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MU: Raising price target

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We are raising MU price target to $80 from $60 based on four ideas: 1) Street's expectations for above-normal growth in ***accelerated computing*** *provides upside to MU's long-term revenue CAGR, 2) our view that China* ***CAC restriction is narrower*** *than Street's expectation; restrictions in the domestic critical infrastructure space may be limited to SSDs and may not include restrictions on DRAM modules, 3) we think* ***macro winds*** *are turning in favor of cyclical names, such as MU, as fears of imminent recession seem to abate and 4) thanks to aggressive supply cuts,* ***spot pricing*** *in the secondary market appear to finally stabilize; the volume of transactions too appears to pick up.*

We necessarily must take a long-term view of earnings potential given the severity of the current downturn and the meagerness of estimated earnings. MU management provided forward-looking revenue CAGR outlook in the high single digit, inline with its trailing 3-year CAGR performance. Based off consensus revenue estimate for FY24 of $21.4bn and revenue CAGR of high single digit, we derive FY27 earnings estimate of $27.8bn/$6.10.

We expect upside to management's CAGR outlook as it may not have fully folded in the opportunity in accelerated computing. If NVDA's extraordinarily positive near-term outlook is anything to go by, we will not be surprised if MU management raises its CAGR outlook at the next earnings call. As such we think it is justified to give an above-historical multiple to our CY27 EPS estimate. At a 15x multiple to CY27 eps, discounted at 5% back to 2024, we derive a ***one-year price target of $80****.*

Our target may seem modest compared to some of the more heroic expectations on the Street, but we would rather wait to see how the Gen AI revolution unfolds in providing a boost to near-term earnings. Even as the Gen AI enthusiasm reaches fever pitch, we caution investors that the extraordinary results at NVDA could be more due to its pricing power and less due to absolute volume of server shipment. Large-scale roll-out of accelerated AI into major data centers we feel is a year away.

China CAC restrictions on MU may be limited to SSDs: At a recent investor conference, the MU CFO said he was unaware of the specifics of the CAC restrictions. He provided a wide range for revenue impact, low to high single digit; impact could start as early as in the Aug quarter

While we wait for clarity from official sources, we take an educated view as to the potential specifics. We think it likely MU's DRAM business is **not** impacted by the CAC restrictions. Rather, the restrictions may apply mostly to MU's storage business, specifically, the SSDs attached to domestic servers and telco appliances. As such, we would narrow revenue impact to the low end of range the CFO provided. If we are correct in our view, **annual exposure we think is likely no more than a few hundred million dollars**.

Could the CAC restrictions be a negotiating ploy? If we are right in our view, the impact to MU would not be too onerous. If the punitive effect on MU is minimal, then why restrict at all? We think it possible that the CAC restrictions released over the weekend is in some way connected to the high-level meeting scheduled to take place between the Commerce chiefs of US and China. As such we think the CAC announcement could merely be a trade negotiation ploy and not necessarily a harbinger of further restrictions on either MU or other US semi companies.

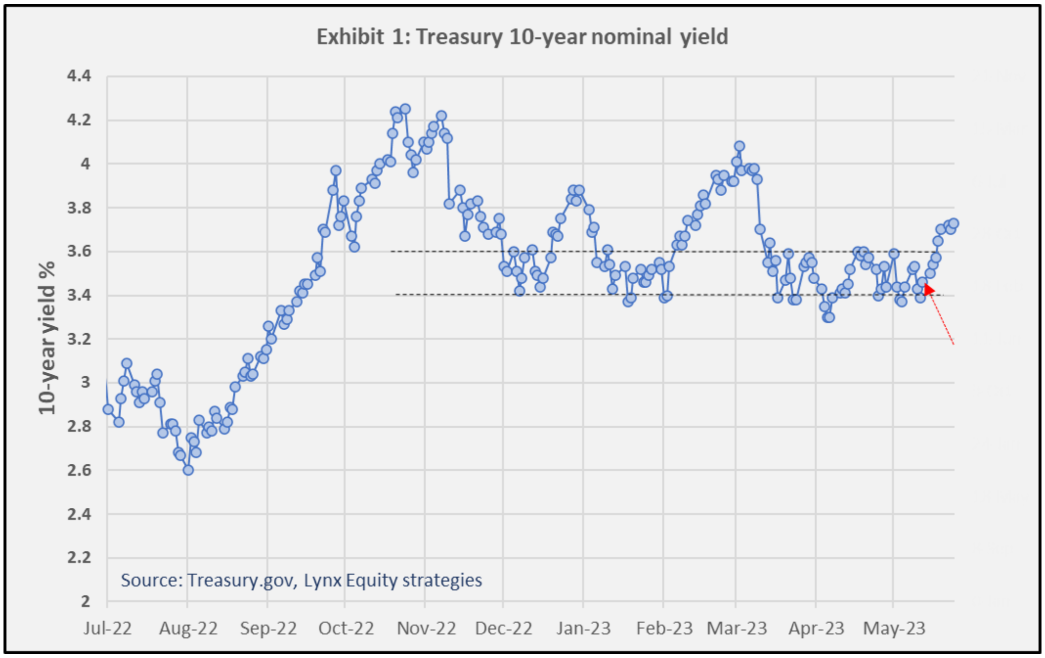
Rather than further escalate of the ongoing tit-for-tat policies emanating from the US and China, we are hoping that the meeting between the Commerce chiefs of the US and China scheduled for today, the first of its kind in a very long time, acts as a catalyst for allowing cooler heads to prevail. We are hoping for some clarity to emerge with regards to impact to MU. If so, the outcome could be positive for MU and for the semis/semicaps in general.

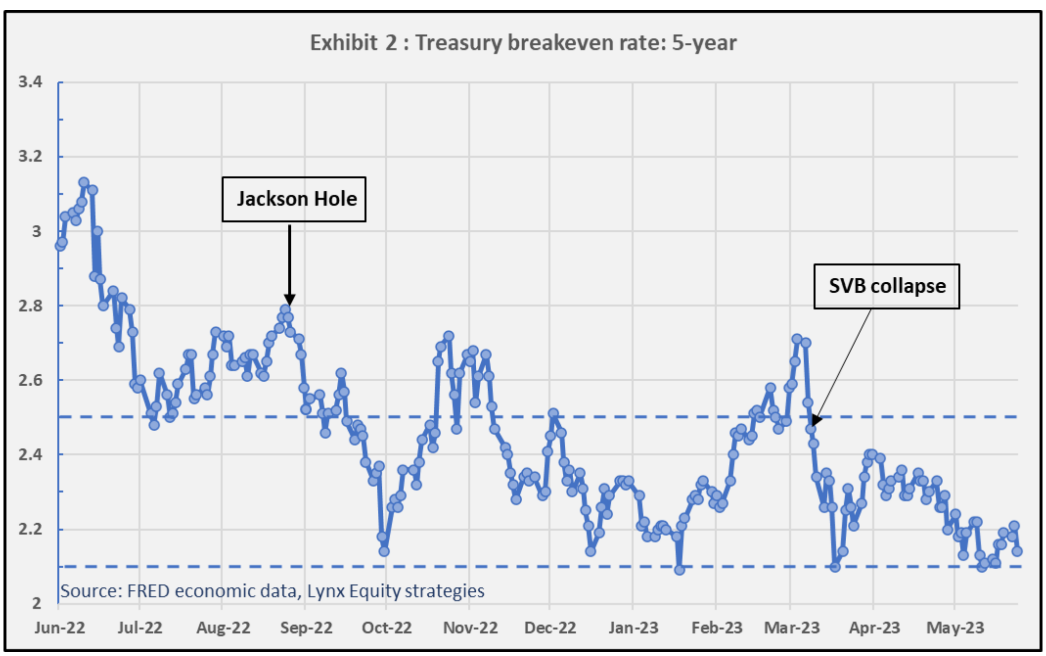
Stabilization of DRAM prices in the secondary market is a positive for the stock: A month after drastic cutback in supply at Samsung, spot prices in the secondary market have finally begun to stabilize. The volume of transactions too has begun to improve. We note that spot pricing of 32GB server modules in the secondary market is down by ~50% from year-ago and ~65% from the peak set early last year. A year ago, we were among the first to call an abrupt decline in memory demand from data center spending (link). The memory market has a long road to recovery. While demand for DRAM from data centers and PCs is yet to recover, **we think inventory in the secondary market appears to have normalized**.

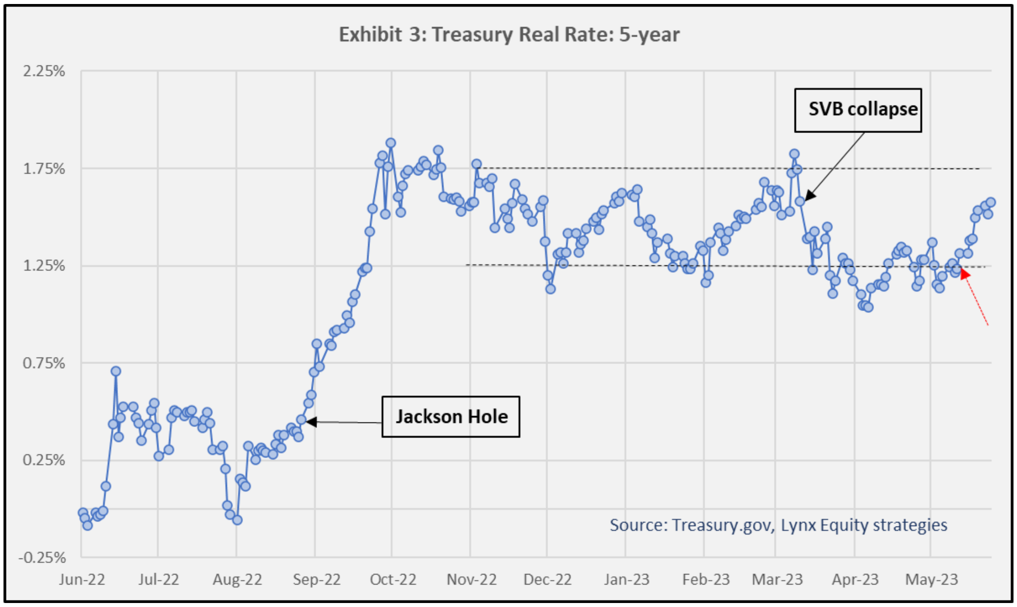
Improving macro indicators are positive for cyclical stocks including MU: We detect a surprising change in economic expectations in recent weeks. GDP estimates, long-term inflation expectation and the 10-year yield, instead of indicating imminent recession, seem to show surprisingly resilience in the US economy. Some of the indicators are

- The Atlanta Fed raised their Q2 estimates for GDPNow from 1.7% at the end of April to nearly 3% by mid-May. A 3% economy does not signal a recession in the near-term.
- Treasury 10-year Nominal yield, after nearly two months of relatively stability, broke out of range last week (Exhibit 1)
- While in recent quarters, a rising 10-year yield had been indicative of rising inflation expectation, this time around though, inflation expectation for the medium term remains firmly grounded. Exhibit 2 is a chart of 5-year Breakeven Rate. It shows recent data firmly settled at the bottom end of range at ~2.1%. In the past the Fed had considered this level as indicative of low inflation expectations.
- Rising nominal 10-year yield and stable Breakeven rate imply rising Real Rate. Exhibit 3 shows a sharp breakout to the upside (red arrow) in recent days, after nearly 2 months of a stable pattern. In the absence of a dramatic change in the restrictive stance in Fed's monetary policy in recent days that could push up Real Rates, the rising 5-year Real Rate we believe implies organic underlying strength in the economy.
- Fed officials in recent days appear increasingly willing to consider further rate hikes vs. previous expectation that the May hike was the last one. This willingness implies the emerging view at the Fed that the economy is resilient enough to handle more rate hikes without spiraling into a hard landing. The Fed would hardly be willing to take this view if it felt a recession was imminent.

- **Net/Net**: If the odds of recession this year fades, cyclical names come back into vogue at the expense of the handful of secular names that have come to dominate stock market gains this year. If such a rotation were to occur, cyclical semi names such as MU could benefit.







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