GRANT'S

INTEREST RATE OBSERVER®

Vol. 42, No. 5c | 233 Broadway, New York, New York 10279 • www.grantspub.com | MARCH 15, 2024

AI on the cheap

Evan Lorenz writes:

It's becoming harder than ever to keep up with the investment Joneses. So far this year, bitcoin has rallied by 66%, non-fungible tokens are once again commanding seven-digit prices and shares of the aptly named Super Micro Computer, Inc. have soared an amazing 307%.

As an antidote to FOMO and—more important—a potential addition to a Graham and Dodd–compliant investment portfolio, we turn to SK Square Co., Ltd. (402340 on the Korea Exchange). It's a cheap stock that sits at the intersection of on-trend technology and South Korea's efforts to boost shareholder returns (see the prior issue). In preview, we're bullish.

Square is part of the SK chaebol, South Korea's second-largest conglomerate after the Samsung group. And no more than Samsung is SK unblotted by scandal. In 2013, Chey Tae-won, chairman of the SK family of companies, went to jail for embezzling more than $40 million to cover up his trading losses.

However, the Chey clan, unlike Samsung's, took away something constructive from their mortification. They reevaluated, and duly reformed, their approach to corporate governance. "They've come out of that and really tried to reposition themselves as being cognizant of shareholder returns," Jack Hsiao, a managing director at Weiss Asset Management, LP, which holds a position in Square, tells me.

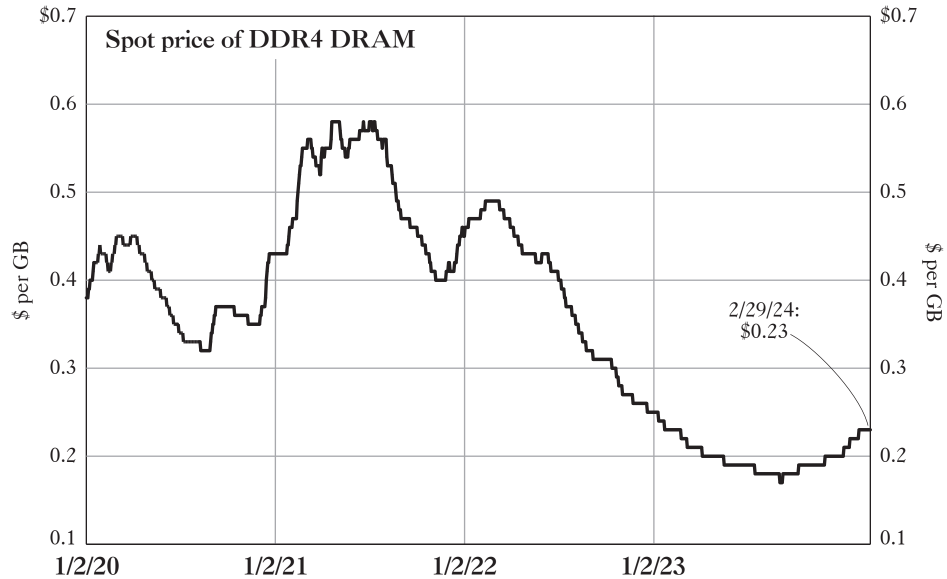
Square emerged three years ago as the spinout of SK Telecom Co., Ltd.'s nontelephony investment portfolio. Assets range from 11Street Co., Ltd., an online marketplace, to SK shieldus Co., Ltd., a cyber-security firm, to TMAP Mobility Co., Ltd., Korea's leading platform for navigation and real-time traffic updates. The pearl in the SK oyster, and Square's biggest position, is a 20.1% stake in SK hynix, Inc., the world's sixth-largest semiconductor company.

Hynix makes data-storing computer chips, both DRAM (dynamic random-access memory, which temporarily store information) and NAND (short for "not and," which permanently store information). In the fourth quarter, DRAM sales made up 65% of the top line and NAND's 29%. Each kind of chip is critical for personal computers, phones and even today's cars.

Don't let hynix's bashful-looking lower-case "h" fool you. The company, along with Samsung Electronics Co., Ltd. and Micron Technology, Inc., dominates the memory market. Interestingly, despite the concentrated character of that market, the memory-chip industry is exiting its worst downturn since the dot-com crash.

In 2020 and 2021, stimmie-infused consumers went on an electronics buying spree that ended only when the lockdowns did. No longer housebound, shoppers next opted for services instead of digital merchandise. This switch sent the spot price of DDR4 DRAM plunging by 62% between year-end 2021 and Sept. 21, 2023, according to Sanford C. Bernstein & Co., LLC. At hynix, between 2021 and 2023, sales

After the fall



source: Sanford C. Bernstein & Co., LLC

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

tumbled by 24% while operating margins collapsed to negative 23.6% from positive 28.9%.

When the market returned to a semblance of balance last fall, spot DRAM prices began a rally that lifted them by 31% through February. Both the East and West branches of Wall Street expect continued recovery. Analysts reckon that hynix will deliver revenue growth of 75.9% in 2024 and 21.6% in 2025. By next year, they expect a rebound in operating margin to 27.9% of sales.

Of course, the mania over artificial intelligence is providing a gale-force tailwind. It seems safe to speculate that a prick of the AI bubble could produce an equally stiff headwind.

The type of server chip that sent Nvidia Corp.'s stock price to the moon requires a fast, energy-efficient DRAM called high-bandwidth memory. The HBM manufacturer stacks memory modules in a 3D array. Let's just say that it isn't easy. On account of the complexity of the configuration, HBM manufacturing equipment costs twice as much as the conventional kind. Compared with typical memory modules, HBM uses a double-size silicon die and commands prices that are three to four times higher than standard.

Hynix is by far the leader in HBM production; Bernstein estimates that it served half of the market last year. While Samsung and Micron are in catch-up mode, most analysts predict that hynix will maintain its lead through at least next year.

"If you talk to anyone who's trained large language models at scale, GPUs are really expensive," Will Garrity, an associate at Weiss, tells me. "Computation is really expensive. Downtime is really expensive. Underutilization of GPUs is really expensive. You really want to get every floating point operation per second you are paying for. That said, we've been memory-bottlenecked for a couple of generations." In other words, Nvidia's chips would be even more productive if they had more memory, but only so much can fit on the silicon with today's technology.

The growth in HBM confers other benefits. "Memory companies are coming out of a historic downturn and have only just recently stopped burning cash, so they are constrained in their capex budgets," Doug O'Laughlin recently noted in Fabricated Knowledge, a Substack about the semiconductor industry. "They will shift what cash they generate to HBM capacity, which will keep supply growth in DRAM and NAND low. This is the best possible case for memory companies."

While Microsoft Corp.'s AI assistant, Copilot, has a dirty habit of "hallucinating" data, i.e., making stuff up (*Grant's*, Feb. 16), artificial intelligence is making genuine breakthroughs. OpenAI's AI image-generator, Dall-E, can make creative new pictures and the output of its AI video-maker, Sora, is indistinguishable from live-action film. Adobe, Inc. has added AI features to Photoshop, its flagship photo-editing software, which allows users automatically to add, expand or remove content from pictures.

Actor and filmmaker Tyler Perry recently put a planned $800 million studio expansion on hold after seeing the output of Sora. "Jobs are going to be lost," Perry told reporters. AI isn't all hype.

Capitalizing on these innovations (aided and abetted by a big marketing push), electronics companies are expected to introduce a wide range of on-device AI personal computers and phones soon. One in 5 PCs this year, and 6 in 10 by 2027, will come equipped with AI-enabled silicon, according to market-research shops IDC and Gartner, Inc.

On Micron's Dec. 20, 2023 earnings call, CEO Sanjay Mehrotra told dialers-in that AI-enhanced computers and phones are on the way. While these consumer products won't use HBM, they do require extra dollops of DRAM and NAND.

Hynix's earnings have yet to recover fully, but that hasn't held back the share price. A recent new high raised it to a 12% premium over the prior, 2021 peak. Even so, the stock doesn't appear expensive at 13 times estimated 2024 earnings and 8.2 times the guesstimate for 2025. By comparison, Micron, which is expected to post a loss this year, trades at 14.2 times the 2025 estimate.

Hynix, which is rated Baa2/triple-B-minus, wears the downturn in the memory cycle on its moderately leveraged balance sheet; as of Dec. 31, 2023, net debt amounted to 3.6 times trailing Ebitda. However, if consensus estimates are on the beam, the leverage ratio will decline to 0.8 times by the end of 2024.

Out of the 43 analysts who pay attention to the Korean chip-maker, 40 rate it a buy, none a sell. Over the past 12 months, insiders have sold a net 9,527 shares for proceeds of $899,978.

. . .

As for the parent, SK Square, it's an A1-rated commercial paper issuer, according to local agencies Korea Investors Service and Korea Ratings Corp., and its balance sheet showed a net cash balance of 0.51 trillion won ($385 million) as of Dec. 31, 2023.

Square also stands well with the transpacific analytical community. Eight of nine analysts rate the stock a buy; a lone dissenter says "hold." Over the past 12 months, insiders have bought a net 5,419 shares at a net cost of $112,120.

The bull case for Square is straightforward enough. At 71,900 won per share, the company is trading at a 67.6% discount to net asset value. Hynix, Square's most valuable holding, accounts for 79% of NAV. In fact, if you ascribe zero value to the other assets, purchasing one share of Square gives you 2.4 shares of hynix.

Management, cognizant of that deep discount, is working to close it. Between April 2023 and February 2024, Square repurchased and canceled 4.9% of shares outstanding. (Canceling is the bullish part: While other Korean companies do buy back stock from time to time, they typically retain those shares in the cause of perpetuating voting control.)

It's the fond hope of the bulls that Square eventually will come to resemble Heineken Holding N.V., which holds a 50.005% stake in publicly traded Heineken N.V. and remits 100% of

SK Square Co., Ltd.'s net asset value

	in Korean won trillions
SK hynix Co., Ltd.	24.34
Dreamus Co.	0.09
Incross Co., Ltd.	0.05
Krafton, Inc.	0.25
Total listed stakes	24.47
Unlisted holdings	5.59
Net cash	0.51
Net asset value	30.80
NAV per share	221,911
SK Square share price	71,900

sources: company reports, the Bloomberg

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

the dividends it receives to shareholders. The beer holding company trades at a 17% discount to NAV.

SK Square's policy is to return to shareholders at least 30% of the dividends it receives from its investment portfolio as well as the proceeds from asset sales, either through buybacks or cash distributions. To achieve Heineken Holding's discount, Square would need to adopt the beer holdco's income pass-through policy. Even measured progress in that direction would bear fruit. For instance, if Square's discount to a stable NAV shrank to 40% from the current 67.6%, shareholders would be looking at a return of 85%.

In Square's short history as an independent company, management has proven itself a good steward of its shareholders' capital. Korean private equity–style deals typically come with options. It's a detail that bears on SK Square's position in 11Street.

In 2018, SK Telecom raised 500 billion won ($385.8 million) by selling a 19.7% stake in the online retailer to a consortium of investors with a commitment to list the business by September 2023. Failing that, SK had the right, though not the obligation, to repurchase the shares from the consortium.

Unfortunately, 11Street has yet to turn a profit and Square could not drum up enough interest for an IPO last year. While it is Square, not its co-investors, that holds the call on the 19.7% stake, an unwritten Korean convention directs the holder to exercise its option and make the other investors whole. It resembles, in that sense, the supposition on the part of the investors in European-bank contingent convertible bonds that the issuers of such "cocos" will exercise their options on the first call date. (Sometimes they have, and sometimes they haven't.)

To the relief of its investors, Square has chosen not to throw good money after bad. "What they said to us is that they're definitely not bailing out any shareholders," Simon Waxley, the head of equity arbitrage at Whitebox Advisors, LLC, which is long Square, tells me.

"And they'd rather the company go to zero than put another penny into it."

•

Grant's® and Grant's Interest Rate Observer® are registered trademarks of Grant's Financial Publishing, Inc.
PLEASE do not post this on any website, forward it to anyone else, or make copies (print or electronic) for anyone else.
Copyright ©2024 Grant's Financial Publishing Inc. All rights reserved.

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.