Investment Insight

NVIDIA: THREE REASONS WHY WE ARE NOT SELLING

Nvidia has been in the World Stars portfolio for over 18 months and it has now become our largest position following its 215% rise year-to-date. The strength in the share price has been driven by rapidly growing demand for Nvidia's high performance GPUs (graphics processing units) in datacentres. This business delivered revenues of USD 10.3 billion in Nvidia's recent second quarter results, growing 141% sequentially and drove total group revenues to USD 13.5 billion.

Data centres are changing to an accelerated compute infrastructure. This involves using specialised hardware (Nvidia) to perform separate tasks which dramatically speeds up the processing speed. The key applications of accelerated compute so far are Generative Artificial Intelligence (GenAI) and Large Language Models. The scale of the growth is such that Nvidia is now guiding to USD 16 billion of revenues in the next quarter, a revenue trajectory that is far steeper than anyone had predicted at the start of the year.

In recent months we have been asked whether Nvidia's valuation is too high or market expectations are unrealistic and have gotten ahead of themselves. Our investment case on Nvidia focuses on three key areas: its competitive position, its addressable market and its valuation. As we outline below, Nvidia continues to be exceedingly well positioned across all three. We believe that the company has the potential for significant upside in the coming years and have decided to keep it as a core position in our portfolio.

Competitive advantage

We have previously written that Nvidia has a structural competitive advantage with its technology that is ideally suited for GenAI workloads. This has become even more apparent this year, as large customers including Microsoft, Meta and Alphabet are all using the Nvidia product suite. These are the largest and most sophisticated companies in the world, they generate more cash than any other and they are choosing to spend billions of dollars on Nvidia's products. If they had the ability to build their own products in this space they would have already done so. Custom ASICs (application-specific integrated circuits) will be used to perform some functions but will not be capable to replace the entire Nvidia product suite.

Nvidia has strong relationships many large companies like these, including Tesla, whose CEO Elon Musk said on a recent earnings call: "W*e'll take Nvidia hardware as fast as they will deliver it to us … tremendous respect for Jensen and Nvidia*."

Nvidia's competitive advantage has also grown from its technical prowess and software (CUDA) integration to include the complexity that goes into its supply chain and sourcing of the components for its high-end products. There are over 35,000 components that go into Nvidia's H100, its most advanced product that delivers a huge advance in accelerated computing performance. It will be very challenging for a competitor to replicate these supply chain logistics.

Addressable market

Every interaction we have with a company we invest in strengthens our view of AI as a technology with an almost limitless range of use cases across many industries. One example is the enormous research and development budgets of big pharma and biotech companies, many of which have begun to utilise computational chemical simulation software for drug discovery and development and will incorporate AI simulation and testing. Another is the USD 1 trillion worth of data centres currently installed around the world used for cloud and enterprise compute. We expect that a significant part of this data centre capacity will transition towards accelerated computing and AI. There is a huge market to transition and many new workloads and applications will be created as a result. Importantly, it is also all-new revenue for Nvidia to capture rather than replacing any prior data centre revenue.

AI will develop in stages. It is helpful to think of a framework: The first stage is the Predictive stage, based on early machine learning in industries like digital advertising where AI can recommend the most appropriate content and adverts.

This year has been about the Generative stage, the evolution of GenAI with the Large Language Models and ChatGPT. This second stage involves both training and inference and the initial demand seen is predominately for training. The inference market is many multiples larger.

The third stage of AI is the Autonomous stage, where the computer can act without human intervention, input or direct supervision. It is best exemplified by self-driving cars at Level 5 automation (see our previous Insight, Driverless cars: Where are they heading?).

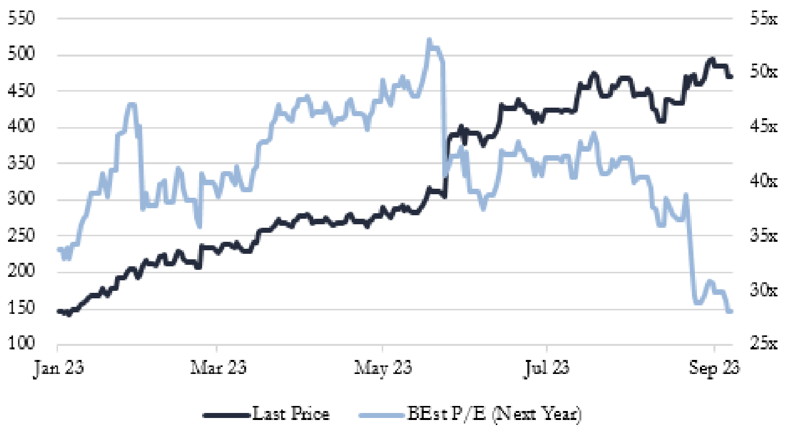
The fourth and final stage of this framework is Artificial General Intelligence (AGI) where the system effectively has generalized human cognitive abilities and can find solutions even to unfamiliar tasks. It can potentially exceed human capabilities just as in science-fiction novels. While the widespread application of AGI is still a long way off, the market and the huge growth potential for AI remains very much intact.

Valuation

Nvidia's shares have climbed significantly this year, but earnings estimates have risen by even more, so the valuation has declined. We base our valuation on a discounted cash flow approach calculating the net present value of the company's future cash flows. Another way of looking at it in simple terms is that the stock now trades on a price to earnings (P/E) multiple of 28x its FY 2025 estimated earnings per share, reasonable multiple both compared to the valuations of other high-growth companies and the market overall.

We expect that earnings per share will continue to grow at a very fast pace given the strong demand and high gross margins for the data centre products. That is why we believe the share price will follow the earnings growth and that relative to the opportunity ahead for Nvidia, the shares are still attractively valued.

Nvidia's Share Price in USD and Forward P/E Ratio



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Nvidia is now a USD 1.1 trillion company. Having risen so sharply, pullbacks will inevitably occur and we expect fluctuations in the share price.

Volatility is an opportunity for long-term investors, not a risk. We look to shut out daily market noise and focus on fundamentals. In the near term, we believe the key issues to include whether Nvidia will be able to gather enough supply to accommodate the strong demand and whether some of this demand is pulled forward as a result of double ordering from customers desperate to have the computing capacity to innovate, sustain and grow their businesses.

Nvidia has said that it is confident that it will deliver strong growth and increase supply in each successive quarter through next year. It has great insight into its customer's plans and is the kingmaker as it determines whose orders are fulfilled. Even Tesla's CEO Elon Musk is grateful for the semiconductors his company gets. It would be surprising if it is caught unawares.

Of course, there will be an inevitable slowdown in Nvidia's growth rate as it cannot continue to double each year. However, we believe that we are still at the foothills of AI and that Nvidia remains the leader in this new computing paradigm.

Giles Tulloch
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J. Stern & Co.

The Value of Long-Term Investing