Educomp Solutions (EDSO.BO)

Sell: More Details on K12 Initiatives; 2Q Preview

- **No legal or regulatory issues with K-12 initiatives per management** — In our earlier report, we had noted potential legal and regulatory risks in the nascent K-12 businesses. According to management, the company complies with all current regulatory requirements, and hence they do not see any legal or regulatory risk here as we had contended.
- **Acquisition cost of Edu-Infra and Edu-Manage** — According to management, the price paid to acquire these companies in FY07 was based on an independent valuation by Grant Thornton. The company has rolled in two schools from 2QFY08 into these subsidiaries – these schools currently have an annual revenue run-rate of Rs100m with 2,000 student enrollments.
- **2QFY08 expectations** — We expect good growth to continue: revenue of Rs356m (+81% yoy) and EPS of Rs5.87 (+85% yoy) in 2QFY08E.
- **Maintain earnings estimates and target price** — We maintain our earnings estimates and Rs2,380 target price, based on 35x FY09E earnings.
- **Maintain Sell / High Risk (3H) rating** — Trading at ~77x FY08E and ~44x FY09E earnings, the stock looks expensive even on high growth expectations.

Sell/High Risk	**3H**
Price (11 Oct 07)	Rs2,973.00
Target price	Rs2,380.00
Expected share price return	-19.9%
Expected dividend yield	0.1%
Expected total return	**-19.9%**
Market Cap	Rs51,212M
	US$1,308M

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	53.0	24.8	0.1
2007A	287	15.93	42.7	186.6	41.4	28.1	0.1
2008E	665	38.74	143.2	76.7	28.7	45.7	0.1
2009E	1,242	67.96	75.4	43.7	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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Educomp K-12 business

K-12 subsidiaries (Edu-Infra and Edu-Manage) have acquired two schools – one each in Bangalore and Chennai in FY08. Company plans to add more schools under the same over next few years. We have assumed addition of five, 15 and 30 schools during FY08, FY09 and FY10, respectively. Other assumptions built into our estimates are detailed in Figure 1.

Figure 1. Key Estimates/Assumptions Built into CIR Forecast

	FY07	FY08E	FY09E	FY10E
Number of schools				
- year beginning	0	0	5	20
- year end	0	5	20	50
- live for academic year	0	3.0	12.0	35.0
Number of students per school	-	2,400	2,400	2,400
Utilization	-	55.0%	50.0%	50.0%
Number of students – total	-	3,960	14,400	42,000
Admission fees per student	-	25,000	25,000	25,000
Admission fee collection (Rs m)	-	8	269	720
Recurring fees per student p.a.	-	36,000	36,000	36,000
Regular fees collection (Rs m)		143	518	1,512
Revenue - K-12 business (Rs m)	-	151	788	2,232
Change (yoy)		-	422.3%	183.4%

Source: Citi Investment Research estimates

In our earlier report, we had noted that there could be potential legal and regulatory risks in the nascent K-12 businesses. According to management, the company has complied with all current regulatory requirements for its K-12 initiatives (including CBSE affiliation) and hence they do not see any legal or regulatory risks as we had contended.

Price paid to acquire Edu-Infra and Edu-Manage

According to the company, valuations paid to acquire these companies in FY07 were based on an independent valuation by Grant Thornton. Subsequently, two schools were rolled into these two companies in 2QFY08. According to management, these two schools currently have annual revenue run rate of Rs100m with about 2,000 students enrolled.

Management has also emphasized that pre-IPO exit by a private equity firm took place a long time ago as part of a commercial agreement in two stages – first in Sept-03 and second in Jun-05. In the first stage, Educomp hived off a division of the company for a certain cash consideration and other terms and conditions. In the second stage in June 2005, under a commercial agreement the PE investor sold their 15% holding in the company to the founders in return for the founders waiving off their 9% stake in Learning Mate and a cash consideration of Rs6m.

Educomp Solutions

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: (1) Smart Class is an online learning aid targeted towards private educational institutes; (2) ICT Solution is targeted towards government-aided schools for IT infrastructure and training; and (3) 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.

Investment strategy

We rate Educomp (EDSO) shares as Sell / High Risk (3H) as we believe its valuations are expensive despite its strong revenue and earnings growth. We forecast strong top-line growth of 102% CAGR and 95% EPS CAGR over FY07-10E 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 the high valuations.

Valuation

We value Educomp shares on a PE basis. Our target price of Rs2,380 is based on 35x FY09E EPS, derived using the stock's historical trading band. Since listing in December 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 believe P/E remains the most appropriate valuation measure given Educomp's profitable track record and the widespread use of this methodology.

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 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 which could cause the shares to continue to trade above 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.

Appendix A-1

Analyst Certification

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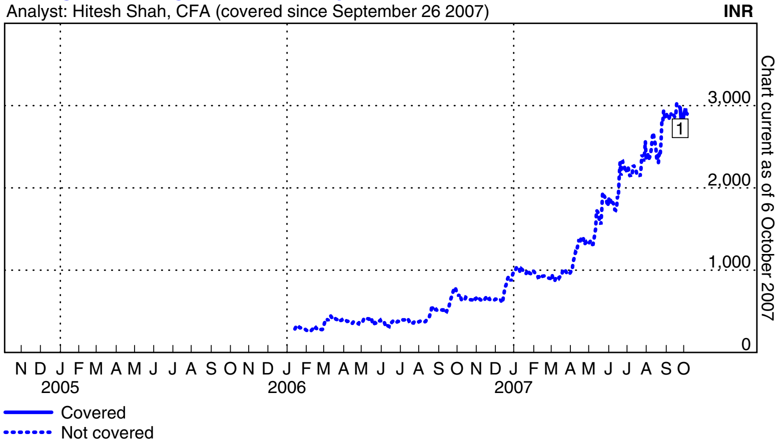
IMPORTANT DISCLOSURES

Educomp Solutions (EDSO.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Hitesh Shah, CFA (covered since September 26 2007)



#	Date	Rating	Target Price	Closing Price
1:	25 Sep 07	3H	2,380.00	2,972.30

*Indicates change.

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