GSX Techedu - An Unsustainable Story, The Stock Should Be Avoided

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Summary

- There have been lots of noise surrounding Chinese stocks recently, as the result of Luckin Coffee's (LK) financial fraud.
- We conducted our own due diligence on GSX and came away with similar bearish views as Citron and Grizzly.
- We see no competitive advantage in GSX, believe that its growth is unsustainable, and have doubts over its management.
- At its current valuation, GSX is to be avoided.

Intro

Multiple short reports were published on GSX (GSX) recently, one by Grizzly and one by Citron. Both reports pointed at similar red flags, such as the accuracy of GSX's enrollment and the ethos of its management. We are certainly not calling GSX to be the next LK, but after reviewing the bears' analysis, we are mostly in alignment with them. We will go through our bear thesis in this article.

The GSX Story and Chinese EdTech

Since its IPO in 2019, GSX's share price soared from $10 to as high as $45 in early 2020 and has since cooled down to ~$35, representing a market cap of roughly $8B, a trailing P/E of ~200x and a forward P/E of ~100x. Although its earnings results have been tremendous - during the latest earnings announcement, 2019 revenue grew more than 400%, and the street is expecting another 200% increase in 2020 - we believe the stock is overvalued and think the hyper-growth is unsustainable.

GSX positions itself as a leader in the Chinese education technology field and claims to be the 3rd largest online K-12 large-class after-school tutoring service provider in China in terms of gross billings in 2018. GSX and the overall online education industry lure students by giving out a couple of free classes and charge between $200 to $500 USD per normal class. According to its students, once their info is registered, they are bombarded with nonstop marketing in their SMS, Wechat, and Email from GSX. While it might be a useful tactic to drive up demand in the short term, we don't think it will be sufficient to maintain its growth in the long term, based on the negative feedback from those who had attended and reviewed its courses.

The competition is fierce in this industry. It's comparable to the online gaming streaming war between Huya (HUYA) and Doyu (DOYU). Platforms spend hefty to acquire users and there is nothing to stop star instructors from going to competitors. Recently, GSX was sued by a competitor in Beijing for stealing their user info. The top two education platforms, TAL (TAL) and EDU (EDU), both have their own online education version and are very well known. In addition, there are many other small competitors such as VIPKID, TutorABC, Zuoye Bang, Yuan Fudao, and many more. While there is increasing demand in online education, the field is awfully competitive.

We tried to identify GSX's competitive advantage through its official material and user review. We came away unimpressed. When the CEO, Larry Chen, is asked "what on earth are GSX competitive advantages?", he answered, " it is our focus on online live large classes." [Q4CC] In that regard, both TAL and EDU are catching up fast in offering their own large online class. Furthermore, contrary to what the company claims, we found several users questioning whether the class is in real-time or pre-recorded. Larry Chen did not offer much more on GSX's competitive advantage.

Student reviews on GSX's own website are a joke, mentioned in Citron's report as well. They usually are just one-liners saying "this class is great" without stating why. We found a much more detailed review on Zhihu (知乎), a Quora equivalent in China. Reviews there are also inline with the negative feedback from other sites - disturbing marketing practices, overpriced course fees, lousy customer service, instructors spent a large portion of online classes promoting their other classes. Given the high pressure to do well in the college entrance exam, students will always have the incentive to try everything to improve their scores. However, we do not see specific advantages in students' reviews over other online platforms.

Lofty Valuation

At $35, GSX is an $8B company that's trading at a trailing P/E multiple of greater than 200x and a forward P/E of almost 100x, assuming it can deliver the growth expectation baked in. After posting a ~400% revenue growth in 2019, which was mainly driven by the growth in paid course enrollments for K-12 courses, the street is expecting another ~200% increase for 2020 with a profit margin of ~9%.

Let's take a moment and reflect on those numbers. How often do you see a company that's growing at such a pace? Is GSX's story too good to be true? For the sake of the analysis, we will assume full accuracy of GSX's financials, so the ultimate question we'd ask is, what's the proper trading P/E multiple for GSX once its growth slows down? A reasonable range would call for something between 20-30x, implying $270-400mm in net income based on current valuation. Recall that GSX earned $33mm in profit for 2019, so it will have to grow its bottom line at a CAGR of more than 50% for the next 5 years, which is what the streets think will happen. Therefore, at today's valuation, you'd be paying for a story of 5-year 50% CAGR EPS growth, assuming no share dilution. Is it doable?

Well, let's look at the annualized 5-year earnings growth rate for the two most successful Chinese EdTech companies - EDU and TAL - and make a comparison to GSX's. From 2014 to 2019, TAL put up an EPS CAGR of 37% and EDU at 2%. Both TAL and EDU are tremendously reputable and resourceful companies in China, and the fact that they weren't able to accomplish such growth figure, it makes us wonder GSX's ability to do so. GSX bulls might argue that EDU and TAL did not concentrate on online courses as GSX does, or that GSX's smaller revenue base could allow the outsized growth to happen. Sure, while those claims could be true, but at what valuation? The current risk/reward profile just doesn't justify for GSX, in our opinion.

One saving grace is GSX's relative valuation compared to a pure-online peer, Koollearn, publicly traded in Hong Kong (HK1797). Koollearn boasts a trailing P/S of 30 with a -20% operating margin. GSX is currently trading at 25 trailing P/S with a 10% operating margin. This is definitely a sector that has benefited from the coronavirus as students were forced to stay home. It will be interesting to see if their growth slows down as people begin to go back outdoors.

Management

Due to the Lucking Coffee fiasco, investors have to be extra cautious when examining a Chinese company. Besides the income statement and the balance sheet, trust in management is equally important. From going through the management's remarks, we do not see anything that increases our confidence in the management. Larry Chen keeps giving out high level and vague reasons on why they are successful, "thanks to this focused strategy, we always think bigger and think deeper on every step we take, where others think of Version 1, we have already reached Version 1.1. [when we] reached Version 1.1; we have already sought out Version 1.1.1."[Q4CC] We simply cannot find concrete evidence to believe GSX can continue to outperform its peers.

Conclusion

We think it's a good idea to take an extra grain of salt when examining Chinese stocks, especially with something like a GSX that could simply be overhyped and "too good to be true". Sure, the addressable market might be a huge one, but, as we pointed out, so is the competition. We simply don't see GSX's growth last and couldn't justify its current valuation. From our point of view, there is a disconnect between the company's fundamentals and its share price. Again, we are not suggesting anything sinister about GSX, but believe it is definitely a stock to shy away from at the current price level.

Disclosure: I am/we are short GSX. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.