

# EDUCOMP SOLUTIONS



## Disappointing results

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Educomp's QFY11 PAT, at INR 365 mn (up 7% Y-o-Y; down 40% Q-o-Q), was ~12% below our and Street's estimates. The variance was account of lower-than-expected EBITDA margins that were negated by below estimated tax rates.

### EBITDA margins down Q-o-Q

Consolidated EBITDA margins declined 1700bps Q-o-Q, to 30%. The company has attributed this dip to 'work in progress' installations for Smartclass, for which expenses were incurred, but revenue were not recognised. The management stated that this impacted ~1,000 classrooms (~15% of the total classrooms implemented in Q1FY11). Staff costs declined Q-o-Q, despite an incremental hiring of 160 personnel. This was on account of lower headcount in the ICT segment where certain projects expired.

### Debtor days rise despite securitisation

Despite Educomp's securitisation program, debtor days increased from 154 days to 183. The company indicated that this increase was on account of schools that had been transferred to Edusmart but were not securitised. During the quarter, net debt increased by ~INR 2.7 bn. With Smartclass requiring little capex under the securitisation model, this increase in net debt is seems to suggest high levels of capex/capitalisation.

### Number of school additions a bright spot

The company added 844 schools (up 4x Y-o-Y; 68% Q-o-Q), with 6,750 classroom additions, including ~2,000 schools that had been signed in Q4FY10 but were implemented this quarter. Average realisations per classroom were flat Q-o-Q. Management expects to add 25,000-30,000 classrooms in FY11.

### Outlook and valuations: Awaiting the annual report; 'HOLD'

The management maintained its full year topline and bottomline guidance of INR 13bn and INR 3.3bn, respectively. While the current quarter was disappointing, we maintain our EPS of INR34 and INR43 for FY11E and FY12E, respectively. Given recent changes in the business model, Educomp's annual report assumes a high degree of importance, particularly w.r.t to the Special Purpose Vehicle, Edusmart. The company is currently trading at 18x FY11 and 15x FY12E. We maintain 'HOLD' recommendation on the stock.

#### Financials

Year to March	Q111	Q110	% change	Q410	% change	FY10	FY11E
Net revenues (INR mn)	2,279	1,937	17.6	3,331	(31.6)	10,405	13,831
EBITDA (INR mn)	693	856	(19.1)	1,590	(56.4)	4,763	6,628
Net profit (INR mn)	365	341	6.9	608	(39.6)	2,713	3,279
Diluted EPS (INR)	3.9	4.1	(5.5)	6.4	(39.9)	28.4	34.3
Diluted P/E (x)						21.9	18.1
EV/EBITDA (x)						12.3	8.8
ROAE (%)						31.7	22.6

August 11, 2010

Reuters : EDSO.BO      Bloomberg : EDSL IN

#### EDELWEISS RATING

Absolute Rating      HOLD

#### MARKET DATA

CMP	:	INR 620
52-week range (INR)	:	1,017 / 442
Share in issue (mn)	:	94.9
M cap (INR bn/USD mn)	:	58.8 / 1,241.3
Avg. Daily Vol. BSE/NSE ('000)	:	2,590.2

#### SHARE HOLDING PATTERN (%)

Promoters*	:	49.8
MFs, FIs & Banks	:	1.6
FIIIs	:	36.9
Others	:	11.7
* Promoters pledged shares (% of share in issue)	:	Nil

#### RELATIVE PERFORMANCE (%)

	Sensex	Stock	Stock over Sensex
1 month	4.4	19.5	15.0
3 months	6.6	9.3	2.7
12 months	14.5	(3.6)	(18.1)

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- Other highlights

Educomp aims to increase K12 schools to 69 by this year end from 43 currently. It has visibility on 73 schools.

It has purchased a strategic stake in Vidya Mandir classes for ~ INR 340 mn. Vidya Mandir Classes is an engineering test preparation company that is likely to have revenues of INR 200 mn and PAT of INR 60 mn in FY11.

The company's Raffles JV, Pearson JV and online subsidiaries made losses of INR 100 mn during the quarter. Subsidiaries are likely to report losses of INR 400 mn in FY11.

**Financial snapshot - (Consolidated)**
**(INR mn)**

Year to March	Q111	Q110	% change	Q410	% change	FY10	FY11E	FY12E
Revenues	2,279	1,937	17.6	3,331	(31.6)	10,405	13,831	16,981
Cost of goods sold	662	421	57.3	466	42.1	1,621	2,092	2,460
Staff costs	515	352	46.4	532	(3.2)	1,793	2,404	3,015
Other expenses	409	309	32.6	744	(45.0)	2,228	2,707	3,345
Total expenditure	1,586	1,081	46.7	1,741	(8.9)	5,642	7,203	8,820
EBITDA	693	856	(19.1)	1,590	(56.4)	4,763	6,628	8,161
Interest	161	102	58.1	128	25.5	489	512	535
Depreciation	198	293	(32.4)	201	(1.5)	1,138	1,363	1,551
Other income	71	116	(38.8)	101	(29.7)	1,262	591	591
PBT	405	578	(30.0)	1,362	(70.3)	4,399	5,344	6,666
Tax	39	225	(82.7)	755	(94.8)	1,625	1,817	2,266
Adjusted net profit	366	353	3.7	606	(39.7)	2,773	3,527	4,400
Extraordinary items	0	0	0.0	2	NM	0	0	0
Net profit	366	353	3.7	608	(39.9)	2,773	3,527	4,400
Minority Interest	1	11	(91.7)	5	(2132.6)	60	249	320
Profit after minority interest	365	341	6.9	604	(39.6)	2,713	3,279	4,079

**as % of net revenues**

Raw material	29.0	21.7		14.0		15.6	15.1	14.5
Staff expenses	22.6	18.1		16.0		17.2	17.4	17.8
Other expenses	18.0	15.9		22.3		21.4	19.6	19.7
EBITDA	30.4	44.2		47.7		45.8	47.9	48.1
Net profit	16.1	18.2		18.3		26.7	25.5	25.9

### ■ Company Description

Incorporated in 1994, Educomp is one of India's leading providers of technology-enabled education solutions and services for the K-12 (Kindergarten to Class 12) segment. It has products targeting both schools and students. The company's product portfolio includes pre schools, K-12 schools. animated course content for the K-12 segment to aid teachers in instruction, computer literacy programmes and professional development courses, Higher education courses, vocational courses, and retailing of educational products

### ■ Investment Theme

Educomp Solutions has steadily moved up the value chain-from an ICT provider to one of the largest school chains in the country. The company has proved its execution skills and is well placed to take advantage of the new opportunities in the education sector. The ICT business gives it access to PPP projects envisaged for government schools, smartclass has helped it develop a differentiated pedagogy for its K-12 schools and proven execution in the K-12 lays the base for the company's future expansion into the vocational/ higher education space.

However, the past two quarters have seen a massive deterioration in the profitability of its core segment i.e. Smartclass. This is a key concern from the near to medium term perspective as the other businesses that can drive growth growing forward are still at nascent stages.

### ■ Key Risks

#### **Capital intensive nature of business**

Educomp's business is capital intensive due to upfront investments required in the K-12 segment or BOOT model for *smartclass*. The capex requirements are set to increase manifold, particularly if the company's plans in K-12 schools materialise.

#### **Regulatory concerns**

The school business, as per regulations, cannot be a profit making enterprise. Most companies have avoided regulatory hassles by creating subsidiaries that charge schools for infrastructure and services provided, while the schools themselves operate at breakeven. Many state governments have set up regulatory bodies to regulate fees charged by schools; any increase in fees will require such a body's prior approval.

#### **Pricing pressure may set in; renewal rates may decline**

Educomp has had a first mover advantage in *smartclass* and has been able to move quickly to establish itself in schools. Though margins are attractive in *smartclass*, with no strong barriers to entry we expect competition. Competition has already eroded margins significantly in ICT, forcing out a few players from the market. Further, contracts in *smartclass* are typically for five years and come up for renewal thereafter. If renewal rates are lower than expected, our thesis could be at risk.

## Financial Statements

<b>Income statement</b>					<b>(INR mn)</b>
Year to March	FY08	FY09	FY10	FY11E	FY12E
Income from operations	2,861	6,371	10,405	13,831	16,981
Total operating expenses	1,587	3,326	5,642	7,203	8,820
Cost of goods sold	798	1,110	1,621	2,092	2,460
Employee cost	488	1,155	1,793	2,404	3,015
Other expenses	302	1,061	2,228	2,707	3,345
EBITDA	1,273	3,044	4,763	6,628	8,161
Depreciation and amortisation	339	814	1,138	1,363	1,551
EBIT	934	2,230	3,625	5,265	6,610
Interest	48	268	489	512	535
Total other income	178	147	1,262	591	591
Profit before tax	1,064	2,109	4,399	5,344	6,666
Provision for tax	351	773	1,625	1,817	2,266
Core profit	713	1,336	2,773	3,527	4,400
Profit after tax	713	1,403	2,773	3,527	4,400
Minority Interest	7	74	60	249	320
Profit after minority interest	705	1,328	2,713	3,279	4,079
Shares outstanding (mn)	86	86	95	95	95
EPS (INR) basic	8.2	15.4	28.7	34.7	43.2
Diluted shares (mn)	87	88	96	96	96
EPS (INR) diluted	8.1	15.2	28.4	34.3	42.7
Dividend per share (INR)	2.5	3.1	3.0	3.0	3.0
Dividend payout (%)	31.0	20.3	10.6	8.8	7.0

**Common size metrics- as % of net revenues**

Year to March	FY08	FY09	FY10	FY11E	FY12E
Operating expenses	55.5	52.2	54.2	52.1	51.9
Material cost	27.9	17.4	15.6	15.1	14.5
Employee cost	17.1	18.1	17.2	17.4	17.8
Other expenses	10.6	16.7	21.4	19.6	19.7
Depreciation and amortisation	11.8	12.8	10.9	9.9	9.1
Interest expenditure	1.7	4.2	4.7	3.7	3.2
EBITDA margins	44.5	47.8	45.8	47.9	48.1
Net profit margins	24.9	21.0	26.7	25.5	25.9

**Growth metrics (%)**

Year to March	FY08	FY09	FY10	FY11E	FY12E
Revenues	159.9	122.7	63.3	32.9	22.8
EBITDA growth	151.3	139.1	56.5	39.2	23.1
PBT	134.2	98.2	108.6	21.5	24.7
Core net profit	150.3	87.4	107.6	27.2	24.7
EPS	124.3	87.9	86.9	20.8	24.4

<b>Balance sheet</b>					
	(INR mn)				
As on 31st March	FY08	FY09	FY10	FY11E	FY12E
Equity capital	172	173	189	189	189
Pref. capital	-	-	-	1	1
Reserves & surplus	2,712	4,030	12,730	15,944	19,960
Shareholders funds	2,884	4,203	12,919	16,134	20,150
Minority interest	194	804	864	1,113	1,433
Secured loans	622	4,689	4,889	4,889	4,889
Unsecured loans	3,151	4,206	4,200	4,200	4,200
Borrowings	3,773	8,895	9,089	9,089	9,089
Deferred tax (Net)	210	439	439	439	439
<b>Sources of funds</b>	<b>7,061</b>	<b>14,342</b>	<b>23,311</b>	<b>26,775</b>	<b>31,111</b>
Gross block	2,890	6,499	10,277	13,603	16,895
Depreciation	548	1,335	2,473	3,836	5,386
Net block	2,342	5,164	7,804	9,768	11,509
Capital work in progress	372	2,962	1,908	1,885	1,885
Intangible assests	280	1,225	1,225	1,225	1,225
Investments	36	729	7,229	7,229	7,229
FCMITDA		346	346	346	346
Inventories	18	316	316	316	316
Sundry debtors	1,157	2,765	4,241	5,754	7,052
Cash and bank balances	2,911	1,901	1,692	1,855	3,382
Loans and advances	490	1,138	1,873	2,490	3,057
Other current assets	62	32	32	32	32
Total current assets	4,638	6,152	8,154	10,447	13,838
Sundry creditors and others	517	1,995	3,109	3,879	4,677
Provisions	92	256	259	259	259
Total current liabilities & provisions	610	2,251	3,368	4,138	4,936
Net current assets	4,029	3,903	4,787	6,310	8,904
Misc expenditure	1	13	13	13	13
<b>Uses of funds</b>	<b>7,061</b>	<b>14,342</b>	<b>23,311</b>	<b>26,775</b>	<b>31,111</b>
Book value per share (INR)	33	48	137	171	213
<b>Free cash flow</b>					
Year to March	FY08	FY09	FY10	FY11E	FY12E
Net profit	705	1,328	2,713	3,279	4,079
Depreciation	339	814	1,138	1,363	1,551
Deferred tax	151	278	-	-	-
Others	8	74	60	249	320
Gross cash flow	1,203	2,495	3,911	4,890	5,950
Less: Changes in working capital	705	884	1,093	1,360	1,067
Operating cash flow	498	1,612	2,818	3,530	4,883
Less: Capex	(2,348)	(7,055)	(2,724)	(3,303)	(3,292)
<b>Free cash flow</b>	<b>(1,850)</b>	<b>(5,444)</b>	<b>95</b>	<b>227</b>	<b>1,591</b>
<b>Cash flow metrics</b>					
Year to March	FY08	FY09	FY10	FY11E	FY12E
Operating cash flow	498	1,612	2,818	3,530	4,883
Investing cash flow	(2,282)	(7,748)	(9,224)	(3,303)	(3,292)
Financing cash flow	3,590	5,159	6,196	(64)	(64)
Net cash flow	1,806	(978)	(209)	163	1,527
Capex	(2,348)	(7,055)	(2,724)	(3,303)	(3,292)
Dividend paid	51	61	64	64	64
Share issuance/(Buyback)	991	98	6,067	-	-

## Ratios

Year to March	FY08	FY09	FY10	FY11E	FY12E
ROAE (%)	35.0	35.7	31.7	22.6	22.5
ROACE (%)	19.6	21.6	24.4	29.6	30.4
Inventory (days)	6	18	20	16	13
Debtors (days)	105	112	123	132	138
Payable (days)	81	138	165	177	177
Cash conversion cycle	31	(7)	(22)	(29)	(26)
Current ratio	7.6	2.7	2.4	2.5	2.8
Debt/EBITDA	3.0	2.9	1.9	1.4	1.1
Interest cover (x)	19.4	8.3	7.4	10.3	12.4
Fixed assets turnover (x)	1.9	1.7	1.6	1.6	1.6
Total asset turnover(x)	0.6	0.6	0.6	0.6	0.6
Equity turnover(x)	1.4	1.8	1.2	1.0	0.9
Debt/Equity (x)	1.3	2.1	0.7	0.6	0.5
Adjusted debt/Equity	1.3	2.1	0.7	0.6	0.5

## Du pont analysis

Year to March	FY08	FY09	FY10	FY11E	FY12E
NP margin (%)	24.7	19.8	26.1	23.7	24.0
Total assets turnover	0.6	0.6	0.6	0.6	0.6
Leverage multiplier	2.4	3.0	2.2	1.7	1.6
ROAE (%)	35.0	35.7	31.7	22.6	22.5

## Valuation parameters

Year to March	FY08	FY09	FY10	FY11E	FY12E
Diluted EPS (INR)	8.1	15.2	28.4	34.3	42.7
<i>Y-o-Y growth (%)</i>	<i>124.3</i>	<i>87.9</i>	<i>86.9</i>	<i>20.8</i>	<i>24.4</i>
CEPS (INR)	10.4	20.8	40.7	49.1	59.6
Diluted P/E (x)	76.8	40.8	21.9	18.1	14.5
Price/BV(x)	18.5	12.8	4.5	3.6	2.9
EV/Sales (x)	19.0	9.4	5.6	4.2	3.4
EV/EBITDA (x)	42.6	19.7	12.3	8.8	7.0

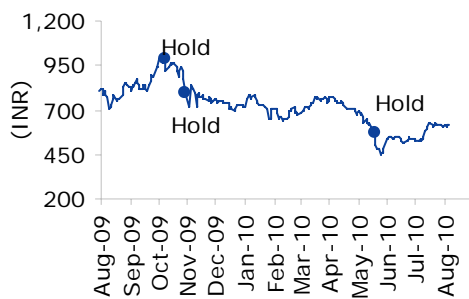
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**Coverage group(s) of stocks by primary analyst(s): Miscellaneous**

Bharat Electronics, Everonn Education and Escorts

**Educomp Solutions**



**Recent Research**

Date	Company	Title	Price (INR)	Recos
19-Jul-10	Escorts	Growth trajectory continues; <i>Result Update</i>	205	Buy
20-May-10	Everonn Education	Strong quarter; vitels drive growth; <i>Result Update</i>	373	Buy
18-May-10	Educomp Solutions	Headline numbers inline; <i>Result Update</i>	575	Hold
03-May-10	Bharat Electronics	Dissapointing quarter, but long term growth intact; <i>Result Update</i>	1,819	Buy

**Distribution of Ratings / Market Cap**

**Edelweiss Research Coverage Universe**

	Buy	Hold	Reduce	Total
Rating Distribution*	109	52	12	177

\* 4 stocks under review

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	108	54	15

**Rating Interpretation**

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

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