilization, that increase in our utilization would be the maximum amount by which we could increase our overall profitability, if we put revenue into those factories. And that is really an incomplete answer.

I will remind you that our stated strategy is to invest in our capacity ahead of demand. By definition, that means we will have open capacity and underutilization costs.

Our purpose, though, for buying ahead of demand is to purchase that capacity with as little cash as possible. So the underutilization charge is mostly a non-cash charge. And it tends to miss the point that our objective is to be maximizing free cash flow. So for that reason, you haven't really head us commenting on or quantifying underutilization charges these past few quarters, and unlikely to in the future, unless there is some material change that causes a better understanding of what is going on.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Yes. And Joe, I'll just add, the last time we had stated our end-to-end capacity, it was in the $18 billion range. So if you want to get a qualitative feel of where capacity is, you could annualize our quarterly revenues and put it against that number, and it will get you into the ZIP Code. So do you have a follow-on, Joe?

Joe Moore - ***Morgan Stanley - Analyst***

Yes. Thank you for that. In terms -- could you give us an update on the base station market? And I know you had said last quarter that continued to be strong. Just anything that you are seeing from that end market?

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Yes, if I just look at the communications market overall. And I would -- it -- from a year-on-year standpoint, it was up, primarily due to wireless infrastructure, while sequentially, it was down. And basically, we just saw that in -- as a seasonal pause in the fourth quarter.

Thank you very much. And go to the next caller please.

Operator

Vivek Arya, Bank of America Merrill Lynch.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Hi, Vivek.

Vivek Arya - ***BofA Merrill Lynch - Analyst***

Hi. Thank you for taking my question. You mentioned a very interesting thing on the improving output from your 300 millimeter fab. And I was wondering if you could give us some more color around what percentage of your starts are moving to that fab? And more importantly, what that implies for gross margins?

For example, in the past, you have mentioned about 75% fall-through on gross margin. So as you increase the loading on 300 millimeter, what does that do to that number over the next several quarters or years?

Kevin March - ***Texas Instruments Incorporated - SVP and CFO***

Yes. Vivek, I don't know that I'm prepared to give you a detailed quantification of that nature.

What I would just say is that we've talked in the past about, just from the geometries alone, that the chip cost itself was about 30% lower on 300 millimeter than it is on 200 millimeter. Not to mention that you also get better yield results, and so on. So you get a number of different benefits. So what we're seeing happening is proportionally more and more new products that we're releasing are being released onto 300 millimeter.

Which means, as we look out over the next year, two, three, four years, more and more of our revenue will be sourced off of 300 millimeter, which inherently means it's got lower cost. Which should allow us to incrementally increase our gross margins, as well as, importantly, our free cash flow. Beyond that, I do not have any specifics

I will give you at this point in time. But I do want to introduce that concept to people, because I think it is being underestimated as to how important that is to TI's continued progress.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Do you have a folow-on, Vivek?

Vivek Arya - ***BofA Merrill Lynch - Analyst***

Yes, Dave. The question is on the end market mix. I believe you mentioned comms was strong on a year-on-year basis.

I was wondering if you could just give us your end market mix overall for Q3? And how do you see those trends playing out in Q4? Thank you.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Sure. Yes.

So on a year-on-year basis, our revenue growth was due to comms equipment, industrial and automotive, as I mentioned before, each of which grew and contributed to that growth by about the same amount. Our enterprise systems was also up, while revenue in personal electronics declined due to legacy wireless products. So if you go down one step in each side of -- inside of each one of those, industrial, we've got about a dozen sectors inside of industrial.

And as we've talked to different investors over the last few months, and as we're traveling around, it becomes clear to us that our definition of industrial probably isn't as well understood. And we've got -- years ago, we used to define it as what it wasn't. Meaning it wasn't comms equipment, or wasn't automotive, or it wasn't other things. But now, we've got very intentional definitions, and we've got about a dozen different sectors that make that up.

So things like appliances and building automation and displays, and point-of-sale products, factory automation, industrial transportation, medical healthcare, fitness, lighting, motor drives, power infrastructure, things like that. So very, very broad, but very specific.

So when you look on a year-on-year basis, we had growth in nearly all of those sectors, with most of the sectors actually providing double-digit growth. It was actually led by medical and healthcare fitness and factory automation. But again, we saw that growth very broad-based.

Automotive, we have got five sectors inside of that. And I will also just point that those sectors are actually out on our website, if people are interested. But we have got double-digit growth in all of the sectors, but led by passive safety and info-tainment.

Comms equipment, as I mentioned, was up due to wireless infrastructure. Personal electronics was down, due to legacy wireless products. And if you take that out, we did see growth in PC and notebooks and mobile phones. And that was partially offset by some weakness that we saw in gaming.

And then the enterprise systems, that is part of that, is where our DLP products will sit, and that was up due to projectors. So I will stop there. Thank you, Vivek. Do we have a follow-up question? (multiple speakers)

Thank you very much. We'll go to our next caller.

Operator

Mark Lipacis, Jefferies.

Mark Lipacis - ***Jefferies & Company - Analyst***

Thanks for taking my question. The first question is, historically, when you saw a lead time stretch for some of your competitors, not -- even if your own lead time stayed stable, you would see not only double ordering at your competitors, but also double ordering at Texas Instruments, as well. And I am wondering if you think something is changed structurally with how you guys are running the business, or how the industry operates, that might have changed that dynamic?

Kevin March - ***Texas Instruments Incorporated - SVP and CFO***

Mark, I don't know that I will speak for the industry, but I will speak for TI, and go back to the comments we made earlier. As a result of us taking an approach whereby we intentionally invest in capacity before we need it, and therefore always have more capacity than was needed for that quarter's business, it allows us to be able to build inventory in a much more thoughtful fashion that we have in the past. A consequence of that has been that, not only have we been able to maintain lead times for the preponderance of our products at six weeks or less for several years now, we have also been able to maintain a very high level of on-time delivery to our customers against those lead times.

So when you put that together, what you have really got for TI is just a different way whereby we are managing our manufacturing footprint, and how we utilize that manufacturing footprint for purposes of managing inventory. As it relates to double ordering, again, one of the biggest things that tends to be evident when double ordering begins to pop up is you start seeing cancellations or re-schedulings beginning to ramp-up. We do not see that, and we have not seen that for some time now.

But I think the strategy whereby we have capacity ahead of demand, and we use that thoughtfully to make sure that we can maintain relatively low lead times, is serving well to satisfy our customers, at least as it relates to demand for our products.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Do you have a follow-up, Mark?

Mark Lipacis - ***Jefferies & Company - Analyst***

Yes, I do. And that's helpful, Kevin. And the follow-up is actually on that topic about the lead times.

I think earlier in the script, you said you're delivering -- you're focused on delivering higher levels of customer service. And then I think you followed that up with saying, we're keeping lead times consistently low.

So I guess I'm just trying to reconcile, when you say delivering higher levels of customer service, are you -- do you think that you have -- your lead times over, maybe, a longer period of time have come in? That they are just structurally shorter? Or are you just delivering them more consistently at a shorter time?

So I'm just trying to reconcile when you said, what is the higher level of customer service? What has the improvement been?

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Yes. Thanks for that clarification. I think it's a real good question.

So when we refer to that, we look at a bunch of different customer service metrics. One is just, how many line items are we shipping on time? And we've had some very intentional initiatives that have been set up to be able to ensure that that is a good solid number. And we're taking advantage of both the capacity and our inventory to ensure that we are consistently delivering on time.

And so that's one of the metrics that we look at it, and that's what we mean by customer service. It's not really changing those lead times, but keeping them stable, and then delivering products when we say that we will deliver them. It is really the combination of those two things.

So thanks, Mark, and we'll go the next caller please.

Operator

Blayne Curtis, Barclays.

Blayne Curtis - ***Barclays Capital - Analyst***

Hey, good afternoon. Thanks for taking my question. Just going back, Kevin, on gross margin. If you could just go through what drove the upside versus your guidance? And then you're obviously sustaining that going forward.

Is there anything that doesn't repeat in such that -- it sounds like you can grow it off the space. Just wanted to make sure I heard that right.

Kevin March - ***Texas Instruments Incorporated - SVP and CFO***

Yes. Blayne, the guidance actually -- we're up a little bit from guidance. Not a huge amount, but really, what we had was a little bit more revenue come through. But importantly, we also had a slightly better mix of product that we shipped to our customer. And so combined, that gave us a slightly higher gross margin than previously expected.

And then, on a go-forward basis, again, that mix continues to be in our favor as we go forward. And so consequently, as we look into fourth quarter, our margins will tend to be quite strong.

And importantly, because of the rather unique situation that we have with 300 millimeter Analog manufacturing capacity, we have significant opportunity to continue to drive, not just improved margins, but importantly, free cash flow. Again, I'll remind you of some of the things that we're doing.

We have got 300 millimeter Analog. I do want to make that point if I haven't yet. We've got a lot more of our revenue coming from catalog parts, which inherently tend to have more attractive margin characteristics. We have increasing portions of our revenue coming from industrial and automotive spaces. And those three concepts are pretty important.

Catalog parts, industrial, automotive, tend to have very nice long revenue streams, which means we have plenty of time to figure out and maximize our cost efficiency from a production standpoint, and maximize our revenue and cash flow offset. We've got increasing customer diversity. So our dependence on any one customer, and therefore the risk to our un-loadings or our cash flow generation are diminished.

And perhaps, also very importantly, we have a sales force that we estimate to be 3 to 4 times larger than our nearest competitors. And those folks have become increasingly productive. And so we're beginning to get a lot more revenue per salesperson, which means we can grow revenue without having to grow OpEx as fast as revenue is growing. So those things combined not only will help our margins, but also definitely help our cash flow.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Okay, Blayne, do you have a follow-up question?

Blayne Curtis - ***Barclays Capital - Analyst***

Yes. Thanks. For a big picture level, I think you already answered this, but I just wanted to make sure I didn't miss anything. We've had seen some companies reference pockets of weaknesses. I would say your results are normal, if not even better than normal.

Are you seeing any areas that are weak, and you're offsetting that with share gains or strength elsewhere? I'm just curious, your perspective. Or are you not seeing any weakness at all, anywhere?

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Yes, I will let you draw the conclusions from the numbers. I think that obviously, the results are solid. I think that the outlook is consistent with the orders and the -- our visibility into what customers are telling us they want from a consignment standpoint, and -- yes.

So -- and from a share gain standpoint, I think that we've had multiple years now where we have had gained share. I think it is always hard to tell, in any one particular quarter, that you are picking up share. But I think when you look back over a year, you can see that trend. So we believe in our numbers, there is share gains, but I would be careful on any one quarter to be able to point that out.

So thank you, Blayne, and we'll go to our next caller please.

Operator

Ross Seymore, Deutsche Bank.

Ross Seymore - ***Deutsche Bank - Analyst***

Hi, guys, and thanks for letting me ask a question. The one segment nobody has asked about thus far is Other. It did a bit better than I had expected.

Dave, you broke down what was the year-over-year and sequentials, with the sub-buckets in the other two segments. Can you do that for the Other segment, as well? And if it is DLP, give us a little description on, is there some seasonality in that that we need to appreciate going forward?

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Sure. Thanks, Ross. Yes, so on a year-on-year basis, again, Other was even. We saw the decline in legacy wireless products. And that was mostly offset by the growth in DLP products.

On a sequential basis -- let me just finish year-on-year. If you look beyond that, calculators, as well as the custom ASIC business were up. And royalties were down just slightly.

So sequentially, revenue was up, due to growth in calculators and DLP. Royalties were flat. And custom ASIC was down a little bit.

So I'd say that all of those businesses are performing well. And if you look at DLP, they are typically stronger in the back half of the year in third quarter, but I would say that that business is just executing well. When we look at that business longer term, I describe that it has got several wild card growth opportunities. If you look at most of the business today, it will be centered up in the front projectors that you will typically see in offices and schools and government buildings.

But -- and it also has a solid cinema business. But from a broader standpoint, it has got some opportunities inside of automotive, as well as some embedded opportunities there, as well.

Kevin March - ***Texas Instruments Incorporated - SVP and CFO***

Mention the Pico, as well.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Yes, the Pico projectors, as well. Thanks Ross, do you have a follow-up?

Ross Seymore - ***Deutsche Bank - Analyst***

I do. Kevin, you were helpful in giving us some bounds around the OpEx, and looking at prior years, and how things have dropped seasonally due to vacations, et cetera, in both the fourth, and then the first quarter doing the other direction.

Can you give us a little bit of a harder number on what that typical percentage change is, quarter-to-quarter? Looking back in the past, you guys have had a number of restructuring programs that make it a little bit difficult to parse out what seasonality, and what is restructuring-driven, in both the fourth and the first quarter? Thank you.

Kevin March - ***Texas Instruments Incorporated - SVP and CFO***

Yes, Ross, I actually pointed to the last fourth-to-first transition, with the idea that that is a good one for you to look at. Because in fact, the timing of the announcement for the embedded process and Japan restructuring, you may remember, we announced that in January this past year. So we hadn't even begun the activities yet, inside the first quarter.

So the underlying cost in there is fairly clean from a comparative standpoint, between fourth and first. And so I'd use that as your figure of merit for trying to figure out where we're going in 2015.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Thanks, Ross, that was a helpful clarification. We'll go the next caller please.

Operator

Doug Freedman, RBC Capital.

Doug Freedman - ***RBC Capital Markets - Analyst***

Hi, guys. Thanks for taking my question. Congrats on the real strong results, here. If I could, Kevin, maybe attack a really high level one. You guys have been, in the past, very acquisitive, so much so that you have really rebuilt your whole business model through acquisitions.

Can you maybe talk about your appetite to maybe add some debt onto your already leveraged balance sheet? And what it would take for you to look at another significant deal?

Kevin March - ***Texas Instruments Incorporated - SVP and CFO***

Okay, Doug, it sounds like maybe there's two ideas in your question, or one on M&A and one on debt.

Clearly, on the M&A front, as you point out, we have been quite willing to take on M&A activities when it makes sense. And our definition of what makes sense is, first of all, it has to be a strategic fit. Meaning that it really has to make sense for where we want to take the Company.

As we look at potential M&A in the future, it is most likely to be biased towards Analog, and probably towards items with catalog parts or that service the industrial or automotive spaces. There may be others, but those are the most likely areas that we would look at.

If it turns out that it checks off that strategic fit standpoint, then of course we have to take a look at the numbers. And make sure that the price that we would pay met -- what I mean by that is not necessarily what its market cap is, but the mark up that we probably have to pay on top of that. That that total cost would be accretive to our WAC, our weighted average cost to capital, within a three to four year time frame. So there's several tests that we go through, and -- when we make a determination on acquisition.

As it relates to debt, as you know, we have taken on debt to support acquisitions in the past. We think having the balance sheet available to support those kind of strategic initiatives are important, and a worthwhile thing for us to maintain, for maximum flexibility as we move forward. And so, as we look out in time, and even if you look at the last couple of years, while we have been issuing new debt, we've also been retiring older debt. And retiring a little bit faster than what we have been issuing, so that we're taking our total debt levels down.

And that is having the result of generally, slowly opening the balance sheet back up to make itself available for any other opportunity that might present itself at some point in the future. That is how we're looking at M&A, and that is how debt rolls inside that look.

Doug Freedman - ***RBC Capital Markets - Analyst***

THOMSON REUTERS

Great. Thanks for all that color. (multiple speakers) Yes, I guess if I could, can you guys -- pretty much along the same ideas on the balance sheet and how you look at cash return, I might have missed it. Did you happen to give out the share price at which you bought back shares this quarter? And would you moderate, going forward, given the share price pullback that we just saw, how we should think about share count going forward?

Kevin March *- Texas Instruments Incorporated - SVP and CFO*

Let's see. We bought back $670 million worth of shares this quarter, a total of 14.1 million shares. So that's an average price of about $47.62. I would point out that over the last -- since the end of 2004, beginning of 2005, we reduced our total share count by 39%. That the average price of those shares that we bought over that time, I believe were about $30.62, give or take.

When we look to buy back shares, as we have talked about in the past, when the intrinsic value, we believe, is higher than what the market value is, then it makes sense to buy back on a steady, if you will, dollar cost averaging basis. That is what we have done for many years, and that is what you have seen us do here recently. In fact, the recent pullback in price is just allowing us to buy back a few more shares with the same number of dollars. That is a round the world look at share repurchase, if you will. I hope I answered your question on that, Doug.

Dave Pahl *- Texas Instruments Incorporated - VP and Head of IR*

OK. Thank you, Doug and we'll go to the next caller please.

Operator

Will Stein, Sun Trust.

Will Stein *- SunTrust Robinson Humphrey - Analyst*

Great. Thank you for squeezing me in. I'm hoping you can quantify a comment that you made earlier about the portion of sales on 300 millimeter today, and that that could increase over time. Kevin, could you talk a little bit about where that number is now, and where you would see it going over the next couple of years?

Kevin March *- Texas Instruments Incorporated - SVP and CFO*

Will, I think we're going to try to just hold back and say, it is proportionately more than it has been. Each period that goes by is proportionately more. But I think that we will hold a little while longer until we can give a more comprehensive look, and a better understanding for everybody on how to think about that 300 going forward. I just do think that it is -- again, at the highest level, it is a fairly straightforward computation.

30% lower die cost, which means about 15% lower total ship cost -- total IC cost. And as we get proportionately more revenue going on there, that will just incrementally benefit our margins and our cash flows, as we go forward in time. And that is something I've become aware of in talking to investors in the last couple of quarters, that is under-appreciated on what is going on inside the portfolio itself.

Will Stein *- SunTrust Robinson Humphrey - Analyst*

That's helpful. I appreciate it.

And as my follow-up, another comment that was made earlier was about, I think, the relative strength of Analog versus the embedded segment this quarter. And I think there was a comment about end markets, the end market mix helping. Can -- I'm wondering if you can clarify that? Maybe help us understand a little bit better?

I know Analog is very diversified relative to embedded. But maybe talk about, if there were maybe some end markets that were a bit more challenging that effected the embedded segment a bit more?

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Yes, I think if you look at embedded, it will have a high exposure to, really, three different markets. It is communications, equipment, industrial and automotive. And like you said, our Analog business has a much broader exposure, including exposure to personal electronics. It has, obviously, good exposure to industrial and automotive, as well. But it's really those types of differences that will explain that performance.

If you look at Embedded Processing, and you look back at the growth rates between the two businesses, you will note that oftentimes, they will grow at different rates. But if you look over an eight -- that eight-quarter period, that Embedded Processing has been growing year-over-year. The growth rate for both of those businesses are essentially exactly the same. So it works out that way over a longer period of time.

Thank you, Will, and we'll go to the next caller please.

Operator

Tore Svanberg, Stifel Nicolaus.

Tore Svanberg - ***Stifel Nicolaus - Analyst***

Yes. Good afternoon Dave and Kevin. My first question is on the general environment. Q4 is obviously a seasonally down quarter anyway, so it is hard to get a read on what is going on. But is -- as we -- or as you talk to your customers, and we compare now, let's say, versus 12 months ago, would you classify the forecast and the environment as better, weaker, or about the same?

Kevin March - ***Texas Instruments Incorporated - SVP and CFO***

Tore, I guess I would probably say that it's about the same. I wouldn't classify it as better or weaker. And I say it's about the same in that, again, we have had the same lead times for several years, and customers are ordering consistent with that, generally speaking. You get some that need to expedite from time to time, because they've under-ordered or had the surprise demand on their end. But that was true a year ago, and it's probably true today.

And we continue to see customers manage their inventories of our product, I would say, very lean. As was mentioned earlier, in the distribution channel, we're at all-time lows of 4.5 weeks of inventory. That is the same last quarter and this quarter. That is very low.

From a customer standpoint, we see them, again, ordering lead time and consistent ordering patterns. So that tells us they are ordering -- they are keeping their inventories very low. So I think overall, I would probably characterize it as relatively the same kind of customer demeanor today as what we saw a year ago.

Tore Svanberg - ***Stifel Nicolaus - Analyst***

Yes, thanks, Kevin, that's very helpful. My follow-up question, Dave, if I have one. Your Analog growth at 10% year over year, is that the goal internally, to continue to grow the Analog business 10% every year? Or was there anything unusual here the last 12 months that kept that growth rate so high?

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

I would say that internally, we have very aggressive goals to grow the businesses. And I just described it as, we want to outgrow the market significantly in Analog. So we have got all the business units that are focused up on that.

We do look at the performance of the product lines every quarter. And we really look at a three-year compounded annual growth rate, and stack that up against all the other businesses, both inside of TI, as well as competitors externally. And that is how we measure it.

So again, as I said earlier, that 10%, we believe, would represent some share gains. But I would be real cautious to look at any one quarter and draw the conclusion, or try to dice out what percentage of that growth would be from share gains.

Thank you, Tore, and operator I think we've got time for one more caller.

Operator

C.J. Muse, ISI Group.

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

Hi. Thank you for taking my question. First question, it's a point of clarification. On the OpEx Outlook for Q4 down $15 million, is that all restructuring, and then there's gravy on top of that in terms of seasonal savings? Or is that $15 million include the seasonal savings?

Kevin March - ***Texas Instruments Incorporated - SVP and CFO***

C.J., the thing you need to do is take a look at a year ago. Third quarter/fourth quarter, there was a seasonal decrease. On top of that will be another $15 million as the last of the EP restructuring is completed.

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

Okay, that's helpful. Second question, was hoping you could talk about inventories downstream. Clearly, relatively healthy on your books, but would love to hear what your thoughts are in terms of, in particular, at the disty level?

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Yes, our inventories, really, from a day standpoint, had remained unchanged at what I would just describe historically low levels, at just a little over 4.5 weeks. Again, that number is low because of the consignment programs that we have put in place. Beyond our distributors, and then to our customers, we do have a good percentage of our revenues on consignment overall. And in fact, if you combine what we shipped through distribution, as well as what we ship to OEMs on consignment, that represents about 50%, or about half of our revenues, where we actually -- there is no inventory sitting in front of us, and that manufacturing line for those inventories.

So we know that inventory number, and it is zero. So we have very good visibility into that portion.

And we do have a balance of the business that is the classic -- I will describe it as book/ship-type business, where they give us an order, it goes onto a backlog, and we ship it at lead time. So -- and there, we haven't seen any reports of large inventory pockets from customers. We're going through and racking up this quarter's results, and we will see what happens on that front. But we are not aware of any big pockets that are downstream.

Dave Pahl - ***Texas Instruments Incorporated - VP and Head of IR***

Thank you very much, C.J., for your question. Thank you all for joining us today, and a replay of this call will be available on our website. Good evening.

Operator

Ladies and gentlemen, this does conclude today's conference. We appreciate everyone's participation.