3D ADVISORS

This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
Governance: Corporate Governance Issues

More High-Level Insider Selling Adds to Concerns Analog Devices, Inc. (NYSE:ADI) Update

February 26, 2003

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Analog Devices, Inc. is engaged in the design, manufacture and marketing of high-performance analog, mixed-signal and digital signal processing (DSP) integrated circuits (ICs). The Company's products play a fundamental role in converting real-world phenomena, such as temperature, motion, pressure, light and sound, into electrical signals to be used in a wide array of electronic equipment, ranging from industrial process control, factory automation systems equipment, smart munitions, base stations, central office equipment, wireless telephones, computers, cars, computer-aided tomography (CAT) scanners, digital cameras and DVD players.

Summary of 3DAdvisors Findings for ADI

- **Insider Trading:** Key executives and directors selling at the lows
- **Accounting:** Inventory levels still questioned in fabrication transition
- **Accounting:** More detail on options expense issue

Discussion of 3DAdvisors Findings

Insider Trading: Key executives and directors selling at the lows

Recent insider sales at Analog Devices are important. They are from new sellers. The biggest one, the sale of 60,000 shares, is by the Company's V.P. - R&D, **Samuel Fuller (56)** and is one of the top key executives at the Company. This guy *never* sells this much stock. He sold only 544 shares in '02 (in Oct.). In '01, he dropped 44,100 shares through the course of the year. In '00, when the shares were peaking, he sold just 6,000 shares.

The other seller is Director **Lester Thurow** (Audit Committee). Thurow has sold more in the past but interestingly enough his largest-ever sale was in 3/02 before the shares began their latest phase of deterioration that brought them to their current four-year low levels.

As you recall, we had been watching other sales by insiders at the lows. The previous sellers included CFO **Joseph McDonough** and GM - Micromachined Products, **Franklin Weigold**. Weigold has subsequently left the firm. There have been two director resignations as well: **Joel Moses** (Audit Committee) will be leaving in March of '03. He is former MIT Provost and currently a professor there. The second director leaving in March of '03 is **Charles Holliday** (Chairman of Compensation Committee). He is Dupont's CEO.

Whether or not Sam Fuller is leaving or not must be left to speculation at this time. If so, he would be the second (along with Weigold) of the top five execs to do so in the past year. Even if he is staying, I note his largest-ever sales as part of a disturbing pattern of key insiders letting stock go at four-year lows.

<u>Accounting: Inventory levels still questioned in fabrication transition</u>

As we mentioned in our last report (1/9/03), the Company is at an important inflection point where it is converting fabrication plants, closing down its existing 4-inch facilities and transferring production to three 6 and one 8-inch facilities. Inventories have been running high related to this strategy as they have beefed up their die bank stocks for the transition. Inventories were 135 days at the end of Q4. In Q1 of '03, this number came down a bit, to 125 days by the Company calculation. In the earnings conference call, there were many questions related to the fabrication transition. There were lots of questions related to the progress of the transition and when it would aid margins. The Company says the project is "on schedule" but that margins will not benefit from this transformation until "business picks up and we more fully utilize the capacity of the plants". The newly released "K" had an interesting explanation about one component of inventory increases. In addition to inventory stocking in response to the fabrication transition, also boosting inventories have been higher Company expectations for handset and other consumer analog products, which has driven ADI's levels of external wafer purchases higher. This brought plenty of questions about Analog and DSL margins. The Company would not discuss margins on a segment level however. It would seem that, if business doesn't pick up, there will be trouble ahead as the ADI will feel a lot of pain if it is going to be successful in working its inventory levels back down to its stated goal of 100 to 110 days by the end of '03.

<u>Accounting: More detail on options issue</u>

As mentioned briefly in last ADI report, another revealing problem area is options compensation. Options are being granted at increasingly high levels; probably due to the sluggish business environment and the associated impacts on compensation (there were no cash bonuses in '02). I note that options granted, in '02, represented 7.1% of outstanding shares. This is up from 4% in '00 and 4.3% in '01. With the lower price of the shares, the Company is not getting much juice from Tax Benefits related to exercises. This number has dropped from $90 million in '01 to just $900 thousand in '02. And this with more options exercised in '02 vs. '01 (in '02 employees exercised options for 4.3 million shares vs. 3.9 million in '01). If you recall, the Tax Benefit is generated from the difference between the strike price of exercised options and the market value of the underlying shares at the time of exercise. I think its significant that employees exercised (and of course, I assume have sold most of the underlying shares) more options in '02, so near the long term lows, even though their profit involved was clearly much smaller.

This options program will cost the Company dearly when new rules surface. In our earlier report, we had mentioned that, in '01, the Company's net income would have dropped to $192 million from the reported $356 million and that EPS would have been $0.50 instead of the reported $0.93. Now that the '02 "K" is out, the Company has updated these numbers and they're pretty ugly. In '02, expensing options would have reduced the $105.3 million net income number to a loss of $121.9 million. Likewise, the reported $0.29 EPS number would have, instead, been a loss of $0.33 a share.

As of Y/E '02 70% of ADI's revenues were offshore which is up from 61%. The Company has over $1 billion of expatriated earnings where no U.S. taxes have been provided for.