

Services Group
Knowledge Services

Educomp Solutions (BSE: EDSL IN)

Growth Trajectory Maintained, Innovations Intact

Company Update

Rating: BUY
Price: INR1,308.70
Price Target: INR1,784.00
Bloomberg: BSE: EDSL IN

Market Data

52-Week Range: INR1,454.45-INR291.00
Total Entprs. Value (MM): INR20,902.5
Market Cap. (MM): INR20,939.2
Insider Ownership: 64.0%
Institutional Ownership: 16.0%
Shares Out. (MM): 16.0
Float (MM): 4.3
Avg. Daily Vol.: 27,917

Financial Summary

Book Value (MM): INR1404.2
Book Value/Share: INR56.11
Net Debt (MM): (INR36.7)
Return on Avg. Equity: 30.8%
Long-Term Debt (MM): INR965.4
LTD/Cap: 68.8%
Dividend Yield: 0.1%

INR	2006A	2007A	2008E	2009E
Rev. (MM)	555.0	1065.1	2548.0	3835.0
EV/Rev.	37.7x	19.6x	8.2x	5.5x

EPS

Jun	0.74	1.18	—	—
Sep	2.34	3.17	—	—
Dec	3.22	5.10	—	—
Mar	4.24	8.22	—	—

FY Mar 11.16 17.72 43.60 66.30

FY P/E NM 73.9x 30.0x 19.7x

The Fiscal Year of the Company is Apr to Mar. Annual EPS estimates are for the respective fiscal years.

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Investment Summary

We retain our Buy rating on Educomp Solutions Ltd. (EDSL) following the company's 1Q 2007 earnings release. We maintain the size of India's addressable market, favorable demography, growing acceptance of technology-aided learning, and EDSL's diverse, innovative and quality product suites should enable rapid top-line growth in coming years.

Event

EDSL reported earnings for the final quarter of FY2007. Sales at INR1065.1mn for the fiscal year stood marginally below our estimate of INR1112.8mn; however, net earnings at INR282.8mn were 20% lower than our estimates due to change in contract mix of products.

Key Points

- FY2007 sales of INR1065.1mn grew 103.6% YoY, while Profits After Tax at INR282.8mn grew 103.4% YoY during the Fiscal Year ending Mar-2007 (FY2006/07).
- The company reported a better-than-expected subscription growth in its flagship product Smart_Class – signing up fully 331 schools as of end-Mar 2007.
- The ICT program had subscriptions from 2808 state schools in Mar 2007, with the state governments of Haryana, Karnataka and Assam signing up for the product.
- Retail business (including Mathguru.com) grew 201.8% YoY, generating revenues of INR122.8mn in FY2006/07. Share of retail revenues have grown from 7.8% to 11.5% of total revenues during the fiscal year.
- However, EDSL's Operating Margins dipped 220bps to 47.2% as part of Smart_Class and ICT contracts were switched to/sold as 'content services only' — unlike the typical BOOT contract that included hardware infrastructure. As a result, Cost of Raw Materials jumped 211% YoY to INR319.2mn, besides lower realization of per-student revenues .
- **Innovation and Product Development.** The company has retained its appetite for continuous product innovation, ensured by investments in product development research. Currently, EDSL is trying to develop a suite of innovative technology-aided systems and product applicable to various aspects of efficient management and monitoring of learning institutions. Bottom line, EDSL is eyeing various high value-added segments of the education "business," and the scope for innovation remains robust.

Valuation/Risks

The trend in top-line growth and product diversification remains encouraging; we are not too concerned of the margin dip. However, we are concerned of the emerging negative impact of schools switching from "full service BOOT" to "content only" contracts. We retain our DCF valuation based price target of INR1784 for EDSL's stock.

Impact on Other Companies

NA

Switching Contract Types and Associated Profitability Implications

We are concerned of the negative impact of schools switching from "full service BOOT" contracts to "content only" contracts. In the former contract category, Smart_Class EDSL charges INR150/student, while in the latter category the product charge is halved at INR75/student. In a scenario of falling prices for hardware infrastructure such switches in contract preference will hurt margins and profitability.

Going by current costs, EDSL recovers Smart_Class infrastructure costs (INR150,000) over 44.4 months(@ INR75 per student per month with average class size of 45). With average contract length of 48-60 months, EDSL would stand to lose as much as INR161,000 over the lifetime of an average school contract (with an average of 25-class subscription per school).

We understand that the company's near-term goal is to increase penetration and market share, and fine price differentiation is not so relevant to EDSL's management at this stage. However, we are not convinced of the above-mentioned differential pricing strategy that does not adequately reflect the higher value-addition of the products' content management over hardware infrastructure and infrastructure management. We do not rule out possibility of product re-pricing thereof, going forward.

Finally, we believe for smaller schools, owning and maintaining of hardware infrastructure would not be feasible. Only very large institutions with enrollments greater than 1500 and class subscriptions greater than 30 may opt out of the infrastructure renting and BOOT contracts. Medium-term impact on revenues and profitability may not be significant, though we would be cautiously monitoring EDSL's contract mix and developments thereof, in coming quarters. We maintain that possible conversion of outstanding convertible bonds and profit-booking by short-term traders pose some immediate-term downside price risks. We recommend buying on such dips with a 12-month investment horizon.

Company Description

Educomp is India's largest market-listed technology-aided education company.

INR mn	4Q06	4Q07	% change y-o-y
Revenues	253.7	498.6	96.5%
Total Expenditure	138.5	265.1	91.4%
Purchase of Raw Material	82.2	194.6	136.7%
Increase/decrease in stock in trade	-9.8	-14.6	49.0%
Staff Cost	22.4	30.2	34.8%
Selling, Distribution & Administration expenses	43.7	54.9	25.6%
OPBDIT	115.2	233.5	102.7%
Depreciation & Amortization	12.5	34.4	175.2%
OPBIT	102.7	199.1	93.9%
Finance Charges	0.9	7.0	677.8%
OPBT	101.8	192.1	88.7%
Other Income	2.8	20.1	617.9%
PBT	104.6	212.2	102.9%
Tax (including deferred)	37.9	80.7	112.9%
PAT	66.7	131.5	97.2%
Basic EPS (Rs.)	4.2	8.2	93.9%

Key Ratios	4Q06	4Q07
OPBDIT/Revenues	45.4%	46.8%
PAT/ Revenues	26.3%	26.4%
Total Expenditure/Revenues	54.6%	53.2%
Consumption of Raw material/Revenues	28.5%	36.1%
Staff Cost/Revenues	8.8%	6.1%
Selling, Distribution & Administration expenses/Revenues	17.2%	11.0%

INR mn	FY06	FY07	% change y-o-y
Revenues	523.0	1065.1	103.7%
Total Expenditure	264.9	562.1	112.2%
Purchase of Raw Material	102.8	319.2	210.5%
Increase/decrease in stock in trade	-7.3	-15.2	108.2%
Staff Cost	75.0	104.8	39.7%
Selling, Distribution & Administration expenses	94.4	153.3	62.4%
OPBDIT	258.1	503.0	94.9%
Depreciation & Amortization	53.1	96.6	81.9%
OPBIT	205.0	406.4	98.2%
Finance Charges	5.0	13.3	166.0%
OPBT	200.0	393.1	96.5%
Other Income	14.7	49.0	233.3%
PBT	214.7	442.1	105.9%
Tax (including deferred)	75.7	159.3	110.4%
PAT	139.0	282.8	103.5%
Basic EPS (Rs.)	11.2	17.7	58.9%

Key Ratios	FY06	FY07
OPBDIT/Revenues	49.3%	47.2%
PAT/ Revenues	26.6%	26.6%
Total Expenditure/Revenues	50.7%	52.8%
Consumption of Raw material/Revenues	18.3%	28.5%
Staff Cost/Revenues	14.3%	9.8%
Selling, Distribution & Administration expenses/Revenues	18.0%	14.4%

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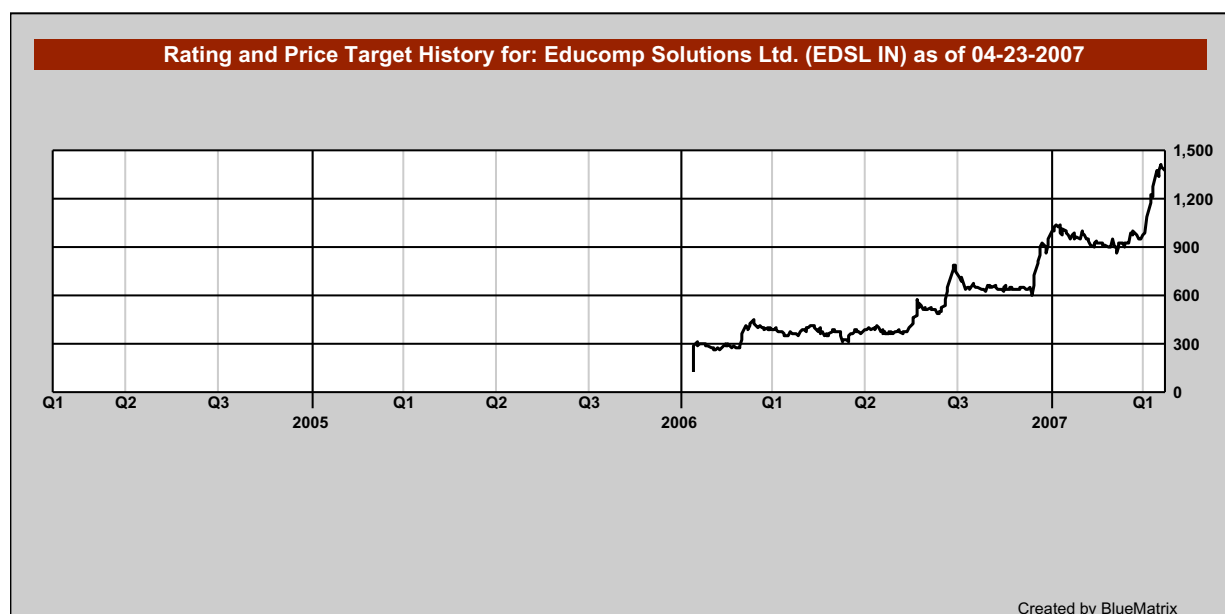
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Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [BUY/SB]	421	53.43	57	13.54
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