Company Name: Texas Instruments
Company Ticker: TXN US
Date: 2017-10-24
Event Description: Q3 2017 Earnings Call

Market Cap: 95,479.33
Current PX: 96.44
YTD Change($): +23.47
YTD Change(%): +32.164

Bloomberg Estimates - EPS
Current Quarter: 1.091
Current Year: 4.339
Bloomberg Estimates - Sales
Current Quarter: 3685.731
Current Year: 14720.714

Q3 2017 Earnings Call

Company Participants

- David Pahl
- Rafael R. Lizardi

Other Participants

- Adam Gonzalez
- Harlan Sur
- John W. Pitzer
- C.J. Muse
- William Stein
- Romit Jitendra Shah

MANAGEMENT DISCUSSION SECTION

David Pahl

Q3 Highlights

Revenue, Operating Margin and EPS

- I'll start with a quick summary of our financial results
- Revenue for Q3 increased 12% from a year ago
- Demand for our products continued to be strong in the industrial and automotive markets
- In our core businesses, Analog revenue grew 16% and Embedded Processing revenue grew 17% compared with the same quarter a year ago
- Operating margins increased in both businesses
- EPS was $1.26

Business Model

- With that backdrop, I'll now provide details on our performance, which we believe continues to be representative of the ongoing strength of our business model
- In Q3, our cash flow from operations was $1.7B
- We believe that FCF growth, especially on a per-share basis, is most important to maximizing shareholder value in the long term
- FCF for the trailing 12-month period was $4.2B, and FCF margin was 29.0% of revenue

Product Portfolio and Dividend

- We continue to benefit from our improved product portfolio that is long-lived and diverse and the efficiency of our manufacturing strategy, the latter of which includes our growing 300-millimeter analog output
- We believe that FCF will be valued only if it's productively invested in the business or returned to owners
- For the trailing 12-month period, we returned $4.3B of cash to owners through a combination of dividends and stock repurchases
- In September, we announced we would increase our dividend by 24% and also increased our share repurchase authorizations by $6B, which together reflect our commitment to return all of FCF to our owners

Analog

- I'll now provide some details by segment
- From a year ago, Analog revenue increased 16% due to growth in power and signal chain
- High volume was about even
- Embedded Processing revenue increased by 17% from a year ago due to growth in both product lines, processors and connected microcontrollers
- In our Other segment, revenue declined $70mm from a year ago, primarily due to custom ASIC and the move of royalties to OI&E, which began in Q1 2017

Industrial and Automotive Demand

- Now I'll provide some insight into this quarter's revenue performance by end markets vs. a year ago
- Industrial demand remains strong, with broad-based growth as most sectors grew double digits
- Automotive demand remained strong, with most sectors growing double digits
- Personal electronics was about even, with results varying by customer
- Communications equipment grew while results varied by customer
- And finally, enterprise systems grew, primarily due to servers

Strategy

- We continue to focus our strategy on the industrial and automotive markets, where we've been allocating our capital and driving initiatives to strengthen our position
- This is based on a belief that industrial and automotive will be the fastest growing semiconductor markets due to their increasing semiconductor content and that they provide diversity and longevity of products, which translates to a high terminal value of the portfolio

Rafael R. Lizardi

Financial Highlights

Gross Profit and Operating Expenses

- Gross profit in the quarter was $2.66B or 64.5% of revenue
- From a year ago, gross profit increased primarily due to higher revenue
- Gross profit margin increased 240BPS
- Operating expenses in the quarter were $787mm, and on a trailing 12-month basis, were 22% of revenue, within our range of expectations
- Over the last 12 months, we have invested $1.5B in R&D, an important element of our capital allocation

Acquisition Charge and Operating Profit

- Acquisition charges were $80mm, all of which was the ongoing amortization of intangibles, which is a noncash expense
- Operating profit was $1.79B, or 43.4% of revenue
- Operating profit was up 27% from the year-ago quarter
- Operating margin for Analog was 47%, up from 41.2% a year-ago, and for Embedded Processing was 34.9%, up from 28.2% a year ago
- Our focused investment on the best sustainable growth opportunities with differentiated positions enable both businesses to continue to contribute nicely to FCF growth

Net Income

- Net income in Q3 was $1.29B or $1.26 per share
- This included $38mm discrete tax benefit that was $18mm higher than our original guidance for the quarter, adding about $0.02 to EPS

Cash Flow Items

CapEx

- Let me now comment on our capital management results, starting with our cash generation
- Cash flow from operations was $1.72B in the quarter, up 18% from a year ago
- CapExs were $186mm in the quarter
- On a trailing 12-month basis, cash flow from operations was $4.82B
- Trailing 12-month CapExs were $574mm or about 4% of revenue, consistent with our long-term expectation

FCF

- FCF for the past 12 months was $4.25B or 29% of revenue
- Our cash flow reflects the strength of our business model
- As we have said, we believe FCF growth, especially on a per share basis, is most important to maximizing shareholder value in the long term, and will be valued only if it is productively invested in the business or returned to owners

Share Repurchasing

- As Dave mentioned already, in September we announced we will increase our dividend by 24% and also increase our share repurchase authorizations by $6B
- Our quarterly dividend went from $0.50 per share to $0.62 per share, or $2.48 annualized
  - This is our 14th consecutive year of dividend increases
- And over the past five years, we have increased the dividend by a compounded average rate of 24%
- Our total outstanding repurchase authorization was about $10B at the end of third quarter

Dividend

- For Q3, we paid $495mm in dividend and repurchased $650mm of our stock, for a total return of $1.15B in Q3
- Over the last 12 months, we paid $1.99B in dividends, or about 47% of FCF, evidence of their sustainability

Share Count

- Outstanding share count was reduced by 1.5% over the past 12 months and has been reduced by 43% since the end of 2004, when we initiated a program designed to reduce our share count
- Total cash returned to owners in the past 12 months was $4.32B
- These combined returns of dividends and repurchases and our recent announcement to increase the dividend and share repurchase authorizations demonstrate our confidence in our business model and our commitment to return excess cash to our owners

Balance Sheet Items

Cash and Short-Term Investments

- Our balance sheet remains strong with $3.44B of cash and short-term investments at the end of Q3, 76% of which was owned by the company's U.S. entities
- This is consistent with our long-term objective to have onshore cash readily available for multiple uses
- Inventory days were 119, up 1 day from a year ago and within our expected range
- Our total debt is unchanged at $3.6B with a weighted average coupon rate of 1.93%

Outlook

Revenue and EPS

- Turning to our outlook
- For Q4, we expect revenue in the range of $3.57B to $3.87B and EPS in the range of $1.01 to $1.15, which includes an estimated $20mm discrete tax benefit

Tax Rate

- Our expected annual operating tax rate for 2017 continues to be about 31%
- For fourth quarter 2017, we expect our effective tax rate to be about 29%, which includes about $20mm of discrete tax items, up from our previous guidance of $10mm
  - This is the rate you should use for your model for fourth quarter
- For 2018, we're providing you with our quarterly tax rate expectations for both the operating and effective tax rates
- You can find this detail on our Investor Relations website under the Financial Summary Data section

Summary

Now to wrap up, we remain focused on growing FCF per share over the long term and investing to strengthen our competitive advantages

We believe our third quarter results continue to demonstrate our progress

QUESTION AND ANSWER SECTION

<Q - Adam Gonzalez>: So my first question is, last year you guided Q4 pretty conservatively and ended up reporting growth that was about twice as fast. How would you contrast the demand environment this year vs. last year? And the reason why I bring this up is because your Q4 outlook of down 10% seems to be below seasonal. And I'm wondering, if that outlook really holds true, what are the areas of weakness that you're seeing that's driving this? Thanks.

<A - David Pahl>: Yes. So I think that if you look at our guidance, I'd say that we're not indicating that anything is atypical that's occurring. And I'd just remind you that whenever we've had something that's been unusual, whether that's been by market or by sector or sometimes even by customer, we've been pretty clear on that and would share it, and we've got nothing to share. So I'd just point out that if you look at the range of our guidance, that's going to vary and can comprehend several different scenarios. And at the midpoint, on a year on year basis, we'll grow about 9%, which we consider to be pretty robust. So, do you have a follow-on?

<Q - Adam Gonzalez>: Yes. I guess looking at your FCF per share growth, the last couple of quarters, it's kind of trended below the longer-term 8% to 10% that you traditionally see. I'm wondering why that is and what are the catalysts to get that back up to where it has been. Thanks.

<A - Rafael R. Lizardi>: Yes, Adam, thanks for giving me opportunity to talk about that. On FCF, it grew 4% on a trailing 12-month basis, and that is compared to a higher number for revenue on the same basis. And the difference is higher working capital, particularly accounts receivables and tax payments. If you look at the accounts receivable from Q3 2015 to Q3 2016, that actually drained whereas from Q3 2016 to Q3 2017, it built. So that is a source of cash in one case and a use of cash in another case. But, and in the case of the tax payments, we had a higher, disproportionately higher tax payment in the most recent comparison vs. the previous trailing 12-month comparison.

<Q - Harlan Sur>: Solid job on the quarterly execution, the FCF generation and the capital return. Clearly the demand trends are pretty strong in the markets that you serve. Maybe you could just talk about the demand trends from a geographical perspective. I think last quarter you saw y-over-y growth in most geographies. I'm just wondering if the strength continues to be broad based.

<A - David Pahl>: Yes, Harlan, I would say that certainly the demand was broad based. If you look across our product lines, we've got 65 to 70 different product lines, and the demand was very strong across those as well as strong across the region. So we had revenue up in three of the four regions year on year in Europe, Asia and the U.S., and it was about even in Japan.

And again, I just always remind that when we give regional color, that's where we ship the product. That's what we can measure. Where that product actually ends up from a regional standpoint, we really don't have visibility into. Do you have a follow-on?

<Q - Harlan Sur>: Yeah, thanks for the color there. On the OpEx front, great operating leverage. You drove 12% sequential growth in sales, but your OpEx declined by 3%. So you guys are driving some serious leverage here. The OpEx as a percent of sales is actually just below your target range, and so I guess the question is, what drove the sequential decline in the OpEx. And how should we think about the OpEx profile just over the next few quarters?

<A - Rafael R. Lizardi>: Yes, I'll take that. For OpEx, we think of that in terms of, from a model standpoint, we think of it as a percent of revenue on a trailing 12-month basis, and for the last couple years, we've actually been running at about 23%. And in the current trailing 12-months, we're about 22% of revenue. So we have said that in a stable environment, which we are, we can run in the bottom half of our expectations of 20% to 25%. So we've been running at about 22%, so that's well within that.

Of course to us, OpEx are investments, and obviously that goes for R&D, but even inside of G&A we think of a large portion there as investment. So in R&D of course we're focusing on industrial and automotive, because those are the best markets. where semiconductor growth is happening. But in the G&A front, we have many investments there on ti.com and demand creation just to continue building on our reach of channels, reach of markets, competitive advantage that we have talked about.

Before we go to the next caller, I'd like to just make a comment on the previous question on working capital. I want to stress that while our accounts receivables increased in that last comparison, the delta DSO actually decreased by 1 day. So it's at 34. So that just goes to show you how healthy the account receivable balance is. I wanted just to clarify that.

<Q>: Just asking about the general end markets here, could you provide some end market detail in terms of how they trended quarter on quarter in addition to year on year?

<A - David Pahl>: Sure, [ph] Jerrell (17:54). If you look at industrial, it increased with most sectors growing. And again, we've got 14 sectors there, so fairly broad based. Automotive increased with most sectors growing. Personal electronics increased, as one would expect, as you move into the holiday builds with most sectors growing there. Comms equipment was even, and enterprise systems grew due to both servers and projectors. Do you have a follow-on?

<Q>: Yes. Just a question on the report here. So your September quarter revenues exceeded the high end of your prior guidance, and it's the first time in about a year that happened. However, gross margins expanded just 20BPS. I think we were expecting more. So given the magnitude of the revenue beat, why didn't higher revenues result in more than 20BPS of gross margin fall through?

<A - Rafael R. Lizardi>: Yes. What I would tell you is that generally what we suggest and what we recommend to analysts and investors to think about our fall through – in the 70% to 75% range. But that is over the long haul, over a relatively long amount of time. In any one quarter, that fall through can be a little different.

Now for example, in the comparison vs. a year ago, which arguably, I would argue is more relevant as it has more time obviously in between, that was close to an 85% fall through, right. The increase in gross margin was 240BPS, just as an example of a comparison to the sequential basis.

<Q - John W. Pitzer>: Congratulations on the strong results. I guess my first question, I'm just kind of curious. When you look at y-over-y growth now for the core business, Analog and Embedded, you've had very healthy sort of double digit y-over-y growth. I'm wondering if you could kind of comment to what extent you think that's share gains, to what extent you think that is just easy compares, to what extent you think that might be a little bit of overheating relative to customer order activity. And you did a fantastic job on your own balance sheet, kind of managing inventories. I'm wondering if you could give us some color around customer inventory levels.

<A - David Pahl>: Yes. So, John, I think that if you look at general market conditions, they're similar to 90 days ago and certainly continue to remain strong. However, I think it's still yet to be seen how long that will extend over how long of a period of time. So we've got no indications of inventories growing or double ordering. And like I pointed out last quarter, history suggests we never really see that, those types of things ahead of time.

But I think again, it's important to qualify what we can see. So we've got really good visibility into our distributors' inventory, and that remains at about four weeks. It's even both sequentially and year on year. Our visibility in customer inventories will vary depending if we're on consignment or not. So for our consignment OEMs, we hold that inventory on our balance sheet, and we don't see any unusual signals or other things like expedites that would suggest that there's issues inside of that. And our visibility of course into inventory beyond that and down our customers' channels, we just can't see that of course.

So we just remain focused, as we have for a long time, focusing on both our internal manufacturing and internal inventory strategies. And we're focused on trying to keep lead time steady, which they have. Delivery metrics really high because that's what gives customers confidence that they can get the product when they need it.

So you have a follow-on, John?

<Q - John W. Pitzer>: Yes. I do for Rafael. As I think Harlan mentioned, you guys did a fantastic job on operating leverage in the quarter. When you look at absolute operating profits though, there's still a pretty meaningful gap between the Embedded business and the Analog business. And I think you've commented in the past that, theoretically, there's no reason why that gap can't close over time. I'm kind of curious. When I look sequentially, the operating leverage in the Embedded business was particularly high. I think the fall through was almost 86% Q on Q. I'm just kind of curious. Have we reached a scale point in that business where we would expect fall through to be higher from here on out and that gap to close more quickly? Any comments around that would be helpful.

<A - Rafael R. Lizardi>: Sure. Well, to your point, the profitability of that business has in fact improved significantly. On a year on year basis, profit from operation is up 673BPS. But at the end of the day, the main objective here is to grow FCF. We think that is – we believe that is what really drives value for the owners of the company, so and then return all that FCF to the owners.

So we're not particularly focused on any one of those percentages because there are many ways to drive that FCF and one of them is expanding the margins. But then the other one is just growing the top line at the same margin, right. So that's the key message that the core objective that we're trying to achieve.

<Q>: Sorry if we missed it, but we were just wondering what book-to-bill was for the quarter.

<A - Rafael R. Lizardi>: Book-to-bill was, it was 1.0.

<A - David Pahl>: 1.0. Yes.

<Q>: 1.0.

<A - Rafael R. Lizardi>: So.

<A - David Pahl>: And again, we always, we give that number. I would say that always be cautious with it because we've got 60% of our revenue that's on consignment that we don't carry any backlog or don't get any orders in advance. So that's part of the reason why we don't focus on it. Do you have a follow-on?

<Q>: Yes. I guess so. We were just hoping for some more color on the OpEx and why it was a bit light and just how you see that trajectory going forward.

<A - Rafael R. Lizardi>: Well, it came in about as expected. So I wouldn't characterize it as a bit light. And as I mentioned earlier on an earlier question, on a trailing 12-month basis, which is how we think is appropriate to look at, is, came in at 22%. I think in the last couple years it's been at 23%. So it's trended a little down over the last few years, but it is well within the bottom half of our expectations of 20% to 25%, which is our expectations when things are stable, which they are now.

<Q - C.J. Muse>: I guess first question, forward look outlook on gross margins. Can you talk about what you're expecting mix wise and whether that fits in with an incremental gross margin around 70%? Or are there kind of puts and takes around that?

<A - Rafael R. Lizardi>: On gross margins, what we have said before, and we'll continue to say, really hasn't changed our guidance on that is that our general expectation is revenue to pull through at about 70% to 75%. And that's over the long haul, right, not in any one quarter. So you should think about it that way. And as we continue to grow the top line, driven by our investments in analog and embedded from a product standpoint, and industrial, automotive from an end market standpoint, we expect to continue gaining share and that additional revenue to fall through at about those rates.

<A - David Pahl>: Do you have a follow on, C.J.?

<Q - C.J. Muse>: Yes, please. Could you provide an update on where you are on the 300-millimeter? Interested in terms of utilization rates as well as some of the work you're doing on the back end and other fronts to drive even higher incremental margins. Thanks.

<A - David Pahl>: Yes, you bet. I think, as C.J. asked that question, there are probably callers on the line and listening that aren't familiar. But we've got four competitive advantages, the first of which is our manufacturing and technology. And I think the 300-millimeter is a good example of that strength.

The other three, just quickly, are the breadth of the product portfolio; our channel advantages, which includes the size of our sales force and ti.com; and then just the diversity and longevity across markets and sectors and customers and products, which I think leads for investors a high confidence and a high terminal value of that product portfolio.

But why 300-millimeter matters is that we've got a structural cost advantage. So with that larger wafer size, we get 40% lower cost on the chip when we manufacture that. And most chips in the industry are built on 200-millimeter. So we started this year, we've had about 25% of our 300-millimeter capacity footprint utilized. Essentially most of the analog growth this year, and as we have seen for several years, is supported by 300-millimeter.

We'll actually give an update to that in our February capital management call on what the precise numbers are, but that revenue continues to grow on 300-millimeter, and we continue to see the benefit.

<Q - William Stein>: You've had for several quarters strength in automotive and industrial, and that continued in the quarter you just reported. In the outlook, I'm wondering if there's any change in terms of the relative strengths of your expected results by end market?

<A - David Pahl>: Yes – well as you know, we don't provide color below the top line, but certainly if there was anything significant there, we'd call out. And I can tell you there isn't anything significant. And I think if you look at that strength inside of industrial and automotive, I think as we look at third quarter, as it has for some time, that strength has been very broad based.

So, we've got 14 sectors inside of industrial. Most of those have been growing double digits for some time. We continue to direct our investments across those 14, so it's a very intentional investment and return. Same thing in automotive. So we've got diversity across five different sectors. All five of those are contributing to growth. And that diversity is across the product lines, it's across geographies. So we feel really good about that strength. Do you have a follow-on?

<Q - William Stein>: Thanks, Dave. I do. One more. We're aware that there's been a change in compensation to distributors. It's been pretty well publicized, I think, relative to paying them for demand – so-called demand creation. I'm wondering if there are still benefits to be made by TI, if there was anything squeezed out in the quarter just reported or anything that's still on the come, either in December or beyond from that change in sort of how you work with distribution. Thank you.

<A - David Pahl>: Yes. So again, we don't – we no longer do pay for demand creation. As you indicated, distributors of course will continue to play a role in order fulfillment for our customers. So those relationships have been evolving, especially as the reach of our channel advantages continues to strengthen. So as I mentioned earlier, even in this call, that is a unique advantage and includes both ti.com and the size and skill of our sales and apps team.

So those changes began implementation three years ago, for any accounts where we had direct TI resources. That represented about 80% of the TAM. And then later last year, we implemented changes with the remaining 20%. So I'd say a good portion of that is worked through, and it's not significant enough that it's going to make any of these earnings conference calls. So we just continue to invest in our demand creation activities, and we feel really good about the results that that is producing.

<Q - Romit Jitendra Shah>: I just wanted to ask about the revenue growth, if you look at sort of growth over the last 12 months. I mean semiconductor demand, it just seems like there's a resurgence here. We certainly see that looking at the performance of your Analog and Embedded businesses. And that it's more than just – it's coming from more than just consumer confidence and how they're managing inventories. And I'm just curious, if you look at the performance of Analog and Embedded over the last 12 months, has it changed your outlook for the long-term growth of the company?

<A - David Pahl>: Yeah, I don't think so, Romit. I think that we're fortunate that we've got investments in capacity and we've got a product portfolio that is very, very diverse. It's rich in automotive and industrial, which are the best growing parts of the market. And I don't think that that changes our outlook over the long term. And the best signal that we get from customers are orders, so we're able to respond to those if things continue to strengthen and strengthen from here. And if they go the other way, we've got a playbook ready to go if that were to happen. So do you have a follow-on?

<Q - Romit Jitendra Shah>: Yeah. I mean you talked about automotive, and one of the things that we see is that this shift to electric vehicles has a lot of momentum and that with electric powertrains, we could see demand for power semiconductors accelerate. And I was just curious how you guys think about the opportunity in electric vehicles. Is that a sub-segment that TI is uniquely positioned for?

<A - David Pahl>: Yeah. I think that our investments in automotive are really directed across five different sectors. So powertrain is one of them, which is primarily EV. So, but if you look at the other spaces like infotainment cluster, passive safety, ADAS or advanced driver assist systems, and body electronics and lighting, we're very intentionally directing our investments across those areas.

So certainly as EVs become a higher mix of units that are sold on an annual basis, we'll benefit from that, but we're not dependent on it. And I think if I bring you back to our four competitive advantages, just that diversity and longevity. We'll benefit from ADAS systems being deployed and as the industry marches forward to autonomous driving or the mix of EVs.

Those are things we'll benefit from, but our business model isn't dependent on them. So we're real excited with the diversity of design wins that we have there, and we think we've got a lot of runway there as well as inside of industrial.