

## Company Report

China Merchants Securities (HK) Co., Ltd.  
Hong Kong Equity Research

### Gaotu Group (GOTU US)

#### Executing transition phase

■ 2Q22 revenue was RMB538mn, -26% qoq, as Gaotu discontinued senior high in end-Feb; recurring revenue +30% qoq, per mgmt.

■ Liquidity remains ample for company to expand to related segments for long term growth; No plans to do live broadcasting

■ BUY: Looking forward to more concrete execution milestones ahead while valuation is defensive via 14% discount to 2Q22 net cash

#### 2Q22 is a new chapter

Gaotu 2Q22 revenue reached RMB538mn -76% yoy, -26% qoq, as a result of policy led restructuring, with company exiting K-9 segment in end-2021, and exiting senior high segment in 1Q22. On a recurring basis, mgmt. indicated recurring revenue growth reached +30% qoq for 2Q22, suggesting roughly half of 1Q22 revenue were recurrent, and we believe most of which were related to adult education. 2Q22 GPM was consistent at 70%, overall NG net income was near breakeven level, with RMB94mn positive free cash flow, thanks to tuition collected for summer programs. 2Q22 gross billing reached RMB612mn, up from RMB318mn from previous quarter. 2Q22 liquidity remains solid at RMB3.4bn with no interest bearing debt (vs. RMB3.2bn for 1Q22).

#### Looking ahead to further milestones

Gaotu is now focused on three major segments: 1) Adult education e.g. college, Master degree exam, civil servant exam etc. 2) Non-academic K-12 tutoring e.g. STEM courses, counselling services etc. 3) Educational content and digital learning products, such as dictionary pen, online books/content, learning device etc. In our view, the adult education is likely to maintain steady growth as Gaotu's more experienced segment, while the company will push ahead to expand in its other two relatively new segments, with non-academic tutoring segment to demonstrate faster trend growth rate. The company will remain diligent in selling market expense in this new normal, and also utilize more offline venues for reaching out to potential students. Gaotu provided 3Q22E revenue guidance of RMB576mn - 596mn (7%-11% qoq).

#### BUY: Executing transition phase

We believe Gaotu has solid balance sheet and experience to navigate new opportunities, we look forward to seeing more concrete execution milestones ahead. We think Gaotu's valuation has good defensive feature, given its 14% market cap discount to latest 2Q22 net cash balance. We forecast Gaotu FY22-24E revenue CAGR to reach 21%. We revised our estimates to reflect latest results and updated outlook, and nudged our TP to USD2.3 from USD2.6 based on 15x FY23E P/E. **Key risks:** New business execution and policy risks.

#### Financials

Year ended 31 Dec (RMB mn)	FY20	FY21	FY22E	FY23E	FY24E
Revenue	7,125	6,562	2,540	3,037	3,739
yoy	237%	-8%	-61%	20%	23%
Gross profit	5,362	4,164	1,784	2,126	2,617
yoy	240%	-22%	-57%	19%	23%
Non-GAAP OP	-1,517	-2,593	9	279	474
yoy	n.a.	n.a.	n.a.	3019%	70%
Core net income	-1,154	-2,758	57	276	454
yoy	n.a.	n.a.	n.a.	386%	65%
Core EPADS (RMB)	-4.82	-10.77	0.21	1.07	1.76
P/E (x)	n.a.	n.a.	58.0	11.9	7.2
P/S (x)	0.5	0.5	1.3	1.1	0.9
ROE	-16%	-35%	1%	7%	10%

Sources: Company data, CMS (HK) estimates; share price as of Sept 12, 2022.

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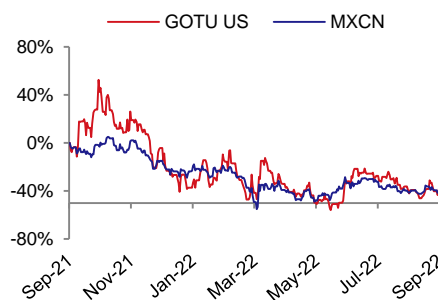
#### WHAT'S NEW

2Q22 results; Forecast/TP revision

### BUY

Previous	BUY
Price (Sept 12, 2022)	USD1.6
12-month Target Price (Potential up/downside)	USD2.3 (+43%)
Previous	USD2.6

#### Price Performance



Source: Bloomberg; share price as of Sept 12, 2022

%	1m	6m	12m
GOTU US	0.6	15.0	(38.8)
MXCN	(6.3)	7.9	(38.2)

#### Sector: Education

Hang Seng Index (Sept 12, 2022)	19,362
HSCEI (Sept 12, 2022)	6,628

#### Key Data

52-week range (USD)	1.15 - 4.58
Market cap (USD mn)	414
Avg. daily volume (mn)	2.43
BVPS (RMB)	20.63

#### Shareholding Structure

Larry Xiangdong Chen	46.1%
Other shareholders	17.7%
No. of shares outstanding (mn)	256
% outstanding	36.2%

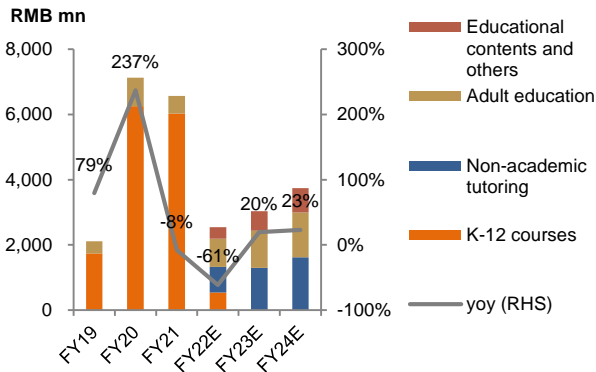
Sources: Company data, Bloomberg

#### Related Research

1. Gaotu Group (GOTU US) - 4Q21 demonstrated positive transition; Upgrade to BUY (BUY) (March 9, 2022)
2. Gaotu Group (GOTU US) - Waiting for transformation execution (HOLD) (Feb 15, 2022)
3. Gaotu Group (GOTU US) - Gradual and bumpy transition to new business model (HOLD) (Oct 4, 2021)
4. Gaotu Group (GOTU US) - Business model under transformation (BUY) (May 27, 2021)

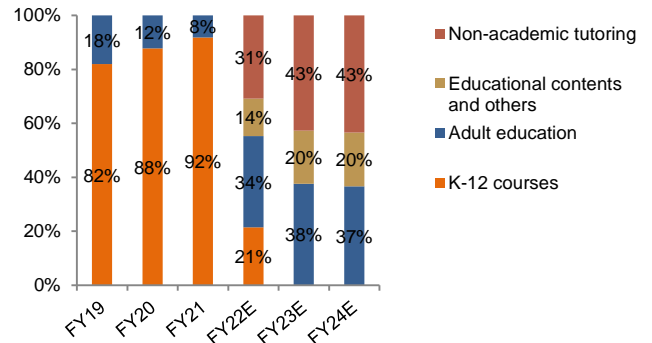
Focus charts

Figure 1: We expect Gaotu's revenue scale to be similar with FY19 after restructuring K-12 business



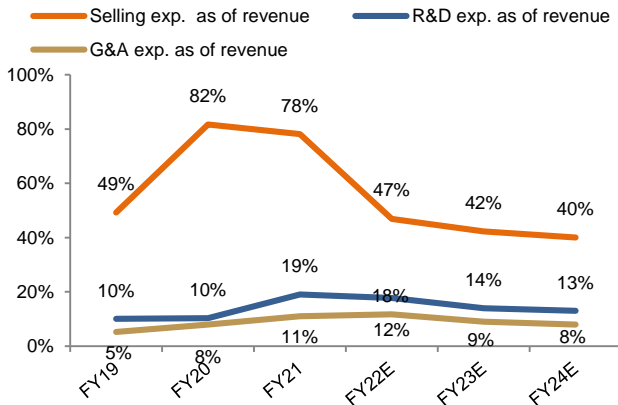
Sources: Company data, CMS (HK) estimates

Figure 2: After exit from senior high segment by the end of Feb 2022, Gaotu's adult education to account 72% of total revenue in FY22E



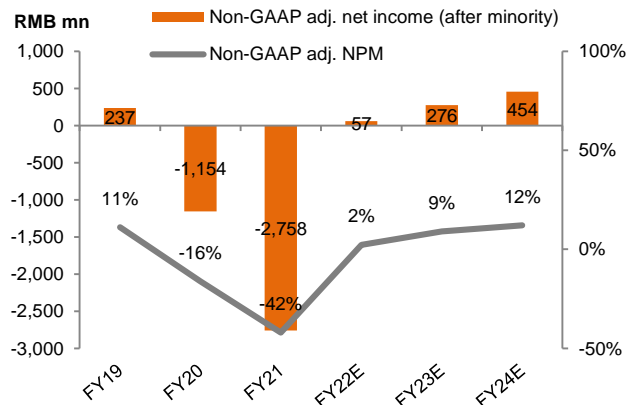
Sources: Company data, CMS (HK) estimates

Figure 3: Gaotu's OPEX as of revenue decreased significantly, and mgmt. expects R&D and G&A expenses as of revenue to be c.20% in long term



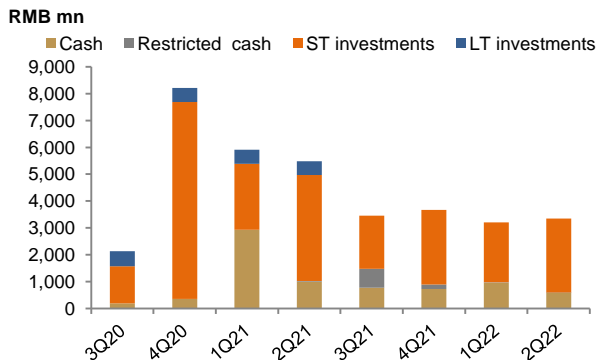
Sources: Company data, CMS (HK) estimates

Figure 4: We expect Gaotu's healthy profitability to continue in next 3 years



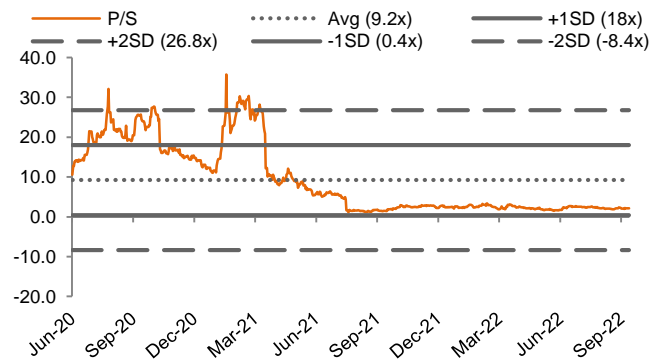
Sources: Company data, CMS (HK) estimates

Figure 5: Total liquidity was RMB3.4bn as of 2Q22, vs. RMB3.2bn in 1Q22



Sources: Company data, CMS (HK)

Figure 6: Gaotu's next 12-mo P/S range



Sources: Bloomberg, Company data, CMS (HK) estimates

Figure 7: Gaotu's learning device



Sources: Company data, CMS (HK)

Figure 8: Gaotu's scanning translation pen



Sources: JD.com, Company data, CMS (HK)

Figure 9: Gaotu's various kinds of courses



Sources: Company data, CMS (HK)

Figure 10: Tutoring sector peers comparison

Company	CN name	Ticker	Price (local currency)	CMS			Mkt cap (USDm)	3-mth avg t/o (Loc\$m )	P/E (x)		PEG*	P/S (x)		PSG*	Sales CAGR (%)	EPS CAGR (%)
				Rating	TP(Local currency)	Up/(Dn ) side (%)			FY22E	FY23E		FY23E	FY22E		FY23E	FY23E
HSI			19,362						10.4	9.1	0.8	0.9	0.8	0.1	9.3	12.0
HSCEI			6,628						8.9	7.9	0.7	0.7	0.7	0.1	9.6	11.3
<b>Offline tutoring - China</b>																
NEW ORIENTAL	新东方	EDU US 9901 HK	26.8 21.1	BUY BUY	33.0 26.0	23.4 23.5	4,572	96.1	n.a.	49.7	n.a.	1.5	1.8	n.a.	(4.3)	n.a.
TAL	好未来	TAL US	5.4	HOLD	5.0	-7.4	3,822	38.2	n.a.	n.a.	n.a.	0.9	3.9	n.a.	(48.1)	n.a.
OFFCN	中公教育	002607 CH	4.5	NR	n.a.	n.a.	4,016	306.2	34.1	22.4	n.a.	3.1	2.7	n.a.	n.a.	n.a.
EAST	东方	667 HK	3.4	NR	n.a.	n.a.	948	14.6	10.7	9.6	n.a.	1.3	1.2	n.a.	n.a.	n.a.
ONLY	昂立	600661 CH	8.7	NR	n.a.	n.a.	360	99.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
SCHOLAR	思考乐	1769 HK	0.8	NR	n.a.	n.a.	55	5.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
BESTSTUDY	卓越	3978 HK	0.4	NR	n.a.	n.a.	47	0.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Online tutoring - China</b>																
GAOTU	高途	GOTU US	1.6	BUY	2.3	42.9	414	6.2	58.0	11.9	0.1	1.3	1.1	0.1	21.3	188.6
KOOLEARN	新东方在线	1797 HK	33.0	HOLD	UR	n.a.	4,218	1274.1	n.m.	43.3	0.1	47.5	10.9	0.1	129.8	299.3
YOUDAO	有道	DAO US	5.7	NR	n.a.	n.a.	717	1.0	n.a.	41.8	n.a.	0.8	0.7	n.a.	n.a.	n.a.
SUNLAND	尚德机构	STG US	4.3	NR	n.a.	n.a.	60	0.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
51 TALK	51 Talk	COE US	2.2	NR	n.a.	n.a.	48	0.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Education (US listed Non-China)</b>																
PEARSON		PSO US	10.8	NR	n.a.	n.a.	7,903	3.6	16.8	15.2	n.a.	1.7	1.6	n.a.	n.a.	n.a.
GRAND		LOPE US	84.6	NR	n.a.	n.a.	2,703	27.5	14.1	12.9	n.a.	2.9	2.7	n.a.	n.a.	n.a.
GRAHAM		GHC US	580.3	NR	n.a.	n.a.	2,810	8.3	n.a.	n.a.	n.a.	0.7	0.7	n.a.	n.a.	n.a.
LAUREATE		LAUR US	11.6	NR	n.a.	n.a.	1,902	9.4	12.5	9.0	n.a.	1.4	1.3	n.a.	n.a.	n.a.
K12		LRN US	39.7	NR	n.a.	n.a.	1,696	34.8	16.6	13.4	0.6	0.9	0.9	0.1	8.0	24.2
STRATEGIC		STRA US	65.9	NR	n.a.	n.a.	1,624	8.3	19.7	15.4	n.a.	1.5	1.4	n.a.	n.a.	n.a.
ADTALEM		ATGE US	39.3	NR	n.a.	n.a.	1,778	16.3	11.4	9.1	3.5	1.3	1.2	n.a.	n.a.	2.6
<b>Average - Offline tutoring - China</b>									<b>14.9</b>	<b>20.4</b>	<b>n.a.</b>	<b>1.4</b>	<b>1.9</b>	<b>n.a.</b>	<b>(17.5)</b>	<b>0.0</b>
<b>Average - Online tutoring - China</b>									<b>58.0</b>	<b>32.3</b>	<b>0.1</b>	<b>16.5</b>	<b>4.2</b>	<b>0.1</b>	<b>75.6</b>	<b>244.0</b>
<b>Average - Tutoring - Non-China</b>									<b>15.2</b>	<b>12.5</b>	<b>2.0</b>	<b>1.5</b>	<b>1.4</b>	<b>0.1</b>	<b>8.0</b>	<b>13.4</b>
<b>Average (all)</b>									<b>19.4</b>	<b>19.5</b>	<b>1.1</b>	<b>4.4</b>	<b>2.1</b>	<b>0.1</b>	<b>17.8</b>	<b>102.9</b>

Sources: Company data, CMS (HK) estimates; share price as of Sept 12, 2022 (US Market) & Sept 9, 2022(HK Market). Note: All information of Non-rated stocks was sourced from Bloomberg.  
\*PEG is calculated by FY23E P/E divided by FY22-24E EPS CAGR, \*PSG is calculated by FY23E P/S divided by FY22-24E sales CAGR.

## Financial Summary

### Balance Sheet

(RMB mn)	FY20	FY21	FY22E	FY23E	FY24E
Year end	Dec 31	Dec 31	Dec 31	Dec 31	Dec 31
Cash and cash equivalents	355	729	1,301	1,532	1,991
Short-term investments	7,331	2,774	1,000	1,020	1,040
Other current assets	771	434	439	445	450
<b>Total current assets</b>	<b>8,457</b>	<b>3,937</b>	<b>2,740</b>	<b>2,997</b>	<b>3,482</b>
Property, equipment and software, net	704	680	646	653	659
Intangible assets & Goodwill	29	28	29	29	30
Long-term investments	531	0	0	0	0
Other non-current assets	964	380	387	395	403
<b>Total non-current assets</b>	<b>2,229</b>	<b>1,088</b>	<b>1,062</b>	<b>1,077</b>	<b>1,092</b>
<b>Total assets</b>	<b>10,686</b>	<b>5,025</b>	<b>3,802</b>	<b>4,074</b>	<b>4,574</b>
Deferred revenue	2,725	1,680	635	759	935
Other current liabilities	1,473	80	64	65	67
<b>Total current liabilities</b>	<b>4,197</b>	<b>1,760</b>	<b>699</b>	<b>824</b>	<b>1,001</b>
Deferred revenue	9	36	37	37	38
Other non-current liabilities	749	348	294	300	306
<b>Total non-current liabilities</b>	<b>759</b>	<b>383</b>	<b>330</b>	<b>337</b>	<b>344</b>
<b>Total liabilities</b>	<b>4,956</b>	<b>2,144</b>	<b>1,029</b>	<b>1,161</b>	<b>1,345</b>
<b>Total shareholders' equity</b>	<b>5,730</b>	<b>2,881</b>	<b>2,772</b>	<b>2,912</b>	<b>3,229</b>
<b>Total liabilities, mezzanine equity and shareholders' equity</b>	<b>10,686</b>	<b>5,025</b>	<b>3,802</b>	<b>4,074</b>	<b>4,574</b>
<b>Net cash/(debt)*</b>	<b>7,686</b>	<b>3,503</b>	<b>2,301</b>	<b>2,552</b>	<b>3,032</b>

### Profit & Loss Statement

(RMB mn)	FY20	FY21	FY22E	FY23E	FY24E
Year end	Dec 31	Dec 31	Dec 31	Dec 31	Dec 31
<b>Net revenues</b>	<b>7,125</b>	<b>6,562</b>	<b>2,540</b>	<b>3,037</b>	<b>3,739</b>
Cost of revenue	-1,763	-2,398	-756	-911	-1,122
<b>Gross profit</b>	<b>5,362</b>	<b>4,164</b>	<b>1,784</b>	<b>2,126</b>	<b>2,617</b>
Selling expenses	-5,816	-5,129	-1,192	-1,284	-1,496
R&D expenses	-734	-1,253	-450	-425	-486
G&A expenses	-567	-720	-298	-273	-299
<b>Operating income</b>	<b>-1,755</b>	<b>-2,938</b>	<b>-156</b>	<b>143</b>	<b>336</b>
Interest income	3	31	14	10	12
Net other income	254	21	29	2	3
Realized gains from investments	70	66	20	0	0
Other gains and losses	0	-242	0	0	0
<b>Pre-tax income</b>	<b>-1,428</b>	<b>-3,062</b>	<b>-94</b>	<b>155</b>	<b>352</b>
Income tax benefits (expenses)	35	-41	-15	-16	-35
(Loss) income from equity method investments	0	0	0	0	0
<b>Net (loss) income</b>	<b>-1,393</b>	<b>-3,103</b>	<b>-108</b>	<b>140</b>	<b>316</b>
<b>Net (loss) income after minority</b>	<b>-1,393</b>	<b>-3,103</b>	<b>-108</b>	<b>140</b>	<b>316</b>
SBC	238	345	165	136	138
<b>Non-GAAP items:</b>					
Non-GAAP gross profit	5,429	4,282	1,849	2,176	2,668
Non-GAAP operating income	-1,517	-2,593	9	279	474
Non-GAAP net income after minority	-1,154	-2,758	57	276	454
Non-GAAP adj. net income after minority	-1,154	-2,758	57	276	454
<b>EPADS (RMB)</b>	<b>-5.81</b>	<b>-12.11</b>	<b>-0.40</b>	<b>0.54</b>	<b>1.22</b>
<b>Non-GAAP EPADS (RMB)</b>	<b>-4.82</b>	<b>-10.77</b>	<b>0.21</b>	<b>1.07</b>	<b>1.76</b>
<b>Non-GAAP adj. EPADS (RMB)</b>	<b>-4.82</b>	<b>-10.77</b>	<b>0.21</b>	<b>1.07</b>	<b>1.76</b>

Sources: Company data, CMS (HK) estimates; \*Net cash includes bank balance and ST investments

### Cashflow Statement

(RMB mn)	FY20	FY21	FY22E	FY23E	FY24E
Year end	Dec 31	Dec 31	Dec 31	Dec 31	Dec 31
Net (loss) income	-1,393	-3,103	-108	140	316
Non-cash Adjustments	228	40	34	33	34
Changes in net operating assets	1,768	-1,734	-1,050	120	171
<b>CFO</b>	<b>603</b>	<b>-4,797</b>	<b>-1,124</b>	<b>293</b>	<b>521</b>
Investments	-5,312	4,932	1,696	-22	-22
CAPEX	-284	-16	0	-40	-40
Others	0	0	0	0	0
<b>CFI</b>	<b>-5,596</b>	<b>4,916</b>	<b>1,696</b>	<b>-62</b>	<b>-62</b>
Repayment to related parties	0	0	0	0	0
Proceeds from private placement financing	5,687	0	0	0	0
Repurchase of ordinary shares	-283	0	0	0	0
Others	-132	255	0	0	0
<b>CFF</b>	<b>5,272</b>	<b>255</b>	<b>0</b>	<b>0</b>	<b>0</b>
Effect of exchange rate changes	2	0	0	0	0
<b>Net increase in cash</b>	<b>281</b>	<b>374</b>	<b>572</b>	<b>231</b>	<b>459</b>
Beginning cash	74	355	729	1,301	1,532
<b>Ending cash</b>	<b>355</b>	<b>729</b>	<b>1,301</b>	<b>1,532</b>	<b>1,991</b>

### Financial ratios

	FY20	FY21	FY22E	FY23E	FY24E
Year end	Dec 31	Dec 31	Dec 31	Dec 31	Dec 31
<b>yoy</b>					
Net revenues	237%	-8%	-61%	20%	23%
Gross profit	240%	-22%	-57%	19%	23%
Operating income	n.a.	n.a.	n.a.	n.a.	135%
Net (loss) income	n.a.	n.a.	n.a.	n.a.	126%
Net (loss) income after minority	n.a.	n.a.	n.a.	n.a.	126%
<b>Non-GAAP items</b>					
Non-GAAP gross profit	240%	-21%	-57%	18%	23%
Non-GAAP operating income	n.a.	n.a.	n.a.	3019%	70%
Non-GAAP net income after minority	n.a.	n.a.	n.a.	386%	65%
Non-GAAP adj. net income after minority	n.a.	n.a.	n.a.	386%	65%
<b>Margins</b>					
Gross profit	75%	63%	70%	70%	70%
Operating income	-25%	-45%	-6%	5%	9%
Net (loss) income	-20%	-47%	-4%	5%	8%
Net (loss) income after minority	-20%	-47%	-4%	5%	8%
<b>Non-GAAP items</b>					
Non-GAAP gross profit	76%	65%	73%	72%	71%
Non-GAAP operating income	-21%	-40%	0%	9%	13%
Non-GAAP net income after minority	-16%	-42%	2%	9%	12%
Non-GAAP adj. net income after minority	-16%	-42%	2%	9%	12%
Effective tax rate	2%	-1%	-16%	10%	10%
Current ratio (x)	2.0	2.2	3.9	3.6	348%
Net cash/equity	134%	122%	83%	88%	94%
ROE	-16%	-35%	1%	7%	10%
<b>P/E (x)</b>	<b>n.a.</b>	<b>n.a.</b>	<b>58.0</b>	<b>11.9</b>	<b>7.2</b>
<b>P/B (x)</b>	<b>0.6</b>	<b>1.1</b>	<b>1.2</b>	<b>1.1</b>	<b>1.0</b>
<b>P/S (x)</b>	<b>0.5</b>	<b>0.5</b>	<b>1.3</b>	<b>1.1</b>	<b>0.9</b>

## Investment Ratings

Industry Rating	Definition
OVERWEIGHT	Expect sector to outperform the market over the next 12 months
NEUTRAL	Expect sector to perform in-line with the market over the next 12 months
UNDERWEIGHT	Expect sector to underperform the market over the next 12 months

Company Rating	Definition
BUY	Expect stock to generate 10%+ return over the next 12 months
HOLD	Expect stock to generate +10% to -10% over the next 12 months
SELL	Expect stock to generate loss of 10%+ over the next 12 months

### Analyst Disclosure

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### Regulatory Disclosure

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