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MXIM - Maxim Integrated Products Inc at Pacific Crest Global Technology Leadership Forum

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PRESENTATION

Michael McConnell - *Pacific Crest Securities-KCBM - Analyst*

We're very pleased this afternoon to have Maxim Integrated presenting at the conference. Representing Maxim is Bruce Kiddoo, their Chief Financial Officer. As usual, I'll kick it off with a few questions, but if any of you have some, please, we encourage participation.

So first question, Bruce, would be if you look at the stocks, it had a real nice bounce since earnings. The Company announced new expense reductions, which were very well received by investors. Could you walk through the rationale behind the cost-cutting and outsourcing and what this could mean to the model?

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

Sure. And thanks, everybody, for spending some time here in our little extended one-on-one. So when you think about Maxim and the drive towards profitability, it really started a year ago May at our Analyst Day, where we drew the line in the sand and said we were going to get to 30% op margin. And clearly, as a Company, that's a very reasonable profitability level. We had been managing expenses to a flat level, but we really wanted to -- we hadn't made progress on getting to the 30% op margin. So we drew that line in the sand.

Last summer, Samsung had a difficult summer. So in October we said, "Okay, we're not going to just wait on revenue. We're going to take control of our destiny." And so we had announced the closure of a small fab, a development fab in San Jose, and we started to look at our operating expenses. And historically, we had been 22% to 23% of revenue when our peers, like Linear or ADI, were like 18% to 19%. So we announced exiting from the MEMS business, getting out of touch.

And so those all were very successful. We took operating expenses from $220 million down to $200 million, and we're closing the fab ahead of schedule. So that was successful for us.

As we got into the May timeframe -- our fiscal year ends in June; we normally do our strategic review process in May -- we had gone through a reorganization where we took -- we used to have three divisions. We consolidated those all under one individual to run all of our business units and sales. And at that point in time, we said, "Look, the consolidation of our businesses has worked. Let's see, are there other businesses which are very low market share and slow-growth markets?"

And we identified additional opportunities for cost savings. That came out in basically another $20 million-per-quarter savings, or $80 million a year in savings. And this is just businesses. And it's just we always thought of ourselves as a broadly diversified analog company. We clearly still are, but if you have 2% market share, 5% market share, and somebody else has 20%, 30%, or 40% in a market that's just growing at 5%, it doesn't make sense to continue investing in that market.

And so these were the areas where we looked at it and said we can reduce our spending. We took some of that to the bottom line. Some of that we actually redeployed and are really doubling down our investments in our growth areas. And so to the extent that people had been worried, "Oh, well, you're cutting R&D. Is that going to impact growth?" first, I think, it's going to allow us to be more focused and invest more in our growth markets, whether that's automotive, whether that's cloud, whether that's industrial. So I think that will actually help us from that point of view.

And the other thing is we were spending too much, right? If you look at peers who are very good, successful companies, we were five points above them. So I think this is just the right thing to get a better return from our R&D and, I think, allow us a more focused effort on growing our top line.

As far as the manufacturing goes, we made a decision a couple of years ago that our next-generation manufacturing technology -- which we're an analog company, so it was 90-nanometer -- was going to be 100% outsourced. When we made that decision, it basically said that at some point in time, we would want to look at rationalizing our fab capacity. And during our strategic planning process this year, we made the decision that it was better to do that sooner, to find a strategic partner to take over that fab and run it for us, while there was still loading in that fab so that they could continue to have an income stream from that fab while they go off and find additional customers to fully load that fab.

And so as the decision was made, "Let's make that now while the fab's still very healthy and economically profitable. We're just going to find a partner to buy the fab. We will in return, though, have a 10- to 15-year supply agreement back."

And so one of the benefits of analog has always been we have proprietary manufacturing processes which allow us to have, generally speaking, higher margin than, say, the digital guys who buy parts from TSMC and use the TSMC process. This deal will allow us to continue to build products in our fab with our proprietary process. We just changed it now to the assets are off our books. It turns into a variable cost model versus a fixed cost model, yet we get to keep that proprietary advantage.

So I think these are all just the evolution of the Company. I think the fab was a natural evolution, and I think the operating expense was just a recognition that as our industry slows down, you need to really focus on where you're going to invest your R&D dollars.

Michael McConnell - *Pacific Crest Securities-KCBM - Analyst*

What were some of the things that you were involved in when you were running at that 22% to 23% that you've now exited, I guess?

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

I think, if you look in the consumer side of the business, we were investing in MEMS. I think we thought we had some unique technology that people would be willing to pay for. It turns out, I think, the large mobility suppliers were really just looking for basic MEMS technology and weren't looking to pay for something differentiated, so from a margin profile, so we exited that business.

The touch business was another one where we were a late entry into that market that had become somewhat commoditized, and so we actually sold that business for $40 million to Qualcomm. And that was just a win-win-win. The employees got jobs, the customers continued to be supported, and from a product point of view, our product design relied upon the apps processor to do the processing work for our analog front end. And so it just makes sense that you find a natural partner in Qualcomm.

We've also looked at other areas to the extent that power management within our consumer business, half our business is power management. So we have it across all of our businesses. And so what we looked at doing, it was we said, hey, let's -- the consumer business has declined over the last couple of years, so we reallocated some of those power management engineers from consumer to automotive. So some of it's productions and some of it's reallocation to the growth markets.

Michael McConnell - *Pacific Crest Securities-KCBM - Analyst*

How is the Company thinking about the smartphone markets? How committed are you? There are some people who would prefer you to maybe even think about getting out of that market, I guess. How realistic is that or how do you think about that, longer term?

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

I think when we think of the smartphone market, it's really what do we do very well, where do we have good share, distinct advantage over our peers? Certainly, power management, we do very, very well, right? And not only do we invest in mobile power, but that same investment applies to automotive. If you think about a lot of the guys who do processors that go into mobile devices are also trying to be successful in automotive, so I think you get a lot of synergies if there's a commonality of IP.

We also look at sensors. Again, sensors are something that are applicable both for the mobile world, but if you think of like a medical wearable device and other areas around, just for the broad term of IOT, sensors is a key part of that. And so, again, that's an area where we'll invest that in smartphones, but that same technology, that same IP, will be applicable to other markets. And then finally, audio is an area where we clearly have something on the amplifier side, where we've won across all the three major areas, right, whether that's Samsung, Apple, and China.

So I think we'll be very focused where we know we do well. I think it will be R&D that's leveraged across multiple markets, so it will be a very efficient and limited-risk investment. So I think you can absolutely make money. You just have to be smart in your investment and only invest where you can get an adequate return.

Michael McConnell - *Pacific Crest Securities-KCBM - Analyst*

At dinner last night you seemed to be pretty excited. We went through automotive and sensors and audio, but you also seemed pretty excited about the server opportunity next year. Could you expand on that a little bit?

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

Sure. If you look at servers today, there's clearly a transition, really, from the traditional enterprise OEM providers to the cloud providers who are building their own servers. So whether that's Amazon, Facebook, Google, Microsoft, the folks who are building their own data centers, there's a well-known trend where they're starting to build their own hardware.

The good news about that is they're actually running the data centers, so when they think of total cost of ownership, energy costs are a key part of that cost equation for them. And so to the extent that we have products from the power management point of view which are much more efficient than, say, our competition, that's something the cloud-based players value, and that's something where we have gotten meaningful design wins. It's probably a year away where it really kicks in such that when we're sitting here next year, that will be something that we'll be talking about as part of our guidance for the quarter, and we're seeing that growth opportunity.

So I think in general, data center is going to be a very good opportunity. If you think of the world of communications and that market, the shift from infrastructure over to data center is a trend that most people see. And for us, we're currently growing our business in connectivity, the 40-gig optical connectivity in the data center. And I think power has the opportunity to be even a bigger opportunity for us within the servers.

QUESTIONS AND ANSWERS

Michael McConnell - *Pacific Crest Securities-KCBM - Analyst*

Any questions from the audience?

Unidentified Audience Member

As far as data center, do you see that opportunity as more of a durable, longer-lasting design win, or is it like (inaudible), like it's never caught up with much after-cycle design and they have to compete for it on a two-yearly type basis?

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

So I think it's a little early to understand exactly how the cloud providers are going to think. Given the amount of investment they're making and in trying to standardize their data centers so that they can -- their concern is the ability to move fast -- our sense is it's going to be a longer life cycle. It's certainly not going to be in a standard consumer life cycle. I don't think it will probably be as long as an industrial. So we don't know, but my guess is it's probably in the two- to five-year range. But again, we're still in our first cycle, so we'll be able to give you better information in a couple of years on that.

Unidentified Audience Member

On the automotive side, could you give a metric, like what your average content is and where you think it could go, dollar value or -- ?

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

We don't, just because it is, for two reasons, so difficult, because we're very broad-based. We have power management across infotainment, ADAS. We have device distribution throughout a car. We have RF, we have high-brightness LED lighting. So it can vary significantly per car.

The other thing is, is we sell to the Tier 1's. We sell to a Continental, a Bosch, a Harmon, a Delphi, a Denso, and then they sell into the OEMs. So we don't get that direct report as far as what our content is for every platform that the Tier 1 is selling into. So we know if we add it all up, we can get to $75 or more per car. Whether we've actually achieved that -- I mean, if you look at our total product offerings -- but we're not able to track that, say, platform by platform.

Michael McConnell - *Pacific Crest Securities-KCBM - Analyst*

Any other questions? Maybe we can just shift a little bit more to the near-term business. June quarter was impacted by Galaxy S6 sales -- well anticipated, not a big surprise. And you're guiding for a sharp decline in your consumer business. In terms of Samsung, are we now at a point where it's started to stabilize, or have you seen even more cuts and weakness since your report?

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

Oh, I think we understand, from a guidance point of view, from a visibility point of view, I think Samsung has definitely become more predictable. It still has its seasonality in that it grows in the June -- basically, March and June, the business grows. And then it declines in September after that channel fill in June. And then they do their inventory correction in December. So I think from that point of view, it's predictable.

We do think, if you just look year over year, we think for the flagship phones, which is where our business is -- Galaxy and the Note models -- we do see consistent content for us in those models. But we see units still continuing to decline. That rate of decline has slowed, but just from our shipments in, we can't comment on what's actually happening out in the channel. But we do see the S6 is continuing to trend a little bit below the S5, both from the June quarter actuals and what we're seeing from a September forecast.

But I think it's interesting. On the older products, I think they've gotten very good at managing their inventory. And so if you look at like the Note product, the Note 4, it's at a significantly lower level than, say, the Note 3 a year ago. And so what that means is as the Note 5 starts to ship here later in the summertime, you're not going to see the big inventory correction for these older products that in the past you might have seen.

Michael McConnell - *Pacific Crest Securities-KCBM - Analyst*

Got you. And then what about the high-profile wearable? You saw some nice growth in the March quarter. June quarter was flat. You're guiding September sales down -- a little bit of a surprise. Is this a yield issue, end demand related, or is it just this product has sold a little bit too early, maybe next year it gets more momentum? What are you thinking around that wearable?

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

Yes, again, I think that's a hard one for us. Even maybe Samsung, we have some visibility, and there's even some third-party reports out there that you can look to, to figure out what's happening in the channel. I think in general, that visibility is still very limited on that product. So I think all we can report is what is it that we're shipping? What are the trends on that? What's impacting that, whether there's inventory in the supply chain, whether there's yield issues, whether there's end demand? It's very difficult for us to do that. And that's why we've just said we just guide to backlog. This is what the customers put orders on for us, and this is, we're just going to not try to provide any unique insight.

Michael McConnell - *Pacific Crest Securities-KCBM - Analyst*

Any questions here?

Unidentified Audience Member

You're planning on outsourcing at 90 nanometers and below. But certainly part of your comparative advantages have derived from your proprietary processes, recipes they have, analog (inaudible ? microphone inaccessible). How do you retain that comparative advantage from those proprietary recipes if you're in fact outsourcing all those products to third parties?

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

Yes, no, it's a good question. So when we say outsource, we have a model of what we call exclusive foundry relationships or strategic foundry relationships. So even before the San Antonio sale, we've been working with, say, like Seiko Epson on 180-nanometer technology, where we transfer our proprietary process to them and they run it in their fab for us. And they have agreements not to do this, provide this foundry services, for other analog customers. So we transfer our proprietary process to them. We feel comfortable that there's protection from an IP point view. And then so they run it.

On the 90-nanometer, that's exactly what we're doing. So we have developed our own proprietary process -- we call it S90. That's been transferred to two strategic foundry partners. These are, think of them as digital fabs. They might not necessarily be foundries; they could be folks, if you think of whether it's Seiko Epson or we have some memory guys in Taiwan who have older lines that they're looking for utilization. They've moved on, well beyond 90. And it's just an asset utilization strategy for them, fully depreciated lines. We get the benefit of that through a very low cost structure.

So we think it's a win-win for us, because clearly, keeping that advantage, allowing it to differentiate on design and on process, is a key part of the 60%-plus gross margin business that analog companies enjoy.

Michael McConnell - *Pacific Crest Securities-KCBM - Analyst*

Any other questions? So maybe we've talked a bit on the consumer side. Maybe we can go more broad base. Can you talk a little bit about inventory, some of the management trends you're seeing in distribution? Have your disties reduced inventories, or are you concerned at all with levels of inventory in your distribution partners?

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

I think overall right now, we see -- the best term is normal. We had an unusual March. We had very low bookings in the March quarter, and Europe grew down their inventory significantly. We speculated that was partly because of currency concerns. And whereas we had China increase inventory due to demand issues, and so because of that, we gave a below-seasonal guide to the June quarter for industrial. We had talked about how we started to see folks normalizing in the June quarter, and it turned out industrial did a little bit better.

So coming out of June, Europe restocked, so they got to normal levels. China reduced their inventory levels, again getting back to normal levels. We ended up at 57 days. A year ago we were at 55 days, so it's a little bit high. But guiding into the September quarter, we see our core industrial, the catalogue parts, we see that down seasonal, down, I think, two to three points, something like that, offset by our vertical industrial businesses being up. And so that's how we were able to guide industrial flat.

So we're not seeing anything -- certainly, nothing robust, to be very clear -- but we're not seeing the world ending, either. It just feels in line to us, or normal.

Michael McConnell - *Pacific Crest Securities-KCBM - Analyst*

M&A -- so you've been a big -- and I remember years ago, you were calling this M&A activity that we've started to see. When we think about Maxim, I talk to investors, people try to figure out, is this a company that's going to be acquired or is it a company that's an acquirer? How do you think about the Company within the M&A space?

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

We worry about things we can control, so we think of ourself as an acquirer. Certainly, if someone comes in and makes an offer, you have a responsibility. And from a shareholder value point of view, if it makes sense, that's something you would look at. That's not something within our control. So to the extent that there are companies out there that can move the needle for us, that fit in with our strategy, that we can certainly create value and to the extent that they help diversify our product portfolio, I think these are deals that we'll look at.

These are much bigger than the old technology tuck-in acquisitions that we all did many, many times over. So these, you have to be right. You want to make sure you understand the risks. I think the challenge out there is for to the extent that how do you balance quality versus value creation? The really high-quality assets are highly valued, and it's pretty hard to see how you're going to create value if you have to pay a premium on a company that's already fully valued and maybe has an M&A premium built into them already. And the companies that you can probably get at a decent price, there's probably a reason for that.

So I think it's just, from our point of view, it's a very simple screen; everybody's done it to see who's out there, right, who can fit our profile. And they are bigger deals. I think the sweet spot right now are companies that are around $500 million, there's $1 billion to $2 billion, maybe a little bit more in valuation that folks look at. Those are a type of deal that we could do with cash. But I think we'll look at those very carefully.

Michael McConnell - *Pacific Crest Securities-KCBM - Analyst*

And I think final question would just be on shareholder returns. Again, up is the dividend, another 7% last quarter, very well received as well. Dividend yields feel over 3%. To what extent can we see the Company increase shareholder returns even further? Is it just purely just continue to expand free cash flow, or is there other levers that you're looking at?

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

We have our commitment; we're going to return 80% of free cash to shareholders. For a long time, we were around over 90%. Last year was right at about 79%, is what we returned.

From a dividend point of view, we look at a free cash flow payout. We look at where we're at. We make sure we don't get too far ahead. And so to the extent that this increase this year, this was really from the cost reductions that we had made over the last year, the $40 million, the $220 million going to $200 million, and then also the fab closure. To the extent that we've identified other opportunities for margin expansion, let alone top line growth, that's going to drive continued free cash flow growth. So we believe, from a model point of view, there's absolutely opportunities. If we just execute on our plan, free cash flow margin will clearly get above 30%, which will provide, I think, ample capital to continue to return that to shareholders.

On the other side, we've historically done a buyback at about the same level. Our buyback has been, over the last couple of quarters, a little bit less than historical. That's primarily for two reasons -- one, the stock price has done a little bit better, and it's a matrix that says as the stock price goes up, we buy less. Certainly, as our earnings power increases over time, we adjust the matrix. We've allowed the matrix to stay in place for the last couple of quarters just because in the environment we're in today, having a little extra cash from a strategic flexibility on the balance sheet probably makes sense.

Michael McConnell - *Pacific Crest Securities-KCBM - Analyst*

Thank you very much, Bruce. Very helpful.

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

Great. Thanks, everybody.
