

**Bhavtosh Vajpayee, CFA**  
bhavtosh.vajpayee@cls.com  
(91) 2266505065

**Nimish Joshi**  
nimish.joshi@cls.com  
(91) 2266505054

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## India Technology

Reuters EDSO.BO  
Bloomberg EDSL IB

**Priced on 21 January 2009**  
India Sensex @ 8,779.2

**12M hi/lo** Rs4,562/1,375

**12M price target** Rs4,400  
**±% potential** +187%  
**Target set on** 6 Nov 08

**Shares in issue** 17.3m  
**Free float (est.)** 45.0%

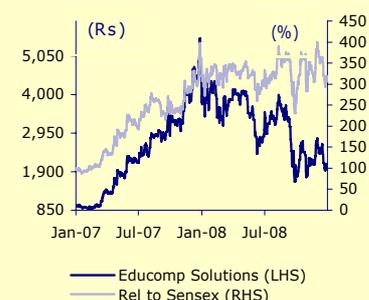
**Market cap** US\$541m

**3M average daily volume**  
Rs3,230.8m (US\$66.3m)

**Major shareholders**  
Promoters 55.0%  
FIIs 35.6%

### Stock performance (%)

	1M	3M	12M
Absolute	(43.8)	(25.7)	(65.5)
Relative	(35.4)	(9.6)	(30.9)
Abs (US\$)	(46.0)	(26.0)	(72.3)



Source: Bloomberg

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## Damage control

**Confidence on corporate governance in India has been hanging by a thread since the Satyam scandal. Anonymous letters claiming accounting irregularities in Educomp have taken the stock down over 25% in two days, but management's strong rebuttal, backed by financial data and the well attended and candid investor call last evening, is likely to limit further damage. We expect strong operating results on 27th Jan and retain Buy on the stock.**

### Allegations

"Guilty until proven innocent" seems the new trend in India post the Satyam debacle. Given the market sentiment, an anonymous, un-signed note alleging accounting irregularities in Educomp was enough to take the stock down 25% in two days. Many of the allegations suggest an incomplete or incorrect understanding of the company's business model, which drives a certain seasonality (Mar quarter is upto 40-45% of yearly revenues), wage bill (lower per person wages c.f. an IT company) and financial parameters. We find these financial parameters in sync with the company's business model. Educomp has in fact been using cash wisely; there has been (and will be) a gradual reduction in debtor days as the business shifts away from the public to the private sector, and substantial investments have been made in sales and marketing.

### Strong management reply should help

Educomp's leadership has replied to allegations with substantial detail and financial data. In an investor call last evening, management clearly stated that "not a single share" owned by the founders had been pledged anywhere. While the futility of a "Top-4" auditor has been exposed by the Satyam scandal (PwC were the auditors here), Educomp has been raked over the coals for using an Indian auditor. Nonetheless, management indicated that a change in auditors was due, and one of the Big-4 would be considered. We consider this only a hygiene factor, as corporate governance norms have been violated by those who wanted to, irrespective of the audit firm. Educomp founders own 55% of the company, and almost all of their financial interests are linked to the company and to the education business, rather than to multiple companies and business segments.

### Lessons from the episode

Shaken by the Satyam debacle, Indian equity markets now risk veering to the other extreme. While these extremes are avoidable, there is a silver lining as well. We believe managements will be under greater pressure to not only have strong corporate governance, but also be perceived as such. This should improve internal processes, expand disclosures, and help investors in the long run. Regulators will be under pressure to follow up on management misdeeds and also track down perpetrators of rumour mongering that may be linked to underlying share activity as well. Overall, India's corporate governance standards are set for an upgrade as management teams, regulators, the media and the financial community increase vigilance. Meanwhile, we continue to back Educomp for its robust business model that should see earnings grow 14 times between FY08-14. Trading at 11xMar2010 earnings after the recent correction, we find valuations attractive relative to its steady and predictable growth profile. BUY rating stays.

**Summary P&L forecast (Rsm)**

Year to 31 March	2007A	2008A	2009CL	2010CL	2011CL
<b>Revenue</b>	<b>1,101</b>	<b>2,861</b>	<b>6,381</b>	<b>11,702</b>	<b>17,824</b>
Operating Ebitda	506	1,266	3,135	5,842	9,296
Operating Ebit	410	934	2,526	4,645	7,310
Interest expense	(14)	(48)	(295)	(591)	(812)
Other items	59	178	43	235	223
<b>Profit before tax</b>	<b>454</b>	<b>1,064</b>	<b>2,273</b>	<b>4,289</b>	<b>6,721</b>
Taxation	(170)	(351)	(773)	(1,458)	(2,285)
Minorities and other	2	(7)	(33)	(69)	(152)
<b>Profit</b>	<b>287</b>	<b>706</b>	<b>1,467</b>	<b>2,762</b>	<b>4,284</b>

**Summary cashflow forecast (Rsm)**

<b>Operating Ebit</b>	<b>410</b>	<b>934</b>	<b>2,526</b>	<b>4,645</b>	<b>7,310</b>
Depreciation/amort	96	331	609	1,197	1,986
Working capital - trade	(132)	(328)	(625)	(430)	(189)
Other operating items	(237)	(368)	(327)	(502)	(562)
<b>Operating cashflow</b>	<b>137</b>	<b>569</b>	<b>2,182</b>	<b>4,910</b>	<b>8,545</b>
Net interest/taxes/other	(125)	(222)	(1,025)	(1,814)	(2,874)
<b>Cashflow</b>	<b>12</b>	<b>348</b>	<b>1,157</b>	<b>3,096</b>	<b>5,671</b>
Capital expenditure	(675)	(2,214)	(3,557)	(5,487)	(7,012)
Acq/inv/disposals	(140)	(112)	(43)	(235)	(223)
<b>Free Cashflow</b>	<b>(804)</b>	<b>(1,978)</b>	<b>(2,443)</b>	<b>(2,626)</b>	<b>(1,564)</b>
Ord div paid/Other items	155	1,266	(34)	122	27
Decrease in net debt	(649)	(712)	(2,477)	(2,504)	(1,537)

**Summary balance sheet forecast (Rsm)**

Cash & equivalents	1,106	2,912	3,562	2,308	3,272
Debtors - trade	496	1,157	2,418	3,810	5,106
Other current assets	160	571	977	1,775	2,693
Fixed assets	831	2,714	5,662	9,952	14,978
Intangible assets	137	280	280	280	280
Other term assets	102	36	36	36	36
<b>Total assets</b>	<b>2,832</b>	<b>7,671</b>	<b>12,936</b>	<b>18,162</b>	<b>26,365</b>
Creditors - trade	185	517	1,154	2,116	3,223
Other current liabs	57	92	380	677	1,033
Long-term debt/CBs	1,255	3,773	6,901	8,151	10,651
Other long-term liabs	59	210	0	0	0
Shareholder funds	1,276	3,078	4,501	7,219	11,459
<b>Total liabs &amp; equity</b>	<b>2,832</b>	<b>7,671</b>	<b>12,936</b>	<b>18,162</b>	<b>26,365</b>

**Ratio analysis (Rsm)**

Revenue growth (%)	98.3	159.9	123.1	83.4	52.3
Op Ebitda growth (%)	89.2	150.2	147.6	86.4	59.1
Op Ebit growth (%)	94.1	128.0	170.3	83.9	57.4
Op Ebitda margin (%)	46.0	44.2	49.1	49.9	52.2
Op Ebit margin (%)	37.2	32.7	39.6	39.7	41.0
Net profit margin (%)	26.1	24.7	23.0	23.6	24.0
Dividend payout (%)	10.7	5.5	2.4	1.2	0.8
Tax rate (%)	37.3	33.0	34.0	34.0	34.0
Return on equity (%)	26.4	32.4	38.7	47.1	45.9
ROCE (%)	51.4	41.5	43.6	46.7	47.2
Return on assets (%)	14.2	13.4	14.2	17.8	19.2

Source: CLSA Asia-Pacific Markets

**Recommendation history - Educomp Solutions Ltd EDSL IB**

Date	Rec level	Closing price	Target
06 November 2008	BUY	2,685.45	4,400.00
20 August 2008	BUY	3,279.50	6,000.00
10 January 2008	BUY	4,359.80	7,000.00
24 July 2007	BUY	2,140.60	3,500.00
04 June 2007	BUY	1,875.80	2,200.00

Source: CLSA Asia-Pacific Markets

**Key to CLSA investment rankings:** **BUY** = Expected to outperform the local market by >10%; **O-PF** = Expected to outperform the local market by 0-10%; **U-PF** = Expected to underperform the local market by 0-10%; **SELL** = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).

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Note: In the interests of timeliness, this document has not been edited.

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