SmartClass New Model – FAQ

Introduction:

At the initial phase of the development of the product, Educomp had to provide financing to its customers to buy SmartClass to create a market entry strategy which made it easy for our customers to buy our product. Now With 2200+ schools SmartClass is an accepted product and the pace of growth is increasing. Under the current capital intensive model, it would strain Educomp's balance sheet to take advantage of large growth opportunities in SmartClass, hence the need to look for alternative financing strategies. We have earlier tried operating lease and financing from our computer vendors which is expensive and the amount available is limited.

Further as the SmartClass business increased its penetration, Educomp also had to manage logistics issues in servicing the "last mile" and to ensure better efficiencies it was required to outsource the non core activities such as installation and maintenance to companies that could focus exclusively on "last mile" servicing, so that Educomp could focus on the high value add and IP activities.

New SmartClass sales Model:

In the new SmartClass business model Educomp will sell, both hardware and content as a package to a third party vendor. The vendor will install the equipment in the schools and also provide services of installation, commissioning, maintenance and servicing the customer. The vendor will securitize the 5 year receivables from the schools from a consortium of banks and pay Educomp towards the hardware and content. The contract with the school will be a tripartite agreement which lays down the responsibilities of Educomp and the vendor.

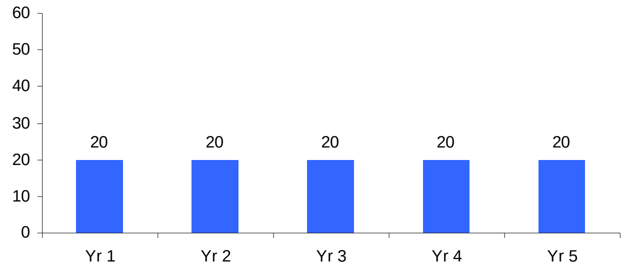
Assuming that the tripartite contract with the school is worth $ 100, Educomp will sell the HW + Content package for $ 75. The vendor will securitize its $ 100 receivable from the school from the bank and receive approx. $ 54-60 which is the discounted value of the receivables and the same will be paid to Educomp upfront. $ 25 will be retained by the vendor to meet its obligation to the bank, and its cost of servicing, operating and maintenance. The vendor will be left with a profit of $ 4 after discharging its obligations. This is in line with the profitability of system integrators and depending on the efficiency of the vendor this profit may increase.

Accounting policy:

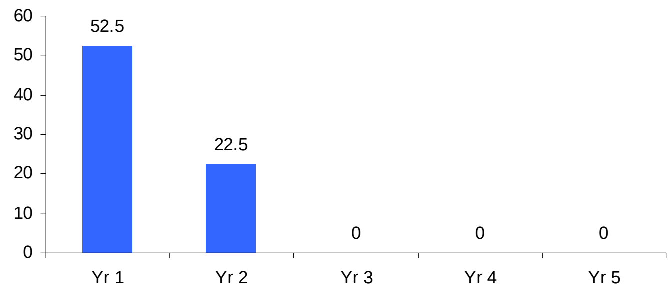
As per the applicable accounting standards the content and the hardware can be recognized upfront being a non refundable sale. The only difference comes in when existing contracts are transferred and securitized as the hardware in the existing contracts is already capitalized in the fixed assets and when we are transferring the hardware it will be removed from the gross block and will become a balance sheet item (cash) while in case of the sale model of new contracts, the hardware will be part of income from operation. Since our content is a non refundable sale but we have an economic obligation (not legal obligation) to provide updates we are recognizing 50% content in current year & balance subsequent year(s). In the new model too the school is locked in for 5 years as before, what we have changed is the recovery of cash and capex upfront along with a portion of content revenues.

The Charts below show the impact of the model on Educomp revenues and profits:

Revenues – BOOT model - Total revenue of 100 divided over 5 years, equally:

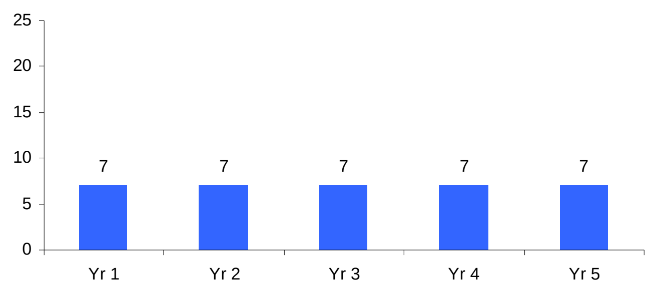


Revenues - NEW model - Total revenue of 75 for Educomp, and 25 to the vendor:

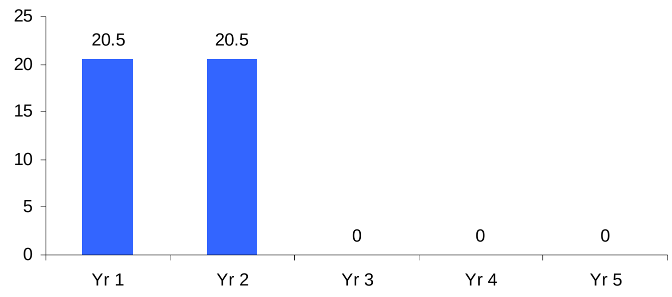


Comments: Revenue visibility increases and is more in line with the actual order booking for Educomp. In the old model the revenue was lagging capex and recognition was lagging order fulfillment.

Pre-tax profits BOOT Model (about a 35% pre tax margin):



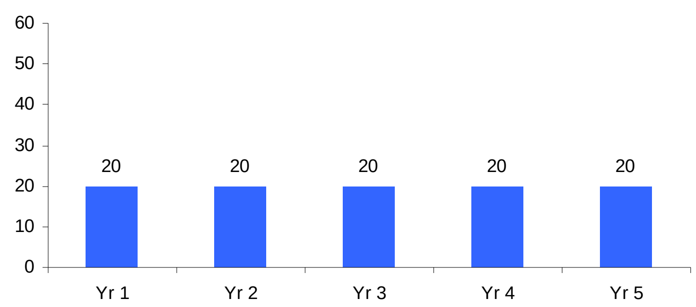
Pre-tax profits = NEW model:



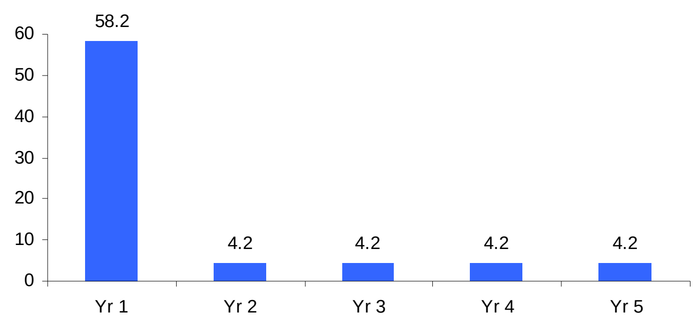
Note: Total profits for Educomp have increased from 35 to 41, which is positive.

Impact on Cash Flow:

In-coming Cash flow in the BOOT Model:



In-coming Cash flow in the NEW model:



Note: Incoming cash flow has also improved which is a positive. Cash flow in year 1 is 3x earlier cash flow.

EduSmart:

EduSmart Services P Ltd, the vendor has been founded by ex-employees of Educomp who understand our quality and delivery norms. Educomp has facilitated the creation of the model and seeded the same. Educomp has conceptualized the model in partnership with a consortium of banks to derive maximum benefit for Educomp. Since this is the first time such as model has been conceptualized, to give comfort to the financial institutions, we have given a corp. guarantee for the time being. We expect that once the securitization model is proven to the bank, this guarantee can be withdrawn. The material risk of recourse to Educomp on the guarantee is minimal as the past record of SmartClass shows almost zero defaults from schools.

Does it make the model more complicated?

No, the model become simpler since going forward an investor needs to only understand the total number of schools signed and the average value of the school contract to arrive at the revenue number, thus our model will become simpler and easier to understand and model. We will provide guidance at the start of the year on the number of schools which Educomp will implement which will be inline with current pattern of seasonality.

Will it make our quarterly revenues more volatile?

No, it will not make quarterly revenues more volatile as we intend to guide about the extent of transfer of old contracts. Once all new orders transition to the new model the volatility will be exactly the same as earlier (i.e. In line with seasonality). Once we guide reasonably well investors would know what to expect. The SmartClass sales engine is now mature enough to predict with a reasonable degree of accuracy.

Benefits to Educomp:

a. Cash flow is significantly improved
b. Profitability is improved at EBIT level by almost 9% due to tax saving strategy
c. Quality of balance sheet improves and can be used for other opportunities
d. No risk of equity dilution due to SmartClass funding needs
e. Debtors are reduced
f. Creates platform for huge scale up for SmartClass model

Going forward – what to expect:

We expect to increase the total number of schools signed on an annual basis by over 100% due to the mass model for SmartClass, however the total number of classrooms per school will be in the range of 15 and the fees will be in the range of 120 -175 per student as we penetrate into the smaller cities and towns.

SmartClass has a lot of further headroom to grow; the current market penetration is less than 5%. Educomp is investing in more people and advertising to accelerate the demand (e.g recent initiative with Saatchi and Saatchi), with these initiatives and SmartClass catching on in schools , it is hardly likely that growth will taper off even in the 5-7 year timeframe so any fears of SmartClass slowing down and revenues falling like a cliff are hypothetical.

Conclusion:

The New model will increase profitability, increase cash flow, reduce debtors, increase operational efficiency, reduce costs, improve quality of balance sheet without any additional risk to Educomp. Further it creates a model/ structure for us to raise more capital from financial institutions to fund our growth without resorting to equity dilution.

Future tax planning

The company has engaged BMR Advisors to conduct a comprehensive tax planning review to save tax in view of the increased profitability of the new model.