

Educomp Solutions

BUY

Maintained

Rs1,721

Margin grief

Reason for report: Q3FY09 results review and earnings revision

Educomp Solutions' (Educomp) Q3FY09 standalone EBITDA margin was lower at 46% on account of lower margins in ICT and retail & consulting segments as well as higher forex loss of Rs101mn. Lower margins in the ICT segment were due to higher proportion of outright buy of hardware deals (with the Government of Karnataka). We believe Educomp would miss its FY09 standalone PAT guidance of Rs1.4bn mainly due to higher mark-to-market (MTM) forex losses (~Rs300mn in 9MFY09). Standalone revenues at Rs1.45bn, driven by robust 152% YoY revenue growth from *Smart_Class*, were higher than our expectations of Rs1.3bn. Based on lower margins, we have lowered our FY10E & FY11E EPS estimates 7.1% and 10.8% respectively. We expect revenue and EPS CAGRs of 50% and 60% through FY09-11E. We believe Educomp's diversified business model is less prone to the ongoing macro-economic slowdown, with strong annuity-based cashflows providing high sustainable growth visibility. High debtor days (170 days) and higher capex requirement remain key risks. Based on higher-than-expected debt and lower margins, we are trimming our target multiples 10% for all businesses; thereby, our EV/EBIT target price stands at Rs2,950/share, down from Rs3,990 earlier (Table 8); the stock will trade at FY10E P/E of 23x. Maintain BUY.

- ▶ **Smart_Class school additions lower in Q3FY09 versus Q2FY09.** Educomp added 212 schools, lower than 238 in Q2FY09, to its *Smart_Class* portfolio, which now stands at a total of 1,479 and covers over 1.7mn students. Order pipeline remains robust. The company has introduced *Smart_Class* online, whereby students can access content from home.
- ▶ **25 K-12 schools expected to be operational by next academic session.** Educomp has 11 operational K-12 schools with 14,000 students. Another six schools are under construction, with another three under JV with Takshila Management Services and five Euro schools on dry management basis with EuroKids International (Pvt). Subsequently, the company plans to commence the next academic year with at least 25 schools. The segment posted 9MFY09 revenue of Rs300mn with EBITDA margin of 77% and PAT margin of 48%.
- ▶ **Acquisitions, JVs to supplement strong organic growth.** Educomp's *Roots to Wings* along with *EuroKids* has emerged as one of the largest pre-school brands, with over 500 pre schools. Further, *Raffles Educomp International College* (JV with Raffles International) is expected to be operational in Delhi and Bangalore from the next academic year. Besides this, Educomp leverages strong synergies with various integrated online solutions.

Market Cap	Rs31.8bn/US\$0.6bn
Reuters/Bloomberg	EDSO.BO/EDSL IN
Shares Outstanding (mn)	18.5
52-week Range (Rs)	4363/1535
Free Float (%)	45.0
FII (%)	37.6
Daily Volume (US\$'000)	46,000
Absolute Return 3m (%)	(10.5)
Absolute Return 12m (%)	(56.3)
Sensex Return 3m (%)	(0.0)
Sensex Return 12m (%)	(50.4)

Year to March	FY08	FY09E	FY10E	FY11E
Revenue (Rs mn)	2,621	5,504	8,414	12,416
Net Income (Rs mn)	701	1,363	2,345	3,537
EPS (Rs)	37.8	73.6	126.7	191.1
% Chg YoY	110.9	94.5	72.1	50.9
P/E (x)	45.4	23.4	13.6	9.0
CEPS (Rs)	55.3	112.3	194.8	291.7
EV/E (x)	26.3	13.6	8.0	5.8
Dividend Yield (%)	0.1	0.1	0.1	0.1
RoCE (%)	13.4	13.9	16.5	18.1
RoE (%)	34.7	38.4	43.9	43.0

Technology

Earnings revisions

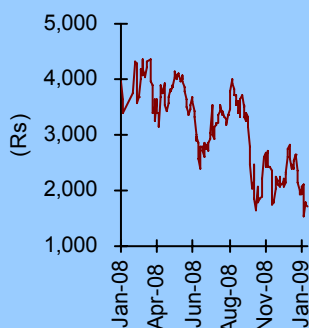
(%)	FY09E	FY10E	FY11E
Sales	↑ 4.9	↓ 0.5	↓ 3.9
EBITDA	↓ 3.5	↓ 5.4	↓ 9.5
EPS	↓ 4.3	↓ 7.1	↓ 10.8

Shareholding pattern

	Jun '08	Sep '08	Dec '08
Promoters	55.0	55.0	55.0
Institutional investors	35.8	37.2	38.5
MFs and UTI	2.7	1.6	0.9
Insurance Cos.	0.0	0.0	0.0
FIs	33.1	35.6	37.6
Others	9.2	7.8	6.5

Source: www.nseindia.com

Price chart



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Table 1: Q3FY09 results review (Standalone)

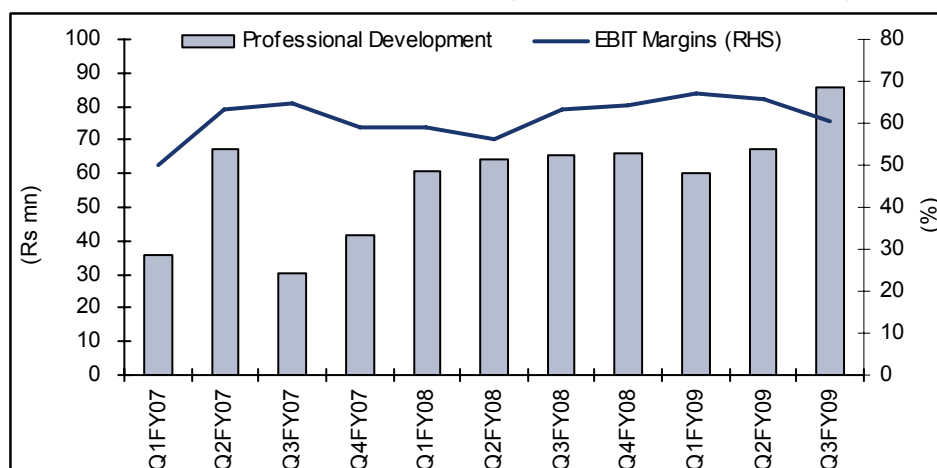
(Rs mn, year ending March 31)

	Q3FY09	Q2FY09	Q3FY08	% chg (QoQ)	% chg (YoY)	I-Sec estimates	% variance
Total Revenues	1,453	981	715	48	103	1,306	11
(a) consumption of raw material	532	116	505	359	5	839	(37)
(b) Increase/decrease in stock in trade	(185)	(7)	(281)	2,543	(34)	(548)	(66)
(c) Staff Cost	172	139	95	24	81	153	12
(d) Admin & other exp	266	226	62	18	333	140	90
Total Operating Expenses	785	474	381	66	106	586	34
EBITDA	668	507	334	32	100	720	(7)
Depreciation	194	157	91	24	112	196	(1)
EBIT	474	350	242	35	95	524	(9)
Other income	17	55	59	(69)	(71)	47	(64)
Interest	24	17	13	41	91	29	(17)
PBT	467	388	289	20	62	542	(14)
Less : Tax provision	152	134	99	13	53	190	(20)
Net income	315	254	190	24	66	352	(10)
Ratios:							
EBITDA margin (%)	46.0	51.7	46.7			55.1	
Net margin (%)	21.7	25.9	26.6			27.0	
Effective tax rate (%)	32.4	34.5	34.2			35.0	

Source: Company data, I-Sec Research

Chart 1: Professional Development segment – Revenues & margins

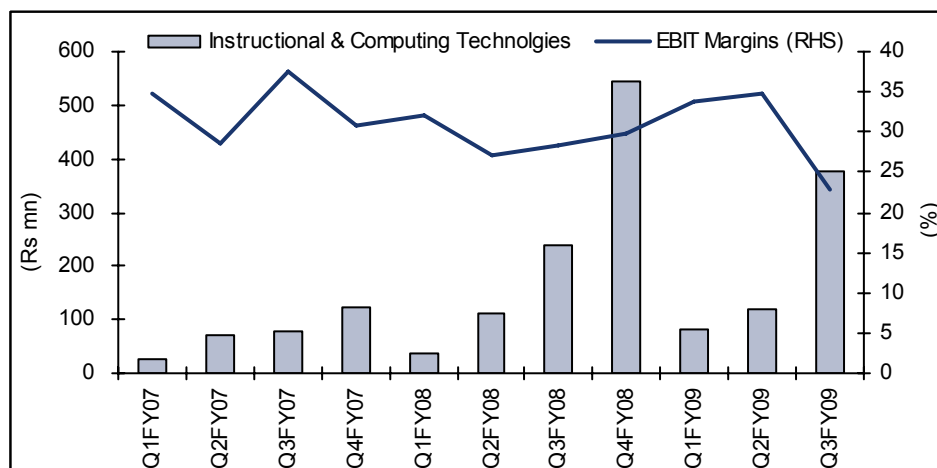
105,333 teachers trained, resulting in cumulative trainee teachers of over 1.3mn; EBIT margin was steady at 61%



Source: Company data, I-Sec Research

Chart 2: ICT segment – Revenues & margins

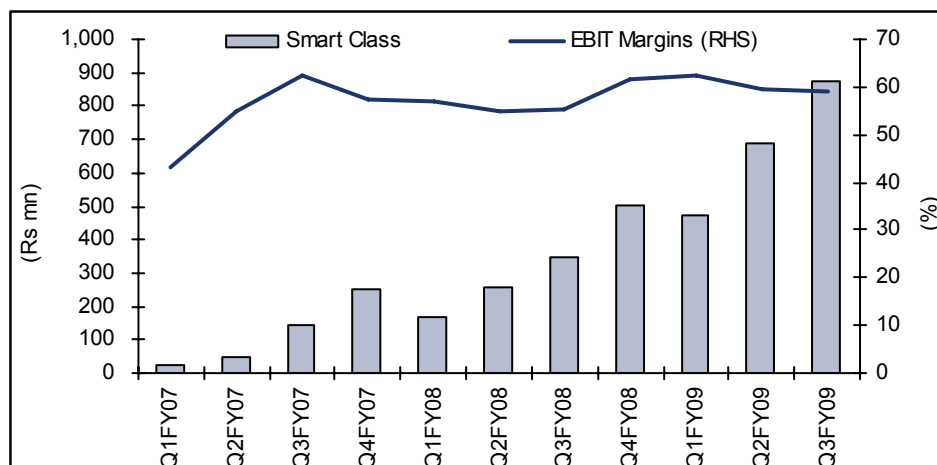
1,055 schools were added, with the total now at 9,970 covering 5.5mn students over 14 states. As per the management, the pipeline is healthy and Educomp has maintained its FY09E guidance of 12,000 schools



Source: Company data, I-Sec Research

Chart 3: Smart_Class segment – Revenues & margins

212 schools were added, taking the total to 1,479 and covering 1.7mn students. Order book remains robust. Educomp recently held a conference in Ahmedabad, addressing ~800 ICSE school principals



Source: Company data, I-Sec Research

Table 2: Strong performance in Smart_Class

(No's)

	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08
School additions	107	152	278	103	231	212
Cumulative no. of schools	503	655	933	1,036	1,267	1479
Total no. of students (mn)		0.74	1.04	1.10	1.43	1.70

Source: Company data

Table 3: Robust Smart_Class growth with healthy margins

(Rs mn)

	FY08	FY09E	FY10E	FY11E
No. of school (at the end)	933	1,700	2,700	3,900
No. of school (avg)	632	1,475	2,200	3,300
Total no. of addressable private school	15,000	15,000	15,000	15,000
as a % of addressable private school	6	11	18	26
Average Classes per school	25	26	28	29
Average Students per class	45	45	45	45
Average Fees per student per month	150	150	150	150
Revenues Rs mn	1,278	3,106	4,990	7,752
YOY growth (%)	175	143	61	55
EBIT	740	1,833	2,944	4,651
YOY growth (%)	174	148	61	58
EBIT margin (%)	58	59.0	59.0	60.0
RoCE (%)	46	58	63	66
Capital employed (Rs mn)	1,593	3,135	4,675	7,013

Source: Company data, I-Sec Research

Table 4: ICT – School additions

(No's)

	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08
School additions	54	0	0	1,285	1,626	1055
Cumulative no. of schools	6,004	6,004	6,004	7,289	8,915	9970

Source: Company data

Table 5: Healthy growth in ICT; margins may decline*(Rs mn)*

	FY08	FY09E	FY10E	FY11E
No. of school (at the end)	6,004	10,000	14,000	20,000
No. of school (avg) assumed	4,406	6,810	9,600	13,600
Revenue per school per month	17,650	15,000	14,250	13,538
Revenues (Rs mn)	933	1,226	1,642	2,209
YOY growth (%)	210	31	34	35
EBIT (Rs mn)	273	319	394	486
YOY growth (%)	179	17	24	23
EBIT margin (%)	29.2	26	24	22
RoCE (%)	54	27	23	20
Capital employed (Rs mn)	503	1,192	1,680	2,380

Source: Company data, I-Sec Research

Table 6: Perpetuity in growth provided by K-12 initiatives*(Rs mn)*

K-12 school set up	FY09E	FY10E	FY11E
No. of K-12 school (EOP)	15	35	65
No. of K-12 school (Avg)	10	25	50
Students per K-12 school at full capacity	2,100	2,100	2,100
Capacity utilisation	0.6	0.5	0.4
Recurring fees per students	3,000	3,000	3,000
Total recurring fees	454	945	1,512
One-time admission fee per students	35,000	35,000	35,000
New additions / admissions	10,080	13,650	15,750
Total admission fees	353	478	551
Total collection by school Rs mn (estimated)	806	1,423	2,063
YOY growth (%)	789	76	45
 Revenue models for Edu Infra and Edu Manage			
Revenues (Net fees after meeting costs)	444	783	1,135
as a % of gross collections	55	55	55
EBIT	323	569	825
EBIT margin (%)	73	73	73
as a % of gross collections	40	40	40
PAT	202	356	516
YOY growth (%)	546	76	45
PAT margin (%)	45	45	45
as a % of gross collections	25	25	25
RoCE (%)	23	16	12
Capital employed	1,400	3,500	7,000

Source: Company data, I-Sec Research

Table 7: Segmental revenues, EBIT, capital employed and RoCE

(Rs mn)	FY08	FY09E	FY10E	FY11E
Revenue				
Smart_Class	1,278	3,106	4,990	7,752
ICT	933	1,226	1,642	2,209
Professional development	256	288	300	320
Retail	154	440	700	1,000
K-12	73	444	783	1,135
Total revenue	2,694	5,504	8,414	12,416
EBIT				
Smart_Class	740	1,833	2,944	4,651
ICT	273	319	394	486
Professional Development	156	181	183	192
Retail	86	220	350	500
K-12	36	323	569	825
	1,291	2,876	4,440	6,654
Less:				
Other income	148	130	120	100
Unallocated expenses	182	658	496	733
Total EBIT	924	2,088	3,824	5,821
Capital employed				
Smart_Class	1,593	3,135	4,675	7,013
ICT	503	1,192	1,680	2,380
K-12	550	1,400	3,500	7,000
Total	2,645	5,726	9,855	16,393
RoCE (%)				
Smart_Class	46.5	58.5	63.0	66.3
ICT	54.3	26.7	23.5	20.4

Source: Company data, I-Sec Research

Table 8: Valuations based on FY10E EV/EBIT

(Rs mn)	EBIT (Rs mn)*	Old target EV/EBIT (x)	New target EV/EBIT (x)	EV (Rs mn)	EBIT (%)	ROCE (%)	Rationale
Smart_Class	2,535	21.0	19	47,919	59	63	First-mover advantage, less competition, high EBIT margin and RoCE, long-term contracts, expect to trade at EV/EBIT of ~20x
ICT	339	15.0	14	4,581	24	23	Low margin, more competition; however, high revenue growth, long-term contracts ensure stability
K-12#	490	12.0	11	5,294	40	16	Nascent stage, low RoCE, sustainable revenue stream after steady state
Others	459	17.0	15	7,023	-	30	High growth, high margin, high RoCEs, relatively unpenetrated
Total	3,824	14.6		64,817			
Less : Net Debt				10,197			
Value of equity				54,620			
No. of shares				18.5			
Target price (Rs)				2,950			

*EBIT adjusted for unallocable expenses/other income; # Multiple for 69% stake in K-12 initiatives

Source: I-Sec Research

Financial Summary (Standalone, including Edu Infra and Edu Manage)

Table 9: Profit and Loss Statement

(Rs mn, year ending March 31)

	FY08	FY09E	FY10E	FY11E
Operating Revenues (Sales)	2,621	5,504	8,414	12,416
Operating Expenses	1,373	2,701	3,328	4,732
EBITDA	1,247	2,803	5,086	7,683
% margins	47.6	50.9	60.4	61.9
Depreciation & Amortisation	323	716	1,262	1,862
Gross Interest	42	89	250	357
Other Income	148	130	120	100
Recurring PBT	1,031	2,129	3,694	5,564
Less: Taxes	330	702	1238	1864
Less: Minority Interest	0	64	112	162
Net Income (Reported)	701	1,363	2,345	3,537
Recurring Net Income	701	1,363	2,345	3,537

Source: Company data, I-Sec Research

Table 10: Balance Sheet

(Rs mn, year ending March 31)

	FY08	FY09E	FY10E	FY11E
Assets				
Total Current Assets	4,649	5,522	6,858	9,928
of which cash and deposits	2,922	1,950	1,215	1,488
Total Current Liabilities & Provisions	610	1,038	1,388	1,729
Net Current Assets	4,039	4,484	5,470	8,199
Investments	36	770	770	770
of which Strategic/Group	36	770	770	770
Net Fixed Assets	2,621	7,578	10,594	15,419
Goodwill	280	280	280	280
Capital Work-in-Progress	372	745	945	1,145
Total Assets	7,068	13,577	17,779	25,533
of which cash and equivalents	2,922	1,950	1,215	1,488
Liabilities				
Borrowings	3,773	8,380	9,897	13,972
Deferred Tax Liability	210	240	280	330
Other Non Current Liabilities				
Minority Interest	194	757	1,119	1,282
Equity Share Capital	172	172	172	172
Face Value per share (Rs)	10	10	10	10
Reserves & Surplus*	2,720	4,027	6,311	9,778
Net Worth	2,892	4,200	6,483	9,950
Total Liabilities	7,068	13,577	17,779	25,533

*excluding revaluation reserves

Source: Company data, I-Sec Research

Table 13: Quarterly trends

(Rs mn, year ending March 31)

	Mar-08	Jun-08	Sep-08	Dec-08
Net sales	1,181	694	981	1,453
% growth (YoY)	136.9	152.4	118.3	103.2
EBITDA	551	372	507	668
Margin (%)	46.7	53.5	51.7	46.0
Other income	14	27	55	17
Extraordinaries Inc / (Loss)	0	0	0	1
Recurring Net Income	315	161	254	315

Source: Company data, I-Sec Research

Table 11: Cash Flow Statement

(Rs mn, year ending March 31)

	FY08	FY09E	FY10E	FY11E
Operating Cash flow before W Cap changes	1,023	2,142	3,719	5,562
Working Capital Inflow / (Outflow)	(553)	(1,387)	(1,681)	(2,406)
Capex	(2,205)	(6,045)	(4,479)	(6,888)
Free Cash flow	(1,734)	(5,291)	(2,441)	(3,732)
Cash Flow from other Invest Act (Ex Capex)	66	(734)	0	0
Proceeds from Issue of Share Capital	1,007	0	0	0
Inc/(Dec) in Borrowings	2,583	5,171	1,879	4,238
Dividend paid	(40)	(55)	(61)	(71)
Increase/(Decrease) in Cash	1,881	(909)	(623)	435

Source: Company data, I-Sec Research

Table 12: Key Ratios

(Year ending March 31)

	FY08	FY09E	FY10E	FY11E
Per Share Data (in Rs.)				
EPS	37.8	73.6	126.7	191.1
Recurring Cash EPS	55.3	112.3	194.8	291.7
Dividend per share (DPS)	2.2	2.4	2.4	2.4
Book Value per share (BV)	156.3	226.9	350.3	537.6
Growth Ratios (%)				
Operating Income (Sales)	138.1	110.0	52.9	47.6
EBITDA	146.2	124.7	81.4	51.1
Recurring Net Income	147.1	94.5	72.1	50.9
Recurring EPS	110.9	94.5	72.1	50.9
Recurring CEPS	130.5	103.0	73.6	49.7
Valuation Ratios (x)				
P/E	45.4	23.4	13.6	9.0
P/CEPS	31.1	15.3	8.8	5.9
P/BV	11.0	7.6	4.9	3.2
EV / EBITDA	26.3	13.6	8.0	5.8
EV / Sales	12.5	7.0	4.9	3.6
EV / FCF	NA	NA	NA	NA
Operating Ratio				
Operating Expenses/Sales (%)	52.4	49.1	39.6	38.1
Other Income / PBT (%)	14.4	6.1	3.2	1.8
Effective Tax Rate (%)	32.0	33.0	33.5	33.5
NWC / Total Assets (%)	52.6	30.7	28.5	30.1
Fixed Asset Turnover (x)	1.0	0.7	0.8	0.8
Receivables (days)	161	165	165	157
Payables (days)	137	133	146	128
D/E Ratio (x)	1.3	2.0	1.5	1.4
Return/Profitability Ratio (%)				
Recurring Net Income Margins	26.7	24.8	27.9	28.5
RoC	16.1	13.2	16.4	16.9
RoCE	13.4	13.9	16.5	18.1
RoNW	34.7	38.4	43.9	43.0
Dividend Payout Ratio	5.7	4.0	2.6	2.0
Dividend Yield	0.1	0.1	0.1	0.1
EBITDA Margins	47.6	50.9	60.4	61.9

Source: Company data, I-Sec Research

ANALYST CERTIFICATION

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