INDIA RESEARCH

Educomp

Rs1720
OUTPERFORMER

RESULT NOTE

Mkt Cap: Rs29.6bn; US$608m

Analyst: Nikhil Vora (91-22-6638 3308; nikhilvora@idfcsski.com)
Shweta Dewan (91-22-6638 3290; shweta.dewan@idfcsski.com)

Result: Q3FY09

Comment: Market Speculation to Market Performance!!

Key valuation metrics

Rs Mn	Net Sales	yoy chg (%)	Net profit	yoy chg (%)	EPS (Rs)	yoy chg (%)	EV/E (x)	PER (x)
FY07	1,101	98	286	105	17.9	105	54.6	96.2
FY08	2,861	160	706	147	40.9	129	24.0	42.0
FY09E	5,179	81	1,382	96	80.1	96	11.5	21.5
FY10E	8,406	62	2,111	53	122.4	53	7.6	14.1

Educomp Solutions continues to lead the way with another stellar performance– the maverick has reported a consolidated revenue growth of 117% at Rs1.9bn, EBITDA growth of 97% at Rs720m and PAT growth of 61% at Rs318m (including a forex MTM loss at Rs101m). Growth has been pillared by a 152% increase in revenues from Smart Class at Rs876m (60% of revenues, with EBIT margins of 59%), while ICT segment has seen blended margins fall from 35% to 23% on the back of incremental contracts on the out-right buy model.

In recent days, Educomp has been hit by a flurry of accusations relating from corporate governance issues, to over-stating revenues / profits to sale of stake by promoters et al. In the wake of the recent Satyam scandal, the management has been super-proactive to quash most of these allegations and in the process also cleared a lot of ambiguities with regards core operational issues. We like the sense of urgency displayed by the management as also the addressal mechanism (as detailed later).

Strong execution track record, adequate capitalization and a near-recession free environment are compulsive arguments which we find difficult to ignore. Educomp's success will be defined by a sticky (5 year lock-in) and scalable (5x in five years) model with 'Smart Class' driving the 64% CAGR in earnings. Further a shift from an asset light to a relatively asset heavy model (K-12), we see the evolution as intent to create a strong back-ended growth engine that would lend further resilience to the annuity model. With limited value creation potential in the space, mainly due to scale issues, our investment thesis in IES ($50bn opportunity; 14%CAGR till 2012) rests on the 4Cs – players with Credibility (management intent & ability), Capital (built to last), Creativity (to 'manage' the overregulated environment) and Content (to differentiate and build annuity). With strong pricing power as indeed ability to create an annuity pool Educomp Solutions exhibit the 4KSFs and is our best bet within the listed space. At 14x FY10E earnings and 7.6X EV/EBITDA, we see value in the stock. With 64% earnings CAGR over FY08-11E, we maintain an Outperformer rating and a target price of Rs2,500 (20xFY10e earnings and PEG of 0.3x FY10E); a 47% upside from the CMP.

KEY HIGHLIGHTS OF Q3FY09 RESULTS AND MANAGEMENT INTERACTION POST RESULTS

- Educomp has reported a consolidated revenue growth of 117% at Rs1.9bn, EBITDA growth of 97% at Rs720m and PAT growth of 61% at Rs318m.

- Educomp has reported a standalone revenue growth of 103% at Rs1.45bn, EBITDA growth of 130% at Rs767m (excluding loss from forex fluctuations; loss of Rs101mn on its existing FCCB at $80m) and PAT growth of 66% at Rs316m.
- Inline with our expectations the growth has been primarily led by **Smart Class** – the segment has reported a revenue growth of 152% at Rs876m and an EBIT margin expansion of ~370bps. With this Educomp has implemented Smart Class in 1433 schools till date. An underpenetrated market (less than 5% of the 44,000 private unaided schools in India have embraced multimedia, which indicates that the market potential is in excess of $1.5bn) we expect the buoyancy to continue.
- Within the **ICT** segment, Educomp has reported a revenue growth of 57% at Rs375m and an EBIT margin contraction of ~540bps. This is primarily due to the large number of outright buys (EBIT margins typically at 12%), leading to blended margins of 23% (35% in the last quarter). With a large number of states opting for outright buys we expect margins to remain sedate in coming quarters. Till date, Educomp has implemented ICT in close to 10,000 schools.

Segmental Revenues (Rs mn)	Q3FY08	Q3FY09
Smart_Class	347	876
yoy growth (%)	139	152
Professional Development	66	86
yoy growth (%)	116	31
Others / Retail	64	116
yoy growth (%)	224	82
ICT Solutions	239	375
yoy growth (%)	198	57

Source: Company, IDFC-SSKI Research

PBIT (%)

	Q3FY08	Q3FY09
Smart_Class	55.4	59.1
Professional Development	63.6	60.5
Others	60.8	35.3
ICT Solutions	28.4	22.9

Source: IDFC-SSKI Research

Revenue Mix

% share	Q3FY08	Q3FY09
Smart_Class	48.5	60.3
Professional Development	9.2	5.9
Others / Retail	8.9	8.0
ICT Solutions	33.4	25.8

Source: Company, IDFC-SSKI Research

- **Schools - Asset Backed business – Creating an annuity** – Securing a back ended growth funnel, Educomp has reported 9m revenues at Rs300m and a PAT of Rs143m. While the number of operational schools (11 till date) remain same as last quarter, the company has started construction in 6 schools - one each in Lucknow, Noida, Panipat, Amritsar and two in Chennai (Porur and DLF-OMR). Admissions process has already begun in Panipat, Amritsar and Chennai. Further 3 schools under Takshila Management Services Pvt Ltd. (JV) are in construction phase in Hoshiarpur, Gaya and Ahmednagar and agreements for 5 additional schools on Dry Management basis have been signed by Eurokids India (Educomp has 50% holding). The management remained committal with regards its target of setting up/managing 150 schools; whilst we believe that 50 schools will be 'financially' operational by FY12e.

- The company is gearing up for its foray into professional education – Educomp has signed lease agreements for Raffles International colleges in Bangalore and Delhi; further the company is offering 'low cost, high end' vocational training under ETCN (Educomp Tele Education Network).
- Educomp acquired 50% stake in EuroKids (India's second largest chain of preschools with 484 centers) in October 2008. Along with its propriety preschool chain Roots to Wings, Educomp is currently the largest preschool chain in India. Euro Kids has reported revenues (from 15th Oct 2008 to 31st Dec2008) at Rs54m and a PAT at Rs0.3m for the same period.

In recent days, Educomp has been hit by a flurry of accusations relating from corporate governance issues, to over-stating revenues / profits to sale of stake by promoters et al. In the wake of the recent Satyam scandal, the management has been super-proactive to quash most of these allegations and in the process also cleared a lot of ambiguities with regards core operational issues. We like the sense of urgency displayed by the management as also the addressal mechanism (as detailed below).

Concern 1: Low asset turnover ratio

Management View: The company's business model is to install computers, plasma monitors and digiboards in classrooms as well as a computer lab in the schools for both private and government schools, respectively, for which the students in private schools pay Rs 150 per student per month fee for a 5-year contract and in government schools, the government pays on an Equated Quarterly Installment (EQI) basis. The company provides this equipment on a BOOT (Build Own Operate and Transfer) basis, whereas the assets are capitalized and are shown as fixed assets and transferred to the school once the contract period is over. The private schools business comes under the segment Smart Class and Government Schools comes under the Segment ICT. Thus ICT and Smart Class are both upfront high Capex businesses, albeit with a robust RoCE in successive years.

IDFC-SSKI View: The reason we are bullish on the stock is the high visibility in revenues due to annuity that the 5 year BOOT model its Smart Class and ICT segments offer. While upfront capex needs to be incurred in the first year, the revenues continue to flow over a 5 year period. We estimate a capex of Rs15.5bn over FY09-11E in order to support the 64%CAGR in earnings over the same period.

Smart Class - While the upfront capital cost (~Rs85,000 per class) borne by Educomp is high, assuming an average of 40 students per class (Rs150 per student per month; payments usually on quarterly basis), the investment is recovered in just over a year. The product fetches high margins (58% at EBIT level) and superior RoCE (49%).

Smart Class – smart economics

Revenue per student pm	Rs150
No of students per class	40
Revenue per class	Rs72,000
EBITDA	Rs41,760
Margin	58%
Investment per class	Rs85,000
RoCE	49%

Source: Company, IDFC-SSKI Research

Industry Economics – a hardware and services contract

Value of contract	Rs1m
Period of contract	5 years
Average revenue per lab pa	Rs200,000
EBIT	Rs40,000
EBIT margin	20%
Investment per lab (30% of Value of contract)	Rs300,000
RoCE	13%

Source: Interaction with industry sources, IDFC-SSKI Research

Concern 2 : Bogus Debtor days

Management View: Debtor days are on account of the billing cycle of the business as well as the seasonal revenue pattern with collection cycles being on a quarterly basis. In the case of private schools, ESL realize this around 30 days of the close of the quarter, making the payment cycle 120 days. In the case of ICT, payment collection is usually between 45 to 60 days of the close of the quarter making the payment cycle at 150 days. The seasonal pattern of the business observed leads to around 10% revenue booking in Quarter 1, progressively increasing to ~20% in Quarter 2, ~30% in Quarter 3 and ~40% in Quarter 4. Hence, due to the large billing in Q4, debtor days appear to be higher as on March 31st.

IDFC-SSKI View: Our channel checks with various private schools ensure that payments are infact made on a quarterly basis. With many schools present in non-metros, the 30 days that ESL takes to realize the collections is in tune with the managements clarifications.

Long receivable days within the ICT segment has been a key concern making the business less attractive for players. Our conversations with various players has revealed that while the payment-release cycle time by state governments has become shorter of late, receivable days are still high at over 150 days.

As Educomp's revenue mix has been moving away from ICT, its overall debtors have been reducing consistently; we expect this phenomenon to continue.

Concern 3: Lower employee costs

Management View: ESL currently works with 9,970 government schools, in which, apart from content costs, incremental costs comes in the form of a lab assistant, typical salary being Rs4500/month. In addition to this, ESL employs one resource coordinator in each Smart Class school (there are 1,267 schools as on September 30, 2009) with a typical salary of Rs8,000 per month. These form the bulk of the manpower of the company. It is completely wrong to compare these people to IT programmers. Educomp is not an IT company and should not be compared to IT companies.

IDFC-SSKI View: Our visits to the private schools and interactions with the resource managers ensure that the employee costs is typically in the range of Rs7000-8000 per month. During the management call, the management gave a complete break up of their employee by department - ~87% of the employees are resource coordinators (smart class) or employees in ICT. Their job profile is largely administrative in nature and involves no programming (not comparable to the IT industry).

Department	No of employees
Resource coordinators (Smart class)	892
Marketing	165
Employees in ICT	2550
Corporate	55
Trainers in professional development and	180
Multimedia professionals.	93
Total	3935

Source: Company, IDFC-SSKI Research

Concern 4 :Sale of shares by promoter

Management View: The promoter group has so far sold only approx. 5.07% on fully diluted basis, of their holdings in the company from the IPO till date. The total number of shares sold are 876,643 only. The promoters still hold 55.03% stake in the company.

IDFC-SSKI View: No opinion on share sale. But over years, most entrepreneur driven organizations have seen changes in promoter ownership structures, given lack of capital by promoters during the early stage growth phase of its entity. We don't necessarily have a negative bias due to that reason. Incrementally, management has clearly stated that 'not a single share owned by the promoters is pledged anywhere'.

Concern 5: Corporate governance issues

Management View: ESL has quantified its corporate governance road map:

- Company is in discussions with Grant Thornton for their appointment as the internal auditors of Educomp Solutions Ltd and statutory auditor of Educomp Infrastructure & School Management Services Ltd. from the next fiscal year
- Disclosure of the intention of sale of shares (if any) in advance and shareholding at the end of every quarter by the Promoter Group
- Approaching NSDL & CDSL/Depository or any other applicable authority to get a certificate to confirm non-pledging of any of its shares
- Expansion of the Board of Directors to include prominent educationists & other eminent persons as independent directors

IDFC-SSKI View: – We believe the move will help boost investor confidence

Quarterly results

Rs Mn	Q3FY08	Q4FY08	FY08	Q1FY09	Q2FY09	Q3FY09	FY09E	FY10E
Net Sales	**715.1**	**1181.3**	**2861**	**694.2**	**982**	**1452.8**	**5179**	**8406**
%yoy	*159*	*137*	*160*	*152*	*119*	*103*	*81*	*62*
Operating profit	333.8	551.128	1273	371.5	508	767.3	2839	4647
EBITDA	**47**	**47**	**45**	**54**	**52**	**53**	**55**	**55**
Depreciation	91.32	109.55	331.3	134.64	157	192.0	699.8	1186.3
EBIT	242.48	441.578	942.0	236.86	351	575.4	2138.8	3461.1
Interest	12.55	16.1	48.1	14.17	17	24.1	239.9	473.5
Other Income	58.85	14.1	177.6	26.87	55	-84.2	177.6	177.6
Profit before tax	288.78	439.578	1071.5	249.56	389	467.1	2076.5	3165.1
Tax	98.73	124.8	351.1	89.06	134	151.5	685.3	1044.5
PAT	**190.05**	**314.778**	**720.4**	**160.5**	**255**	**315.5**	**1391.2**	**2120.6**
%yoy	*131*	*140*	*152*	*171*	*88*	*66*	*93*	*52*
PAT post minority interest			705.61				1382.3	2110.8

Quarterly nos are standalone, annual nos are consolidated

Analyst	Sector/Industry/Coverage	E-mail	Tel. +91-22-6638 3300
Pathik Gandotra	Head of Research; Financials, Strategy	pathik@idfcsski.com	91-22-6638 3304
Shirish Rane	Construction, Power, Cement	shirish@idfcsski.com	91-22-6638 3313
Nikhil Vora	FMCG, Media, Retailing, Education, Mid Caps	nikhilvora@idfcsski.com	91-22-6638 3308
Ramnath S	Automobiles, Auto ancillaries, Real Estate	ramnaths@idfcsski.com	91-22-6638 3380
Nitin Agarwal	Pharmaceuticals	nitinagarwal@idfcsski.com	91-22-6638 3395
Chirag Shah	Metals & Mining, Pipes, Textiles	chirag@idfcsski.com	91-22-6638 3306
Bhoomika Nair	Logistics, Engineering, Power	bhoomika@idfcsski.com	91-22-6638 3337
Hitesh Shah	IT Services	hitesh.shah@idfcsski.com	91-22-6638 3358
Bhushan Gajaria	FMCG, Retailing, Media, Mid Caps	bhushangajaria@idfcsski.com	91-22-6638 3367
Ashish Shah	Construction, Power, Cement	ashishshah@idfcsski.com	91-22-6638 3371
Salil Desai	Construction, Power, Cement	salil@idfcsski.com	91-22-6638 3373
Ritesh Shah	Metals & Mining, Pipes, Textiles	riteshshah@idfcsski.com	91-22-6638 3376
Neha Agrawal	Financials	neha@idfcsski.com	91-22-6638 3237
Swati Nangalia	Mid Caps, Media	swati@idfcsski.com	91-22-6638 3260
Sameer Bhise	Strategy	sameer@idfcsski.com	91-22-6638 3390
Shweta Dewan	Mid Caps, Education, FMCG	shweta.dewan@idfcsski.com	91-22-6638 3290
Nikhil Salvi	Cement, Construction	nikhil.salvi@idfcsski.com	91-22-6638 3239
Rajeev Desai	Real Estate	rajeev@idfcsski.com	91-22-6638 3231
Chinmaya Garg	Financials	chinmaya@idfcsski.com	91-22-6638 3325
Aniket Mhatre	Automobiles, Auto ancillaries	aniket@idfcsski.com	91-22-6638 3311
Probal Sen	Oil & Gas	probal@idfcsski.com	91-22-6638 3238
Rupesh Sonawale	Database Analyst	rupesh@idfcsski.com	91-22-6638 3382
Dharmesh Bhatt	Technical Analyst	dharmesh@idfcsski.com	91-22-6638 3392

Equity Sales/Dealing	Designation	E-mail	Tel. +91-22-6638 3300
Naishadh Paleja	MD, CEO	naishadh@idfcsski.com	91-22-6638 3211
Paresh Shah	MD, Dealing	paresh@idfcsski.com	91-22-6638 3341
Vishal Purohit	MD, Sales	vishal@idfcsski.com	91-22-6638 3212
Nikhil Gholani	MD, Sales	nikhil@idfcsski.com	91-22-6638 3363
Sanjay Panicker	Director, Sales	sanjay@idfcsski.com	91-22-6638 3368
V Navin Roy	Director, Sales	navin@idfcsski.com	91-22-6638 3370
Suchit Sehgal	AVP, Sales	suchit@idfcsski.com	91-22-6638 3247
Pawan Sharma	MD, Derivatives	pawan.sharma@idfcsski.com	91-22-6638 3213
Dipesh Shah	Director, Derivatives	dipeshshah@idfcsski.com	91-22-6638 3245
Jignesh Shah	AVP, Derivatives	jignesh@idfcsski.com	91 22 6638 3321
Sunil Pandit	Director, Sales trading	suniil@idfcsski.com	91-22-6638 3299
Mukesh Chaturvedi	SVP, Sales trading	mukesh@idfcsski.com	91-22-6638 3298

Explanation of Ratings:

1. Outperformer: More than 10% to Index
2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

Disclosure of interest:

1. IDFC - SSKI and its affiliates may have received compensation from the company covered herein in the past twelve months for Issue Management, Capital Structure, Mergers & Acquisitions, Buyback of shares and Other corporate advisory services.
2. Affiliates of IDFC - SSKI may have mandate from the subject company.
3. IDFC - SSKI and its affiliates may hold paid up capital of the company.
4. IDFC - SSKI and its affiliates, their directors and employees may from time to time have positions in or options in the company and buy or sell the securities of the company(ies) mentioned herein.