PARTICIPANTS

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David Pahl – Vice President, Director, Investor Relations, Texas Instruments Incorporated
Kevin P. March – Chief Financial Officer & Senior Vice President, Texas Instruments Incorporated

Other Participants

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James V. Covello – Analyst, Goldman Sachs & Co.
Stacy Aaron Rasgon – Analyst, Sanford C. Bernstein & Co. LLC
Blayne Curtis – Analyst, Barclays Capital, Inc.
Doug Freedman – Analyst, RBC Capital Markets LLC
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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the Texas Instruments second quarter 2014 earnings conference call.

At this time I'd like to turn the conference over to Ron Slaymaker. Please go ahead, sir.

Ron Slaymaker, Vice President, Head of Investor Relations

Good afternoon and thank you for joining our second quarter 2014 earnings conference call. As usual, Kevin March, TI's Chief Financial Officer, is with me today. In addition, Dave Pahl has joined us.

As many of you know, I will return – retire in August and Dave will replace me as Head of Investor Relations. Dave has worked at TI for 25 years and has worked directly with me in Investor Relations for 10 years. With that consideration, you probably should allow him some time to come up to speed. Dave has also been recently elected by TI's Board to the position of company Vice President. Dave will moderate today's call.

With that, let me turn it over to Dave.

David Pahl, Vice President, Director, Investor Relations

Thank you, Ron. It's good to join you today for the call, and now down to business.

For any of you who missed the release, you can find it and any 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 second quarter was another solid quarter. Our core businesses of Analog and Embedded Processing grew strongly with combined revenue up 14% from a year ago. We continue to benefit from our investments in industrial and automotive as these important markets continue to grow as a percentage of our revenue.

Revenue of $3.29 billion came in slightly higher than the middle of the expected range we communicated to you in April. Earnings per share of $0.62 were near the top of our expected range as profitability was stronger in the quarter.

Free cash flow of $3.2 billion or 25% of revenue for the trailing 12-month period was right in line with the 20% to 30% range in which we expect to operate over time. Also, over the past 12 months we returned $4.2 billion of cash to investors through a combination of dividends and stock repurchases.

As a reminder, our model for cash returns to shareholders is to return all of our free cash flow, less the net debt amount that is retired, plus any proceeds we receive from exercises of equity compensation. This model demonstrates our confidence in TI's business and our commitment to return excess cash to our shareholders.

In the second quarter, TI revenue grew 8% from a year ago, with double-digit growth in both Analog and Embedded Processing. Analog revenue grew 14% from a year ago, primarily driven by Power Management. High-Performance Analog, High-Volume Analog & Logic and Silicon Valley Analog also grew. Embedded Processing revenue grew 14% from a year ago primarily due to Processors and Microcontrollers, both of which grew about the same amount. Connectivity grew at a faster rate although it was coming from a much smaller base.

Embedded Processing delivered its seventh quarter in a row of year-over-year growth as our investments over the past few years in strategic areas are yielding favorable results. In our Other segment, revenue declined $90 million or 13% from a year ago, due to legacy wireless which is essentially gone.

Turning to distribution, resales increased 15% from a year ago while distributors' inventories were about even. Weeks of inventories fell by several days to just over four and a half weeks. This reduction was driven by a higher percentage of resales being supported by TI's consignment inventory programs.

From an end market perspective, most growth from the year ago came in Communications Equipment, followed by Automotive and Industrial. Enterprise Systems was also up while revenue in Personal Electronics declined due to mobile phones and tablets, areas that use legacy wireless products from TI.

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

Kevin P. March, Chief Financial Officer & Senior Vice President

Thanks, Dave, and good afternoon, everyone.

Gross profit in the quarter was $1.88 billion, or 57.1% of revenue. Gross profit increased 20% from the year-ago quarter and gross margin hit another new record. When compared with the previous record in the third quarter of 2013, revenue was $48 million higher and gross profit was $102 million higher. This reflects an improved product portfolio focus on Analog and Embedded Processing as well as increased efficiency in our manufacturing operations.

Moving to operating expenses, combined R&D and SG&A expense of $821 million was down $39 million from a year ago. The decline primarily reflects the reductions in legacy wireless as well as continued cost discipline across TI.

Acquisition charges were $82 million, almost all of which were the ongoing amortization of intangibles, a non-cash expense. Restructuring and other charges were a $4 million benefit. As a reminder, the year-ago quarter included a gain of $315 million associated with the transfer of wireless connectivity technology to a customer.

Operating profit was $982 million, or 29.8% of revenue. Operating profit was up 8% from the year-ago quarter. Net income in the second quarter was $683 million, or $0.62 per share.

Let me comment on our capital management starting with our cash generation. Cash flow from operations was $775 million in the quarter. Inventory days were 111 days, consistent with our model of 105 days to 115 days.

Capital expenditures were $80 million in the quarter. On a trailing 12 months basis, cash flow from operations was $3.59 billion, up 8% from the same period a year ago. Trailing 12 months capital expenditures were $388 million, or 3% of revenue, even lower than our long-term expectation of 4%.

Although we've been able to keep capital expenditures at this low level, we continue to invest to expand both our capabilities and our capacity. As examples, capital expenditures in second quarter included the cost to prepare the site and install the first tools into our new assembly and test facility in Chengdu, China. We completed manufacturing our first units there for qualification purposes. In addition, we brought on additional tools to expand capacity in our 300-millimeter facility in Richardson, Texas. We are able to make these investments and keep our capital spending at low levels because of our strategy to invest in capacity opportunistically and ahead of demand.

Free cash flow for the past 12 months was $3.20 billion, or 25% of revenue, in the middle of our expected 20% to 30% range. Free cash flow was 10% higher than a year ago.

Depreciation expense for the past 12 months was $856 million. Depreciation exceeded our capital expenditures by $468 million, or 3.7% of revenue.

We continue to expect to hold capital spending at low levels or at about 4% of revenue. As a result, the depreciation will decline to the rate of capital spending and our gross margins will directly benefit.

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 and will be valued only if it's returned to shareholders or productively re-invested in the business. To that end, in the second quarter, TI paid $323 million in dividends and repurchased $743 million of our stock for a total return of $1.07 billion.

The shareholder return part of our capital management strategy is to return all of our free cash flow minus debt retirement, plus any proceeds that we receive from exercises of equity compensation. Total cash return in the past 12 months was $4.2 billion, which was 18% higher than a year ago. Dividends were up 32% and stock repurchases were up 13%.

Fundamental to our cash return strategy are our cash management and tax practices. We ended the second quarter with $2.80 billion of cash and short-term investments, down from $4.03 billion at the beginning of the quarter. The decline mostly reflects the use of $1 billion to retire debt in the quarter. TI's U.S. entities own 82% 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 orders in the quarter were $3.33 billion, up 7% from a year ago, and our book-to-bill ratio was 1.01, which would have been higher but was impacted by the conversion of consignment of some products that are sold through distribution.

Turning to our outlook, we expect TI revenue in the range of $3.31 billion to $3.59 billion in the third quarter. At the middle of this range, revenue would increase 6% from a year ago. If you exclude the $57 million of legacy wireless revenue from the year-ago quarter, revenue would increase 8%.

We expect third quarter earnings per share to be in the range of $0.66 to $0.76. Restructuring charges will continue to be essentially nil. Acquisition charges, which are non-cash amortization charges, will remain about even and hold at this level 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 third quarter.
In summary, the second quarter demonstrates the strength of TI's business model focused on Analog and Embedded Processing, which we believe are the best opportunities inside of the semiconductor market. We continue to invest in areas that offer sustainable growth, solid profitability and good cash flow from operations.

The percentage of our business from industrial and automotive markets continues to grow as customers increasingly embrace technology that makes end products smarter and more connected. At the same time, we continue to invest in our manufacturing capabilities. And our strategy to opportunistically acquire manufacturing assets means that we can deliver strong free cash flows.

We continue to demonstrate, as we did again in the second quarter, our commitment to provide strong returns to our shareholders in the form of dividends and share repurchases.

With that, let me turn it back to Dave.

David Pahl, Vice President, Director, Investor Relations

Thanks, Kevin.

Operator, you can now open the lines up for questions. In order to provide as many people as possible the opportunity to ask a question, please limit yourself to a single question. After our response, we'll provide you an opportunity for an additional follow- up.

Go ahead, Renee.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] We'll now take our first question from John Pitzer with Credit Suisse. Please go ahead.

<Q – John Pitzer – Credit Suisse Securities (USA) LLC (Broker)>: Yeah, good afternoon, guys. Congratulations on the strong results. Kevin, I guess my first question is on OpEx. I think for the June quarter, going into June, you kind of guided that OpEx would be flattish Q-on-Q, and you did better than that. I'm kind of curious, is that a pull-in of the $130 million of annualized savings you expected from the restructuring? Or is that just a bigger number than $130 million? And how do we think about OpEx trending in September and the back half of the year?

<A – Kevin March – Texas Instruments Incorporated>: Yeah, John. You're right. The OpEx we had expected to be roughly even from first quarter to second quarter, in fact, came in a bit lower than we'd expected. iAnd part of that was some pull-in with the restructuring actions that we announced in first quarter for both Embedded Processing and the resizing of our operation in Japan. And part of it was just continued discipline on the part of all the business units in TI when it came to spending. As you look into 3Q, we continue to expect the second half to see the primary benefit of the cost savings that we talked about for those restructuring actions. Recall that we expect about $130 million of annualized savings, with about 85% of that in OpEx and the balance in cost of revenue.

So as we go into third quarter, we'll see probably about half of that amount come into our results in OpEx with the balance in fourth quarter so that by the time we leave the year, we should be at an annualized $130 million cost savings from that action.

<A – Dave Pahl – Texas Instruments Incorporated>: Do you have a follow-up, John?

<Q – John Pitzer – Credit Suisse Securities (USA) LLC (Broker)>: Yeah, that's helpful, Kevin. As a follow up, I know this is somewhat of an unfair question but if you look at the proceeds from equity compensation, last year it was almost about a third of the cash returns to investors. I know that's been a volatile number and probably a number that's impossible to predict. But I'm kind of curious, how do you think we should think about that number going forward from here? How do we try to model that number in the future?

<A – Kevin March – Texas Instruments Incorporated>: John, we talked during the update to our capital management strategy that going forward, we would expect the proceeds from stock option exercises to reduce considerably. We saw – gosh, I guess it was probably two to three times our normal rate of stock option exercises and cash proceeds in 2013 than we'd seen in prior years. So we talked about that going forward that would probably come back down to a more normalized level. I would suspect what we saw last quarter, what we saw this quarter, probably is more reflective of what you should model going forward. Figure about – I think we saw about 4% or 5% of stock options exercised last year and that will probably drop down to 1.5%, 2% kind of level.

<A – Dave Pahl – Texas Instruments Incorporated>: Okay. Thank you, John. Next caller, please.

Operator: Thank you. We'll go next to Jim Covello with Goldman Sachs.

<Q – Jim Covello – Goldman Sachs & Co.>: Great, guys. Thanks so much for talking the question; I appreciate it. Could you just give us some perspective on kind of the broader cyclical environment? Would you say there's anything at all going on other than normal and maybe break that down by sub category a little bit? And I'll leave that as both questions and pass from there. Thanks.

<A – Dave Pahl – Texas Instruments Incorporated>: Okay, Jim. I think that we don't have any unique insight into what's going on from a cyclical standpoint. I think that the quarter that we just delivered, we feel good about. If you look at the middle of our range into third quarter, 8% if you're excluding legacy wireless is another good quarter on a year-on-year basis.

If you look at a lot of the signals that one would pay attention to, such as inventory inside of the channel, we took several days out of inventory in the quarter as we had a higher percentage of revenue supported by our consignment programs inside of distribution. And if you look at cancellations they continue to remain at very, very low levels. We think inventory at customers remains in check as well. And then if you look at our lead times they continue to remain stable. We'll always have some pockets where they may move out temporarily but with our capacity and the position of our inventory, we feel really good to be able to continue to support that. So you have a follow-on question?

<A – Kevin March – Texas Instruments Incorporated>: I think he said...

<Q – Jim Covello – Goldman Sachs & Co.>: The sub – the verticals, any differences by vertical?

<A – Dave Pahl – Texas Instruments Incorporated>: No. I think that from a year-on-year standpoint we had – if you look at industrial, we had growth in nearly all the sectors, so very broad-based from that standpoint, led by areas like factory automation. Automotive, we had double-digit growth in all of our sectors led by ADAS or Advanced Driver Assist System. Personal Electronics was down but it would have been up had it not been for legacy wireless. Our Enterprise Systems we saw growth driven by projectors and servers. And Comms Equipment was up due to wireless infrastructure, so really broad-based growth on that standpoint.

<A – Dave Pahl – Texas Instruments Incorporated>: Okay, thanks. We'll go to the next caller.

Operator: Thank you. We'll take Stacy Rasgon with Sanford Bernstein.

<Q – Stacy Rasgon – Sanford C. Bernstein & Co. LLC>: Hi, guys. Thanks for taking my questions. First I want to dig into your margin trajectory. Your incremental operating margins for Analog and Embedded Processing both exceeded 100% sequentially in the quarter. Your Analog business also has about 100% incremental operating margins year-over-year. I guess the strong performance, particularly in Analog, surprises me a little bit. I thought most of the cuts you did were in Embedded Processing. So do you think you can you give us some sort of view on what's driving that strong incremental margin? How much is gross margin expansion within the businesses versus OpEx? What do you see as sustainable levels of incremental operating margin going forward as the revenues and the businesses continue to grow?

<A – Kevin March – Texas Instruments Incorporated>: Stacy, the fall-through was very good both on a quarter-over-quarter and on a year-over-year basis, certainly at the company level and at the segment levels. I mentioned I guess on the first call from John, from an OpEx standpoint, spending remained disciplined across the company. So while the restructuring action that you referred to will disproportionately benefit Embedded Processing versus other areas of the company, some of that restructuring will benefit other areas of the company as well.

For example, we've mentioned resizing our sales team in Japan and that's not just the sales team in support of the Embedded Processing but also those in support of some of the other business units. So you get a little bit of benefit there, but then really you've got just disciplined spending across the company, as frankly, people are only spending only what they need to support the growth of the business.

On a go-forward basis, again we expect OpEx to be down a little bit sequentially, primarily for the benefit of Embedded Processing. That will be true for both the third and fourth quarter. Beyond that I don't know if I can give you any more specific forecast on OpEx other than by the time we've reached the end of the year we will enter next year with OpEx – a total cost savings from the restructuring of about $130 million, about 85% of that coming from OpEx.

<Q – Stacy Rasgon – Sanford C. Bernstein & Co. LLC>: Got it. That's helpful. For my follow-on I want to dig into gross margins just a little bit. So if I take that half of the $130 million kind of hitting you or 85% hitting you next quarter, sounds to me like your guiding OpEx down about 2% which would give me an implied gross margin guidance at the corporate level call it into the upper 57% so up maybe 500 basis points maybe even a little more from Q2. So can you give us just some view of what's driving that gross margin expansion? Is this just further efficiencies, manufacturing efficiencies? Is it just depreciation coming down? Is it something else to do with mix or pricing, or just overall revenue leverage as revenues grow?

<A – Kevin March – Texas Instruments Incorporated>: I think it's a little bit of all of that, to be quite frank, Stacy. If you take a look at as we go forward on gross margin, there's multiple drivers inside the portfolio. Not the least of which is being able to load or fill up our very cost effective factories. We also get improved product mix especially as we see Industrial and Automotive becoming a larger portion of our total revenue mix. Finally, we get the benefit from depreciation as it begins to roll off, being that CapEx has run substantially below depreciation now for quite some time.

Again, just as a reminder, depreciation was about 7% of revenue over the last 12 months and CapEx we expect to be around 4%. So we've got some closure that will start happening on that over the next couple of years. Depreciation this year is expected to be down a bit versus last year but it will start declining more rapidly next year. So you've got a number of different things going on, not just next quarter that will move gross margins up again as you indicated, but should also continue to benefit us as we look out into the balance of the year, and going into 2015.

<A – Dave Pahl – Texas Instruments Incorporated>: Great. Thank you, Stacy. Operator we can go to next caller, please.

Operator: Thank you. [Operator Instructions] We'll go to Blayne Curtis with Barclays next.

<Q – Blayne Curtis – Barclays Capital, Inc.>: Hey. Good afternoon. Thanks for taking my question. Wondering what your utilization was in the quarter and where you expect that to go? And then the second part of my question, as you look into December, typically seasonally a softer period, things seem fairly normal, I was wondering your thoughts on seasonality into December?

<A – Kevin March – Texas Instruments Incorporated>: I'll mention – I'll talk to utilization and Dave will talk to seasonality there. But Blayne we look at utilization 2Q to 3Q, we don't expect that to really change all that much as we have our wafer starts not too far off from what we saw in the first quarter – excuse me, second quarter and what we started in the second quarter will come out of the factory in the third quarter. So overall utilization unlikely to change all that much as we look into the near term.

<A – Dave Pahl – Texas Instruments Incorporated>: Yeah, and from a seasonality standpoint, Blayne, essentially we're going to let you determine what you believe seasonality is. And just a few things to consider as you go through that, obviously calculator revenue is usually strongest in second quarter and third quarter with the back-to-school buying period, and we saw that in our results this quarter. And our semiconductor growth is typically relatively stronger in the second and third quarters compared with the first and fourth.

So outside of that, we don't put much credence on a specific sequential growth number just because the numbers around that have been so unpredictable. And we're just going to step back from trying to provide any appearance of doing math on it because it will appear that we're endorsing one number over another.

So do you have a follow-on, Blayne?

<Q – Blayne Curtis – Barclays Capital, Inc.>: Just wondering maybe in the September quarter, a similar question, whether outside of calculators there was any areas of particular strength or weakness. You had mentioned Comm had been a strong point. Is that sustaining? And then it seems like Autos as well have held in there better. Usually a seasonally weaker second half but seemed strong. Any comment there?

<A – Dave Pahl – Texas Instruments Incorporated>: Yeah, sure. Other than the top-level guidance we don't really get into strength or weakness by sector. If there's something very unusual going on, like with our legacy wireless, of course we've given visibility into those types of things in the past.

So with that, we'll move to the next caller.

Operator: Thank you. We'll move to Doug Freedman with RBC Capital Markets.

<Q – Doug Freedman – RBC Capital Markets LLC>: Hi, guys. Thanks for taking my question. And before I begin my question, Ron, it's been great working with you and best of luck in retirement, before I forget to say that.

<A – Ron Slaymaker – Texas Instruments Incorporated>: Thank you.

<Q – Doug Freedman – RBC Capital Markets LLC>: So going into the numbers, if you could talk a little bit maybe about your strategy to maybe increase free cash flow. When we look at what's going on with your balance sheet, you're getting pretty close to getting a debt level that might be good to carry that debt and stop retiring it or maybe just start rolling it forward. Can you maybe talk a little bit, Kevin, about your strategy there?

<A – Kevin March – Texas Instruments Incorporated>: Well, the strategy is less about debt and more about the actual product portfolio and the markets that we're going after, Doug. It's really about being sure that we're thoughtful on how we spend our research and development dollars and that we spend them on products that we expect to have very long revenue life streams off of them. And then in correlation with that is to continue to be opportunistic and to expand our manufacturing capacity at times when you may least expect us to do that, because we can get it for costs that are very low. Those are our two biggest levers for expanding cash flow.

As it relates to debt going forward, as you observed, we just paid off a net of $500 million this year. We raised $500 million in the first quarter and repaid a billion in the second quarter, so a net reduction of $500 million. We still have on the balance sheet a total debt of about $4.625 billion, and those actually have lives that extend all the way out to 2023. So I don't see debt vanishing from our balance sheet any time soon.

On a go-forward basis, of course, our buy-back, and I think that was one of the things you were asking about on our free cash flow, is really a function of what our calculation of net present value of the company is. And so long as we see that the intrinsic value of the company exceeds the market value, we'll continue to be buyers of the stock.

<A – Dave Pahl – Texas Instruments Incorporated>: Okay. Doug, do you have a follow-up?

<Q – Doug Freedman – RBC Capital Markets LLC>: Yeah. What role will M&A possibly play? And when do you think is there an opportunity to re-enter the M&A market? You guys really have not been active since the National Semi deal has closed.

<A – Kevin March – Texas Instruments Incorporated>: When it comes to M&A, and again, it's about product strategy, our bias is likely to be simply find an opportunity that would be attractive to us. Our bias would probably be in the Analog space as opposed to Embedded Processing. And frankly, aside from the technology that we acquire or the product opportunity that we acquire being attractive, meaning long revenue streams, it would also have to work for us mathematically, meaning that the price at which we could acquire it would have to be such that we could get a return on our invested capital inside a three- to four-year period, and we're pretty disciplined about that. Some of the opportunities that some have speculated on here in recent months are such, if you do the math, it's very difficult to overcome that hurdle of making sure it's ROIC accretive. And we think that's very important if we're going to actually generate excess cash flow and free cash flow off of any acquisition in the future.

<A – Dave Pahl – Texas Instruments Incorporated>: Okay. Thank you, Doug. Operator, next caller, please.

Operator: Thank you. We'll take Joe Moore with Morgan Stanley.

<Q – Joe Moore – Morgan Stanley & Co. LLC>: Great. Thank you. Wondering if you could touch on the strength that you had alluded to in communications equipment in Q2. Is that macro base stations? Or is there some other element of that?

<A – Dave Pahl – Texas Instruments Incorporated>: Yeah, the majority of that is, would be macro base stations. If you look at investments that we're making longer term, that will include small cell, but we really don't have measurable revenue on products like that at this point.

<Q – Joe Moore – Morgan Stanley & Co. LLC>: Okay. Thanks. And as part of the Embedded restructuring that you had done, it sounded like you were pulling back on some of the investing in that category. Does that change your trajectory at all? Or does that mean you'll participate less in basestations over time?

<A – Dave Pahl – Texas Instruments Incorporated>: No. I think if you look at those investments and those product cycles, they tend to be very long in nature. So the areas that we've pulled back tend to be areas that we now believe are either mature or in the process of maturing, and yet we continue to invest in areas that will drive growth in the future such as small cells, as I indicated before.

So thank you, Joe. And we'll go to the next caller, please.

Operator: Thank you. We'll move to Ambrish Srivastava with BMO.

<Q – Ambrish Srivastava – BMO Capital Markets (United States)>: Hi. Thank you. A question on CapEx, Kevin. Your capital intensity has been fairly below the 4% that you had said that you would be. What should we be modeling for the remainder of the year and more importantly what would cause it to [indiscernible] (28:31) to move, inflect upwards?

<A – Kevin March – Texas Instruments Incorporated>: Yeah, Ambrish, again, I think for purposes of your models, I would just assume about a 4% of revenue kind of planning is going to get you pretty close to probably the right answer over time. In any one quarter, I'm sure it's going to be off but it will be okay on a rough annual period.

Anything that might cause us to go above that could possibly be if we had a sudden opportunity present itself where we could add capacity at a significant cost savings. We wouldn't let that 4% artificially restrain us from taking advantage of very inexpensive manufacturing capacity which would benefit our future free cash flow. But right now I don't see that on the horizon. So again, for your model, I'd probably just use 4%.

<Q – Ambrish Srivastava – BMO Capital Markets (United States)>: Okay. And my quick follow up: Dave, you mentioned that consignment as a percent of sales has changed. What has it gone back up? And I think that I remember it used to be in mid-40s before.

<A – Dave Pahl – Texas Instruments Incorporated>: Yeah, if you look overall, our consignment as a percent of revenue has moved up a little bit from about 45% to about 50%. If you look inside of our distribution channel, so about 55% of our revenues go through distribution and about 55% of those revenues are supported by consignment. So that's really the part that's beginning to drive that higher and our inventories that's owned by distributors, lower.

Thanks, Ambrish. Can we go to next caller, please?

Operator: Thank you. We'll take our next question from Christopher Rolland with FBR Capital Markets.

<Q – Chris Rolland – FBR Capital Markets & Co.>: Hey, guys. So your extra capacity at the bottom of the cycle may have been a bit of a burden but can be very valuable as the cycle heats up here. So, do you think we're at the point in the cycle where you guys are benefiting from that extra capacity, either front end or back end? Do you that think that some of your competitors might have a lack of capacity there and might be switching to your products?

<A – Kevin March – Texas Instruments Incorporated>: Christopher, clearly we've had the strategy in place now for a number of years where we're acquiring as inexpensively as we can manage to, in advance of our needs. The most recent example was the acquisition of an assembly test operation in Chengdu, China, that I commented on earlier in the call that we're now bringing online, so that has certainly been a benefit to us to allow us to have very stable lead times on behalf of our customers and to be able to meet any short-term spikes or inside lead time requests that customers have had.

Broadly speaking across the industry, it does strike us that many people perhaps have chosen not to invest in as much capacity as they might have in the past. It's unclear to us just what that may mean going forward. But at least from our standpoint for our customers, they can have confidence to know that we have ample capacity to meet their need.

<A – Dave Pahl – Texas Instruments Incorporated>: Yeah, and, Chris, I'll add also we've taken other actions that utilize that capacity different, different points of demand. And so one thing that we've done and you can see it on the balance sheet is that in periods of weaker demand we'll actually build finished goods inventory as well as staging wafers to support future demand on low volume product. And so it may take 20 minutes, 30 minutes to set up a piece of assembly test equipment and you may run only 10,000 units on that part, and it may take you a half hour or an hour. It doesn't take much longer to build either six months of demand or a full year of demand or a year-and-a-half of demand and put that on the shelf. So when demand actually gets stronger, we've got the capacity open and available to support that stronger demand. So we feel good to be able to support really any demand environment that we see in the future.

Do you have a follow-on, Chris?

<Q – Chris Rolland – FBR Capital Markets & Co.>: Sure. The other segment, it was above the Street, also above seasonality. Is that just calculators or is there something else there?

<A – Kevin March – Texas Instruments Incorporated>: Yeah, that's really just calculators. It's seasonally strong in the second and third quarter for the back-to-school selling season and then it's typically weaker in the fourth and first quarter as kids are already in school and have their calculators.

<A – Dave Pahl – Texas Instruments Incorporated>: Thank you, Chris. We'll go to the next caller, please.
Operator: Thank you. We'll take our next question from Vivek Arya with Bank of America.

<Q – Vivek Arya – Bank of America Merrill Lynch>: Thanks for taking my question and good luck to both Dave and to Ron. So my first question, I'm curious, what are underutilization charges running at right now and at what level of utilization can they go to zero?

<A – Kevin March – Texas Instruments Incorporated>: Yeah, Vivek, they were about $56 million last quarter, down from the prior quarter which was about $105 million. And that's a bit of a theoretical question as to what revenue it would take to get to zero. Clearly the mix of products flowing across the various manufacturing flows are going to have a direct bearing on that. So if we had much higher demand but it was on a flow where we didn't have a lot of excess capacity, it wouldn't help much on the underutilization.

Our job on that is to make sure that all of our flows maintain open capacity and I would remind everybody again that the underutilization, we don't let that distract us; it's an accounting adjustment that affects nothing having to do with free cash flow. We are completely focused on free cash flow as the way to return value to our shareholders.

<A – Dave Pahl – Texas Instruments Incorporated>: And, Vivek, I'll also mention that, that charge is – less than half of it is actual cash. Or about half of it is non-cash. So it really doesn't impact our free cash flow by having that open capacity. Do you have a follow-up?

<Q – Vivek Arya – Bank of America Merrill Lynch>: Yeah, so I guess that means the open capacity you have is more a source of keeping CapEx low and free cash flow rather than being a big source of expanding gross margin per se?

Maybe on to my second question. On the demand environment, can you give us a sense, I think you mentioned end markets, but what about the geographies? Are there certain geos that are better or worse than what you thought three months ago? Thank you.

<A – Dave Pahl – Texas Instruments Incorporated>: Okay. So let me follow up on the last one just to make a clarifying point. So as Kevin talked about there's certain factories that – you've seen some competitors, some of the manufacturers in Taiwan run above 100% capacity. So when we've got factories or flows that run above 100% or above the theoretical level that we've got from utilization standpoint, we'll continue to get a benefit. And we still may have a underutilization charge. So don't think that all you have left is revenue growth, that, that small number that's been underutilization charge, so just wanted to make that clear.

So from a regional standpoint year-over-year, Vivek, we saw Asia, Europe and Japan were up, the U.S. we saw it was roughly even from a year-ago standpoint.

So with that, we'll go to the next caller.

Operator: Thank you. We'll take our next question from C.J. Muse with ISI Group.

<Q – C.J. Muse – International Strategy & Investment Group LLC>: Good afternoon. Thank you for taking my question. I guess the first question, once OpEx normalizes exiting calendar 2014, how should we think about growth in OpEx relative to top line into 2015 and beyond?

<A – Kevin March – Texas Instruments Incorporated>: Well, C.J., that's a long-range plan you're doing here for a semiconductor analyst. From an OpEx standpoint I think that it will probably grow at least with the change of pay and benefits that you'd expect on a year-over-year basis. So you'd certainly start there. And then to the extent that we see additional opportunities that we may want to invest in from an R&D standpoint or additional sales opportunities we may want to expand, it may go a bit beyond that. But typically you're going to see – I think this last year pay and benefits increased average around 3%, maybe 4% depending upon the average from around the world. So that's what I'd probably use for planning.

<Q – C.J. Muse – International Strategy & Investment Group LLC>: Okay, helpful. I guess as a follow-up, question on the cycle. It looks like your guide for Q3 year-over-year is slowing a bit. And would love to hear your thoughts on where we are here, were we rebuilding inventory downstream and now we're normalizing and now we're tracking more with GDP and/or are there any signs of re-acceleration in GDP or in demand in any parts geographically or product wise, et cetera?

<A – Dave Pahl – Texas Instruments Incorporated>: Yeah, C.J., I think on that front, we really don't spend a lot of time looking at the cycle and our strongest indicator of demand of course is the view that we get from orders and the forecasts that we get from our consignment customers as they'll give us forecasts, those forecasts of course can change. We just turned in good growth year-on-year. If you look at the year-on-year growth it's 6%, 8% without legacy wireless continues to be strong.

<A – Kevin March – Texas Instruments Incorporated>: At the midpoint.

<A – Dave Pahl – Texas Instruments Incorporated>: At the midpoint of the guidance range. Yep. So that's what we believe all those indicators are showing us. As I talked about before, things like you said that we're rebuilding demand in the channel or downstream. We actually took inventory out of the channel as more of our distributors moved to consignment and as the products that were on consignment actually grew faster than the other products.

So we really, it's a little over four and a half weeks of inventory that's in the channel. We consider that to be lean but probably will be running in what is the, more of a new normal range, so those changes in inventory downstream because of the consignment that we've got, going to have less of an impact on revenues as what they've had in the past.

So with that, we can go to the next caller, please.

Operator: Thank you. We'll move to David Wong with Wells Fargo.

<Q – David Wong – Wells Fargo Securities LLC>: Thank you very much. Could you give us some idea of how your policy of returning the bulk of your cash to shareholders affects future acquisition policy? Do you have an expectation your acquisition activity will be relatively low or that you'll be working primarily in stock purchases?

<A – Kevin March – Texas Instruments Incorporated>: Yeah, David. I think the way to think about it, and it relates, it kind of goes back a bit to a question that was asked earlier about, I believe by Doug, on debt on the balance sheet. From an acquisition standpoint, again, we'll look at first the strategic fit, make sure it makes sense and second, to make sure the numbers actually work from return on invested capital that we put into it.

Beyond that, the way we'd pay for it is probably very similar to what we did this last time. When we bought National Semiconductor we used some cash on hand but we actually released the strength of the balance sheet and went out to the bond markets and issued quite a bit of debt which supported that acquisition.

As we slowly retire debt as we had been, and continue to over the next foreseeable future, that just opens the balance sheet back up and makes it available again to take on debt if there's an attractive ROIC accretive acquisition out there. So that's how I would think about the strategy going forward. I don't see any of our cash management strategy having any interference whatsoever with our ability to continue to acquire when it makes sense.
<Q – David Wong – Wells Fargo Securities LLC>: Great. Thanks.

Operator: Thank you. We'll take next question from William Stein with SunTrust.

<Q – William Stein – SunTrust Robinson Humphrey>: Great. Thanks for taking my question and congratulations on the good quarter and guide. I'm hoping you might comment on the margin progression in the Embedded segment. It seems to have progressed a bit better and it looks to us as though perhaps the restructuring benefits that you're targeting are coming in a bit earlier than you previously expected.

<A – Kevin March – Texas Instruments Incorporated>: Yeah, you're exactly right on that. They have started to come in a bit earlier than we planned, but we still have a long way to go. We will see additional benefit as we move into third and fourth quarter, as we talked about earlier, as we see more of the costs beginning to come out of there. But frankly, while that's certainly helpful in moving the profit performance of that segment forward, it is not going be done when that's over with. There's a lot more work to be done there and the work is really on the revenue growth side. The operating profit clearly is below what we think the potential for that segment is, and that management team is very focused on driving results to get that profit up to where it should be.

And really, after the restructuring actions that are complete by the end of this year, it's really going be all about revenue growth. It actually has been a lot about revenue growth as evidenced by the fact that, that business has successfully grown for seven quarters in a row on a year-over-year basis, and we expect to see more of that as we go forward, so that business can grow its way into the cost structure we'll have remaining.

<Q – William Stein – SunTrust Robinson Humphrey>: Kevin, that's helpful. If I can follow up just a bit in that, I think there's one area of that business where you're kind of under-hitting, relative to your weight in the industry, and that's microcontrollers. I know that you've invested in this area in the last year or two. I'm wondering if you can talk about the strategy in terms of products, end markets, features that might lead to accelerating share gain in that category.

<A – Dave Pahl – Texas Instruments Incorporated>: Yeah, maybe I'll make a comment and if you'd like to add in, Kevin. Yeah, Will, as you know, that's an area that we decided to step up investments going back several years ago now: back 2010, 2011, in that period. And the expansion of investments included both development teams to produce more products and begin to broaden the portfolio, and second has been in application support, basically supporting customers and design-in.

So we feel really good about the progress that we've got. We've had several years that we have gained share inside of microcontrollers. I think that we still – and I think we're – some industry analysts will have us at like a number six position inside of the market, so we've got plenty of room to grow. And those are the types of markets that take a while to begin to get traction, and it's somewhat like a flywheel that you keep investing, keep making progress, and that progress begins to snowball.

From a product standpoint, we're really building out a broad portfolio. We're focused on catalog product primarily going into industrial applications. You'll note inside of Embedded Processing, we also have Connectivity products, so there we support about a dozen different wireless standards. So we're getting very good traction, and you can go to our website today and be able to find reference designs with microcontrollers ranging from $0.25 up to a couple of dollars, using all of those different combinations of the Connectivity products.

So we feel really good about the progress. As I said in the opening remarks, Embedded Processing has had seven quarters of year-on-year growth, and a big part of that is driven from microcontrollers.
<Q – William Stein – SunTrust Robinson Humphrey>: Thanks.

<A – Dave Pahl – Texas Instruments Incorporated>: Okay. Thank you very much, Will. We can go to the next caller, please.

Operator: Thank you. We'll move to Ross Seymore with Deutsche Bank.

<Q – Ross Seymore – Deutsche Bank Securities, Inc.>: Hi, guys. Before my questions, I also wanted to just pass on the congrats to Ron and to Dave on the promotion, best of luck to both of you. I guess, Kevin, one clarification that I wanted to get from you if I could. What was the starting point off of which that $130 million in savings exiting this year was going be achieved?

<A – Kevin March – Texas Instruments Incorporated>: Ross, we announced that action with our first quarter result. And we took the – excuse me, the fourth quarter and first quarter results as I recall. Fourth quarter we took a charge first quarter for Embedded Processing, so that's the start there. And the second quarter, we took the charge for the Japan restructuring. So it's a bit of a mixed start if you will. So it will be a little hard for you to do a direct correlation, but again, the math you should be using is $130 million annualized savings by the time we end the year, with 85% of it coming out of OpEx.

<Q – Ross Seymore – Deutsche Bank Securities, Inc.>: Great. And I guess as my follow-up, in the past, and I don't know if you guys are going to do this anymore now that you've started to split out the revenues in a different way. But in the past in the middle of the year, you would say what the revenues by end market did mid-year. Is that something that you can give us now?

<A – Dave Pahl – Texas Instruments Incorporated>: Yeah, Ross, we're really just planning on giving those numbers on an annualized basis. As I answered Jim's question earlier, we'll provide revenue on a quarterly basis, just color on what's happened in each of the markets, and that's what we've decided to move to.

So with that, we can move to our next caller, please.

Operator: Thank you. Our next question comes from Tore Svanberg with Stifel.

<Q – Tore Svanberg – Stifel, Nicolaus & Co., Inc.>: Yes. Thank you, Ron, and best wishes in your retirement. First question, you talk a lot about strength being broad-based, but are there any segments or markets in Q3 that are relatively weak, whether that's seasonal or even secular?

<A – Dave Pahl – Texas Instruments Incorporated>: From an end market standpoint, Tore, the only market that we saw a decline was in Personal Electronics, and that was in – I'm sorry, was it third quarter or second quarter?

<Q – Tore Svanberg – Stifel, Nicolaus & Co., Inc.>: For your Q3 guidance.

<A – Dave Pahl – Texas Instruments Incorporated>: Oh, I'm sorry, yeah. Yeah, again, I somewhat addressed that, that we're really not trying to get into the color by end market or our product segments or that. We're really just focused on the top line number overall. Did you have a follow-on, Tore?

<Q – Tore Svanberg – Stifel, Nicolaus & Co., Inc.>: Yeah, that's fair. My follow-up is, did you have a change in your distribution strategy at all in the quarter or are you planning it? I'm thinking, are you going to go to certain customers more of a direct business?

<A – Dave Pahl – Texas Instruments Incorporated>: No. We haven't had any change in the quarter. I can say that we've had changes to our business arrangements with distributors on a periodic basis over the years. And for example, if we just go back a few years ago as an example, we implemented the consignment program with distribution. So now we've got more than half of our overall revenues supported by distribution, so they're going to continue to be a very important part of our business. We're focused on growing our revenues overall, which will mean growing our revenues with them. As we invest in catalog product and in industrial markets, we want to work with the distributors to be able to broaden our reach with customers. So we will do things that will optimize both our resources and theirs, but any specifics of details that we've got going on with changes, we just won't get into.

Okay. With that, we'll go to the next caller, please.

Operator: Thank you. We'll take our next question from Srini Pajjuri with CLSA Research.

<Q – Srini Pajjuri – CLSA Americas LLC>: Thank you. Dave, just looking at the end-market breakdown one more time – I apologize; I know this question has been asked several times – you gave the year-on-year trends. Can you also talk about sequential trends from Q1 to Q2?

<A – Dave Pahl – Texas Instruments Incorporated>: Sure. Yeah, I think aside from the increase in calculators, Communication, and Personal Electronics actually grew the most. And we did see a benefit in Personal Electronics led by a strong quarter in PC and notebooks. We did see Industrial, Enterprise Systems and Automotive all contribute to the growth sequentially. So if you look underneath that in Industrial as an example, we had – we've got over a dozen sectors inside of Industrial. So with that we saw areas like Factory Automation and Control, Smart Grid, Motor Drives drive that. In Automotive on a sequential basis, we had growth in all sectors overall and that was led by ADAS. So those are the things that drove the revenue in the quarter sequentially.

<Q – Srini Pajjuri – CLSA Americas LLC>: Okay, great. Thank you. And then on the connectivity front, Dave I think you mentioned your parts have met a number of different standards. If I recall correctly, you sold the smartphone business a while back. My question is, is there anything preventing you from participating in the wearables market, if you think about the watches, et cetera?

<A – Dave Pahl – Texas Instruments Incorporated>: No, and in fact, I actually wear some of those products to track my steps and it has quite a bit of TI content both from a power management standpoint and other Analog products as well as Connectivity. So, the beauty of having a catalog portfolio is that the incremental cost to engage a customer, the tools and the support are all in place. So we can very readily and very easily support markets like that overall.

So thanks, Srini. We'll go to the next caller, please.

Operator: And the next question comes from Ian Ing with MKM Partners.

<Q – Ian Ing – MKM Partners LLC>: Yeah, thanks. Just a clarification on being opportunistic in acquisition of manufacturing assets. Is it for taking a long view on increasing capacity or are you removing bottlenecks in the manufacturing flow? It looks like Richardson Analog is still a lot of headroom here.

<A – Kevin March – Texas Instruments Incorporated>: Yeah, Ian, it can be a little bit of both. If we see bottlenecks popping up someplace and we're able to go ahead and pick up equipment inexpensively or if we anticipate that a flow is going to become a bigger, more important revenue source in the future, we can go ahead and pick up for that, or just outright new factories for example. That's what we did when we bought the assembly/test site in Chengdu, China. It was an entire factory that we bought in that case. We'll take advantage of whatever opportunity presents itself, especially if the finances are compelling.

<Q – Ian Ing – MKM Partners LLC>: Great. And this commentary on Connectivity growing faster within Embedded, I'm assuming we're talking about Internet of things and wearables. Do these sockets have good attach with microcontrollers and power management? Do you have a sense if IoT mix, how much of it is more like industrial, military, first-responder type of applications with long cycles?

<A – Dave Pahl – Texas Instruments Incorporated>: Yeah, if you look at the product portfolio, we actually support a dozen or so different wireless technologies. So whether you need Bluetooth low energy or Wi-Fi, we've got GPS. We have multiple sub gigahertz standards including things like ZigBee. So whatever label that you want to put onto that, essentially if things are getting smarter and more connected, we've got a broad range of catalog products in which to show to customers. We can be fairly agnostic on how to solve their problem and bring really the best fit of the technology to whatever market they're trying to enter. Oftentimes we'll find manufacturers that have never had any wireless experience. So they'll want to go to the web. They'll want to contact our local apps people and get support for that product and they really don't have to become RF experts, and so they can focus their time on other things. And that's a combination that's working real well.

Okay. With that we can go to next caller please.

Operator: The next question comes from Chris Caso with Susquehanna Financial Group.

<Q – Chris Caso – Susquehanna Financial Group LLLP>: Yeah, thank you. Wonder if I could go back to some of your earlier comments with regard to the consignment revenue. I guess just to clarify that, I guess what you're saying is, the higher percentage of fulfillment through consignment that you're expecting for third quarter is what's pulling down the book-to-bill. And I think in the past you've talked about your book-to-bill for the non-consignment portion of your business. Could you tell us what that is? And perhaps that's a better indicator of the end market booking trends.

<A – Kevin March – Texas Instruments Incorporated>: Yeah, what I talked about, Chris, was that we've had a conversion of more products into consignment going through distribution. And so that's suppressed the book-to-bill a little bit that we just came out of the quarter with. If you keep in mind, that – how much of our revenue is going through consignment now?

<A – Dave Pahl – Texas Instruments Incorporated>: 50%.

<A – Kevin March – Texas Instruments Incorporated>: 50% for the total company is going through consignment. So what that really means is that book-to-bill for that consignment revenue is, by definition, 1. And so the book-to-bill that we report at the company level really just applies to the other half of the revenue. So that 1.01 that we just reported, in very simple terms would be 1.02 because it really applies to the non-consignment portion of the business. And again, that was suppressed somewhat as a result of a conversion from a previously direct sale to a consigned arrangement.

<A – Dave Pahl – Texas Instruments Incorporated>: Yeah, and, Chris, I'll just add, in second quarter we delivered a 10% sequential growth and our book-to-bill was 1.03. If you look at orders, they were up 9% sequentially, so that book-to-bill number is just one number, and as Kevin said, it's got some noise in it. So it's one consideration that we look at as we put together the demand forecast.

Do you have a follow-on, Chris?

<Q – Chris Caso – Susquehanna Financial Group LLLP>: Yeah, sure. For my follow-on I guess I'll ask a little bit of a bigger picture question. TI over the years has always been a cyclical company, just a function of the industry. But as you guys are operating the business a little bit differently now, your focus is on some different end markets. Just interested in your view of, going forward, what does that do to the cyclicality of TI as we go over the next couple years?

<A – Kevin March – Texas Instruments Incorporated>: I think you're spot-on Chris. As you look at the mix of what's going on inside our portfolio, in years past, as you observed, we had some big verticals. Certain end markets you might be able to take a look at, and our business would cycle with that end market in addition to any so-called semiconductor cycle itself.

Now, as we have industrial and automotive becoming a larger and larger percentage of our total revenue, and the markets to which our products are being shipped into, arguably we would see, likely see less impact as a result of big vertical fluctuations, and begin to see a little bit more correlation between TI's growth going forward and the global GDP as a whole. So we'll probably track more to the economy as opposed to a particular single end market.

That's not to say that we escape the semi-cycle if there still is one, it's simply to say that our fortunes are more tied much more broadly than they have been ever in the past, and therefore, they're much more reflective of how does the overall global GDP tend to expand over time.

<A – Dave Pahl – Texas Instruments Incorporated>: Okay. And with that, operator, we have time for one last caller.

Operator: Thank you. Our final question comes from Timothy Arcuri with Cowen and Company.

<Q – Timothy Arcuri – Cowen & Co. LLC>: Thanks so much. Guys, based on your current schedule of depreciation, and if you assume that CapEx remains at roughly 4% of sales, when is depreciation going to hit the level of CapEx? Is this a 2016 event? Or is this sometime beyond that? Thanks.

<A – Kevin March – Texas Instruments Incorporated>: Yeah, Tim. It's unlikely that we would see CapEx and depreciation converge prior to 2016, so that's probably a good starting point for you to build your models with.

<A – Dave Pahl – Texas Instruments Incorporated>: Do you have a follow-on, Tim?

<Q – Timothy Arcuri – Cowen & Co. LLC>: Okay. Great. And then a question about gross margin drop-through. The number has been a little bit above 75% the last couple quarters. But is that still the right number to think about, going forward, for the gross margin drop-through? I know people were talking about operating margin drop-through but I'm wondering about gross margin. Thanks.

<A – Kevin March – Texas Instruments Incorporated>: Well, certainly we're operating at a higher level now, Tim, than we have in years past. And we talked a number of years ago about over a long term – a long window of time that, that fall through during the course of a business cycle historically has been a pretty good indicator to follow. But in any one time period it has always been a number that doesn't really apply very well.

More importantly going forward, we're operating at a much higher level of gross profit than we have ever in our past, and I would expect that to continue to drop through quite richly, and importantly drop through as free cash flow that we can continue to return to our shareholders in the form of the dividends and stock buyback.

<A – Dave Pahl – Texas Instruments Incorporated>: Okay, great. And with that, I will turn it over to Ron to make some final remarks.

Ron Slaymaker, Vice President, Head of Investor Relations

Okay. As we wrap this up, let me just close by saying the past 32 years working at TI really has been a good – actually a great ride. For Dave and Kevin, let me simply pass on the requests and words of advice that have been passed down through generations of TI managers and that's, please don't screw it up.

Thank you all for joining us. A replay of the call is available on our website. Good evening.

Operator: That does conclude today's presentation. We thank you for your participation.