

Educomp Solutions

Rs513
UPGRADE TO OUTPERFORMER

RESULT NOTE

Mkt Cap: Rs48.7bn; US\$1.08bn

Analyst: Nikhil Vora (91-22-6622 2567; nikhil.vora@idfc.com)
Swati Nangalia (91-22-6622 2576; swati.nangalia@idfc.com)
Result: Q2FY11 results

Key Financials

Rs Mn	Net Sales	yoy chg (%)	Net profit	yoy chg (%)	EPS (Rs)	yoy chg (%)	EV/E (x)	PER (x)
FY08	2,861	160	706	146	40.9	128	35.4	62.6
FY09	6,371	123	1,325	88	77.7	90	16.9	33.0
FY10	10,406	63	2,767	109	29.1	-63	8.2	17.6
FY11E	13,031	25	3,302	19	34.8	19	9.3	14.7
FY12E	15,545	19	3,707	12	39.2	12	6.9	13.1

All nos are on a consolidated level; EPS is post the adjustment of stock split (1:5) in FY10

An annuity backed and highly profitable business model, a strong execution track record and adequate capitalization are compulsive arguments in favour of Educomp.

- Enhanced stickiness in the business:** Evolution of Educomp from a 3-5year annuity business (in the digital content space) to a 10year annuity in business (K12 schools) reflects the innate ability of Educomp to capitalize on the sticky nature of the Education space. With over Rs13bn of capital deployed towards K-12 schools till date which offers RoCEs of 20-30%, we see Educomp transforming to an extremely 'scalable', 'profitable' and 'value accretive' business in the longer run.
- Execution comfort:** Within 3yrs, Educomp's reach in 30,000 classrooms in Smart Class and 79 K-12 schools (by FY11), demonstrates the inherent execution capability of the management. Given the current business momentum and past deliverances by the management, our sense is that over next 4-5 years Educomp will be nearly 10x the scale of the nearest competitor in the country!
- Adequate capitalization:** With the overall balance sheet funded to the tune of Rs3.36bn, we see back ended growth levers in place. While the core SLS business continues to sustain momentum, investments in high RoCE businesses such as schools (target of 150schools by FY13) will aid furthering the value proposition in the business.

While the business fundamentals make us extremely bullish, we continue to remain cautious with respect to the Edusmart structure (would have preferred if Educomp had securitized Smart Class receivables on its own books). However, our concerns are alleviated to a large extent with the recent development towards receivables securitization (recourse on Educomp reduced from 100% earlier to 20% now). Further, we see consistency in operational performance and more critically transparent deliverance on financial parameters as key positives. We believe the issues relating to corporate governance and changes in structure are largely captured in the over 40% underperformance of the stock in the last 12 months. At a market capitalization of USD1.1bn, we believe Educomp - the key proxy to play the USD30bn private Education play in India - makes a strong case of re-rating. Trading at 13x FY12E earnings, we upgrade our call on Educomp from Neutral to Outperformer with a target multiple of 20x FY12E earnings (equivalent to the Sensex multiple, albeit higher earnings growth) which implies a target price of Rs780 - a 52% upside from the current levels.

IDFC Securities Ltd.

Naman Chambers, C-32, G- Block, Bandra-Kurla Complex, Bandra (East), Mumbai 400 051 Tel: 91-22-6622 2600 Fax: 91-22-6622 2501

"For Private Circulation only" and "Important disclosures appear at the back of this report"

Highlights of Q2FY11 and our interaction with the management

- Educomp reported its Q2FY11 results. Reported numbers are not comparable on a yoy basis due to change in the business model (tripartite agreement with EDUSMART).
- During the quarter, Educomp has reported consolidated revenues of Rs2.76bn (estimates of Rs2.06bn), EBITDA of Rs1.04bn (estimates of Rs766m), and a PAT of Rs578m (estimates of Rs457m).
- The operational performance during the quarter is ahead of estimates on account of higher than expected deliverance in the School Learning Solutions (SLS) business which includes smart class and ICT businesses.
- **SLS** reported revenues of Rs1.92bn and EBIT of Rs888m in Q2FY11. The financials are not comparable to Q2FY10 on account of change of business model of smart class.
- **Smart Class** reported revenues of Rs1.5bn and EBIT of Rs816m in Q2FY11. On a like to like basis, Educomp reported a revenue growth of 46% in the Smart Class business. Within the Smart Class segment, revenue recognized in the quarter includes Rs420m on account of deferred revenue pertaining to contracts transferred to EduSmart. The management has guided for deferred revenues of Rs980m and Rs1.54bn in Q3FY11 and Q4FY11 respectively.
- **Smart additions** - Within Smart Class, Educomp added 5309 schools with 8 classrooms per school, at an average price of Rs4.04lakh per classroom. With H2FY11 accounting for over 60% of classroom addition during the year and 12,059 classrooms additions completed in H1FY11, we expect Educomp to add 25,000 classrooms for the year. Further we expect the renewals cycle for schools signed in FY08/FY09 and same school expansion to impart further momentum.
- **Margins improving** - During the quarter, Smart Class EBIT margins stood at 54% on the back of improved yields and booking of deferred revenue from EduSmart. As per the new revenue recognition policy, as Educomp starts reported the balance 22.5% of contracts of new schools addition (margins of 80-90%), overall EBIT margins of the smart class segment will improve. For FY11, Educomp is expected to maintain EBIT margins at 60%+.
- **EduSMART** – We would have preferred if Educomp had securitized its SmartClass receivables on its own books. However, with all of the existing contracts transferred to EduSmart and improved disclosures across segments over the last few quarters, we believe the extent of ambiguities will be limited going forward. Further a key development during the quarter has been the new agreements signed with a financial institution wherein recourse to Educomp has been reduced from 100% earlier to 20% now. Securitization to the tune of Rs3bn has been done on the new terms. Going forward, the company expects to securitize future receivables without a potential contingent liability on Educomp's balance sheet, which would help Educomp leverage its balance sheet to fund growth across businesses. Currently, Educomp has an investment by way of 8% non-convertible preference shares (~Rs450m.) in EduSmart.
- **ICT – Cautious on additions** - ICT reported a revenue growth of 34% at Rs421m and EBIT of Rs95m. Of the revenues of Rs421m, Rs210m was towards sale of hardware. No new schools were added during the quarter. We are aligned Educomp's strategy of cautiously deploying capital towards the ICT business (L1 bidding, high debtor days).
- **Schools – funding back ended growth** - K12 (EISML+Euro Kids+RTW) reported a revenue growth of 54% at Rs321m and an EBIT growth of 144% at Rs129m. EISML (Educomp holds 78.5%) reported revenues growth of 69% at Rs212m, EBITDA margins of 74% at Rs156m and a PAT of Rs37m. Going forward, K-12 (schools) remains a key focus area. Educomp now has a presence in 46 schools operational (32 under EISML; 14 under its JV with Euro Kids) and has visibility for 79 schools till date (including dry management, land sites and under construction sites). Educomp has signed a JV with Lavasa Corporation to set up a residential school in Lavasa. The management expects to reach 150 schools by FY13. Around 50% of the schools are expected to be owned under various models and price points – Millennium (capex at ~Rs350m), Takshila (capex at ~Rs100m) and Vidya Prabhat (capex at ~Rs10m). The remaining 50% will follow the content licensing/ management services to schools route.
- **HLS** (Higher Learning Solutions) reported a revenue growth of 123% at Rs137m and an EBIT loss of Rs65m.
- **Online/global** reported a revenue growth of 48% at Rs387m and an EBIT profit of Rs31m (against a loss of Rs69m in the same quarter last year). We expect EBIT losses from the other businesses (HLS + Online/global) to the tune of ~Rs400m in the current year.

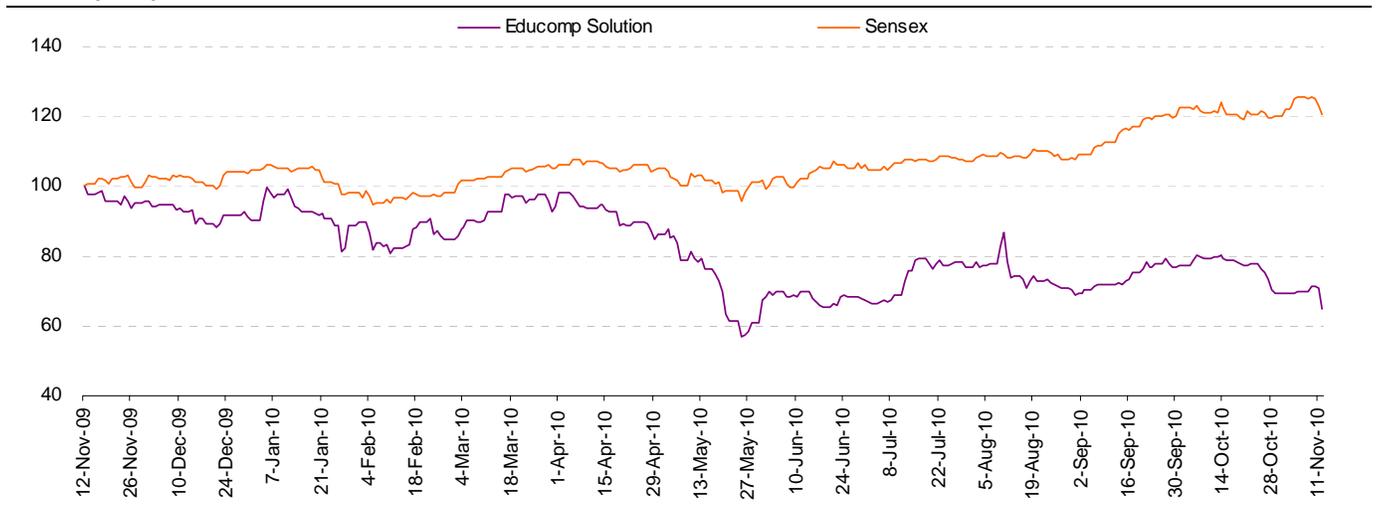
- As on 30th September 2010, gross debt stood at Rs14bn (this includes FFCB worth \$78.5m) and cash at Rs4.7bn.
- For the quarter Q2FY11, debtor days stood at 249 days. However, as on 5th October 2010 debtor days stand at 149 days on account of bank funding of non-securitized receivables.

Financial performance

	Q2FY10	Q3FY10	Q4FY10	FY10	Q1FY11	Q2FY11	FY11E	FY12E
Net Sales	2,535.3	2,601.0	3,330.7	10,405.9	2,279.2	2,767.6	13,031.3	15,545.2
%yoy	92.0	37.0	47.0	63.0	18.0	9.0	25.0	19.0
Operating profit	1,048.2	1,362.3	1,589.7	4,858.5	693.2	1,037.6	4,833.1	6,376.1
EBITDA	41.0	52.0	48.0	47.0	30.0	37.0	37.0	41.0
Depreciation	306.3	337.8	201.0	1,138.1	198.0	207.8	827.3	900.0
EBIT	741.9	1,024.5	1,388.7	3,720.4	495.2	829.8	4,005.8	5,476.1
Interest	119.6	138.8	128.3	488.5	161.2	211.8	631.1	733.9
Other Income	850.1	158.5	101.4	1,262.0	100.0	83.7	360.0	600.0
Forex fluctuations	(32.6)	(27.9)	(2.1)	(99.4)	(28.8)	21.3	-	-
Profit before tax	1,439.8	1,016.4	1,359.7	4,394.4	405.2	723.0	3,734.7	5,342.2
Tax	269.6	375.0	755.5	1,625.5	39.0	140.8	373.5	1,575.2
PAT	1,170.2	641.4	604.1	2,769.0	366.2	582.2	3,361.3	3,766.2
PAT post minority interest	1,155.3	610.2	594.3	2,701.7	365.3	578.2	3,302.1	3,707.1
%yoy	301.0	92.0	7.0	103.0	7.0	(50.0)	22.2	12.3

Source: IDFC Securities Research

Relative price performance



IDFC Securities

Analyst	Sector/Industry/Coverage	E-mail	Tel. +91-22-6622 2600
Pathik Gandotra	Head of Research; Financials, Strategy	pathik.gandotra@idfc.com	91-22-662 22525
Shirish Rane	Construction, Power, Cement	shirish.rane@idfc.com	91-22-662 22575
Nikhil Vora	FMCG, Media, Mid Caps, Education, Exchanges	nikhil.vora@idfc.com	91-22-662 22567
Nitin Agarwal	Pharmaceuticals	nitin.agarwal@idfc.com	91-22-662 22568
Chirag Shah	Metals & Mining, Telecom, Pipes, Textiles	chirag.shah@idfc.com	91-22-662 22564
Bhoomika Nair	Logistics, Engineering	bhoomika.nair@idfc.com	91-22-662 22561
Hitesh Shah, CFA	IT Services	hitesh.shah@idfc.com	91-22-662 22565
Bhushan Gajaria	Automobiles, Auto ancillaries, Retailing	bhushan.gajaria@idfc.com	91-22-662 22562
Salil Desai	Construction, Power, Cement	salil.desai@idfc.com	91-22-662 22573
Ashish Shah	Construction, Power, Cement	ashish.shah@idfc.com	91-22-662 22560
Probal Sen	Oil & Gas	probal.sen@idfc.com	91-22-662 22569
Chinmaya Garg	Financials	chinmaya.garg@idfc.com	91-22-662 22563
Abhishek Gupta	Telecom, Metals & Mining	abhishek.gupta@idfc.com	91-22-662 22661
Ritesh Shah	Pharmaceuticals	ritesh.shah@idfc.com	91-22-662 22571
Saumil Mehta	Metals, Pipes	saumil.mehta@idfc.com	91-22-662 22578
Vineet Chandak	Real Estate	vineet.chandak@idfc.com	91-22-662 22579
Kavita Kejriwal	Strategy, Financials	kavita.kejriwal@idfc.com	91-22-662 22558
Anamika Sharma	IT Services	anamika.sharma@idfc.com	91-22-662 22680
Varun Kejriwal	FMCG, Mid Caps	varun.kejriwal@idfc.com	91-22-662 22685
Swati Nangalia	Mid Caps, Media, Exchanges, Education	swati.nangalia@idfc.com	91-22-662 22576
Sameer Bhise	Strategy, Financials	sameer.bhise@idfc.com	91-22-662 22574
Nikhil Salvi	Construction, Power, Cement	nikhil.salvi@idfc.com	91-22-662 22566
Dharmendra Sahu	Database Analyst	dharmendra.sahu@idfc.com	91-22-662 22580
Rupesh Sonawale	Database Analyst	rupesh.sonawale@idfc.com	91-22-662 22572
Dharmesh R Bhatt, CMT	Technical Analyst	dharmesh.bhatt@idfc.com	91-22-662 22534
Equity Sales/Dealing	Designation	E-mail	Tel. +91-22-6622 2500
Naishadh Paleja	MD, CEO	naishadh.paleja@idfc.com	91-22-6622 2522
Paresh Shah	MD, Dealing	paresh.shah@idfc.com	91-22-6622 2508
Vishal Purohit	MD, Sales	vishal.purohit@idfc.com	91-22-6622 2533
Nikhil Gholani	MD, Sales	nikhil.gholani@idfc.com	91-22-6622 2529
Sanjay Panicker	Director, Sales	sanjay.panicker@idfc.com	91-22-6622 2530
Rajesh Makharria	Director, Sales	rajesh.makharria@idfc.com	91-22-6622 2528
Nirbhay Singh	SVP, Sales	nirbhay.singh@idfc.com	91-22-6622 2595
Suchit Sehgal	AVP, Sales	suchit.sehgal@idfc.com	91-22-6622 2532
Pawan Sharma	MD, Derivatives	pawan.sharma@idfc.com	91-22-6622 2539
Jignesh Shah	AVP, Derivatives	jignesh.shah@idfc.com	91-22-6622 2536
Sunil Pandit	Director, Sales trading	sunil.pandit@idfc.com	91-22-6622 2524
Mukesh Chaturvedi	SVP, Sales trading	mukesh.chaturvedi@idfc.com	91-22-6622 2512
Viren Sompura	SVP, Sales trading	viren.sompura@idfc.com	91-22-6622 2527
Rajashekhar Hiremath	VP, Sales trading	rajashekhar.hiremath@idfc.com	91-22-6622 2516

Disclaimer

This document has been prepared by IDFC Securities Ltd (IDFC SEC). IDFC SEC and its subsidiaries and associated companies are a full-service, integrated investment banking, investment management and brokerage group. Our research analysts and sales persons provide important input into our investment banking activities.

This document does not constitute an offer or solicitation for the purchase or sale of any financial instrument or as an official confirmation of any transaction.

The information contained herein is from publicly available data or other sources believed to be reliable. While we would endeavor to update the information herein on reasonable basis, IDFC SEC, its subsidiaries and associated companies, their directors and employees ("IDFC SEC and affiliates") are under no obligation to update or keep the information current. Also, there may be regulatory, compliance, or other reasons that may prevent IDFC SEC and affiliates from doing so. We do not represent that information contained herein is accurate or complete and it should not be relied upon as such. This document is prepared for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigations as it deems necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in this document (including the merits and risks involved). The investment discussed or views expressed may not be suitable for all investors.

Affiliates of IDFC SEC may have issued other reports that are inconsistent with and reach different conclusions from, the information presented in this report.

This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject IDFC SEC and affiliates to any registration or licensing requirement within such jurisdiction. The securities described herein may or may not be eligible for sale in all jurisdictions or to a certain category of investors. Persons in whose possession this document may come are required to inform themselves of, and to observe, such applicable restrictions.

Reports based on technical analysis centers on studying charts of a stock's price movement and trading volume, as opposed to focusing on a company's fundamentals and, as such, may not match with a report on a company's fundamentals.

IDFC SEC and affiliates may have used the information set forth herein before publication and may have positions in, may from time to time purchase or sell, or may be materially interested in any of the securities mentioned or related securities. IDFC SEC and affiliates may from time to time solicit from, or perform investment banking, or other services for, any company mentioned herein. Without limiting any of the foregoing, in no event shall IDFC SEC, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind. Any comments or statements made herein are those of the analyst and do not necessarily reflect those of IDFC SEC and affiliates.

This document is subject to changes without prior notice and is intended only for the person or entity to which it is addressed and may contain confidential and/or privileged material and is not for any type of circulation. Any review, retransmission, or any other use is prohibited.

Though disseminated to all the customers simultaneously, not all customers may receive this report at the same time. IDFC SEC will not treat recipients as customers by virtue of their receiving this report.

Explanation of Ratings:

1. Outperformer: More than 5% to Index
2. Neutral: Within 0-5% to Index (upside or downside)
3. Underperformer: Less than 5% to Index

Disclosure of interest:

1. IDFC SEC and affiliates may have received compensation from the company covered herein in the past twelve months for issue management, capital structure, mergers & acquisitions, buyback of shares and other corporate advisory services.
2. Affiliates of IDFC SEC may have received a mandate from the subject company.
3. IDFC SEC and affiliates may hold paid up capital of the subject company.
4. IDFC SEC and affiliates, their directors and employees may from time to time have positions or options in the company and buy or sell the securities of the company(ies) mentioned herein.