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EDITED TRANSCRIPT

TXN - Texas Instruments Inc Capital Management Strategy Webcast 2018

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OVERVIEW:

TXN provided an update on its Capital Management Strategy.

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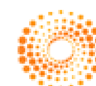

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CORPORATE PARTICIPANTS

Dave Pahl *Texas Instruments Incorporated - Head of IR and VP*

Rafael R. Lizardi *Texas Instruments Incorporated - CFO, CAO & Senior VP*

CONFERENCE CALL PARTICIPANTS

Blayne Peter Curtis *Barclays PLC, Research Division - Director and Senior Research Analyst*

Christopher James Muse *Evercore ISI, Research Division - Senior MD, Head of Global Semiconductor Research & Senior Equity Research Analyst*

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

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

Mark John Lipacis *Jefferies LLC, Research Division - Senior Equity Research Analyst*

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

Stacy Aaron Rasgon *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

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

PRESENTATION

Operator

Good day, and welcome to the Texas Instruments Capital Management Strategy Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Dave Pahl. Please go ahead, sir.

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Thank you. Good morning, and thank you for joining our 2018 capital management call. This call is being broadcast live over the web and can be accessed through our website at ti.com/ir. 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 our most recent earnings release as well as our most recent SEC filings for a more complete description.

During today's presentation, we'll begin with a quick recap of our capital management strategy and our scorecard for 2017. Then we'll provide a historical summary of our capital allocation and take a deeper look into specific areas of investments and our free cash flow per share performance. Finally, we'll wrap up with a review of our cash returns.

We believe the key points that investors can take away from our discussion today are: first, we remain focused on consistent execution of our capital management strategy; second, our business model is designed around 4 sustainable competitive advantages and we continue to strengthen and leverage those advantages with a view towards the long term; third, our disciplined allocation of R&D and investments in our initiatives is delivering growth from the best products - analog and embedded - the best markets - industrial and automotive. Our 300-millimeter analog manufacturing strategy has a unique advantage and will provide benefits for a long time in the future. And lastly, we remain committed to returning all free cash flow to our owners. These key points are consistent with what we've been doing over the last several years.

As a reminder, we believe TI is in a unique class of companies that can grow, generate and return significant cash.

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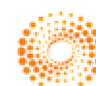

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We're focused on the best products in the best markets in the semiconductor industry. We believe analog and embedded are the best products. They are large markets with fragmented competitor bases and are used across a diverse set of applications and customers. Moreover, these products have demonstrated decades of generating profitable returns and significant amounts of cash. We believe industrial and automotive are the best markets and will drive growth in our industry and at TI. These markets are the fastest growing due to their increasing semiconductor content, a trend fueled by products becoming more intelligent, more connected, safer and more efficient, especially as mechanical and electromechanical features are replaced with solid-state electronics.

Electric vehicles are a great example of this potential. The chip content in the powertrain of an internal combustion engine is about $25 per car today and focused on mechanical components like cylinders, cranks and carburetors. In an electric vehicle, that chip content could increase tenfold to more than $250 per car as battery management, motor control and power electronics come into play. This is an example of one system in electric automobile. Now imagine similar increases across thousands of industrial and automotive applications. That's why we believe these markets will outperform the overall semiconductor market and why we have made them a priority.

Finally, our strategy is designed around 4 sustainable competitive advantages that, in combination, provide tangible benefits that are difficult to replicate. The first is manufacturing and differentiated technology, the broadest portfolio of analog and embedded products, the reach of our market channels and then diverse and long-lived positions, which results in a high terminal value.

With that, I'll turn it over to Rafael and he'll review our capital management strategy. Rafael?

Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

Thanks, Dave. As we have said, our objective is to maximize long-term growth of free cash flow per share, which we believe is the best metric to judge our financial performance and to drive higher intrinsic value for the owners of the company.

We do this in 3 ways. First, by having a great business model that is built on our 4 competitive advantages, advantages in which we're continuing to invest and make even stronger. Second, by being disciplined on how we allocate our resources, focusing on the best product opportunities as well as what strengthens and leverages our competitive advantages. And third, by striving to constantly increase our efficiency, which is generally about achieving more output for every dollar of input.

As a reminder, our capital management strategy begins with a great business model that focuses on analog and embedded, the best products in semiconductors with a demonstrated history of cash generation. We have designed a company that is capable of growing, generating and returning significant amounts of cash to our owners. It takes into consideration a strong balance sheet and investments to strengthen our competitive advantages.

The tax landscape has changed significantly due to the U.S. tax reform act passed in December. We applaud the reform to U.S. corporate tax laws because it enables U.S.- headquartered companies, like TI, to compete more effectively on a global basis. The new law recognizes and rewards companies for exporting and for having manufacturing, R&D and intellectual property in the United States.

There are many important financial implications with this change. We gave a lot of detail on this in our recent earnings call, so I will just highlight 3 items here.

First, investors should assume an ongoing 18% annual operating tax rate starting 2019. This rate comprehends the 21% statutory corporate rate and the benefit of exports and having manufacturing, R&D and intellectual property in the United States. This rate does not include an estimate for stock-based compensation benefit, which we provide at the start of each year.

Second, for 2018, investors should assume a transitional 23% annual operating tax rate before the benefit of stock-based compensation. The 5 percentage points of transitional tax effects are mostly non-cash charges.

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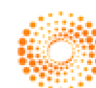

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Lastly, in the fourth quarter of 2017, our tax expense included approximately $800 million of tax expense that was primarily related to the recently passed tax reform act. Although there was no impact to free cash flow in the fourth quarter of 2017, we will pay this out over the next 8 years. I'll refer you to our fourth-quarter 2017 earnings call for more details, which may help with your longer-term models.

Again, we believe the reform to U.S. corporate tax law will enable U.S.- headquartered companies, like TI, to compete more effectively on a global basis. And importantly, with more cash available on an ongoing basis, we will continue to have a strong balance sheet to invest to grow our business, strengthen our competitive advantages and return all free cash flow to the owners of the company.

Our capital management scorecard is one that we have shared with you every year since 2013. Consistent with prior years, in 2017, we again met our multiple objectives. We are pleased with the consistency that our business model and strategic decisions have allowed us to deliver in these results. Note with the recent changes in tax law, the metric on cash owned by U.S. entities is no longer relevant moving forward.

This year, to provide more clarity and insight into how we think about our business, we have updated our scorecard in 2 ways. First, we have included descriptions of our long-term objectives for each metric. And second, we have adjusted or simplified how we will judge several of the metrics while eliminating those that are no longer relevant.

The long-term objectives should provide more insight into how we actually run the business as opposed to a number that reflects only a single data point. For example, a long-term capital expenditure objective is to invest to support new technology development and revenue growth. We also want to expand our low-cost manufacturing advantage, including 300-millimeter, while maximizing long-term free cash flow per share. We recognize CapEx may run higher in any period if there is an opportunity to extend our long-term manufacturing advantage. We continue to believe that about 4% of revenue is still the right long-term capital expenditure target.

Additionally, we're adjusting how we will judge a few of these objectives.

First, we have updated our expectation for free cash flow generation to 25% to 35% of trailing 12-month revenue, primarily driven by the impact of U.S. tax reform.

Second, we have increased the range for inventories to 115 to 145 days. This reflects our continuing plans to own and therefore control more of our inventory. Increased control of inventory results in improved visibility to customer demand as well as improved customer service, since we can rapidly direct the inventory to the demand. This is consistent with the past few years as we have increased our consignment levels.

Third, our cash balance allows us to provide necessary liquidity through all market conditions with about 10% of trailing 12-month revenue and our 12 months of dividend payments.

Finally, we're simplifying how we communicate 2 of our targets. The first is to say that we will return all free cash flow over time, and the second is for dividends to be 40% to 60% of current year free cash flow. Neither simplification changes the overall objectives. They are just a simpler way in how we describe them and an easier way in how to think of them.

Overall, our objectives remain consistent, and we hope these additional insights give you a better understanding of how we run our business.

In summary, our capital management strategy continues to serve the owners well. Free cash flow per share continues to grow steadily while we continue to strengthen and leverage our competitive advantages.

Now I would like to provide additional insight into how we allocate our capital and I'll give you updates on several key investment areas.

Over the last 10 years, we have allocated about $72 billion of capital. Given that magnitude, you can quickly appreciate why capital allocation is a job we take quite seriously and one that has significant impact on owners' returns. You can see our largest category of capital allocation is investment in critical areas that drive organic growth such as R&D, sales and marketing, capital expenditures and inventory. With our approach of funding

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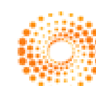

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strategies, not projects, we spend significant time ensuring these investments are delivering long-term competitiveness and generating returns greater than our cost of capital.

The second largest category is share repurchases. Here, our objective is the accretive capture of future free cash flow for the long-term owners. We focus on consistent repurchases when the present stock price is below the intrinsic value, using reasonable growth assumptions.

Next is dividends, where our objective is to appeal to a broader set of investors, and we focus on their sustainability and growth for obvious reasons.

And finally, potential acquisitions are evaluated through 2 primary factors that have remained unchanged. First, it must be a strategic match, meaning catalog, analog focused with high exposure to industrial and automotive. Second, it must meet certain financial metrics such as generating a return greater then a weighted average cost of capital within about 4 years.

For simplicity, we have not included changes in net debt, which over this period, was $2.1 billion.

With that framework said, let me now examine our investments in several specific areas. I will first focus on our R&D investments that we allocate to higher value growth opportunities.

As you may recall, our broad portfolio of analog and embedded products is an important competitive advantage. This breadth of portfolio brings more visitors to ti.com each year than to our competitors' website. It is also critical that we continually grow and strengthen this portfolio with highly differentiated products that are developed with an eye on the best market opportunities over the next 10 years.

At the highest level, we see good opportunities in all of our markets but we believe that industrial and automotive will be the best opportunities over the next decade. This is primarily because semiconductor content in industrial and automotive applications will significantly increase as companies make their equipment smarter, more connected, safer and more efficient.

This chart summarizes the direction of our R&D investments across end markets and also provides the revenue breakout for 2013 through 2017.

In industrial and automotive, we continue to increase investments broadly across sectors and product categories. We're excited to see the continued progress on revenue growth as these markets comprise about 54% of TI revenue, up from about 42% in 2013.

Personal electronics is an important market, and while investment level in total is down, we do invest selectively.

In communications equipment, we announced several years ago that we were reducing our Embedded investments but we continue our investment in the Analog growth opportunity.

Our investment in enterprise systems and other have been flat and at low levels.

We will now talk to our manufacturing advantage. We have two 300-millimeter wafer fabs supporting our Analog business. We made good progress on this plan again in 2017 as we continued to increase factory loadings in both of these fabs. In 2017, we utilized about 50% of the combined capacity which supported about $4 billion of revenue. This was up from about $2.5 billion in 2016. We remain committed to strengthening and leveraging this competitive advantage over the long term.

As a reminder, for those not as familiar with the semiconductor industry, a chip, meaning an unpackaged product made on a 300-millimeter wafer, costs about 40% less than a chip built on a 200-millimeter wafer, the size used by most of our competitors. This translates into a great competitive advantage.

The reason it is an advantage is because a 300-millimeter wafer has 2.25x more area, which in turn means we can get about 2.3x more chips but it does not cost 2.3x to process that large a wafer. This translates into a structural cost advantage.

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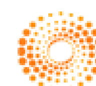

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To understand how a 40% less expensive chip impacts gross margin, it is easiest to use an example of a part built on 200-millimeter compared with 300-millimeter. This example shows a theoretical part that sells for $1 with a gross margin of 60%. The chip itself would cost about $0.20 built on 200-millimeter and this would reduce to $0.12 on 300-millimeter. In this example, the remaining cost of assembly and test are the same regardless of the size of the wafer. The net result is that gross margin improves by 8 percentage points. As this simple example illustrates, our 300-millimeter manufacturing capability and the resulting cost structure provide a unique competitive advantage for TI.

And the best part of our 300-millimeter advantage is that it is just beginning. In 2017, we continued to make steady progress. We have about 40% of Analog revenue built on 300-millimeter and a lot of room to expand. Moving forward, we believe that the majority of our incremental Analog revenue will be built on 300-millimeter.

We will now go through our free cash flow growth and outlook.

As we described at the beginning, our overall objective is to maximize long-term free cash flow per share. We believe this is not only the best metric to judge our performance. It is also the one that owners ultimately care about.

Since 2004, our free cash flow per share compounded annual growth rate has been 13%. In 2017, free cash flow margin increased 70 basis points to 31.2% of revenue. We reduced share count by 1.3% and free cash flow per share increased 15.7%.

Last year, we had 3 drivers of free cash flow per share growth: top-line revenue growth driven by Analog and Embedded; incremental free cash flow margin increases; and additional share count reductions.

We believe these 3 drivers of free cash flow per share growth will continue. Our Analog and Embedded segments have a proven track record of growth. Combined, they have recorded both 5- and 10-year revenue CAGRs of 8%. Part of that growth is market share gains where we have seen, on average, 30 to 40 basis point improvement annually over time. With Analog and Embedded comprising 90% of our revenue, we expect they will be able to continue to drive the top-line growth.

Now let me change gears and talk about tax returns.

Our free cash flow margin also stacks up well against the S&P 500. Over the last 12 months, our free cash flow margin of 31.2% places us in the top 15% of the S&P 500.

Generating cash is obviously important but it is only valued if it is invested wisely, which we have already discussed, or it is returned to investors.

We have an equally strong benchmark in how well we'll return cash through dividends and stock repurchases, where we are in the top 10% of the S&P 500 in terms of cash returns as a percentage of revenue.

As our cash return to owners has grown, so too has our dividend as a percentage of the cash return. We continue to believe a sustainable growing dividend is an important element of our capital management strategy.

Our objective in repurchasing shares is the accretive capture of free cash flow for long-term investors. We focus on consistently repurchasing shares where the intrinsic value of the company exceeds its market value.

By using realistic discount factors and reasonable growth assumptions to calculate intrinsic stock value, we're aiming to have confidence that investments made in stock repurchases are, in fact, earning rates of return greater than our cost of capital.

While the ultimate assessment of ROI depends on the future cash-flow stream, the track record of this approach is encouraging. If you make the very conservative assumption that TI's future free cash flow remains flat, we will be earning about 10% annualized return on all stock repurchases made to date since 2004.

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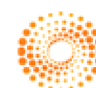

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We have reduced shares outstanding 43% since 2004 including the 1.3% reduction in 2017. We ended 2017 with $9.2 billion in open authorizations, having bought back $2.6 billion of stock in 2017 including $706 million in the fourth quarter.

As we commented earlier, our objective with dividends is to appeal to a broader set of investors and our focus is on both growth and sustainability. We have now raised the dividend for 14 consecutive years including a 24% increase in the fourth quarter of 2017. We have increased the dividend at a compounded annual growth rate of 24% over the last 5 years.

Our consistent growth of free cash flow resulted in our dividend in 2017 consuming only 45% of free cash flow, supporting our objectives of sustainability and growth of dividends.

Let me now wrap up my prepared remarks with a few summary comments.

TI is in a unique class of companies that can grow, generate and return cash. Our business model is designed around 4 competitive advantages that deliver tangible benefits unique to TI and are difficult to replicate: first, manufacturing and differentiated technology; second, breadth of products; third, broad reach of our channels; and finally, diversity and longevity of products, markets and customer positions.

We will continue to focus on growing free cash flow per share. It is the ultimate objective, and we believe focusing on it will deliver the highest growth in the value of the company. In the coming years, we believe that we will have 3 drivers contributing to free cash flow per share growth: top-line revenue growth, free cash flow margin expansion; and share count reduction.

Top-line revenue growth will be driven by our position in the best products, analog and embedded, and in the best markets, industrial and automotive.

Our 300-millimeter Analog manufacturing strategy is a unique advantage and will provide benefits for a long time.

And finally, owner returns will continue it to be driven by dividends and share repurchases. We have a disciplined culture and processes to ensure that we are strengthening our competitive advantages and generating the maximum return for the investments we make. Thank you. With that, I'll turn it back to Dave.

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Thank you very much, Rafael. Operator, you can now open the lines up for questions. (Operator Instructions) Tracy?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we'll go first to William Stein with SunTrust.

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

Gentlemen, I'd like to ask something that's maybe a little bit off-focus and that's how your capital allocation, let's say, not strategy, but tactics might shift somewhat given different positions in the cycle, in particular M&A and inventory builds, how your approach to those might shift as we see different parts of the cycle.

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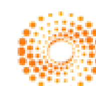

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Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

Yes. Let me get a start on that and then I'll hand it over to Dave to give his comments. But the bottom line is that I don't see any change in our strategy because of that. We -- for many, many years now, we've been very consistent on how we allocate capital. Let me just comment on a few of the specific things that -- and that goes through any cycle, by the way. And if you look at our free cash flow trends, they actually have been pretty steady during the cycle, which actually goes to show the stability and the strength of the business model to begin with.

But let me comment on a few of the things you mentioned. On M&A, our strategy hasn't changed. We have 2 criteria. First, you have to be a strategic fit, and as I mentioned before, during the prepared remarks, it needs to be analog-focused, differentiated products, and then we will focus on industrial and automotive, and then the price has to be right. So that hasn't changed.

And then on inventories, we spelled out in our objectives, in our scorecard, how we think about it. And our objective, as I said earlier, is to maintain high levels of customer service, minimize inventory obsolescence, improve manufacturing utilization. And some of these things will vary based on things like consignment where we control the inventory and we think we can deploy it very efficiently to -- ultimately to drive higher long-term free cash flow growth. So we will continue to do that.

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Yes. If I could just add a couple of comments, Will. I'd say, as Rafael laid out, the strength of our business model, one of those is not to have to focus on the cycle, but I think it's something that you do have to respect and sort of be prepared for. So we've got a playbook that we've been through many cycles, both Rafael and I through our careers, and there's 4 things that I'd highlight of that playbook.

For us, the first thing is getting the operating plan correct. So depending on the magnitude, we bring down wafer starts, that's probably the first thing operationally that's most important. We have a list of long-lived, low-volume products that we know we would build inventory on, so I think that you could expect to see that but we don't want to put infinite dollars into working capital. So -- and you want to set that operating plan so that if it's a shallow correction, you've got inventory positioned on the other side of it. And so that's probably the first and most important step.

The second is when you look at R&D, our investments are 3- and 5-year-type horizons. So in the short term, demand changes and fluctuations in the short term won't curb our enthusiasm for the opportunities that we see both in industrial and automotive.

The third thing on SG&A, there's places I think when things weaken that you can be prudent. You've seen us do those types of things in the past but there's also places that we're investing to strengthen our competitive advantages like in ti.com and in our demand creation, so we wouldn't change that.

And then the last one is the more interesting one and that's where other opportunities might present themselves. So whether that's assets that we can buy to strengthen 1 of our 4 competitive advantages in manufacturing and technology, those types of things can become available. That's what you saw us do in the '08-'09 downturn with purchasing assets. So somewhat of a long answer to that question but it was a good one. So thank you, Will. Do you have a follow on?

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

Great, robust answer. I appreciate it.

Operator

And we'll go next to Blayne Curtis with Barclays.

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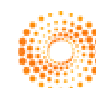

Blayne Peter Curtis - *Barclays PLC, Research Division - Director and Senior Research Analyst*

Just want to follow up. You've obviously been allocating more to dividends here. Just kind of curious, you talked about reasonable growth assumptions. Just your perspective, obviously, it was a knockout year in '17, and just kind of curious what you're thinking about growth in the market as you go forward.

Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

So let me give you my take on that, and Dave, if you want to chime in. But from a growth standpoint, I think your question is on revenue growth. You started asking about dividend but I think you're going on, yes, revenue growth. My answer is going to be long term. We view this long term, not on any particular quarter, or even any particular year. But longer term, we see our semiconductor business tied to global GDP. That's kind of the starting point and think of that over the long haul maybe around 3% or so, and semiconductor should grow faster than that. And then on top of that, now the markets where we're focused in, in industrial and automotive, those are outgrowing the overall semiconductor. So if you add 3 points GDP plus maybe 1 point on semiconductor, 1 to 2 on that and 1 to 2 on industrial and automotive, that gives you kind of the range of where we think the revenue growth over the long haul should be in the markets where we play, and for our Analog and Embedded business.

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Yes. And if I just added on that, Blayne. I think automotive, it's easier to drop into a spreadsheet and see that the growth first. You just go down to a showroom and you can viscerally see the electronics content going into a car and contrast that to 5 or 10 years ago. But if you look last year, there's probably $375, $400 of content in a typical car. I think most industry analysts will have that number doubling, some have it tripling, over the next 10 years. And usually the difference between those 2 forecasts are the rate of expectations of electric vehicles' takeup on that. And electric vehicles average $1,100 to $1,200 of content in a car. So if it doubles, that means we're looking at somewhere in the upper single digits of growth over that period of time. We're not really worried about whether it doubles or not or whether it triples or not. We just know that there's good growth there. So that'll drive that -- those investments.

The most exciting thing I think with industrial is you can imagine that type of growth. You can't drop it into a spreadsheet the same way but there is content growth going into a lot of things. We've got 14 sectors there and hundreds of end equipments. So that's what makes us so excited about those 2 markets.

Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

Let me just add to that because -- particularly on the industrial market, the really exciting thing is when you look at those end equipments, it's not a coincidence that they perfectly match the capabilities that we have in our portfolio. If you look at -- we have power management, we have sensing, we have signal chain, we have Embedded Processing, we have connectivity. And that talks to our -- the breadth of our portfolio, one of our competitive advantages. Then the other one is the diversity of the marketplace in terms of number of sectors and equipments and customers. Just highlight the importance of the channel reach advantage, which is another competitive advantage that we have. So the entire industrial market really plays well to how we have positioned Texas Instruments and the competitive advantages that we have to play in this environment.

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Okay. Blayne, do you have a follow-on?

Blayne Peter Curtis - *Barclays PLC, Research Division - Director and Senior Research Analyst*

Yes. Sorry, might have intermingled my 2 questions on -- because you had talked about the decision between dividends and buybacks and looking at the intrinsic value of the stock. Maybe if you could just talk on the dividend side, you gave this range of 40 to 60. You've been more at the lower

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end of that range. And I know you want to grow dividends. Can you just talk about the decision to allocate more to dividends than buy backs? And do you think -- do you expect to get more to the midpoint of that range?

Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

Let me step back a second. Our intent to return all free cash flow to the owners of the company, and we have been doing that for many years and we will continue to do that. Then the question is how we do that. And in fact, in 2017, 45% of the returns were dividends, so dividend as a percentage of free cash flow, and then buybacks were actually more, were 55-or-so percent because we returned $4.7 billion and free cash flow was $4.7 billion. So we returned everything. And that's our model. On the dividend side, we talk about, as we spelled out on the prepared remarks, we want to be between 40% and 60%. That's the range for a reason. We don't want to be tied to any particular end of that range. We do what makes sense. Now we think that, as we have said, our intent is to -- the dividend is to be sustainable, and it needs to be growing. We understand that being able to grow the dividend is important. But being in any particular end of that range, that just depends on various factors, one of which is the stock price. And we think the model is robust enough to allow us to both have a sustainable and growing dividend and take advantage of buybacks. And as we do both cases, the ultimate intent is to return all free cash flow to the owners of the company.

Operator

We'll go next to Ross Seymore with Deutsche Bank.

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

Just had a question on your free cash flow margin target update. You took the lower and the upper end up by 5 points. If the tax benefit is the primary reason why, and at least by next year, the tax benefit should be at least 10 points, is there a reason why you only increased the free cash flow margin by 5?

Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

Let me first maybe clarify something. We think -- we increased that margin primarily due to tax reform. If you do -- I'm going to let you do the math on the -- our ongoing tax rate had been 31%. In fact, it was 31% for 2017 and now we said that starting 2019, it will go to 18%. And actually in 2018, from a cash standpoint, it will be close to that 18% right away in 2018. If you do the math with that, you probably get about 5 percentage point increase on the margin, not 10. I just wanted to clarify that. But beyond that, remember, our ultimate objective here is to drive free cash flow growth. It's not a percent, right? We don't pay dividends with a percent, we don't buy back shares with a percent, we do it with dollars. So we just want to drive those dollars, free cash flow per share growth higher and higher over the long haul.

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

You have a follow-on, Ross?

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

Yes, just a quick one. I know you guys didn't talk about OpEx as a percentage of sales, and I assume you're going to keep the 20% to 30% range that you've long held. But within that OpEx number, last year was a good example of R&D going up. I think it was about 10% and SG&A coming down by about 4%. Can you just talk about how you approach OpEx, and more specifically, those 2 lines, any balance between them?

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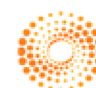

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Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

Yes. I think you asked a similar question there in the earnings call, but I'll go ahead and try to answer it. We're pleased with our level of OpEx. Our focus is to wisely allocate our money to the best opportunities and ultimately to drive higher free cash flow per share. Remember that is the ultimate objective. And then how we look at this is, it helps to look at it in absolute terms rather than percentages, right? So in 2017, for example, we spent $3.2 billion of OpEx. And I know you asked about the metrics in R&D and SG&A. We like to look at it combined because there are good things in both, in R&D and in SG&A, in terms of things that we're investing to strengthen our competitive advantages. By the way, that $3.2 billion increased 3% from 2016. So pretty reasonable and we will just continue to look at opportunities. If we have opportunities to invest more and drive higher free cash flow per share growth, we will do that. And if they're not, we will not invest more. So that's how we think about it. Now if you want to -- as a guide, if you want to look at OpEx as percent of revenue, and that is a helpful guide for some things, we ended the year at 21%. That's inside our range that we have talked about. In fact, it's towards the lower end of the range. Did that help or...?

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

Yes, it did.

Operator

We'll go to Stacy Rasgon with Bernstein Research.

Stacy Aaron Rasgon - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

I was wondering if you could comment a little bit on how you see the potential M&A landscape as it stands today viewed through the filter of your 2 criteria, both strategic fit and financial return. And also maybe if you could comment how maybe your -- like, the valuation of your stock currently might impact that second criteria.

Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

Yes. M&A is -- our criteria's the same, like I talked about. And so the criteria itself didn't change or hasn't changed. Valuations, up until last week, they had gone up significantly and they're still high compared to historical standards or compared to the last 2 years. So we have to take that into account. But frankly, as you saw earlier in the presentation, where we spend the bulk of our capital, where we allocate capital is on organic growth with things that is -- that's where a lot of the great opportunities are and have been. So we'll continue to focus on that. And if there is an M&A opportunity that makes sense, we'll consider that and we constantly see opportunities but very, very rarely do we pull the trigger. Dave, do you have a comment on that?

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Yes. I'll just add. I think as we look at the potential target strategically, National is just a great example of what we would look for. So an analog-based company that has catalog, high-quality catalog products that are finding very diverse places in the marketplace. And one way to measure that quality is by a higher gross margin, that's not the only way, there could be some structural problems or whatever, but we're not interested in finding commodity-based products as a contrast. We want to have a company that has product teams that are continuing to put out high-quality products. So we don't want to buy that asset for what they did 10 and 20 years ago. We want to be able to take that asset and have it continue to grow longer term. And then I think the other thing that we would want from a potential target is does it strengthen one of our 4 competitive advantages or does it take advantage of those 4 competitive advantages. So as you walk through that list and think of National, I think they fit that very nicely, and that's what we'd look for. So that's -- then you've got the financial piece that Rafael talked about that's layered on to that.

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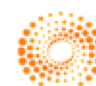

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Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

Yes. Let me comment on the second part of his question. Stacy, you asked about repurchases. So as I said earlier in the prepared remarks, the goal there is -- the objective is the accretive capture of future free cash flow for long-term owners. So we would look at our free cash flow, we make realistic projections of the growth of free cash flow for the next x number of years. And let me stress that they're realistic. They're not conservative, they're not aggressive, they're realistic. And then based on that, we've come up with a valuation. And as long as the stock price in the market is less than the valuation, we'll be buying back. As we said earlier, we bought back over $700 million worth of stock in fourth quarter.

The other thing that I'll point out is clearly tax reform was a good thing. As I talked in my prepared remarks, it's putting U.S.-headquartered companies in a better position to compete effectively. So we're obviously taking that into account as we make those realistic assumptions of where free cash flow can go.

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

You have a follow-on, Stacy?

Stacy Aaron Rasgon - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

I do. I wanted to ask a bit about the increase in the inventory targets. Is this increased consignment? Or is this owned inventory? And I guess, why are you doing this? Are you actually seeing issues with your service levels? Or is this just an opportunity to improve above and beyond where you were before?

Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

Sure. So it's both on the first part of your question, and let me step back and talk about the objective. So just to remind everybody in the call. So we want to maintain high levels of customer service, minimize inventory obsolescence, improve manufacturing utilization, and this will vary depending on various factors, and one of which is consigned inventory. But ultimately, we want to have control of the inventory. That just makes it more efficient for us to deploy. And that -- one good example of that is consigned inventory, where even though it could be at a customer's warehouse or at a distributor's warehouse, it's our inventory. So we can actually redeploy it or we can keep the inventory levels as we need them to support that particular customer versus just having it in the distribution channel, non-consignment, where it may not be as efficiently used.

Another way, as I mentioned during our earnings call, is to have buffers of low-volume inventory. That's another way where we can own and control the inventory and we can redeploy it or deploy it very effectively to ultimately drive higher free cash flow growth.

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

And I'll just add, as we think about allocating capital, working capital as a piece of that puzzle, there's strategic value in owning and controlling that inventory going forward. So that's why you see differences in what we do and what we're trying to do there perhaps versus others.

Operator

And we'll go next to C.J. Muse with Evercore.

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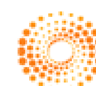

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Christopher James Muse - *Evercore ISI, Research Division - Senior MD, Head of Global Semiconductor Research & Senior Equity Research Analyst*

I guess, first question, in terms of CapEx, it was elevated in calendar '17 above that 4% target. And it sounded like, on the last call, that will stay elevated in calendar '18. Curious when you would expect to normalize and I guess more color around that 4% as being sustainable as you fill out your 300-millimeter factories.

Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

Yes. It all depends. It depends on many factors, one of which are expectations of revenue growth, of course. So we will see how that develops. I do want to emphasize, as Dave talked about earlier or during the prepared remarks, that if we see opportunities of adding assets opportunistically, manufacturing assets, 300-millimeter analog assets, we will do that, and that could drive that percent higher but then keeping in mind that over the long term, 4% is the right way to look at it in any given year. But any one of your those years, especially as we drive high revenue growth -- or the capacity to be able to handle high revenue growth, we will not be afraid of pulling the trigger and going higher than that percent. Do you have a follow-on, C.J.?

Christopher James Muse - *Evercore ISI, Research Division - Senior MD, Head of Global Semiconductor Research & Senior Equity Research Analyst*

Yes, Dave, a quick follow-up. In terms of taxes, you talked about GAAP. I guess, at 18%, curious what we should be thinking about long term for cash tax rate.

Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

So let me clarify. The 18% is cash and GAAP, it's both for 2019 and beyond. For 2018, the GAAP rate is 23%, but on a cash basis, we'll be very close to that 18%. So on a cash basis, you can think of 18% and that's the operating tax rate. That's the ongoing one. That does not include discrete items. And as you have seen over the last few years, we've been getting a benefit. In fact, for 2018, what we're projecting and we have on the website is about a 1 point benefit. So whatever GAAP or tax rate you want to use following our guidance for 2018, subtract about 1 point to get to the all-in effective tax rate.

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Yes. And those that didn't hear, we put a lot of detail on that, just as a reminder, in our fourth quarter call. We also have that information on our website by quarter because we're expecting about $55 million in discrete items and it will vary by quarter fairly significantly.

Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

And let me just clarify 2 points. One is a lot of companies are reporting this and you may be hearing all kinds of numbers. Just remember that we report GAAP. Many companies out there, they also report GAAP, of course, but they focus on non-GAAP, so that could be a little confusing. And also, that the percentages that I told you, or the headline numbers that I told you about, are operating, so they're ongoing, not the all-in. As I said, the all-in, you would have to subtract about 1 point. Many companies talk about the all-in and only that one. The other one is, stepping back, what is the big deal about tax reform is that we are now on a -- much better able to compete effectively on a global basis. So that is a really good thing and that will enable us to be that much stronger going forward.

Operator

We'll go next to Mark Lipacis with Jefferies.

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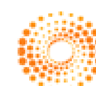

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Mark John Lipacis - *Jefferies LLC, Research Division - Senior Equity Research Analyst*

It seems an important driver of the free cash flow margin growth has been the expansion in gross margins, which have increased by about 1,200 basis points over the last 4 years. And one of the ways that we try to determine if that is going to continue is look at the incremental gross margins. You've characterized your gross margin fall-through around 70% to 75%, but this year, it was -- the incremental gross margin was 87%. So I just wondered if you could help us understand what were the drivers of that incremental gross margin above your normal, what you would characterize your normal fall-through? Is it mix? Is it 300-millimeter? Is it less pricing pressure? And is it -- because that gross margin fall-through of 70% to 75% looks a little -- looks a bit conservative at least after this year.

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Sure, Mark. I'll go ahead and start off on that. I think that we've talked about 70% to 75%. And I think with that, and with any of the other targets and objectives, what we're focused on is growing the free cash flow per share over a long period of time. And so the 70%, 75% is just a guideline. Now it could be above that, it could be below that. In any given period, sure. It's a lot easier to look at it when it's above it, but both sides of that coin are certainly possible. But our focus is really just growing free cash flow per share over a long period of time.

Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

I'll just add that there were several factors that have contributed to that increase over the years, but probably the most important one, consequential one over the long term, especially on a go-forward basis, is the 300-millimeter factories that we have. That is a unique competitive advantage, right. We're the only one in the space that have around 300-millimeter factories. As I talked during the prepared remarks, why is that a big deal? Because it gives us the structural cost advantage. We have a 40% advantage versus 200-millimeter, and we can deploy that in any number of ways.

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Do you have a follow-on, Mark?

Mark John Lipacis - *Jefferies LLC, Research Division - Senior Equity Research Analyst*

Yes. And I guess most people believe the -- if you look at your vertical market distribution, that the profitability of the industrial and automotive markets would be higher than the other ones. Would you be so kind as to confirm that? And can you characterize that or quantify that in any sense with a range? Are these markets 500 bps better? Or like, how should investors think about those particular vertical markets when we think about mix?

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Sure, Mark. I'll start off on that one. I think we like those markets for multiple reasons, and we don't want to quantify the margins by market or by customers or any of those types of cuts, but I'll tell you why we like them, is the diversity of those markets. So inside of industrial, we've got 14 different sectors and hundreds of customers that sit inside of that. Even inside of automotive, you think of the diversity that we've got there. So we've got 5 sectors so we could cut it by that. We're seeing good growth out of all 5 of those sectors, but you could cut it by technology, by product level, by region of the world. Lots of different cuts to be able to show that diversity. We have hundreds of customers that even inside of automotive that we're shipping to that represent Tier 1s and Tier 2s. And the fact that these products tend to live a long time, that provides lots of benefits, right? That when you have a product that can live 5 years or 10, sometimes 20 or 30 years, the financial returns on those products are very, very high. So all those things combined are the reasons why we like those markets.

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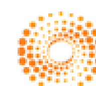

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Operator

We'll go next to John Pitzer with Credit Suisse.

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

Rafael, in the past, as you've looked at profitability between your Analog and Embedded Processing businesses on the operating line, you've kind of mentioned that there's really no reason over the longer term why Embedded Processing margins can't approximate Analog. And if you look at the last quarter, there's still probably 12 to 13 percentage points gap between the two. I guess my question is, is that still a valid statement? And as you think about closing that gap, is it a function of Embedded finally starting to look like Analog? Or would you expect maybe with higher levels of investment, that Analog might come down as you close that gap?

Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

Yes, I'll get it started, and Dave if wants to chime in. But let me just remind everybody the objective is to grow free cash flow per share and nothing else. It's not any particular margin. So while Embedded has increased their margins a little faster than Analog's, so they're looking like they're catching up, that's not the objective, right? The objective is free cash flow per share growth, and Embedded has been and continues to be and we expect it going forward to continue to be a great contributor to that.

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Yes. And I'll add, John, I think by way of demonstration, if we go back to 2010, if you look at the operating margins of Embedded, we were running in the mid-20s from an operating margin standpoint. And at that point, we decided to significantly increase our investments in that business, and we wanted to repurpose application processors and connectivity products so that we could use them in both automotive and industrial, and there's a quarter transition there that you can see how those investments impacted operating profits. So we're not running around with an objective to optimize that. We made that decision so that we could build over time a high-quality business that has diverse products, diverse markets and will contribute to that free cash flow growth over a long period of time.

So you've seen us take decisions like that, that will play out over a long period of time, and again, it's really that focus back on growing free cash flow per share. Do you have a follow-on, John?

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

This is my follow-on. When you guys look at your kind of your core Analog and Embedded Processing markets, you've consistently grown share at a measured pace every year. And I'm kind of curious just relative to the investments you're making, the end markets you're investing in, your 300-millimeter strategy and sort of what you're doing around inventory and your inventory strategy, should we expect or do you expect that the historic share gains you've seen should accelerate from here? And again -- I guess the real question is relative to outsized growth to the market, how important is that relative to growing your free cash flow per share?

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Well, yes, I'll start off and if Rafael wants to add anything. But it's importance -- revenue growth and share gains, we believe, are important long term to growing free cash flow. They're important component of it and the great news is that we'll have 3 contributors to it. But long term, investing in our 4 competitive advantages, whether that's manufacturing and technology, if I just take that one for an example, we spent some time going through the 300-millimeter example of that competitive advantage, but the other is we own those assets. And over time, the control of those assets, the ability to improve the technology differentiation over time through that ownership as the years go by, that will make a very significant difference in the types of products and the differentiation of those products over time.

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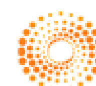

So other investments in channel advantages, the investments in ti.com, making it easier for engineers to find our products and when they find those products, to be able to have the opportunity to recommend and sell other products to them is very, very important. So I think those types of activities, John, it's not something that we can drop into a spreadsheet and say, "We'll see an inflection point." But would we like it to be higher? Absolutely. But I think if we just continue to make those investments over time, we're going to like those results.

Operator

We'll go next to Harlan Sur with JPMorgan.

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

As a follow-on to the prior Embedded question, as you think about this segment and the overall goal of driving free cash flow per share, how is the team allocating R&D to Embedded versus Analog? And is the op margin expansion in Embedded more a function of a revenue growth and leverage going forward or are there other initiatives you're focused on to continue to drive margins higher?

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Yes, Harlan, I'll start off with that. I think when we allocate R&D, you can think of it as 3 major buckets.

The biggest bucket that we've got goes to product development. So inside of Embedded, just like inside of Analog, our structure across the company, we have around 70 or so product lines, and each product line manager will have design resources, product engineering teams, marketing teams, application engineering teams and operations. So basically, everything that you need to run a business, we measure that at a full P&L at those levels. And those product line managers will have, at any given time, a number of products in development and then a backlog. And as we judge those -- that backlog and starting new projects and a number of projects that, that product line manager starts, we look at the quality of that opportunity. So how many customers do we expect them to use, how many markets, how many sectors, how long will that product be in the marketplace, what's the differentiation of that product, and how long will we have it. So those are more qualitative judgments that our product line managers and the business unit managers and then the senior managers that make all of those judgment calls, and we're constantly trying to find the best places where to allocate that R&D. If you sit through those reviews and you walk out and say, "Hey, we're leaving on the table more opportunities than we can get to," that's when you actually take up the amount of spend that we would allocate in that bucket.

The other 2 buckets, real quickly, the second one is a centralized R&D function that's kind of the-- that the teams have put together, the tools that the engineers used, whether that's SPICE models and the development backplanes, those types of things, the good news with that is if we had 7 product lines or 70, our investments there are really -- would be the same. So we get some leverage off of that just because of the scale we have.

And then lastly, is over-the-horizon investments. And we do that in what we call Kilby Labs, named after Jack Kilby, the TI employee who invented the integrated circuit. And so some examples of that in Analog is our gallium nitride products. In Embedded, it is our millimeter wavelength products that have come. Multiple years of investments, a high degree of differentiation in products and certainly things that will contribute to free cash flow.

So that's how we think about allocating R&D across the board and specifically in Embedded. Do you have a follow-on, Harlan?

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

Yes. So the team always thinks longer term. So assuming a normalized demand environment and above-market growth for the team, you'll probably start to get to kind of max capacity on your 300-millimeter assets in about 5 to 7 years. How are you guys thinking about 300-millimeter capacity expansion to support the continued margin expansion? Do you guys have land to expand the area footprint for DMOS6 and RFAB?

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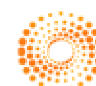

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Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

Good question, Harlan, and we'll finish with this question. Let me tell you how we're thinking about 300-millimeter capacity, and we just gave you all the numbers that you need to do the math you mentioned, right? The how much of our 300 we're currently using, how much is left, our Analog business. So as you project that growth forward, you can figure out how we continue to fill that capacity. So -- and we are looking at adding additional because, obviously, we want to continue to support the long-term growth of revenue and free cash flow.

So the preferred option would be to buy a used facility and we've done that before in multiple places. And the reason that's a preferred option is, one, it would be immediately available; two, generally, we can get that at a good price when you're buying a used facility that somebody else doesn't want and it would be, come fully equipped. So when you buy a used facility that's generally a running factory. So it already has a lot of equipment, not everything that we need but a lot of what we need.

Now that is not the only option. The other option is for us to build a new facility. Keep in mind, the cost of the building itself of a new facility, relatively low compared to the overall cost once you include equipment, but we could build a new facility, an actual shell, a building and then we fill it with the equipment and that equipment would be mostly used, not all, but mostly used. So we're looking at both of those options and have been and depending on various factors, obviously, demand growth being a big one, we then decide when it makes sense to pull the trigger on either one of those options. Dave, do you want to comment?

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

I think that's good. We'd like to wrap this up.

Rafael R. Lizardi - *Texas Instruments Incorporated - CFO, CAO & Senior VP*

Yes. So I want to -- just to finish off, I want to thank all of you for taking time today to going through our capital management strategy. Let me just emphasize a few points. We remain focused on consistent execution of our capital management strategy as we have done for many, many years. Our disciplined allocation of R&D is delivering growth from the best products, analog and embedded, and the best markets, industrial and automotive. We have great diversity across all the sectors within this market. And 300-millimeter manufacturing advantage, as we talked about during the call, is a unique advantage and will continue to benefit TI for a long time to come. We remain committed to returning all free cash flow to the owners of the company. Dave?

Dave Pahl - *Texas Instruments Incorporated - Head of IR and VP*

Okay. Thank you all for joining us. A replay of this call will be available on our website as well as the slides we used today. Good day.

Operator

This does conclude today's conference. We thank you for your participation. You may now disconnect.

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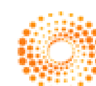

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