

Educomp Solutions Ltd

Core segment growth remains healthy; Stock de-rating overdone

We are re-visiting our thesis on Educomp's SmartClass (interactive multimedia) segment given the recent growth concerns. Post our interactions with zonal heads from Educomp, we believe that the company guidance is likely conservative. Moreover, our analysis of Educomp's SmartClass FY11 guidance indicates that organic revenue growth is 30%+ which should ease concerns on volume growth and pricing. The other key driver for revenues is the K12 segment which would grow at 75% CAGR over FY09-12E in our view - contributing to 19% of revenues by FY12. With the stock correcting 25%+ since results, we believe that the stock de-rating is overdone and believe it provides a good entry opportunity into multi-year themes of SmartClass and K12 schools. We have an OW rating with Mar-11 PT of Rs 650.

- **SmartClass segment remains a key growth driver** with addressable market of 76,000 private unaided schools. We expect SmartClass growth to be driven by: 1) Widening target market – Educomp is increasing its sales force from 220 currently to 350 over FY11; 2) Increasing penetration of the number of classrooms within existing schools. Educomp SmartClass revenues guidance is at Rs8.5-9 Bn. **Assuming no change in revenue recognition model, this implies FY11 SmartClass revenues of Rs 5.9-6.0 Bn (32-35% y/y growth)** (please see Tables 1, 2 for details). This reinforces our belief that underlying growth in the segment continues to be healthy.
- **FY11 guidance:** Educomp guided for revenues of Rs13-13.5Bn (up 25-30% Y/Y) and net income of Rs3.3-3.5bn (up 22-23% Y/Y). We expect SmartClass, K-12 schools segments to drive the growth, while investments in other businesses (Pearson, Raffles, online) will drag profitability.
- **Estimate changes and valuation:** We have reduced our FY11/12 revenue estimates by -3% / -20% to incorporate the change in SmartClass revenue recognition. Our EPS estimates go down by -0.2%/ -18% for FY11/12. On the back of lower estimates and lower P/E multiple (FY10-12E EPS CAGR of 15%), we set a new Mar-11 PT of Rs650 based on 16x FY12 P/E. Key risk to our positive thesis is poor execution on SmartClass, higher than expected content costs and pricing pressure due to competition.

Reuters: EDSO.BO; Bloomberg: EDSL IN

Rs in millions, year-end March

	FY09	FY10	FY11E	FY12E		FY09	FY10	FY11E	FY12E		
Sales	6,342	10,405	15,069	17,432	Y/E BPS (Rs)	49	174	207	245	52-Week range	Rs440-1,020
Operating Profit	2,295	3,750	5,057	5,912	ROE (%)	40.9	27.7	18.5	18.1	Shares Outstg	95Mn
EBITDA	3,100	4,888	6,018	7,130	ROIC (%)	17.6	14.4	14.3	14.6	Date of price	5/28/2010
Net profit	1,449	2,870	3,349	3,882	Qtr EPS (Rs)	1Q	2Q	3Q	4Q	Avg daily volume	1.32Mn
EPS Consol (Rs)	16.6	30.2	34.8	40.3	EPS (FY10)	4.5	12.3	6.8	6.6	Avg daily value (US\$ Mn)	27.5
P/E Cons (x)	30.5	16.7	14.5	12.5	EPS (FY11E)	4.0	7.3	10.3	13.2	Index (Sensex)	16,935
P/B (x)	10.4	2.9	2.4	2.1	EPS (FY12E)	9.7	10.2	10.5	9.9	Free float	50%
Cash	1,902	7,825	10,063	11,796	Local	1M	3M	12M		Dividend Yld (%)	0%
Gross Debt	8,895	10,475	13,739	13,861	Abs. perf.(%)	-36.0	-32.3	-17.1		Exchange rate	Rs46.4/US\$1
Total Equity	4,203	16,496	19,623	23,283	Rel. perf.(%)	-30.7	-32.1	-31.3		Market Cap (Rs B)	48.1
										Mkt cap (US\$ m)	1,035

Source: Company data, Bloomberg, J.P. Morgan estimates.

See page 7 for analyst certification and important disclosures, including non-US analyst disclosures.

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Overweight

EDSO.BO, EDSL IN

Price: Rs482.50

▼ Price Target: Rs650.00

Previous: Rs1,000.00

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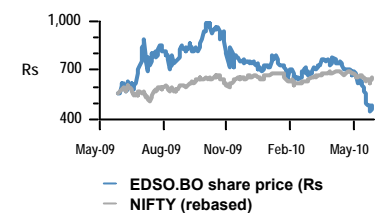
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Price Performance

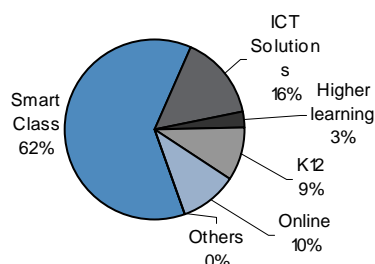


— EDSO.BO share price (Rs)
— NIFTY (rebased)

Company description

Educomp Solutions Ltd, founded in 1994, is a diversified education solutions provider and the largest education company in India. The Educomp Group reaches out to over 23,000 schools and 12 million learners and educators across the world through 27 offices worldwide, including an office in Canada and Sri Lanka, two in Singapore, three in the US and 20 in India. It also operates through its subsidiaries, including authorGEN, Threebrix, Learning.com (US), AsknLearn (Singapore) and associates such as Savvica in Canada.

Revenue



Source: Company data.

EPS: J.P. Morgan vs. consensus

	J. P. Morgan	Consensus
FY11E	34.8	35.2
FY12E	40.3	44.3

Source: Bloomberg, J. P. Morgan estimates.

P&L sensitivity metrics

	EBITDA impact (%)	EPS impact (%)
Sales growth assumption (FY11E): 44.8%		
Impact of each 5%	3.9%	5.0%
Operating margin assumption (FY11E): 33.6%		
Impact of each 1%	2.7%	3.6%
Capacity utilization assumption (FY11E): NM		
Impact of each 5%	NM	NM
Debt/equity assumption (FY11E): 70%		
Impact of each 10%	0%	-0.4%

Source: J. P. Morgan estimates.

Price target and valuation analysis

Our Mar-11 price target of Rs 650 is based on one-year forward P/E of 16x – broadly in-line with its EPS CAGR of 15% over FY10-12E. Educomp is currently trading at FY10/FY11E P/E of 15x/13x and we expect the trading multiples to expand slightly as execution in key segments underlines the growth guidance.

Risk-free rate:	6.50%
Market risk premium:	8.00%
Beta:	0.9
Debt/equity:	33%
Cost of debt:	11.5%
Terminal “g”:	5%

Key risks to our price target are: (1) managing growth, especially on the SmartClass segment; (2) high investments being spread across multiple business segments like Pearson, Raffles and online businesses could impact profitability; (3) presence in too many small segments that stretches management bandwidth.

Re-visiting the SmartClass thesis – growth is not an issue

Educomp's SmartClass target market size is at 76,000 schools. However, our recent conversations with management suggest that immediate addressable market for FY11 – in terms of sales people bandwidth, access to key management personnel in the school etc – would be as high as ~43,000 schools. Management confidence in FY11 guidance of selling SmartClass to 30,000 classrooms comes from target of penetrating over 3,500 new schools during FY11 from the immediate accessible market, with greater traction in tier-2 and tier-3 cities.

Key drivers of growth in SmartClass segment are:

- **Ramp up in business development team:** SmartClass management is looking to ramp up its business development team to ~350 from ~210 currently over the next 2-3 months. This would broaden their reach in tier-2, tier-3 cities. This team is mandated to spend over 90% of their time in customer facing role.
- **Cycle time for decision making is much shorter in tier-2, tier-3 cities** as all decision makers (teachers, principal and management personnel) are in one location making it easier to take a decision.
- **Re-modeling the content:** As indicated by management, Educomp is currently in the process of converting its 2D content into 3D and making it more interactive. This will ensure that Educomp maintains its lead in the digital content/multimedia market for education.
- **Pressure on schools to adopt** – from parents who have seen the SmartClass model being adopted in other schools in the same locality. Improving brand visibility from the recent ad campaign has helped making adoption in schools easier.
- **Competition continues to struggle:** Our channel checks indicate that competition has increased over the last 2-3 quarters but content quality and breadth continues to be markedly inferior to Educomp's offering. We expect Educomp to continue to invest in enhancing its existing content and developing new modules to stay ahead of competition.
- **Product innovations** – Educomp is looking to leverage its existing expertise in delivering VSAT-enabled IIT JEE coaching to smaller towns – by introducing Smart class Live. Through this product Educomp will provide tutorial services from highly regarded teachers through its VSAT and studio network.

What are the risks?

- **Execution** remains the key risk to the sharp ramp-up in SmartClass penetration. Over the last 5 years Educomp has implemented SmartClass in 3077 schools. Management plans to implement SmartClass in 3,500+ schools in FY11 to achieve their guidance of 30,000 classrooms. This would be a significant logistical challenge in our view.
- **Competition:** While SmartClass currently has significant lead over competition, we expect competition to continue to increase given the large under-penetrated addressable market. Entry from a player having access to a large content repository could be a key risk.

- Government regulation of school fees:** Schooling is regulated by state governments in India (concurrent with central government) and is exposed to sudden changes in operational rules by states. The case in point is the ongoing tussle between the Maharashtra state government and private unaided institutions on school fees. However, given that SmartClass fees (less than Rs 150 per student) range from 3-15% of overall fees, we do not foresee any pressure on SmartClass pricing from such regulatory changes.

Analyzing the FY11 SmartClass revenue guidance

Educomp's SmartClass guidance for FY11 is to add 25,000 – 30,000 classrooms – implying an organic growth of ~50%-80% in SmartClass (based on the number of classrooms added).

FY11 SmartClass revenue guidance of Rs 8.5-9.0Bn has Rs 5.5-6 Bn from organic growth and the balance coming from deferred content revenues from FY10. Below, we analyze the growth rate if there were no change in the revenue recognition model for the company. Our conclusion is that guidance for SmartClass segment implies organic growth rate of 30-33% in FY11.

Table 1: Analyzing the FY11 SmartClass guidance – Implied growth rate assuming no change in revenue recognition model

SmartClass	FY09	FY10	FY11 guidance	
			Lower-end	High-end
Reported revenues	3,172	6,445	8,500	9,000
Adjustments:				
Less: Export revenues	279	31	0	0
Add: BOOT revenue forgone (due to transfer of existing contracts)	0	2,020	4,387	4,387
Less: Extra revenue collected (due to transfer of existing contracts)	0	2,939	2,939	2,939
Less: Extra revenue from EduSmart model (i.e. recognizing 52.5% of revenues vs. 20% earlier)	0	1,605	3,789	4,170
Less: Extra revenue from EduSmart model (22.5%) in FY10			588	588
Add: Revenues from outright sale (assuming 10% of overall sales in FY11)	0	544	291	317
Revenues if there were no change in the model	2,893	4,434	5,861	6,007
Y/Y revenue growth (%)		53%	32%	35%
Not eliminating impact of change to Edusmart model		5,495	9,947	10,447
			81%	90%

Source: J.P. Morgan estimates.

K-12 schools – tapping the core

Educomp reported strong revenue and profitability growth in its K-12 schools segment in FY10 – driven by schools under operation increasing to 43 by end FY10 from 20 at end FY09 in addition to increased capacity utilization in existing schools. Revenues for this segment were Rs551mn in FY10 (up 42% y/y) with EBIT margins improving to 67% (vs. 58% in FY09). Management has an additional visibility of 26 schools (land and under-construction sites) which would take the total number of schools to 69 over the coming 12-18 months.

We expect K-12 segment to continue to grow rapidly on the back of increasing student intake in existing schools and new schools being built. We expect revenue contribution to go up from 10% in FY10 to ~20% in FY12.

Investment in new initiatives to drag profitability

Educomp's Higher Learning solutions segment reported revenue decline of 7%y/y driven by decline in teacher training business. Segment profitability declined sharply to loss of Rs 107mn – primarily due to investments in Raffles and Pearson business in 2HFY10. The Educomp-Raffles JV is expected to ramp up from three operational institutes to seven by June 2010. With a 2 year break even period per institute and investments of ~Rs30mn per institute – we are estimating losses of Rs 200-250m in this segment in FY11E. Pearson JV would require additional investment of ~Rs 150-200m in FY11E, taking total investment estimate to ~Rs 450m.

Valuation and recommendation – Mar-11 PT of Rs 650/share

Our Mar-11 price target of Rs 650 (previous June-10 PT of Rs 1000) is based on one-year forward P/E of 16x – broadly in-line with its EPS CAGR of 15% over FY10-12E. Educomp is currently trading at FY10/FY11E P/E of 15x/13x and we expect the trading multiples to expand slightly as execution in key segments underlines the growth guidance.

Key risks to our price target are: (1) managing growth, especially on the SmartClass segment; (2) high investments being spread across multiple business segments like Pearson, Raffles and online businesses could impact profitability; (3) presence in too many small segments that stretches management bandwidth.

Educomp Solutions Ltd: Summary of financials

Rs in millions, year-end March

Income statement						Ratio analysis					
	FY08A	FY09A	FY10A	FY11E	FY12E	% , year-end March	FY08A	FY09A	FY10A	FY11E	FY12E
Revenues	2,861	6,342	10,405	15,069	17,432						
Cost of Goods Sold	1,919	4,047	6,656	10,013	11,521	EBITDA margin	44.5	48.9	47.0	39.9	40.9
						Operating Margin	32.9	36.2	36.0	33.6	33.9
Operating Profit (EBIT)	942	2,295	3,750	5,057	5,912	Net Margin	24.7	22.9	27.6	22.2	22.3
EBITDA	1273	3100	4888	6018	7130						
Other Income	121.9	-142.0	649.1	18.3	-29.6	Sales growth	159.9	121.7	64.1	44.8	15.7
						Operating Profit Growth	129.4	143.7	63.4	34.9	16.9
Earnings before tax	1,064	2,153	4,399	5,075	5,882	Net profit growth	146.0	105.4	98.0	16.7	15.9
Tax	-351	-704	-1,529	-1,725	-2,000	EPS (Reported) growth	128.0	105.4	83.8	14.2	15.9
Net Income (Reported)	706	1449	2870	3349	3882						
						Net debt to total capital	12.9	53.4	9.8	11.0	5.6
Rs						Net debt to equity	29.9	166.4	16.1	18.7	8.9
EPS (Reported)	8.2	16.8	30.9	35.3	40.9	Asset Turnover	37.3	38.2	32.8	37.3	39.6
EPS (diluted)	8.1	16.6	30.2	34.8	40.3						
BPS	33.4	48.7	173.7	206.6	245.2	ROE	35.0	40.9	27.7	18.5	18.1
DPS	0.5	2.5	0.0	2.0	2.0	ROIC	21.0	17.6	14.4	14.3	14.6
Shares Outstanding (mn)	85.0	86.2	92.3	95.0	95.0	ROCE	13.1	14.4	11.6	10.8	10.8
Balance sheet						Cash flow statement					
	FY08A	FY09A	FY10A	FY11E	FY12E		FY08A	FY09A	FY10A	FY11E	FY12E
Cash and cash equivalents	2,912	1,902	7,825	10,063	11,796	Net Income	706	1,449	2,870	3,349	3,882
Accounts receivable	1,157	2,765	5,621	8,228	7,385	Depr. & Amortisation	331	804	1,138	961	1,218
Inventories	18	316	465	699	627	Change in working capital	-703	-883	-1,831	-1,314	933
Others	552	1,170	1,665	2,503	2,246	Other	72	611	0	0	0
Current assets	4,639	6,153	15,576	21,493	22,054	Cash flow from operations	407	1,981	2,177	2,996	6,033
LT investments	0	0	0	0	0	Capex	-2,214	-6,217	-6,818	-3,800	-4,200
Net fixed assets	2,714	8,126	13,806	16,645	19,627	Disposal/ (purchase)	-79	-1,995	0	0	0
Others	318	2,313	2,313	2,313	2,313	Cash flow from investing	-2,293	-8,212	-6,818	-3,800	-4,200
Total assets	7,671	16,592	31,695	40,450	43,993	Free cash flow	-1,808	-4,236	-4,640	-804	1,833
Liabilities						Equity raised/ (repaid)	95	184	9,482	122	-120
						Debt raised/ (repaid)	2,518	5,122	1,580	3,264	122
Payables	517	1,995	3,544	5,719	5,538	Other	1,130	167	-499	-122	120
Others	92	256	376	565	507	Dividends paid	-51	-252	0	-222	-222
Total current liabilities	610	2,251	3,920	6,284	6,045	Cash flow from financing	3,692	5,221	10,563	3,042	-100
Long term debt	3,773	8,895	10,475	13,739	13,861						
Other liabilities	210	439	0	0	0	Net change in cash	1,806	-1,010	5,923	2,238	1,733
Total liabilities	4,593	11,585	14,395	20,023	19,906	Beginning cash	1,106	2,912	1,902	7,825	10,063
Shareholders' equity	2,884	4,203	16,496	19,623	23,283	Ending cash	2,912	1,902	7,825	10,063	11,796

Source: Company reports, J.P. Morgan estimates.

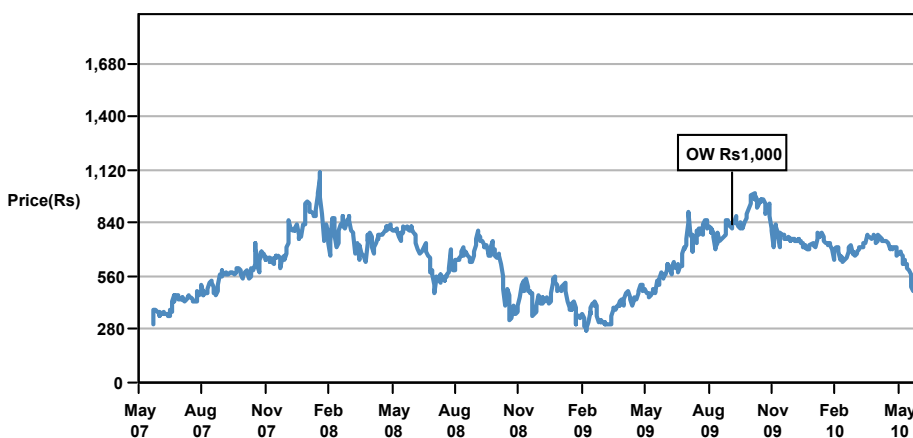
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- **Client of the Firm:** Educomp Solutions Ltd is or was in the past 12 months a client of JPMSI.

Educomp Solutions Ltd (EDSO.BO) Price Chart



Date	Rating	Share Price (Rs)	Price Target (Rs)
02-Sep-09	OW	826.90	1000.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Sep 02, 2009. This chart shows J.P. Morgan’s continuing coverage of this stock; the current analyst may or may not have covered it over the entire period. J.P. Morgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

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