Operator

Good day, everyone, and welcome to today’s Texas Instruments Q4 2020 earnings release conference call.

At this time, I would like to turn things over to Mr. Dave Pahl. Please go ahead, sir.

Dave Pahl Texas Instruments Incorporated - Head of IR & VP

Good afternoon, and thank you for joining our fourth quarter and 2020 earnings conference call. Rafael Lizardi, TI’s chief financial officer, is with me today.

For any of you who missed the release, you can find it on our website at ti.com/ir. This call is being broadcast live over the web and can be accessed through our website. A replay will be available through the web.

This call will include forward-looking statements that involve risks and uncertainties that could cause TI’s results to differ materially from management’s current expectations. We encourage you to review the “Notice regarding forward-looking statements” contained in the earnings release published today, as well as TI’s most recent SEC filings, for a more complete description.

First, let me provide some information that’s important for your calendars. We plan to hold a call to review our capital management on February 4 at 10:00 a.m. Central Time. Similar to what we’ve done in the past, Rafael and I will summarize our progress and provide some insight into our business and approach to capital allocation.

For today’s call, let me start by summarizing what Rafael and I will be reviewing. First, I’ll start with a quick overview of the quarter, and next, I’ll provide some insight into fourth quarter revenue results. And as we’ve done the past few quarters, we’ll provide details by end market, including sequential performance, since it’s more informative at this time. I’ll also provide the annual summary of revenue breakdown by end markets. And lastly, Rafael will cover the financial results, some insight into one-time items and our guidance for the first quarter of 2021.

So starting with a quick overview of the fourth quarter: The company’s revenue increased 7% sequentially and 22% year-over-year, driven by strong demand in automotive, personal electronics and the industrial markets. Analog revenue grew 9% and Embedded grew 11% sequentially. On a year-over-year basis, Analog revenue grew 25% and Embedded grew 14%. Our Other segment grew 4% from a year-ago quarter.

Moving on, I’ll now provide some insight into the fourth quarter revenue by end market.

First, the automotive market continued its rebound following the second quarter bottom, with 19% sequential growth and 25% year-over-year growth. The industrial market was up 7% sequentially and 16% from the year ago. The strength was seen across most market sectors.
Personal electronics was up 11% sequentially and up 39% compared to a year ago. The strength was broad-based across sectors and customers within personal electronics.

Next, as expected, communications equipment was down 28% sequentially and down 8% from the year ago.

Enterprise systems was down 2% sequentially and down 13% from a year ago.

And lastly, as we do at the end of each calendar year, I’ll describe our revenue by end market for 2020. We break our end markets into six categories that are grouped by their life cycles and market characteristics. The six end markets are industrial; automotive; personal electronics, which includes products such as mobile phones, PCs, tablets and TVs; communications equipment; enterprise systems; and other, which is primarily calculators.

As a percentage of revenue for the year, industrial was 37%; automotive 20%; personal electronics 27%; communications equipment 8%; enterprise systems 6%; and other was 2%.

Looking at the changes versus 2019, industrial increased one percentage point, automotive declined one percent (added by company after the call), personal electronics increased four, communications equipment declined three, enterprise systems was even and other declined one percentage point. In 2020, industrial and automotive combined made up 57% of TI’s revenue, about even with last year and up from (added by company after the call) 42% in 2013. We see good opportunities in all of our markets, but we place additional strategic emphasis on industrial and automotive. Our industrial and automotive customers are increasingly turning to analog and embedded technology to make their end products smarter, safer, more connected and more efficient. These trends have resulted and will continue to result in growing chip content per application, which will drive faster growth compared to our other markets.

Rafael will now review profitability, capital management and our outlook.

Rafael R. Lizardi Texas Instruments Incorporated - Senior VP of Finance & Operations, CFO and CAO

Thanks, Dave, and good afternoon, everyone.

Gross profit in the quarter was $2.6 billion, or 65% of revenue. From a year ago, gross profit increased primarily due to higher revenue. Gross profit margin increased 230 basis points.

Operating expenses in the quarter were $786 million, down 2% from a year ago and about as expected. On a trailing 12-month basis, operating expenses were 22% of revenue.

For the year, we have invested $1.5 billion in R&D, an important element of our capital allocation. We are pleased with our disciplined process of allocating capital to R&D, which we believe will allow us to continue to grow our top line over the long term.

Acquisition charges, a noncash expense, were $47 million in the fourth quarter. Acquisition charges will remain at about this level through the third quarter of 2021.

Operating profit was $1.8 billion, or 44% of revenue. Operating profit was up 45% from the year-ago quarter.

Other income and expense was $162 million in the quarter due to a one-time benefit related to the signing of a multiyear royalty agreement.

Net income in the fourth quarter was $1.7 billion, or $1.80 per share, which included a 16-cent benefit that was not in our prior outlook, primarily due to the royalty agreement we just mentioned.

Let me now comment on our capital management results, starting with our cash generation.
Cash flow from operations was $2.1 billion in the quarter. Capital expenditures were $212 million in the quarter. Free cash flow on a trailing 12-month basis was $5.5 billion, down 5% from a year ago.

In the quarter, we paid $937 million in dividends. We have increased our dividend per share by 13%, marking our 17th year of dividend increases. We repurchased $15 million of our own stock for a total return of cash to owners in the fourth quarter of about $1 billion. For the year 2020, we returned $6 billion, consistent with our strategy to return all free cash flow to our owners. Over the same period, our dividend represented 62% of free cash flow, underscoring its sustainability.

Our balance sheet remains strong with $6.6 billion of cash and short-term investments at the end of the fourth quarter. Total debt was $6.8 billion with a weighted average coupon of 2.77%. Inventory days were 123, down 21 days from a year ago and down 14 days sequentially.

Now let's look at some of these results for the year.

In 2020, cash flow from operations was $6.1 billion. Capital expenditures were $649 million, or 4.5% of revenue. Free cash flow for 2020 was $5.5 billion, or 38% of revenue. Our cash flow reflects the strength of our business model.

As we have said, we believe that growth of free cash flow per share is the primary driver of long-term value. And after accretive investments in the business, the remaining cash will be returned over time via dividends and share repurchases. Over the last 12 months, we paid $3.4 billion in dividends and purchased $2.6 billion of our shares, reducing outstanding share count by 1.4% in 2020.

Turning to our outlook for the first quarter, we expect TI revenue in the range of $3.79 billion to $4.11 billion and earnings per share to be in the range of $1.44 to $1.66. We expect our 2021 annual operating tax rate to continue to be about 14% and our effective tax rate about a percentage lower than that -- a percentage point lower than that.

In closing, we will stay focused in the areas that add value in the long term. We continue to invest in our competitive advantages, which are manufacturing and technology, broad product portfolio, reach of our channels, and diverse and long-lived positions. We will continue to strengthen these advantages through disciplined capital allocation and by focusing on the best market opportunities, which we believe will enable us to continue to improve and deliver free cash flow per share growth over the long term.

With that, let me turn it back to Dave.

Dave Pahl Texas Instruments Incorporated - Head of IR & VP

Okay. Thanks, Rafael. Operator, you can now open the lines for questions. (Operator Instructions) Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll go first today to John Pitzer with Crédit Suisse.

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

Congratulations on the solid results. Dave and Rafael, I'm wondering if you could talk a little bit about just the current demand backdrop. I mean, clearly, we're hearing about lead times stretching out in the semi industry. Many of your peers are talking about raising pricing. I guess, specifically to you guys, can you help us understand what your lead times are doing? What do you guys think about pricing? And I guess more importantly, given your inventory strategy and the fact that your fabs a little bit fuller last year, do you think the current results represent your ability to gain some incremental share as some of your peers just are having a harder time supplying customers right now?
Yes, John, let me take -- you covered a lot of ground with that first question, so let me take some pieces of it. Rafael, if you want to add anything, and if I miss any, John, we'll give you a chance for the follow-up. But the first one, certainly, we've read the same reports and seeing the same releases from our peers on the supply constraints and raising prices. The short answer -- are we doing that -- the short answer is no. And I think that, that brings us to, one of our foundational competitive advantages is manufacturing and technology, and that really provides two benefits. One is the obvious, which is lower cost, but the second is just greater control of our supply chain. So it's really times like this and really throughout 2020 that, that greater control of your supply chains really becomes a great advantage.

Yes. I'll just add on the inventory angle of your question, John. Remember, our long-term objective for inventory, as we have talked about in many capital management calls, is to maintain high levels of customer service while we minimize inventory obsolescence. Now part of the reason we can do that is that we are strategically positioned -- the way we run the company, our business model and competitive advantages where we -- our parts are mainly catalog parts that sell into industrial and automotive, our focus is on those, with very long product life cycles so we can build inventory ahead of demand, we can position that inventory well. That served us well in 2020, and will continue to serve us well from a business model standpoint in order to maintain those high levels of customer service with our customers.

So I think we've got most of the pieces. John, do you have a follow-up or other pieces we can touch on?

Yes, just a quick follow-up for Rafael. Rafael, I know you don't specifically guide gross margins, but I was wondering if you could give us some parameters around OpEx for the next couple of quarters. I mean, we're heading into a strong cyclical recovery in revenue off of what was kind of an unusual expense year last year with COVID. And so as we think about the March quarter, can you help us kind of frame the period cost around SG&A and R&D that we should be thinking about? If you want to give us a gross margin target, that would be great, but I know you tend to avoid that.

Yes. On a gross margin, like we have said before, just think of 70% to 75% fall-through. So you figure out what revenue -- incremental revenue you want to play in and just fold that through at 70% to 75%, you get at a good place -- over the long term, right? Any one quarter can be a little higher or lower, right?

On OpEx, we talked about we can operate between 20% and 25%. The last -- the last three or four years, we have been between 21% and 22% pretty much, right? So I don't mean to narrow that range, but that's where we've been running. And I would expect to stay somewhere in that neighborhood for a foreseeable future.

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Between 20% and 25%.

Yes, between 20% and 25%.

Right, right. Yes. Okay. Thank you, John, and we'll go to the next caller, please.

That will come from Vivek Arya with Bank of America.

Congratulations on the strong growth. Just wanted to follow up on the demand question. I'm curious, even if you are able to supply because of your very strong strategic capacity, do you think your customers, especially on the automotive side, might be constrained with
other parts of the bill of materials that they get from others and maybe those become bottlenecks? I'm just trying to reconcile the very strong demand backdrop that we are hearing from your results and your outlook versus all the news around auto supply chains facing more constraints. What is the true sense of kind of supply and demand across your customer base? It would be very helpful to hear your views.

Dave Pahl Texas Instruments Incorporated - Head of IR & VP

Sure, Vivek. Yes, I think that's a great question. We see the same reports that you're seeing. And I think the best way to maybe describe what we're seeing in the automotive market is just a -- just-in-time supply chain that's restarting from essentially a full stop that happened in second quarter. And just as a reminder, what we saw in third quarter was a 75% sequential increase, followed by this last quarter with a 20% sequential increase. So what I'll say is that those reports are fairly widespread. And -- but we aren't seeing demand signals that would show us that there's anything that's consistent with any of those constraints that you're pointing out or that are in press releases.

Do you have a follow-on?

Vivek Arya BofA Merrill Lynch, Research Division - Director

Yes. Good to see the growth in the Embedded segment. And I know you made some changes in that business last year. Do you think we will start to see the benefits of that in 2021, because they also tend to be somewhat stickier markets? So I'm just curious if you could give us an update on what are you doing specifically to regain market share. And do you think we can start to see your Embedded business start to grow in line with your Analog business this year?

Rafael R. Lizardi Texas Instruments Incorporated - Senior VP of Finance & Operations, CFO and CAO

Yes. I'll give you a few on those ones. So first, we're pleased with the progress we're seeing in Embedded. Our plan has called to first stabilize the business and then start to prove that we can resume long-term consistent growth. We're leveraging our competitive advantages, particularly building a broad-based, a more diverse product portfolio that can then deliver long-term sustainable growth. I think it was in second quarter of '20 where we announced -- when we had a restructuring charge related to Embedded -- and we reallocated resources from some product lines, increased investments, some we decreased, others stayed about the same, and we're seeing the beginning of that stabilization on that front.

Operator

We'll hear next from Craig Hettenbach with Morgan Stanley.

Craig Matthew Hettenbach Morgan Stanley, Research Division - VP

Dave, just following up on your comments around autos and particularly the just-in-time inventory angle. Certainly, 2020 was a challenging year for the supply chain, and we're dealing with some of those repercussions now. But do you think you'll see some changes to that over time in terms of how they operate from an inventory perspective or something that might be difficult for the next couple of quarters, but kind of gets back to that just-in-time?

Dave Pahl Texas Instruments Incorporated - Head of IR & VP

Yes, Craig, I don't want to speak for our customers or how they're managing their inventories. I think, as you've seen us and how we've managed our business and our operations, we would just work very hard to try to have capacity in place to support our customers' needs. You saw the decisions that we made earlier in the year to try to keep high service and optionality in place. And we'll just continue to try to support our customers' needs, whatever their supply chains look like. So -- and whether that's in the automotive market or the other markets. So we just -- we try to make them happy. That's what we're trying to do. Do you have a follow-on?

Craig Matthew Hettenbach Morgan Stanley, Research Division - VP

I do. And just looking at Analog up 25% year-over-year, I know that comes off of a difficult year and coming out of a down cycle, and so that's some of it. But just curious at a high level, just to get your thoughts of just the type of strength you're seeing and how you feel about what the demand is out there?
Dave Pahl Texas Instruments Incorporated - Head of IR & VP

Can you clarify that a little bit for me, Craig, just so I make sure I answer the right question?

Craig Matthew Hettenbach Morgan Stanley, Research Division - VP

Yes. So just with the Analog business up 25% year-over-year, that's coming off of an easy comp, if you will, coming out of the down cycle. So I think that's some of it. But just curious, I know in some of these calls, you've talked about just your view of just, hey, our supply and demand equilibrium or how you feel like demand is relative to how your business is trending right now?

Dave Pahl Texas Instruments Incorporated - Head of IR & VP

Well, yes. Yes, I think that when you look at where that business is, I think that we've just come through a -- from cyclical indicators and those types of things. You'd even have to go back to 2018 when the industry had reached a cyclical peak, then you throw in and sprinkle on top COVID-19. And it was really at the beginning of, or the end of last year and the beginning of 2020, that we had begun to see signs of stabilization before COVID had hit.

So inventories really weren't a problem at that point in time, and we had said at that point in time that our shipments were beginning to reflect what customers were beginning to ship overall. So again, I think that what we are shipping today is reflective of what customers are asking us to ship. We have a good availability of product because of the decisions that we've made, and our lead times have remained stable. That doesn't mean, of course, that we don't have hot spots that we're working, and we always have hot spots. But that's kind of where we are today.

Operator

We'll hear next from Harlan Sur with JPMorgan.

Harlan Sur JPMorgan Chase & Co, Research Division - Senior Analyst

Congratulations on the strong execution. Amidst the strong demand environment, as we all know, foundry capacity is pretty tight, both leading edge and lagging edge. And I know that TI outsources about 20% of its wafer requirements, most of it with your Embedded products, MPUs, MCUs. So because of the foundry tightness, is the team also somewhat constrained on your Embedded products, either Q4 or here in Q1? And also the same thing from an assembly test perspective, where I think about 40% of your assembly and test requirements are outsourced to the subcons? Is this constraining maybe some of your shipments near term?

Rafael R. Lizardi Texas Instruments Incorporated - Senior VP of Finance & Operations, CFO and CAO

At a high level, we have long-term agreements with these suppliers, like we do with other suppliers. Even though we only outsource a relatively small part of our loadings, we're still, being a big company there, that's still a good amount of loadings, right? So we still get some decent leverage. So we're seeing some hot spots here and there, but to the largest degree, we're getting what we need.

Dave Pahl Texas Instruments Incorporated - Head of IR & VP

Yes. And I would say having 80% of our wafers sourced internally, almost all of our Analog sourced internally, and that is a great advantage for us. So overall, as we've talked about, that, lead times have remained stable. So that has been a huge advantage for us. Do you have a follow-on, Harlan?

Harlan Sur JPMorgan Chase & Co, Research Division - Senior Analyst

Yes, absolutely. Can you guys just provide us with the shipment trends quarter-over-quarter, year-over-year by geography? I know it's shipped to location, but I think it's still useful to kind of understand the breadth of the overall demand profile you guys are seeing.

Dave Pahl Texas Instruments Incorporated - Head of IR & VP

Sure. So in the quarter, and thank you for the preamble there, so I won't repeat it. But year ago, Asia was up and all of the other regions were either flat or down. And sequentially, all the regions except for the U.S. were up. And just as another point of color on where we ship our products, 90% of our revenues come from shipments outside of the U.S., and we've got about 20% of our revenues that are based by customers in China. So just a little bit more color on the comment that you made there earlier.
Operator

And we'll hear now from Timothy Arcuri with UBS.

Timothy Michael Arcuri  UBS Investment Bank, Research Division - MD and Head of Semiconductors & Semiconductor Equipment

Rafael, I guess I asked this question last quarter, too, but you, again, bought back next to no stock, and I totally get that you were running ahead of the plan in the first half and you were certainly ahead of 100% for the full year. But you also have a pretty strong intrinsic value model for the share repo and you'd be pretty good at buying back the stock. So I guess maybe I'll ask you again to just sort of comment on that. Is there anything that we can read into that, given that it's the second quarter in a row?

Rafael R. Lizardi  Texas Instruments Incorporated - Senior VP of Finance & Operations, CFO and CAO

What I would tell you is that as we talk about during capital management, our goal is to return all free cash flow to the owners of the company. We generated in 2020 $5.5 billion of free cash flow and we generated $6 billion of free cash flow. So clearly, well above the cash flow generation.

Do you have a follow-up?

Timothy Michael Arcuri  UBS Investment Bank, Research Division - MD and Head of Semiconductors & Semiconductor Equipment

And then I guess -- yes, yes, yes, I do. I guess, can you give us an update on the 300-millimeter, the new fab and sort of the timing around that? And I guess on that, can you qualify for some of these subsidies coming from the government? Or is that mostly going to be leading edge?

Rafael R. Lizardi  Texas Instruments Incorporated - Senior VP of Finance & Operations, CFO and CAO

Yes, sure. So the update on the factory is the same as -- nothing has changed as far as our expectation. The new factory is being built. We expect it to be completed in 2022. So next year. In fact, we should have some level of output in the second half of next year. So that's all going as per plan. When it's fully equipped, it has the potential for revenue of about $5 billion per year.

On your question on the incentive -- a lot of that remains to be seen. There are two legislations, one that was approved but was not funded. Another one hasn't been approved. The chips, I think, is the one that hasn't been approved. But the one that was approved has not been funded. So -- and there's a lot of uncertainties on that, depending on how that comes out. So when that comes out, we'll look at it, and we'll decide if it makes sense for us. But at the biggest or the highest level, we think semiconductor is a foundational technology and anything that the government can do to strengthen that and to keep us at a level playing field -- companies in the United States versus other countries -- that would be a good thing.

Operator

That will come from Tore Svanberg with Stifel.

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

Congratulations on the results. First question for Rafael. I typically wouldn't ask you this because I know you get a lot of these, but the royalty this quarter was pretty material, $162 million. Can you maybe add any color on that? And should we expect sizable things like that going forward as well?

Rafael R. Lizardi  Texas Instruments Incorporated - Senior VP of Finance & Operations, CFO and CAO

Yes. So it was about -- inside that $162 million it was more -- most -- of that $162 million. And we recognize it based on accounting rules. The cash actually comes in not quite like that. It comes in over time. But it's just -- it's a licensing agreement. We've had those for many years. They have become de minimis at the highest level, frankly. So I don't expect that to change. From a cash standpoint, it's about $100 million a year. So from the revenue or the income recognition standpoint, sometimes they come in as pops as what you saw, but the cash, which is really what matters, it's more stable than that. And again, like I said, it's about $100 million a year. I don't expect that to change much.
Dave Pahl  Texas Instruments Incorporated - Head of IR & VP

You have follow-on, Tore?

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

Yes. Thank you, Dave. So I know your long-term goal is to grow CapEx at 6% or -- to spend 6% of your revenues in CapEx. I think last year, you said it was 4.5%. Were there sort of any COVID-related issues that slowed things down? And as we look at 2021, do you think it will come in close to that range of sort of 6%?

Rafael R. Lizardi  Texas Instruments Incorporated - Senior VP of Finance & Operations, CFO and CAO

Yes. So I'll go ahead and take that. So yes, our guidance is 6%. Our guidance continues to be 6% CapEx as a percent of revenue. That's a long-term guidance, includes everything that goes into CapEx as far as building and equipment. Now, of course, that number can fluctuate, right? Like you pointed out, it just fluctuated down in 2020 to 4.5%. So I wouldn't be surprised if it's a little higher than 6% for a year or two. But for your models, I would suggest you stick with 6% out into the future. It's just -- it's simpler that way, and it gets the point across.

That concludes the call. So let me finish with a few comments on key items that we believe deeply. First, we run the company with the mindset of being a long-term owner. We believe that growth of free cash flow per share is the primary driver of long-term value. Our ambitions and values are integral to how we build TI stronger. When we’re successful in achieving these ambitions, our employees, customers, communities and shareholders all win.

Dave Pahl  Texas Instruments Incorporated - Head of IR & VP

Okay. And thank you all for joining us. A replay of this call will be available shortly on our website. Good evening.

Operator

And again, that will conclude today's conference. Thank you all for joining us.