Educomp Solutions Ltd

Inline performance but disclosures improve. Maintain BUY

CMP	TARGET	RATING	RISK
Rs 512	Rs 820	BUY	MEDIUM

BSE	NSE	BLOOMBERG
532696	EDUCOMP	EDSL IN

We have been positive on Educomp given our view that it is the best play on the fast growing and secular Indian education story. However the stock has been weak of-late largely due to concerns on balance sheet, cash flow and a weak 1QFY11. In our view, 2QFY11 performance partially addresses these concerns as SmartClass business improved (though classroom additions were still weak). Further we had detailed discussions with management on issues and their responses are presented in this note (please see Fig-4). We have marginally adjusted our estimates and roll over our PT to Sep-12 to Rs820 (Rs700 earlier). Overall, we believe that concerns are overdone and we continue to like Educomp with significant share price upside potential – our target price is 820, 60% upside from current levels.

2QFY11 largely inline: Educomp reported Rev/EBIT/PAT of Rs2,768mn/Rs851mn/ Rs578mn largely inline with our expectations. EBIT margins at 38% in 2QFY11 improved 800bps sequentially driven by improvement in smartclass segment. However classroom additions were lower QoQ at 5,309 vs. 6,750 in 1QFY11 with management citing seasonality as the key issue. Overall the company has maintained its FY11 Revenue/PAT guidance of Rs13bn-Rs13.5bn/Rs3.3bn-Rs3.35bn as well as the smartclass guidance of 25k-30k classrooms.

Smartclass additions lower QoQ on account of seasonality but guidance intact: Smartclass Rev/EBIT came in at Rs1500mn/Rs816mn. This also included Rs420mn deferred revenues from transferred contracts. The classroom addition at 5,309 was lower QoQ. As per the management schools add smartclass before new session hence 3Q and 4Q are the stronger quarters. Also there was some spill over of 4QFY10 into 1QFY11 leading to unusually strong additions in previous quarter. Realizations were up marginally to Rs0.40mn; however it is expected to remain around Rs0.39mn. Despite lower sequential additions the company maintained its FY11 classroom addition guidance of 25k-30K classrooms.

Other segments performance mixed: K-12 Rev/EBITDA at Rs211mn/Rs156mn was largely inline with expectations. Growth was strong in higher learning but remained in losses at EBIT level (Rs65mn). However online business turned profitable at EBIT level and reported an EBIT of Rs31mn vs. loss of Rs63mn in 1QFY11. ICT revenues jumped to Rs421mn in 2QFY11 (Rs205mn in 1QFY11) but the number of schools reduced by 1,612 to 13,814 as some contracts concluded.

Disclosures levels improve: The company has increased its disclosures with complete balance sheet details, debtor days and detailed explanation on business model. The debtor days stood at 149 as of 5th Oct (249 days Sep-10). Further fresh securitization is at 20% recourse as opposed to 100% earlier. Also we have exclusively interacted with the management with key investor queries and have compiled the responses for the same (please see Fig-4).

Company data

Market cap (Rs mn / US$ mn)	48,923 / 1,091
Outstanding equity shares (mn)	96
Free float (%)	46.1
Dividend yield (%)	0.6
52-week high/low (Rs)	876 / 440
2-month average daily volume	920,471

Stock performance

Returns (%)	CMP	1-mth	3-mth	6-mth
Educomp	512	(19)	(12)	(17)
CNX IT	6,663	(1)	9	13
Sensex	20,157	(0)	12	17

Valuation matrix

(x)	FY09	FY10	FY11E	FY12E
P/E @ CMP	33.8	18.2	14.4	12.6
P/E @ Target	46.2	24.8	19.7	17.2

Financial highlights

(Rs mn)	FY10	FY11E	FY12E	FY13E
Revenue	10,405	13,602	15,801	20,445
Growth (%)	*61.3*	*30.7*	*16.2*	*29.4*
Adj net income	2,713	3,421	3,922	5,488
Growth (%)	*104.7*	*26.1*	*14.7*	*39.9*
FDEPS (Rs)	28.2	35.5	40.8	57.0
Growth (%)	*86.2*	*26.1*	*14.7*	*39.9*

Profitability and return ratios

(%)	FY10	FY11E	FY12E	FY13E
EBITDA margin	46.7	39.5	47.1	48.6
EBIT margin	35.8	33.3	40.0	42.0
Adj PAT margin	26.1	25.1	24.8	26.8
ROE	32.0	21.1	18.3	21.2
ROIC	14.3	15.2	13.6	16.5
ROCE	12.1	12.6	11.5	14.0

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Results Review

Fig 1 - Results review

(Rs mn; YE March)	Actuals	Estimates	Diff. %	Q1FY11	Q/Q %	Q2FY10	Y/Y %
Revenue	2,768	2,664	3.9	2,279	21.5	2,535	9.2
EBIT	851	771	10.4	495	72.0	742	14.7
EBITDA	1,059	1,012	4.7	693	52.9	1,048	1.0
Pre Tax Profit	723	644	12.3	405	78.6	1,440	(49.8)
Net Profit	578	570	1.4	365	58.5	1,155	(49.9)
EPS (Rs)	6.1	6.0	1.4	3.8	58.5	13.2	(53.9)
Margins (%)							
Operating Margin	30.8	28.9		21.7		29.3	
EBITDA Margin	38.3	38.0		30.4		41.3	
Net Margin	20.9	21.4		16.0		45.6	

Source: Company, RCML Research

Fig 2 - Smartclass metrics

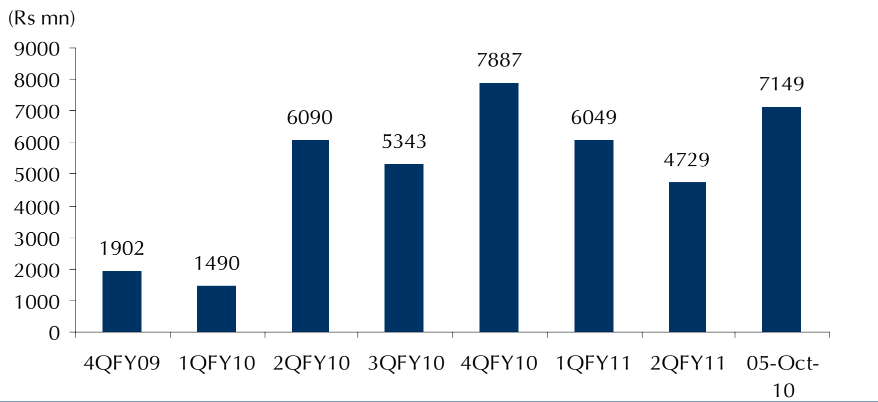
	4QFY10	1QFY11	2QFY11
Total Classrooms	42648	49398	54707
Classrooms added	4038	6750	5309
School additions	503	844	664
Pricing	392,000	392,000	404,768

Source: Company

Key Management Comments

- Consolidated FY11 revenue guidance at Rs13bn-Rs13.5bn and consolidated PAT guidance at Rs3bn-Rs3.35bn.
- Smartclass classroom addition guidance for FY11 maintained at 25,000 -30,000
- Debtors as on 5-Oct-10: 149 Days (after Bank funding of non securitized schools).
- Debtors guided at 160 - 170 days on sequential turnover basis for Q3 & Q4 FY11.
- Capex of Rs3.72bn in 1HFY10. As per the management capex for schools is frontloaded in 1H.
- Online and Supplemental business should continue to be EBIT margin positive.
- New securitizations of smartclass at 20% corporate guarantee from Educomp vs. 100% earlier.
- Have incrementally securitised Rs3bn in Oct-10 with a consortium of banks.
- 46 K-12 schools active of which 21 schools are under dry management/JV model.

Fig 3 - Cash and cash equivalents



Source: Company

Key investor queries

In addition to the disclosures this quarter, we had an exclusive Q&A with the Educomp management on some of the key investor queries and concerns on the company. We believe that the answers do clear many of the doubts and concerns on the business model of Educomp.

Fig 4 - Key investor queries / concerns

Queries / Concerns	Educomp response	Religare Comments
Questions on Edusmart and securitization model		
How does the securitization model work, what are the charges that are paid to bank per classroom? Which are the key banks that have so far securitized classrooms?	Educomp bills 75% of the contract value to Educomp towards hardware & content under securitisation model . Edusmart securitises the receivables to the bank & gets 54% upfront from the bank calculated on NPV basis. There is no per classroom charges paid to bank. Name of banks under 1st Tranche were PNB, Indusind, Stanchart, & ICICI & under 2nd tranche is Axis bank .	
Given the banks would need to securitize all/most of the classrooms sold, scalability of the business model is dependent on banks appetite to securitize?	Now the Edusmart model is well established with banks and we don't forsee any issues with future securitization	If the banks are comfortable with the securitization model, why are there separate banks for securitizing the two tranche's.
What are the contingent liabilities of Rs6650mn on loans to third party in FY10 balance sheet? Are these the bank guarantees given on behalf of Edusmart?	Yes.	The treatment of these contingent liabilities will be a concern for investors. However incremental securitization at 20% recourse from 2QFY11 is a positive.
How will these contingent liabilities be accounted for in IFRS- will they be shown as debt on Educomp's balance sheet?	Under IGAAP, contingent liabilities are not accounted under debt. We are evaluating the accounting under IFRS	This remains a key concern for investors and we will keep in touch with the management for a clear answer on this.
What is the shareholding pattern of Edusmart?	100% equity capital held by ex Educomp employees and Rs450mn non convertible Preference capital at yield of 8% held by Educomp.	
How were the assets accounted for in the earlier BOOT model in the balance sheet? What happens now? The computer peripherals and accessories Fixed assets has come down in FY10? Is it because of shift from BOOT to outright?	In BOOT model they were capitalised in Fixed asset and in Edusmart model charged to Profit & Loss account as COGS as Edusmart model is a sale model	
Why were receivable days high in the earlier model? Why are the receivable days still at 183 despite securitizing most of the schools? By when should the receivable days come down?	In earlier model debtors were high due to following factors : a) Under BOOT model of Smart class, wherein we bill after 90 days post implementation b) Seasonality wherein ~40-45% of revenues are booked under Q4 & 60-65% in both Q3 & Q4 , leading to increased debtors at the date of balance sheet c) Under ICT business , Government delays are inadvertent, & are generally from 7-8 months In Q1, Under new model receivables were high due to following factors: a) Due to transfer of all existing BOOT contracts during the year & all were transferred, but not securitised b) Due to ICT business c) Due to increased receivables under K-12 business	Management has guided to maintaining debtor days at 160-170 in the next two quarters as the new tranches of securitization come in.
By when do you expect to turn FCF positive?	Securitisation model has facilitated FCF positive situation now	
How much of the content and other costs are capitalized in the Balance sheet?	Content cost capitalised Rs207.4mn.	

Queries / Concerns	Educomp response	Religare Comments
Questions on K-12		
How are the assets of K-12 accounted for? Is it in the trust or on Educomp's Balance Sheet	Assets are normally capitalised in Educomp's balance sheet & given on 30 year lease basis to trust, the only exception is where a particular state government requires educational land to be in the name of trusts/society	
What is the deprecation policy of the K-12 schools?	As per Schedule XIV of Companies Act, except for buildings which are being depreciated on SLM basis over 30 years.	
How does Educomp make a 75% EBITDA margin on K-12? Also why there is large difference between EBTIDA margin (75%) and PAT margin (25%)?	On consolidated basis, EBIDTA is 65% for FY10, & 35% pertains to operational expenses consisting of salaries & administrative expenses. The difference between EBIDTA & PAT is Interest (Rs127.6mn) and Rs56.7mn of depreciation.	
In FY10 the company Increased stake in EISML by from 69.38 to 78.5%? What is the shareholding pattern of the remaining 21% in Educomp Infrastructure & School Management Limited?	Promoters of Educomp: 16.58% Body corporate: 3.22% Employees: 2%	Not clear as to why Educomp doesn't have 100% ownership of EISML.
What were the QIP proceeds used for? Was most of it used to capitalize Educomp Infrastructure & School Management Limited?	For Smartclass, ICT and majorly K-12	
What is the total debt in Educomp Infrastructure & School Management Limited? How much of it is related party loans and advances?	Rs3.6bn, it is all deployed in fixed assets & nil amount is towards related party loans. All the loans & advances are funded out of equity.	

Source: Company, RCML Research

Estimate changes

Fig 5 - Estimate changes

Rs M, Year end March	Revised			Earlier			Difference %		
	2011E	2012E	2013E	2011E	2012E	2013E	2011E	2012E	2013E
Revenue	13,602	15,801	20,445	13,126	16,013	20,412	3.6	-1.3	0.2
EBIT	4,524	6,326	8,594	4,422	6,486	8,703	2.3	-2.5	-1.3
EBITDA	5,373	7,441	9,943	5,386	7,732	10,240	-0.2	-3.8	-2.9
Pre Tax Profit	4,063	5,895	8,249	3,972	6,036	8,296	2.3	-2.3	-0.6
Net Profit	3,421	3,922	5,488	3,524	4,024	5,530	-2.9	-2.5	-0.8
EPS (Rs)	36.0	41.3	57.8	37.1	42.4	58.3	-2.9	-2.5	-0.8
Margins (%)									
Operating Margin	33.3	40.0	42.0	33.7	40.5	42.6			
EBITDA Margin	39.5	47.1	48.6	41.0	48.3	50.2			
Net Margin	25.1	24.8	26.8	26.8	25.1	27.1			

Source: RCML Research

Valuations

We believe that EDSL remains the best play on the Indian education theme and value the stock at a P/E of 17x one-year forward to arrive at our Sept-11 price target of Rs820. While EDSL has historically traded at a significant premium to the market, slower growth and a changing business model have resulted in multiple contraction. We believe that continued execution on the current business model is critical for any re-rating of the stock. Key risks to our thesis are regulations in K-12 and execution slippages as management bandwidth is stretched over multiple business lines.

Fig 6 - Rolling 1 year forward P/E

Source: Company, RCML Research and Bloomberg

Fig 7 - DCF assumptions

Key assumptions		**WACC Assumptions**	
10-year Revenue CAGR (FY10-20E)	21.1%	Cost of equity =	14.3%
10-year EBIT CAGR (FY10-20E)	23.3%	Risk free rate =	7.8%
10-year NOPAT CAGR (FY10-20E)	24.1%	Beta =	1.30
EBIT margin (FY10; FY20)	36%, 43%	Equity risk premium =	5.0%
NOPAT margin (FY10; FY20)	22%, 29%	Cost of debt =	11.5%
ROIC (FY10; FY20)	14%, 21%	Tax =	30.0%
Terminal assumptions		Debt/capital =	30.0%
Terminal Revenue Growth Rate %	4%	Equity/capital =	70.0%
Terminal EBIT Margin	42%	**WACC =**	**12.4%**
Terminal NOPAT Margin	28%	DCF output (US$ mn)	
Terminal ROIC	19%	Current Equity value	66,222
Terminal Fixed asset turns	1.0	Current equity value/share	698
		Sept-11 equity value/share	800

Source: RCML Research, Company

Fig 8 - Global Comps

		Year End	Price	Market Cap	EPS		P/E		P/B		ROE	
					FY11	FY12	FY11	FY12	FY11	FY12	FY11	FY12
Indian Comps												
Educomp	EDSL IN	March	512.2	1,094	35.5	40.8	14.4	12.6	2.5	2.1	21.1	18.3
NIIT	NIIT IN	March	62.85	232	5.5	7.1	11.4	8.9	1.8	1.5	16.3	18.3
Everonn	EEDU IN	March	640	216	38.5	51.2	16.6	12.5	3.1	2.5	21.4	22.4
International comps												
Apollo Group	APOL US	August	36.56	5,404	4.4	4.4	8.2	8.2	2.6	2.0	43.6	30.3
New Oriental	EDU US	May	108.3	4,077	2.5	3.4	42.9	31.9	8.7	7.2	18.5	20.8
DeVry	DV US	June	46.53	3,260	4.6	5.0	10.2	9.4	2.3	1.8	24.6	22.2
Strayer Education	STRA US	December	143.87	1,950	9.6	11.0	14.9	13.0	9.2	6.8	63.6	56.3
Career Education	CECO US	December	17.78	1,445	2.9	3.0	6.1	6.0	1.4	1.1	23.6	22.3
Megastudy	072870 KS	December	169200	952	11,255.0	13,171.0	15.0	12.8	3.7	3.0	27.0	25.8

Source: Company, RCML Research and Bloomberg

Consolidated financials

Profit and Loss statement

Y/E March (Rs mn)	FY10	FY11E	FY12E	FY13E
Revenues	**10,405**	**13,602**	**15,801**	**20,445**
Growth (%)	*61.3*	*30.7*	*16.2*	*29.4*
EBITDA	**4,859**	**5,373**	**7,441**	**9,943**
Growth (%)	*92.4*	*10.6*	*38.5*	*33.6*
Depreciation & amortisation	1,138	849	1,115	1,349
EBIT	3,721	4,524	6,326	8,594
Growth (%)	*122.3*	*21.6*	*39.8*	*35.9*
Interest	773	(461)	(431)	(345)
Other income	(95)	0	0	0
EBT	4,399	4,063	5,895	8,249
Income taxes	1,625	620	1,945	2,722
Effective tax rate (%)	*37.0*	*15.3*	*33.0*	*33.0*
Extraordinary items	0	0	0	0
Min into / inc from associates	(60)	(22)	(27)	(38)
Reported net income	2,713	3,421	3,922	5,488
Adjustments				
Adjusted net income	**2,713**	**3,421**	**3,922**	**5,488**
Growth (%)	*104.7*	*26.1*	*14.7*	*39.9*
Shares outstanding (mn)	95	95	95	95
FDEPS (Rs) (adj)	**28.2**	**35.5**	**40.8**	**57.0**
Growth (%)	*86.2*	*26.1*	*14.7*	*39.9*
DPS (Rs)	2.8	3.0	3.0	3.0

Cash flow statement

Y/E March (Rs mn)	FY10	FY11E	FY12E	FY13E
Net income + Depreciation	3,851	4,270	5,037	6,838
Non-cash adjustments	364	982	27	38
Changes in working capital	(2,519)	(2,074)	496	(1,402)
Cash flow from operations	1,696	3,178	5,561	5,473
Capital expenditure	(4,982)	(2,941)	(4,000)	(4,400)
Change in investments	60	(795)	27	38
Other investing cash flow	0	(5,576)	0	0
Cash flow from investing	(4,922)	(9,312)	(3,973)	(4,362)
Issue/repay debt	1,401	3,527	0	0
Dividends paid	(305)	(333)	(333)	(333)
Other financing cash flow	6,008	3,863	(27)	(38)
Change in cash & cash eq	3,877	922	1,228	740
Closing cash & cash eq	5,742	6,665	7,893	8,633

Balance sheet

Y/E March (Rs mn)	FY10	FY11E	FY12E	FY13E
Cash and cash eq	5,742	6,665	7,893	8,633
Accounts receivable	5,530	5,963	5,195	6,161
Inventories	73	400	362	465
Other current assets	1,332	5,852	5,287	6,791
Investments				
Gross fixed assets	14,564	17,779	21,779	26,179
Net fixed assets	13,063	15,155	18,040	21,091
CWIP				
Intangible assets				
Deferred tax assets, net				
Other assets	708	7,079	7,051	7,013
Total assets	**26,449**	**41,113**	**43,828**	**50,154**
Accounts payable	1,717	5,047	4,204	5,292
Other current liabilities	444	319	289	371
Provisions				
Debt funds	10,475	14,002	14,002	14,002
Other liabilities	1,092	2,083	2,083	2,083

Financial ratios

Y/E March	FY10	FY11E	FY12E	FY13E
Profitability & Return ratios (%)				
EBITDA margin	46.7	39.5	47.1	48.6
EBIT margin	35.8	33.3	40.0	42.0
Net profit margin	26.1	25.1	24.8	26.8
ROE	32.0	21.1	18.3	21.2
ROCE	12.1	12.6	11.5	14.0
Working Capital & Liquidity ratios				
Receivables (days)	194	160	120	110
Inventory (days)	3	11	8	8
Payables (days)	60	135	97	94
Current ratio (x)	5.9	3.5	4.2	3.9
Quick ratio (x)	5.2	2.4	2.9	2.6
Turnover & Leverage ratios (x)				
Gross asset turnover	0.9	0.8	0.8	0.9
Total asset turnover	0.5	0.4	0.4	0.4
Adjusted debt/equity				
Valuation ratios (x)				
EV/Sales	5.2	3.9	3.4	2.6
EV/EBITDA	11.0	10.0	7.2	5.4
P/E	18.2	14.4	12.6	9.0
P/BV	3.8	2.5	2.1	1.7

Company profile

Educomp provides technology based electronic learning solutions for schools and educational institutions. Besides they have also started their own school chains in the K-12 segment.

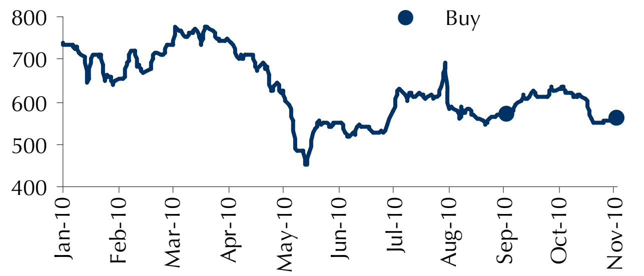
Shareholding pattern

(%)	Mar-10	Jun-10	Sep-10
Promoters	50.1	49.8	49.8
FIIs	40.8	36.9	38.5
Banks & FIs	1.4	1.6	1.7
Public	7.7	11.7	10.0

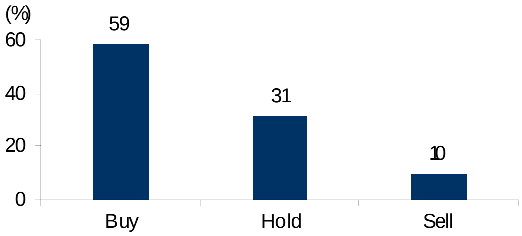
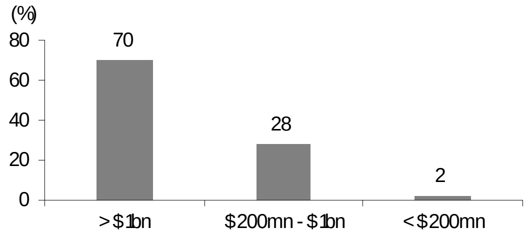
Recommendation history

Date	Event	Reco price	Tgt price	Reco
15-Sep-10	Initiating Coverage	578	700	Buy
14-Nov-10	Company Update	512	700	Buy

Stock performance



Coverage Profile

By recommendation	By market cap (US$)
	

Recommendation interpretation

Recommendation	Expected absolute returns (%) over 12 months
Buy	More than 15%
Hold	Between 15% and –5%
Sell	Less than –5%

Recommendation structure changed with effect from March 1, 2009

Expected absolute returns are based on share price at market close unless otherwise stated. Stock recommendations are based on absolute upside (downside) and have a 12-month horizon. Our target price represents the fair value of the stock based upon the analyst's discretion. We note that future price fluctuations could lead to a temporary mismatch between upside/downside for a stock and our recommendation.

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Disclaimer