Company update Nov 18, 2024

SMCI: Not for the faint of heart

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An article published in Barrons after-market close on the 15th quotes an unnamed source stating SMCI could be submitting a plan today to NASDAQ regarding the filing of its 2024 10-K. This should not come as a surprise since the CFO had said as much during the recent earnings call (submit a plan and ask for an extension). We note that as of this writing, we are not aware of a formal announcement from SMCI regarding submitting a plan.

SMCI's delisting could lead to its loss of access to capital, which could then negatively impact timely delivery of NVDA's ambitious plans. We think SMCI's unique position in the crucial AI industry goes to SMCI's advantage in remaining listed.

This note is not about the timing of regulatory filings. Rather, we focus on clearing up Street misconception regarding the competitive landscape. We do not believe liquid cooling technology is commoditized. We do not believe server vendors are fungible. We take the contrarian view that regardless of its regulatory woes, SMCI maintains its leadership in the AI infrastructure market for liquid-cooled AI server racks at scale. We doubt if any other vendor is on par with SMCI's proven capability.

With the delisting possibility likely priced in, it is not unreasonable to expect the shorts who followed the recommendation of the short-seller report on 8/27 to cover positions. At current level, we think the stock is trading at a deep discount. We expect management to cut out low margin customers and prioritize allocation of limited financial resources to higher margin customers. We are reducing our FY25 expectations well below consensus to $21.7bn/$2.93 vs consensus of $25bn/$3.15. We assume revenue growth of 45% vs. consensus of 68%, GM of 14% vs. consensus 12.9% and OM of 10% vs. consensus 9.2%.

We have faith in the competitive position of the company's DLC technology. Given its centrality in the AI infrastructure market, we think it is likely that the regulatory authorities will give the company the benefit of the doubt and allow it to remain listed. This could then re-open access to credit markets and enable financing of Hopper and Blackwell platforms. The stock is not for the faint of heart. We think the stock may be a couple of headlines away from a rapid reversal. At a trough multiple of 15x we derive a PT of $45.

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Our view: SMCI has a competitive leadership position in the rapidly expanding liquid-cooled GPU server data center market, a position it is unlikely to give up any time soon. To our knowledge, there is only one new entrant. Foxconn is the ODM lined for the upcoming AWS Blackwell server farm. We believe the delivery of the 20K GPU data center is scheduled to be completed in the next couple of months. The reliability of the Foxconn system is yet to be demonstrated, the site is still in construction. On the other hand, SMCI has already had experience designing, manufacturing, delivering and setting up massive sever farms, each with as many as 100K GPUs.

Until the AWS/Foxconn data center is set up and brought online, SMCI has **100% market share** for liquid cooled AI GPU server farms **in the US**. At the June earnings call, SMCI management estimated its worldwide share of liquid cooled GPU data centers may be as high as 70%-80%. We believe xAI and META have been key SCMI customers of its DLC technology.

Why does SMCI have leadership position? We believe, among its ODM/OEM peers, SMCI has had longer experience with design and manufacture of liquid cooled systems at scale. We think SMCI activity in this area started with its association with **Google** a few years ago. Google has been using liquid cooling for its CPU server data centers for a few years, quite some time before the NVDA GPU market opened. We believe SMCI built its knowledgebase working with Google.

We believe SMCI worked with NVDA for **over a year** before rolling out liquid-cooled H100 in the June quarter. We think NVDA's association with Foxconn is of more recent vintage. Also, Foxconn has had no prior experience with liquid-cooled servers, either GPU or CPU based. The reliability of Foxconn systems at data center scale is yet to be proven.

How about DELL? There is a growing coterie of investors who believe that the regulatory woes at SMCI may incentivize data center customers to abandon SMCI and run to DELL. Historically speaking, DELL has outsourced design and manufacturing of servers to Taiwan ODMs. In case of GPU servers, we believe DELL's preferred ODM is **Quanta**. And indeed, we do see a sudden uptick in Quanta's monthly output.

For the month of October, Quanta reported ~$4bn in shipment vs. average monthly run rate of ~$2bn. We think the m/m increase in October may well be H100 shipment.

However, here is the problem with the investor thesis – Quanta does not have an internal design solution for liquid cooled systems. Quanta mainly does **air-cooled systems**. Our checks show Quanta has started working with a Taiwan-based component supplier for cooling solutions. However, the component supplier too is on a learning curve. We believe it may be 3-4 quarters before Quanta has a shot at delivering scalable cooling solution.

DELL recently made an announcement regarding shipping liquid-cooled GB200 to Coreweave. But we suspect this may be just a few test racks as opposed to an entire data center with 20+K GPUs. We do not expect DELL to threaten SMCI's liquid cooling technology leadership any time soon.

HPE? The company recently announced a liquid-cooling solution, but no customers. We believe HPE, in contrast to DELL, has had internal technology for liquid cooled server systems, perhaps even before SMCI. But for reasons we do not quite understand, the company may not have put resources into the technology, until recently. HPE too, we do not think it is likely to threaten SCMI any time soon.

The underlying problem: We believe that the fragmented development of the liquid cooled technology in the industry may find its roots in NVDA not having taken the leadership in developing precise engineering design and then rolling out a standardized design to its ODM/OEM partners. The ODM/OEM hardware vendors end up having to design internal proprietary solutions. And this leads to fragmentation.

Maintaining the temperature stability of hundreds of server racks each rack running up to72 GPUs, each GPU consuming 1+kilowatt of power is an enormous engineering challenge. When seen at the scale of a data center, the plumbing and water chilling challenges are severe and may not have been appreciated by the supply chain until recently.

SMCI- relation with NVDA:

- In the still-evolving industry of delivering cooling solutions at scale, the first-mover advantage SMCI has had over its peers could sustain.
- Contrary to media reports and Street views, we think NVDA is not likely to abandon support of SMCI and turn to other server vendors, simply because in our view that is not in NVDA's interest.
- The delays associated with bringing new server vendors up to speed, and without the active participation of SMCI, could have a material impact on NVDA's pace of fulfilling customer demand at the hyperscale CSPs.
- Therefore, we think it is in NVDA's interest to work with credit providers and keep open access of capital to SMCI.

Regulatory

- It is in the interest of the AI industry to preserve SMCI and help keep open its access to capital.
- And this means the regulatory agencies may need to give SMCI the benefit of the doubt and grant an extension to the filing deadline.
- Whatever may be the reason(s) behind the resignation of the previous auditor, renewed commitment of credit by bankers to SMCI may provide an incentive for a successor audit firm.

Net/Net: The stock is not for the faint of heart.

- Unrelated to its regulatory woes, SMCI has solid technology leadership and competitive positioning that makes the company a vital player in the rapidly evolving market for liquid cooled AI server data centers. The engineering challenges associated with the design, manufacture, installation and maintenance of hundreds of racks with power consumption running into the megawatts are enormous
- However, we think the company needs to reset its growth ambitions to more realistic levels. Growing at 100% rate is simply not sustainable, in our view. Excess growth rate leads to margin dilution and inventory bloat
- We are looking at a more modest 45% revenue growth in Fy25. We estimate EPS a tad below $3. At trough multiple of 15x we derive PT of $45.
- If the Foxconn solution at AWS can be validated, it could offer credible competition to the rest of the industry including SMCI, for the simple reason that Foxconn has a bigger balance sheet. It will be months before the AWS data center will be validated.

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