

Company Flash

30 October 2007 | 6 pages

Educomp Solutions (EDSO.BO)

Sell: Good Quarter; Valuations Expensive

- 2QFY08 result** — The company reported revenue of Rs449m (up 128% yoy) while EBIT margin was down 200 bps to 35.5%. Net profit at Rs.136m was up 169% while fully diluted EPS at Rs6.48 was up 104% yoy due to higher diluted equity shares.
- Consolidated results** — The company reported consolidated revenue of Rs569 m and consolidated EPS of Rs6.2. Consolidated earnings were lower due to losses in its subsidiaries.
- Segment-wise performance** — SmartClass revenue was Rs260m (58% of stand-alone revenue). The company signed over 100 schools under this flagship segment covering over 500 schools. ICT Solution revenue was up 58% yoy to Rs112m while Professional development revenue was down 5% at Rs64m.
- FY08 guidance maintained** — The company maintained its full-year guidance – revenue of Rs.2.2b to Rs2.3b and net profit of Rs600-650m.
- Equity dilution** — With stock prices above the strike price for second FCCB, diluted share count has increased by ~1.1m shares (~6.4% of basic quarter end equity) due to possible dilution from FCCB conversion. Also, the company has approval to issue up to 0.2 m shares under ESOP Plan 2007.
- Maintain Sell (3H)** — Trading at ~85x FY08E and ~49x FY09E earnings, the stock looks expensive even on high growth expectations.

Sell/High Risk		3H
Price (30 Oct 07)		Rs3,303.45
Target price		Rs2,380.00
Expected share price return		-28.0%
Expected dividend yield		0.1%
Expected total return		-27.9%
Market Cap		Rs56,905M
		US\$1,446M

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



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	139	11.16	82.4	nm	58.9	24.8	0.0
2007A	287	15.93	42.7	nm	46.0	28.1	0.1
2008E	665	38.74	143.2	85.3	31.9	45.7	0.1
2009E	1,242	67.96	75.4	48.6	19.3	52.7	0.1
2010E	2,115	115.76	70.3	28.5	11.4	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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¹Citigroup Global Markets India Private Limited

Figure 1. Key Financial

Rs m	2Q07	2Q08	YoY
Revenue	197	449	128.0%
COGS	22	116	417.3%
Personnel expenses	34	52	52.8%
Gross profit	141	281	100.1%
SG&A expenses	48	52	9.4%
EBITDA	93	229	147.0%
Depreciation & Amortization	19	69	272.1%
EBIT	74	159	115.5%
EBIT margin	37.5%	35.5%	-206bp
Other income, net	3	29	961.8%
PBT	77	189	145.8%
Provision for tax	26	52	100.9%
Profit after tax	51	136	168.9%
Basic EPS	3.17	7.95	150.8%
Diluted EPS	3.17	6.48	104.4%

Source: Company Reports

Figure 2. Segment wise Financials

	2Q07	2Q08	Change
Professional Development			
Revenue	67.3	64.0	-4.9%
EBIT	42.6	36.0	-15.5%
EBIT margin	63.3%	56.3%	-704bp
Smart Class			
Revenue	47.7	259.5	444.0%
EBIT	26.2	142.9	446.1%
EBIT margin	54.9%	55.1%	21bp
ICT Solutions			
Revenue	70.9	112.0	58.0%
EBIT	20.3	30.3	49.2%
EBIT margin	28.6%	27.1%	-159bp
Others			
Revenue	11.2	13.8	22.9%
EBIT	4.4	5.7	29.6%
EBIT margin	39.2%	41.3%	214bp
Unallocated expenses	19.5	55.5	184.8%

Source: Company Reports

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) as Sell/High Risk 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 FY07-10 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 the high valuations and high risks in the company's business model.

Valuation

We value Educomp on a P/E basis. Our target price of Rs2,380 is based on 35x FY09E 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 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 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.

Appendix A-1

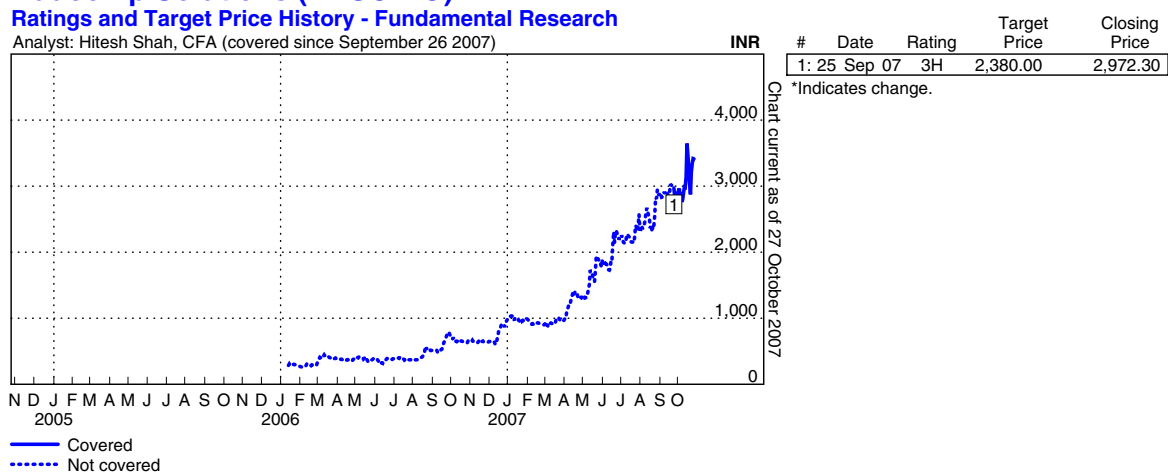
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Analyst: Hitesh Shah, CFA (covered since September 26 2007)



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