

Chegg, Inc.
NYSE: CHGG

Analyst: Joseph Gonyeau
Sector: Consumer Disc.

BUY

Price Target: \$6.95

Key Statistics as of 4/2/2016

Market Price: \$4.45
Industry: Education Services
Market Cap: \$390.41M
52-Week Range: \$3.15-8.84
Beta: 0.83

Thesis Points:

- The market overreacted to Q4 guidance, dropping the price by 50%, providing an ideal entry point.
- By 2017, Chegg will have a 100% digital business model which will bolster profit margins.
- Chegg's market is far from saturated, thus subscriber growth rate is not expected to stabilize.

Company Description:

Based in Santa Clara, California, Chegg helps both college and high school students by offering a wide array of services that include tutoring, help with homework, internship matching, online textbook rentals, and even scholarships. Chegg's integrated platform offers products and services that students utilize throughout the college lifecycle, from choosing a college through graduation and beyond. In 2015, Chegg matched roughly 5.0 million domestic and international students with colleges and universities and provided over 6.4 million textbooks and eTextbooks. Due to Chegg's new partnership with Ingram Content Group (Ingram), they are no longer spending their own capital on owning or warehousing textbooks. This is anticipated to save more than \$100 million in working capital annually. The partnership has affected Chegg's top line, causing an unwarranted 35% drop in their stock price, providing an opportune time to buy a growth stock at a significant discount.



Thesis

Five years ago, Chegg was solely focused on textbooks and had zero digital footprint. Through their partnership with Ingram, Chegg has undergone a shift in long-term direction, working to establish a 100% digital business model with a focus on Chegg services. In five years they have been able to go from generating 0 revenues digitally to anticipated 2016 digital revenues between \$137 and \$145 million. The transition has been successful so far, with 70% of Chegg users now using Chegg Services, while the other 30% rely on Chegg for textbook rentals. Due to this, Chegg anticipates revenues to grow by 57% in Q2 this year. This growth will help transition Chegg into a high margin business with low capital expenditures. After poor forward guidance, Chegg's stock price dropped by 35%; however, this was unwarranted as it was largely due to a change in revenue recognition timing from their transition. Due to Chegg's recent price drop, its skyrocketing profit margins, and its ability to tap into an \$84 billion market, now is the perfect time to enter a long-term position on a very bullish company.

Business Model

Chegg's revenues are derived from three main areas: rental, services, and sales. In 2015, 40% of their net revenues were from rentals, 44% were from services, and 16% were through sales. Under their changing platform, rentals are either fulfilled through Chegg or their new partner, Ingram. A Chegg-fulfilled rental of \$50 results in \$50 of revenue for Chegg at a very low margin. An Ingram-fulfilled rental at \$50 results in \$20 of commission for Chegg at a very large margin. Gross margin dollar for each are roughly the same, which has led to a decline in revenues, yet profits have stayed constant. Chegg has announced that it is unsure of the pace at which Ingram will transition into providing all of their rentals, but it is expected to handle all textbook rentals by 2017. Chegg Services consist of their connected learning platform (the Student Hub), ACT and SAT test preparation services, online tutoring, Chegg Study Service, College admissions, and Scholarship and Internship Services. Students typically pay for Chegg Services on a monthly or annual basis, and these services are experiencing rapid growth as their partnership with Ingram is saving capital which is being injected into Chegg Services. Sales of print textbooks account for the least of their revenues. These are

generally done through direct website purchases or on a just-in-time basis and are recognized based on shipment.

People

Chegg is led by their CEO Dan Rosensweig. Mr. Rosensweig joined Chegg from Yahoo in 2010, and is the driving force behind their shift to a 100% digital model. Mr. Rosensweig was inspired by companies such as Netflix and Adobe which have seen tremendous success converting to these models. Rosensweig believes that the change in model will help Chegg better serve student needs, as they are now focused on the student relationship while Ingram controls the catalog.

Product Differentiation & Competition

Chegg does not have any competitors that compete across their business as a whole, rather, they face significant competition in each aspect of their business. They see major competition in their products and services for students, as the market for textbooks and supplemental materials is extremely competitive. They face competition from college bookstores, online marketplaces like Amazon and eBay, providers of eTextbooks such as Apple, Blackboard, and Google. Chegg differentiates itself by emphasizing its extremely low prices compared to competitors, as well as the broad selection of their books, and on the compatibility of their eTextbooks across a wide variety of desktops and mobile devices. They also see major competition in their enrollment marketing services, where they compete against traditional methods of student recruitment. These include student data providers, radio, internet advertising, and even television. Chegg is able to differentiate itself through their extremely low cost, as well as the high level of quality connections that they have between prospective students and colleges. They foster these connections by providing prospective students with an easy-to-use platform that allows them to input goals and academic history, helping them learn about colleges and locate scholarships.

Subscriber Growth

Chegg currently has the room and expertise to grow and thrive, and is very far from saturating its Total Addressable Market (TAM). From FY2012 to FY2015, they were able to grow subscribers by 233%. Annual subscriber growth is around 40% YoY, with growth

from FY2013-FY2014 at 40%, and growth from FY2014-FY2015 at 43%. This trend suggests that there is much more room for growth and that Chegg has not yet saturated its Total Addressable Market

Financials

Chegg's stock price plummeted 35% in the wake of their Q4 earnings report. This was largely due to their release of poor forward guidance and missing their projected revenue; however, the market does not entirely understand what is happening. Both of these issues are due to Chegg's recent partnership with Ingram Content Group. The problem is that partnering with Ingram has hurt Chegg's topline revenue. This is not that big of an issue as Chegg is just as profitable. Although the new partnership with Ingram hurt revenues, profit margin increased significantly. Q4 Revenues of \$68 million were at the bottom end of guidance, ultimately missing analyst estimates. Yet a gross margin of 61.4% was ahead of a guided 56-58%, due to the increase in rentals through Ingram. On top of this, Q4 adjusted EBITDA of \$15.3 million topped the guided range of \$10-\$15 million. Chegg also has a 2018 projected model forecasting that Chegg Services will grow at 30%, with upwards of 60% in gross margins, and greater than 25% EBITDA margin. It is evident that Chegg is on the path to becoming profitable, with a current market cap of 390.41M as a percentage of sales is quite low. New Guidance projects 2017 adjusted EBITDA to be around \$40 million, and possibly \$75 million by 2018. Chegg's current enterprise value is about \$280 million, which leaves the stock at about 1.6x revenue on an enterprise basis. This is quite reasonable relevant to peers. Based on the proforma, as Chegg transitions into a 100% digital model, we can expect significant value creation, with an ROIC of 13.9% compared to a WACC of 11.6% in the continuing period. The proforma also shows that NOPAT margins are on a steady rise, jumping from negative 1% to positive 18% from 2017 to 2018. Based on UFCF valuation, Chegg has an intrinsic value of \$5.55 and a 1-year target value of \$6.95. Chegg's management also feels that the stock is undervalued, with the CEO Dan Rosensweig and CFO Andrew Brown both disclosing six-figure purchases on the open market just above \$4. For these reasons, now is the perfect time to buy a value stock at a serious discount.

Conclusion

Chegg is on the verge of a massive transition towards a 100% digital business model. This new model is anticipated to save upwards of \$100m in capital per year, with this savings being reinvested into Chegg Services. As Chegg Services grow, Chegg will be on the brink of receiving monthly and annual revenues from student subscribers. Subscriber revenue is very promising, and this is accentuated in this case, as the market for helping students is an \$84 billion market. The market overreacted to Chegg's missed revenue and poor forward guidance. Both of which were attributed to Chegg's partnership with Ingram, and the uncertain rate at which the transition was to occur; however, it is anticipated that Ingram will be handling all rentals by 2017. This transition also brings with it revenue growth of 20%, gross margins upwards of 60%, and EBITDA margins greater than 25%. With bolstered margins on the horizon, low capital expenditures, and a 40% YoY subscriber growth, Chegg is very close to tapping into an \$84 billion market. For these reasons, Chegg is significantly undervalued, giving us the opportunity to buy a very bullish stock at a significant discount.

Chegg, Inc. (CHGG)

CENTER FOR GLOBAL FINANCIAL STUDIES

BULLISH

Analysis by Joseph Gonyeau
4/3/2016

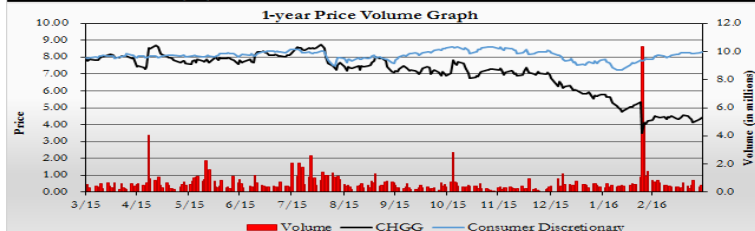
Current Price:
Divident Yield:

\$4.45
0.0%

Intrinsic Value
Target Price:

\$5.55
\$6.95

Target 1 year Return: 56.22%
Probability of Price Increase: 98%



Description
Chegg, Inc. operates student-first connected learning platform that empowers students to take control of their education to save time, save money, and get smarter.

General Information	
Sector	Consumer Discretionary
Industry	Diversified Consumer Services
Last Guidance	November 3, 2015
Next earnings date	May 3, 2016
Estimated Country Risk Premium	10.94%
Effective Tax rate	40%
Effective Operating Tax rate	40%

Market Data	
Market Capitalization	\$403.01
Daily volume (mil)	0.32
Shares outstanding (mil)	89.96
Diluted shares outstanding (mil)	86.82
% shares held by institutions	54%
% shares held by investments Managers	46%
% shares held by hedge funds	19%
% shares held by insiders	9.78%
Short interest	14.67%
Days to cover short interest	16.86
52 week high	\$8.84
52-week low	\$3.15
Levered Beta	1.61
Volatility	0.00%

Past Earning Surprises	
Quarter ending	Revenue
12/31/2014	-0.95%
3/31/2015	8.26%
6/30/2015	4.89%
9/30/2015	3.84%
12/31/2015	-5.20%
Mean	2.17%
Standard error	2.4%

EBITDA	
12/31/2014	152.82%
3/31/2015	-353.15%
6/30/2015	347.88%
9/30/2015	-215.68%
12/31/2015	34.12%
Mean	-6.80%
Standard error	125.8%

Peers	
American Public Education, Inc.	
Capella Education Co.	
Strayer Education Inc.	
2U, Inc.	
eBay Inc.	
K12, Inc.	
Bridgepoint Education, Inc.	
Alphabet Inc.	

Management	
Rosenrweig, Daniel	Chairman, Chief Executive Of
Brown, Andrew	Chief Financial Officer
Geiger, Charles	Chief Technology Officer
Tomasello, Robin	Principal Accounting Officer
Osier, Michael	Chief Information Officer
Chesnut, Robert	Senior Vice President, Gener

Total compensations growth	
22.91% per annum over 2y	
87.71% per annum over 2y	
42.72% per annum over 2y	
N/M	
N/M	
N/M	
N/M	
N/M	

Total return to shareholders	
N/M	
N/M	
N/M	
N/M	
0% per annum over 0y	
N/M	

Profitability	
ROIC	-2.7%
NOPAT Margin	-4%
Revenue/Invested Capital	0.64
ROE	-2.7%
Adjusted net margin	-4%
Revenue/Adjusted Book Value	0.62

CHGG (LTM)	
ROIC	-2.7%
NOPAT Margin	-4%
Revenue/Invested Capital	0.64
ROE	-2.7%
Adjusted net margin	-4%
Revenue/Adjusted Book Value	0.62

CHGG (5 years historical average)	
ROIC	3.41%
NOPAT Margin	0.52%
Revenue/Invested Capital	6.58
ROE	-1.78%
Adjusted net margin	-1.00%
Revenue/Adjusted Book Value	1.78

Invested Funds	
CHGG (LTM)	
Total Cash/Total Capital	16.5%
Estimated Operating Cash/Total Capital	10.1%
Non-cash working Capital/Total Capital	-1.6%
Invested Capital/Total Capital	93.0%

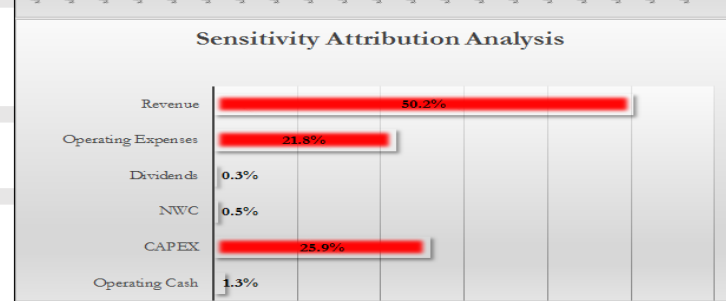
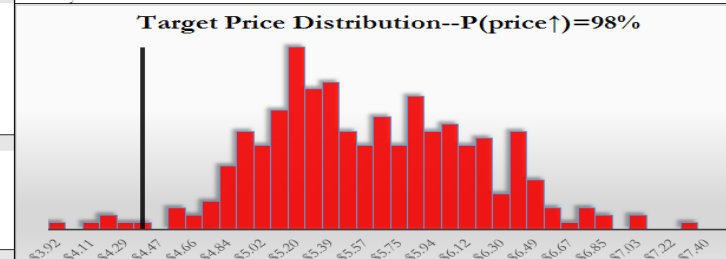
CHGG (LTM)	
Total Cash/Total Capital	16.5%
Estimated Operating Cash/Total Capital	10.1%
Non-cash working Capital/Total Capital	-1.6%
Invested Capital/Total Capital	93.0%

CHGG (5 years historical average)	
Total Cash/Total Capital	21.5%
Estimated Operating Cash/Total Capital	12.5%
Non-cash working Capital/Total Capital	-10.2%
Invested Capital/Total Capital	113.6%

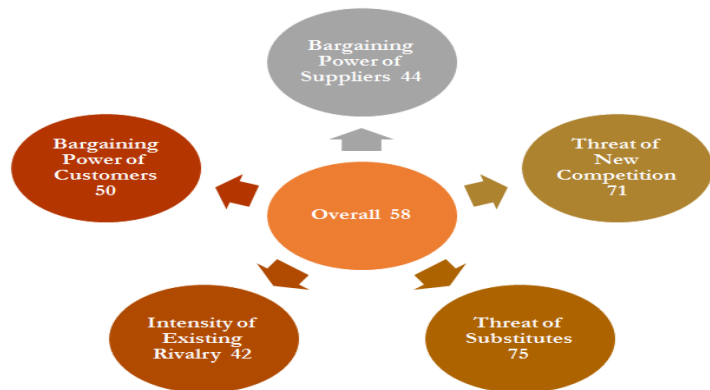
Capital Structure	
CHGG (LTM)	
Total Debt/Common Equity (LTM)	0.05
Cost of Existing Debt	2.34%
Estimated Cost of new Borrowing	1.37%
CGFS Risk Rating	2.34%
Unlevered Beta (LTM)	0.00%
WACC	2.34%

CHGG (LTM)	
Total Debt/Common Equity (LTM)	0.05
Cost of Existing Debt	2.34%
Estimated Cost of new Borrowing	1.37%
CGFS Risk Rating	2.34%
Unlevered Beta (LTM)	0.00%
WACC	2.34%

CHGG (5 years historical average)	
Total Debt/Common Equity (LTM)	0.05
Cost of Existing Debt	14.98%
Estimated Cost of new Borrowing	1.58%
CGFS Risk Rating	AAA
Unlevered Beta (LTM)	0.00%
WACC	19.74%



Porter's 5 forces (scores are out of 100)



Period	
Base Year	-1.1%
12/31/2016	-20.1%
12/31/2017	-18.0%
12/31/2018	39.2%
12/31/2019	24.4%
12/31/2020	20.2%
12/31/2021	18.0%
12/31/2022	14.2%
12/31/2023	10.6%
12/31/2024	8.3%
12/31/2025	6.5%
Continuing Period	3.0%

Revenue growth	
Base Year	-1.1%
12/31/2016	-20.1%
12/31/2017	-18.0%
12/31/2018	39.2%
12/31/2019	24.4%
12/31/2020	20.2%
12/31/2021	18.0%
12/31/2022	14.2%
12/31/2023	10.6%
12/31/2024	8.3%
12/31/2025	6.5%
Continuing Period	3.0%

Valuation

NOPAT margin	
Base Year	-4.3%
12/31/2016	-2.0%
12/31/2017	-1.5%
12/31/2018	17.8%
12/31/2019	22.8%
12/31/2020	24.9%
12/31/2021	26.3%
12/31/2022	26.7%
12/31/2023	26.7%
12/31/2024	26.5%
12/31/2025	25.9%
Continuing Period	17.9%

ROIC/WACC

Base Year	-0.14
12/31/2016	-0.05
12/31/2017	-0.04
12/31/2018	0.69
12/31/2019	1.00
12/31/2020	1.19
12/31/2021	1.37
12/31/2022	1.49
12/31/2023	1.56
12/31/2024	1.63
12/31/2025	1.68
Continuing Period	1.20

Period	
Base Year	\$52.64
12/31/2016	\$223.19
12/31/2017	\$225.46
12/31/2018	\$420.38
12/31/2019	\$469.20
12/31/2020	\$478.85
12/31/2021	\$437.81
12/31/2022	\$401.92
12/31/2023	\$463.71
12/31/2024	\$534.93
12/31/2025	\$607.05
Continuing Period	

Invested Capital	
Base Year	\$52.64
12/31/2016	\$223.19
12/31/2017	\$225.46
12/31/2018	\$420.38
12/31/2019	\$469.20
12/31/2020	\$478.85
12/31/2021	\$437.81
12/31/2022	\$401.92
12/31/2023	\$463.71
12/31/2024	\$534.93
12/31/2025	\$607.05
Continuing Period	

Net Claims

Base Year	\$23.81
12/31/2016	-\$42.47
12/31/2017	-\$103.55
12/31/2018	-\$136.66
12/31/2019	-\$198.14
12/31/2020	-\$284.38
12/31/2021	-\$390.20
12/31/2022	-\$515.78
12/31/2023	-\$664.17
12/31/2024	-\$830.94
12/31/2025	-\$1,011.46
Continuing Period	

Price per share

Base Year	\$5.20
12/31/2016	\$6.58
12/31/2017	\$8.02
12/31/2018	\$9.75
12/31/2019	\$11.76
12/31/2020	\$13.93
12/31/2021	\$16.20
12/31/2022	\$18.51
12/31/2023	\$20.84
12/31/2024	\$23.15
12/31/2025	\$25.40
Continuing Period	

Continuing Period