J.P.Morgan

Asia Pacific Equity Research
02 September 2009

Initiation

Overweight

EDSO.BO, EDSL IN

Price: Rs4,070.10

Price Target: Rs5,000.00

Educomp Solutions Ltd

Leading the Indian education story, this is just the beginning

- **We initiate coverage of Educomp Solutions Ltd with an Overweight rating and Jun-10 PT of Rs 5000:** Educomp is the largest listed player in the huge, fast-growing and under-tapped Indian private education sector. With private initiatives in education just beginning to take off and its first-mover edge, we expect strong growth trajectory for Educomp (50%+) over the next few years. Hence, we are fundamentally positive on the company and would be buyers from a 12-18 month view.
- **Indian education sector is a huge but inefficient system:** This is due to limited private sector presence and a cultural mindset of running schools in the non-profit paradigm. However, government's willingness to allow private participation in education seems to be changing and we believe that this would lead to large addressable market size of US$25B/$35B for private players by 2012/2015 just in key segments (K-12, Multimedia and ICT).
- **We expect growth to remain strong:** Despite its small size (FY09 revenue of US$140MM), Educomp is one of the largest private players in the education space (showing lack of private participation). With its first-mover edge in multimedia (SmartClass) and K-12 segments, Educomp has delivered 140%/100% revenue/EPS CAGR over FY07-09. We expect EPS growth to remain strong (50% EPS CAGR over FY10E-12E) as Educomp continues to scale, helped by government policies.
- **Valuation and key risks:** Educomp trades at FY10E P/E of 40x, which is not cheap on an absolute basis but reasonable given the growth prospects. Our price target assumes one-year forward P/E of 28x. Risks to our thesis and price target are: (1) managing growth and delivering on already high consensus expectations; (2) high capex requirements for all segments could lead to higher leverage on balance sheet (current net debt-to-equity is 0.4x) or equity dilution; (3) presence in too many small segments that stretches management bandwidth; and (4) disclosure levels to be improved.

India

Indian IT Services

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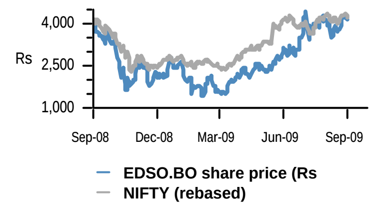
J.P. Morgan India Private Limited

Price Performance



Reuters: EDSO.BO; Bloomberg: EDSL IN

Rs in millions, year-end March

	FY09	FY10E	FY11E	FY12E		FY09	FY10E	FY11E	FY12E	52-Week range	Rs1,331-4,590
Sales	6,450	10,127	15,595	21,796	Y/E BPS (Rs)	246	653	827	1,074	Shares Outstg	19Mn
Operating Profit	1,674	2,733	4,300	6,232	ROE (%)	37.2	24.9	23.8	26.2	Date of price	9/1/2009
EBITDA	2,473	4,133	6,572	9,451	ROIC (%)	12.6	10.9	11.8	13.0	Avg daily volume	1.32Mn
Net profit	1,326	2,066	3,322	4,703	Qtr EPS (Rs)	1Q	2Q	3Q	4Q	Avg daily value (U$ Mn)	77.0
EPS Stdalone (Rs)	69.0	90.3	124.2	169.9	EPS (FY09)	8.9	15.5	17.1	29.9	Index (Sensex)	15,551
EPS Consol (Rs)	71.4	103.9	164.7	233.2	EPS (FY10E)	18.4	21.2	29.6	34.7	Free float	45%
P/E Std (x)	59.9	45.8	33.3	24.3	EPS (FY11E)	31.4	39.7	44.5	49.1	Dividend Yld (%)	0.1%
P/E Consol (x)	57.9	39.8	25.1	17.7	Local	1M	3M	12M		Exchange rate	Rs49.1/US$1
P/B (x)	16.8	6.3	5.0	3.9	Abs. perf.(%)	0.8	32.0	5.7		Market Cap (Rs B)	78.0
Cash	1,865	6,889	3,826	2,912	Rel. perf.(%)	1.5	26.2	2.3		Mkt cap (US$ m)	1,588

Source: Company data, Bloomberg, J.P. Morgan estimates.

See page 39 for analyst certification and important disclosures, including non-US analyst disclosures.

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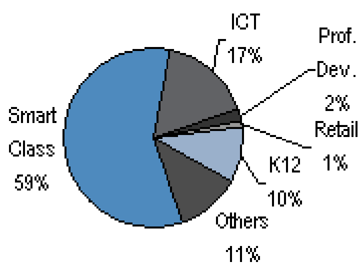
Company description

Educomp Solutions Ltd, founded in 1994, is a diversified education solutions provider and the largest education company in India. The Educomp Group reaches out to over 23,000 schools and 12 million learners and educators across the world through 27 offices worldwide including an office in Canada and Sri Lanka, two in Singapore, three in the US and 20 in India. It also operates through its subsidiaries, including authorGEN, Threebrix, Learning.com (US), AsknLearn (Singapore) and associates such as Savvica in Canada.

Revenue



Source: Company data.

EPS: J.P. Morgan vs. consensus

	J. P. Morgan	Consensus
FY10E	111.7	114.2
FY11E	176.1	171.6
FY12E	249.3	253.9

Source: Bloomberg, J. P. Morgan estimates.

P&L sensitivity metrics

P&L sensitivity metrics	EBITDA impact (%)	EPS impact (%)
Sales growth assumption (FY11E): 54.0%		
Impact of each 5%	3.8%	4.9%
Operating margin assumption (FY11E): 27.6%		
Impact of each 1%	2.8%	3.7%
Capacity utilization assumption (FY11E): NM		
Impact of each 5%	NM	NM
Debt/equity assumption (FY11E): 93%		
Impact of each 10%	0%	-0.5%

Source: J. P. Morgan estimates.

Price target and valuation analysis

Our Jun-10 price target of Rs5,000 is based on one-year trailing/forward P/E of 43x/28x. We believe the valuation is justified given the EPS CAGR of 48% over FY09-12E. Educomp is currently trading at FY09 P/E of 57x and FY10E P/E of 40x, and we expect the trading multiples to come down in line with growth expectations.

Risk-free rate:	6.50%
Market risk premium:	8.00%
Beta:	0.9
Debt/equity:	33%
Cost of debt:	11.5%
Terminal "g":	5%

Key risks to our price target are: (1) managing growth and delivering on already high consensus expectations; (2) high capex requirements for all segments could lead to higher leverage on balance sheet (current net debt-to-equity is at 0.4x); (3) presence in too many small segments that stretches management bandwidth; and (4) disclosure levels to be improved.

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Table of Contents

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Investment summary

Business: Edcuomp's business is split across 3 key verticals:

(1) Smart Class (multimedia) segment – which provides content and related infrastructure to K-12 schools

(2) Infrastructure (land and building) and vendor services to schools in K-12

(3) ICT – IT-enabling government-run schools.

Educomp is the market leader in these segments with significant lead over competition in Smart Class and K-12 schools.

ICT and Smart Class segments operate under the BOOT model, requiring upfront investment from Educomp with revenues accruing over a three-five-year period. Setting up a greenfield school under the K-12 segment requires upfront investment of Rs 80-140 million per school in infrastructure. Educomp leases out the infrastructure for a 30-year period and also earns revenues from providing vendor services to the schools.

With robust growth expected in each of these segments, the company is increasingly moving towards a capex-lite business – by providing only content in Smart Class and just vendor services to K-12 schools.

India has a population of 1.1 billion, with a literacy rate of just 61%, ranking a disappointing 172nd in the world on this front. Clearly, India struggles to meet up to the huge requirement of talent in several upcoming sectors such as infrastructure, hospitality, retail, and financial services. This has led to both the government and the private sector focusing on the education space, with total spending crossing US$60 billion. However, government spending has proved to be very ineffective over the past decade as high spending has not translated to higher literacy or better quality education.

We believe that the government's increasing willingness to allow private sector participation in the large sector would lead to large addressable market size of US$25 billion/$35 billion for private players by 2012/2015 just in key segments (K-12, Multimedia and ICT).

Educomp being the first-mover in the education space in India has a dominant market share (over competitors such as NIIT and Everonn) in all key segments. We believe Educomp can sustain strong revenue and EPS growth rates of over 50% CAGR over the coming 2-3 years. We set a Jun-10 price target of Rs5,000 based on a one-year forward P/E of 28x—reasonable in our view, given the high growth rates.

Key risks to our thesis are high capex requirements for all the target segments, which could lead to further equity dilution or higher gearing if growth is below expectations. Moreover, management ability to straddle several high growth business segments is a risk in addition to regulatory risks due to high central and state government involvement in the education segment.

Multimedia segment

India has ~70,000-80,000 privately-run (unaided) schools in urban India, of which we believe the target market for multimedia is in the range of 15,000-20,000 schools. With a number of private schools also expected to grow rapidly (over 13% CAGR from FY02-07), the addressable market will expand significantly, in our view. Moreover, this market is largely un-penetrated—Educomp has installed its Smart-class solution in ~1,900 schools and Everonn in ~550.

We believe multimedia will gradually become a de-facto standard for teaching given its usefulness in teaching and emphasis laid by Indian middle class on quality education. As of now, we believe that the target segment would be higher-end private schools (15,000-18,000), leading to a huge untapped market for Educomp.

With expanding market and rising penetration, we expect this space to grow from US$560 million to $1.1 billion in the next three years.

Table 1: Multimedia—Large potential with low penetration

Multimedia market	Current	FY12E	FY15E
Private Un-Aided (Rural + Urban) schools	197,385	300,198	399,563
Target Urban private schools	18,000	30,020	39,956
Multimedia addressable market size (Rs MM)	27,000	54,036	83,908
Multimedia addressable market size (US$ MM)	563	1,126	1,748
Total number of schools having Multimedia	2,294	9,006	21,976
Total Penetration	13%	30%	55%
Educomp smart class	1,737	5,260	12,087
Educomp Smart Class market share	76%	58%	55%
Total revenues from Multimedia segment (Rs MM)	3,445	16,211	46,150
Total Penetration	13%	30%	55%
Educomp smart class	3,141	13,746	29,997
Educomp Smart Class market share		85%	65%

Source: NCERT, J. P. Morgan estimates.

Educomp: Market leader in multimedia for the school segment, key growth driver for the next two-three years

Educomp is the pioneer in multimedia for the school segment with its Smart Class product that has found significant acceptance in the private school segment. Smart Class allows teachers to use multimedia modules to effectively teach students for all subjects across K-12 grades. With over 16,000 content modules developed over the past five-six years and ~1,700 schools already running Smart Class, Educomp is the market leader in this segment.

Table 2: Private schools employing Smart Class

	FY06	FY07	FY08	FY09	FY10E	FY11E	FY12E
Revenues in Rs MM	201	466	1,278	3,141	5,637	9,198	13,746
Growth %		131.9	174.4	145.8	79.5	63.2	49.5
No of schools at end FY	91	331	933	1,737	2,660	3,860	5,260

Source: Company data, J.P. Morgan estimates.

Smart Class contributed ~49% of Educomp's consolidated revenue in FY09, having grown 160% CAGR over the past two years. We expect strong 70% revenue CAGR in this segment over FY09-11E as Educomp continues to penetrate more in this segment.

ICT (Information and Communications Technology)

This segment primarily involves supply, installation and maintenance of IT hardware and software in government schools under a three-five year build-own-operate-transfer (BOOT) model. So far state governments have awarded ICT contracts for ~40,000 schools over the past two-three years, with the expectation of awarding incremental ~60,000 over the next three-four years.

Table 3: ICT business growth and Educomp's market share

	Current	FY12E	FY15E
Total number of schools contracted	40,000	100,000	180,000
CAGR		36%	22%
Market size (Rs MM)	5,600	14,000	25,200
Market size (US$ MM)	117	292	525
Educomp's market share (schools)	30%	22%	20%
Educomp's revenue from ICT (Rs MM)	1,135	3,055	5,040
Educomp's revenue from ICT (CAGR)		39%	18%

Source: J.P. Morgan estimates.

K-12 schools: Just the beginning, long way to go

Educomp has set up ~23 schools (CBSE-affiliation) under three brands—Millenium, Takshila and Vidya Prabhat—based on socio-economic levels of the area. While running a school is a high-margin business, the initial capex requirement is a hindrance to the scalability of the model. As a result, Educomp is now focusing on providing services to run schools owned by other trusts/societies leading to lower incremental capex requirement, while providing similar margins.

We believe this model is easily scalable and estimate Educomp to have ~100 schools under management over the coming three years.

Limited private participation due to regulatory and cultural hurdles—times are changing

Education is a clear focus for the current government, with higher spending by the government to boost inclusiveness and target a higher enrollment in K-12 education. Educomp will be a clear beneficiary as it is present in all aspects of K-12 education.

More importantly, the education ministry is opening up to the view that education could be set up with 'for-profit' motive. While we don't expect complete commercialization of education to be allowed in the near-future (especially for K-12), the education ministry could take a middle ground allowing re-investment of profits from one education-related activity into another.

Other segments: Limited upside in the near-term

Educomp has entered all other markets such as pre-schools, higher education (beyond grade 12), vocational training and online educational content/training. We believe Educomp is setting up its expertise to enter these markets so that the company is in a position to garner decent market share when these segments gain critical mass.

Estimates: 55% revenue CAGR and 52% EPS CAGR over FY09-11E

Educomp has achieved very strong growth—100%+ CAGR over FY05-09. This growth has been largely driven by the Smart Class and ICT businesses. We expect Educomp to sustain strong growth over the next 2-3 years, led by continued momentum in the Smart Class segment (71% CAGR) further augmented with its foray into schools business. We expect margins to remain stable as moderating margin in Smart Class segment is offset by higher margins in the K-12 and retail initiatives. Overall, we expect FY09-11E revenue CAGR of 55%, with stable operating margins. However, we expect EPS CAGR to be slightly lower at 52% over FY09-11E, mainly due to higher interest payments on debt.

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Risks to our thesis

Capital-intensive nature of all key businesses: Balance sheet leverage could lead to further equity dilution

ICT and Smart Class segments operate under the BOOT model, requiring upfront investment from Educomp with revenues accruing over a three-five-year period. Additionally, setting up a greenfield school under the K-12 segment requires upfront investment of Rs 80-140 million per school, mainly for land and construction costs. Educomp plans to set up ~100-150 schools in the coming three years.

Educomp has a net debt of Rs1.7 billion (gross debt of Rs9.3 billion against cash of Rs7.56 billion). The current net debt/equity stands at 0.4x and net debt/EBITDA stands at 0.60x. We expect a sharp ramp-up in these segments would require higher capital requirement for Educomp. We expect the net debt to increase to Rs8 billion by FY11E, given the high capex requirement for all businesses. While high growth rate would support more debt, we believe increasing leverage does expose the company to go in for further equity dilution.

Management bandwidth to be stretched by multiple forays

Over the past 12-18 months, Educomp has entered several new lines of businesses, including setting up its own schools, venturing into pre-school business, tutoring (online and offline), etc. With each line of business being a large market in itself, Educomp would be stretching its management resources to compete efficiently in each market, in our view.

Regulatory risk in case of school business

Current Indian regulations allow only not-for-profit trusts/societies registered with the government to operate private schools. Moreover, education is concurrently regulated by both the central and state governments. As a result, regulations can differ from state to state, which could hamper scalability of a private player looking at pan-India coverage.

Dilution from FCCB and ESOPS

Educomp recently raised Rs6.07 billion from a QIP (fresh equity) issue of 1.62 million shares at Rs3,750/share—leading to a dilution of 8.6%. The company also has FCCBs outstanding with conversion price of Rs2,950 per share. The conversion of these FCCBs would lead to further dilution of 6% (1.1 million new shares). Total ESOPs outstanding are 0.57 million (~3% of shares outstanding).

Valuation and recommendation

Our Jun-10 price target of Rs5,000 is based on one-year forward P/E of 28x. We believe the valuation is justified given EPS CAGR of 50% over FY10E-12E. Educomp is currently trading at FY09/FY10E P/E of 58x/40x and we expect the trading multiples to come down in line with growth expectations.

For our DCF valuation, we use a 10-year revenue growth rate of 34% and terminal growth rate of 5%. Combined with our ROIC assumption of 14.7%, we have a Jun-10 DCF fair value of Rs3,100. Our price target is at a 60% premium to DCF, primarily driven by the strong growth expectation over the coming three-four years compared to more conservative long-term assumptions.

Key risks to our price target are: (1) managing growth and delivering on already high consensus expectations; (2) high capex requirements for all segments could lead to higher leverage on balance sheet; (3) presence in too many small segments that stretches management bandwidth; and (4) disclosure levels to be improved.

Table 4: Educomp—Relative valuation

	Price	Mkt cap	EPS in local currency			P/E			EPS CAGR	PEG
	LC	US$MM	CY08/ FY09	CY09 / FY10E	CY10E/ FY11E	CY08 / FY09	CY09 / FY10E	CY10E/ FY11E	FY10E-12E	FY10E
Apollo Group	64	9,779	2.87	4.18	5.19	22.2	15.2	12.3	23%	0.67
ITT Education Services	103	3,893	5.17	7.75	9.15	20.0	13.3	11.3	15%	0.89
DeVry	51	3,604	2.28	3.01	3.64	22.2	16.8	13.9	22%	0.75
Strayer Education	207	2,902	5.67	7.53	9.34	36.6	27.6	22.2	22%	1.24
Career Education	23	1,982	0.77	1.08	1.69	30.2	21.6	13.8	39%	0.55
New Oriental Education	68	2,570	1.59	2.30	2.93	42.5	29.3	23.0	32%	0.92
Educomp	4,135	1,597	71.4	103.9	164.7	57.9	39.8	25.1	50%	0.80
Megastudy	238,800	1,241	8,169	10,423	13,077	29.2	22.9	18.3	26%	0.89

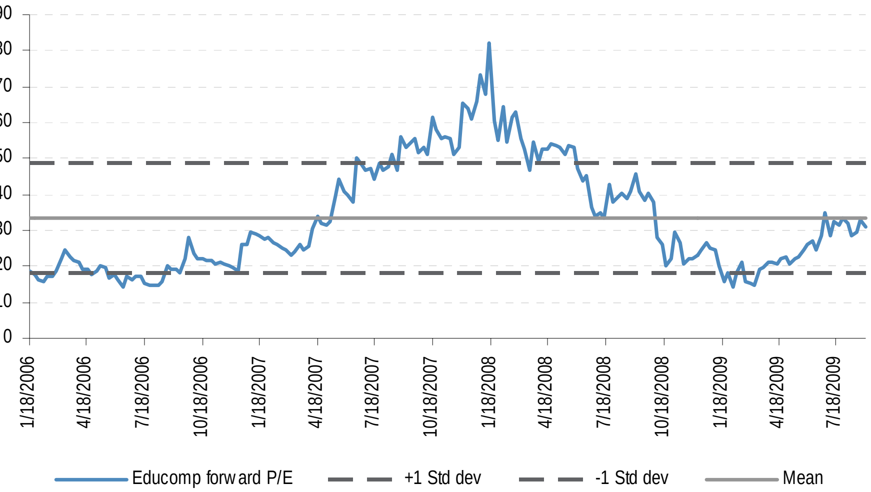
Source: Bloomberg consensus estimates, J.P. Morgan estimates. Note: Prices are as of September 1, 2009.

Table 5: Educomp—One-year average trailing and forward multiples

	P/E		P/B	
	Trailing	Fwd	Trailing	Fwd
1-year average	39.5	25.9	10.2	4.6
Current	48.0	31.6	9.9	5.6
Jun-10 PT	42.8	28.5	7.3	5.7

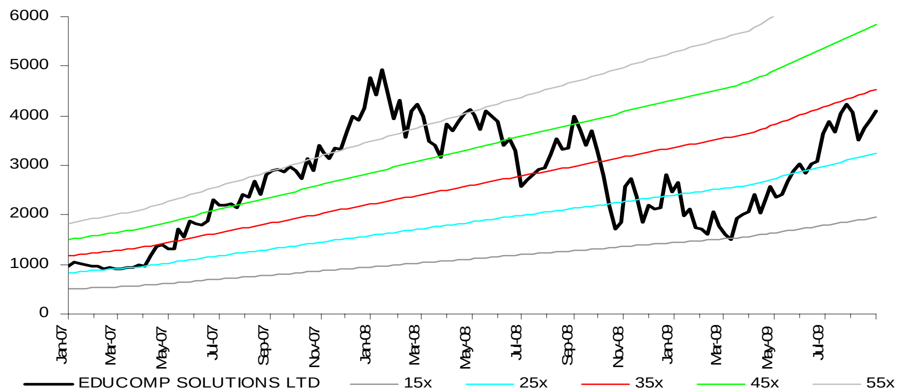
Source: J.P. Morgan estimates.

Figure 1: Educomp—Forward one-year P/E (limited trading history)



Source: Company reports, J.P. Morgan estimates.

Figure 2: Educomp—Forward one-year P/E



Source: Company reports, J.P. Morgan estimates.

DCF valuation: Jun-10 fair value estimate of Rs3,100

Our DCF-based, Jun-10 fair value for Educomp is Rs3,100, based on a FY09-FY19E revenue CAGR of 35%, terminal growth rate of 5%, EBIT margin of 28%, ROIC of 15% and WACC of 12.3%. Our price target assumes a 60% premium to this value, given the strong growth rate in the coming two-three years, which is significantly above long-term growth rates.

Revenue

We have explicit quarterly revenue forecasts until FY12. We expect 47% revenue CAGR over FY10-12. We expect Educomp's medium-term growth rate to remain high (our estimate is 30%) due to the large untapped nature of the market and increased government focus on the education space. Our terminal revenue growth rate assumption is 5%.

Operating and NOPAT margins

Educomp's margins should stabilize over the next 18-24 months. In the long term, we expect Educomp's margins to remain at ~28%. Our long-term NOPAT margin assumption is 20%.

Asset turns

We assume asset turns to be on the conservative side of historical averages given the high growth and high capex nature of most of Educomp's segments, which yield revenues only over a longer term. Overall, we expect long-term invested capital turns of 0.75x.

Cost of capital

We assume a cost of capital of 12.3%, based on cost of equity of 14% and cost of debt of 11.5%. We assume that over the long term Educomp would have 25% of its invested capital from debt and remaining from equity/internal accruals.

ROIC

Putting all the above together, we get a long-term ROIC of 14.7%.

Table 6: DCF sensitivity to WACC and long term growth rate

	Growth Rate						
	Terminal growth						
WACC	*2%*	*3%*	*4%*	***5.00%***	*6%*	*7%*	*8%*
10.3%	4,641	4,958	5,377	5,954	6,801	8,164	10,724
11.3%	3,555	3,736	3,965	4,268	4,685	5,297	6,283
12.3%	2,729	2,826	2,947	3,101	3,304	3,584	3,995
13.3%	2,088	2,135	2,191	2,262	2,351	2,469	2,632
14.3%	1,584	1,599	1,617	1,639	1,666	1,700	1,746

Source: J.P. Morgan estimates.

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K-12: The core of the system

K-12 (kinder garden to standard 12) education forms the core of the Indian education system. K-12 involves the entire education starting from 4-5 years of age up to 17-18 years of age. This is the largest segment in terms of revenue with an estimated size of US$15 billion. While regulation and a culture of non-profit-education have limited private participation in this segment so far (most investments by the government), we are beginning to see a change with some of the upcoming private players (such as Educomp).

We believe the government is supportive of such private players and would provide further incentives for private players to fill in the huge gap of quality education in the K-12 segment—we estimate a gap of ~350,000 schools currently. As a result, we expect the K-12 market size for private players to grow from US$15 billion currently to US$30 billion by FY15. Further, we note that school is a profitable business model with ~30% steady state EBIT margins, though it requires significant upfront investment—we estimate 10-year average ROIC of 17%.

Educomp has just started to focus on this segment with 20 schools operational by end-FY09 and revenue/EBITDA of Rs389/227 million in FY09. We expect a strong 80%/73% CAGR in revenue/EBITDA over the next three years. We expect schools to contribute 10%/13% of revenue/EBITDA by FY12 from 6%/9% currently.

Table 7: Educomp K-12 performance and estimates

	FY08	FY09	FY10E	FY11E	FY12E
Revenue (RsMM)	290	389	638	1,544	2,301
Revenue growth (%)		34%	64%	142%	49%
EBITDA (RsMM)	151	227	436	844	1,167
EBITDA margin (%)	52%	58%	68%	55%	51%

Source: Company reports, J.P. Morgan estimates.

K-12: The core segment with significant size

K-12 is the core bracket of the education chain. With over 300 million children in the 6-18 age bracket, India's school-going population is among the highest in the world. Currently, India has over 1 million schools with 220+ million students enrolled in them, implying a school-going percentage of 75%.

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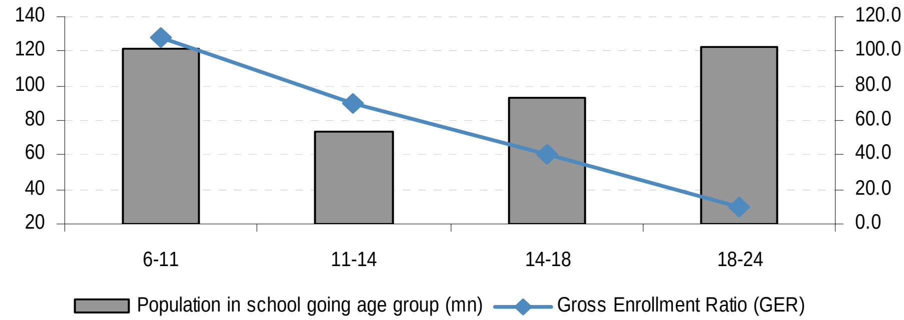
Figure 3: Gross enrollment is very low in the higher age group



Source: MHRD.

Dominated by public sector

The K-12 segment is currently dominated by the public sector—government and local bodies account for 79% of all schools and 65% of enrolled students. The skew is higher in urban areas where private schools account for 60% of enrolled students but the proportion is only 23% in rural areas.

Table 8: Number of schools, students and size of schools

		Students in MM	Student distribution	Schools	Students / school	School distribution
	Government	71.2	51%	473,323	150	55%
	Local body	36.4	26%	262,189	139	31%
Rural	Private aided	19.5	14%	51,909	376	6%
	Private unaided	13.2	9%	65,763	201	8%
	Total	140.4		853,184	165	
	Government	14.8	24%	47,237	312	27%
	Local body	8.4	14%	30,594	274	17%
Urban	Private aided	17.6	29%	29,230	603	16%
	Private unaided	20.3	33%	70,751	287	40%
	Total	61.1		177,812	343	
	Government	86.0	43%	520,560	165	50%
	Local body	44.8	22%	292,783	153	28%
Total	Private aided	37.2	18%	81,139	458	8%
	Private unaided	33.5	17%	136,514	246	13%
	Total	201.5		1,030,996	195	

Source: NCERT survey (2002).

Backed by huge government spending on education

Indian government spends over US$40 billion on education (and allied activities) each year with a large part going towards schemes to increase enrollment ratios and making education more accessible. The spending is at the lower end of the global average of 3-6% of GDP and 10-20% of government spend. However, the Indian government has increased its spending significantly over the past two-three years and it was at over Rs2.1 trillion in FY08, accounting for ~4% of GDP.

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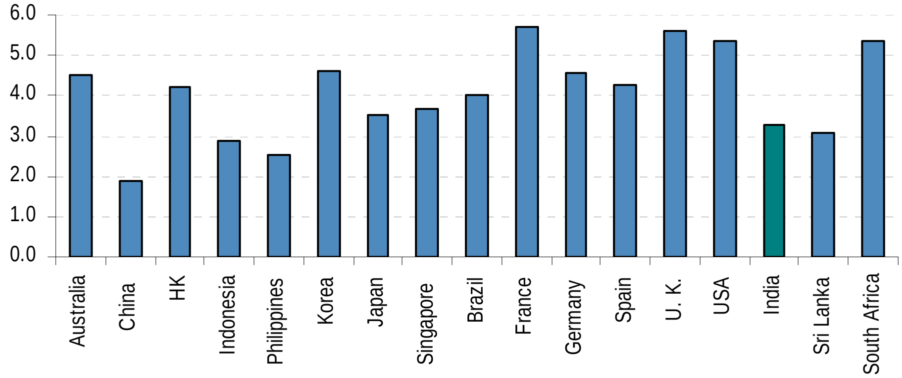
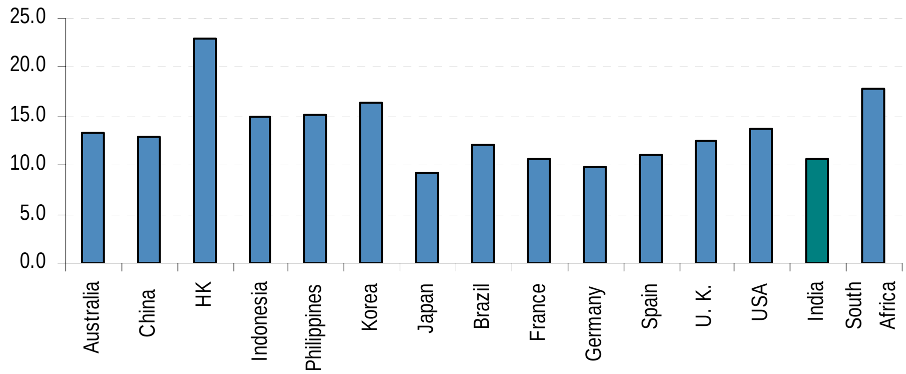
Figure 4: Public expenditure on education as % of GDP



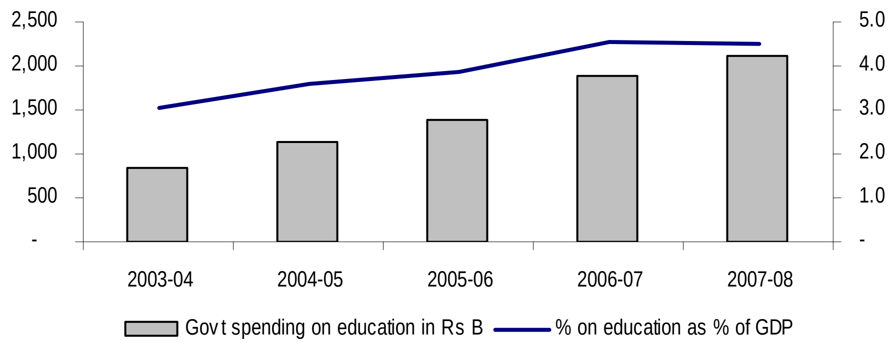
Source: UNESCO (2005).

Figure 5: Public expenditure on education as % of total government expenditure



Source: UNESCO (2005).

Figure 6: Public spending on education is growing



Source: Company data, J.P. Morgan estimates.

Spending on education: Private + government = US$60B in all

While the headline number of ~US$60 billion looks quite sizeable, we note that: (1) the government accounts for ~77% of total spend; and (2) ~ 80% of the total government spending goes towards K-12 education - ~Rs1.7 billion in FY08. Also, private spending on education includes spend on books, magazines, newspapers and private tuitions.

Table 9: Private and public expenditure on education

RsB	Govt. spending on education	Pvt spending on education	Total
2003-04	842	383	1,225
2004-05	1,127	430	1,557
2005-06	1,388	485	1,873
2006-07	1,880	551	2,431
2007-08 (budgeted)	2,105	627	2,731

Source: Union Budget data, Dept of Education, CSO.

But quality of education is far from satisfactory

India scores far behind other BRIC nations, far behind developing nations in Latin America and South East Asia and better than most of its neighbors with the exception of Sri Lanka.

Despite significant spending by the government on education, India trails behind on literacy parameters, indicating a gap in translating the spending to quality education. Interestingly, India has a good enrolment ratio of 76% but data from the Ministry of Education indicate that the drop-out ratios between class 1-10 was 62%—showcasing the high leakage and low quality of the delivery system.

Table 10: Government spend on education as a % of GDP along with literacy rates in various countries

	Govt expenditure on education as % of GDP	Adult Literacy	Youth literacy
India	3.7	66.0	82.1
Russia	3.8	99.5	99.7
China	1.9	93.3	99.3
Brazil	4.0	90.5	97.8
Pakistan	2.6	54.9	70.0
Bangladesh	2.7	53.5	72.1
Sri Lanka	3.2	91.5	97.6
Indonesia	3.6	91.4	98.9
Malaysia	6.2	91.9	98.3
Chile	3.2	96.5	99.1
Peru	2.5	90.5	97.9
France	5.7		
Germany	4.6		
UK	5.6		
US	5.3		

Source: UNESCO Institute of Statistics, government of India data.

As a result, private sector is gaining share

With education being a key cultural imperative for the Indian middle class, lack of quality education has led to a sharp increase in private schools that provide better quality of education albeit at a higher price. As per the government's education statistics (2007), India has ~197,000 private unaided schools, over half of which are located in urban areas. This is an increase of 86% since 2002 whereas total schools have grown by just 27%. As a result, private (unaided) schools now constitute 15% of total schools compared to 10% of total schools in 2002.

Importantly, the overall number of students enrolled in private unaided schools grew at 10.5% CAGR from 17.6 million in 1995-96 to 37 million in 2004-05. Students enrolled in private unaided schools accounted for 31% of total enrolled students in 2004-05, up from 27% in 1995-96.

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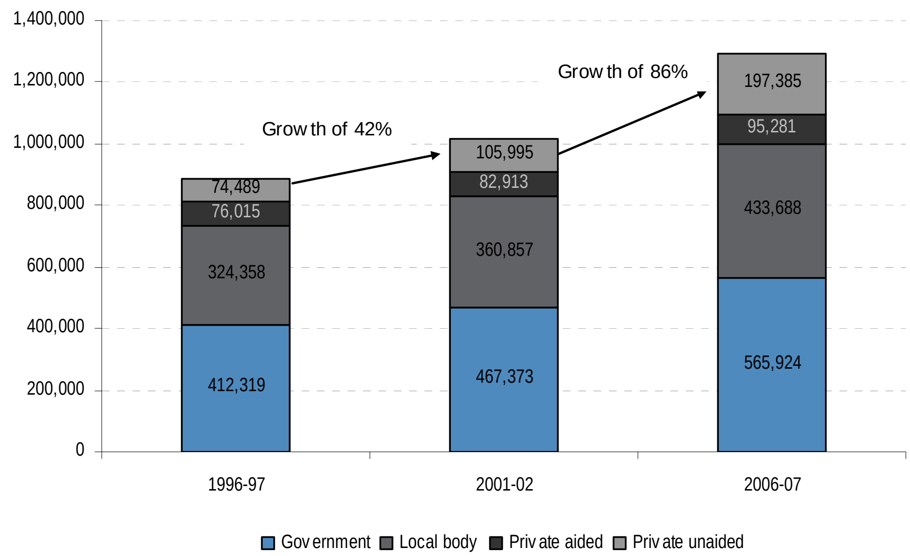
Table 11: Distribution of persons in the age group 5-29 years who are attending educational institutions by the type of institution

	Government	Local body	Private aided	Private unaided	Unknown
2004-05	62.5	5.9	13.9	16.9	0.5
1995-96	63.7	7.8	17.7	10.5	0.0
Rural					
2004-05	70.6	6.2	10.3	12.2	0.4
1995-96	72.8	7.6	12.0	7.1	-
Urban					
2004-05	40.7	5.1	23.5	29.7	0.8
1995-96	42.3	7.9	31.2	18.2	-

Source: NSS report No. 517: Status of Education and Vocational Training in India, 2004-05.

Figure 7: Private (unaided) schools growth has outpaced all other schools



Source: MHRD survey (2007).

The potential is still huge

We believe that the shift to private sector is just the beginning and there is still a huge shortage of schools. We estimate a shortage of ~350,000 schools based on the low enrollment ratios currently (over 80 million children in the 6-18 age group). Moreover, we expect private schools to fill in at least 10% of this large gap—indicating a potential of 35,000 schools.

So what has prevented private sector from K-12 so far and what is changing?

It is important, in our view, to ask the question as to what has prevented the private sector from trying to enter the K-12 sector aggressively so far given the huge size of opportunity. We believe that the key stumbling blocks include:

Regulations: Non-profit nature

CBSE by-laws mandate the running of a school as a non-profit entity. Key requirements include:

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1. It (society/trust) shall ensure that the school is run as a community service and not as a business and that commercialization does not take place in the school in any shape whatsoever.

2. It shall ensure that the funds accruing from the school are spent for the benefit of the school and for its expansion.

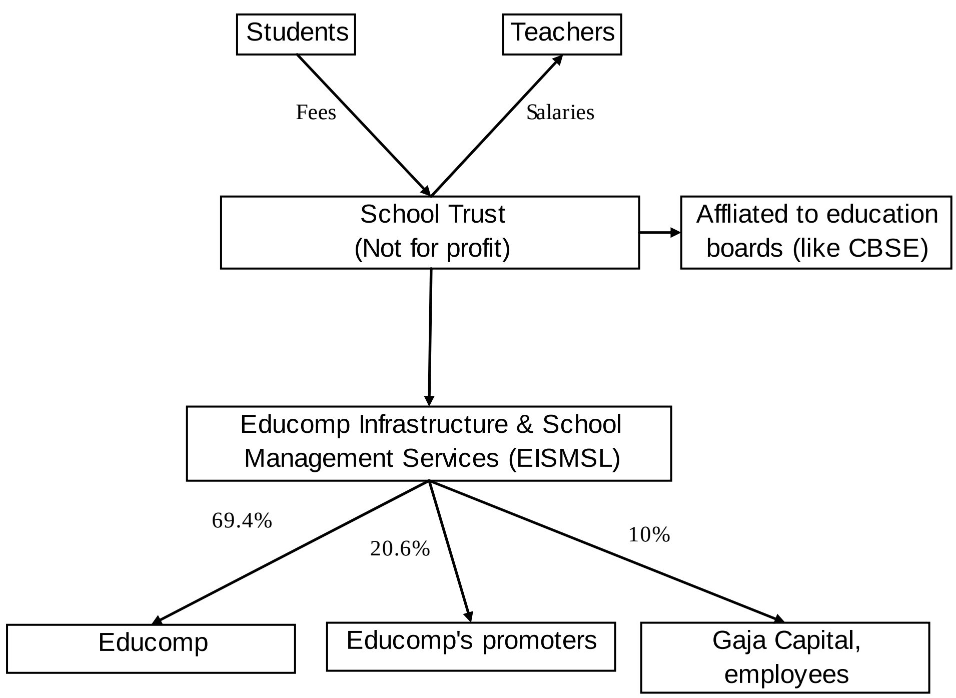
Moreover, the cultural fabric of India has led to a perception that schools/healthcare should normally be run as non-profit entities, making private entities in these sector non-appealing.

However, this is beginning to change as:

1. People have begun to realize that the current government-run infrastructure is not meeting the required quality standards.

2. Further, private players such as Educomp have come up with new structures (as shown below) where the school trust passes on all profit to a facilities provider/school management entity. Interestingly enough, the government/CBSE are fine with this structure (though one can argue that it does not meet the "spirit" of the rule). We think this is again driven by the government's realization of private-sector participation required to provide quality education to all.

Figure 8: Educomp provides services to schools through a multi-tiered structure



Source: J.P. Morgan.

Regulations: A state government matter

Schooling is a state subject in India (concurrent with central government) and is exposed to sudden changes in operational rules by states. The case in point is the recent proposal by the Maharashtra state government to reserve 90% seats in junior colleges (grade 11-12) for students only from the state-run SSC board, leaving only 10% seats for CBSE, ICSE and other boards. The Mumbai High Court had to intervene and strike down the proposal.

Scaling up

Education has been a very fragmented market so far with each state/region having its own nuances in terms of culture, language of education, timings and several such factors. As a result, it has been very difficult for schools to have a pan-India model and scale up from 1-2 states to an India level. The only notable school chains of any size are Dayanand Anglo Vedic (DAV) and Bhartiya Vidya Bhawan, still with limited schools. While this is not an insurmountable problem, it has complicated matters in a sector already dodged with regulatory uncertainty.

Table 12: List of school chains

Name of the school chain	Number of schools
Vidya Bharati	~18,000
Kendriya Vidyalaya Sangathan (KVS)	~980
Dayanand Anglo Vedic (DAV)	~660
Nashik District Maratha Vidya Prasarak Samaj (NDMVP)	325
Bhartiya Vidya Bhawan	180
Maharshi Vidya Mandir	143
Ramakrishna Mission	137
DPS - Delhi Public School	120

Source: J.P. Morgan.

Back-ended returns

High capex requirement for setting up a school is likely to dampen the ROIC in initial years as a school ramps up to accommodate higher grades and capacity utilization is below steady state levels. Again this is true for several other businesses also, but it does make the sector unattractive if one has regulatory issues to deal with as well.

Our financial model for a school indicates a long-term EBITDA/net margin of 37%/18%, pretty attractive, in our view. However, it requires upfront investments, resulting in a pay-back period of over 10 years.

Table 13: Financial model for a school

Years -->	0	1	2	3	4	5	6	7	8	9	10
Capex less depreciation (Rs MM)	140	138	136	134	133	131	129	127	126	124	122
Up to Grade -->		6	8	10	12	12	12	12	12	12	12
Total capacity (no. of seats)		1,080	1,440	1,800	2,160	2,160	2,160	2,160	2,160	2,160	2,160
Total enrolled students		486	792	990	1,296	1,404	1,512	1,620	1,728	1,728	1,728
Tuition fees (RsMM)		14	24	31	43	49	56	63	70	74	77
Admission fees (RsMM)		15	10	8	11	8	6	6	7	4	5
Total fees (RsMM)		28.6	33.6	39.6	53.8	56.7	61.6	68.9	76.7	78.0	81.9
Teachers required											
(Student-Teacher ratio of 25:1)		19	32	40	52	56	60	65	69	69	69
Support staff		25	30	50	50	50	50	50	50	50	50
Total salaries (RsMM)		6.4	10.3	14.6	18.6	20.7	23.0	25.7	28.4	29.8	31.3
Other operating costs											
(electricity, water, overheads)		12.9	11.8	11.9	16.2	14.2	15.4	17.2	19.2	19.5	20.5
EBITDA		9.4	11.5	13.2	19.1	21.8	23.2	25.9	29.2	28.7	30.1
Margin		*33%*	*34%*	*33%*	*35%*	*38%*	*38%*	*38%*	*38%*	*37%*	*37%*
Depreciation		4.7	4.6	4.5	4.5	4.4	4.4	4.3	4.2	4.2	4.1
EBIT		4.7	6.9	8.6	14.6	17.4	18.9	21.6	24.9	24.5	26.0
Margin		16%	21%	22%	27%	31%	31%	31%	32%	31%	32%
PAT		-1.5	0.5	1.7	5.8	8.0	9.3	11.4	13.9	13.9	14.9
Margin		*-5%*	*2%*	*4%*	*11%*	*14%*	*15%*	*17%*	*18%*	*18%*	*18%*
RoCE		7%	8%	10%	14%	17%	18%	20%	23%	23%	25%
Free cash (RsMM)	-140	-2.0	1.9	3.1	6.4	9.5	10.6	12.5	15.0	15.5	16.3
NPV (RsMM)	148										
NPV for Educomp (69.4% share)	103										
Share count (Educomp) (MM)	18.9										
Per share value of each school (Rs)	7.8										

Source: J.P. Morgan estimates.

More pro-active moves by the government

The government has mandated starting of secondary schools under the PPP model, where the government would invest in providing land and incur construction costs, whereas private player would be asked to provide all education-related services—including content and teachers. We believe this is the first step from the government in opening up the secondary education space more for private players.

Educomp: A key player in K-12 as the segment opens up

With the government beginning to promote private players in K-12, Educomp is one key player that has decided to aggressively target this space. This is understandable given Educomp's 10+ years of experience in the education sector, a strong content repository and aggressive management team. Currently, the company has just 20 schools as of end-FY09 but plans to ramp up to 150 by FY12. As one can see, this is a very small number in the overall scheme of things but still enough to provide a significant revenue/earnings stream for Educomp.

Educomp's school strategy

Educomp has set up K-12 schools under three different price brands: (a) **Millennium Schools** are a network of premium schools with fees in the range of Rs3,000-3,500 per student per month; (b) **Takshila Schools** cater to tier 2 and tier 3 cities, charging fees in the range of Rs1,500-1,700 per student per month; (c) **Vidya Prabhat Schools** are low-budget schools in semi-urban towns with a fee of Rs700-800 per student per month. Educomp plans to ramp up its total school base to 48-50 schools by FY10 and further to 150 schools by FY12.

Educomp plans to generate revenues from three streams: (1) tuition fees charged according to the brand of the school; (2) admission fee – one-time fee charged based on the admission time of new students; and (3) license fees—one-time fee of Rs5 million paid by the school trust to ESIMSL when the school is set up.

But the path is not easy due to the high capex requirement: The asset-light model is another innovation

Due to the high upfront capex requirement for setting up schools, Educomp has had difficulty in scaling up aggressively. Hence, the company is now looking to move to a pure-play school services model. Under this model, Educomp would provide all the education services such as hiring and training teachers, conducting admissions process, providing educational content and conducting examinations. In return, Educomp would charge 15% of the schools' revenues as the price for the services provided and Educomp would look to earn ~60% operating margins. While the company has very few such projects currently, it is looking at increasing schools managed under this model to reduce upfront capex costs.

Performance mixed so far

Educomp's K-12 model has generated notable revenues only over the past three-four quarters. The performance has been mixed—while revenue has declined Q/Q, margins have increased.

Due to the nature of the financial model (three revenue streams, of which two are one-time fees)—revenues from the K-12 business tend to be lumpy. Since the size of the school business is small currently, the license fees form a significant part of the revenues currently. The decline in license fees over 3Q/4QFY09 has been partly responsible for K-12's revenue decline.

Educomp believes that as the revenue base becomes more broad-based, the quarterly fluctuation in revenues will be normalized.

Multimedia: Substantial first-mover edge for Educomp

The Indian education system has seen a new concept of content delivery in classrooms through digital content and LCD-TVs/projector-assisted-whiteboards. This concept was pioneered by Educomp through its product called Smart Class and is fast catching up in private schools. It is universally accepted by all schools that Smart Class massively improves the learning and teaching experience (as we felt in the demo). Hence, it offers a massive market opportunity with an estimated market size of US$ 1.1 billion/$1.7 billion by FY12/FY15 from $560 million currently. Key constraints, in our view, are affordability and educating the market (especially in tier-2, tier-3 cities and rural areas) about the use of this concept.

Educomp is the market leader in this segment with a school market share of 75% and revenue of US$70 million in FY09, 150% CAGR over FY06-09. Still, the penetration of the addressable market (~18,000 schools, in our view) is just 13% and hence we expect Smart Class to continue to deliver strong 64% CAGR over FY09-12E. The space also offers a very attractive 45-50% EBIT margin and 1.5 years payback period.

Further, we are seeing a number of other players entering the space given the attractiveness. However Educomp's first-mover advantage and large content library should allow it to sustain market leadership, though we have conservatively built in a decline in market share from 75% to 60%/55% in FY12/FY15.

Table 14: Educomp's Smart Class performance and estimates

	FY07	FY08	FY09	FY10E	FY11E	FY12E
Revenue (Rs MM)	466	1,278	3,141	5,637	9,198	13,746
Revenue growth (%)	131.9	174.4	145.8	79.5	63.2	49.5
EBIT (Rs MM)	271	740	1,856	2,912	4,259	6,048
EBIT margin (%)	58	58	59	51.7	46.3	44.0

Source: Company reports, J.P. Morgan estimates.

Multimedia: Under-penetrated, large addressable market

Of the 70,000-80,000 privately-run (unaided) schools in urban India, we believe that target market for multimedia is in the range of 15,000-20,000 schools. Educomp has implemented Smart Class in ~1,700 schools, indicating a penetration of ~10%. Including other players, the total penetration is just 13%.

As the number of private schools grows and the multi-media concept catches up, we expect the penetration to go up to 55% by FY15. This would imply 54% revenue CAGR for the multi-media segment. For Educomp, we expect Smart Class revenue to grow at 46% CAGR over FY09-15E.

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Table 15: Smart Class—Large potential with low penetration

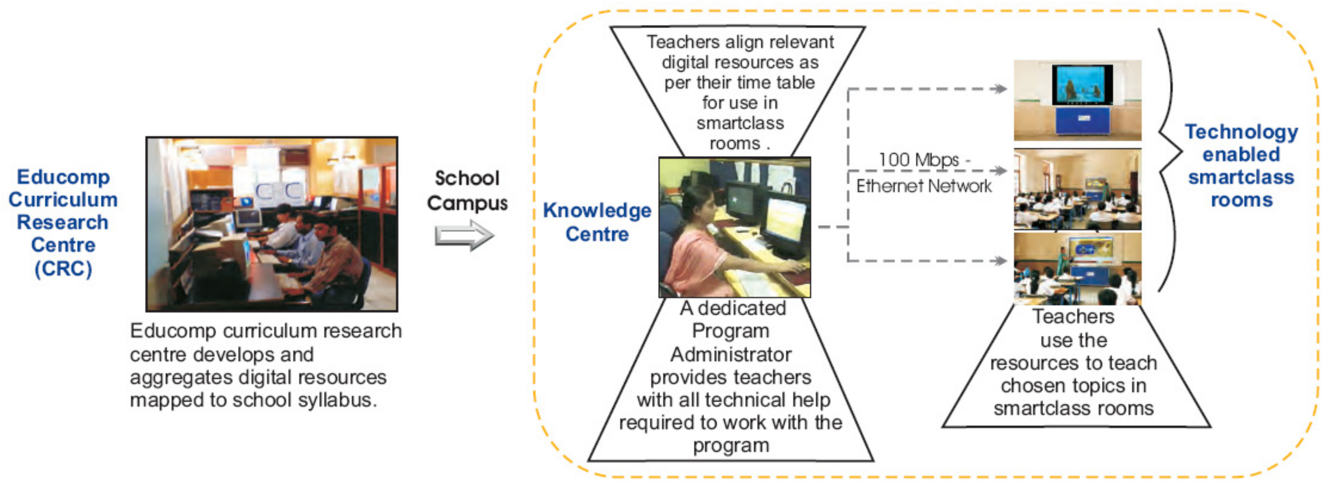
Multimedia market	Current	FY12E	FY15E
Private unaided (Rural + Urban)	197,385	300,198	399,563
Target urban private schools	18,000	30,020	39,956
Classes per school	20	20	20
Students per class	50	50	50
Fees per student per month (Rs)	125	150	175
Multimedia addressable market size (Rs MM)	27,000	54,036	83,908
Multimedia addressable market size (US$ MM)	563	1,126	1,748
Total number of schools having multimedia	2,294	9,006	21,976
Total penetration	13%	30%	55%
Educomp Smart Class	1,737	5,260	12,087
Educomp Smart Class market share	76%	58%	55%
Total revenues from multimedia segment (RsMM)	3,445	16,211	46,150
Total Penetration	13%	30%	55%
Educomp Smart Class	3,141	13,746	29,997
Educomp Smart Class market share		85%	65%

Source: NCERT, J. P. Morgan estimates.

Smart Class: The concept

Educomp has been the first-mover in the multimedia segment by providing a digital teaching aid product called Smart Class targeted towards the private school segment.

Figure 9: How Educomp Smart Class works



Source: Company reports.

The content library for each school is loaded on a central server in the school. Each classroom in the school is equipped with a computer connected to the server and an overhead projector to display the content. The interactive board allows instructors to overlay their input on the content for customizing their lecture.

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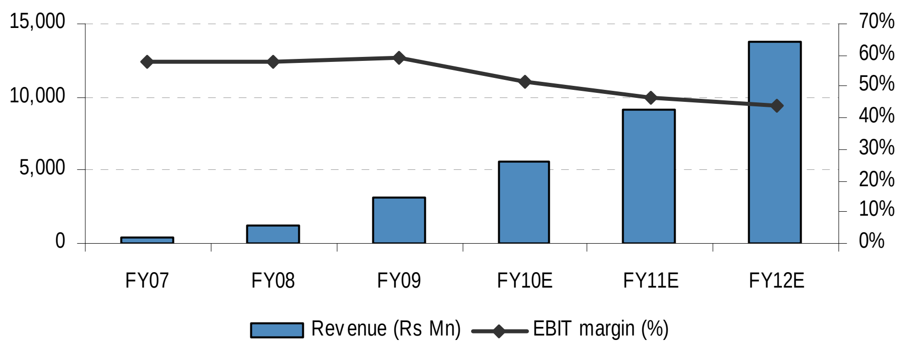
Figure 10: Smart Class implementation in schools

Source: Company reports.

We expect competitors to gain some market share and estimate 63% CAGR for Educomp Smart Class. With Educomp's early-mover advantage and fully mapped content, it has significant lead over competitors such as NIIT and Everonn in this space.

Educomp generated Rs3.14 billion from the Smart Class segment in FY09, accounting for ~49% of Educomp's consolidated revenue in FY09. We estimate revenue for Smart Class to grow at over 60% CAGR over the next three years from FY09-12E.

Figure 11: Educomp has seen a sharp growth in Smart Class with good EBIT margins



Source: Company data, J.P. Morgan estimates.

Competition increasing but Educomp still has first-mover edge

Competition in the multimedia market is increasing with the entry of other education players such as NIIT and Everonn. However, Educomp is the market leader with a 76% market share currently and hence has the first-mover edge.

Further, Educomp's massive and comprehensive content repository is the key differentiator. It consists of ~16,000 animated, subject-specific 3D and 2D multimedia modules covering almost all subjects and across all grades in K-12. Educomp also has exclusive access to educational videos from Eureka and Discovery channel for teachers to use in the classroom.

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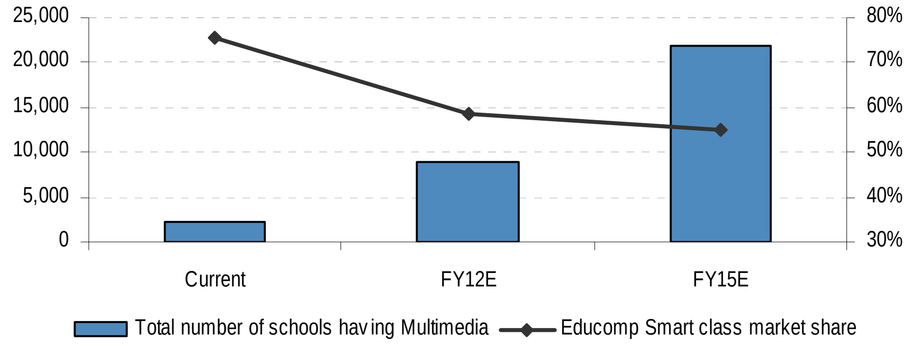
Figure 12: Educomp's market share in the multimedia segment is expected to remain high with the first-mover advantage



Source: J.P. Morgan estimates.

Competition still has a long way to go

NIIT

NIIT launched its own model of delivering school content under various initiatives such as 'Interactive Classrooms', 'Math lab', 'IT Wizard' under the 'eGuru' brand. However, this has been initiated only in late 2008 and is yet to see any significant pickup—it contributes to less than 5% of revenue.

Everonn

Everonn offers multimedia content for private schools under its ViTELS brand using VSAT technology in its studios—with its in-house teaching staff delivering lectures and content to students/trainees sitting in classes spread across geographical locations. The company acquired Aban Informatics in Jan-08, mainly to get access to content for grade 6-12 in CBSE and ICSE syllabi. As of Mar-09, Everonn had over 550 schools and 800 colleges under this offering.

However, we note that this approach has its own disadvantages of: (a) very high capex of setting up studios; (b) these courses are supplementary to the regular courses and do not form the core of the syllabus, unlike Smart Class; and (c) requires Everonn to maintain subject experts to impart lectures.

Financials

The economics of Smart Class: High ROIC and high margin

Educomp follows two models for Smart Class:

a) The standard implementation is based on a five-year BOOT model for Smart Class where Educomp sets up the required infrastructure for the school (cost of Rs85,000 per classroom). For the service, Educomp charges Rs150 per student per month for five years. At the end of five years, the infrastructure is handed over to the school.

b) Some schools prefer to buy the infrastructure outright—in which case Educomp charges Rs75 per student per month for five years for providing content and support services.

Smart Class is an attractive financial model as:

1. Revenue stream is stable for five years once contracts are signed, indicating good visibility. Further renewal of contracts is almost a given.

2. Payback period is <2 years and ROIC is ~50%.

3. Operating margins are 50%+ as content costs have already been expensed (mostly one-time costs) and incremental expenses are sales (currently over 180 people) and support staff. We expect margins to moderate over time as higher investment is required in sales force and competition matures over time.

Table 16: The economics of Smart Class

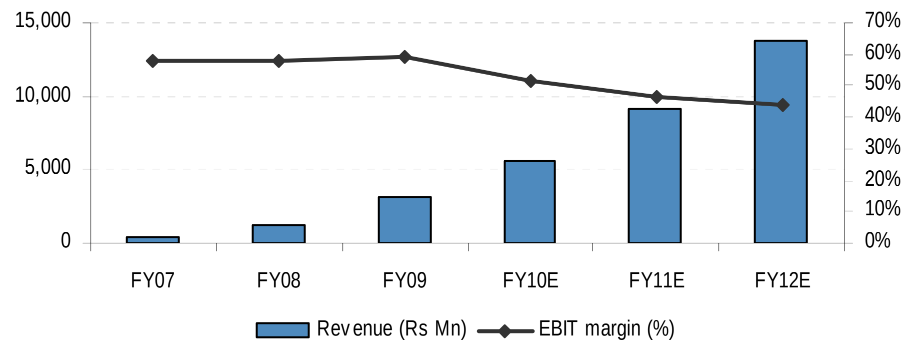
Initial investment per classroom	Rs85,000
Fee per student per month	Rs150
Number of students per classroom	40
Net profit per classroom (discounted over 5 years)	127,174
ROIC	50%

Source: J.P. Morgan.

Educomp performance

Educomp generated Rs3.14 billion from the Smart Class segment in FY09, accounting for ~49% of Educomp's consolidated revenue in FY09. We estimate revenue for Smart Class to grow at over 60% CAGR over the next three years from FY09-12E. Margins should remain high, though we expect some decline due to increasing competition.

Figure 13: Educomp has seen sharp growth in Smart Class with good EBIT margins



Source: Company data, J.P. Morgan estimates.

Key risks

Protecting content IP is a key risk: Educomp's key USP in this segment is its vast content repository that it has built over the past 5-7 years. Protecting this key differentiator would be the key to maintaining its lead over competition.

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ICT (information and communications technology)

ICT is a government-led portion of the private education space where private players take over contracts for supply and maintenance of IT hardware and software in government schools. Given the L1 nature of bidding and long payment schedules, ICT offers lower margins than other segments and high receivable days. While this segment should continue to grow at 39% CAGR over the next three years given increased government focus to install computers in schools, value-accretion to Educomp from this segment would decline gradually. We expect ICT to move from 18% of revenue in FY09 to 14% in FY12. However, we believe that ICT is important from a tactical viewpoint as it allows Educomp to build relationship with the government in the education sector and also become a government-ally in its endeavor to provide quality education in the country. This would help Educomp to share its ideas with the government on education being a party to decision-making for the education sector to some extent.

Table 17: Educomp ICT performance and estimates

	FY07	FY08	FY09	FY10E	FY11E	FY12E
Revenue (Rs MM)	301	933	1,135	1,984	2,600	3,055
Revenue growth (%)	90	210	22	75	31	17
EBIT (Rs MM)	98	273	263	396	520	611
EBIT margin (%)	32	29	23	20	20	20

Source: Company reports, J.P. Morgan estimates.

What is ICT?

This segment primarily involves supply, installation and maintenance of IT hardware and software in government schools under a three-five year build-own-operate-transfer (BOOT) model. At the end of the contract, the ownership of infrastructure shifts to the school, while the state government has the option to renew the contract.

State governments typically float tenders for a certain number of schools and the project is jointly funded by the central and state governments. The central government funds this initiative under the Sarva Shiksha Abhiyaan (SSA) and ICT@Schools programs.

Market size and growth

So far state governments have awarded ICT contracts for ~40,000 schools over the past two-three years, with the expectation of awarding contracts of 100,000 schools in the 11th Five-Year Plan. We estimate the current market size of US$117 million going up to US$292/525 million by FY12E/FY15E. Educomp has a 30% market share currently, but we expect it to come down as the company focuses more on K-12 and Smart Class.

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Table 18: ICT business growth and Educomp's market share

	Current	FY12E	FY15E
Total number of schools contracted	40,000	100,000	180,000
CAGR		36%	22%
Revenue per school per year (Rs '000)	140	140	140
Market size (RsMM)	5,600	14,000	25,200
Market size (US$MM)	117	292	525
Market share of schools			
Educomp	12,012	22,292	36,000
NIIT	12,159		
Everonn	4,442		
Others	11,387		
Educomp's market share (schools)	30%	22%	20%
Educomp's revenue from ICT (RsMM)	1,135	3,055	5,040
Educomp's revenue from ICT (CAGR)		39%	18%

Source: J.P. Morgan estimates.

Key players

Educomp, Everonn, and NIIT are the key national players in this segment, in addition to several regional players. The ICT business contributed to ~18% of Educomp's consolidated revenue, making it the second-largest segment for the company.

Table 19: Key players in the ICT space

Cumulative number of schools	FY08	FY09
Educomp	6,004	12,012
Everonn	3,164	4,442
NIIT	7,881	12,159

Source: Company reports.

Financial model: Low margin and low RoCE make ICT less attractive

We believe there is little scope for innovation or product differentiation in this space. Moreover, state government awards contracts based on L1 bidding basis (lowest bidder wins) in addition to providing very detailed requirement specification, leading to little room for differentiation. As a result, margins are lower in the ICT business (~23% in FY09), compared to other segments and we expect the margin performance to remain muted in this segment. With high initial capex requirements, ROIC is also on the lower side. Further, there are high debtor days (150-200 days) due to the delay in receiving payments from the government.

Having said that, governments are beginning to move to T1-based bids (technical qualifications to be met), leading to some entry barrier for new players. However, the proportion of such bids is still on the lower side.

Professional development business

Educomp is also present in the teacher training business, running a two-week training program for teachers. Educomp is currently the largest teachers' trainer in India, having trained over 352,000 teachers during FY09 and over 1.4 million teachers over the past several years. However, business is small on an overall level, contributing ~5% to the company's total revenue during FY09.

While there is good potential for growth in this field given the paucity of teachers and increased focus on improving the quality of education, we believe this is unlikely to be a part of Educomp's key focus areas and expect growth rate to remain muted at ~8% CAGR for the next two-three years. With margins declining significantly in 1QFY10E (due to the reclassification of reporting segments), we expect margins in this business to remain stable at ~60%.

Table 20: Educomp's professional development (teacher training) performance and estimates

	FY07	FY08	FY09	FY10E	FY11E	FY12E
Revenue (RsMM)	175	256	287	278	316	341
Revenue growth (%)	43	46	12	-3	14	8
EBIT (RsMM)	105	156	179	71	79	85
EBIT margin (%)	60	61	62	26	25	25

Source: Company reports, J.P. Morgan estimates.

Teacher shortage

As per the Indian Ministry of Education, India has ~6.1 million teachers, resulting in an overall pupil-to-teacher ratio of 37:1 with the ratio close to 40:1 in the case of government schools and 28:1 in the case of private-unaided schools. We note that UNSECO indicates worldwide average pupil-to-teacher ratio to be close to 25:1 for primary and 18:1 for secondary education. We expect the focus to move to the quality of teaching, especially in public schools and as a result professional development business could gain increasing importance over the next 5-10 years.

Other ventures by Educomp: An attempt to cover the entire gamut

Pre-schools

Roots to Wings
Educomp runs its pre-schools segment (largely using the franchisee model) under the ‘Roots to Wings’ brand. Educomp has 193 franchisees signed, generating revenue of Rs34 million for 4QFY09.

Euro Kids
Educomp had acquired a 50% stake in pre-school educator EuroKids International for $8.7 million (Rs390 million). Educomp has indicated that it would expand EuroKids’ present network of 450 (35 self-owned) pre-schools to 1,000. This JV contributed to Rs75 million in 4QFY09.

Higher education

JV with Raffles
Educomp formed two joint ventures with Raffles one each in India and China. The Indian JV is for professional education, while the China partnership is for K-12 business (still in evaluation stage). The 50:50 partnership will be rolled out over the next 1-2 years, with 2 institutes already operational.

Vocational training

JV with Pearson
Educomp’s JV with Pearson will support vocational learning in India. Pearson acquired a 50% stake in Educomp’s existing vocational training business for $17.5 million. The technology-based teaching products will be targeted to schools, e-learning initiatives, public-private partnerships with 14 state governments in India, as well as its nascent businesses in school management.

A-plus Education Solutions
Educomp had acquired 76% stake in A-Plus Education Solutions for Rs107.5 million. This venture focuses on skill enhancement of graduates to make them ‘workplace-ready’.

Enabling online content/learning

Learning.com (online content)
Educomp had acquired a 51% stake in the US-based e-learning company, Learning.com, for US$24.5 million. Learning.com has distribution access to over 800 districts and 2.5 million students across the US.

ASKnLearn
Educomp owns 51% of ASKnLearn, which provides internet-based e-learning solutions, content and services to over 180 institutions in Singapore, China, Thailand, the Philippines, Japan, Brunei, Vietnam and Kuwait.

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AuthorGen Technologies

Educomp holds 51% of AuthorGen Technologies, whose main product is WiZiQ. WiZiQ.com is an online facility that enables teachers and learners to collaborate through virtual classes, online tests and educational content. It had ~244,000 registered users by end-FY09.

MathGuru

Mathguru.com is an online portal with over 10,000 content modules covering NCERT books for grades 6-12 in mathematics. This resource is now available for free and is now part of the Smart Class online suite of products.

ThreeBrix

Educomp has a 76% stake in online tutoring service provider ThreeBrix E-Services. ThreeBrix owns online education portal (www.learninghour.com). The company claims to have gained early success in providing tutoring services in the Middle East and Dubai markets.

Savvica

Educomp holds 70% in Savvica, which is an educational technology company, which is into online teaching and learning.

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Financials

56% revenue CAGR and 50% EPS CAGR over FY09-11E

From its very small beginning with a revenue base of ~US$10 million in FY05, Educomp has achieved very strong growth over the past three-four years to ~$130 million in FY09, implying over 100% CAGR over FY05-09. This growth has been largely organic, driven by the Smart Class and ICT businesses.

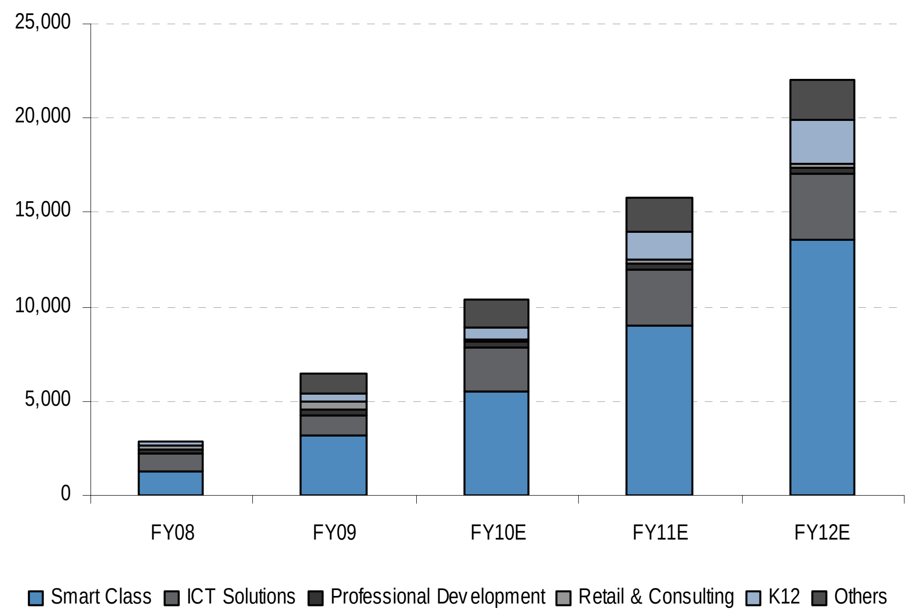
We expect Educomp to sustain strong growth over the next two-three years, led by continued momentum in the Smart Class segment, further augmented with its foray into the school business. Overall, we expect FY09-11E revenue CAGR of 56% with stable operating margin. However, we expect EPS CAGR to be slightly lower at 50% over FY09-11E, mainly due to higher interest payments on debt.

We note that the high capex outlay required for all the segments has led to debt or equity dilution (through FCCB and QIP) for funding the forays over the next 3-4 years. Hence, we note that the company's ability to fund its capex remains a concern despite the low net debt-to-equity ratio that it enjoys currently.

Revenue CAGR of 56% over FY09-11E

Smart Class and K-12 initiatives will be the biggest revenue drivers for Educomp in the coming two-three years, in our view. We expect Smart Class to grow at 68% CAGR and K-12 schools initiative to grow at 100% CAGR over FY09-11E. As a result, Smart Class will continue to contribute over 50% of Educomp's revenue, while the K-12 segment will increase to over 10% of revenue (from 6% currently), in our view.

Figure 14: Educomp—Revenues and growth



Source: Company reports, J.P. Morgan estimates.

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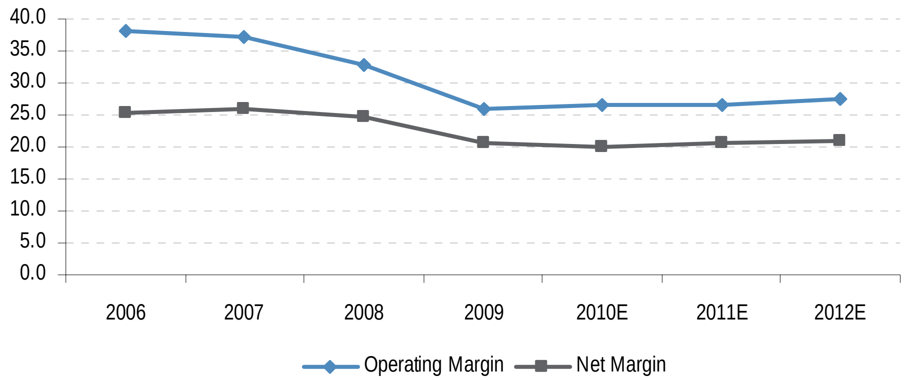
We expect margins to remain stable

Educomp's FY09 operating (EBIT) margins declined ~600bp Y/Y in FY09, mainly due to lower margins in the retail & consulting business where it converted the online MathGuru site to a free resource and incurred high advertisement costs on pre-school venture. We expect margins to stabilize over the next two-three years as moderating margins in the Smart Class segment is offset by higher margins in the K-12 and retail initiatives.

Figure 15: EBIT and net margins



Source: Company reports, J.P. Morgan estimates.

Table 21: Educomp—Consolidated P&L account

Rs in millions, year-end March

	FY09				FY10E										
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE	FY06	FY07	FY08	FY09	FY10E	FY11E	FY12E
Revenue	860	1,430	1,896	2,264	1,938	2,285	2,739	3,165	555	1,101	2,861	6,450	10,127	15,595	21,796
EBIT	242	384	479	569	579	564	703	888	211	411	942	1,674	2,733	4,300	6,232
EBITDA	382	551	687	853	861	888	1,071	1,313	268	507	1,273	2,473	4,133	6,572	9,451
Pre tax profit	255	422	470	883	529	650	905	1,060	220	454	1,064	2,030	3,143	5,035	7,129
Net profit	166	288	318	554	342	429	597	699	141	287	706	1,326	2,066	3,322	4,703
EPS (Rs)	9.6	16.7	18.4	32.1	19.8	23.1	31.6	37.1	8.8	17.9	40.9	76.9	111.7	176.1	249.3
Diluted EPS (Rs)	8.9	15.5	17.1	29.9	18.4	21.2	29.6	34.7	8.7	17.7	38.0	71.4	103.9	164.7	233.2
Margins (%)															
Operating margin	28.1	26.9	25.3	25.1	29.9	24.7	25.7	28.0	38.0	37.3	32.9	26.0	27.0	27.6	28.6
EBITDA margin	44.4	38.6	36.2	37.7	44.4	38.9	39.1	41.5	48.2	46.0	44.5	38.3	40.8	42.1	43.4
Net margin	19.2	20.1	16.8	24.5	17.6	18.8	21.8	22.1	25.3	26.1	24.7	20.5	20.4	21.3	21.6
Sequential growth (%)															
Revenue		66.2	32.6	19.4	-14.4	17.9	19.9	15.5	67.1	98.3	159.9	125.5	57.0	54.0	39.8
EBIT		58.7	24.7	18.8	1.8	-2.6	24.6	26.3	100.4	94.5	129.4	77.7	63.3	57.3	44.9
EBITDA		44.5	24.5	24.2	1.0	3.1	20.6	22.7	70.7	89.2	151.3	94.2	67.2	59.0	43.8
Net profit		74.0	10.4	74.2	-38.3	25.3	39.3	17.1	109.6	103.9	146.0	87.9	55.9	60.7	41.6
EPS		74.0	10.4	74.2	-38.3	16.7	36.7	17.1	110.3	102.8	128.0	87.9	45.3	57.7	41.6
F.D. EPS		74.0	10.4	74.2	-38.3	15.3	39.3	17.1	107.0	103.6	114.6	87.9	45.5	58.5	41.6

Source: Company reports, J.P. Morgan estimates.

Capital expenditure

Educomp has a capex intensive business—Smart class, ICT and K-12 segments require high initial investments. Smart Class and ICT operate on the BOOT model—where Educomp makes the initial investment for five years. The K-12 segment requires initial investment of Rs80-140 million per school and Educomp plans to expand its school business from 20 currently to ~100 schools in the next three years.

Educomp is trying to manage capex by going slower on ICT business (aiming for higher ROE) and trying to move the K-12 segment to asset-light ‘management-only’ business. Educomp spent ~Rs7.2 billion in FY09 and is projecting a capex of Rs4 billion in FY10.

Receivables, debt and net cash

Educomp has faced higher DSOs, primarily due to the ICT segment. ICT has DSO of over 170 days as it is a government schools business where the receivable days can range from 150-200 days. We believe that this nature of the business is unlikely to change and expect the DSO to remain high.

Educomp has net debt of Rs1.7 billion (gross debt of Rs9.3 billion including FCCB against cash of Rs7.56 billion after recent QIP). The current net debt/equity stands at 0.4x and net debt/EBITDA stands at 0.60x. As we expect a sharp ramp-up in Smart Class, segments would require higher capital requirement for Educomp. We expect net debt to increase to Rs8 billion by FY11, given the high capex requirement for all businesses. Interest coverage ratio stands at 4x, which is comfortable at current levels and expected EBIT growth rate of 51% over FY10-12 would provide further cushion on interest coverage.

While the high growth rate would support more debt, we believe increasing leverage does expose the company to go in for further equity dilution. The company is also looking to securitize its receivables to reduce debt burden.

Table 22: Educomp—Balance sheet

Rs in millions, year-end march

Balance sheet	FY06A	FY07A	FY08A	FY09E	FY10E	FY11E	FY12E
Cash and cash equivalents	606	1,106	2,912	1,865	6,889	3,826	2,912
Accounts receivable	255	496	1,157	2,977	4,162	6,167	8,545
Inventories	18	33	18	50	69	103	142
Others	54	127	552	906	1,266	1,876	2,599
Current assets	932	1,762	4,639	5,798	12,386	11,972	14,199
LT investments	0	0	0	0	0	0	0
Net fixed assets	252	831	2,714	9,235	14,993	21,056	25,469
Others	22	239	318	768	768	768	768
Total assets	1,206	2,832	7,671	15,801	28,148	33,796	40,436
Liabilities							
Payables	76	185	517	1,392	1,826	2,691	3,563
Others	106	57	92	302	422	625	866
Total current liabilities	182	242	610	1,694	2,248	3,317	4,430
Long term debt	110	1,255	3,773	9,074	11,834	11,834	11,834
Other liabilities	16	59	210	0	0	0	0
Total liabilities	308	1,556	4,593	10,768	14,082	15,151	16,264
Shareholders' equity	895	1,148	2,884	4,245	12,323	15,601	20,260

Source: Company reports, J.P. Morgan estimates.

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Cash flow

Given its high growth pace driven by high initial investments, Educomp doesn't generate positive free cash flow. While the operating cash flow is positive, the high capex drives FCF negative. We expect Educomp to be FCF-negative till FY12.

Overall, we expect some improvement in the net cash position over the next two years, given the adoption of asset-light model for the K-12 segment

Table 23: Educomp—Cash flow statement

Rs in millions, year-end March

	FY06	FY07	FY08	FY09E	FY10E	FY11E	FY12E
Net income	141	287	706	1,326	2,066	3,322	4,703
Depr. & amortization	57	96	331	799	1,400	2,273	3,219
Change in working capital	-36	-270	-703	-1,121	-1,011	-1,580	-2,028
Other	0	125	72	594	955	1,302	868
Cash flow from operations	162	237	407	1,597	3,411	5,317	6,762
Capex	-163	-675	-2,214	-7,320	-7,158	-8,336	-7,632
Disposal/ (purchase)	-7	-217	-79	-450	0	0	0
Cash flow from investing	-169	-893	-2,293	-7,770	-7,158	-8,336	-7,632
Free cash flow	0	-438	-1,808	-5,723	-3,747	-3,019	-870
Equity raised/ (repaid)	115	0	95	86	6,153	86	-23
Debt raised/ (repaid)	64	1,146	2,518	5,301	2,760	0	0
Other	438	49	1,130	-210	-86	-86	23
Dividends paid	-27	-39	-51	-50	-55	-44	-44
Cash flow from financing	589	1,156	3,692	5,126	8,772	-44	-44
Net change in cash	582	500	1,806	-1,047	5,024	-3,063	-914
Beginning cash	23	606	1,106	2,912	1,865	6,889	3,826
Ending cash	605	1,106	2,912	1,865	6,889	3,826	2,912

Source: Company reports, J.P. Morgan estimates.

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Management profiles

Board of directors

Mr. Shantanu Prakash, 44 years, Chairman and MD
He is one of the founder members of Educomp Solutions Limited and has been responsible for the overall operations and growth since the company's inception in September 1994. Mr. Prakash is an alumnus from IIM, Ahmedabad.

Mr. Jagdish Prakash, 74 years, Director:
He has previously worked as Chief Material Manager with Steel Authority of India and has been a marketing and management consultant with various public sector undertakings and academic institutions. Mr. Prakash holds a Master of Commerce degree from Agra University. Mr. Jagdish Prakash is Mr. Shantanu Prakash's father.

Mr. Gopal Jain, 38 years, Director:
Mr. Jain is the Managing Director of Gaja Capital Partners, a private equity firm. Mr. Jain holds a Bachelor of Technology degree from IIT Delhi.

Mr. Sankalp Srivastava, 44 years, Director:
Mr. Srivastava is the founder of Mark & Space, a company engaged in the design & manufacture of microprocessor-based telecom, power control & energy management systems. Mr. Srivastava holds a Bachelor of Electronics & Communication Engineering degree from University of Roorkee.

Mr. Shonu Chandra, 44 years, Director:
Mr. Chandra is Executive Producer and Director at Waves Communication Pvt. Ltd. Mr. Chandra holds a Master of Arts in Mass Communications degree from Mass Communication Research Centre (J.M.I.), and a Post Graduate Diploma (CYD) from Institute of Social Studies (The Hague, The Netherlands).

Executive management

Mr. Abhinav Dhar, President—K12 Initiatives—Mr. Dhar has vast experience in the domain of K□12 technology education in India and a deep understanding of the K□12 education market landscape.

Mr. Soumya Kanti, President—ICT Solutions—Mr. Kanti, an alumnus from IIM Ahmedabad, has over 14 years' experience in international & domestic markets in consulting & implementing IT solutions.

Mrs. Sangeeta Gulati, CFO—Mrs. Gulati holds a Master in Commerce degree and is a Chartered Accountant. She has over 14 years of experience in money market operations, raising funds, finance and accounting management.

Dr. Gaurav Bhatnagar, Senior VP—DIPS—Online Tutoring—Mr. Bhatnagar holds a Ph.D in Mathematics, MSc in Mathematics and BSc with Honors in Mathematics. He has over 18 years of experience.

Mr. Harish Doraiswamy, President—Education Projects–Mr. Doraiswamy is an alumnus of IIT, Chennai & IIM, Kolkata. He has over 19 years of experience in companies such as HLL, Bank of America and GE Capital.

Mr. Sharad Aggarwal, President –Professional Education—Mr. Aggarwal holds a Post Graduate Diploma in Business Management degree from IIM, Ahmedabad, and a Bachelor of Technology degree from IIT Kanpur. He has over 21 years of experience in manufacturing and marketing and has had international exposure in automotive OEMs (original equipment manufacturers).

Dr. Bindu Rana, Director R&D—Dr. Rana holds a Ph.d in education. She has over 23 years of experience. She has worked with several NGOs. Her work on special education has been published in various journals.

Mr. Sharad Talwar, President –Vocational Education —Mr. Talwar is an alumnus from IIT, Kharagpur & IIM, Ahmedabad. He has diverse experience of over 21 years in companies such as Convergys, Dell, GE capital.

Mr. Sandeep Kumar, President –Edumatics Corporation—Mr. Kumar has an engineering degrees from IT – BHU, India and University of California at Santa Barbara and MBA from Cornell University. Previously, he has worked as material scientist.

Rakesh Sood, Business Head of Asia Pacific—Mr. Sood has over 22 years of experience in companies including Philip Morris in the areas of managing P&L responsibility, business planning and development, marketing/distribution and regulatory affairs.

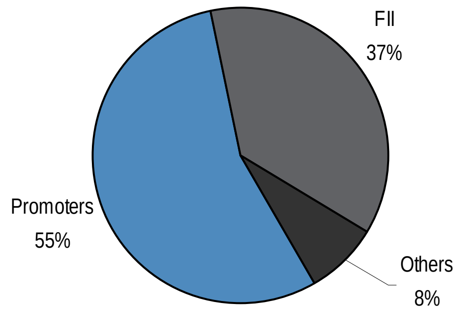
Table 24: Educomp—Timeline of events in company history

2009	Entered into vocational business Launched smartclassonline.com Raffles Millennium International Institutes in Delhi and Bangalore were launched
2008	Restructuring of subsidiaries EduInfra and EduManage into one entity - Educomp Infrastructure & School Management Services Ltd. Acquired 51% stake in learning.com Educomp forms a 50:50 joint venture with Raffles Education Corp. for professional education in India Acquired 76% stake in A-Plus Education Solutions Pvt Ltd Acquired 50% stake in Eurokids International
2007	Investment in EduInfra and EduManage to set up private schools Acquired Ask 'n' Learn, Three Bricks E-Services, Savvica Inc (70.5%) & AuthorGen Tech (51%) Raised $80MM via FCCBs
2006	Launched first pre-school in Delhi under the brand 'Roots to Wings' Raised $25MM via FCCBs Launch of Mathguru.com Public issue
2005	Launched online tutoring service SM1- highest credit rating from CRISIL
2004	ISO 9001:2001 certification for ICT solutions Signed US pilot with Santa Barbara School District Entered Asia Pacific market with pilots in Singapore Set up R&D division
2003	Launched Smart Class Content solution
2002	Established US subsidiary- Edumatics Corporation Launched Learning Mate Nhance- Learning Content Management Platform
2000	Started India's first K12 content development center Conversion to Public Ltd. Company
1995	Incorporation

Source: Company reports.

Shareholding pattern

Figure 16: Educomp shareholding pattern



Source: BSE.

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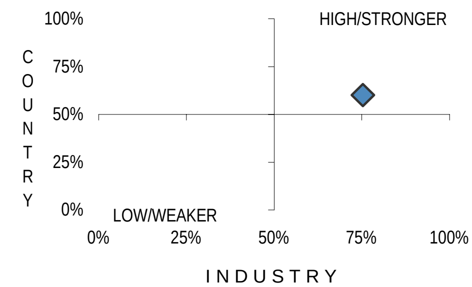
All Data As Of 01-Sep-09

Q-Snapshot: Educomp Solutions Ltd.

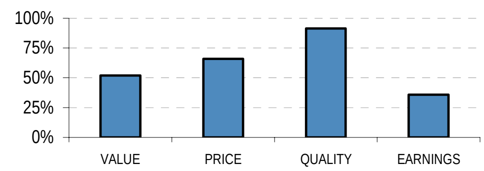
Quant Return Drivers (a Score >50% indicates company ranks 'above average')

Score 0% (worst) to 100% (best)	vs Country	vs Industry	Raw Value
Value			
P/E Vs Market (12mth fwd EPS)	15%	10%	1.8x
P/E Vs Sector (12mth fwd EPS)	16%	24%	1.5x
EPS Growth (forecast)	96%	98%	50.0%
Value Score	52%	57%	
Price Momentum			
12 Month Price Momentum	57%	80%	17.1%
1 Month Price Reversion	78%	77%	-2.0%
Momentum Score	66%	85%	
Quality			
Return On Equity (forecast)	95%	98%	38.3%
Earnings Risk (Variation in Consensus)	41%	28%	0.14
Quality Score	91%	95%	
Earnings & Sentiment			
Earnings Momentum 3mth (risk adjusted)	24%	47%	-8.1
1 Mth Change in Avg Recom.	21%	19%	-0.09
Net Revisions FY2 EPS	60%	58%	33%
Earnings & Sentiment Score	36%	40%	
COMPOSITE Q-SCORE* (0% To 100%)	60%	75%	

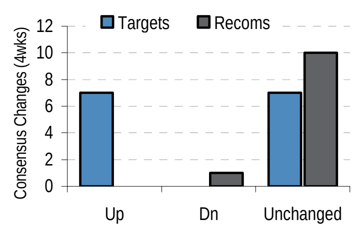
J.P. Morgan Composite Q-Score



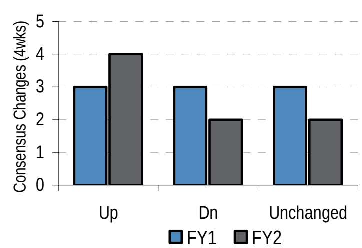
Quant Return Drivers Summary (vs Country)



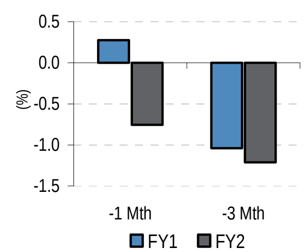
Targets & Recommendations**



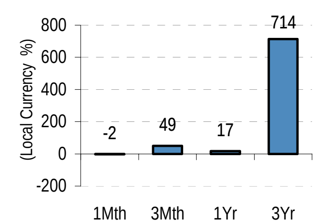
EPS Revisions**



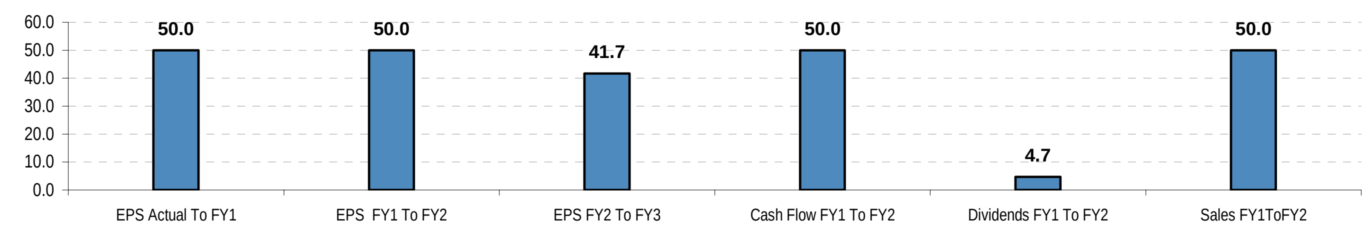
EPS Momentum (%)



Historical Total Return (%)



Consensus Growth Outlook (%)



Closest in Country by Size (Consensus. ADV = average daily value traded in US$m over the last 3 mths)

Code	Name	Industry	USD MCAP	ADV	PE FY1	Q-Score*
500830-IN	Colgate-Palmolive (India) Ltd.	Household/Personal Care	1,684	0.78	22.2	88%
511218-IN	Shriram Transport Finance Co. Ltd.	Finance/Rental/Leasing	1,536	0.75	10.4	67%
500086-IN	Exide Industries Ltd.	Auto Parts: OEM	1,529	0.73	17.6	85%
500116-IN	IDBI Bank Ltd.	Regional Banks	1,514	5.32	7.7	85%
512070-IN	United Phosphorus Ltd.	Chemicals: Agricultural	1,496	1.42	12.3	41%
532696-IN	**Educomp Solutions Ltd.**	**Miscellaneous Commercial Services**	**1,489**	**22.77**	**34.8**	**60%**
532947-IN	IRB Infrastructure Developers Ltd.	Engineering & Construction	1,449	3.43	21.5	20%
522275-IN	Areva T&D India Ltd.	Electrical Products	1,447	1.83	27.7	37%
500302-IN	Piramal Healthcare Ltd	Pharmaceuticals: Other	1,419	0.38	14.8	49%
532488-IN	Divi's Laboratories Ltd.	Pharmaceuticals: Other	1,400	0.70	22.7	3%
532708-IN	GVK Power & Infrastructure Ltd.	Electric Utilities	1,373	5.07	38.3	15%

Source: Factset, Thomson and J.P. Morgan Quantitative Research. For an explanation of the Q-Snapshot, please visit http://jpmorgan.hk.acrobat.com/qsnapshot/
Q-Snapshots are a product of J.P. Morgan's Global Quantitative Analysis team and provide quantitative metrics summarized in an overall company 'Q-Score.'
Q-Snapshots are based on consensus data and should not be considered as having a direct relationship with the J.P. Morgan analysts' recommendation.
* The Composite Q-Score is calculated by weighting and combining the 10 Quant return drivers shown. The higher the Q-Score the higher the one month expected return. On a 14 Year back-test the stocks with the highest Q-Scores have been shown (on average) to significantly outperform those stocks with the lowest Q-Scores in this universe. ** The number of up, down and unchanged target prices, recommendations or EPS forecasts that make up consensus.

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Educomp Solutions Ltd: Summary of financials

Rs in millions, year-end March

Income statement	FY08A	FY09A	FY10E	FY11E	FY12E
Revenues	2,861	6,450	10,127	15,595	21,796
Cost of Goods Sold	1,919	4,776	7,394	11,295	15,564
Operating Profit (EBIT)	942	1,674	2,733	4,300	6,232
EBITDA	1273	2473	4133	6572	9451
Other Income	121.9	355.7	410.0	735.5	897.1
Earnings before tax	1,064	2,030	3,143	5,035	7,129
Tax	-351	-704	-1,077	-1,713	-2,426
Net Income (Reported)	706	1326	2066	3322	4703
Rs					
EPS (Reported)	40.9	76.9	111.7	176.1	249.3
EPS (diluted)	38.0	71.4	103.9	164.7	233.2
BPS	167.2	246.1	653.2	826.9	1,073.8
DPS	2.5	2.5	2.5	2.0	2.0
Shares Outstanding (mn)	16.8	17.2	18.4	18.9	18.9

Ratio analysis %, year-end March	FY08A	FY09A	FY10E	FY11E	FY12E
EBITDA margin	44.5	38.3	40.8	42.1	43.4
Operating Margin	32.9	26.0	27.0	27.6	28.6
Net Margin	24.7	20.5	20.4	21.3	21.6
Sales growth	159.9	125.5	57.0	54.0	39.8
Operating Profit Growth	129.4	77.7	63.3	57.3	44.9
Net profit growth	146.0	87.9	55.9	60.7	41.6
EPS (Reported) growth	128.0	87.9	45.3	57.7	41.6
Net debt to total capital	12.9	54.1	20.5	29.2	27.8
Net debt to equity	29.9	169.8	40.1	51.3	44.0
Asset Turnover	37.3	40.8	36.0	46.1	53.9
ROE	35.0	37.2	24.9	23.8	26.2
ROIC	21.0	12.6	10.9	11.8	13.0
ROCE	13.1	10.3	9.0	10.1	12.4

Balance sheet	FY08A	FY09A	FY10E	FY11E	FY12E
Cash and cash equivalents	2,912	1,865	6,889	3,826	2,912
Accounts receivable	1,157	2,977	4,162	6,167	8,545
Inventories	18	50	69	103	142
Others	552	906	1,266	1,876	2,599
Current assets	4,639	5,798	12,386	11,972	14,199
LT investments	0	0	0	0	0
Net fixed assets	2,714	9,235	14,993	21,056	25,469
Others	318	768	768	768	768
Total assets	7,671	15,801	28,148	33,796	40,436
Liabilities					
Payables	517	1,392	1,826	2,691	3,563
Others	92	302	422	625	866
Total current liabilities	610	1,694	2,248	3,317	4,430
Long term debt	3,773	9,074	11,834	11,834	11,834
Other liabilities	210	0	0	0	0
Total liabilities	4,593	10,768	14,082	15,151	16,264
Shareholders' equity	2,884	4,245	12,323	15,601	20,260

Cash flow statement	FY08A	FY09A	FY10E	FY11E	FY12E
Net Income	706	1,326	2,066	3,322	4,703
Depr. & Amortisation	331	799	1,400	2,273	3,219
Change in working capital	-703	-1,121	-1,011	-1,580	-2,028
Other	72	594	955	1,302	868
Cash flow from operations	407	1,597	3,411	5,317	6,762
Capex	-2,214	-7,320	-7,158	-8,336	-7,632
Disposal/ (purchase)	-79	-450	0	0	0
Cash flow from investing	-2,293	-7,770	-7,158	-8,336	-7,632
Free cash flow	-1,808	-5,723	-3,747	-3,019	-870
Equity raised/ (repaid)	95	86	6,153	86	-23
Debt raised/ (repaid)	2,518	5,301	2,760	0	0
Other	1,130	-210	-86	-86	23
Dividends paid	-51	-50	-55	-44	-44
Cash flow from financing	3,692	5,126	8,772	-44	-44
Net change in cash	1,806	-1,047	5,024	-3,063	-914
Beginning cash	1,106	2,912	1,865	6,889	3,826
Ending cash	2,912	1,865	6,889	3,826	2,912

Source: Company reports, J.P. Morgan estimates.

Other Companies Recommended in This Report (all prices in this report as of market close on 02 September 2009)
Educomp Solutions Ltd (EDSO.BO/Rs4,070.10/Overweight)

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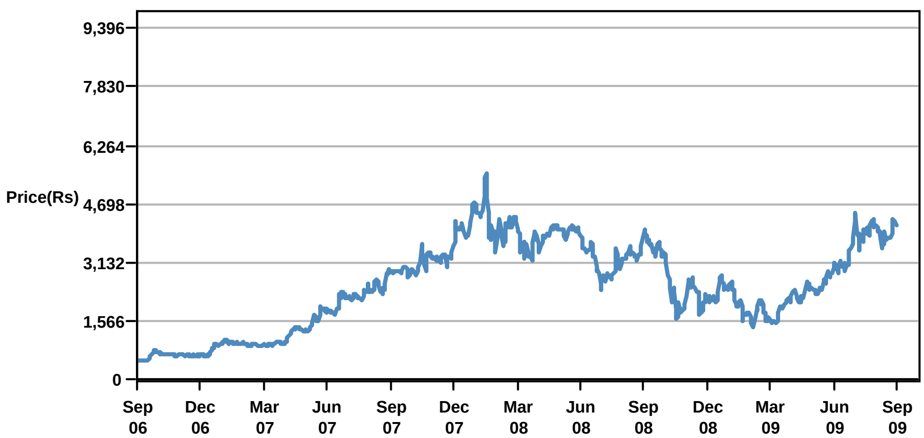
Educomp Solutions Ltd (EDSO.BO) Price Chart



Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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