

## Educomp Solutions Ltd

### Best play on Indian education theme; initiate with BUY

We initiate coverage on Educomp Solutions (EDSL) with a BUY and a March '11 price target of Rs 700/sh, an upside of 21% from current levels. We believe that education remains one of the most attractive multi-year growth themes in India, with two key growth segments: 1) Multimedia (US\$ 1.2bn by FY15), and 2) K-12 schools (US\$ 29bn by FY15). In our view, EDSL remains best positioned to capture the market with its leadership in multimedia (*Smartclass*) and strong focus on the lucrative K-12 segment. Further, the company's securitisation model in *Smartclass* and dry K-12 management should help improve cash generation and ease investor concerns on high capex. We estimate Educomp should be able to generate Rs1.5bn of FCF in FY12. We expect EDSL to report a revenue/EPS CAGR of 24%/22% (FY10-FY12), driven by strong revenue growth of 31% in *Smartclass* and 66% in the K-12 business. Continued execution in these two segments would drive share performance. In our view Educomp has the potential to be a US\$5bn market cap over the next 5 years.

**Education – a multi-year growth opportunity:** We believe that education in India is a multi-year growth story driven by improving literacy, a need for quality services, favourable demographics and rising affluence. We expect the K-12 market to grow from the current US\$ 16bn to US\$ 29bn by FY15. Further, the multimedia-aided teaching opportunity is likely to be worth US\$ 1.2bn by FY15.

**Leadership in multimedia with Smartclass:** EDSL is the market leader in multimedia-aided teaching in India. We expect new classroom additions in the segment to pick up, spurred by a renewed focus on schools in smaller cities and supported by significant additions to the sales force. We expect EDSL to add ~31,000 classrooms this year, ahead of the management's FY11 guidance of 25,000–30,000. The company is likely to benefit from the securitisation model, aiding revenue/EBIT growth of 31%/27% over FY10-FY12.

**K-12 segment to further support growth:** EDSL offers infrastructure and management services to schools (own/dry management). We expect the company to benefit from the increasing demand from private unaided schools. EDSL already has 43 operational schools and expects to take this up to 75 over the next 12 months—a combination of own schools and dry management. We expect strong student growth of 13%/72% in FY11/FY12 with stable 75% EBITDA margins, resulting in a robust revenue/EBITDA CAGR of 66%/77% over FY10-FY12.

**Initiate with BUY:** 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 price target of Rs 700. While EDSL has historically traded at a significant premium to the market, slower growth and a changing business model have resulted in multiple contraction. Continued execution on the current business model is critical for any re-rating of the stock.

#### Financial highlights

(Rs mn)	FY10	FY11E	FY12E	FY13E
Revenue	10,405	13,126	16,013	20,412
Growth (%)	61.3	26.1	22.0	27.5
Adj net income	2,713	3,524	4,024	5,530
Growth (%)	104.7	29.9	14.2	37.4
FDEPS (Rs)	28.2	36.6	41.8	57.5
Growth (%)	86.2	29.9	14.2	37.4

#### Profitability and return ratios

(%)	FY10	FY11E	FY12E	FY13E
EBITDA margin	46.7	41.0	48.3	50.2
EBIT margin	35.8	33.7	40.5	42.6
Adj PAT margin	26.1	26.8	25.1	27.1
ROE	32.0	24.6	22.7	24.9
ROIC	13.7	17.3	17.7	20.7
ROCE	12.1	14.2	13.8	16.1

CMP	TARGET	RATING	RISK
Rs 578	Rs 700	BUY	MEDIUM

BSE	NSE	BLOOMBERG
532696	EDUCOMP	EDSL IN

#### Company data

Market cap (Rs mn / US\$ mn)	55,118 / 1,189
Outstanding equity shares (mn)	95
Free float (%)	46.0
Dividend yield (%)	0.5
52-week high/low (Rs)	1020 / 440
2-month average daily volume	1,420,289

#### Stock performance

Returns (%)	CMP	1-mth	3-mth	6-mth
Educomp	578	(2)	7	(21)
CNX IT	6,602	8	12	9
Sensex	19,502	7	12	14

#### Valuation matrix

(x)	FY09	FY10	FY11E	FY12E
P/E @ CMP	38.1	20.5	15.8	13.8
P/E @ Target	46.2	24.8	19.1	16.7

#### RCML vs consensus

Parameter	FY11E		FY12E	
	Cons	RCML	Cons	RCML
Sales (Rs mn)	13,861	13,126	17,036	16,013
EPS (Rs)	35.7	36.6	40.6	41.8



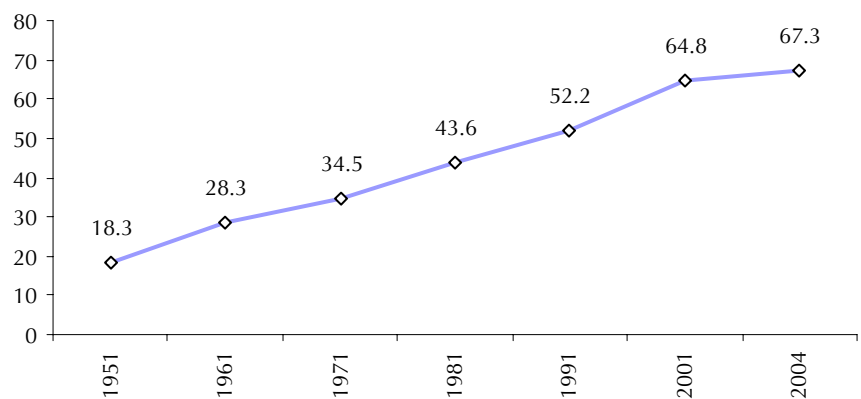
## Industry overview

### India – Large addressable education market

India has more than 464mn people in the 5–24 age group and a low literacy rate of 67%

India is expected to be one of the largest education markets globally with a population of 1.4bn people and potentially more than 464mn students (5–24 age group). As per the UN, India has one of the largest populations under the age of 29, at 650mn+. Further, the country still has a low literacy rate of 67% (2004) as compared to 90% in China and ~100% in developed nations. This is despite government efforts and GDP spends on education (3.5%), clearly suggesting a lack of quality services and high dropout rates. Additionally, we believe that increasing per capita income and a rising middle class will further boost investment in education.

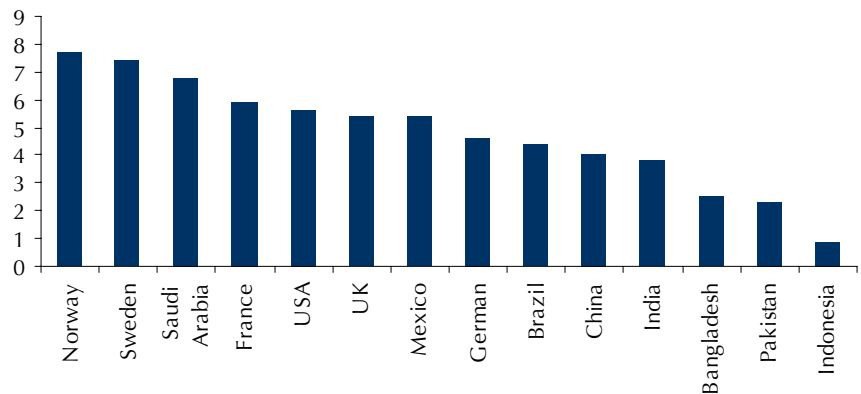
Fig 1 - India literacy rate (per 100 persons)



Source: HRD Ministry

Literacy levels low despite government efforts, implying poor quality of education

Fig 2 - GDP spend on education



Source: UNESCO, HRD Ministry

Fig 3 - India's budgeted education spend

	FY06	FY07	FY08	FY09
Budgeted expenditure on Education (Rs bn)	1,132	1,374	1,614	1,865
% of GDP	3.3	3.5	3.6	3.6

Source: MHRD



## The market opportunity

**Private urban K-12 market to grow from the current US\$ 16bn to US\$ 29bn by FY15**

### K-12 – The big opportunity

As per government statistics, India has ~230mn students enrolled in the K-12 (Kindergarten to Class 12) segment with ~1.3mn schools. The government currently has the dominant market share in the K-12 category. This can be attributed to the significant government focus on primary education and various social schemes that have led to over 1mn government schools. With improving purchasing power and the need for quality education, the current private urban K-12 education market of US\$ 16bn is estimated to grow at a CAGR of 12% over the next five years. We believe that K-12 services along with multimedia offer significant room for value creation. EDSL, in our view, remains best positioned to capitalise on the ample opportunity.

### Government the largest player in K-12

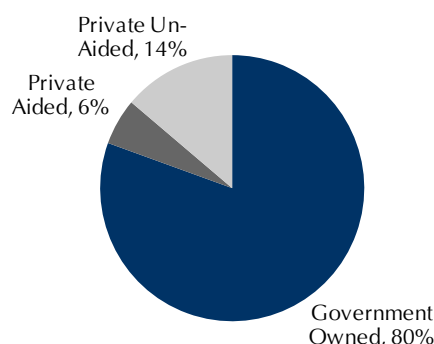
The government, by far, remains the largest player in the K-12 segment with nearly 67% of the schools under government and local body management. Further, the government spends ~Rs 1,900bn in this segment annually.

**Fig 4 - Total schools**

	Government	Private Aided	Private Unaided
Rural	936,119	46,636	97,363
Urban	99,059	26,261	79,661
Total	1,035,178	72,896	177,024

Source: NCERT, RCML Research

**Fig 5 - Schools by management mix**



Source: NCERT (As of 2008-2009)

**Fig 6 - Private urban K-12 – To be US\$ 29bn market opportunity**

	Current	FY12E	FY15E
Private Unaided (Rural + Urban)	177,024	269,231	358,347
Private Unaided urban (RCML estimate)	79,661	107,692	143,339
Average number of students per school	800	800	800
Number of students enrolled (mn)	64	86	115
School fees per student per month (Rs)	1,000	1000	1000
Total market size (Rs bn)	765	1,034	1,376
Total market size (US\$ mn)	15,932	21,538	28,668

Source: NCERT, RCML Research

Note: Using NCERT 2008-09 data due to lack of availability

**Government a key K-12 player, spending ~Rs 1,900bn annually**




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**Weak infrastructure and low-quality education affect enrolment and dropout levels**

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### Lack of quality in public schools

Despite significant government investment in education, the results have been far from satisfactory with illiteracy levels high at 33% and a low ranking of 105 (out of 129) for India on the Education Development Index (EDI\*). Government efforts have been largely focused on the primary school segment. Further, poor infrastructure and a lack of quality education have affected gross enrolment ratios and resulted in high dropout rates. We believe the government would look to explore public-private partnerships (PPP) in the segment to further boost reach and quality.

**Fig 7 - India has a low ranking in EDI**

Country	EDI*	Ranking out of 129 countries
<b>Countries with high EDI (&gt;.950)</b>		
UK	0.995	2
France	0.991	9
Sweden	0.994	4
Norway	0.995	1
Switzerland	0.985	19
<b>Countries with medium EDI (0.800 to 0.950)</b>		
Brazil	0.901	76
Mexico	0.953	48
China	0.938	61
Egypt	0.883	91
Indonesia	0.935	62
<b>Countries with low EDI (&lt;0.800)</b>		
<b>India</b>	<b>0.797</b>	<b>105</b>
Pakistan	0.640	120
Bangladesh	0.759	107
Nigeria	0.734	110

Source: UNESCO, HRD Ministry      Note \* : Education For All Development Index (EDI): The EDI is the arithmetic mean of its four components- total primary NER, adult literacy rate, GEI and survival rate to grade 5.

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**Proportion of private unaided schools has doubled to 30% from 1993 to 2005**

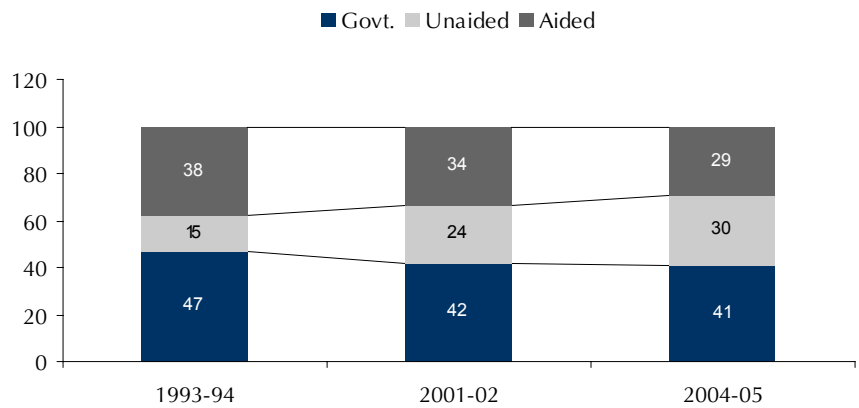
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### Quality and rising affluence to drive demand for private unaided education

With inadequate government infrastructure and the poor quality of secondary and higher education, we expect continued demand for private education in India. This is expected to be well supported by increasing purchasing power and emergence of the Indian middle class. Nearly 60% of secondary schools are run by private managements both aided and unaided, almost in equal proportions. The share of government and local body schools as well as private aided schools has shown a declining trend, with private unaided schools showing an increase from 15% in 1993–94 to 24% in 2001–02 and further to 30% in 2004–05.



**Fig 8 - Growing proportion of schools under private-unaided management**



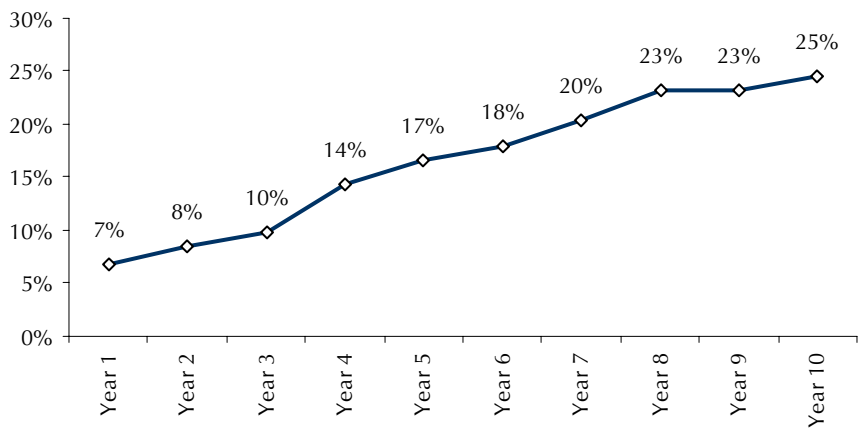
Source: Planning Commission

**K-12 schools can deliver an EBIT margin of 30%+ with an ROCE of 25% over the medium term**

### K-12 business – Attractive economics

In our view, the economics for setting up K-12 schools and offering managed services to private unaided schools remains an attractive business model, with customers locked in for 14 years and steady cash flows. However, setting up schools requires large amounts of upfront capex and returns are largely back-ended, making scalability difficult. We believe that a K-12 school can deliver an EBIT margin of 30%+ with an ROCE of 25% over the medium term. However, brand and quality of curriculum remain the key drivers and, once established, do offer significant pricing power. As per regulations, schools in India have to be incorporated under a trust structure and cannot be run for profit; EDSL offers managed services to these schools.

**Fig 9 - Attractive long-term ROCE business**



Source: RCML Research

**Large upfront capex of US\$ 3mn–5mn hinders ramp up of the business**

### Scalability an issue

In our view, scalability of K-12 remains an issue given large upfront capex requirements (US\$ 3mn–5mn) and the trust structure, restricting investment across different schools. Further, the increasing land-cum-construction costs, lack of capital and scarce talent (teachers) make execution challenging, resulting in slower growth rates. In India, however, a limited number of players have been able to build national school chains despite these constraints and logistical issues.

**Fig 10 - Leading K-12 players with India footprint**

Chains	Number of schools
EDSL	43
Vidya Bharti	~23,000
Kendriya Vidyalaya Sangathan (KVS)	~1100
Dayanand Anglo Vedic (DAV)	~670
Bhartiya Vidya Bhawan	~280
Nashik District Maratha Vidya Prasarak Samaj (NDMVP)	~250
Maharshi Vidya Mandir	~150
Ramakrishna Mission	~140
Delhi Public School (DPS)	~140

Source: RCML Research

#### EDSL – JV and Managed Services model to fast-track growth

EDSL currently has 43 operational schools and expects this number to grow to ~75 over the next two years. While the company continues to invest in new K-12 schools, it is also now incorporating joint ventures with land owners and engaging in managed services contracts with schools. Further tie-ups with reputed schools should help EDSL develop brand equity and attract students. We believe that K-12 will be the key growth driver for the company along with *Smartclass* and expect the revenue contribution from K-12 to rise to 15% by FY13, aiding a revenue/EBITDA CAGR of 66%/77% over FY10-FY12. Additionally, we expect EDSL to benefit from its pre-school presence through *Roots to Wings* and *Euro-Kids*.

**Fig 11 - EDSL – K-12 brands**

K-12 Brand	Presence	Fees per Month (Rs)
The Millenium School	Tier I and Tier II Cities	3000-3500
Takshila School	Tier III and Tier IV Cities	1500-1800
Universal Academy	Semi Urban	~1000

Source: Company



Fig 12 - P&amp;L of a typical K-12 school

Year	0	1	2	3	4	5	6	7	8	9	10
Capital expenditure less depreciation (Rs mn)	140	138	136	134	133	131	129	127	126	124	122
<b>GRADE</b>		<b>I-VI</b>	<b>I-VIII</b>	<b>I-X</b>	<b>I-XII</b>	<b>I-XII</b>	<b>I-XII</b>	<b>I-XII</b>	<b>I-XII</b>	<b>I-XII</b>	<b>I-XII</b>
Total capacity - Students		1,080	1,440	1,800	2,160	2,160	2,160	2,160	2,160	2,160	2,160
Utilization (%)		45%	55%	55%	60%	65%	70%	75%	80%	80%	80%
Total enrolled students		486	792	990	1,296	1,404	1,512	1,620	1,728	1,728	1,728
Tuition fees (p.m.)		2,400	2,520	2,646	2,778	2,917	3,063	3,216	3,377	3,546	3,723
Tuition fees (Rs mn)		14	24	31	43	49	56	63	70	74	77
Admission fees (Rs mn)		15	10	8	11	8	6	6	7	4	5
<b>Total fees (Rs mn)</b>		<b>28.6</b>	<b>33.6</b>	<b>39.6</b>	<b>53.8</b>	<b>56.7</b>	<b>61.6</b>	<b>68.9</b>	<b>76.7</b>	<b>78.0</b>	<b>81.9</b>
Teachers required (Student-Teacher ratio of 25:1)		19	32	40	52	56	60	65	69	69	69
Support staff		25	30	50	50	50	50	50	50	50	50
Total salaries (Rs mn)		6.4	10.3	14.6	18.6	20.7	23.0	25.7	28.4	29.8	31.3
Other operating costs (electricity, water, overheads)		12.9	11.8	11.9	16.2	14.2	15.4	17.2	19.2	19.5	20.5
as % of revenues		45%	35%	30%	30%	25%	25%	25%	25%	25%	25%
EBITDA (Rs mn)		9.4	11.5	13.2	19.1	21.8	23.2	25.9	29.2	28.7	30.1
Margin		33%	34%	33%	35%	38%	38%	38%	38%	37%	37%
Depreciation (Rs mn)		4.7	4.6	4.5	4.5	4.4	4.4	4.3	4.2	4.2	4.1
EBIT (Rs mn)		4.7	6.9	8.6	14.6	17.4	18.9	21.6	24.9	24.5	26.0
Margin		16%	21%	22%	27%	31%	31%	31%	32%	31%	32%
Int Expense @ 6%		6.2	6.1	6.1	6.0	5.5	5.0	4.6	4.1	3.7	3.7
PBT (Rs mn)		-1.5	0.8	2.6	8.6	11.9	13.8	17.0	20.8	20.8	22.3
Tax @ 33%		0.0	0.3	0.9	2.8	3.9	4.6	5.6	6.8	6.9	7.4
PAT (Rs mn)		-1.5	0.5	1.7	5.8	8.0	9.3	11.4	13.9	13.9	14.9
Margin		-5%	2%	4%	11%	14%	15%	17%	18%	18%	18%

Source: RCML Research

Fig 13 - K-12 assumptions

	2010	2011	2012	2013
<b>No. of schools</b>	<b>43</b>	<b>58</b>	<b>78</b>	<b>98</b>
Billable schools	29	43	58	78
Billable students per school	621	633	808	843
Revenue per billable student per month	2,551	2,679	2,715	2,805
<b>K-12 revenues (Rs mn) *</b>	<b>551</b>	<b>875</b>	<b>1,527</b>	<b>2,214</b>
Growth (%)	42%	59%	75%	45%

Source: RCML Research, Company. \*Excludes EuroKids revenues.



**We estimate 48% CAGR in revenue market size for multimedia content delivery by 2015**

## Multimedia content – Another key opportunity

Over the past few years, IT has played a rapidly increasing role in the field of education, particularly with the rising use of digital multimedia content to deliver courses/concepts in the classroom. We believe that the penetration of schools for multimedia content delivery is low at ~5% (urban private unaided) and expect it to grow to 18% by 2015, resulting in potentially 22,000 schools moving to multimedia content. Within this content opportunity, EDSL is clearly the leader with over 50% market share of schools. An 18% penetration by FY15 implies a revenue market size of US\$ 1.2bn and 5-year CAGR of 48%. Urban private schools are expected to double to 140,000 over the next five years and an adoption rate of 33% implies a US\$ 2.2bn revenue market opportunity for multimedia.

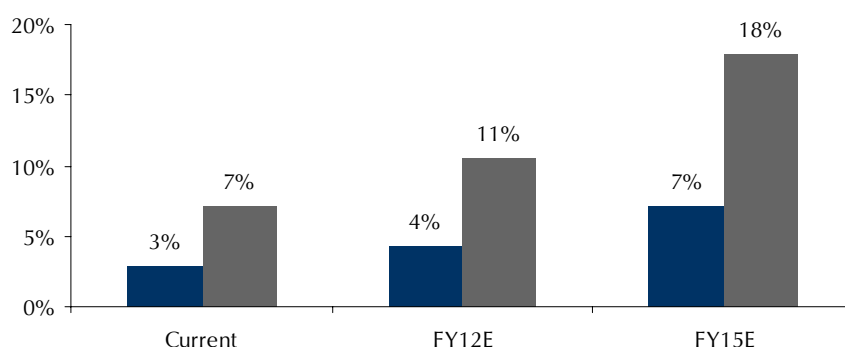
**Fig 14 - Revenue potential**

	Current	FY12E	FY15E
<b>Target Urban private schools</b>	<b>19,000</b>	<b>29,615</b>	<b>46,585</b>
<i>% of urban private schools</i>	24%	28%	33%
Classes per school	20	20	20
Students per class	50	50	50
Fees per student per month (Rs)	135	160	185
Multimedia addressable market size (US\$ mn)	655	1,210	2,200

Source: Company, NCERT, RCML Research

**Fig 15 - Our multimedia penetration estimates**

■ Private School Penetration (Urban + Rural) ■ Private Urban School Penetration



Source: Company, NCERT, RCML Research

### Competition to rise but EDSL has first-mover advantage

The attractive industry profile and high growth rates will lead to competition in the segment. So far, we have seen limited players with a digital portfolio in the content space. Further, we believe that EDSL-Smartclass has the first-mover advantage and is the market leader in this segment. Contracts with schools are long-term (five years) and we expect high renewal rates. Given that contracts are sticky in nature, we believe it is important to gain new-school market share. EDSL has now started focussing on schools with lower classroom potential (2–3) versus its earlier strategy of targeting those with a minimum of 15–20 classrooms.

**Fig 16 - Multimedia content players**

Company	Category	Product Name	Schools
EDSL	Multimedia Content Delivery	Smartclass	3,921
Everonn	Multimedia Content Delivery	iSchool	1,017
NIIT	Multimedia Content Delivery	eGuru	1,532

Source: Company, RCML Research





### Securitization model to ease cash flow concerns

Educomp has moved to upfront licensing of smartclass to third party (Edusmart). This in our view is positive change in the business model as it helps resolve the cash flow mismatch issue and ease large working capital requirements. In the previous model Educomp had to do the complete investment upfront and recognized cash flows each year leading to poor cash generation.

In the new model Educomp licenses the complete solution to Edusmart ( third party entity - owned by ex-Educomp employees) , which in turns gets the complete cash flow over the period securitized from banks. Edusmart recognizes 25% of the total value per classroom (Rs 392,000), while Educomp recognizes the remaining 75% over two years ( 52.5% in Year I and 22.5% in Year II). Year I revenues are mix of content and hardware and have margin of ~45%, while Year-II revenue recognition is purely content which has a margin of 80%+.

### EDSL to take up new ICT contracts on selective basis

### ICT government opportunity – Large but difficult to execute

The ICT opportunity in government schools is significant with ~100k schools expected by FY12. Further, the government has increased its focus on improving quality of content and delivery, and is open to the use of multimedia. While the opportunity is large, there are several key challenges: 1) high upfront investment in hardware infrastructure and software, 2) increase in working capital and cash flow requirements to support growth, 3) L1 bidding structure, which creates pricing pressure, and 4) high receivable days. Given challenges in executing the ICT opportunity, the company has now shifted focus to private *Smartclass* and K-12 and will take up new ICT contracts on a selective basis.

### Other Businesses

Educomp has invested in other business including professional development (Educomp Raffles JV, Educomp Pearson JV) and other online educational ventures. Both these segments are currently under losses and are a drag on the overall profitability of the company. Although we expect losses in these segments should moderate over the next 2-3 years; however any significant capex commitments and higher than estimated losses will be a negative. As such we estimate consolidated EBIT losses in these two segments to be in the range of ~Rs500mn per year over FY11 and FY12.

**Fig 17 - Revenue and Losses in other business**

In Rs Mn	FY10	FY11E	FY12E
Revenues	1,356	1,602	1,803
EBIT	(273)	(482)	(466)
EBIT Margin	-20%	-30%	-26%

Source: Company and RCML Research



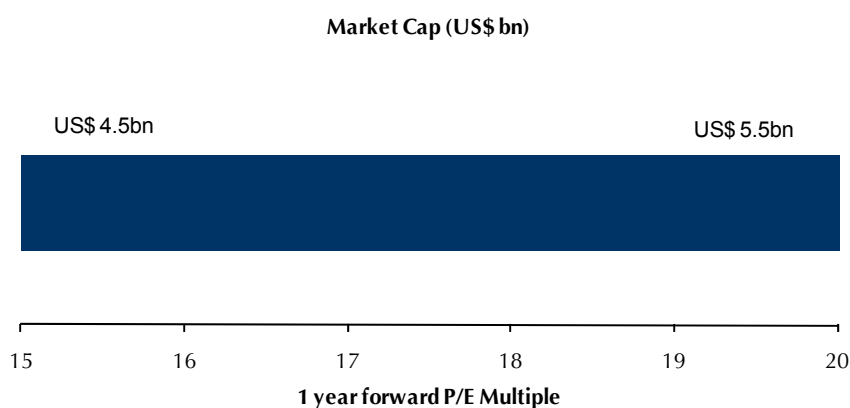
## A US\$5bn Mcap potential over the next 5 years

Fig 18 - 5 year Assumptions

School Learning Solutions (Smart Class + ICT)	FY10	FY11E	FY12E	FY13E	FY14E	FY15E	FY16E
<b>Net Revenues</b>	8,065	10,265	12,097	15,257	19,244	24,272	30,613
Y/Y growth - net rev	87.4	27.3	17.8	26.1	26.1	26.1	26.1
<b>EBIT</b>	4,483	4,639	6,153	7,840	9,888	12,471	15,730
EBIT Margin (%)	55.6	45.2	50.9	51.4	51.4	51.4	51.4
<b>Higher Learning Solutions (Professional Development, Educomp Raffles JV, Educomp Pearson JV)</b>							
<b>Net Revenues</b>	285	375	422	475	535	602	677
Y/Y growth - net rev	(6.8)	31.6	12.6	12.6	12.6	12.6	12.6
<b>EBIT</b>	(107)	(186)	(190)	-119	(107)	(60)	(34)
EBIT Margin (%)	(37.6)	(49.7)	(45.0)	(25.0)	(20.0)	(10.0)	(5.0)
<b>K-12 Schools</b>							
<b>Net Revenues</b>	983	1,259	2,113	3,125	4,688	6,797	9,516
Y/Y growth - net rev	57.8	28.0	67.8	47.9	50.0	45.0	40.0
<b>EBIT</b>	331	442	798	1,215	1,875	2,719	3,807
EBIT Margin (%)	33.6	35.1	37.8	38.9	40.0	40.0	40.0
<b>Online, Supplementary &amp; Global</b>							
<b>Net Revenues</b>	1,071	1,227	1,381	1,554	1,749	1,969	2,216
Y/Y growth - net rev	(3.4)	14.6	12.6	12.6	12.6	12.6	12.6
<b>EBIT</b>	(166)	(296)	(276)	-233	(175)	(98)	0
EBIT Margin (%)	(15.5)	(24.1)	(20.0)	(15.0)	(10.0)	(5.0)	0
<b>Consolidated EBIT</b>	4,541	4,598	6,486	8,703	11,481	15,032	19,503
Net Other Income	678	(449)	(450)	(407)	(407)	(407)	(407)
PBT	4,399	3,972	6,036	8,296	11,074	14,625	19,095
Tax	-1,625	(431)	(1,992)	(2,738)	(3,654)	(4,826)	(6,301)
ETR (%)	37%	11%	33%	33%	33%	33%	33%
<b>PAT</b>	<b>2,713</b>	<b>3,524</b>	<b>4,024</b>	<b>5,530</b>	<b>7,420</b>	<b>9,798</b>	<b>12,794</b>

Source: Company and RCML Research

Fig 19 - Potential Valuation - 5 years



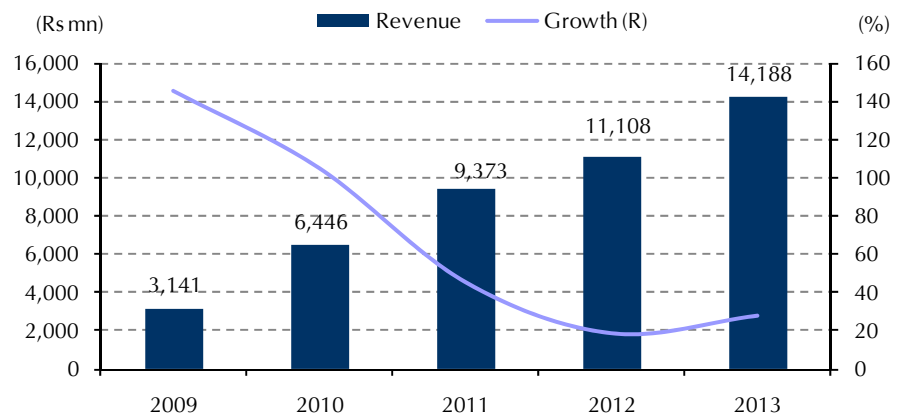
Source: RCML Research ( Note: USD/INR assumption is Rs45)



## Financial overview

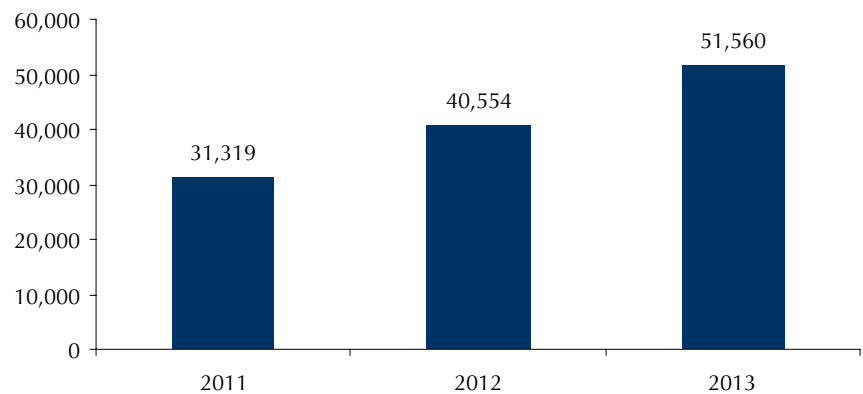
### Smartclass and K-12 key assumptions

Fig 20 - Smartclass revenues



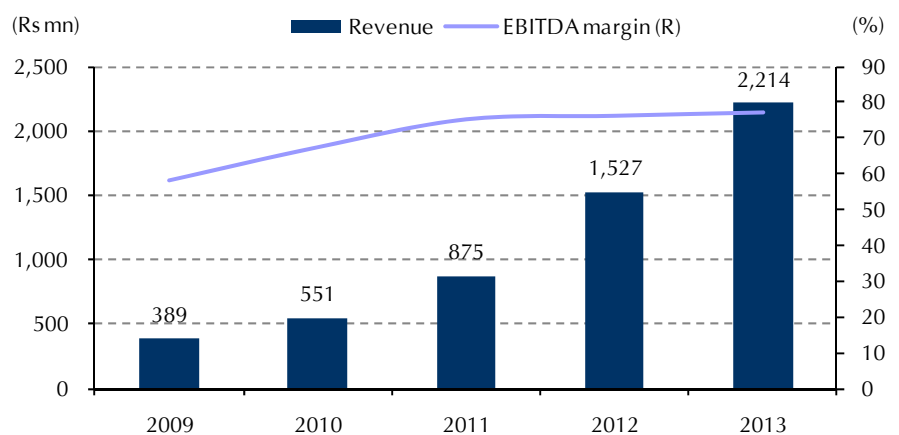
Source: RCML Research, Company

Fig 21 - Smartclass classrooms added



Source: RCML Research, Company

Fig 22 - K-12 revenues and EBITDA margins



Source: RCML Research, Company. Excludes EuroKids revenues.



Fig 23 - K-12 assumptions

	2010	2011	2012	2013
<b>No. of schools</b>	<b>43</b>	<b>58</b>	<b>78</b>	<b>98</b>
Billable schools	29	43	58	78
Billable students per school	621	633	808	843
Revenue per billable student per month	2,551	2,679	2,715	2,805

Source: RCML Research, Company.

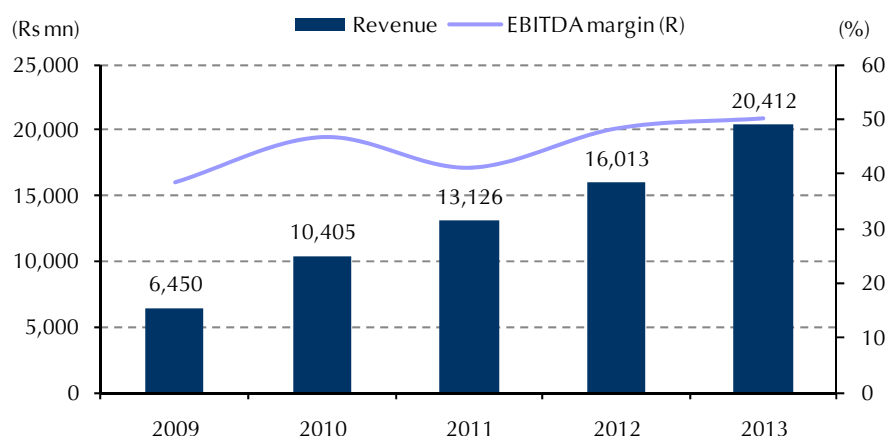
## Overall EDSL

Fig 24 - Educomp Segmental split

(Rs mn; Year end March)	2010	2011	2012	2013
<b>Revenues</b>	<b>10,405</b>	<b>13,126</b>	<b>16,013</b>	<b>20,412</b>
School learning solutions	8,065	10,265	12,097	15,257
K-12 Schools	983	1,259	2,113	3,125
Higher Learning Solutions	285	375	422	475
Online, Supplementary & Global	1,071	1,227	1,381	1,554
<b>Y/Y Growth (%)</b>				
School learning solutions	87	27	18	26
K-12 Schools	58	28	68	48
Higher Learning Solutions	(7)	32	13	13
Online, Supplementary & Global	(3)	15	13	13
<b>EBIT</b>				
School learning solutions	4,483	4,639	6,153	7,840
K-12 Schools	331	442	798	1,215
Higher Learning Solutions	(107)	(186)	(190)	(119)
Online, Supplementary & Global	(166)	(296)	(276)	(233)
<b>EBIT Margins (%)</b>				
School learning solutions	56	45	51	51
K-12 Schools	34	35	38	39
Higher Learning Solutions	(38)	(50)	(45)	(25)
Online, Supplementary & Global	(15)	(24)	(20)	(15)

Source: RCML Research, Company

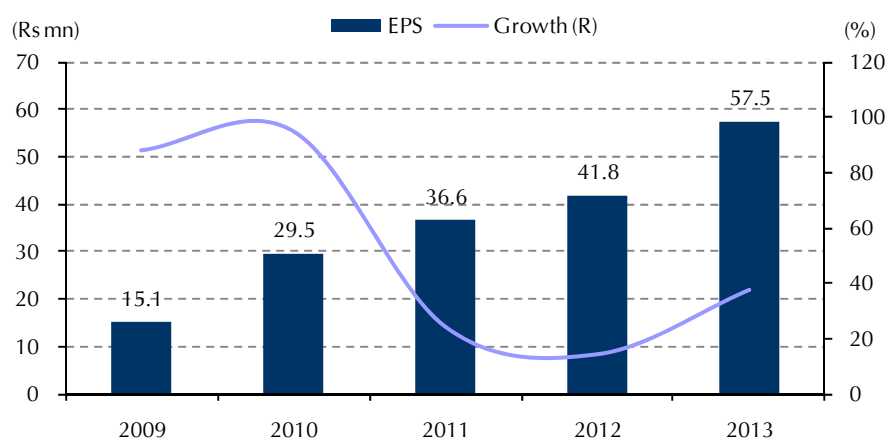
Fig 25 - EDSL revenues and EBITDA margins



Source: RCML Research, Company



Fig 26 - EDSL EPS and growth



Source: RCML Research, Company

Fig 27 - Cash Flow metrics

	2010	2011	2012	2013
DSO	194	183	143	133
FCF (Rs mn)	(3,303)	406	1,470	1,703
FCF/Sales (%)	(32)	3	9	8

Source: RCML Research, Company



## Valuation

Target price of Rs 700 based on 17x  
one-year forward P/E; BUY

### Best play on the Indian education theme; initiate with BUY

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 price target of Rs 700. 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.

### Multiples not Euphoric anymore

Educomp currently trades at a Fwd 12-m P/E of 14x implying a PEG of 0.65. We note that the stock has historically traded at valuations of over 50x Fwd P/E. However we do not believe that the stock will re rate back to those levels given that growth has slowed down, nonetheless in our view the multiples are not stretched anymore, given the still attractive growth profile of the company. While growth rates have come off due to the change in the business model, additional clarity on cash flows will provide investors with added comfort.

Fig 28 - Rolling 1 year forward P/E



Source: Company, RCML Research and Bloomberg

Fig 29 - 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	43%	<b>WACC =</b>	<b>12.4%</b>
Terminal NOPAT Margin	29%	DCF output (US\$ mn)	
Terminal ROIC	20%	Current Equity value	67,449
Terminal Fixed asset turns	1.0	Current equity value/share	711
		Mar-11 equity value/share	768

Source: RCML Research, Company



Fig 30 - Global Comps

	Year End	Price	Market Cap	EPS		P/E		EPS CAGR (FY10-12)	P/B		ROE		
				FY11	FY12	FY11	FY12		FY11	FY12	FY11	FY12	
<b>Indian Comps</b>													
Educomp	EDSL IN	March	577.5	1,189	36.6	41.8	15.8	13.8	21.8	3.4	2.8	24.6	22.7
NIIT	NIIT IN	March	67.15	239	6.3	8.1	10.7	8.2	38.2	1.8	1.6	18.4	20.4
Everonn	EEDU IN	March	640	209	39.1	51.5	16.4	12.4	30.9	3.1	2.5	21.0	22.4
<b>International comps</b>													
Apollo Group	APOL US	August	47.74	7,043	5.6	6.1	8.6	7.8	7.7	3.0	2.3	42.0	35.4
New Oriental Education	EDU US	May	102.14	3,848	2.9	3.8	35.8	26.9	121.9	7.2	5.8	20.9	22.3
DeVry	DV US	June	42.48	3,005	4.6	5.2	9.3	8.1	16.3	2.0	1.6	24.6	21.6
Strayer Education	STRA US	December	151.68	2,106	9.9	12.1	15.3	12.5	26.1	10.5	7.9	59.0	56.0
ITT Education Services	ESI US	December	56.71	1,905	11.2	12.2	5.1	4.7	24.0	7.0	3.3	183.7	99.3
Career Education	CECO US	December	18.59	1,511	3.0	3.4	6.3	5.4	34.3	1.5	1.2	24.9	24.3
Megastudy	072870 KS	December	173000	945	11,613.0	13,478.0	14.9	12.8	11.0	3.7	3.0	27.9	26.1

Source: Company, RCML Research and Bloomberg

## Key risks

### Regulations in K-12

Current Indian regulations allow only not-for-profit trusts/societies registered with the government to operate private schools. Education in India is concurrently regulated by both the central and state governments. As a result, regulations can differ from state to state, which could hamper scalability of a private player looking at pan-India coverage. Any change in regulations may impact EDSL.

### Multiple education ventures to stretch management bandwidth

EDSL is into multiple education-related ventures/businesses which in our view could stretch the management bandwidth. While the company now has business heads for each of the key verticals, we believe that the number of new ventures increases execution risks in key segments. Further, the new businesses are making losses—any significant capex or higher-than-estimated losses in new business would pose a downside risks to our thesis.

**Risk of execution slippages as management bandwidth is stretched over multiple business lines**



## Consolidated financials

### Profit and Loss statement

Y/E March (Rs mn)	FY10	FY11E	FY12E	FY13E
<b>Revenues</b>	<b>10,405</b>	<b>13,126</b>	<b>16,013</b>	<b>20,412</b>
<i>Growth (%)</i>	61.3	26.1	22.0	27.5
<b>EBITDA</b>	<b>4,859</b>	<b>5,386</b>	<b>7,732</b>	<b>10,240</b>
<i>Growth (%)</i>	96.5	10.9	43.5	32.4
Depreciation & amortisation	1,138	965	1,246	1,537
EBIT	3,721	4,422	6,486	8,703
<i>Growth (%)</i>	122.3	18.8	46.7	34.2
Interest	773	(449)	(450)	(407)
Other income	(95)	0	0	0
EBT	4,399	3,972	6,036	8,296
Income taxes	1,625	431	1,992	2,738
Effective tax rate (%)	37.0	10.9	33.0	33.0
Extraordinary items	0	0	0	0
Min into / inc from associates	(60)	(17)	(20)	(28)
Reported net income	2,713	3,524	4,024	5,530
Adjustments				
<b>Adjusted net income</b>	<b>2,713</b>	<b>3,524</b>	<b>4,024</b>	<b>5,530</b>
<i>Growth (%)</i>	104.7	29.9	14.2	37.4
Shares outstanding (mn)	95	95	95	95
<b>FDEPS (Rs) (adj)</b>	<b>28.2</b>	<b>36.6</b>	<b>41.8</b>	<b>57.5</b>
<i>Growth (%)</i>	86.2	29.9	14.2	37.4
DPS (Rs)	2.8	3.0	3.0	3.0

### Cash flow statement

Y/E March (Rs mn)	FY10E	FY11E	FY12E	FY13E
Net income + Depreciation	3,851	4,489	5,270	7,067
Non-cash adjustments	364	17	20	28
Changes in working capital	(2,536)	(749)	180	(992)
Cash flow from operations	1,680	3,756	5,470	6,103
Capital expenditure	(4,982)	(3,350)	(4,000)	(4,400)
Change in investments	60	17	20	28
Other investing cash flow	0	0	0	0
Cash flow from investing	(4,922)	(3,333)	(3,980)	(4,372)
Issue/repay debt	1,401	2,099	27	307
Dividends paid	(305)	(333)	(333)	(333)
Other financing cash flow	6,008	(17)	(20)	(28)
Change in cash & cash eq	3,861	2,172	1,164	1,676
Closing cash & cash eq	5,726	7,898	9,062	10,739

### Balance sheet

Y/E March (Rs mn)	FY10E	FY11E	FY12E	FY13E
Cash and cash eq	5,726	7,898	9,062	10,739
Accounts receivable	5,530	6,581	6,273	7,438
Inventories	73	89	92	117
Other current assets	1,332	1,621	1,684	2,144
Gross fixed assets	15,191	18,541	22,541	26,941
Net fixed assets	13,079	15,465	18,218	21,081
Other assets	708	691	671	643
<b>Total assets</b>	<b>26,449</b>	<b>32,345</b>	<b>36,001</b>	<b>42,163</b>
Accounts payable	1,717	2,227	2,145	2,649
Other current liabilities	444	540	561	715
Debt funds	10,475	12,574	12,601	12,908
Other liabilities	1,092	1,092	1,092	1,092
Equity capital	190	190	190	190
Reserves & surplus	12,531	15,722	19,412	24,609
Shareholder's funds	12,721	15,912	19,602	24,799
<b>Total liabilities</b>	<b>26,449</b>	<b>32,345</b>	<b>36,001</b>	<b>42,163</b>
BVPS (Rs)	134	168	207	261

### Financial ratios

Y/E March	FY10	FY11E	FY12E	FY13E
<b>Profitability &amp; Return ratios (%)</b>				
EBITDA margin	46.7	41.0	48.3	50.2
EBIT margin	35.8	33.7	40.5	42.6
Net profit margin	26.1	26.8	25.1	27.1
ROE	32.0	24.6	22.7	24.9
ROCE	12.1	14.2	13.8	16.1
<b>Working Capital &amp; Liquidity ratios</b>				
Receivables (days)	194	183	143	133
Inventory (days)	3	2	2	2
Payables (days)	60	62	49	47
Current ratio (x)	5.9	5.9	6.3	6.1
Quick ratio (x)	5.2	5.2	5.7	5.4
<b>Turnover &amp; Leverage ratios (x)</b>				
Gross asset turnover	0.8	0.8	0.8	0.8
Total asset turnover	0.5	0.4	0.5	0.5
Adjusted debt/equity	0.8	0.8	0.6	0.5
<b>Valuation ratios (x)</b>				
EV/Sales	5.7	4.5	3.7	2.9
EV/EBITDA	12.3	11.1	7.7	5.8
P/E	20.5	15.8	13.8	10.0
P/BV	4.3	3.4	2.8	2.2





### Quarterly trend

Particulars	Q2FY10	Q3FY10	Q4FY10	Q1FY11	Q2FY11E
Revenue (Rs mn)	2,535	2,601	3,331	2,279	3,198
YoY growth (%)	77.3	37.2	47.1	17.6	26.1
QoQ growth (%)	30.8	2.6	28.1	(31.6)	40.3
EBITDA (Rs mn)	742	1,025	1,389	495	1,103
EBITDA margin (%)	29.3	39.4	41.7	21.7	34.5
Adj net income (Rs mn)	1,155	612	604	365	864
YoY growth (%)	301.1	92.3	9.0	6.6	(25.2)
QoQ growth (%)	237.4	(47.0)	(1.3)	(39.6)	136.9

### DuPont analysis

(%)	FY09	FY10	FY11E	FY12E	FY13E
Tax burden (Net income/PBT)	65.3	61.7	88.7	66.7	66.7
Interest burden (PBT/EBIT)	121.2	118.2	89.8	93.1	95.3
EBIT margin (EBIT/Revenues)	26.0	35.8	33.7	40.5	42.6
Asset turnover (Revenues/Avg TA)	0.5	0.5	0.4	0.5	0.5
Leverage (Avg TA/Avg equitiy)	3.3	2.5	2.1	1.9	1.8
<b>Return on equity</b>	<b>37.2</b>	<b>32.0</b>	<b>24.6</b>	<b>22.7</b>	<b>24.9</b>

### 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

(%)	Dec-09	Mar-10	Jun-10
Promoters	50.1	50.1	49.8
FIs	39.3	40.8	36.9
Banks & FIs	1.5	1.4	1.6
Public	9.1	7.7	11.7

### Recommendation history

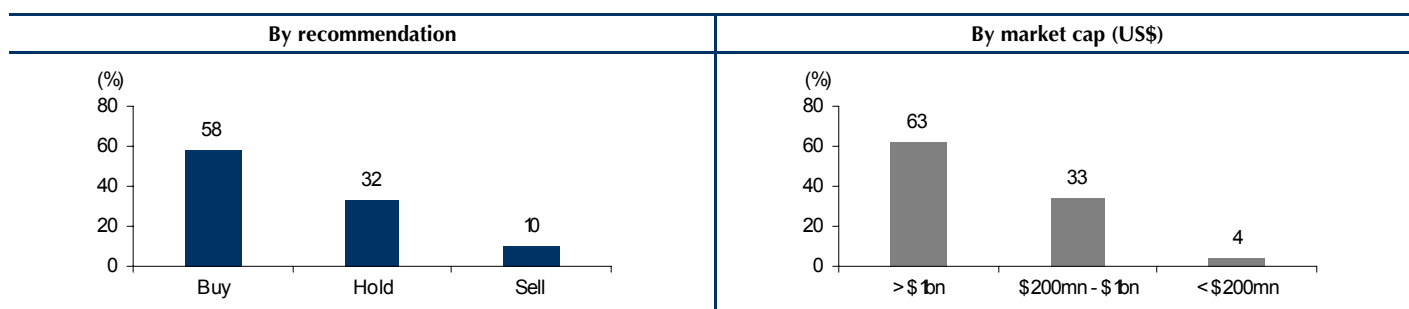
Date	Event	Reco price	Tgt price	Reco
15-Sep-10	Initiating Coverage	578	700	Buy

### Stock performance





### Coverage Profile



### 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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