THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

MXIM - Maxim Integrated Products Inc at Citi Global Technology Conference

EVENT DATE/TIME: SEPTEMBER 02, 2014 / 2:15PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Bruce Kiddoo *Maxim Integrated Products, Inc. - SVP and CFO*

Kathryn Ta *Maxim Integrated Products, Inc. - Managing Director, IR*

CONFERENCE CALL PARTICIPANTS

Atif Malik *Citigroup - Analyst*

PRESENTATION

Atif Malik - *Citigroup - Analyst*

My name is Atif Malik. I cover specialty semiconductor and capital equipment names here at Citi. It's my pleasure to welcome Bruce Kiddoo, CFO of Maxim; and Kathryn Ta, Investor Relations for Maxim.

I'm going to start off with a few general questions in the analog space, and then some Maxim-specific questions. (Conference Instructions) I'm going to start with some -- a few general questions on the analog space, and then we could dive into Maxim-specific questions. In terms of the emerging growth drivers, with PC stabilizing and smartphones decelerating, what will be the new leading growth drivers over the next three to five years? Do you see a shift or a deceleration in auto growth occurring in the near term, after two years of expanding content growth?

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

So good morning. It's kind of a different format. It's kind of interesting.

I think will we look at growth. I think it's the things that most people have been focused on and looking at. If you think of Maxim, with our balanced portfolio -- and, certainly, automotive has been our fastest growing market to date; it's about 10% of revenue. It grew last year around 45% year over year. So it had very strong growth.

We used to kind of say it was growing off a small base, but given it's now about 10% of revenue, that base is actually getting pretty large. We see that growing in a very broad manner in that we sell to most of the OEMs, the Continental, the Bosch, the Harmans of the world.

We sell across -- Europe is our biggest opportunity there, followed by Asia; and then, third, by the US. And of course it's a business which has long product life cycles, seven-year life cycles. You get good design win visibility.

And it's a business were generally it does well in March and June, and then it sort of stabilizes in the back half of the year. So I think that's the fastest-growing business for us. We do think industrial, which is about 27% of revenue, is a good growth business for us.

Most people think of that at a global-GDP-plus sort of growth rate. We do have the opportunity where about two-thirds of our industrial business is in core industrial, and so this is -- if you think about selling through distribution, kind of building-block, high-margin business. The other third is vertical markets, which are like smart meters; financial terminals; mobile payment systems; medical. And these are markets that rely upon high integration and have secular growth trends that can grow faster than the overall industrial market. And so then we can get sort of that high single-digit growth rate in the industrial market.

And then third, of course, is then mobility. And I think that's an area that has done very well for us, especially a couple years back, when we exited notebook. It was mobility that grew and allowed the Company to grow and then maintain our revenue base while we exited notebooks.

I think there has been some -- you know, over the last two years, high-end demand for smartphones has slowed down. Obviously, that impacted our near-term business this quarter. And it was the reason we gave a wider range to our guidance, because of that weakness in high-end smartphones.

That said, we been working on broadening our base of business. So that Samsung has come down from, at its peak, 28% of revenue to this quarter will be around 15%, mid-teens. We're growing our business at the other large mobility account. We are growing our business in China.

We are selling new technologies from -- in addition to power, we are selling sensors; we're selling audio; we are selling into new platforms in addition to smartphones. We're selling into tablets, we're selling into e-readers, we are selling into wearables. So I think mobility will be probably the third leg of our growth driver.

And then, finally, I do think kind of the common data center is a market that can provide good growth. Last year that business grew 10% year over year for us organically. We added on the Volterra acquisition that allowed us to grow in the June quarter 30% year over year.

And so I do believe the data center -- and we do very well in fiber optics, both in our connectivity within the data center. So I think that's a good business that can also probably grow kind of mid-single digit, I think, on a good year. Because it can be calm, can be lumpy; it can get up, as we did this last year, into high single digit, or like at 10%. But I think in general, that's a little bit lower growth rate. And so automotive, industrial, mobility, common data center, in kind of that order, is how we think about our growth opportunities.

Atif Malik - *Citigroup - Analyst*

Bruce, in terms of the geographic demand, what is your specific view on meter activity in the US, China, Europe as accelerating or decelerating in second half of 2014? If you can provide any insight as to which markets are seeing more or less strength than others?

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

I think right now -- so for us, our best view into that is through the distribution channel. Just to the extent we sell to OEMs, and then they sell into all markets, so we don't get a good view of where their products end up.

I would say right now we are seeing normal seasonality across the markets. We saw -- industrial is always very strong in the first half of the year. So we saw good business in Europe, good business in Asia -- China, specifically -- and then also the US as well.

As we move into the second half of the year and certainly in the summertime, Europe slows down from an industrial point of view. And similar in -- not to the same level, but in the US, as well. So I think it's following our -- our distribution follows the normal industrial patterns, which is strength in the first half of the year; kind of slow down in the second half of the year. And we are not seeing anything unusual geographically.

Atif Malik - *Citigroup - Analyst*

In terms of bookings, then, are bookings at distributors better or worse than -- thus far in the current quarter? And you expect lead times to stretch?

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

I think our bookings are what we would expect for distribution, especially. And, again, I think you normally see Europe slow down from -- say, in the month of August. And then I will get back from Labor Day, and we wait and see how they look in the month of September.

Lead times are in line. So we've seen no stretching of lead time. Actually, inventory levels in the channel -- it was 54 days in June quarter. A year ago June, it was 53. So there hasn't really been any change in the inventory levels.

In March, our inventory levels were at 48. And I think some people have commented that oh, we saw the build and the channel go from 48 to 54. We have actually been at this 50 to 55 for the last three years. And in March, actual industrial business did very well. Resales were very strong. Inventory levels came down.

And our franchise partner is Avnet; they were very clear. It finally got to a point where it was too low. And so they said they were going to restock in June, and we gave that indication they would. They did, and therefore we came back up to 54 days.

But overall, channel inventory is, I would say, in line. Lead times are in line. I would say the only place we have seen any kind of stretch in lead times is in automotive, and that's where the business has been growing very strongly. And I think that is natural. When you're growing a business 40%-plus year over year, people are going to stretch out lead times a little bit.

Atif Malik - *Citigroup - Analyst*

I had a question on the consolidation. We have seen quite a bit of consolidation this year, 11-plus acquisitions in the analog RF space. How do you perceive the M&A landscape shaping out in the second half and next year? And are there any holes in your current portfolio that you feel like you need to address?

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

So consolidation is happening, obviously. We see these deals on a regular basis.

The sense is companies like Maxim used to do tuck-in acquisitions. And we bought all the small companies, all the privately funded, that -- this was sort of an exit. And as you said, we would usually do that kind of a time-to-market on specific technologies.

I think we will always continue to look at tuck-in acquisitions, and we will look at where we need to fill a gap in our technology roadmap. But I think what has occurred now is industry growth rates have slowed down. There are less startups out there within the semiconductor environment or landscape today.

And so what you're seeing is companies that are in the $1 billion to $2 billion market cap -- they are having a difficult time growing and funding R&D. Scale does matter. And so I think you are seeing those companies either consolidating amongst themselves, or you're seeing larger companies like a Maxim take advantage of this opportunity.

A perfect example for us was the Volterra acquisition. It was a little bit larger than a tuck-in. We paid $450 million enterprise value, kind of 3X revs for that deal. That was a great opportunity for us, great team, great technology. We got the cost cuts, the thesis around growing outside of their server OEM business into the cloud, into the comm power companies.

That is all working out. That takes time. But I do think you are going to start seeing more of those type of acquisitions. We've seen them already. ADI Hittite was another, you know, right along the lines within the analog space.

So I think you'll see these deals, but I do think you'll see the large companies -- the Maxims of the world -- be selective. I think we are very profitable; we are very stable. We don't need to do this. We have the scale to be successful.

But to the extent that a high-quality asset comes along that fits within our strategy, where we can create value, and where -- to the extent it helps us rebalance our portfolio and broadening our revenue base, I think those are opportunities we will look at. I think those are similar opportunity our peers will look at. But I think it will all be very selective.

Atif Malik - *Citigroup - Analyst*

Bruce, let's start with your consumer mobile segment and strategy. You talked about your biggest customer is Samsung, being 30% of sales last year, coming down to 20% and down now to mid-teens. How should we think about Maxim balancing a mobile market growth with exposure to other end markets?

And the reason I ask this question is because we see analog companies that are exiting the PC market, such as yours, and some of the analog companies that are actually exiting the smartphone market. And Maxim is kind of uniquely placed because of its platform in sensor and MEMS portfolio, where you guys are parsing both markets.

So the question I get asked frequently is: what makes sense for you to be remaining in the mobile market? And if you can talk about how you balance the growth among other markets?

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

Yes, I think -- certainly, when you look at the mobile market, and it has caused issues from a predictability point of view, I do think it probably got a little bit too big. Obviously, when it was at 47% consumer -- was 47% of revenue and Samsung was at 28% of revenue, that was too large within a balanced portfolio.

We have addressed that. We've probably addressed it the hard way in that Samsung revenue in the high end has come down, such that our consumer business is now 35% of revenue. And Samsung, as you said, will probably be about 15% of revenue this quarter. And there clearly is near-term weakness. And as I said, that's probably one of the reasons we guided a little bit wider than we normally do in the quarter.

That said, we think at the right size, with the right diversification of customers, we think mobility is a good business. We've always indicated, and I think most people realize, the gross margins are just a little bit below corporate average.

Operating margins are in line with the corporate average. We outsource probably about half of our manufacturing in this area, so return on invested capital is solid. So this is a good, profitable business for us. We just need to broaden the customer base. And so to that extent, we think we've indicated we've made progress with the other large mobility player, both from audio and tablets and in other new, upcoming platforms.

We are growing our business in China. And then in addition to that customer diversification, where we used to be just power management, we're now doing very well in sensors; we are a market leader in optical sensors, driving those new applications. We are gaining in audio, and we are now shipping audio in high-volume platforms at both of the large mobility players.

And then from a platform point of view, again, beyond smartphones, doing well in tablets; doing well in wearables; doing well in e-readers. Some of those are smaller markets versus the others. It will be interesting to see -- you know, I think the open question is, on wearables, how big will that market be? I think that's still a fair, open question for people to debate.

But to the extent that we are in the Samsung wearables; we are in garments; we're in a lot of the other existing ones, we believe we have meaningful content in new platforms that are upcoming. To the extent that that's a successful market, that will be another opportunity to broaden, in addition to tablets, in addition to smartphones, another mobility market.

Atif Malik - *Citigroup - Analyst*

Bruce, you talked about design wins at other key OEMs. Is it possible for you to provide a range of dollars of content for these new categories, like wearables? What's the typical range for Maxim's dollars of content?

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

Yes, I think until products come out and until there's teardowns, it's probably not a good thing to talk about things too far ahead of time. Generally, our customers like to announce their products first.

Atif Malik - *Citigroup - Analyst*

On your earnings call, you guys talked about mobile payments. You are sampling some new highly integrated systems in the mobile payments. Can you talk about what those products are?

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

Sure. I think it's interesting -- if you think of financial terminals and payment systems, we have actually very high share on the terminal side, and primarily in secure microcontrollers, along with analog wrapped around that. And so we have a leading market share in that market today.

As that market moves into mobile payment systems, we've done very well in winning designs there and starting to ship those products. I think this is still a small market for us. But to the extent that the mobile payment system -- and it needs to be a market where you move from basically just putting a dongle onto a standard smartphone to actually having a mobile payment system that is fully -- has industry certification and meets all the requirements that you actually use in a small business or in any other kind of -- where you want that mobile payment system.

Atif Malik - *Citigroup - Analyst*

Outside of handsets, what are two or three areas where Maxim is focusing most on integrated product development?

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

Yes, I think -- well, certainly, if you want to go to wearables, that's an obvious choice. We do our integrated power management. That's shipping today in multiple wearable devices. Integration of sensors, integration of other building-block parts, low-power microcontrollers.

I think all of that, whether it's in a -- it's not all going to be integrated on a single piece of silicon, but whether it's within a system in package or it's just an overall reference design system integration with software and algorithms that sit on top of that, that's an obvious area. We talked about mobile payment systems. That's another area. Certainly smart meters is a growth area for us -- has an integrated analog front end, microcontroller security.

Another area where we are doing very well, obviously, is automotive, as we said, growing that 45% year over year, 10% of revs. That's an area where people are starting to drive towards integration as well. A lot of electronics in the headend unit, the center console. People are looking for integration, both from a space, but also from a managing the bill of materials, and the supply chain, and from a quality point of view -- more warranty if you have less parts that you have to manage.

So I think that's another area where integration is driving -- and I think it's worthwhile to highlight -- we've talked about integration, and people think about analog as single-function parts. About 50% of our business right now is high-integration parts. And yes, that started off in consumer, and about two-thirds of that 50% is consumer.

But the other third is in industrial; it's in communication. We have a very strong optical business, where we are doing fiber optic products, where we are integrating -- whether it's in fiber to the home or other -- like, data center connectivity, optical products, where we are doing high-integration solutions for our customers.

Atif Malik - *Citigroup - Analyst*

Moving on to the auto segment, it is 9% of your sales, but growing fast. What is driving outside growth in your auto markets?

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

I think most people know content is increasing very rapidly in the space. All you have to do is get in a car today.

We've done very well in infotainment. So from that point of view, if you just think about power management, there's significant amount of systems that have processors that require power management for them. Think about getting in a car today without a USB port.

We are actually a market leader in USB ports. This is a -- tens of millions, approaching 100 million units installed a year, of which you can get good dollar content for a part like that. We do video distribution throughout a car. And that started off in the infotainment side, but that's now also on the driver's assistance and safety.

We can have $30, $40 of content in a car just for sturdy video distribution. We do satellite tuners; we do DAB -- direct access broadcast tuners for Europe. We have Keyless Go, the key fob that we have a leading technology in.

And we even have battery management systems for lithium-ion batteries. So I think the important takeaway: it's a very broad product set that's sold into many OEMs on a broad geographic basis. So it is a great business in that it is very stable. You get long product life cycles. You get good visibility.

I think the other thing to point out is this is a business which today is below the corporate average from a gross margin point of view. We took products which were designed for other end markets and adapted those to the automotive market. Obviously, the quality standards a very high, as you would expect in automotive.

And so we've been, in essence, testing-in quality. And so from that point of view, that has increased our test cost. To the extent that we can continue to design products for automotive first, to the extent we can improve our quality levels, that will allow an opportunity to improve gross margins in automotive as well.

So very -- it's our fastest-growing business. It has an opportunity for margin expansion, long product life cycles, good visibility. It's a great business for us.

Atif Malik - *Citigroup - Analyst*

Bruce, on your target model, Maxim reaffirmed the target model of revenue growth of 3 to 5 points above the industry, 61% to 64% gross margins, and 30% operating margins at the May analyst day. What is required to accelerate the growth next year? And with the smartphone and tablet weakness in the June quarter, does that kind of throw you off your target model?

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

Certainly, we expected high-end smartphone growth to slow down. Certainly not as fast as it did in the June and the September time period, but we knew we had to broaden our revenue base and grow by growing market share and not counting on unit growth.

And so that's why -- you know, all of the things we talked about -- broadening the customer portfolio, broadening the technology, the platforms. I think that's going to allow -- and we've kind of taken Samsung to a point where it's at a more manageable level. And so from that point of view, I think we have a base to build upon on the mobility side, where mobility has been kind of not growing the last couple of years.

But to the extent -- when you kind of stabilize mobility, and then the growth we've seen in all the rest of our businesses, the growth we've seen in automotive; in industrial; in common data center, I think that's what is going to allow us to achieve those growth rates a little bit above the market that we are expecting.

Atif Malik - *Citigroup - Analyst*

And on the gross margin, can you remind us what percentage of your manufacturing is outsourced? And where are the gross margins right now?

I believe your capitalizations have a lot of headroom to improve once you get through inventory corrections on the smartphones. Can you remind us how much headroom you have in the gross margin as the volumes come back?

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

Sure. So we're about 50%/50% from a fab point of view, as far as what we do internally versus what we do externally. I think it's fair just to remind folks: externally, what we do is we actually go with old digital fabs; and, obviously, analog runs on much older process technology. We run on 180-nanometer.

And so we will go to one of these digital fabs, and will get a contract -- we are the only analog customer they can have from a foundry point of view. And therefore, we transfer our proprietary process technology to them. And so one of the reasons analog has always been able to get good margin is not only do we run on old fab equipment, but that we have our own proprietary manufacturing process. So you can't get second-sourced is the short answer.

And we found a way to do that by running on somebody else's CapEx through these exclusive relationships with the foundry partners. But it's about 50%/50%. Utilization was 75% in the June quarter, and we actually said because of the decline in revenue, we see that dip down to probably closer to 70% or slightly below in the September quarter.

Gross margin in June was 60.5%. Our target range is 61% to 64%. Structurally, there's no reason we should not be able to comfortably operate within that range. And, in fact, we think to the extent that we improve utilizations and manage our inventory and inventory reserves better, which we will, we should be able to get into the upper half of that range.

And so when we think about leverage in the model, we absolutely think about -- there's a couple points at least of leverage in the gross margin line going forward. And it's really just a combination of managing our utilization and then managing inventory reserves, which we got -- we took a 1-point hit in the June quarter for.

Atif Malik - *Citigroup - Analyst*

Okay. Let me stop here and see if there are any questions in the audience. If you have a question, please press the pushbutton on the microphone.

Unidentified Audience Member

Can you talk about how you are positioned in some of the Chinese -- have so many factions, like Xiaomi, that have taken share from Samsung. And also if you think about your content per those types of devices, given that they have a lower selling price for a Samsung than an Apple, how that affects you guys?

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

Yes, no, it's a good question. Obviously, that's an area where we've been focused. We're growing that business. I would say it's still a much smaller business than what we have at the other two larger OEMs.

It is a business where we are initially doing well in power management. And at Maxim, we've talked for many years about our highly integrated power management and integrated analog -- things like the fuel gauge, the battery charger, the USB port controller, all of that integrated with the power management solution.

And so the benefits of integration, which includes lower costs, lower space, makes it more simple to design -- that's what we've been winning with in China. I would say it's still a very -- it's still a relatively small business for us. It is one that's growing.

But to the extent that if the large guys -- and you get designed into a high-selling platform, there's tremendous leverage. I think China is taking a little bit longer for us simply because you have to sell to the seven OEMs, and they all have multiple SKUs.

And so we are getting -- we are growing it. It's growing at a reasonable rate. It's off of a very low base. I think it's a multiyear investment for us. But certainly, it's something we recognize that we need to be there, and we need to have a solid relationship and a solid business with those vendors.

Atif Malik - *Citigroup - Analyst*

Questions?

Unidentified Audience Member

Thanks very much. Just wondering if you could elaborate a little bit on your autos revenue growth, of about 45%. How much of that is driven by content growth, and how much of that is driven by share gains, because I think car production -- unit growth is about 6%. And I can understand you're taking share, but just wanted to understand the weight of either arguments. Thanks.

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

Yes, I think is very difficult for us to separate those two out, just because today it is all just -- it's sharing contents, right? It's new content in cars.

Video distribution is -- it used to be just a couple cameras, maybe, for a rearview -- rearseat viewing. And then you had the rear backup camera. Now you have cameras on the side and 360 view. So from that point of view, just that increasing content.

So my sense is our growth is all about content and getting in new platforms. And we're not -- it doesn't appear that we are tied to industry unit growth at this point in time. I'm sure at some point that will have an impact, but today it's just getting in new designs and in new platforms.

Atif Malik - *Citigroup - Analyst*

Any questions? Bruce, you guys have set up a 80% of free cash for a return-to-shareholder target. And if I look at your stock, it trades at 20% to 30% discount to some of the peers who have similar free cash to return targets. Outside the Samsung concentration, is there anything that investors are missing, or anything that comes to your mind, why your stock trades at the discount to your peers'?

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

No. Well, I think it's, A, Samsung concentration. I think that issue is, as we have said, working its way through the hard way. I do think there's some -- even the mobility, at about 35% of revenue.

But I do think if you get a broad-based mobility -- and I think if you look at some of our other peers, who you refer to, who -- people think of themselves as maybe an industrial company, yet they are 30% consumer business as well. But it's just a question of having that broad-based customer base and products that you sell into it.

So I think to the extent that we can continue to grow our business outside of mobility, continue to diversify within mobility, that return of capital profile that we have -- and over the last four years, we've actually -- I think it was returned 92% of free cash to shareholders. And if you look at structurally the ability to bring down CapEx this year from -- we were running at 5% to 7% of revenues, and we brought it down to 3% to 5%. And that's a permanent change, because we are now going to -- that next node, we will outsource 100%. So we won't have to build that capability within our internal factories.

You look at the ability to drive leverage in operating margin, which translates into EBITDA margin -- and so what happens is where, like, last year we generated 26% free cash as a percent of revenue. Based simply on the CapEx, which will happen, and off of our commitment on the operating margin leverage, you can get free cash into the high 20s as a percent of revenue. And so that will allow for continuing increase in the return of capital.

Obviously, in July we increased our dividend by 8%; prior year we had increased it by 9%. Every year we have increased the dividend, except for the recession year, where we kept it flat. So this is analog. This is a great business to be a CFO.

Atif Malik - *Citigroup - Analyst*

We're almost out of time. Thanks, Bruce and Kathryn, for coming to this Citi conference.

Bruce Kiddoo - *Maxim Integrated Products, Inc. - SVP and CFO*

Thank you so much.

Kathryn Ta - *Maxim Integrated Products, Inc. - Managing Director, IR*

Thank you.
