

Equity | India | Education & Training Services
22 January 2009

RESEARCH

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Stock fall unwarranted; Buy

Stock down 30% on baseless rumors, Reiterate Buy

Educomp stock corrected 30% over last two days on an anonymous note claiming management has “manipulated books of accounts to show higher profits and diverted company funds “. We view the report as a clear misinterpretation of facts and would like to reiterate our Buy on the stock. Management also hosted an investor call to address each and every concern raised by the note. Our channel checks with competition supports the high growth numbers reported by company.

Anonymous note : Misinterpretation of facts in our view

First key issue raised by the note relates to relatively high capital expenditure relative to FY08 sales. We believe this is a reflection of Smart Class its flagship content offering for private schools being a capital intensive model, school additions being skewed towards second half and ironically a factor of high growth. With revenues to flow over next 5 years capital expenditure is likely to be higher than revenues during its initial growth years. Second issue raised is on employee cost appearing low relative to sales. Based on channel checks we believe salary paid by Educomp is in line with industry for similar profile of work. Given lumpiness in 4Q, employee cost in 4Q FY08 is a better indicator to measure per employee expenses than full year employee costs.

Reassures on promoter holding; To strengthen corp gov

On the investor call, management mentioned that over the next few weeks the Board will consider appointing a leading auditor for statutory/internal audit and hopes to further strengthen the Board itself with inclusion of new members. Management also reiterated that it has not pledged any shares and promoter holding stood at 55%. Retain Buy

Estimates (Mar)

(Rs)	2007A	2008A	2009E	2010E	2011E
Net Income (Adjusted - mn)	287	707	1,410	2,320	3,372
EPS	15.25	38.21	76.23	124.73	180.34
EPS Change (YoY)	111.4%	150.5%	99.5%	63.6%	44.6%
Dividend / Share	2.42	2.93	3.00	3.00	3.00
Free Cash Flow / Share	(31.92)	(99.66)	(115.03)	(75.64)	(12.74)

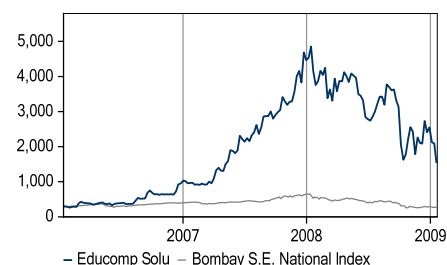
Valuation (Mar)

	2007A	2008A	2009E	2010E	2011E
P/E	100.09x	39.96x	20.03x	12.24x	8.47x
Dividend Yield	0.159%	0.192%	0.196%	0.196%	0.196%
EV / EBITDA*	53.53x	21.38x	9.31x	5.55x	3.76x
Free Cash Flow Yield*	-1.94%	-6.53%	-8.08%	-5.34%	-0.904%

* For full definitions of *iQmethod*SM measures, see page 5.

Stock Data

Price	Rs1,527
Price Objective	Rs3,700
Date Established	5-Nov-2008
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs1,375-Rs4,566
Mrkt Val / Shares Out (mn)	US\$535 / 17.2
Average Daily Volume	1,555,249
ML Symbol / Exchange	EUSOF / BSE
Bloomberg / Reuters	EDSL IN / EDSO.BO
ROE (2009E)	27.6%
Net Dbt to Eqty (Mar-2008A)	28.0%
Est. 5-Yr EPS / DPS Growth	53.0% / 53.0%
Free Float	35.0%



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iQprofileSM Educomp Solutions Ltd.

Key Income Statement Data (Mar)	2007A	2008A	2009E	2010E	2011E
(Rs Millions)					
Sales	1,100	2,861	5,626	8,394	11,710
Gross Profit	670	1,575	4,161	6,650	9,587
Sell General & Admin Expense	(164)	(301)	(744)	(1,194)	(1,718)
Operating Profit	410	935	2,364	3,925	5,806
Net Interest & Other Income	45	129	(160)	(284)	(487)
Associates	NA	NA	NA	NA	NA
Pretax Income	455	1,065	2,204	3,641	5,319
Tax (expense) / Benefit	(170)	(351)	(749)	(1,238)	(1,809)
Net Income (Adjusted)	287	707	1,410	2,320	3,372
Average Fully Diluted Shares Outstanding	19	19	18	19	19

Key Cash Flow Statement Data

Net Income	284	711	1,410	2,320	3,372
Depreciation & Amortization	96	331	544	956	1,394
Change in Working Capital	(225)	(730)	(490)	(806)	(959)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	10	193	44	84	139
Cash Flow from Operations	165	505	1,509	2,553	3,945
Capital Expenditure	(675)	(2,224)	(3,637)	(3,960)	(4,183)
(Acquisition) / Disposal of Investments	(101)	85	(1,000)	0	0
Other Cash Inflow / (Outflow)	38	141	0	0	0
Cash Flow from Investing	(739)	(1,998)	(4,637)	(3,960)	(4,183)
Shares Issue / (Repurchase)	0	0	1	2	3
Cost of Dividends Paid	(27)	(40)	(55)	(56)	(56)
Cash Flow from Financing	1,127	3,461	2,038	2,211	1,312
Free Cash Flow	(510)	(1,719)	(2,128)	(1,407)	(238)
Net Debt	150	862	900	2,361	2,652
Change in Net Debt	(482)	(1,634)	3,182	1,460	291

Key Balance Sheet Data

Property, Plant & Equipment	831	2,714	5,806	8,810	11,600
Other Non-Current Assets	240	318	1,318	1,318	1,318
Trade Receivables	496	1,157	1,504	2,244	3,121
Cash & Equivalents	1,106	2,912	1,814	2,619	3,693
Other Current Assets	159	570	615	748	915
Total Assets	2,832	7,671	11,058	15,739	20,647
Long-Term Debt	1,255	3,773	2,715	4,980	6,345
Other Non-Current Liabilities	59	210	210	210	210
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	242	586	552	621	707
Total Liabilities	1,556	4,569	3,477	5,810	7,262
Total Equity	1,276	3,078	7,558	9,906	13,362
Total Equity & Liabilities	2,832	7,647	11,034	15,716	20,623

iQmethodSM - Bus Performance*

Return On Capital Employed	16.9%	16.1%	19.5%	21.0%	22.4%
Return On Equity	28.1%	35.1%	27.6%	27.4%	30.0%
Operating Margin	37.3%	32.7%	42.0%	46.8%	49.6%
EBITDA Margin	46.0%	44.3%	51.7%	58.2%	61.5%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	0.6x	0.7x	1.1x	1.1x	1.2x
Asset Replacement Ratio	7.0x	6.7x	6.7x	4.1x	3.0x
Tax Rate (Reported)	37.3%	33.0%	34.0%	34.0%	34.0%
Net Debt-to-Equity Ratio	11.7%	28.0%	11.9%	23.8%	19.8%
Interest Cover	28.5x	19.5x	20.0x	11.4x	10.6x

Key Metrics

* For full definitions of iQmethodSM measures, see page 5.

Company Description

Set up in 1994, Educomp is India's largest provider of technology driven education solutions co. It provides end to end solutions for K12 through licensing of digital content to enhance the teaching process. It aims to be a comprehensive provider of solutions in India's school education economy and has expanded its offerings to cater to pre schools, online tutoring, professional development for teachers etc.

Investment Thesis

We expect Educomp to be one of the fastest growing companies in our universe. Key positives include growing adoption of technology based education amongst K-12 (Kindergarten to Class12) private schools, low market penetration of under 5 percent amongst private schools in India and increased spending by state governments on technology adoption in public schools. Besides revenue visibility is high as company enters in to 5 year contracts with private schools.

Stock Data

Price to Book Value 3.6x

Key highlights of the call

Management hosted an analyst call for investor to address key allegations raised by an anonymous note yesterday. Key highlights are as under:

Table 1: Key Mgt comments on allegations

Allegations	Mgt comments
	Management gave detailed break down of capital expenditure incurred for Smart Class, ICT and content. While Smart Class is capital intensive, it is also seasonal in nature.
High Capex vs Revenues in FY08.	ML comment : As most of the school wins happens during 2nd half, capital expenditure is skewed .With revenues to flow over next 5 years, mismatch between capital expenditure and revenues is likely in our view. As per MLe around 70% of capex in FY08 was incurred in 2 nd Half and revenues from these school additions would happen largely from FY09.
	Mgt gave detailed break down of employees per quarter and associated cost. End of FY08 it had :
	892 resource coordinators (Smart class) 165 marketing people, 2550 employees in ICT 55 in corporate 180 trainers in professional development and 93 multimedia professionals.
Avg employee exps are lower than industry standards.	Besides it also had 397 employees with other content providers. ML Comment: Given seasonality in business, 4Q FY08 costs in our view would be more relevant for per employee analysis than full year employee cost numbers as employee numbers increased every quarter with additions of schools during the year. Also the note seems to have calculated per employee cost on closing numbers rather than average.
Sale of shares by promoters	Mgt reiterated that promoter group sold 846,643 shares over last three years and holds 55% stake in the company-. It provided a complete break down of shares with dates and prices at which it was sold. On the call mgmt reiterated that it has not pledged any shares with financial companies and its current shareholding is 55.03%.
	Mgt likely to unveil detail corporate governance road map on 27 th Jan, along with 3Q results.
Corporate Gov issues	Mgt mentioned that the board would invite presentations from reputed auditors on 27 th and would recommend appointing a new auditor. Board strength would be increased with inclusion of new members on the board.

Source: Company, Bank of America Securities- Merrill Lynch Research

Biz fundamentals strong: ICT win likely

Management commented that company operations remain robust. It is likely to announce a large deal in ICT during this month. Its 3Q results are due on 27th Jan. We expect the company to report 84% yoy growth in revenues to Rs1626mn and 104% yoy growth in Profit to Rs403mn, and believe they could raise the guidance for FY09 Smart Class additions.

Price objective basis & risk

Educomp Solu (EUSOF)

Our PO of Rs3700 is at PEG of 0.9 (FY09/FY09-11e), lower than historical PEG of 1.2, and implies a PE of 30x FY10e. We believe premium valuations are fair considering the high 68 percent earnings growth over FY08-11E and derisked revenue model given focus on non discretionary education spend and high exposure to domestic economy.

Risks to our valuation are delays in execution of contracts in government schools, acquisition related risks and managing multiple growth initiatives.

Analyst Certification

I, Pratish Krishnan, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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India - Software & IT Services Coverage Cluster

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	Educomp Solu	EUSOF	EDSL IN	Pratish Krishnan
	Infotech India	IFKFF	INFTC IN	Prasad Deshmukh
	Mphasis Ltd	MPSSF	MPHL IN	Pratish Krishnan
	Rolta India	RLTAF	RLTA IN	Prasad Deshmukh
	Rolta India-GDR	XLROF	RTI LI	Prasad Deshmukh
	Tata Consultancy	TACSF	TCS IN	Mitali Ghosh
	Tech Mahindra	TMHAF	TECHM IN	Pratish Krishnan
	WNS (Holdings) L	WNS	WNS US	Mitali Ghosh
NEUTRAL	Genpact Ltd	G	G US	Mitali Ghosh
	HCL	HCLTF	HCLT IN	Mitali Ghosh

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India - Software & IT Services Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
	Infosys Tech	INFYF	INFO IN	Mitali Ghosh
	Infosys Tech - A	INFY	INFY US	Mitali Ghosh
UNDERPERFORM				
	ExlService Holdi	EXLS	EXLS US	Mitali Ghosh
	Firstsource	FSSOF	FSOL IN	Mitali Ghosh
	Hexaware Tech	XFTCF	HEXW IN	Pratish Krishnan
	KPIT Cummins Inf	KPTCF	KPIT IN	Prasad Deshmukh
	Mastek	MSKDF	MAST IN	Prasad Deshmukh
	Patni	PATIF	PATNI IN	Mitali Ghosh
	Patni Computer	PTI	PTI US	Mitali Ghosh
	Sasken Communic	SKNCF	SACT IN	Pratish Krishnan
	Subex Ltd	SBXSF	SUBX IN	Pratish Krishnan
	Subex Ltd-GDR Regs	XZSUF	SUBX LI	Pratish Krishnan
	Wipro	WIPRF	WPRO IN	Mitali Ghosh
	Wipro	WIT	WIT US	Mitali Ghosh

*iQmethod*SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Other LT Liabilities}$	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

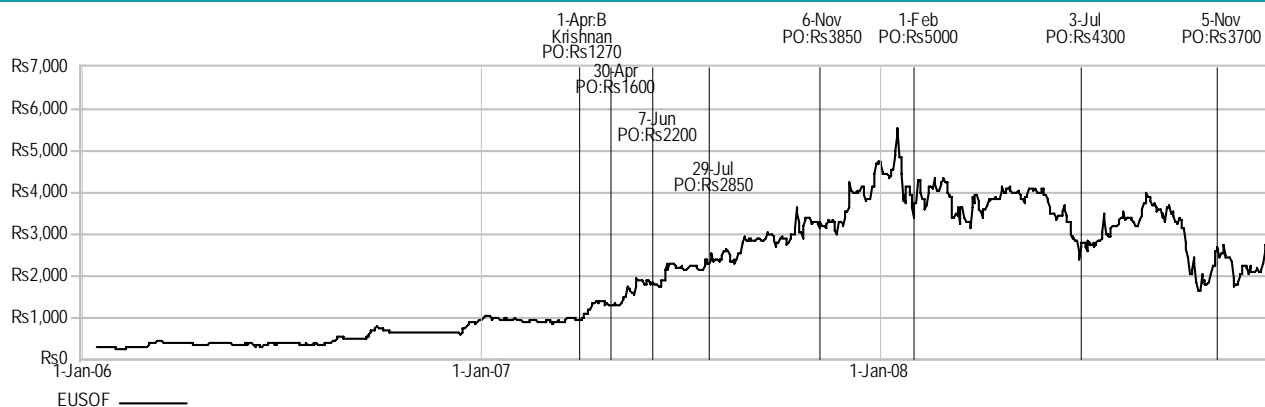
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B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

*Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of December 31, 2008 or such later date as indicated.

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Investment Rating Distribution: Education & Training Services Group (as of 01 Jan 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	14	82.35%	Buy	4	28.57%
Neutral	2	11.76%	Neutral	1	50.00%
Sell	1	5.88%	Sell	0	0.00%

Investment Rating Distribution: Global Group (as of 01 Jan 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1297	38.46%	Buy	314	26.81%
Neutral	859	25.47%	Neutral	210	28.23%
Sell	1216	36.06%	Sell	229	20.71%

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