

Vast opportunity, unique competitive position

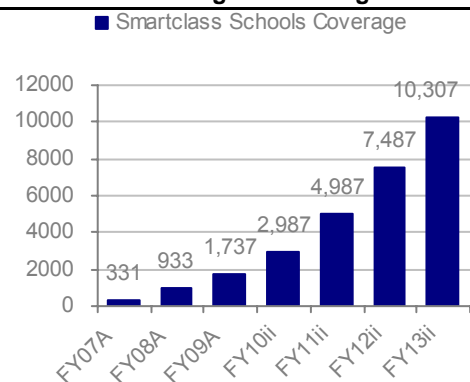
Educomp enjoys a unique competitive position and early-mover advantage in the Indian education industry, which we believe is capable of rapid and sustainable long-term growth. We forecast by FY15, a 6x increase in *Smartclass* installations, driven by product superiority and peer pressure among schools, and a significant ramp-up in K-12 schools (225 schools). Key risks include excessive acceleration at the expense of execution and service quality. We initiate with a BUY and a 12-month DCF-based target price of Rs865.

Indian education – a large opportunity in the making: A large 'under-24' population of ~500m, one of the world's lowest GERs (17%), low literacy rates and number of schooling years (5.1) in the world, promise long-term growth. According to CBSE (Central Board of Secondary Education), by FY12 India will need ~150,000 more private schools—twice as many as it has at present. Various education services, including more schools, smart classrooms, faculty training, and vocational training—all of which face serious shortages today—will be needed.

Upsides for Educomp from early start in *Smartclass* and K-12 businesses: We believe that *Smartclass* (and similar products) will increasingly be adopted by schools, fuelled by product superiority (over traditional methods) and peer pressure among schools. Educomp's product, currently in 2,574 schools (forecast to exceed 16,000 schools by FY15) is the clear class leader and we foresee a widening lead over competition. Educomp is also increasing focus on the K-12 business at the right time, and we forecast it will be in use in 200+ schools by FY15 (currently 36). Securitisation of *Smartclass* receivables and K-12 execution through the 'dry management' models are important steps towards accelerating execution, which is vital to capturing this opportunity.

BUY with DCF TP of Rs865: We believe that acceleration will gain visibility in the coming quarters (management has guided for 2500 *Smartclass* schools in FY11, compared to 355 added in 3QFY10). Longer-term triggers may include Educomp's banks foregoing recourse to Educomp for securitised receivables. Key risks are Educomp's accelerating too fast for its execution capability to keep pace, as well as increased involvement in government business spurred by the Right to Education Act. BUY with DCF TP of Rs865 with 11.5% WACC and 4% TGR.

Smartclass coverage set to surge



Source: Company, IIFL Research

Financial Summary

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenues (Rs m)	2,861	6,371	11,644	12,795	16,124
EBITDA Margins (%)	44.5	47.8	50.0	50.3	52.9
Pre-Exceptional PAT (Rs m)	710	1,347	3,633	2,796	3,842
Reported PAT (Rs m)	710	1,347	3,633	2,796	3,842
EPS (Rs)	8.2	15.6	38.5	29.6	38.1
Growth (%)	129.5	89.7	146.5	-23.0	28.6
PER (x)	89.2	47.0	19.1	24.8	19.3
ROE (%)	35.2	38.0	40.6	18.6	19.1
Debt/Equity (x)	1.3	2.1	0.8	0.8	0.5
EV/EBITDA (x)	50.4	21.1	11.0	10.0	7.5
Price/Book (x)	22.0	15.1	5.1	4.2	3.1

Price as at close of business on 10 March 2010

12-mth TP (Rs) 865 (18%)

Market cap (US\$ m) 1,775

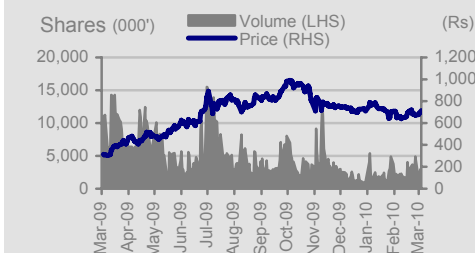
52Wk High/Low (Rs) 1020/304
 Diluted o/s shares (m) 95
 Daily volume (US\$ m) 33
 Dividend yield FY10ii (%) 0.2
 Free float (%) 49.9

Shareholding pattern (%)
 Promoters 50.1
 FIIs 39.3
 DIIs 1.5
 Others 9.1

Price performance (%)

	1M	3M	1Y
Educomp	11.7	-3.6	136.3
Rel. to Sensex	4.3	-3.1	26.8
Everonn	-1.6	-6.6	330.3
Education			
NIIT Ltd	-1.4	-12.2	349.0

Stock movement



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Company background

Aiming for full spectrum of education services; SmartClass the mainstay: Educomp, one of India’s largest companies in the education space, was started in 1994 by Shantanu Prakash, an alumnus of IIM Ahmedabad. Educomp provides educational aids for primary and K-12 schools, vocational courses and higher education (besides online tutoring), and has presence across the education life cycle (2 to 25 yrs).

Figure 1: Management

Name	Designation	Management description
Shantanu Prakash	Chairman, MD and founder	Founded the company in 1994, a few years after acquiring an MBA from IIM Ahmedabad. Involved with expanding the company’s footprint and building revenues.
Sangeeta Gulati	CFO	CA, with over 14 years of experience in money market operations, raising funds, finance and accounting management.

Source: Company, IIFL Research

Its most successful product is *SmartClass* (2,574 schools), which involves use of digital screens and computers as teaching aids. The company charges schools for *Smartclass* in five-year contracts at ~Rs130/student/month. Per-school capex is typically Rs1.5m. The other major cost is that of content, which Educomp has built over time.

The other major focus areas are K-12 (where Educomp runs schools), vocational and higher education (50-50 JVs with Pearson and Raffles respectively) and online tutoring. Edureach (ICT), the government schools business, has been de-emphasised, because of low profitability.

Competitive positioning: Educomp’s nearest competitors in the listed space are Everonn Education, NIIT and Aptech, with the latter two being stronger in IT education than in conventional school education. There are numerous unlisted companies and corporate foundations such as the Wipro Foundation and the Bharti Foundation involved in educational activities. In digital classrooms, Educomp dominates, with ~60-70% market share—about 3m students in almost 2,500 schools.

Current education infrastructure inadequate: Currently, there are ~1m schools in India, including ~0.9m government schools and 75,000

private schools. No group has a dominant share of the private segment. Out of 360m children of school-going age, only 210m actually attend school. Dropout rates are very high, and the average years of education (4.9) are among the lowest in the world. Shortage of high-quality faculty is also a widespread problem, in schools as well as colleges.

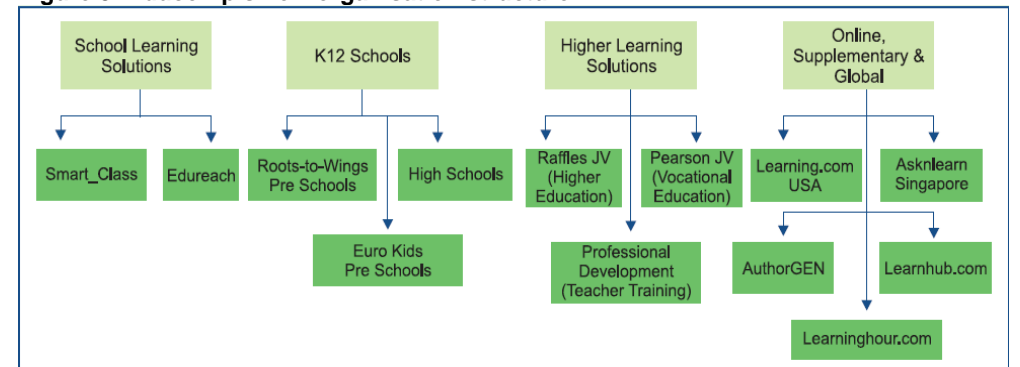
Restrictive regulations: While these numbers suggest a large opportunity for the taking, the government does not allow ‘for-profit’ investment in education, which means that any profits generated by an entity providing education have to re-invested in the business (they cannot be taken out). Private players have worked around this restriction by assuming profitable ‘supplier’ relationships to schools instead of generating profits in the schools; thus, they have positioned themselves to exploit a large opportunity.

Figure 2: Revenue break-up

Revenues (Rs m)	FY08	FY09
Smartclass	1,268	3,157
Edureach (formerly ICT)	933	1,137
Professional Development	256	287
Retail	403	1,790
Total	2,861	6,371

Source: Company, IIFL Research

Figure 3: Educomp’s new organisation structure



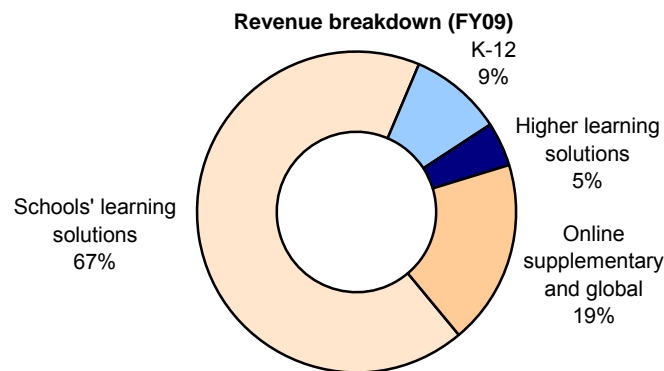
Source: Company, IIFL Research; Most of the subsidiaries are majority but not fully owned by Educomp. Raffles and Pearson JVs are 50-50. Promoter holding in the company is 50.1%.

Educomp positioning itself for full range of services

Educomp has structured itself along four business segments:

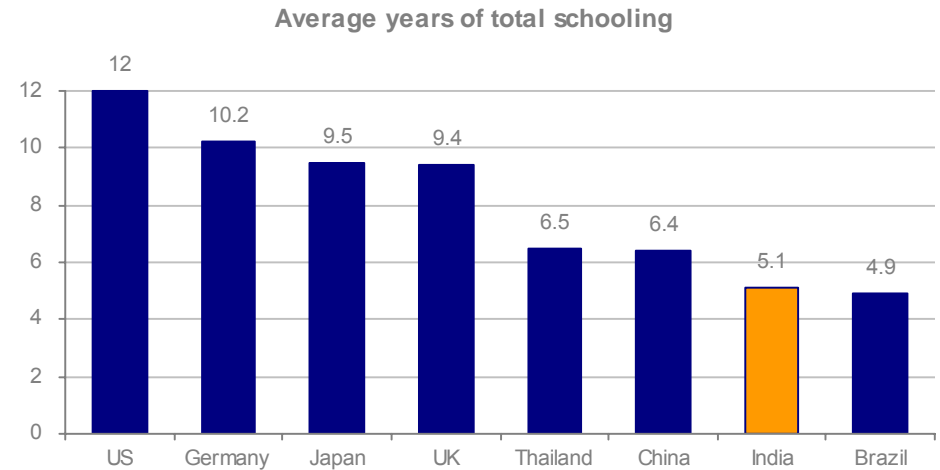
- 1) **School learning solutions:** This business consists of *Smartclass* and *Edureach* (formerly ICT), where Educomp supplies digital teaching equipment. *Smartclass* is positioned at private schools—Educomp has supplied to 2,574 private schools (out of a total of ~75,000 schools). *Edureach* is targeted at government schools—Educomp has supplied to 14,826 schools (there are a total of ~900,000 government schools). Educomp is the leader in both segments.
- 2) **K12 schools (pre-schools and standard I to XII schools):** Educomp has made an early start in pre-schools education for children with its *Roots to Wings* brand and by acquiring 50% of the Euro Kids chain of pre-schools. Between the two brands, Educomp has 780 pre-schools and is the leader in this segment as well. Educomp has also built and started running full-fledged schools under the *Millennium*, *Takshila* and *Vidya Prabhat* brands. It has 36 schools operational and 20 more under construction.
- 3) **Higher learning solutions:** Educomp has 50-50 JVs with Raffles of Singapore (higher education) and Pearson (vocational education).
- 4) **Others:** Online tutorials, supplementary and global (overseas).

Figure 3: Revenue break-down (FY09)



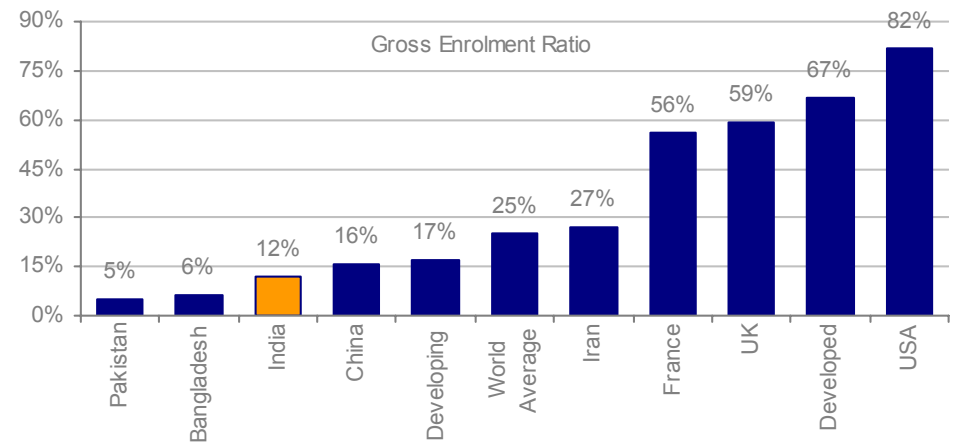
Source: IIFL Research

Figure 2: India has among the lowest average years of schooling as compared to other countries; it ranks 65th in the world (average years of schooling over 15 years)



Source: UNESCO, IIFL Research

Figure 3: Gross enrolment ratio in India is much lower than the world average of 25%, and also lower than the average in developing countries (17%)



Source: EFA Global Monitoring Report 2009, IIFL Research

Smartclass – strong product, sustainable growth

Smartclass is a digital classroom teaching solution that replaces the traditional ‘chalk and blackboard’ infrastructure with smart-boards and digital content.

Educomp’s content library has a repository of 16,000 multimedia modules, developed partly in-house and partly through partnerships with content providers (such as Discovery channel). It covers the entire K-12 education curriculum and is currently available in 10 regional languages. The product has been installed in 2,574 schools across 65-70 cities (3QFY10). *Smartclass* currently contributes ~60% of Educomp’s revenues.

Expect sustainable revenue growth: We expect *Smartclass* to take root strongly as: 1) current stipulation of a five-year lock-in ensures that the current batch of pupils using *Smartclass* get accustomed to this method of teaching, and will be reluctant to go back to the ‘boring’ blackboard system again; 2) teachers would have invested substantial effort to orient themselves to this way of teaching, and hence would be hesitant to shift; and 3) *Smartclass* is sufficiently differentiated through brand reminders and distinct look-and-feel to create a barrier to switching to competing products. Revenue growth will come from:

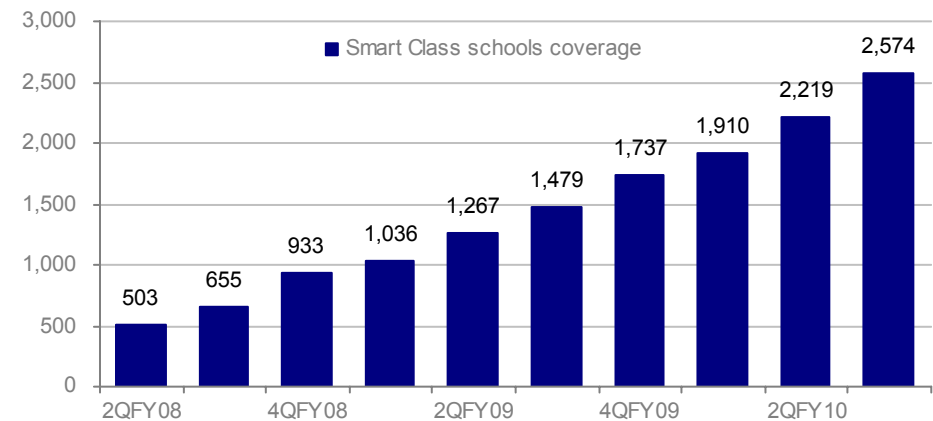
- 1) **increase in *Smartclass* penetration in schools:** Currently, *Smartclass* (and similar products from competitors) are present in ~3.4% of all private schools in India. We believe this is a significantly superior teaching method, and over time, the intrinsic merit of the solution and peer pressure will get a majority of schools to convert; and
- 2) **growth in the number of digital classrooms per school:** Schools typically do not adopt *Smartclass* in all their classrooms.

Potential market of US\$2.5bn annual revenues—compared to Educomp’s FY09 revenue of US\$68m: Educomp charges schools ~Rs130/student/month. Assuming 50 students per classroom and 15 classrooms per school, the annual revenues that can be drawn per

school is ~Rs1.2m. We believe that eventually most schools will convert to *Smartclass* or similar solutions. Lastly, 5000-6000 new private schools may be needed per year for the next several years. All taken, the addressable market could be more than 100,000 schools in 5-6 years, implying annual industry revenues from these smart teaching solutions of Rs120bn or US\$2.5bn (at INR/US\$ rate of 46). By comparison, in FY09, Educomp’s revenues from this segment were US\$68m.

Major scale-up in execution capability needed: Educomp added 355 schools in 3QFY10. To reach 20,000 schools in five years from the current 2,574, it will need to step up execution significantly if it is to make use of this huge opportunity without losing ground to increasing competition. Educomp’s recent securitisation is a step towards this.

Figure 5: Number of schools under *Smartclass* coverage has registered CQGR of 20% over the past nine quarters



Source: Company, IIFL Research

Securitisation will help accelerate growth

Under the old BOOT model, revenues were booked over five years, but capex was undertaken during the installation phase itself.

Figure 6: Capex per classroom of Rs80,000 in addition to the Rs225,000 per school

Per-classroom hardware	Price (Rs)
1 LCD/Interactive Screen	25,000
Audio system	10,000
Cabinet	5,000
CPU	25,000
Others	15,000
Total	80,000
Per-school (content lab)	Price (Rs)
5 X computers	100,000
1 server	100,000
Other hardware	25,000
Total	225,000

Securitisation will improve cashflow profile: Under the new arrangement, Educomp sells to Edusmart, the “vendor” (to use the company’s terminology for the sake of simplicity). Edusmart, in turn, securitises a part of the school’s receivables (at Educomp’s cost of debt) and pays Educomp 58.2% of the total contract value (but Educomp recognises only 52.5%).

The remaining 16.8% value of the contract is obtained as four annual payments of 4.2% each (passed on from the unsecuritised school receivables). This means that the debtors for Educomp fall sharply, though a small part of the revenue remains under the five-year arrangement. Note that Educomp recognises 52.5% of the contract revenue in the first year and the rest 22.5% in the subsequent year.

Tax rate reduction to improve margins: Educomp stands to expand EBITDA margins through the arrangement, as an outright sale attracts 4% VAT on the hardware component of the sale (40% of contract amount), implying a net rate of 1.6%. By contrast, the tax rate payable

under the previous revenue model was a flat 10% (service tax), since Educomp’s offering was categorised as a ‘service’.

Financiers have recourse to Educomp: Educomp is the corporate guarantor for the vendor third party and also holds convertible preferential shares (yielding 8% on Rs250m investment), and the bank has full recourse to Educomp if the schools default on payments.

Securitisation cash flow

- Assuming a payment of Rs100, the vendor securitises a part of Rs5 X 20 payments due from the school. (According to the management, the cost of financing the deal is the same as the cost of debt for Educomp (~11%), so in effect, the vendor securitises only ~79% of receivables)
- Of the Rs20 to be received annually over five years, Rs15.8 per year is securitised in return for a lump-sum payment of Rs54-60 from the bank. The remaining Rs4.2 is not securitised, so it is the cash-flow that comes to the vendor directly.
- The vendor pays Rs58.2 to Educomp (from the Rs60 received from the bank) and pockets the remaining Rs1.8 if the bank pays 60) **along** with the receivable of Rs4.2 (the unsecuritised amount in the first year), so the vendor’s total inflow is Rs6. This is the amount that the vendor will make depending on how much the bank pays up (between Rs 54-60)
- The rest of the \$4.2X4 payments are made to Educomp by the vendor when the same is received from the school (which is the unsecuritised amount).

Smartclass projected to grow ~16,400 schools by FY15

Revenues from *Smartclass* are seasonal, as there are more school additions before the new education session starts (in April), so 4Q is the strongest quarter.

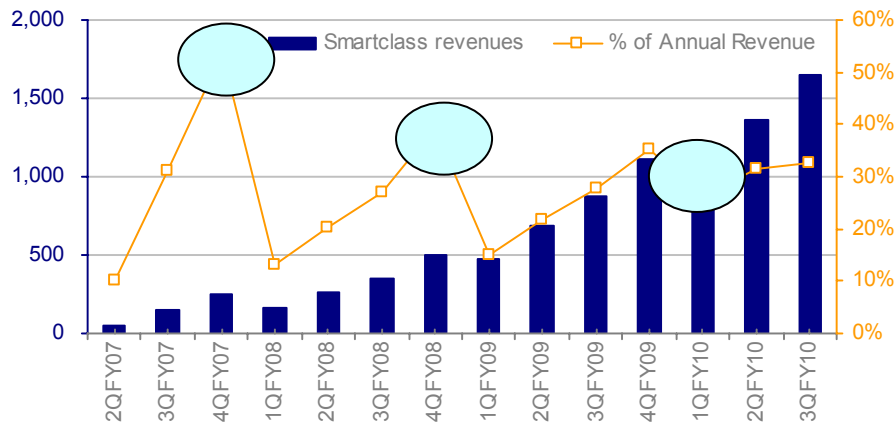
This pattern will become pronounced under the securitisation deal, which makes revenues lumpy. In FY09, *Smartclass* revenues were ~Rs3,157m, and the number of schools added were 804 (currently 2,594 schools). We build in 44% CAGR in number of schools using *Smartclass*, to ~16,388 schools by FY15 (from FY09), conservative in comparison to management’s guidance of 20,000 schools.

Assuming 750 students per school, at Rs130/month

- We build in an average classroom of 50 students, and every school contract signs 15 classrooms.
- We assume a constant fee of Rs130 per student per month. Competition will increase — but so will inflation, and the two effects may cancel out.

The securitisation model is assumed, with 52.5% of the contract amount booked upfront, and the rest 22.5% to be booked in year 2.

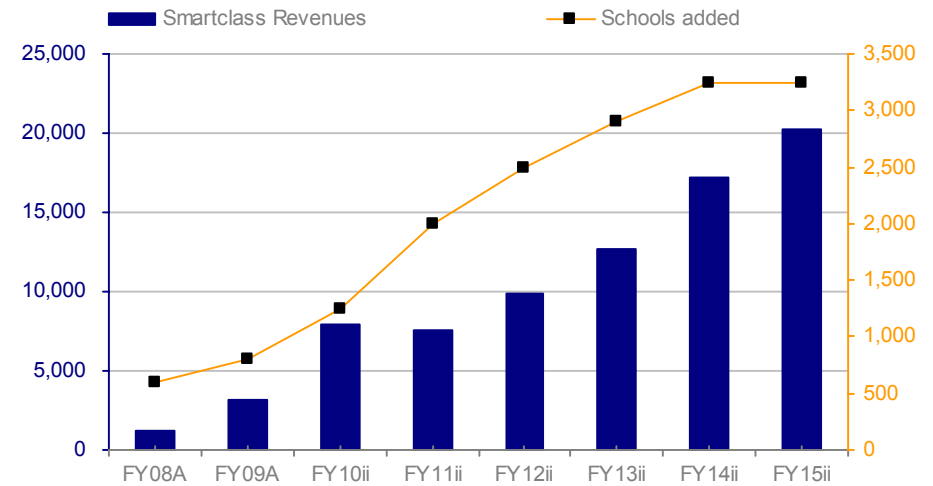
Figure 7: Smartclass revenues follow the school-year cycle, with 1Q being the weakest quarter and 4Q the strongest.



Source: Company, IIFL Research

EBITDA CAGR of 22% FY10-FY15, margins to improve: Our assumptions give an earnings CAGR of 22% for the Smartclass business segment from FY10 to FY15 and further growing at a modest annualised rate of 8% from FY15 to FY20. We model in repeat revenues with a 90% rate of renewal and also build in 10% probability of contingent liabilities accruing to Educomp, which is much higher than historical delinquencies (management expects 2-3% at worst). EBITDA margins should grow to ~65% (by FY15) from the scalable nature of content development costs. Also, the securitisation deal would boost EBITDA, given reduced service + sales tax rates.

Figure 8: Revenue CAGR of 28% between FY11 and FY15



Source: Company, IIFL Research; Smartclass revenues to be flat between FY10-FY12, owing to lumping of revenues due to securitisation of all contracts in FY10 (with 22.5% booked in FY11)

Figure 10: Smartclass projections

Annual Projections	Comments	FY09A	FY10ii	FY11ii	FY12ii	FY13ii	FY14ii
Total number of schools	A	1,737	2,987	4,987	7,487	10,307	13,362
New Schools	B=Δ A	804	1,250	2,000	2,500	2,900	3,250
BOOT School Additions			713				
EDUSMART Additions			537	1900	2475	2780	3208
Old Contracts Transferred			2,450				
# of students per school	D=15*50 from FY10	1000	750	750	750	750	750
Avg Revenue / student	E=Rs130*12mths	1800	1,560	1,560	1,560	1,560	1,560
Revenue (Y1, Rs m)	F	724	2,483	5835	7601	8538	9851
Securitised (Y2, Rs m)	G			707	2501	3258	3659
Old Securitized Revenue (Rs m), Order book at Rs6bn in FY10	H	2,432	3,150	1,350			
Renewal Revenue (Y1, Rs m)	I					1,306	3,378
Renewal Revenue (Y2, Rs m)	J						560
Old boot revenues in 9m FY10	K		2,337				
Gross Revenue	ΣF to K	3,156	7,970	7,892	10,102	13,101	17,447
Growth %				-1%	28%	30%	33%
Tax (Vat and Service tax)			394	126	162	210	279
Net Revenue	F		7,576	7,766	9,941	12,892	17,168
EBITDA margin (FY09 Est)			63.0%	62.9%	63.6%	64.2%	64.7%

Source: Company, IIFL Research

New revenue is the revenue generated in the current year from new school additions (spread over two years in the securitisation deal)

FY10 is the last year in which there is lagged revenue from previous years, which appears in the P&L (this is the cumulative amount collected, based on the number of schools added before)

K-12 to be another significant opportunity

Educomp runs several categories of schools:

- **Premium pre-school brands:** *Euro Kids* (394 franchisee schools, 30 self-owned, 114 under implementation; Educomp acquired 50% stake), *Roots to Wings* (~240 franchisees) totalling almost ~780 pre-schools.
- **Premium schools:** *Millennium* schools are premium schools, with monthly fees of ~Rs3500 per student per month.
- **Mid-tier schools:** *Takshila* schools are middle-income-class schools with an average fee of Rs2,000 per student per month.
- **Low-budget schools:** *Vidya Prabhat* schools are low-budget schools with an average fee of Rs700 per month.

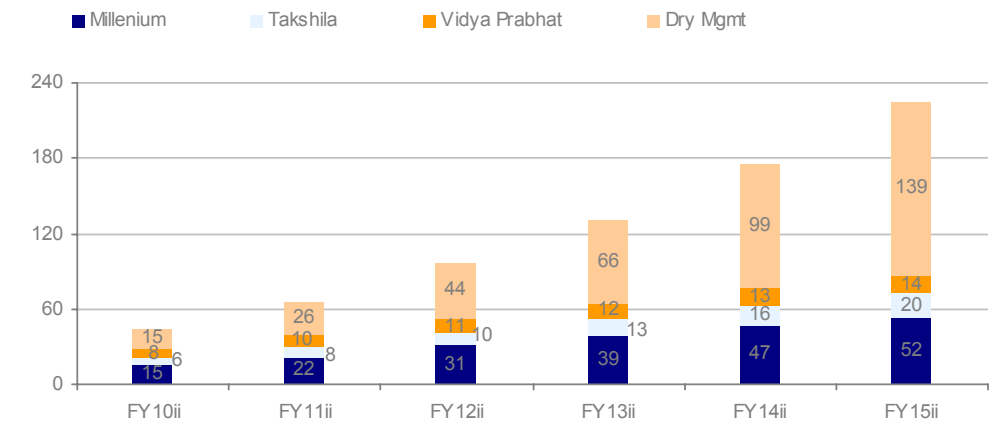
'Dry management' the way forward

In addition, the company is also looking at capex-light 'dry-management' models, in which Educomp provides the brand (such as *Millennium*) and content/curriculum/teacher training, in return for a revenue share in the business. The company has a target of 150 schools by FY12 (including dry-management arrangements). This is a relatively new business vertical and currently contributes ~8-10% of Educomp's total revenue.

Low literacy rates, increased government focus and demand-supply mismatch to drive growth: India has one of the lowest literacy rates in the world, and is thus positioned for structural growth in the education business over the long term. Currently, 40% of students study in private schools, which account for 7-9% of the total schools. Demand for private schools is very high, as most of them have far superior infrastructure and other facilities as compared to government schools. To bridge this gap, India will need ~150,000 schools by FY12, according to CBSE. Educomp targets to build just ~150 by FY12. There are sufficient demand drivers, and the only major risk that the business faces is that of execution, but given the focus on 'dry management' 'capex-light models', execution speeds should be faster.

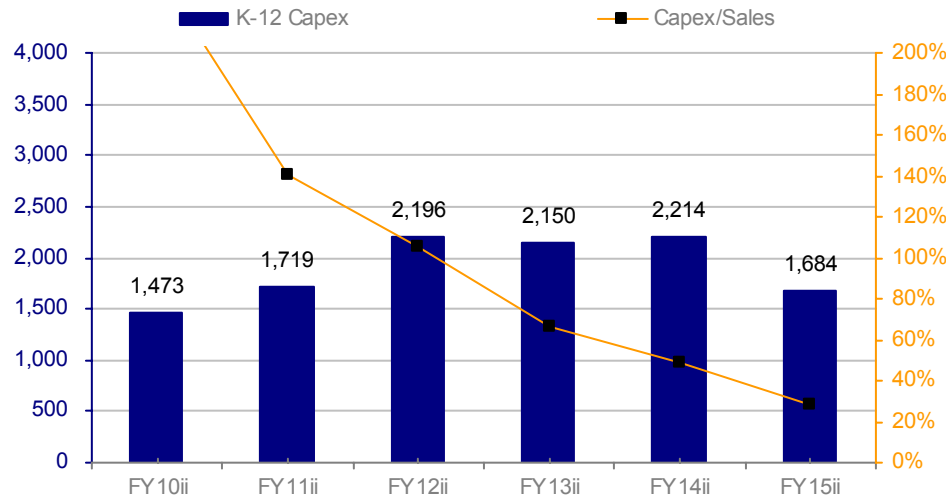
We have built in growth in number of schools from the current base of ~36 schools (we estimate 16 *Millennium*, three *Vidya Prabhat* and three *Takshila*, the remaining 14 being dry-managed) to reach 96 by FY12 and further to 225 by FY15, with most of the additions coming via the dry management model for a fixed share of revenue (we work with 15%).

Figure 11: Total number of schools to grow to 96 by FY12, most additions will be through the 'dry management' model



Source: Company, IIFL Research

Figure 12: Capex-to-sales for K-12 schools will fall as more schools are added under the 'dry management' model



Source: Company, IIFL Research

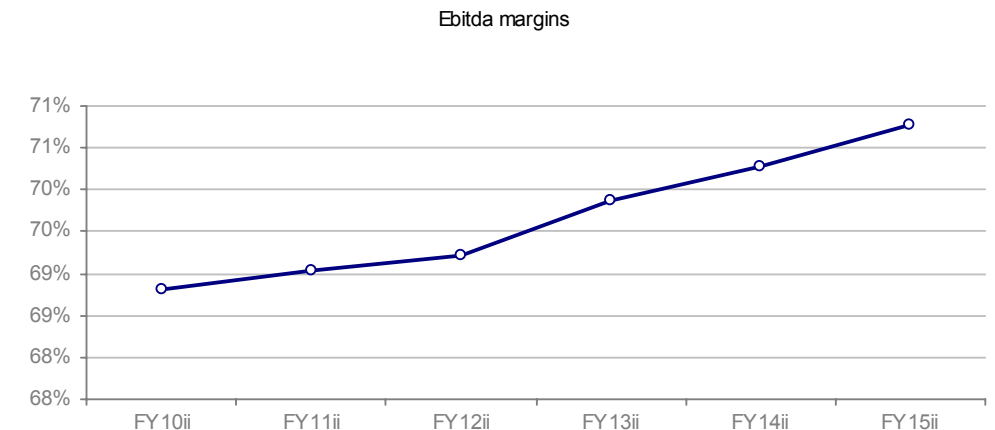
K-12 to form ~20% of total revenues and 23% of EBITDA by FY15; EBITDA CAGR of 58%, high margins: We model earnings (EBITDA) CAGR of 58% over the next five years, with blended EBITDA margin of 69-71% over the next five years (currently they are >70%). Margins are increasing on account of the increase in additions under the 'dry management' model (where Educomp does not incur costs for running the school such as teachers' salaries and electricity), which we assume has a higher EBITDA margin of ~80%.

Our key assumptions are:

- 1) A debt-to-equity financing ratio of 40:60, to finance the upfront capital expenditure (which is almost in line with the current capital structure);
- 2) Teacher-student ratio of 1:25 (much lower than the average 1:40 ratio in India);
- 3) operating costs to be 20% of revenues;

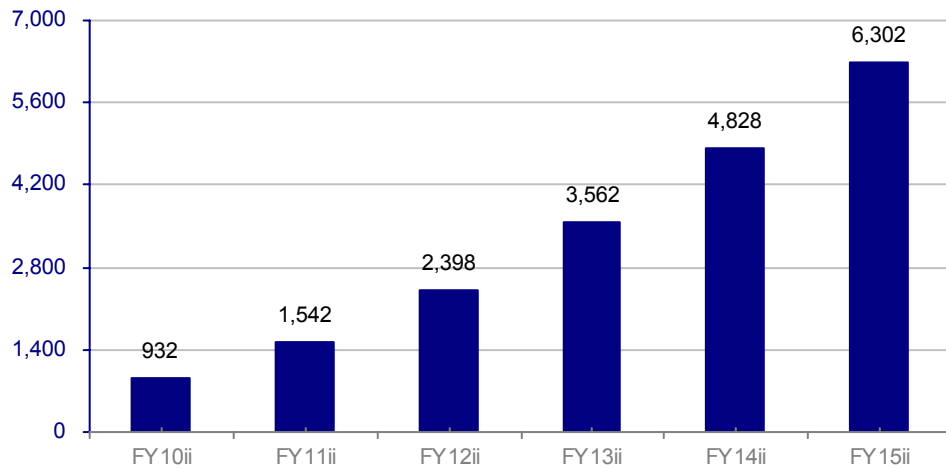
- 4) 30-40% of the capex investment towards land and the rest on development of building, which has depreciation rate of 5% (other items to have higher rates). We work with a blended rate of 5%; and
- 5) Average increase in tuition fees, admission fees and staff cost inflation of 4% annually.
 - a. Fee inflation for *Millennium* schools is considered higher at 5% (opex as % of revenues, hence they have a similar rate of increase). Since *Millennium* is in top-tier cities, we have built in a higher rate of inflation in fee.
 - b. Fee inflation for *Vidya Prabhat* at 4% and wage inflation at 3% (historically, education fee inflation has been 100bps higher than wage inflation).

Figure 13: EBITDA margins to rise, owing to the growing contribution from 'dry management' setups



Source: Company, IIFL Research

Figure 14: K-12 school revenues to grow at annual rate of ~ 33% from FY10 to FY18



Source: Company, IIFL Research

Pre-school brands not bottomline-accretive yet: Educomp's two pre-school brands—*Eurokids* and *Roots to Wings*—together have 750 schools (franchise-based) and ~30 own schools. The pre-school business contributes ~Rs300m to topline, but has struggled to contribute to the bottomline. Even after becoming the biggest pre-schools chain, with the premium positioning, they haven't reached sufficient profitability, for reasons including these: 1) capacity utilisation is still low; and 2) post-acquisition integration is yet to be achieved.

Pre-schools currently form ~40-50% of K-12 revenues, expected to be ~6% by FY15, no growth upsides priced in: We model flat revenues and earnings from the pre-schools business. Currently, this business makes an EBITDA margin of ~2%. Assuming that EBITDA margins improve to the blended margin in K-12 schools (60-70%), with moderate growth (5%) over the period FY10-FY15, the upside to the target price could be **Rs15** (1.7% to the TP of Rs865). The company has guided for earnings contribution in 18-24 months.

ICT: de-emphasised because of low ROE, margins

ICT (Edureach) caters to government schools, providing hardware and software solutions to enable multimedia and computer-aided learning. The coverage spans 14,826 schools at present and contributes ~10% of Educomp's total revenues. The company is now de-emphasising this business.

Low margins and high debtor days have led to de-emphasis: The opportunity in the ICT space is dwindling, and there are various factors that we believe make the business ROE-dilutive for Educomp.

- 1) **Margins deteriorate:** The government follows an L1 bidding mechanism (though there are eligibility criteria such as minimum company turnover of Rs2.5bn), as in several other sectors. In this mode of procurement, bidders typically do not make money without resorting to collusion, which the government always has the ability to overcome by re-negotiating. We build EBITDA margins at 25% (flat), as the management has said it will not bid in projects where the pricing does not yield a 30% margin.
- 2) **High debtor days:** As per the contracts, Educomp obtains payment on a quarterly basis (90 days). Every quarter-end, Educomp submits the government bills that take 60-90 days to process and another 30-60 days to pay, which gives a debtor cycle of 180-240 days.

ICT business defocus could slow school additions, but 'cherry-picking' could improve margins, drive 13% earnings CAGR (FY10-15): Educomp is clearly going slow on this segment, and will bid only for the "meatier" contracts (ie, those with EBITDA margin of 30% or more, according to management). We model in a slowdown in school additions post FY10 and build in deceleration in the school additions, while the revenue per school rises at a modest 4% annually (partly inflation and partly due to better realisations as a result of cherry-picking). This translates into earnings CAGR of 13%.

Other business – bandwidth consumers for now

Broadband could foster growth in online businesses: Educomp has a clutch of online businesses, among them 1) the US-based *Learning.com*, which provides online curriculums and assessment tools; 2) AsknLearn, a Singapore-based e-learning solutions provider; 3) WizIQ to facilitate virtual classes, online tests and other content to end-users; and 4) MathGuru an online portal based on NCERT curriculum for grades 6-12.

Drivers for this business are: 1) increasing broadband penetration in India, which is currently less than 5%; 2) rising incomes, which will translate into increased broadband penetration; and 3) increasing adoption of computers as a medium of education.

Between the government's proposed mega optic-fibre initiative, 3G and Wimax auctions to be held later this year, broadband is likely to get a fillip, and these businesses may prosper and deliver upsides.

We build in 5% topline growth for each of the acquisitions *Learning.com* and *Asknlearn*, while keeping flat revenues for other smaller online portals (10% of revenues and 2% of EBITDA in FY12)

Vocational training has significant potential: The higher-learning solutions segment is the smallest revenue contributor (2-3%).

The company recently entered a 50:50 JV with Pearson, one of the world's largest education companies. This JV offers a number of courses, and among the more popular ones is English language training. Educomp plans to leverage Pearson's expertise in English language (the 'Longman' brand from Pearson is renowned).

- The labour force in India is ~400m and adds ~13m annually.
- English-speaking enhances employability and salaries of unskilled and semi-skilled workers such as drivers and waiters.

Our current model does not factor in any growth from the vocational education business and professional development verticals, building in flat revenues from the segment.

The major sub-segment is the professional development business, which trains teachers through a variety of media (ETEN or Educomp Tele-education Network, VSAT, direct initiatives, etc). Educomp has trained ~1.6m teachers till date (which as per our calculations is ~36% of total teachers as shown below). This can be a steady business, but without dominating in size.

Figure 15: Estimated number of total teachers

	Government Schools	Private Schools
No. of Schools	900,000	75,000
Proportion of total students	60%	40%
Total Students (mn) (<i>our estimate</i>)	126	84
Teacher student ratio (<i>our estimate</i>)	1:50	1:40
Teachers (m)	2.5	2.1
Total Teachers (m)	4.6	
% trained by Educomp (1.6m / 8.8m)	34.6%	

Source: IIFL Research

BUY with TP Rs865

We value Educomp on DCF basis, with a WACC of 11.5% and TGR of CF of 4%, and arrive at a 12-month target price of Rs865 per share.

Figure 16: Summary of assumptions for the different segments

Assumptions	FY10ii	FY11ii	FY12ii	FY13ii	FY14ii
Smartclass					
New Schools	1,250	2,000	2,500	2,900	3,250
Number of students per school	750	750	750	750	750
Average per student	1,560	1,560	1,560	1,560	1,560
Renewal Rates	90.0%	90.0%	90.0%	90.0%	90.0%
Average Employee Cost (mn/annum)	0.1	0.1	0.1	0.1	0.1
ICT					
Schools Under Coverage	16,012	18,212	19,712	21,212	22,712
Revenue per school	103,892	108,048	112,370	116,864	121,539
K-12					
Total Schools	44	66	96	130	175
Millenium	15	22	31	39	47
Takshila	6	8	10	13	16
Vidya Prabhat	8	10	11	12	13
Dry Mgmt	15	26	44	66	99
Online Biz					
Asknlearn Revenue Growth	5%	5%	5%	5%	5%
Learning Revenue Growth	5%	5%	5%	5%	5%

Source: IIFL Research

Smartclass is the major valuation driver, but K-12 offers growth opportunities and will continue to account for an increasing proportion of Educomp's revenue and EBITDA.

Figure 17: K-12 and Smartclass will be the major contributors

Revenues	FY08ii	FY09ii	FY10ii	FY11ii	FY12ii
Schools Learning Solutions	2,211	4,294	9,240	9,734	12,156
K-12 (excl pre-schools)	-	605	932	1,542	2,398
Higher Learning Solutions	256	287	283	283	283
Online Supplementary & Global (+pre-schools)	394	1,185	1,189	1,237	1,287
Total	2,861	6,371	11,644	12,795	16,124

Source: Company, IIFL Research. Historical revenue total (FY08 and FY09) is based on actuals, but segmental classification is as per our estimates. The classification above is being followed by the company from FY10. The re-classification mainly relates to K-12 as a separate segment.

Figure 18: K-12 should increase contribution to EBITDA rapidly

EBITDA	FY08ii	FY09ii	FY10ii	FY11ii	FY12ii
Schools Learning Solutions	1,242	2,412	5,191	5,376	6,875
K-12	-	280	431	853	1,449
Higher Learning Solutions	69	77	76	76	76
Online Supplementary & Global	(37)	276	123	130	137
Total	1,274	3,044	5,821	6,435	8,536

Source: Company, IIFL Research. Historical EBITDA total (FY08 and FY09) is based on actuals, but segmental classification is as per our estimates.

Figure 19: Segment-wise summary of our estimates suggests that K-12 and Smartclass will be the major contributors to both topline and bottom-line

Capex	FY08ii	FY09ii	FY10ii	FY11ii	FY12ii
Smart Class	1,332	2,182	2,031	3,078	3,807
ICT Solutions	4	56	82	97	109
K-12	399	3,620	1,473	1,719	2,196
Others	484	392	395	395	375
Total	2,219	6,250	3,981	5,288	6,488

Source: Company, IIFL Research. Historical capex total (FY08 and FY09) is based on actuals, but segmental classification is as per our estimates.

Securitisation and Dry management should prevent further dilution: As depicted in the table below, Educomp had been constantly diluting equity to keep up with the pace of expansion, but given innovative capital management techniques such as dry management and securitisation, we expect little dilution in the medium term.

Figure 20: Educomp's capital raising history

Mode of Raising	Amount	Year
IPO	Rs 500 mn	2005
FCCB	\$ 25mn	2006
FCCB*	\$ 80mn	2007
QIP	Rs 6070 mn	2009

Source: IIFL Research, * The 5-year at par, zero-coupon FCCB was issued by Educomp in 2007-08 at an exercise price of Rs2950 (Rs590 post-split) aggregating US\$80m. Assume full conversion in 2012, which would lead to fresh issue 6.4m shares.

Key risks to valuation

- Execution risk – going too slow will dilute the opportunity:** To enable *Smartclass* penetration to reach ~16,388 schools and to reach 225 K-12 schools by FY15 would require strong execution capabilities. Educomp currently rolls out *Smartclass* at a run rate of 300-400 schools per quarter, and as per our estimates would need to reach a level of ~750-1000 schools when it peaks in terms of school additions, thereby implying a ~2x jump in execution rates. If Educomp does not step up, competition will certainly step up to exploit this opportunity.
- Going too fast will create default risk:** We have built in 10% risk of default on *Smartclass* receivables that Educomp will build from the securitisation deal. But if the number of defaults increases significantly, it could be a key risk. Although there has not been a single case of default from schools reported by Educomp so far, this might change as growth accelerates.
- Several businesses; synchronising strategy will be a major challenge:** Educomp has significant upsides from the *Smartclass*

and K-12 businesses waiting to be tapped, but it has also invested effort and capital in vocational training (Pearson), online training, and higher education (Raffles). While management states that the businesses are to be managed by independent managers with substantial stakes in the business, directing the overall group strategy can become complex, especially as the core businesses (*Smartclass* and K-12) demand acceleration and innovation.

- 4) **Right to Education Act promises big government spending but profitability questionable:** With the Right to Education Act, the government has created a mega opportunity for education companies, but at the same time, typical of government contracts, the bidding will likely follow the L1 format. Winners in government contracts usually end up bloodied. Educomp has stated this Act as one of the major growth opportunities, and claimed sufficient differentiation to command margins, but this is still an open issue. Increasing focus on the government sector would cause worry.

Financial summary

Revenue shows muted growth over FY10-11 owing to the bunching of revenues securitised in FY10

YoY Profit decline in FY11ii is mainly on account of the one time gain from the 1) upfront securitization revenue and 2) One-time gain from hiving-off the vocational education business to the Pearson JV

The company had undertaken a QIP earlier this year; this is shown as an equity raising of ~Rs6bn in FY10, and further a 100% FCCB conversion in FY12. These resulted in almost ~17% equity dilution

Income statement summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenue	2,861	6,371	11,644	12,795	16,124
EBITDA	1,274	3,044	5,821	6,435	8,536
EBIT	942	2,230	4,562	4,771	6,253
Interest income	96	127	273	614	851
Interest expense	-48	-268	-533	-1,270	-1,309
Exceptional items	-8	-1	0	0	0
Others	82	101	1,314	300	300
Profit before tax	1,064	2,189	5,617	4,415	6,095
Taxes	-351	-773	-1,910	-1,501	-2,072
Minorities and other	-3	-68	-75	-118	-181
Net profit	710	1,347	3,633	2,796	3,842

Cashflow summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Profit Before Tax	1,064	2,189	5,617	4,415	6,095
Depr. & amortisation	322	786	1,259	1,665	2,283
Tax Paid	-351	-773	-1,266	-995	-1,373
Working capital Δ	-704	-883	-3,678	4,345	-820
Other operating items	0	-358	0	0	0
Operating cashflow	331	961	1,932	9,430	6,184
Capital expenditure	-2,348	-7,143	-3,981	-5,288	-6,488
Free cash flow	-2,017	-6,183	-2,049	4,142	-304
Equity Raised	95	62	5,950	0	3,800
Investments	66	-692	-73	-80	-88
Debt financing/disposal	2,518	5,122	1,593	2,115	-1,404
Dividends paid	-51	-61	-111	-126	-173
Other items	1,195	742	0	-75	-118
Net change in cash	1,806	-1,010	5,309	5,976	1,713

Source: Company data, IIFL Research

Debtor days will improve substantially beyond FY10 as: 1) ICT business is de-emphasised; 2) securitisation deal improves debtor days for *Smartclass*

Balance sheet summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Cash & equivalents	2,912	1,902	7,212	13,262	15,093
Sundry debtors	1,157	2,765	7,076	3,155	3,976
Inventories - trade	18	316	578	348	416
Other current assets	552	1,170	2,139	2,350	2,962
Fixed assets	2,714	8,126	10,849	14,473	18,677
Intangible assets	280	1,225	1,225	1,225	1,225
Other term assets	38	1,088	1,161	1,241	1,329
Total assets	7,671	16,592	30,238	36,054	43,677
Sundry creditors	517	1,995	3,646	4,007	4,553
Other current liabs	92	256	467	513	647
Short-term debt	622	4,689	6,281	8,397	10,992
Long-term debt/CBs	3,151	4,206	4,206	4,206	207
Other long-term liabs	210	439	1,083	1,589	2,288
Minorities/other equity	194	804	879	997	1,177
Net worth	2,884	4,203	13,675	16,345	23,813
Total liabs & equity	7,671	16,592	30,238	36,054	43,677

EBITDA margins expand as: 1) securitisation raises *Smartclass* EBITDA margins; 2) contribution of the low-margin ICT business declines; and 3) contribution of the high-margin K-12 business increases

Ratio analysis

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenue growth (%)	159.9	122.7	82.8	9.9	26.0
Op Ebitda growth (%)	151.4	139.0	91.2	10.6	32.6
Op Ebit growth (%)	129.5	136.6	104.6	4.6	31.1
Op Ebitda margin (%)	44.5	47.8	50.0	50.3	52.9
Op Ebit margin (%)	32.9	35.0	39.2	37.3	38.8
Net profit margin (%)	24.8	21.1	31.2	21.9	23.8
Dividend payout (%)	0.1%	0.1%	0.1%	0.2%	0.2%
Tax rate (%)	33.0	35.3	34.0	34.0	34.0
Net debt/equity (%)	29.9	166.4	26.5	3.6	-9.5
Net debt/op Ebitda (x)	67.6	229.7	62.4	9.2	-26.5
Return on equity (%)	35.2	38.0	40.6	18.6	19.1
ROCE (%)	20.7	27.5	29.2	22.1	25.3

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.

SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.

Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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