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MXIM - Maxim Integrated Products Inc Conference Call to Update its Business Model For Investors

EVENT DATE/TIME: SEPTEMBER 05, 2017 / 9:00PM GMT

OVERVIEW:

Co. provided details about its business model update.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Maxim Integrated Business Model Update for Investors. (Operator Instructions) As a reminder, today's program is being recorded.

I would now like to introduce your host for today's program, Kathy Ta, Vice President, Investor Relations. Please go ahead, Kathy.

Kathy Ta - *Maxim Integrated Products, Inc. - MD of IR*

Thank you, Jonathan. I would like to welcome everyone to Maxim Integrated Business Model Update for Investors. Before we begin our slide webcast today, I would like to provide a few guidelines for a better listening experience for our audience. The audio in today's webcast will be audible both on the phone line as well as through the video feed on our website. We will use the phone lines for Q&A following our prepared presentation. However, for best performance of the slide webcast, we suggest that you listen to our presentation on your computer via the video feed on our website, rather than the phone line. Listening directly through the webcast through our website will ensure that the slide presentation visuals are synchronized with our audio narration. Once we are done with our slide cast, I will post the final slide deck on our website for your reference. To allow for any latency in webcast, we will wait a few moments at the conclusion of our web presentation before taking questions on our phone line, per our usual process. We'd also like to point out that we will not be updating near-term guidance in our call today. We will instead provide an update on our long-term business strategy and financial model. With that, let me move to our safe harbor statement.

During today's call, we will be making some forward-looking statements in light of the Private Securities Litigation Reform Act. I'd like to remind you that these statements must be considered in conjunction with the cautionary warnings that appear in our SEC filings. Investors are cautioned, all forward-looking statements in this call involve risks and uncertainties and that future events may differ materially from these statements. For additional information, please refer to the company's Securities and Exchange Commission filings that are posted on our website.

Joining me on the call today are Chief Executive Officer, Tunç Doluca; and Chief Financial Officer, Bruce Kiddoo. Tunç will begin with an update on our business strategy and Bruce will conclude our prepared remarks with an update on our financial model.

Now I'll turn the call over to Tunç.

Tunç Doluca - *Maxim Integrated Products, Inc. - President, CEO & Director*

Thank you, Kathy. Welcome, everyone, to our business model update. I realize that you have a busy schedules, so I appreciate you joining us today. Thank you for your continuing interest in Maxim, and for those of you who are new to Maxim, thank you for making time to listen to us. I would like to start out by reviewing Maxim's financial results for the just ended fiscal year.

Fiscal '17 was a breakout year for Maxim. The company transformation we set in motion in 2015 delivered the results we planned on, and more. Revenue growth swung 10 points from 2 years of decline to 5% year-over-year growth. The changes we made in manufacturing resulted in a 330 basis point increase in gross margin. The gross margin for the fiscal year was 65.2%, and better yet, the final quarter gross margin was over 67%.

We held spending in check, and this enabled operating margin to reach almost 33% for the fiscal year, an improvement of 520 basis points. Operating income grew 25% due to lower taxes. Earnings per share grew 30%.

Investors have been asking us, "Now that you exceeded your financial model ahead of plan, what's next?" So we decided to use this webcast and Q&A to share our new business model with you. But first, I will start with our strategic priorities.

Our high-level priorities are to grow the company, do so profitably, and to improve our financial stability, in that order. What does each priority mean specifically?

Let's talk about growth first. Our goal is to achieve top line growth that is at market. You can assume that we are the driving the organization for more aggressive growth.

Turning to profitability, we will achieve our goals with several initiatives. First, we'll grow the higher-margin small and medium business, or SMB, customer revenue. We recently crossed the $1 billion distribution retail milestone and expect to continue to grow this channel with multiple internal initiatives. Second, we still have additional manufacturing transformation tailwinds that have a multiple-year time horizon. Third, we intend to grow operating spending that passed the rate of revenue growth, providing us with modest but realizable leverage, even at mid-single-digit top line growth.

As to stability, we plan to broaden our customer base and not be reliant on any single customer or any single market. For opportunities with outsized returns, we'll only consider if they fit within our variable manufacturing model, not reduce R&D focus on diversification, and to create long-term value.

Which markets are we investing in and relying on for growth? These would be: automotive; industrial, including health care; data center; and mobility markets. In each of these markets, we have multiple product lines where we are making a difference for our customers with high-performance products. Let me provide you with some details on a select few markets.

In automotive, we have investments in 4 applications: infotainment, body electronics, electric vehicle batteries, and advanced driver assist (sic) [assistance] systems, better known as ADAS. Our strong technology know-how in power management provides us ample opportunity in all 4 of these applications.

Decades of experience in battery management systems makes us a solution of choice with customers globally. In addition, we have great market position in serial link products, both for instrument cluster and sensor data transport in the car. We expect continued above-market growth in automotive.

A leading indicator of future revenue growth is design wins achieved at customers. Each design win results in multiple years of revenue, so we dollarized each win as lifetime revenue from the design win. Each fiscal year, we add up the total lifetime design wins for all projects and all customers tracked. This is a good and directional indicator for future growth that would thus like precision.

These 2 charts illustrate the CAGR of automotive lifetime design win revenue for each application on the left and region on the right for the last 5 years. We like the trend. Specifically, we expect outsized growth in battery management systems and ADAS. Infotainment, which is 2/3 of our revenue today, will also continue to grow double digits.

Our customers are distributed in all the major industrialized regions of the world, and we are winning designs at customers in each and every one of these regions.

Over the last decade, worldwide car units have grown an average of 3% annually. With growth in contents related to driver assistance, electric vehicles, infotainment and body electronics, we expect to grow our Automotive business in the low teens.

The second market opportunity we will benefit from is the revolution in factory automation. Factory automation is the largest submarket within industrial and is expected to outpace analog TAM growth through the next 5 years. With Industry 4.0, factory productivity is enhanced with higher levels of configurability of production lines. Industry 4.0 requires that there is network access to every sensor and actuator in the manufacturing line. Most sensors in use today are not enabled with network access. Our robust IO-Link products enable network access to sensors and actuators using existing wiring, an easy upgrade for factory owners. And of course, all the additional electronics needed efficient and cool power management, meaning low heat dissipation, not just cool. Collectively, this is a $700 million market for the communications and power areas Maxim serves, growing 10% per year, a great opportunity for us.

During the last 5 years, we have grown our Automotive and Industrial business to become nearly half of our revenue last year. We expect this percentage to continue to grow since these businesses have many customers and make up -- that make up the revenue and design wins that result in long production lines. This growth supports our margin and stability objectives.

The third growth engine for us is data center, with near-term revenue growth in optical connectivity. According to third-party market research, 90% of data traffic stays within the data center, including data traffic local to each server rack. As the volume of data traffic continues to increase at a 30% CAGR, high-speed optical connectivity within the data center becomes paramount. Here, we have introduced products that are best-in-class for intra-data center data transport at 100G data rate. Our laser drivers are robust, low power and are easy to design in. This has already been recognized by all the key cloud customers.

Additionally, we continue to invest in expanding our SMB customer design win. During the past 5 years, the share of our revenue from distribution that proxy for our smaller customers has grown from 29% to 42%. With all the actions we're taking to expand franchised distributors, invest in catalog distributors, enable more effective marketing and generate more design collaterals, we expect that the share of revenue from distribution has more headroom to grow.

So what does this all mean in growth contribution? We expect Automotive to grow in the low teens, with growth resulting from design wins in infotainment, ADAS and electric vehicles. Factory automation strength will provide high single-digit growth in the industrial market as well as better penetration with our core products. In communications and data center, optical and 48-volt option will drive growth in mid-single digits. Finally, we expect mobility product lines to stabilize and grow modestly by broadening our customer base, platforms we sell to and markets that we're in.

With that, I will pass the microphone to Bruce to talk about our business model update. He has the numbers, as usual.

Bruce E. Kiddoo - *Maxim Integrated Products, Inc. - CFO & Senior VP*

Thanks, Tunç, and thanks, everyone, for joining us today. Just over 2 years ago, we announced the transformation in Maxim. The first half was to focus our R&D in market where we have a strong brand, such as in power, or have differentiated technology. The end goal was a return to growth, which we achieved in the fiscal year just completed. However, we acknowledge that we did not grow faster than the market. The second half of our transformation was to significantly improve margins and cash flow. We have met or exceeded all of our margin goals. So as Tunç said, the obvious question is, what's next?

For gross margin, we laid out a plan to improve from low 60s to mid-60s. This plan included: shutting down our development fab in San Jose; selling our production fab in San Antonio to TowerJazz; fully outsourcing our bump operations, which allowed us to sell our Dallas campus, which included a small bump fab; and general cost savings across the board. We executed all or plans on or ahead of schedule. The result is that we exceeded our 65% gross margin target, guiding to 66.5% gross margin for the current quarter.

We have several tailwinds which will provide an upward bias to gross margin over the next 3 to 5 years, above our 65% target we put in place a couple years ago. The first is our flexible manufacturing strategy, which allows us to optimize wafer loadings across our supply network. We will maximize utilization in our last remaining internal fab in Oregon, tip production from our former San Antonio fab and maximize loadings with our 300-millimeter foundry partner. It is important to note that, despite shifting to a flexible manufacturing model, about 85% of our wafers are manufactured using our proprietary processes. In addition to lower wafer costs, with roughly 75% of fab manufacturing outsourced, we have a variable cost structure, which allows for stability in our gross margin throughout economic and market cycles. This is critical to enable strong and consistent cash flow and our ability to reliably return cash to investors.

Another tailwind for gross margin is the gap between depreciation and CapEx. Currently, depreciation is around of 4% to 5% of revenue. For the past few years, we have been keeping CapEx spending well below depreciation, and expect future CapEx to be in the 1% to 3% of revenue range. Ultimately, depreciation will decline to match CapEx. Two important items to note: first, this will occur gradually over a multiyear period; second, part of the benefit is in operating expenses.

A third tailwind is a change in customer mix toward smaller, broad-based customers, often supported through distribution. As Tunç said, we are making a big push to better reach and support smaller customers. This includes improving both our distribution business and online selling capabilities. As you might expect, smaller customers generally purchase lower volumes and, thus, pay higher prices. Add it all up, and we believe over a 3- to 5-year period, we can achieve 67% to 70% gross margins. Increases will not occur in step functions as in the recent past when we closed the fab; instead, there'll be a steady upward bias in gross margins over time. I also think it is important to note that these tailwinds are from structural changes in our business and still provide the ability to manage a portfolio of businesses with a range of gross margins and growth rates. We have been careful to set a long-term gross margin range that still supports top line growth. Overall, I'm a firm believer that gross margins are the best indicator of the quality of your revenue, and at 67% to 70% gross margins, Maxim has positioned itself as one of the highest-quality semiconductor companies.

In addition to improving gross margin, we will continue to tightly control operating expenses. I believe we have done an excellent job, over the past 2 years, reducing and controlling operating expenses. Going forward, our plan is to grow operating expenses at half the rate of revenue. This will provide some leverage going forward, but any meaningful leverage is dependent on top line growth. It is also important to note that we will continue to invest in our growth drivers through active portfolio management, allocating engineers to the highest return markets and products. With improving gross margins and continued tight spending controls, we expect to achieve sustainable operating margins in the range of 37% to 40%. Similar to gross margins, operating margins in this range place Maxim in the upper echelon of semiconductor companies.

Higher profitability and low CapEx results in strong sustainable free cash flow. We are currently operating in our current target range of 30% to 35% free cash flow margin. With continued revenue growth and higher margins, we are confident we can achieve 35% or better free cash flow margins. I also want to note that for those who follow Maxim closely, you know that our definition of free cash flow is based on net CapEx, including the benefit of asset sales. We did this to ensure such asset sales were included in our capital return commitment of 80% of free cash flow. However, now that the major restructuring activities, including asset sales, are behind us, we are transitioning to a more traditional definition of free cash flow using gross CapEx.

Maxim has a long history of returning capital to shareholders. Our commitment is to return 80% of free cash flow to shareholders through both dividends and buybacks. During our most recent earnings release, we renewed the buyback authorization by $1 billion and increased the dividend by 9% to $1.44 per share on an annual basis. We first initiated our dividend 15 years ago, and have increased it every year, except for 2009 when we held it flat during the recession. The net result is a much stronger, long-term business model.

For revenue, our target, is to grow at market. Of course, our internal target is to grow faster, but even if we grow at market, we create significant earnings power going forward. With growth drivers in automotive, industrial and data center and a more diversified consumer business, I am confident we can continue to grow the top line. For gross and operating margins, we continue to improve, executing at the highest levels. The tax rate going forward declined slightly to 14%, with a downward bias. Our flexible manufacturing strategy results in sustainable, low CapEx of 1% to 3%. All of these items result in a world-class free cash flow margin of 35% or better. And as we have demonstrated over many, many years, we are committed to returning any excess cash to shareholders. With continued revenue growth, we are highly confident we will achieve our prior target of $3 in free cash flow per share within 1 to 2 years, and expect to achieve $3.50 in free cash flow per share in the next 3 to 5 years.

Finally, investors often ask me, "Why should I invest in Maxim?" I truly believe we provide excellent value for long-term investors based on our proven ability to grow free cash flow and return it to shareholders. With half of our revenue coming from high-growth, high-quality Automotive and Industrial businesses with world-class profitability and with a variable cost structure and diversified customer base to reduce volatility, I believe that as we continue to execute to our long-term financial model, Maxim will create significant shareholder value.

With that, I will turn the call back to our operator and open it up for questions. Thank you very much.

Kathy Ta - *Maxim Integrated Products, Inc. - MD of IR*

Thanks, Bruce. We will now post our complete slide deck to our website and we will shift back to the phone line to take questions from our audience. We will pause here for a moment to enable people to have time to make this transition. Please stand by while we allow time for this transition.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Kathy Ta - *Maxim Integrated Products, Inc. - MD of IR*

At this time, I would like to open the call for questions. There may be some delay in our responses as Bruce and I are in New York and Tunç is in San Jose. We would like to continue the same Q&A process as we have used in previous calls. We will take one question from each caller, so we can get to more people in the queue. If you have more than one question, please hop back into the queue.

Jonathan, could we please have our first question?

Operator

Our first question comes from the line of Ross Seymore from Deutsche Bank.

Ross Clark Seymore - *Deutsche Bank AG, Research Division - MD*

So let me ask a question. I want to focus a bit on the Industrial side, and not only does it have implications for revenue, but also the gross margins. When you talk about the focus on the small and medium business customers and the importance of disti, can you talk a little bit about your disti strategy? How concentrated is that going to be, as you have won one very large one in the U.S. that's been having some of their own issues? Or is it a business that you can actually spread to a multitude of distribution partners? So if you could just talk about how broad that disti strategy is and how important it would be, that would be helpful.

Tunç Doluca - *Maxim Integrated Products, Inc. - President, CEO & Director*

Thanks for the question, Ross. So I mean, in a nutshell, it's safe to say that it is a broad strategy from a distribution standpoint. Throughout last year, we actually made quite a bit of differences or additions in our global distribution strategy. We added EBV in Europe for better strength. We added Future in the U.S. We added a couple of more in Asia. We also added 2 more catalog distributors. So we really have increased our access and exposure to more small and medium business customers. And this was really part of the strategy to grow this business, and not be overly reliant on 1 or 2 distributors in each region. So we are pretty confident in what we've done. We think that we've got better reach now to more customers, and we're already seeing in -- at some of these distributors, which we added very recently, we're seeing that a lot of the business we're getting actually turns out to be either new customers or new applications from new products. So they're not just cannibalizing the other distributor. That's a great sign in terms of us being able to diversify the access to our customers as well.

Operator

Our next question comes from the line of Harlan Sur from JPMorgan.

Harlan Sur - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Sort of as a follow-up, as you focused on growing the catalog, analog business, so what you guys call broad market business, it's obviously a diverse customer base, very sticky, 70% gross margin profile. It's a big part of the Industrial segment. You listed it as one of the growth drivers. Do you expect this to grow in line with the Industrial business at high single digits, maybe plus or minus? And Tunç, if you can just remind us what are some of the initiatives that the team has going here outside of just expansion of the distribution channel and web programs. Maybe you can talk about the expansion of the catalog portfolio and reference designs, et cetera.

Tunç Doluca - *Maxim Integrated Products, Inc. - President, CEO & Director*

Yes. So we do expect to do better than market growth in this space, and I'll walk you through why I think that. First of all, we do have -- it all starts with having a very strong lineup of products. And Maxim really does have a very strong lineup of products and technologies for this broad customer base. Now having said that, obviously, it's also important to help our customers as much as we can in terms of achieving the design win with them, being able to provide the technical assistance, et cetera. And if you look at it, the one that we have here is quite good because, as we mentioned in the prepared webcast, our share of distribution business, our revenue, even though we're -- probably we surpassed $1 billion, it's still in the low 40% as a total -- as a ratio of the total company revenue. And many of our peers actually have a larger ratio for distribution. So that, we see as an opportunity for us to actually grow this business stronger. Now in terms of what are we doing specifically to increase this demand, clearly, I talked about distribution and expanding the channel. We've done some great work there last year, and we're very happy, actually, with the results we're seeing, especially of sales through our catalog distributors, which are outgrowing our total growth in the market -- in the broad market. But we're also doing work on selecting the products that seem to have the best level of success following up with any inquiry about those products in the channel through small customers, making sure that we're giving them the best technical support. We call this our star products program. We are working on all kinds of technical resources that we can post on our website for self-help by our customers, so that they can design our products in better. These can be application notes. These can be more products that have simulation models for online simulation of our products, especially our power products. We're also making sure that we have excellent training courses for our distributor field applications engineers, so that they actually can be helpful to the customers they access that they can help with. So there is -- we are seeing good growth. We are seeing growth that's very encouraging. And we definitely have all kinds of programs internally and through distribution to get better access to these smaller customers, which we call our small and medium business customers.

Operator

Our next question comes from the line of John Pitzer from Credit Suisse.

John William Pitzer - *Crédit Suisse AG, Research Division - MD, Global Technology Strategist and Global Technology Sector Head*

Congratulations on moving up the profitability targets, that's nice to see. I'm wondering, Tunç, if you can talk a little bit about your growth aspirations. If I kind of bottoms-up sort of the detail you gave us, I'm getting to an overall CAGR of 6% to sort of 7%. Is that the right way to think about it? And you said in your prepared comments that you want to achieve a market CAGR. So is this what you believe the market's growing? And if I think back to the 2016 Analyst Day, I think you were talking about growth rates of 1.5x to market. So maybe you can help me understand that.

Tunç Doluca - *Maxim Integrated Products, Inc. - President, CEO & Director*

Yes, so I'd love to. I knew somebody was going to ask this question. So in terms of -- you're absolutely right. In our previous Investor Day, we put out a bold target for us, to grow 1.5x market. But having thought about this more and seeing what kind of results that we're getting in terms of growth, we decided that it would be better for us to give the commitments that we have higher confidence that we can meet and really show that we actually have an excellent model for leverage in growing our earnings per share, even if we grow with market. And internally, absolutely, we're putting targets in front of our business units, and they're making commitments. They're going to beat that. So the obvious question is, what is the market growth rate that we're assuming? Obviously, this is a really long-term conversation that we're having here. But we're thinking that the growth rate long term in the analog business is going to be in the 3% to 5% range. So it's a little bit lower that the numbers that you used at the beginning. But in that range, if we achieve those ranges, I think we'll have an excellent financial model and be able to grow our free cash flow and be able to get great returns for our investors. But as I said, internally, we definitely have set more aggressive goals for ourselves, and we'll be even better if we achieve those.

Operator

Our next question comes from the line of Ambrish Srivastava from BMO.

Ambrish Srivastava - *BMO Capital Markets Equity Research - MD of Semiconductor Research & Senior Research Analyst*

I just wanted to get back to the manufacturing tailwinds, Bruce. You listed a few items here. On the outsourcing front, on the flexible manufacturing, you already had 75% in your last fiscal year. So how should we think about rank ordering the tailwinds on the manufacturing side?

Bruce E. Kiddoo - *Maxim Integrated Products, Inc. - CFO & Senior VP*

Yes. Thanks for the question. I think when we think about these tailwinds, and as we said, they're all -- none of them are a step function or a specific event. They all can happen over time. And when we think about kind of over that 3- to 5-year period, some will contribute more or less in different quarters or different years. So there's no single item that stands out. I mean, when we think about the items, obviously, optimizing the wafer loadings to get better utilization within our Oregon fab and to get the lowest wafer cost across our foundry networks, that happens over time. That's probably the one area that allowed us to get to the 65% a little bit sooner than we thought, right? That ability to load Oregon internally was helpful. And I think that ability -- we have a long-term supply agreement with TowerJazz. We're continuing to add some capacity to Oregon in order to kind of absorb those fixed costs. So I think that one will happen over time. The depreciation to CapEx gap, I think that one is generally math, right? Obviously, that depreciation will come down to the kind of 1% to 3% CapEx level. It is worthwhile noting on that one, and I said it on the call, but I want to make sure since that one is the cleanest math for people to do. In addition to that happening over multiple years, part of that hits in the gross margin line, but part of that benefit in the operating expenses as well. And so that's not -- all of that doesn't flow through. Otherwise, you would see an immediate 2 -- you would see 2 points over the long term. And it's probably closer to about half that, that benefit. The SMB customer base, again, from a mix point of view, we all know the profitability there. I think the accounting change with Dig-Key in the fourth quarter was a very good example where folks can do some math and quantify what the kind of gross margin is out in the channel. Now that was a catalog distributor, so that's the most profitable business that we have. And then finally, just the overall pricing environment, right? We've talked about that before. But just to as there's fewer companies and through consolidation and as those remaining companies are more focused on delivering margin and cash flow, I think it's a little bit better pricing environment for chip companies out there in our industry. And I think that's a very nice, long-term tailwind for us, and quite frankly, for the industry as well. So I mean, it's a long way of saying, it's hard to rank-order them, given that they're all more kind of analog over time. They're not digital over time. No pun intended. And -- but clearly, they're all going to contribute to the long-term growth, and this kind of strong upward bias in our gross margins in that 67% to 70% range.

Operator

Our next question comes from the line of Vivek Arya from Bank of America Merrill Lynch.

Vivek Arya - *BofA Merrill Lynch, Research Division - Director*

Bruce, I just wanted to revisit the different components of operating margin expansion. So if I got it right, you are guiding operating margins at the midpoint, up about 250 to 300 basis points or so, but about 200-plus basis points comes from the roll-off on the depreciation side. So what are the benefits from operating leverage and mix? If you could just help us quantify, in operating margins, I understand that depreciation part hits some gross margins, some OpEx also. But just from an operating margin perspective, what are the different components of that?

Bruce E. Kiddoo - *Maxim Integrated Products, Inc. - CFO & Senior VP*

Sure. I think it's clear the major contributor to kind of the future growth or continued growth in our operating margin is going to be gross margin, right? And I think you've seen sort of we took our 65-35 model. And as we increased the gross margin by 3 to 5 points, we sort of increased operating margin by 3 to 5 points. You can clearly expect that we'll continue to be very disciplined in managing operating expenses. If you think of a market growth rate, as Tunç said, of 3% to 5%, and that said, we're going to grow the operating expenses at around 2% a year. It's tough to get a lot of leverage through that. If the market grows faster or we're able to grow a little bit faster than that 3% to 5%, then there'll be more leverage in there. But I think we've kind of built a model, as Tunç said, that's based on market growth. And so from that point of view, if the market grows faster than our assumptions or we're able to grow a little bit faster than market ourselves, that will just provide additional leverage in the kind of a commitment that will only grow operating expenses at half the rate of revenue. But kind of how the model is built right now, and most of that leverage is going to come from the gross margin at this point in time. I think it's also really important just to kind of highlight, and I think I said this in the slide cast, was the fact that we will -- even though we'll continue to be disciplined on the operating expense side, I think we've proven the ability to be very good at kind of allocating where our analog engineers work and make sure they're focused on the highest return products. And that will continue to invest for success in our growth drivers. And that's a dynamic process. We look at that really on a continuous basis and trying to make sure we're investing in the right areas. So just because we say we're going to be disciplined on operating expenses, don't interpret that to mean we won't be continuing to invest in the growth drivers in order to drive that top line growth. I think it's worthwhile, just as a high-level statement, if you think about this revised business model, it is about improving profitability with market top line growth. We're very sensitive to the fact that we want to make sure, within our margin targets, we left room to invest and grow the top line. With think that's very important to make the model work. And we do believe, within both our gross margin target and our operating margin target, there's the opportunity to kind of manage the portfolio businesses at different margins and different growth rates. And so that's something that we thought very carefully about when updating our model.

Operator

Our next question comes from the line of Tore Svanberg from Stifel.

Tore Svanberg - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Yes. Just a question on the automotive growth rate. So that market has been dominated by microcontroller and analog companies the last 10 years. But it does seem like some other digital companies are now investing in that market, including QUALCOMM, Intel and so on. So how should I think about the growth in the low teens? How many years -- or how long is that sustainable with obviously all the capital now pouring into that market?

Tunç Doluca - *Maxim Integrated Products, Inc. - President, CEO & Director*

So if you want to kind of build up the growth there, in the prepared remarks, we did talk about car unit sales growth as being in about 3% range globally. But it's all about the content story and it's all about where you're investing in automotive. That's important. So our estimate is that the overall automotive electronics market is growing roughly about 8% or so per year. And Maxim has been growing, obviously, much faster than that, roughly 2x to 3x that in the past. So the question is, once we said that -- where our growth is going to be around low double digits or low teens range, I think many investors asked -- the question is, "Well, is it going to -- is that growth rate going to continue to slow?" And our belief is that it will not. And the reason we don't believe it will not is because we look at the design win pipeline in specific areas that we are investing in, and I shared that both for regions and for the types of applications we're investing in. We see still a lot of runway for Maxim, and actually, frankly, the automotive semiconductor suppliers, many of them to grow rapidly. Most of our growth for the past 5 years came in infotainment, and now that's why it's 2/3 of our business. We continue to invest in that space, which I think is going to continue to grow. But there's a lot of growth that's going to come in advanced driver assist (sic) [assistance] systems, and that's been the area that we've put a lot of R&D into in the last few years. And these drivers assist systems that are going to gradually penetrate more cars to higher and higher levels of driver assist is really going to be a boom for many companies, including Maxim, with our -- with the products that we provide for serial links, for data transport, products we provide for power management, because you got to power up all these very sophisticated power CPU systems that are required for data crunching. So I see automotive as a growth area, mainly because of the content growth, and a lot of it coming from really 2 areas, one of them being advanced driver assist and the other one that we mentioned was also battery management systems for electrification of cars. So I think that runway is there for multiple years. And since this call is mostly about longer term, and the term that we're talking about, 2- to 5-year time frame, I think we're going to have continued growth.

Operator

Our next question comes from the line of Craig Hettenbach from Morgan Stanley.

Craig Matthew Hettenbach - *Morgan Stanley, Research Division - VP*

Yes. I had a question on the communications growth outlook. Tunç, can you talk about just kind of some of the legacy business and enterprise and wireline versus data centers? Is there a point where you would expect the data center to become more than half of the business and kind of visibility into the growth drivers there?

Tunç Doluca - *Maxim Integrated Products, Inc. - President, CEO & Director*

Yes. So let me just give a little bit of background for everybody. So the -- if you look at our business, the comms infrastructure side is currently about 2/3 of the segment and data center is about 1/3, so that's kind of the ratio. We expect the comms infrastructure side to be roughly flat with market. We're really not seeing a large growth in that space. And we do expect the data center piece, which is 1/3, to grow at 20%-plus rates in the future. So I think -- I haven't done the arithmetic, but we can see that, with that growth we see in optical and possibly in the long term in 48 volts, we can see that it should approach the infrastructure side pretty quickly in the next few years in terms of size.

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Operator

Our next question comes from the line of Amit Daryanani from RBC Capital Markets.

Amit Jawaharlaz Daryanani - *RBC Capital Markets, LLC, Research Division - Analyst*

I guess, just a question on gross margins. Last quarter, I think you guys were essentially at the low end of the gross margin range you're providing the new model. How do we think about the path from where you are right now towards the mid- or high end of your gross margin target? How much of that do you think is really driven by self-help levers that you've talked about versus incremental revenue that you need in the model? Just trying to get a sense, is that a case where maybe you can get to midpoint on a flattish revenue profile? And get to the higher end, you might need x dollars of revenue contribution? Just trying to get a sense on the revenue run rate to achieve the mid- and the high end of your revenue -- gross margin targets.

Bruce E. Kiddoo - *Maxim Integrated Products, Inc. - CFO & Senior VP*

Yes. So like you said, last quarter, we came in at 67.2%. We did get some benefit of the accounting transition, which we said was about 50 bps. So we're really sort of at 66.5%, 66.7% or so. So we're a little bit below the low end right now. We do feel much of what we see out there is structural, certainly kind of the CapEx -- our depreciation decline to CapEx will just occur, right, naturally. So that's a helpful one. The SMB does require some growth, right? You need that growth in the SMB business. And the ability to kind of leverage the foundry network does require a little bit of growth as well. So I think we're very comfortable. Obviously, we can get to the lower end of this range with no revenue growth. I think if you get kind of at market, you can probably get to the middle of that range. And then, either if you get above market revenue growth or some of the items kind of -- all kind of fall the right way and the number of levers, that's how you get to the high end of the range. And so that's sort of how we think about it, obviously. We gave a range because this is over a long time period and there's always uncertainty into how everything falls out. I do think we, like we always do, we give numbers that we've done the work. We're confident we'll be able to meet this business model. And so from that point of view, I think we're confident that we'll deliver on our promises.

Operator

Our next question comes from the line of Srini Pajjuri from Macquarie Securities.

Srinivas Reddy Pajjuri - *Macquarie Research - Senior Analyst*

Bruce, a question on the free cash flow margin. Your operating margin target is 37% to 40% and your free cash flow, you're saying greater than 35%. I'm just curious, I mean, given the difference between depreciation and CapEx, I would've thought your free cash flow would be higher than your operating margin. I'm just trying to understand the puts and takes as to why. Of course, you're saying it's greater than 35%. But you did seem a little bit cautious there versus your operating margin targets. If you can give us a bit more color as to what's giving you that path?

Bruce E. Kiddoo - *Maxim Integrated Products, Inc. - CFO & Senior VP*

Sure. I mean, obviously, there's a little bit of items below operating income which will impact the free cash flow margin as well as far as tax expense, interest expense, things like that. So in general, we are confident that as our operating margin improves, that's going to drive the free cash flow margins and sort of hit the lever point -- the leverage on the CapEx already. We're sort of in that range of 1% to 3%. So I don't think there's a lot of drivers there. So I mean, I think, we're at a point, as taxes kind of drift down, that could be some positive favorability on free cash flow margin as well. I think, we take down taxes from 15% to 14%. There's probably a little kind of a bias to the downside on that. And on the tax side, it is just simply -- as we get more profitable, that profit from a gross margin point of view, is generally earned in our international subsidiaries. So that's sort of mix, kind of the profit that's earned offshore, sort of brings down the overall tax rate, because obviously our offshore entities are at a lower tax rate than the U.S. But we're basically paying taxes on R&D and cost-sharing, and so that's why we'll get that benefit there. So I agree that I, think, the free cash flow margin should continue to do well. But there's just a couple of other factors that enter into that.

Operator

Our next question comes from the line of William Stein from SunTrust.

William Shalom Stein - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Congrats on the great margin targets that you laid today. And of course, there's a growth component to this as well. But there is another area that many companies have used to drive earnings growth, and that's financial leverage. I think you still have negative financial leverage today. And I'm wondering, what's the company's current thought process around using the balance sheet either for greater buybacks or for M&A?

Bruce E. Kiddoo - *Maxim Integrated Products, Inc. - CFO & Senior VP*

Sure. No, we absolutely have some capacity obviously within our balance sheet. We recently borrowed $500 million at the end of Q4 for general corporate purposes. I think in an industry that is kind of going through long-term consolidation, I think having that strategic balance sheet capacity to participate in consolidation, at this point, is probably the best use of that capacity versus doing a large buyback or accelerated share repurchase from that point of view. That said, I think as folks know, we can sort of have our filters as far as what we look at from an M&A point of view and as far as kind of companies that will make a difference. So a little bit larger than the old tuck-ins that we did. We look for high-quality assets that kind of fit our strategic model. It doesn't mean they have to get to 67% to 70% gross margin, but within a portfolio of businesses after synergies, Maxim can still get there. So there's absolutely companies out there. The problem is, they're all very expensive right now. And so that's the issue we have. From our point of view, we can be very patient. We're doing great organically. We're now growing the top line. We're improving margins. We're continuing to deliver a very strong free cash flow. So we're going to continue to focus on our organic plan, while at the same time, continuing to look at opportunities. And to the extent the right opportunity presents itself, we're confident we can present that to investors. That is a kind of long-term value-creating idea. We will pull the trigger, and when we do, we know we have the balance sheet. We know we have the operational execution -- excellent skills to go do it. And eventually, that will -- that time will come, but we're going to wait and do it right and not do anything dumb.

Operator

Our next question comes from the line of David Wong from Wells Fargo.

David Michael Wong - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Technology and Services Analyst*

Given your high exposure to foundries, do you expect to make capital investments in your foundry to take any foundry ownership stakes in the future?

Bruce E. Kiddoo - *Maxim Integrated Products, Inc. - CFO & Senior VP*

So in general, while we may help out on like the kind of the one-off piece of capital, those are generally pretty small. We won't -- we don't have any current plan to make equity investments in any of our foundry partners.

Operator

And Jonathan, I think we have time for one more question, please.

Operator

Our final question comes from the line of Ruben Roy from MKM Partners.

Ruben Roy - *MKM Partners LLC, Research Division - MD*

Tunç, I just had a follow-up on the commentary you're making on the automotive market. I don't have the chart in front of me, but it sounds like infotainment is still sort of the larger part of your automotive revenues. And I just want to make sure I was characterizing what you said correctly and that it sounds like you have design wins in ADAS and electric batteries, et cetera, to support sort of this longer-term, 3- to 5-year growth target in the low teens. Is that correct? And also, if you could also talk about how you see the design win environment in the design cycle really in automotive. Is it getting faster, the design cycle, as the technology is changing at a more rapid pace in auto? And is that a benefit for you folks?

Tunç Doluca - *Maxim Integrated Products, Inc. - President, CEO & Director*

Yes. So there's a couple of questions in there. The first one was about infotainment, it being a large piece of our revenue. Do we have a robust design win pipeline there? And the answer is yes. The chart that you were talking about, but you didn't have in front of you, is the one that actually showed our design wins from fiscal years '13 to '17. And after the call, you can take a look at it, but you can see that infotainment is that -- and we didn't put a scale on it. That's -- cut the grid line on purpose, because, as I said, this is not very precise because you don't exactly know what's going to go into production or not. But you will see that infotainment is still has a relatively high number. But the bigger design win growth has been in battery management, approaching almost 50% CAGR and ADAS, which is getting close to that as a well. So those are the biggest ones that we're getting large growth in. But infotainment is also pretty robust, even though it's a pretty large business for us already. Now in terms of your second question about design speed from getting a design win to that turning into revenue, it actually is pretty region-dependent we're finding. In the more conventional automotive markets in the U.S. and in Europe, these times to revenue seemed to be long, like it was in the past. There still maybe some shortening there, but the big change that we see is actually in countries like Korea and China where the design win to revenue ramp is fast. And I'm even surprised to see, in some cases, it's almost as fast as what you get in Consumer. But I would say, that's not the -- that's very isolated cases. In most cases, Automotive still is a long design win and a long lifetime type projects. But there are some isolated cases, to our surprise, that we're seeing where you can turn things into revenue pretty quickly. I don't think the fundamentals of Automotive, and frankly, Industrial, have really changed, where people are looking for designing in products. They're going to stay there for a long time. And especially, in the analog space, where we're not a huge portion of the bomb, so people really don't want to take big risks in terms of making sure that they get to overall performance of the system. So the basic characteristics of those 2 markets really have not changed. They're still characterized by sticky sockets that stick around for a long time, and we like that.

Kathy Ta - *Maxim Integrated Products, Inc. - MD of IR*

All right. So thank you, Jonathan, and that concludes today's conference call. We would like to thank you for your participation and for your interest in Maxim.

Operator

Thank you, ladies and gentlemen, for your participation in today's conference call. This does conclude the program. You may now disconnect.