

Educomp Solutions

Rs513
UPGRADE TO OUTPERFORMER

RESULT NOTE

Mkt Cap: Rs48.7bn; US\$1.08bn

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Result: Q2FY11 results

Key Financials

Rs Mn	Net Sales	yoy chg (%)	Net profit	yoy chg (%)	EPS (Rs)	yoy chg (%)	EV/E (x)	PER (x)
FY08	2,861	160	706	146	40.9	128	35.4	62.6
FY09	6,371	123	1,325	88	77.7	90	16.9	33.0
FY10	10,406	63	2,767	109	29.1	-63	8.2	17.6
FY11E	13,031	25	3,302	19	34.8	19	9.3	14.7
FY12E	15,545	19	3,707	12	39.2	12	6.9	13.1

All nos are on a consolidated level; EPS is post the adjustment of stock split (1:5) in FY10

An annuity backed and highly profitable business model, a strong execution track record and adequate capitalization are compulsive arguments in favour of Educomp.

- Enhanced stickiness in the business:** 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 over Rs13bn of capital deployed towards K-12 schools till date which offers RoCEs of 20-30%, we see Educomp transforming to an extremely 'scalable', 'profitable' and 'value accretive' business in the longer run.
- Execution comfort:** Within 3yrs, Educomp's reach in 30,000 classrooms in Smart Class and 79 K-12 schools (by FY11), demonstrates the inherent execution capability of the management. 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!
- Adequate capitalization:** With the overall balance sheet funded to the tune of Rs3.36bn, we see back ended growth levers in place. While the core SLS business continues to sustain momentum, investments in high RoCE businesses such as schools (target of 150schools by FY13) will aid furthering the value proposition in the business.

While the business fundamentals make us extremely bullish, we continue to remain cautious with respect to the Edusmart structure (would have preferred if Educomp had securitized Smart Class receivables on its own books). However, our concerns are alleviated to a large extent with the recent development towards receivables securitization (recourse on Educomp reduced from 100% earlier to 20% now). Further, we see consistency in operational performance and more critically transparent deliverance on financial parameters as key positives. We believe the issues relating to corporate governance and changes in structure are largely captured in the over 40% underperformance of the stock in the last 12 months. At a market capitalization of USD1.1bn, we believe Educomp - the key proxy to play the USD30bn private Education play in India - makes a strong case of re-rating. Trading at 13x FY12E earnings, we upgrade our call on Educomp from Neutral to Outperformer with a target multiple of 20x FY12E earnings (equivalent to the Sensex multiple, albeit higher earnings growth) which implies a target price of Rs780 - a 52% upside from the current levels.

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Highlights of Q2FY11 and our interaction with the management

- Educomp reported its Q2FY11 results. 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 Rs2.76bn (estimates of Rs2.06bn), EBITDA of Rs1.04bn (estimates of Rs766m), and a PAT of Rs578m (estimates of Rs457m).
- The operational performance during the quarter is ahead of estimates on account of higher than expected deliverance in the School Learning Solutions (SLS) business which includes smart class and ICT businesses.
- **SLS** reported revenues of Rs1.92bn and EBIT of Rs888m in Q2FY11. The financials are not comparable to Q2FY10 on account of change of business model of smart class.
- **Smart Class** reported revenues of Rs1.5bn and EBIT of Rs816m in Q2FY11. On a like to like basis, Educomp reported a revenue growth of 46% in the Smart Class business. Within the Smart Class segment, revenue recognized in the quarter includes Rs420m on account of deferred revenue pertaining to contracts transferred to EduSmart. The management has guided for deferred revenues of Rs980m and Rs1.54bn in Q3FY11 and Q4FY11 respectively.
- **Smart additions** - Within Smart Class, Educomp added 5309 schools with 8 classrooms per school, at an average price of Rs4.04lakh per classroom. With H2FY11 accounting for over 60% of classroom addition during the year and 12,059 classrooms additions completed in H1FY11, we expect Educomp to add 25,000 classrooms for the year. Further we expect the renewals cycle for schools signed in FY08/FY09 and same school expansion to impart further momentum.
- **Margins improving** - During the quarter, Smart Class EBIT margins stood at 54% on the back of improved yields and booking of deferred revenue from EduSmart. As per the new revenue recognition policy, as Educomp starts reported 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%+.
- **EduSMART** – We would have preferred if Educomp had securitized its SmartClass receivables on its own books. However, with all of the existing contracts transferred to EduSmart and improved disclosures across segments over the last few quarters, we believe the extent of ambiguities will be limited going forward. Further a key development during the quarter has been the new agreements signed with a financial institution wherein recourse to Educomp has been reduced from 100% earlier to 20% now. Securitization to the tune of Rs3bn has been done on the new terms. Going forward, the company expects to securitize future receivables without a potential contingent liability on Educomp's balance sheet, which would help Educomp leverage its balance sheet to fund growth across businesses. Currently, Educomp has an investment by way of 8% non-convertible preference shares (~Rs450m.) in EduSmart.
- **ICT – Cautious on additions** - ICT reported a revenue growth of 34% at Rs421m and EBIT of Rs95m. Of the revenues of Rs421m, Rs210m was towards sale of hardware. No new schools were added during the 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** - K12 (EISML+Euro Kids+RTW) reported a revenue growth of 54% at Rs321m and an EBIT growth of 144% at Rs129m. EISML (Educomp holds 78.5%) reported revenues growth of 69% at Rs212m, EBITDA margins of 74% at Rs156m and a PAT of Rs37m. Going forward, K-12 (schools) remains a key focus area. Educomp now has a presence in 46 schools operational (32 under EISML; 14 under its JV with Euro Kids) and has visibility for 79 schools till date (including dry management, land sites and under construction sites). Educomp has signed a JV with Lavasa Corporation to set up a residential school in Lavasa. The management 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.
- **HLS** (Higher Learning Solutions) reported a revenue growth of 123% at Rs137m and an EBIT loss of Rs65m.
- **Online/global** reported a revenue growth of 48% at Rs387m and an EBIT profit of Rs31m (against a loss of Rs69m in the same quarter last year). We expect EBIT losses from the other businesses (HLS + Online/global) to the tune of ~Rs400m in the current year.

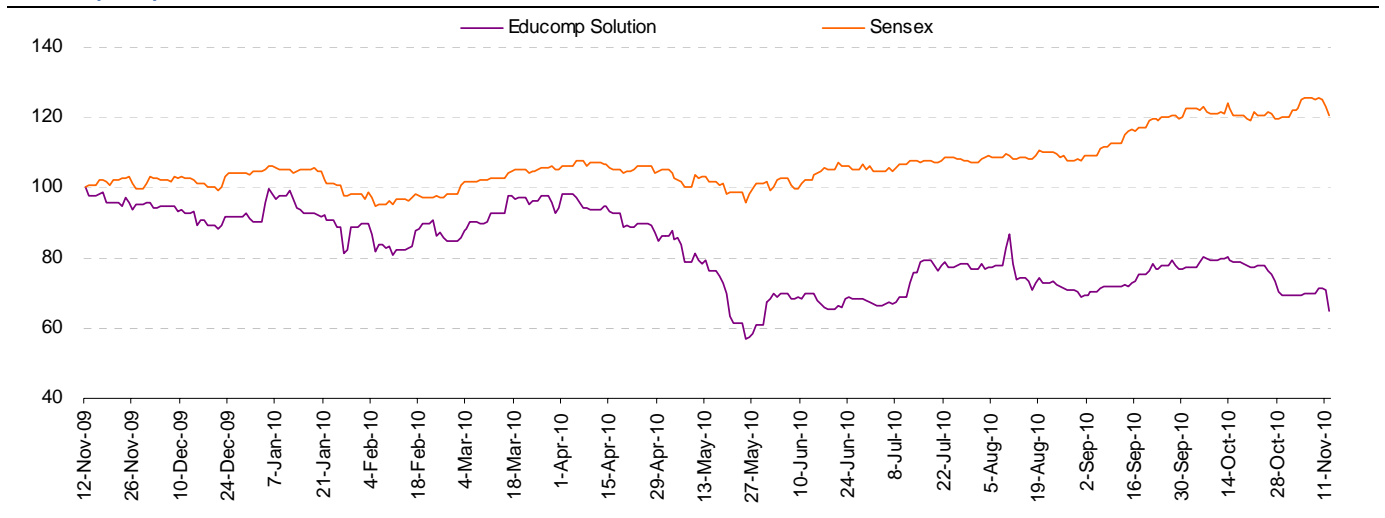
- As on 30th September 2010, gross debt stood at Rs14bn (this includes FFCB worth \$78.5m) and cash at Rs4.7bn.
- For the quarter Q2FY11, debtor days stood at 249 days. However, as on 5th October 2010 debtor days stand at 149 days on account of bank funding of non-securitized receivables.

Financial performance

	Q2FY10	Q3FY10	Q4FY10	FY10	Q1FY11	Q2FY11	FY11E	FY12E
Net Sales	2,535.3	2,601.0	3,330.7	10,405.9	2,279.2	2,767.6	13,031.3	15,545.2
%yoy	92.0	37.0	47.0	63.0	18.0	9.0	25.0	19.0
Operating profit	1,048.2	1,362.3	1,589.7	4,858.5	693.2	1,037.6	4,833.1	6,376.1
EBITDA	41.0	52.0	48.0	47.0	30.0	37.0	37.0	41.0
Depreciation	306.3	337.8	201.0	1,138.1	198.0	207.8	827.3	900.0
EBIT	741.9	1,024.5	1,388.7	3,720.4	495.2	829.8	4,005.8	5,476.1
Interest	119.6	138.8	128.3	488.5	161.2	211.8	631.1	733.9
Other Income	850.1	158.5	101.4	1,262.0	100.0	83.7	360.0	600.0
Forex fluctuations	(32.6)	(27.9)	(2.1)	(99.4)	(28.8)	21.3	-	-
Profit before tax	1,439.8	1,016.4	1,359.7	4,394.4	405.2	723.0	3,734.7	5,342.2
Tax	269.6	375.0	755.5	1,625.5	39.0	140.8	373.5	1,575.2
PAT	1,170.2	641.4	604.1	2,769.0	366.2	582.2	3,361.3	3,766.2
PAT post minority interest	1,155.3	610.2	594.3	2,701.7	365.3	578.2	3,302.1	3,707.1
%yoy	301.0	92.0	7.0	103.0	7.0	(50.0)	22.2	12.3

Source: IDFC Securities Research

Relative price performance



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2. Neutral: Within 0-5% to Index (upside or downside)
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