

Educomp Solutions

Rs438
OUTPERFORMER

RESULT NOTE

Mkt Cap: Rs43.9bn; US\$924m

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Result: Q3FY11 results

Comment: Game changer!

Key Financials

(Rs m)	Net Sales	yoy chg (%)	Net profit	yoy chg (%)	EPS (Rs)	yoy chg (%)	EV/E (x)	PER (x)
FY08	2,861	160	706	146	8.2	128	30.3	53.5
FY09	6,371	123	1,329	88	15.4	88	14.6	28.5
FY10	10,395	63	2,759	108	29.0	89	9.1	15.1
FY11E	12,634	22	3,307	20	34.8	20	9.7	12.6
FY12E	15,012	19	3,698	12	36.8	6	7.6	11.9

Consolidated financials

Highlights of Q3FY11 results and our interaction with the management

- Educomp reported its Q3FY11 results. While numbers for the quarter are strong, we see the improvement in financial disclosures across all business units as a key positive. Reported numbers are not comparable on a yoy basis due to change in the business model (tripartite agreement with Edusmart).
- During the quarter, Educomp has reported consolidated revenues of Rs3.58bn (estimates of Rs3.4bn), EBITDA of Rs1.63bn (estimates of Rs1.5bn), and a PAT of Rs967m (estimates of Rs952m).
- The operational performance during the quarter is ahead of estimates on account of higher than expected deliverance in the School Learning Solutions (SLS) and the Higher Learning Solutions (HLS) businesses.
- SLS** reported revenues of Rs2.79bn and EBIT of Rs1.7bn in Q3FY11. The financials are not comparable to Q3FY10 on account of change of business model of smart class.
- Within the SLS segment, **Smart Class** reported revenues of Rs2.5bn and EBIT of Rs1.65bn in Q3FY11. The revenues recognized in the quarter include Rs980m on account of deferred revenue pertaining to contracts transferred to EduSmart. Further, deferred revenues of Rs1.54bn on account of Edusmart are also expected to come in Q4FY11.
- Smart class additions** - Within Smart Class, during the quarter Educomp added 7,085 classrooms with 7.5 classrooms per school, at an average price of Rs0.39m per classroom. In 9mFY11, Educomp has added 19,144 classrooms. With Q4 being the strongest quarter for the business, Educomp is well on track to add 26,000+ classrooms for FY11.
- Margins improving** - During the quarter, Smart Class EBIT margins stood at a strong 66% primarily on account booking of deferred revenue from EduSmart. As per the new revenue recognition policy, as Educomp starts reporting the balance 22.5% of contracts of new schools addition (margins of 80-90%), overall EBIT margins of the smart class segment will improve. For FY11, Educomp is expected to maintain EBIT margins at 60%+.
- Securitization structure – more transparency!** – In Q2FY11, Educomp had announced a change in arrangement with Edusmart, wherein the recourse on Educomp for all further securitization done by Edusmart was reduced from 100% earlier to 20%. This move addressed our apprehensions on the structure to a large extent. Incrementally, Educomp is now looking to add more vendors like Edusmart to partner in the smart class business. Importantly, the management has indicated that for securitization done by these new vendors the recourse would remain 20% or less. This imparts further comfort on the structure as also enhances the transparency in the system. The management has also indicated

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that eventually Educomp would not have any recourse to the securitization done by third party vendors. These recent developments impart higher comfort on the business as also the management.

- **ICT – Cautious on additions** - ICT reported a revenue decline of 7% at Rs293m and EBIT of Rs55m. The decline in the segment is attributable to no new school additions during the quarter and contracts for 3,264 schools expiring in the current quarter. We are aligned Educomp's strategy of cautiously deploying capital towards the ICT business (L1 bidding, high debtor days).
- **Schools – funding back ended growth** – Educomp has demonstrated strong execution in the K-12 space which is the largest annuity stream in the Education sector. **With 60% of total capital employed deployed towards the K-12 segment at Rs15.6bn, Educomp is demonstrating the ability to leverage on the sticky nature of the education space.** During the quarter, the K12 business (EISML+Euro Kids+RTW) reported a revenue growth of 21% at Rs304m and an EBIT of Rs107m.
- Educomp has increased its stake in the K-12 subsidiary – EISML – from 69.4% in FY10 to 80.4% now. This transaction has valued EISML at Rs16.4bn or at Rs664 per share. For 9mFY11, EISML has reported revenues of Rs675m, EBITDA of Rs464m and PAT of Rs124m.
- Educomp now has 50 schools operational (39 under EISML; 11 under its JV with Euro Kids) and has visibility for 81 schools till date (including dry management, land sites and under construction sites). Schools operated in JV with Eurokids (called Euroschools) are operated under the franchise model and during the quarter Educomp has terminated its agreement with three franchises. Thus, number of operational Euroschools has dropped on a QoQ basis from 14 in Q2FY11 to 11 in Q3FY11.
- Educomp is adopting an aggressive strategy in expanding its K-12 network and expects to reach 150 schools by FY13. Around 50% of the schools are expected to be owned under various models and price points – Millennium (capex at ~Rs350m), Takshila (capex at ~Rs100m) and Vidya Prabhat (capex at ~Rs10m).The remaining 50% will follow the content licensing/ management services to schools route. Educomp has also signed a JV with Lavasa Corporation to set up a residential school in Lavasa.
- **HLS** (Higher Learning Solutions) reported a revenue growth of 87% at Rs146m and an EBIT loss of Rs60m. Educomp in JV with Raffles operates 7 Raffles Millennium International institutes in the country. While the JV is not looking at adding more institutes, is it focused towards improving the occupancies across the existing network. IndiaCan (Educomp's JV with Pearson) now has a presence across 279 centers reaching 52,500 students.
- **Online and supplemental segment** reported a revenue growth of 16% at Rs331m and an EBIT loss of Rs44m.
- For the quarter Q3FY11, debtor days stood at 168 days, with debtor days for Smart Class at 87 days, ICT at 52 days and K-12 at 22 days.
- As on 31st December 2010, gross debt stood at Rs14.6bn (this includes FFCB worth \$78.5m) and cash at Rs5.05bn.
- Educomp has inducted eminent personalities on its Advisory Board including Amjad Ali Khan (renowned sarod player), Gurcharan Das (author and management guru), Indu Shahani (Sheriff of Mumbai) and many more. We believe this will play a key role in improving the credibility of the business.

Unmatched scale, strong earnings momentum, enhanced visibility and stickiness in the business and most importantly significant improvement in disclosures across financial parameters form key reasons for our positive bias towards Educomp. Evolution of Educomp from a 3-5year annuity business (in the digital content space) to a 10year annuity in business (K12 schools) reflects the innate ability of Educomp to capitalize on the sticky nature of the Education space. With 60% of the total capital committed in the business (or Rs15.6bn) deployed towards K-12 schools (RoCEs of 20-30%), we see Educomp transforming to an extremely 'scalable', 'profitable' and 'value accretive' business in the longer run. Given the current business momentum and past deliverances by the management, our sense is that over next 4-5 years Educomp will be nearly 10x the scale of the nearest competitor in the country! Incrementally, our apprehensions towards the new structure in smart class have been further alleviated with the management intention of increasing the number of vendors (with recourse to Educomp at 20% or less). Highest transparency levels, stronger than ever visibility in the business and value drivers clearly identified, Educomp is looking better placed than ever before across all parameters. The largest player in the USD50bn Education space riding on a high conviction business model is available at less than USD1bn! – we believe the stark divergence

between Educomp's superior business model backed with strong operational deliverance and the current valuation of 12xFY12E earnings will need to correct. Maintain Outperformer with a price target Rs780.

Segmental revenues

(Rs m)	Q3FY11	Q3FY10	% growth
School Learning Solutions	2,794	1,987	41
Higher Learning Solutions	146	78	87
K12 Schools	304	251	21
Online, global & supplemental	331	285	16
Total	3,575	2,601	37

Source: Company, IDFC Securities Research

Segmental contribution to revenues

(%)	Q3FY11	Q3FY10	Change in bp
School Learning Solutions	78	76	177.6
Higher Learning Solutions	4	3	107.8
K12 Schools	8	10	(114.3)
Online, global & supplemental	9	11	(171.1)

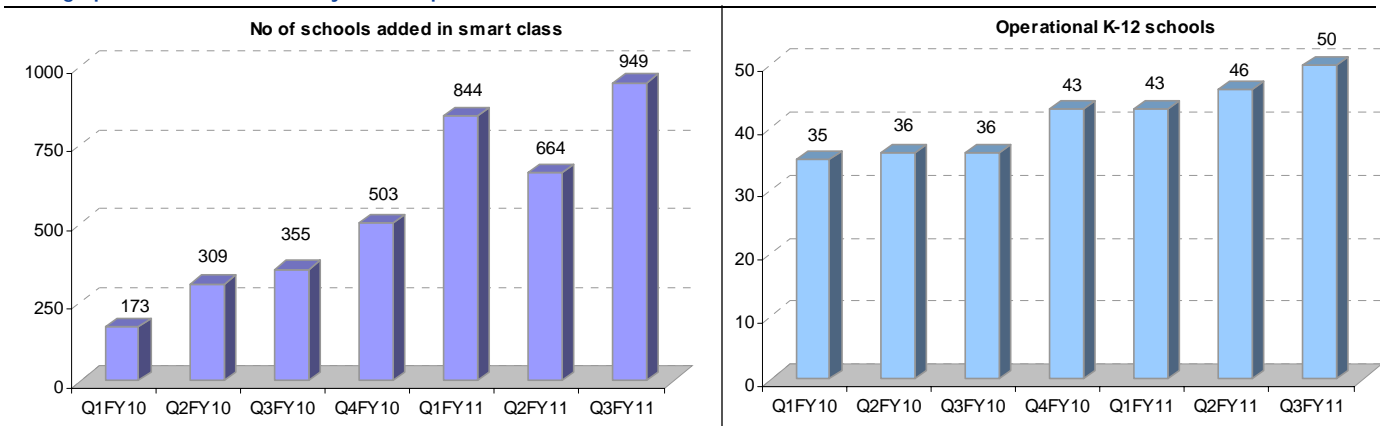
Source: Company, IDFC Securities Research

Segmental EBIT

(Rs m)	Q3FY11	Q3FY10	% growth
School Learning Solutions	1709.0	1216.4	41
Higher Learning Solutions	(60.4)	(41.2)	-
K12 Schools	106.5	103.1	3
Online, global	(44.3)	(47.2)	-
Total	1710.8	1231.1	39

Source: Company, IDFC Securities

Strong operational deliverance by Educomp



Source: Company, IDFC Securities Research

Smart class additions

	Q4FY10	Q1FY11	Q2FY11	Q3FY11
No of classrooms added in smart class	4038	6750	5309	7085

Source: Company, IDFC Securities Research

Higher Learning Solutions

	Q1FY10	Q2FY10	Q3FY10	Q4FY10	Q1FY11	Q2FY11	Q3FY11
No of Raffles Millennium Institutes	2	2	2	3	7	7	7
No of IndiaCan points of presence	40	105	122	220	251	277	279

Source: Company, IDFC Securities Research

K-12 economics

Category	School trust level			Average capex (Rs m)	EISML		
	EBITDA (%)				RoCE (%)		
	Year 1	Year 2	Year 3 onwards		Year 1	Year 2	Year 3 onwards
Millenium	(12.5)	0.1	44% - 64%	250	10.1	11.6	13%-26%
Co-Branded	(3.8)	11.1	54% - 68%	310	10.0	12.0	13%-25%
Universal Academy	(16.5)	12.9	24% - 44%	20	4.0	10.5	11%-31%
Takshila	(16.3)	(14.4)	26% - 51%	120	9.1	9.9	13%-25%
JVs	One time amount of Rs1m charged + 15% of revenue as management fees			400-450	8.1	20.4	30%+

Source: Company

Financial performance

(Rs m)	Q3FY10	Q4FY10	FY10	Q1FY11	Q2FY11	Q3FY11	FY11E	FY12E
Net Sales	2601.0	3330.7	10394.9	2279.2	2767.1	3574.7	12634.3	15012.1
%yoy	37	47	63.2	18	9	37	22	19
Operating profit	1362.3	1589.7	4860.7	693.2	1037.1	1631.1	5155.2	7054.8
EBITDA	52	48	47	30	37	46	41	47
Depreciation	337.8	201.0	1142.3	198.0	207.8	200.8	831.3	1057.1
EBIT	1024.5	1388.7	3718.4	495.2	829.3	1430.3	4324.0	5997.7
Interest	138.8	128.3	538.7	161.2	211.8	278.8	937.4	1092.8
Other Income	158.5	101.4	1255.3	100.0	83.7	86.6	351.5	421.8
Profit before tax	1016.4	1359.7	4421.0	405.2	722.5	1256.6	3738.0	5326.7
Tax	375.0	755.5	1584.2	39.0	140.8	253.2	373.8	1571.4
PAT	641.4	604.1	2836.8	366.2	581.7	1003.4	3364.2	3755.3
PAT post minority interest	610.2	594.3	2758.6	365.3	577.7	966.6	3306.7	3697.8
%yoy	92	7	108	7	(50)	58	19.9	11.8

Source: IDFC Securities Research

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