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Value Investor INSIGHT

The Leading Authority on Value Investing

Dealing with Success

It's a high-rent and rare problem to have to figure out how best to manage a position in a stock that explodes upward. Here's how two managers have tried to do that successfully over the past year with stakes in Super Micro Computer.

Before it had become a well-known equity market phenomenon, two investors last year in *Value Investor Insight* described their enthusiasm for the shares of server manufacturer Super Micro Computer [SMCI]. In the first instance [*VII*, April 30, 2023], Crescent Rock Capital's Chris Campbell spoke of the company's accelerated growth, apparent resolution of previous accounting and corporate-governance controversies, and increasingly in-demand ability to "tailor-make better solutions for fast-growing applications like artificial intelligence."

In the second instance [*VII*, September 30, 2023], John Barr of Needham Funds described having first bought Super Micro shares in 2009 not long after its initial public offering and lauded its long-lived persistence in carving out a viable position in customizable servers for data centers, "including those used to run large artificial intelligence models." In April, Super Micro shares traded at just over $105, 10x trailing earnings. By September, they were at $275, less than 17x estimated forward earnings.

You might say those turned out to be two pretty good calls. Ignited by customer demand for its AI-enabling servers and by investor enthusiasm for anything related to AI, Super Micro's share price took off earlier this year, increasing from $284 at the beginning of the year to nearly $1,230 in March. They've fluctuated significantly since – the share price, for example, fell 23% on April 19th when the company announced a date for the March quarter earnings release without concurrently pre-announcing favorable results – and closed recently at around $890.

While it's a high-rent and quite rare problem to have, it isn't at all easy to own and manage a position like this when it goes through the roof. That prompted us to check in recently with Crescent Rock's Michael Marone and Needham's Barr for a fresh look at Super Micro and their handling of their positions in it.

Crescent Rock first started looking into

INVESTMENT SNAPSHOT

Super Micro Computer
(Nasdaq: SMCI)

Business: Develops and manufactures high-performance customizable servers and storage solutions recently highly popular for use in artificial intelligence-related applications.

Share Information (@4/29/24):

Price	**890.35**
52-Week Range	101.71 – 1,229.00
Dividend Yield	0.0%
Market Cap	$52.13 billion

Financials (TTM):

Revenue	$9.25 billion
Operating Profit Margin	10.1%
Net Profit Margin	7.9%

Valuation Metrics
(@4/29/24):

	SMCI	S&P 500
P/E (TTM)	69.4	22.6
Forward P/E (Est.)	32.9	20.8

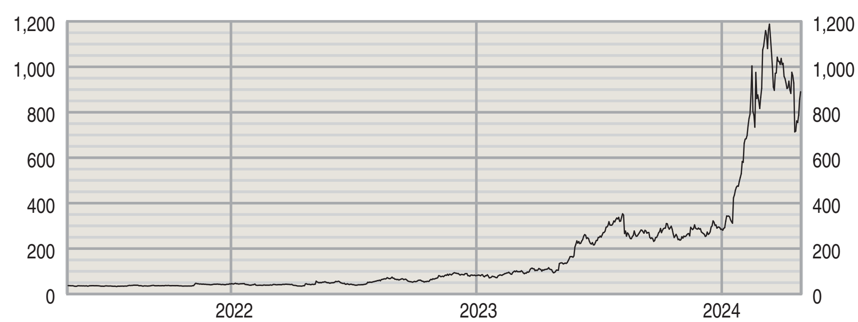
Largest Institutional Owners
(@12/31/23 or latest filing):

Company	% Owned
BlackRock	10.9%
Vanguard Group	10.6%
Disciplined Growth Inv	4.7%
State Street	3.1%
Jane Street Group	1.9%

Short Interest (as of 4/15/24):

Shares Short/Float	5.8%

SMCI PRICE HISTORY



THE BOTTOM LINE

Having made multiples of his original investment on the company's stock, Michael Marone sold out of it in this year's first quarter as the shares "went parabolic." John Barr says that though exceedingly rare, this type of situation is exactly what he aspires for: "I just hope to be prepared to reap as much of the benefit as possible when it happens."

Sources: S&P Capital IQ, company reports, other publicly available information

SMCI in the fourth quarter of 2022 – ironically, initially as a short – and took a long position in the stock in early 2023, says Marone. As AI enthusiasm built in earnest last summer, the shares tripled from the firm's average cost and "risk management entered the equation," he says. Re-underwriting the investment and concluding the fundamental improvement in the business hadn't kept up with the stock appreciation, Crescent Rock trimmed its position heavily.

It didn't exit, however, and as SMCI's quarterly results improved, the expected risk/reward on the stock improved enough – based on much better expected results and the assumption of a higher-than-historical valuation multiple being placed on those results – for Crescent Rock to rebuild a mid-sized position in SMCI by the fourth quarter. "I will give us some credit for staying involved and keeping the numbers fresh," says Marone. "That served us well here."

But when the stock in January "went parabolic," he says, it got too difficult to stay involved. "Even late last year you could believe at some level that the shares were still reasonably underfollowed and there was some skepticism creeping in about how sustainable and profitable SMCI's AI-related growth was going to be," Marone says. "But when the stock got to $700-800 per share, seemingly everybody was completely on board and in our experience that's when you're playing with fire. You're trying to assess more what other people expect, not just the fundamentals. That is not only tricky, but it's also not something we're good at." Crescent Rock exited its position in this year's first quarter.

As a long/short manager, would he consider shorting SMCI shares today? "In the same way it's difficult to understand and underwrite something that's going up rapidly because of animal spirits, when those animal spirits are there it makes it exceptionally difficult to short," says Marone. "If there's really a short story here that has merit, you'll very likely be able to short it at a lot lower price than this and still do well. But for now, there's no way we would short this stock today."

To describe how he's managed his Super Micro position since last September, Needham's Barr first describes how the company is a "prototype" of what he typically looks for. "When I first invest I'm more of a value investor, looking for hidden compounders with something exciting going on that doesn't seem well understood but we think is about to start showing real results," he says. "We're hoping then there's a transition phase where the results do start shining through, and then a 'quality compounder' phase where things are going great and everyone sees it. This last period – where Super Micro is today – can actually last longer than you'd expect and we try our best to have a mindset that allows us to stick around and benefit from it."

He had added to his SMCI position during the first quarter of 2023 after Spruce Point Capital wrote what turned out to be an ill-fated short report. He added again to his position in the fourth quarter of last year when the shares were mostly moving sideways and Barr entered 2024 with the stock as his fund's largest position.

When the shares skyrocketed, he reassessed the company's addressable market, concluding that the AI server market within four years could be 5x what it is today. He reassessed the company's competitive advantage, concluding that it had long been "first and fastest" to market with new products and that that would continue to allow it to capture incremental share in the burgeoning sector. He assessed the issue of margins declining as revenues took off, concluding this was a temporary problem and that profitability for new business would eventually match or exceed historical levels.

As for valuation? "If I think through the market's potential growth, the company's competitive advantage and the potential margin upside, I can pencil in close to $40 per share in earnings by 2025," says Barr. "So at today's price that's around 22x earnings. I don't think historical multiples are relevant any longer and consider the current valuation within the realm of reasonable." His modest sale of 7% of his SMCI position in the first quarter was purely a function of risk management, he says, resulting from trimming back the position as it reached more than 10% of his portfolio.

His relative patience is a reflection of his long-held strategy, he says. "It's important to know yourself and your process and how you try to make money. How this investment has evolved is exactly what I hope happens: a 'hidden' entree, maybe some controversy in the middle that allows us to dig in and buy more, a clear improvement phase and then everything starts firing on all cylinders. It doesn't happen often, but given that's exactly what I'm investing for, I hope to be prepared to reap as much of the benefit as possible when it happens." VII

Definitions and Disclosures

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