Company Focus

25 September 2007 | 24 pages

Educomp Solutions (EDSO.BO)

Initiation of coverage

Initiate with Sell: Time to Temper Optimism

- **Target price of Rs2,380 based on 35x FY09E EPS** — We are initiating coverage on Educomp with Sell/High Risk (3H). The market is ignoring expensive valuations and high risks in Educomp's business model and aggressive accounting policy, in our view. We see 20% downside for the stock.
- **Strong top-line growth to continue in FY08E** — We forecast 102% revenue CAGR and 95% EPS CAGR over FY07-10 as Educomp penetrates beyond tier 1 & 2 cities. We see stable margins as pressure in school ventures and the ICT business is countered by leverage in Smart_Class and MathGuru. We believe there is high execution and regulatory risks in Edu-Infra and Edu-Manage.
- **Adjusting for aggressive accounting policy of deep discounted ESOPs** — Deep discounted ESOPs (c.3-4% equity), convertible at Rs125, are issued to key managers. The company is using fair value of Rs834 for ESOP expensing vs. the market price of Rs2,898 when shareholders' approval was sought. We estimate that this aggressive accounting policy could inflate EPS by Rs51 and Rs21 over the next two years.
- **Points to ponder** — a) High valuations paid to acquire start-ups Edu-Infra and Edu-Manage; b) Reasons for exit taken by private equity firm just before IPO; and c) High regulatory risk in the K-12 business.
- **Key risks** — a) As the company is expensing deep discounted ESOP using fair value of Rs834, reported earnings might still appear strong, keeping valuations and the stock price higher; b) concentrated shareholding; and c) high-growth phase of the company could keep valuations higher for some time.

Sell/High Risk	3H
Price (25 Sep 07)	Rs2,980.00
Target price	Rs2,380.00
Expected share price return	-20.1%
Expected dividend yield	0.1%
Expected total return	**-20.1%**
Market Cap	Rs51,333M US$1,299M

Price Performance (RIC: EDSO.BO, BB: EDSL IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	139	11.16	82.4	nm	53.1	24.8	0.1
2007A	287	15.93	42.7	187.1	41.5	28.1	0.1
2008E	665	38.74	143.2	76.9	28.8	45.7	0.1
2009E	1,242	67.96	75.4	43.9	17.4	52.7	0.1
2010E	2,115	115.76	70.3	25.7	10.3	53.3	0.1

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	nm	187.1	76.9	43.9	25.7
EV/EBITDA adjusted (x)	190.8	101.0	45.5	25.5	15.7
P/BV (x)	53.1	41.5	28.8	17.4	10.3
Dividend yield (%)	0.1	0.1	0.1	0.1	0.1
Per Share Data (Rs)					
EPS adjusted	11.16	15.93	38.74	67.96	115.76
EPS reported	11.16	15.93	38.74	67.96	115.76
BVPS	56.11	71.81	103.48	171.10	289.88
DPS	1.50	2.00	2.50	3.00	3.50
Profit & Loss (RsM)					
Net sales	555	1,101	2,398	4,919	9,124
Operating expenses	-344	-691	-1,436	-3,083	-5,971
EBIT	**211**	**410**	**962**	**1,835**	**3,153**
Net interest expense	-6	-14	-21	-28	-32
Non-operating/exceptionals	15	59	84	60	60
Pre-tax profit	**220**	**454**	**1,025**	**1,867**	**3,181**
Tax	-81	-170	-359	-626	-1,066
Extraord./Min.Int./Pref.div.	0	2	0	0	0
Reported net income	**139**	**287**	**665**	**1,242**	**2,115**
Adjusted earnings	139	287	665	1,242	2,115
Adjusted EBITDA	268	507	1,139	2,065	3,453
Growth Rates (%)					
Sales	67.1	98.3	117.8	105.1	85.5
EBIT adjusted	100.4	94.1	134.7	90.8	71.8
EBITDA adjusted	70.7	89.2	124.7	81.4	67.2
EPS adjusted	82.4	42.7	143.2	75.4	70.3
Cash Flow (RsM)					
Operating cash flow	**151**	**108**	**228**	**328**	**429**
Depreciation/amortization	57	97	177	230	300
Net working capital	-33	-271	-551	-1,112	-1,958
Investing cash flow	**-162**	**-849**	**-880**	**-1,332**	**-2,101**
Capital expenditure	-163	-676	-944	-1,364	-2,129
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**595**	**1,238**	**3,210**	**-59**	**-69**
Borrowings	64	1,146	3,258	0	0
Dividends paid	-27	-39	-48	-59	-69
Change in cash	**584**	**497**	**2,558**	**-1,064**	**-1,741**
Balance Sheet (RsM)					
Total assets	**1,205**	**2,832**	**6,945**	**8,534**	**11,154**
Cash & cash equivalent	606	1,106	3,664	2,600	858
Accounts receivable	255	496	1,084	2,224	4,125
Net fixed assets	252	831	1,599	2,733	4,562
Total liabilities	**308**	**1,556**	**5,052**	**5,458**	**6,032**
Accounts payable	0	0	0	0	0
Total Debt	110	1,255	4,514	4,514	4,514
Shareholders' funds	**897**	**1,276**	**1,893**	**3,076**	**5,122**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	48.2	46.0	47.5	42.0	37.8
ROE adjusted	24.8	28.1	45.7	52.7	53.3
ROIC adjusted	39.8	27.0	29.5	31.6	30.5
Net debt to equity	-55.3	11.7	44.9	62.2	71.4
Total debt to capital	10.9	49.6	70.5	59.5	46.8

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Investment Strategy: Time to Temper Optimism

Educomp is a Delhi-based leading player in K-12 business in India. We forecast strong top-line growth of 102% CAGR and 95% EPS CAGR over FY07-10 as the company penetrates beyond tier 1 & 2 cities. We see stable margins as pressure in school ventures and the ICT business is countered by leverage in Smart_Class and MathGuru. However, we believe the market has been ignoring high valuations and high risks in the company's business model and accounting policies. The company has issued ESOPs at a deep discount (strike price of Rs125) to key managers. To expense this discounted ESOPs, the company is using a fair value of Rs834 when the market price is more than thrice that level. This is likely to inflate EPS by Rs51 and Rs21 in FY08 and FY09, respectively, in our view. Apart from aggressive accounting policies for deep discounted ESOPs, markets could get concerned about a) high valuations paid to acquire start-ups Edu-Infra and Edu-Manage, b) reasons for the exit of a private equity firm just before the IPO; and c) high legal risk in the K-12 business.

We rate Educomp (EDSO) as Sell/High Risk as we believe its valuations are expensive despite its strong revenue and earnings growth. We also see high risks in its aggressive accounting policies and new business models of Edu-Infra and Edu-Manage.

Company description

- Educomp is one of India's largest market-listed educational service providers focused on the K-12 space (both IT and IT-enabled education).
- Based in New Delhi, the company operates across various metros and mini metros for private schools and partners various state governments for IT education.
- The company has three primary business segments:
  - Smart Class is an online learning aid targeted towards private educational institutes;
  - ICT Solution is targeted towards government-aided schools for IT infrastructure and training; and
  - Professional Development instructor-led training targeted at school teachers.
- Apart from these key segments, the company has also ventured into retail initiatives with a) MathGuru.com, a retail online offering; b) Online tutoring (through ThreeBrix acquisition); and c) K-12 schools (Roots-to-Wings), pre-schools and high schools.

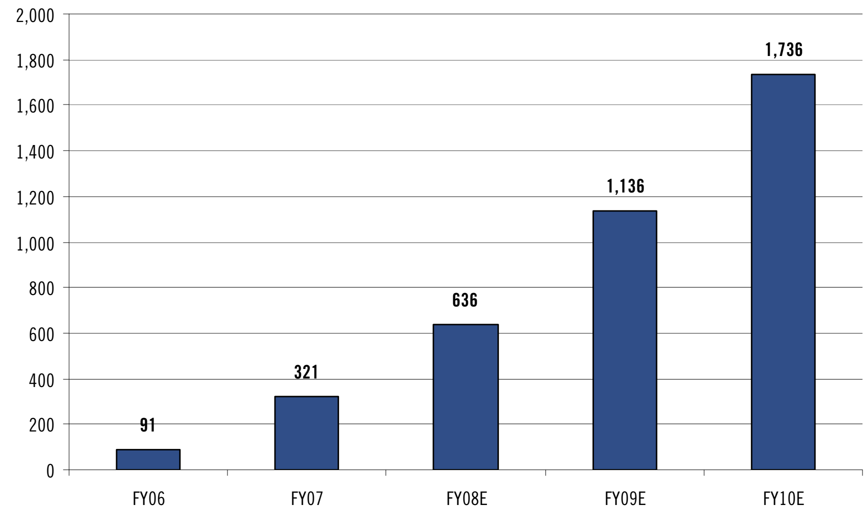
Business segments and dynamics

The company traditionally operated in three business segments with each having its own business model. These segments target educational spend towards formal education/schooling. Apart from these, the company, in recent past, started targeting educational expenditure for supplementary spend such as private tuitions, self-help material, etc.

Smart_Class – Online learning aid for private schools

Smart_Class is an online learning aid (animated content) used for the K-12 (Kindergarten to Class XII) segment. The company follows a BOOT model for this offering. It enters into long term contracts (three to five years) with a school wherein the company invests in infrastructure and delivers educational content. The company owns the infrastructure on its books and transfers it at the end of contract. The company also maintains a full time resource to support the school. During the contract life, the company charges quarterly fees to recover the initial investment and running cost of the Smart_Class. Several variants are followed, which include a fixed quarterly fee and subscription fee per student (Rs75-150 per student per month based on whether infrastructure costs are borne by the company or school).

Figure 1. Smart_Class – Number of Schools Covered



Source: Company reports, Citi Investment Research estimates

It is the fastest growing segment of revenue, accounting for ~44% of the company's revenue and has EBIT margin of ~60% (FY07). Target segment for this offering is private schools, and the company currently has 386 installations (as of June 2007). The company was enjoying almost a blue ocean with little competition, though NIIT has ventured into this segment with its eGuru suite of courses.

We expect strong revenue growth of 100%+ to continue over the next two years, driven by increasing penetration beyond schools in tier 1 and 2 cities. We assume that the market size is ~5,000 schools (charging upwards of Rs2,000 to Rs3,000 per student per month) across India. In our view, Educomp would be able to penetrate over 30% of this market over the next three years from existing 6% penetration. Also, we expect over 250 enrolling schools in international markets.

We estimate some pricing increase in fees charged to students, though management maintains the view that it would not increase subscription fees for the next few years after sharp increases over the last two years. Also, management focus is on broader coverage requiring modest pricing.

Figure 2. Key Assumptions in Smart_Class Forecasts

	FY07	FY08E	FY09E	FY10E
Revenue (Rs m)	**466**	**1,291**	**2,826**	**5,136**
Average schools (during the year)	189	517	924	1,486
Revenue per schools (Rs m/school)	2.46	2.50	3.06	3.46
Students per school	1,786	1,600	1,700	1,800
Fees per student per month (Rs/student p.m.)	115	130	150	160

Source: Company reports, Citi Investment Research estimates

We also expect modest margin expansion over this period; we estimate EBIT margin of 60%, 63%, and 65% over the next three years in this business.

ICT Solution – Partnering with state government

Under this offering, the company primarily serves government schools in setting up IT education centers. A BOOT (Build-Own-Operate-Transfer) model is used for this offering wherein Educomp sets up training infrastructure and imparts training through IT centers in schools. The company owns and operates this infrastructure in return for a fixed annuity, paid quarterly or on a six-month basis, from school authorities/state governments usually for a period of three to five years. It involves executing a turnkey project for the state government for setting up computer labs and running IT educational services and other computer-aided learning programs in schools.

ICT Solution makes up the second largest segment of Educomp revenue, accounting for 28% of revenue, and had EBIT margin of ~32% (FY07). The target segment for this offering is government-aided schools. The company currently has close to 6,000 schools under this program. It works with state governments of Karnataka, Gujarat, West Bengal, Chattisgarh, UP, Uttaranchal, Orissa, Tripura, Nagaland, and Assam. With intensifying competition, margins in this business appear to be on a downward trend. Current margins are unsustainable and likely to trend towards 15-20% over couple of years, in our view.

Industry players such as Aptech and NIIT have indicated that many regional players are getting aggressive in this space. With institutional buyers such as governments highly focused on price, margins have been on the downtrend. Aptech has decided to exit this space altogether, while NIIT continues to be selective in bidding. Generally, most government contractors in the Indian engineering and infrastructure space make margins in single digit or low double digits, while Educomp continues to make EBIT margin upwards of 30%.

We estimate 40% revenue CAGR in this business with a modest decline in margins to 30% in FY08 and then to 25% by FY10. We project margin declines as we expect aggressive competition in this space. In our view, this business has very low IRR (as low as 10%) as DSO can range from 150-200 days of sales.

Professional Development – Train the trainer

One of the smaller segments of Educomp is Professional Development, which offers instructor-led training for teachers. The company partners with state governments and various NGOs (i.e., Microsoft's "Project Shiksha", Azim Premji Foundation) for this training program. Apart from these partnerships, Educomp runs its own training program QuEST (Quality Education for Students and Teachers). The company has cumulatively trained over 700,000 teachers under the program as of June 2007. It charges close to Rs1,000 per teacher and makes EBIT margin as high as 60% in this business.

We estimate 38% revenue CAGR with gradual decline in margins over the next three years.

Retail initiatives

The company has various other initiatives including a) MathGuru.com, an online retail portal helping students to improve their Maths grades; b) Roots-to-Wings (R2W), a branded pre-school chain for toddlers in the two- to five-year old age group.

MathGuru.com – Retail self-help program

MathGuru.com is the company's online retail portal, which works as self-help aid for students of class VI to class XII. The company charges Rs1,800/student per year (launched in July 2006 with introductory price point of Rs1,200) and has generated over 12,000 registrations within the first year of operation. With increasing penetration of the Internet and broadband, we believe this could be a good business with very high operating leverage. The current offering includes solutions to various questions from curriculum books; the company plans to add more modules to the same over a period of time.

Learning Hour - Online tutoring

With its acquisition of ThreeBrix, Educomp has forayed into online tutoring wherein a student subscribes to a suite of online assistance services. The company currently offers one-on-one training and plans to offer group tuitions and home tutoring over a period of time. Recent acquisition of 51% stake in Chandigarh-based AuthorGen was to hone the technology infrastructure used in online tutoring.

K-12 business - Roots-to-Wings

Educomp has forayed into the formal K-12 education space. Under this, it plans to start pre-schools and high schools.

The pre-school space is unorganized in India and is targeted towards toddlers aged two to five years with no standardized curriculum. Educomp has started with three such play schools in Delhi and plans to add 12 more by next fiscal year. It is also evaluating buying a pre-school chain. The company plans to position it as a premium brand, charging fees of Rs3,000 per student per month.

The company also acquired a majority equity stake in two promoter-owned companies, Edu-Infra and Edu-Manage.

Edu-Infra and Edu-Manage business model

Educomp plans to create a three-tier structure to run primary and high schools as "for-profit" organization. Edu-Infra would hold real estate assets for the schools, while Edu-Manage would help school trusts manage these schools. School trusts would transfer 14.5% of development costs to Edu-Infra (with 15% inflation build every year). Also the trusts would pay 4.5% of revenue every year and an initial one-time management fee of Rs5m. All the residual income left in school trust (after deducting 1% trust charges) would be transferred to Edu-Manage.

Thus, all the profits generated in school business would be transferred to Edu-Infra and Edu-Manage using aggressive transfer pricing.

Management expectations on capex, revenue and profitability

Management expects average capital expenditure of Rs140 m per school (Rs 300, 200, and 100 m for schools in tier 1,2, and 3 cities, respectively). Management expects revenue of ~US1.8-2 m with 60% EBIT margin (EBIT of US$1 m) from one school every year in the steady state. It expects to reach steady state in three years of operations.

Points to ponder

Deep discounted ESOPs and aggressive accounting policy

Rs834 is used for P&L expensing

The company has issued ESOPs (c.3-4% of equity) at a strike price of Rs125. This is at a deep discount to the market price (Rs2,898 as of 13-Sep-07 when shareholders' approval was sought for vesting schedule). Management has decided that the fair value used for expensing this would be Rs834. We believe markets are likely to be concerned as Rs834 fair value per share for P&L expensing compares to the market price of ~Rs2,900.

Figure 3. Cost to Company for Deep Discounted ESOPs

	CIR estimate	Company estimate
Number of ESOPs	625,000	625,000
- strike price (Rs)	125	125
Fair value for option expensing (Rs)	2,898	834
Cost to company for discounted options (Rs m)	1,734	454

Source: Company report, Citi Investment Research estimates

In our view, fair cost to the company for these deep discounted ESOPS is ~Rs1,734m against the company's estimated cost of Rs454m

Straight-line amortization for accelerated vesting

Also, these ESOPs vest in an accelerated way while total cost is amortized on a straight-line basis. The company has decided to amortize the value of deep discounted options on a straight-line basis. It has not shared vesting schedules with the public; however, it commented that it accelerated vesting in favour of employees. Comparing this with generally followed accounting practice by a few other Indian IT companies in our coverage universe (Infosys, Wipro, and Satyam), we estimate this aggressive accounting policy would lead to EPS being inflated by Rs51.3, Rs21.1 and Rs8.5 in FY08, FY09 and FY10, respectively. In absence of information about actual accelerated vesting schedule from the company, we have assumed vesting of 30%, 25%, 20%, 15%, 5%, 2.5%, 2.5% over a 7-year period.

Aggressive accounting policies and possibility of issuing further ESOPs may be considered dilutive and hence a concern for many investors, in our opinion.

Figure 4. Cost Amortization and EPS Overstatement

Rs m	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Company view	**65**	**65**	**65**	**65**	**65**	**65**	**65**
CIR view							
1st year ESOP	520						
2nd year ESOP	217	217					
3rd year ESOP	116	116	116				
4th year ESOP	65	65	65	65			
5th year ESOP	17	17	17	17	17		
6th year ESOP	7	7	7	7	7	7	
7th year ESOP	6	6	6	6	6	6	6
Total amortization	**948**	**428**	**211**	**96**	**31**	**13**	**6**
Difference	**883**	**363**	**146**	**31**	**-34**	**-51**	**-59**
EPS over statement (first three years) (Rs)	**51.3**	**21.1**	**8.5**				

Note: CIR view of amortization is in-line with other Indian IT companies in our coverage universe.

Source: Citi Investment Research

Expensive acquisition of Edu-Infra and Edu-Manage

Edu-Infra and Edu-Manage were incorporated by Educomp promoters in FY07 with initial seed capital of Rs1.8m and Rs 0.2m, respectively. Later during the same year, Educomp invested Rs500m and Rs50m in both companies for 69.4% and 68% stakes, respectively.

Figure 5. Educomp Pays Over 100x for a Percentage Stake in Two Companies

	Edu Infra	Edu Manage
Promoters and Key employees		
- stake (%)	30.6%	32.0%
- investment (Rs m)	1.8	0.2
Educomp		
- stake (%)	69.4%	68.0%
- investment (Rs m)	500.0	50.0

Source: Company Reports

According to the FY07 annual report, as of 31-Mar-2007, Educomp had already invested Rs250m in Edu-Infra and Rs12.5m in Edu-Manage. Both companies had no revenue or operating profits during FY07. We remain skeptical about Educomp paying 100-120x the original price for newly incorporated companies with no revenue/operating profits.

Regulatory risk in the Edu-Infra and Edu-Manage businesses

As discussed earlier, the company is attempting to set up "for-profit" primary and high schools. Indian regulations do not allow setting up educational institutes to be run as a commercial activity. The operating model of Educomp in such ventures is to run the schools by a trust. Edu-Infra would hold real estate, while Edu-manage would help manage schools. All profits generated in the schools would be transferred to these two entities. We believe there may be high regulatory and legal risks in the current arrangement.

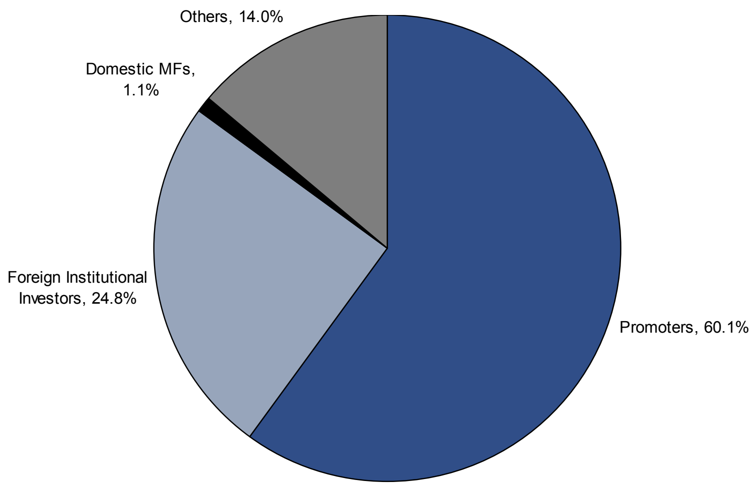
Private equity investment and exit before IPO

Carlyle, a leading private equity group, had invested ~Rs130m in Educomp in June 2000. The investment firm exited a few months before the IPO, transferring shares back to promoters of Educomp at Rs6m. In return, Educomp promoter relinquished its 9% stake in Learning Mate Solutions Ltd. (LMS). LMS employed 844 employees as of December 2005 and was involved in providing technology enabled education solutions and services for K-12 institutions.

Insider selling: A lead indicator?

Insiders have sold more than 340,000 shares (over 2% of equity capital) over the last couple of months. Expensive valuations and insider selling could dampen the sentiment, in our view.

Figure 6. Shareholding Pattern, June 2007



Source: Company Reports

Financials

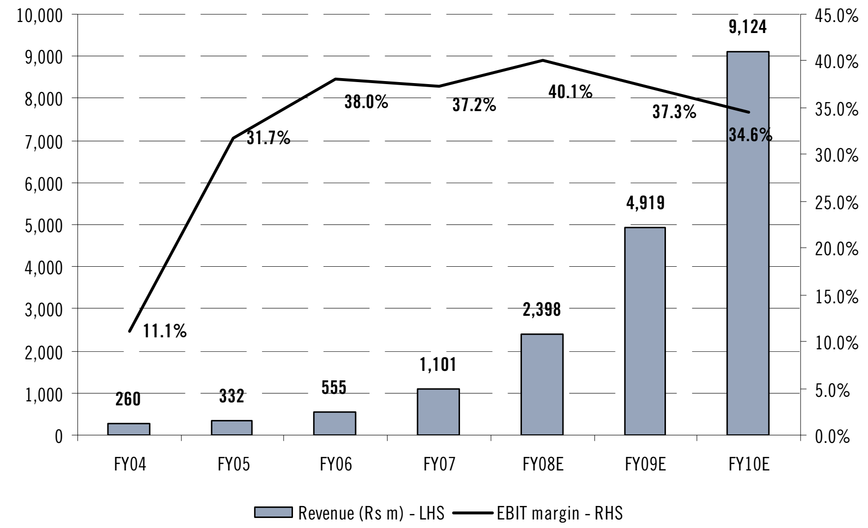
Revenue and growth trajectory

Educomp has grown revenues at a CAGR of 62% over FY04-07, with growth accelerating in FY07. We expect strong growth led by strong Smart_Class enrollments and high school-led acquisitions of Edu-Infra and Edu-Manage. Over the next three years, we are estimating revenue CAGR of 102% over FY07-10E.

Margins likely to sustain in narrow range

We expect margin leverage to play out in the Smart_Class segment while margins decline in the ICT business. Edu-Infra and Edu-Manage businesses will likely put downward pressure on operating margins. Thus overall, we expect EBITDA margins to remain in a narrow range.

Figure 7. Educomp: Revenue Growth to Remain Strong

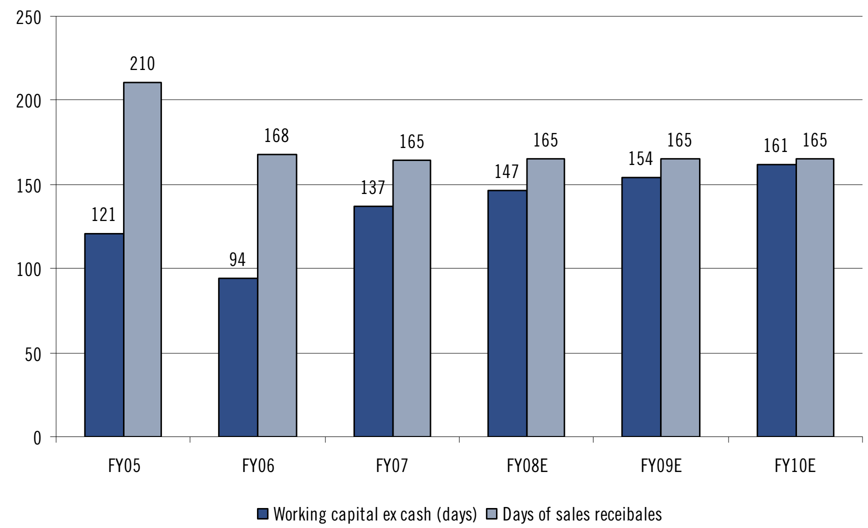


Source: Company reports and Citi Investment Research estimates

High DSO bloats working capital

The company has high receivable days of ~165, leading to high working capital (WC) requirements. A high receivable ratio is a function of high exposure to the ICT business where the typical receivable time frame is 180 days. High working capital requirements have kept return ratios at modest levels. We do not expect significant improvement as investments in Edu-Infra and Edu-Manage are likely to keep return ratios subdued. Note that the company has been fully paying taxes as the business is domestically focused and there are no tax benefits.

Figure 8. Receivable Days and Working Capital (ex cash)



Source: Company reports and Citi Investment Research estimates

Free cash flow to remain negative

High working capital requirement, high growth phase of companies, inorganic initiatives, and further investment requirement in Edu-Infra are likely to keep free cash flow negative over the next couple of years.

Significant dilution from FCCB and ESOPS

The company over the last few quarters has raised US$105m through two FCCB issuances: (a) US$25m was raised with a conversion price of Rs900 at a forex rate of 45.58 INR/USD; and (b) In April 2007, the company raised US$80m through another FCCB issuance with a conversion price of Rs2,950 at a forex rate pf 40.73 INR/USD. Much of the dilution from the first FCCB has already happened, while the second issuance has become convertible from September 2007.

The company has decided to issue ESOPs converting to 625,000 shares at a strike price of Rs125 to promoters and key management personnel. This was approved by shareholders in the AGM held on 13-Sep-07 when the closing price of stock was Rs2,898.

These ESOPs would get vested in an accelerated way, while the company plans to amortize the cost of ESOPs on a straight-line basis. The company board has decided to use a fair value of Rs834 for ESOP cost amortization.

Financials statements, abridged

Figure 9. Income Statement, Rs m

Year to Mar 31	FY05	FY06	FY07	FY08E	FY09E	FY10E
Revenues	**332**	**555**	**1,101**	**2,398**	**4,919**	**9,124**
Growth		*67.1%*	*98.3%*	*117.8%*	*105.1%*	*85.5%*
Operating expenses	175	287	594	1,259	2,853	5,671
EBITDA	**157**	**268**	**507**	**1,139**	**2,065**	**3,453**
EBITDA margin	***47.2%***	***48.2%***	***46.0%***	***47.5%***	***42.0%***	***37.8%***
Depreciation	52	57	97	177	230	300
Operating profit (EBIT)	**105**	**211**	**410**	**962**	**1,835**	**3,153**
Operating margin	***31.7%***	***38.0%***	***37.2%***	***40.1%***	***37.3%***	***34.6%***
Other income/(expense)	9	9	45	63	32	28
Profit before tax	114	220	454	1,025	1,867	3,181
Income tax expense	45	81	170	359	626	1,066
Income from operations	69	139	285	665	1,242	2,115
Prior period items	2	0	-2	0	0	0
Reported net profit	67	139	287	665	1,242	2,115
EPS - Basic	**6.12**	**11.16**	**17.97**	**39.46**	**72.10**	**122.81**
Growth		*82.4%*	*61.0%*	*119.6%*	*82.7%*	*70.3%*
EPS - Fully diluted	**6.12**	**11.16**	**15.93**	**38.74**	**67.96**	**115.76**
Growth		*82.4%*	*42.7%*	*143.2%*	*75.4%*	*70.3%*

Source: Company reports and Citi Investment Research estimates

Figure 10. Balance Sheet, Rs m

Year to Mar 31	FY05	FY06	FY07	FY08E	FY09E	FY10E
Cash and equivalents	22	606	1,106	3,664	2,600	858
Sundry debtors	191	255	496	1,084	2,224	4,125
Other current assets	43	70	159	360	738	1,370
Total current assets	**257**	**930**	**1,761**	**5,108**	**5,562**	**6,353**
Goodwill and Intangibles	5	2	138	137	137	137
PPE, net	146	252	831	1,599	2,733	4,562
Investments	10	21	102	102	102	102
Total Assets	**417**	**1,205**	**2,832**	**6,945**	**8,534**	**11,154**
Total Current Liabilities	125	182	242	480	885	1,460
Borrowings	45	110	1,255	4,514	4,514	4,514
Other liabilities	22	18	187	187	187	187
Total Liabilities	**192**	**310**	**1,685**	**5,181**	**5,586**	**6,161**
Total Equity	226	895	1,148	1,765	2,947	4,993
Total Liabilities and Equity	**417**	**1,205**	**2,832**	**6,945**	**8,534**	**11,154**

Source: Company reports and Citi Investment Research estimates

Figure 11. Cash Flow Statement, Rs m

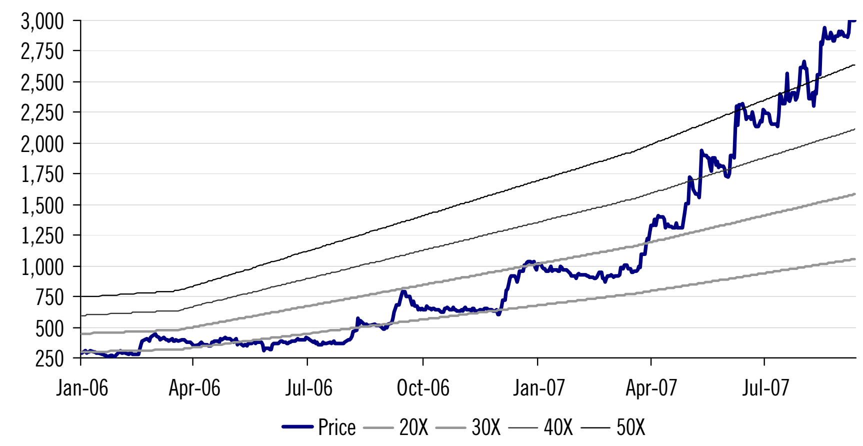
Year to Mar 31	FY05	FY06	FY07	FY08E	FY09E	FY10E
Net income	67	139	287	665	1,242	2,115
Depreciation	52	57	97	177	230	300
Other operating cash flows	-4	-12	-2	-63	-32	-28
Working capital changes	-24	-33	-271	-551	-1,112	-1,958
Cash flow from Operations	**91**	**150**	**111**	**228**	**328**	**429**
CapEx	-96	-163	-676	-944	-1,364	-2,129
Other investing cash flows, acquisitions, divestures	0	0	-173	64	32	28
Cash flow from Investing	**-96**	**-162**	**-849**	**-880**	**-1,332**	**-2,101**
Equity changes	-1	558	4	0	0	0
Borrowings	16	64	1,146	3,258	0	0
Dividends	0	-27	-39	-48	-59	-69
Other financing cash flows	3	0	127	0	0	0
Cash flow from Financing	**17**	**595**	**1,238**	**3,210**	**-59**	**-69**
Net cash flows	**12**	**583**	**500**	**2,558**	**-1,064**	**-1,741**

Source: Company reports and Citi Investment Research estimates

Valuations

We value Educomp on a PER valuation basis. Our target price of Rs2,380 is based on 35x FY09E fully diluted EPS, derived using the stock's historical trading band. Since listing in Dec 2005, the stock has traded in a range of 15-58x one-year forward P/E, with an average of 29x. Over the past year, the average P/E has been 34x. Our target multiple of 35x is at 20% premium to the stock's average historical valuation to factor in the company's stronger growth prospects. It is supported by valuation multiples of other educational services companies in the Asia Pacific region. We believe 35x is fair as we expect strong revenue CAGR of 102% and an earnings CAGR of 95% over FY07-10E. We also compare its valuation with Indian IT companies. Our target multiple of 35x is at a premium to the average valuation for Indian IT companies, which in our view is justified by Educomp's growth prospects. We believe P/E remains the most appropriate valuation measure given Educomp's profitable track record and the widespread use of this methodology.

Figure 12. Educomp - Valuation Band Chart - 12-month Forward PER



Source: DataStream, Company reports, Citi Investment Research estimates

Peer comparison– Asian and global educational services companies

We compare Educomp with regional and global educational services companies. Most of Asian educational companies trade in a broad P/E range of 11-34x for FY09E (average of 23x). MegaStudy, the closest comparable in terms of business model, trades at 38x CY08E and 30x Mar'09E (equivalent to FY09E for Educomp) earnings.

Figure 13. Educational Services Companies — Valuation Comparison Table

Name	RIC Code	Year end	Rating	Mkt. cap (US$ m)	CMP (LC)	TP (LC)	P/E (x) FY08E	P/E (x) FY09E	EV/EBITDA (x) FY08E	EV/EBITDA (x) FY09E	3 year CAGR EPS	3 year CAGR EBITDA	P/E (x) 12M-fwd
Asian													
NIIT	NIIT.BO	31-Mar	3M	643	155	153	26.6	16.8	24.6	15.3	56.8%	45.1%	20.7
New Oriental	EDU.N	31-May	1L	2,155	58	76	47.1	34.0	41.7	28.0	37.1%	46.6%	42.0
Megastudy	072870.KQ	31-Dec	1M	1,934	280,900	300,000	38.0	30.4	29.6	22.0	41.8%	45.1%	32.1
ABC Learning Centres	ABS.AX	30-Jun	2H	2,596	6.40	8.10	14.7	11.3	10.8	7.8	20.3%	33.0%	13.7
Average							**31.6**	**23.1**	**26.7**	**18.3**			**27.1**
Global													
Universal Tech Institute	UTI.N	30-Sep	2S	537	19	25	25.0	25.2	10.2	9.5	-3.3%	3.9%	25.0
Corinthian Colleges	COCO.O	30-Jun	1S	1,317	16	19	36.8	22.4	13.1	9.5	44.4%	29.2%	32.0
Strayer Education	STRA.O	31-Dec	2H	2,430	168	170	37.6	31.0	21.8	18.1	19.8%	15.3%	32.5
DeVry Inc	DV.N	30-Jun	1H	2,595	37	40	28.6	22.1	15.5	12.7	26.9%	18.0%	26.8
Career Education Corp	CECO.O	31-Dec	2S	2,490	27	30	24.8	18.5	9.7	7.6	-0.2%	1.0%	19.9
ITT Edu. Services	ESI.N	31-Dec	2H	4,686	116	120	32.7	27.4	18.1	16.1	22.2%	16.3%	28.7
Apollo Group	APOL.O	31-Aug	2S	10,175	59	58	23.7	21.6	12.5	11.4	7.7%	5.4%	21.4
Average							**29.9**	**24.0**	**14.4**	**12.1**			**26.6**
Overall average							**30.5**	**23.7**	**18.9**	**14.4**			**26.8**

Note: LC= local currency (INR for NIIT, KRW for MegaStudy, ASD for ABC Learning and USD for others); Prices as of 21-Sep-07

Source: Company reports, Citi Investment Research estimates

We believe Educomp's earnings growth is one of the fastest amongst the peer group and hence it deserves a premium - justifying our 35x target multiple.

Comparison with Indian IT valuations

We compare Educomp with our Indian Technology coverage universe. We believe that Educomp deserves a premium to the Indian IT universe due to its high growth potential and little exposure to forex currency fluctuations. Our 35x target P/E is the highest in our Indian IT/Educational services universe.

Figure 14. Indian IT Services – Valuation Comparison Table

Company	RIC Code	Rating	Mkt cap (US$m)	CMP (Rs)	TP (Rs)	P/E (x)		EV/EBITDA (x)		EV/Sales (%)	
						FY08E	FY09E	FY08E	FY09E	FY08E	FY09E
Infosys	INFY.BO	1L	26,201	1,822	2,440	23.8	19.4	19.8	15.3	6.0	4.7
TCS	TCS.BO	1L	25,006	1,015	1,460	20.9	17.2	16.8	13.6	4.5	3.6
Wipro	WIPR.BO	1L	16,157	440	650	20.5	16.6	16.5	12.9	3.4	2.7
Satyam	SATY.BO	1M	7,050	419	570	18.0	14.8	14.5	11.5	3.2	2.5
HCL Tech	HCLT.BO	1M	4,636	277	400	17.1	14.3	12.4	10.2	2.5	2.0
I-Flex	IFLX.BO	3M	3,877	1,840	2,025	20.2	14.1	16.6	11.7	3.5	2.5
Tech Mahindra	TEML.BO	1H	3,915	1,282	1,920	41.0	29.5	28.7	20.3	6.0	4.5
Patni*	PTNI.BO	1M	1,619	463	525	15.6	14.4	9.9	9.3	2.0	1.7
Mphasis	MBFL.BO	1M	1,109	268	400	25.4	16.3	10.7	7.5	2.0	1.4
NIIT	NIIT.BO	3M	643	155	153	13.5	11.8	8.5	7.3	1.2	1.0
Hexaware*	HEXT.BO	1M	450	125	155	22.3	14.1	20.9	13.0	2.3	1.9
Sasken	SKCT.BO	1M	246	343	505	18.9	11.6	12.3	6.9	1.5	1.1
KPIT	KPIT.BO	1M	230	120	154	16.8	11.9	10.3	7.8	1.6	1.2

Source: Powered by DataCentral; *Using CY07E and CY08E for these companies (31-Dec year-ending); Prices as of 21-Sep-07

Is PEG the right way to look at valuations?

We evaluate whether a PEG ratio is an appropriate way to value Educomp due to the high-growth stage. PEG has been a widely used tool to value high growth technology and Internet companies. We compare the PEG ratio and earnings CAGR of some educational services stocks. Most of the high-growth companies have a higher PER ratio; however, PEG does not correlate with high-growth rates in a linear manner.

Figure 15. Select Educational Services Companies: Comparing PER and PEG with Earnings CAGR

Company	12m fwd PER	3 yr EPS CAGR	PEG ratio
NIIT	20.7	57%	0.4
New Oriental	42.0	37%	1.1
Megastudy	32.1	42%	0.8
ABC	13.7	20%	0.7
Corinthian Colleges	32.0	44%	0.7
Strayer Edu.	32.5	20%	1.6
DeVry	26.8	27%	1.0
ITT	28.7	22%	1.3

Source: Company reports, Citi Investment Research estimates

Some of the companies with relatively lower growth rates (~20-30%) have PEG of more than 1.0, while some others with growth rates in a range of 39-60% have PEG of less than 1.0

In our view, PE ratio is a more appropriate valuation tool than PEG ratio for educational services companies.

Risks and Concerns

Risks

Our quantitative risk-rating system, which tracks 260-day historical share price volatility, rates Educomp Solutions as High Risk. We believe this risk rating is appropriate as there are execution and regulatory risks in recent initiatives like Edu-Infra and Edu-Manage. Also, the company still has negative free cash flow and high receivable days on its balance sheet. The key upside risks to our target price include (1) higher-than-expected sign-ups for Smart_Class; (2) faster-than-expected fresh orders in the ICT and professional development businesses; (3) higher than expected enrollment in retail initiatives such as MathGuru.com and online/home tutoring; (4) lower-than-expected inflation in fixed/corporate costs; and (5) better than expected EBIT margins in various business segments.

Concerns

- **Risk of high street expectations:** Currently, the Street seems to be building a blue-sky scenario for Educomp. Bloomberg consensus expectation is for 107% revenue CAGR, 136% EBITDA CAGR and 110% EPS CAGR over the next two years. This indicates that on incremental revenue, Educomp would make 60-70% EBITDA margin. We believe this is a very high risk from a stock point of view. Our EPS estimates for FY08 and FY09 are 8% and 4% lower than consensus estimates.
- **Further ESOP issuance:** With the current ESOP policy, which we view as highly value destructive for minority shareholders, any further ESOP issuances at deep discounts would be a risk.
- **Requirement of further capital:** The company has been aggressive on acquisitions. Also, there is significant cash requirement due to the growth phase of the company. Need for further capital could lead to dilution of equity for minority shareholders

Appendix A-1

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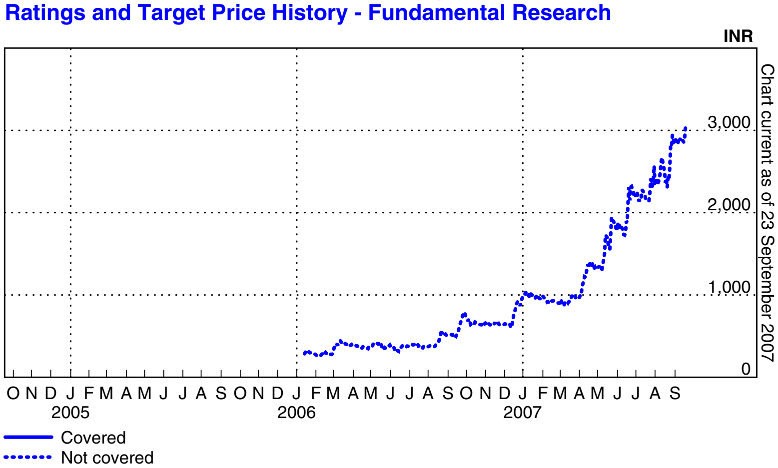
Educomp Solutions (EDSO.BO)

Ratings and Target Price History - Fundamental Research



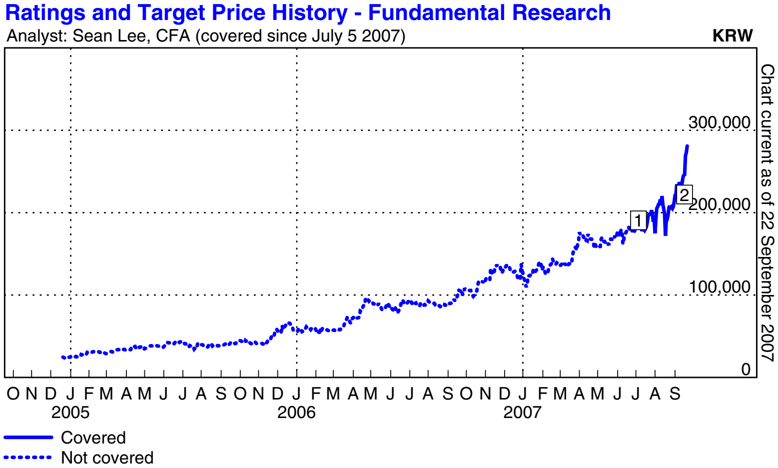
#	Date	Rating	Target Price	Closing Price

*Indicates change.

MegaStudy (072870.KQ)

Ratings and Target Price History - Fundamental Research

Analyst: Sean Lee, CFA (covered since July 5 2007)



#	Date	Rating	Target Price	Closing Price
1:	5 Jul 07	1M	260,000.00	188,000.00
2:	18 Sep 07	1M	*300,000.00	244,900.00

*Indicates change.

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