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Analog Devices: Growth at a Reasonable Price

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Investors in the semiconductor company get a cheaply priced dividend stock that's exposed to a high-growth market.

If you judge a company by its name alone, semiconductor maker Analog Devices doesn't appear to be a cutting-edge tech play.

Analog? This is a digital world. Devices? Technology these days often exists in the ephemeral world of the Internet.

And unlike classic tech companies which tend to hoard cash for research and development, **Analog Devices** (ticker: ADI) pays the dividend of a more traditional nontech company: 2.5% currently. The company is sitting on a whopping pile of cash: $2.7 billion, more than $8 a share. And it's buying back about a $1 billion worth of stock, another way to reward shareholders.

At a Glance

Analog Devices (ADI)

Stock Price:	$37.89
52-Week High:	$38.32
52-Week Low:	$26.28
Market Cap:	$11 billion
Est. FY 2011 EPS:*	$ 2.64 per share
FY 2011 P/E:	14 times
Est. Long-Term EPS Growth:**	12%
Est. (FY'11/10) EPS Growth:	12%
Revenue (trailing 12 months):	$2.8 billion
Dividend Yield:	2.50%
CEO:	Jerald Fishman
Headquarters:	Norwood, Mass.

* Company's 2011 fiscal year ends Oct. 30.
** Based on analyst estimates looking ahead three to five years.
Sources: Thomson Reuters

But any investor who peels back the onion will see just how advanced this company really is. Certainly, its stock price, like a lot of tech stocks, has gone up nicely this year – it's up 25% year-to-date. And analysts think that it's bound to go higher.

Projections range for a 12-month target of $44 to $49 a share, which would take prices 22% to 36% above the current $38 a share.

"Analog Devices is a cheap stock with strong profits in a growing sector," says David Trainer, president of research firm New Constructs.

There's been some hesitation about Analog Devices in the wake of the guidance tied to its fiscal fourth-quarter earnings report, issued Nov. 22.

The quarter itself proved stellar: Earnings came in three cents above consensus estimates at 73 cents a share, and revenue increased 37% year-over-year – and 7% for sequential quarters – thanks to higher sales of its analog products.

However, the guidance proved a little hesitant. Analog Devices sees current-quarter revenue sliding 4% to 7%. This stretch of the calendar is generally weaker, owing to the company's exposure to the consumer market. But the expected seasonal downturn would be closer to 2% on a quarter-over-quarter basis.

That's led to some expectations that Analog Devices is going to have to cut back on production, which could hit margins, something that the company itself suggested in its guidance. Its book-to-bill – basically a measure of the orders that come in compared with the orders that go out – is expected to slip below a measure of 1.

Still, the hit to margins looks minimal: Gross margins are expected to "plunge" all the way to 65% in the current quarter, after creeping up to 67% in the previous quarter.

The analog semiconductors that Analog Devices makes are used to process real-world signals such as sound, temperature and pressure, and convert those into digital signals.

When you talk into a phone, an analog chip in the base station of the device amplifies your voice. All the fancy gadgets in your automobile, from electronic windows to the feature that chirps when a driver backs up, are powered by analog processors.

However Analog Devices' technology is rarely found in computers, which is its area of weakness. Just 2% of its sales go into the computer channel.

Instead, it's heavily exposed to the industrial channel, which accounts for 45% of sales. The automotive market represented 12% of sales. Those jumped 12% in the fourth quarter versus the third, and are up 34% over last year. Its other big market is communications – making chips for the base stations of wireless phones – which is 23% of its business and grew 19% over the third quarter.

"Potentially improving industrial and continued upside strength in communications could potentially drive upside," says Vijay Rakesh, a chip-sector analyst at Sterne Agee & Leach.

Even with the company's somewhat-cautious guidance last month, several analysts have boosted their earnings estimates for fiscal 2011. Rakesh, who this week upped his rating on the stock to a buy, took his estimate to $2.71 a share from $2.64. He also established a 2012 per-share estimate of $3.25.

For 20% profit growth, investors are paying less than 14 times forward-year earnings, for a growth company sitting on a pile of cash, and paying a solid dividend.

Granted, there could be a period of traditional seasonal weakness, given the company's exposure to the industrial and automotive businesses. Its consumer market – its chips are used on a variety of household electronics, such as televisions and game systems – has shown some weakness.

But investors also need to realize that this isn't the boom-and-bust business that used to characterize the chip industry.

"The chip industry is more closely aligned with consumption," says Craig Berger, semiconductor analyst at FBR Capital Markets. "Consumption is now driven by demand, not by supply."

That means manufacturers aren't building big inventories, something that inevitably leads to down cycles for suppliers, such as chip makers.

So while there could be a short-term dip in sales, analysts insist that growth will resume by the beginning of the second quarter of the calendar year.

"Analog Devices could benefit from broad-based communications and industrial demand in 2011-2012," Rakesh says. "We believe potential catalysts are lining up with a conservative guidance and significant share repurchases."

Full Disclosure

Sterne Agee & Leach rates Analog Devices a Buy. The firm has received compensation for investment banking activities from the company in the last 12 months.

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