THE REED REPORT

COMPANY SPOTLIGHT – CHEGG

11/22/2016

Business Overview

Chegg (Ticker: CHGG) Chegg is the leading student-first connected learning platform. Their goal is to help students transition from middle school to high school to college to their career, with a view to improving student outcomes. They help students study more effectively for college admissions exams, find the right college to accomplish their goals, get better grades and test scores while in school, and find internships that allow them to gain valuable skills to help them enter the workforce after college. Chegg has two revenue streams. Required Materials revenues, which includes selling print textbooks and eTextbooks, and Chegg Services revenues, which includes Chegg Study, Chegg Tutors, Enrollment Marketing, Brand Partnerships, Writing Tools, and Careers. Chegg Study helps students master challenging concepts on their own. It includes textbook solutions which are step-by-step answers to the questions at the end of each chapter in a student's textbook. For other questions, Chegg offers their Expert Answers service, where a student can ask a question on their website and subject matter experts will provide detailed answers. Chegg Tutors is an online, on demand tutoring service for students. Enrollment Marketing is a service provided to colleges to help them recruit students in Chegg's network. Brand Partnerships is a brand advertising service for companies who want to reach high school and college students. Writing Tools, is a service that helps students write papers. Careers helps students figure out what they want to do after college and what they have to do in college to get the job they want. Students typically pay for services on a monthly or annual basis. Colleges subscribe to their enrollment marketing services and brands pay depending on the nature of the campaign.

Previous Quarter

On 11/7/2016, Chegg reported Q3 2016 results. EPS (earnings per share) was negative $0.03 which beat analysts' expectations by $0.01 and revenue was $71.34M which beat analysts' expectations by $3.45M. During the quarter, more than 800,000 subscribers used Chegg services which translates to 40% growth from last year. This was also a new record for the company.

Growth Opportunities

For 2016, Chegg expects total revenue in the range of $246 million and $251 million, services revenue in the range of $126 million and $129 million, gross margin between 51% and 53% and adjusted EBITDA (Earnings before interest, taxes, depreciation, and amortization) in the range of $18 million and $20 million. For 2017, Chegg expects total revenue of $230 million, services revenue $172 million, gross margin over 60% and adjusted EBITDA in the range of $35 million. Chegg will be able to grow their services revenue and gross margins by growing their subscriber base, and leveraging their student graph and business structure.

At the end of 2016 Chegg expects to have 1.5 million Chegg service subscribers. This would be 50% growth from last year. So how will Chegg sustain this growth going forward? According to the National Center of Education Statistics and US Census Bureau, there are over 47 million students in middle school, high school, and college. The majority of these students are having a hard time in school as 82% of high school students and 96% of college students use help outside of what their schools offer to pass their classes. 78% of college students and 63% of high school students have heard of Chegg. Last month, Chegg had 10 million visits to their website and 40 million visits over the last 12 months. There is a huge market for Chegg services and this gives them a significant opportunity to continue to grow in the future.

What allows Chegg to provide great services to their customers is their student graph. The student graph is the accumulation of the collective activity of the students in their network. Chegg uses this information to market more efficiently and effectively to acquire new customers and keep current subscribers engaged. Let's say you buy a textbook from Chegg (which uses textbook sales as a way to acquire customers at a low cost). According to the CEO Dan Rosensweig, based on the information you give them as well as other students, they know what school you go to, what class you are taking, what textbook you are using, when your midterms are, when your finals are, what chapter you are on, and what problem you are on. So now they can suggest additional services just for you exactly when you may need them. This is how Chegg is able to attach customers to multiple services. They use the attach rate to measure the performance of their business. In Q3 2016, the attach rate from textbook customers to Chegg Study grew 25% from last year. About 50% of Chegg Tutors customers come from Chegg Study.

Once Chegg gets a student to try one of their services, they are able add information to their student graph and improve the quality of each of their services. Chegg Study, the largest of Chegg services, continues to see growth in frequency of subscriber visits, total questions asked, and solutions viewed per subscriber. Chegg Study is helping subscribers improve their academic performance. 90% of students reported that they got a better grade after using Chegg and 84% reported that Chegg helped them master the subject. As a result, Chegg Services has a monthly renewable rate of about 80%.

Chegg is building their business to provide high growth high margin services to students while keeping most of their costs as fixed or eliminating them completely. Take the print textbook business. At first, they would buy textbooks and rent them to students. Now they have a partnership with Ingram where Ingram owns the textbooks and Chegg gets 20% of each sale. This decreases revenue in the short term but, as sales increase in the future, it will go directly to income as the costs of buying the books have been eliminated. For their services business, as revenue increases, most of it goes to income since the services have a relatively fixed cost structure. Chegg's gross margin increased from 24.1% in Q3 2015 to 45.8% in Q3 2016. The cash Chegg generates from additional sales and the capital that was used to purchase textbooks in the past can be used to invest in future growth opportunities such as acquisitions and new services that deliver more value to subscribers.

Technical Analysis

Below is the chart for Chegg for 2016.

After a rough start to the year, Chegg's stock has bounced back and is up almost 19% for the year. The decrease at the beginning of the year was due to Chegg cutting Q1 2016 revenue guidance which was related to the previously discussed change in their print textbook business. Once analysts and investors realized that this was the cause of the decrease in revenue, the stock started moving up and recently hit a 2016 high of $8.32.

After Chegg reported Q2 2016 earnings in early August the stock went up to $7 and stayed around there for 3 months. The stock broke out from that level in November after reporting Q3 2016 earnings. Between August and November $7 was resistance also known as a ceiling for the stock. Now that the stock has broken through the resistance $7 becomes support also known as a floor. Unless some bad news comes out about the stock or the overall market the stock should not go lower than $7.

Since Chegg records a loss on their income statement, I used the price to sales ratio (P/S) to determine the valuation of the company. The price to sales ratio is calculated by dividing the market cap of the company by the total revenue over the last 12 months. The market cap is the share price multiplied by the number of shares outstanding. Chegg's P/S is 2.84. Since Chegg is such a unique company with so many services there is nothing to directly compare it to. So I looked at companies that have a service similar to Chegg. For textbooks and on demand services, I looked at Amazon which has a P/S of 2.88. For another example of an on demand service, I looked at Netflix which has a P/S of 6.18. For advertising, I looked at Facebook which has a P/S of 14.32. Lastly, for career services, I looked at Linkedin which has a P/S of 7.25. It seems that Chegg is undervalued and at worst fairly valued.

When reviewing an income statement, I primarily focus on the year over year change in revenue and margins. In this case, I want to focus on service revenues and gross margins since that is where the company is planning to grow in the future. For the first 9 months of 2016, service revenues grew 20% and gross margins went from 30% to 48.2%. Also, the operating expenses were unchanged from 2015. Refer to the income statement below for more details.

CHEGG, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net revenues:				
Rental	$ 5,511	$ 22,703	$ 32,081	$ 93,199
Services	49,765	33,358	126,795	94,001
Sales	16,067	25,225	32,157	46,019
Total net revenues	71,343	81,286	191,033	233,219
Cost of revenues:				
Rental	7,646	27,080	26,505	86,873
Services	12,884	10,377	38,691	32,189
Sales	18,169	24,263	33,833	44,407
Total cost of revenues	38,699	61,720	99,029	163,469
Gross profit	32,644	19,566	92,004	69,750
Operating expenses:				
Technology and development	16,241	15,664	49,232	45,076
Sales and marketing	15,256	16,211	41,449	49,985
General and administrative	13,905	12,060	41,140	35,780
Restructuring (credits) charges	(100)	342	(298)	3,320
Loss (gain) on liquidation of textbooks	2,673	(909)	(523)	(2,649)
Total operating expenses	47,975	43,368	131,000	131,512
Loss from operations	(15,331)	(23,802)	(38,996)	(61,762)
Interest expense and other (expense) income, net:				
Interest expense, net	(30)	(61)	(151)	(182)
Other (expense) income, net	(148)	85	(146)	217
Total interest expense and other (expense) income, net	(178)	24	(297)	35
Loss before provision for income taxes	(15,509)	(23,778)	(39,293)	(61,727)
Provision for income taxes	554	389	1,463	1,113
Net loss	$ (16,063)	$ (24,167)	$ (40,756)	$ (62,840)
Net loss per share, basic and diluted	$ (0.17)	$ (0.28)	$ (0.45)	$ (0.73)
Weighted average shares used to compute net loss per share, basic and diluted	91,059	87,706	90,201	86,419

When reviewing a balance sheet, I calculate the debt ratio. The debt ratio is total liabilities divided by total assets. Anything less than 1 means the company has more assets than debts. I use this to determine if a company is having any financial issues. Chegg's debt ratio is 0.56 and that's not including goodwill and other intangible assets. Refer to the balance sheet below for more details.

CHEGG, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except for number of shares and par value)

	September 30, 2016	December 31, 2015
Assets	(unaudited)	*
Current assets		
Cash and cash equivalents	$ 90,213	$ 67,029
Short-term investments	—	17,800
Accounts receivable, net of allowance for doubtful accounts of $390 and $378 at September 30, 2016 and December 31, 2015, respectively	9,481	13,157
Prepaid expenses	4,018	3,117
Other current assets	35,570	31,732
Total current assets	139,282	132,835
Long-term investments	—	4,229
Textbook library, net	3,956	29,728
Property and equipment, net	30,766	19,971
Goodwill	114,980	91,301
Intangible assets, net	21,659	8,865
Other assets	5,565	4,427
Total assets	$ 316,208	$ 291,356
Liabilities and stockholders' equity		
Current liabilities		
Accounts payable	$ 7,992	$ 5,860
Deferred revenue	30,004	14,971
Accrued liabilities	59,034	35,280
Total current liabilities	97,030	56,111
Long-term liabilities		
Total other long-term liabilities	4,075	4,170
Total liabilities	101,105	60,281
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock, $0.001 par value – 10,000,000 shares authorized, no shares issued and outstanding	—	—
Common stock, $0.001 par value 400,000,000 shares authorized; 91,113,230 and 88,099,983 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	91	88
Additional paid-in capital	584,999	560,242
Accumulated other comprehensive loss	(148)	(172)
Accumulated deficit	(369,839)	(329,083)
Total stockholders' equity	215,103	231,075
Total liabilities and stockholders' equity	$ 316,208	$ 291,356

* Derived from audited consolidated financial statements as of and for the year ended December 31, 2015 .
See Notes to Condensed Consolidated Financial Statements.

Recommendation

Chegg's growth strategy reminds me of Facebook and I believe it can experience similar success with it. Facebook built up its ecosystem and then used the information from their users to make money with advertising and eventually changed the advertising business. I believe Chegg has an opportunity to do this in the education industry. Chegg started as a textbook rental company. It has used the information from its users to transition into a student services company. Not only can they be a platform for companies to connect to their target audience like Facebook, they can also charge their customers for services whereas Facebook is free to use.

The online learning service industry is a $30 billion market. Chegg is one of the few leading growth companies in the education sector and it doesn't have a competitor that can provide all of their services. Once Chegg gets a customer their ecosystem, they are able to learn about them and keep them engaged with all of their services. They can acquire subscribers as early middle school. These subscribers have the potential to be in Chegg's network for 10 years.

With the stock trading near 2016 highs and the overall market trading all time highs, I would wait for a pullback in the stock before I started a position. I like to follow Warren Buffet's investment advice of "Be fearful when others are greedy, be greedy when others are fearful". My suggestion would be to buy some at $7.90 which would be a 5% pullback from the 2016 highs.