

## UBS Investment Research

### Educomp Solutions

## Proxy to the Indian education market

### ■ Educomp is a leader in India's fast growing education market

We believe Educomp Solutions (Educomp), a leading supplier of educational services in India, is an attractive investment in the country's private education sector. We estimate the sector's revenue will expand at a 15% CAGR in 2008-15 to US\$42bn, due to favourable demographics, rising income levels, and demand for superior alternatives to public education.

### ■ Market share gains in key segments to support industry-leading growth

We forecast Educomp to increase its revenue at a 25% CAGR in 2008-15, outpacing the market, by gaining market share and maintaining dominance in its key segment—multimedia course content for schools (with its smartclass brand). We also expect the company to increase its market share in the kindergarten-to-twelfth-grade (K-12) schools segment.

### ■ Move to asset-light model to help extend growth trajectory

Educomp has moved to an upfront licence-fee-based model for smartclass. We believe this will lower incremental capex, improve cash flow, and help the company sustain growth in the long term. We forecast a 20% EPS CAGR in FY10-12, and expect free cash flow to turn positive in FY12. We believe our estimates are conservative and leave room for potential upside.

### ■ Valuation: initiate coverage with a Buy rating and price target of Rs775.00

We derive our price target from a DCF-based methodology and explicitly forecast long-term valuation drivers using UBS's VCAM tool. We assume WACC of 13.3%, and our price target implies a terminal growth rate of 5%. We believe the current weakness in the share price reflects investor concern about slower growth in FY11-12, but does not adequately factor in the large growth potential.

Highlights (Rsm)	03/09	03/10	03/11E	03/12E	03/13E
Revenues	6,371	10,405	12,792	15,503	20,865
EBIT (UBS)	2,212	3,721	4,908	6,361	8,974
Net Income (UBS)	1,322	2,713	3,071	4,089	6,035
EPS (UBS, Rs)	15.21	29.33	32.34	43.06	63.55
Net DPS (UBS, Rs)	0.70	1.00	2.00	2.00	2.00
Profitability & Valuation	5-yr hist av.	03/10	03/11E	03/12E	03/13E
EBIT margin %	-	35.8	38.4	41.0	43.0
ROIC (EBIT) %	-	18.3	16.4	19.0	23.7
EV/EBITDA (core) x	-	14.4	8.9	7.1	5.3
PE (UBS) x	-	24.5	16.8	12.6	8.5
Net dividend yield %	-	0.1	0.4	0.4	0.4

Source: Company accounts, Thomson Reuters, UBS estimates. (UBS) valuations are stated before goodwill, exceptionals and other special items. Valuations: based on an average share price that year, (E): based on a share price of Rs541.95 on 08 Jun 2010 23:39 HKT

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## Global Equity Research

India

Consumer Services

12-month rating **Buy**  
Prior: *Not Rated*

12m price target Rs775.00/US\$16.54

Price Rs541.95/US\$11.57

RIC: EDSO.BO BBG: EDCB IB

9 June 2010

### Trading data (local/US\$)

52-wk range	Rs999.48-452.05/US\$21.13-9.48
Market cap.	Rs51.7bn/US\$1.10bn
Shares o/s	95.4m (ORD)
Free float	50%
Avg. daily volume ('000)	404
Avg. daily value (Rsm)	247.4

### Balance sheet data 03/11E

Shareholders' equity	Rs18.9bn
P/BV (UBS)	2.7x
Net Cash (debt)	(Rs13.1bn)

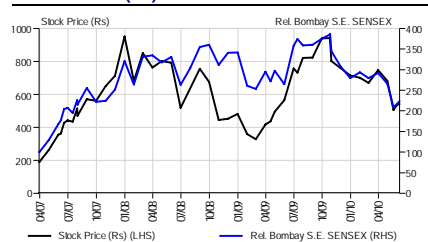
### Forecast returns

Forecast price appreciation	+43.0%
Forecast dividend yield	0.4%
Forecast stock return	+43.4%
Market return assumption	12.8%
Forecast excess return	+30.6%

### EPS (UBS, Rs)

	03/11E			03/10
	From	To	Cons.	Actual
Q1E	-	5.82	-	4.38
Q2E	-	7.11	-	13.18
Q3E	-	8.73	-	6.78
Q4E	-	10.67	-	6.38
03/11E	-	32.34	-	
03/12E	-	43.06	-	

### Performance (Rs)



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ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 32.

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## Investment Thesis

We initiate coverage of Educomp Solutions (Educomp) with a Buy rating and a 12-month price target of Rs775.00. Educomp is the leading provider of multimedia content in private schools, in terms of market share, under the *smartclass* brand name. It is also a leading education services provider to India's public education system. The company has a presence in the kindergarten to twelfth-grade (K-12) school and pre-school segments, with more than 40 schools operating under multiple brand names. It also has exposure to higher education, online tutoring and vocational training.

We expect private spending on education in India to grow to US\$45bn by 2015, propelled by favourable demographics, rising income levels, and demand for superior alternatives to public education. We believe Educomp is likely to benefit disproportionately from the increase in spending on private education by growing market share in its key segments—multimedia course content and K-12 schools.

Educomp has moved to an upfront license-fee-based sales model in *smartclass* (62% of revenue), and an increasingly franchisee-based model in K-12 schools. We believe this will lower the company's capex requirements and help it turn free cash flow positive by H2 FY11. We expect improving cash generation post FY11 to help fuel growth in the K-12 schools business (43% in FY10-12E) and that *smartclass* growth will remain steady at 20% over the same period.

We forecast a 20% earnings CAGR in FY10-12, driven by 22% sales growth, and a marked improvement in cash flow as the company begins to benefit from its recent transition to a less capital-intensive model. We forecast FY12-15 earnings growth of 35%, backed by sales growth of 28%, as the effects of the business model change in FY10-11 even out.

Educomp's share price has corrected more than 20% YTD following the announcement of lower-than-expected FY11 guidance. We believe the current price does not adequately factor in the improvement in balance sheet leverage and cash flow, which we believe will allow the company to invest for growth. We derive our price target of Rs775.00 from a DCF-based methodology and explicitly forecast long-term valuation drivers using UBS's VCAM tool. Our price target implies a one-year forward PE multiple of 23.5x, a discount of 33% to the three-year historical average, which we believe adequately reflects the slower expected growth momentum.

## Key catalysts

- **Biggest beneficiary of the fast growing education market.** We estimate private spending on education in India will grow to US\$45bn in 2015, representing a three-fold expansion in 2008-15. We expect this to be led by increasing spending on private schooling and higher education, as well as increased participation of private enterprise in government spending. We believe Educomp is best positioned to benefit from the strong growth in private education through its scalable offerings in K-12 (primary and secondary education), multimedia content and the government sector. We forecast revenue growth of 20% in the company's School Learning Solutions division (comprising *smartclass* and ICT—government schools) and 43% in K-12 schools in FY10-12, and earnings growth of 20% over the same period.

We expect Educomp to benefit disproportionately from the strong growth in India's education market

**Table 1: Educomp has the most comprehensive offering in Indian education**

Segment	Multimedia content	Pre-schools	Schools	Tutorials	Online education	Vocational training
Estimated market size (2015, US\$ bn)	2	1	20	5	0.5	15
Market participants	Educomp, NIIT, Everonn, Edurite	Educomp, Kangaroo Kids, KidZee, Shemrock, Apple Kids, Tree House	Delhi Public School, Educomp, GEMS, Career Launcher	Mahesh tutorials, Kalrashukla, Chate, Ramchandars, Educomp, Sinhal	Educomp, Compass Box, CBSE Tutor, EducoSoft, eShikshak,	Manipal, NIIT, Career Launcher, Educomp

Source: Company data, UBS estimates

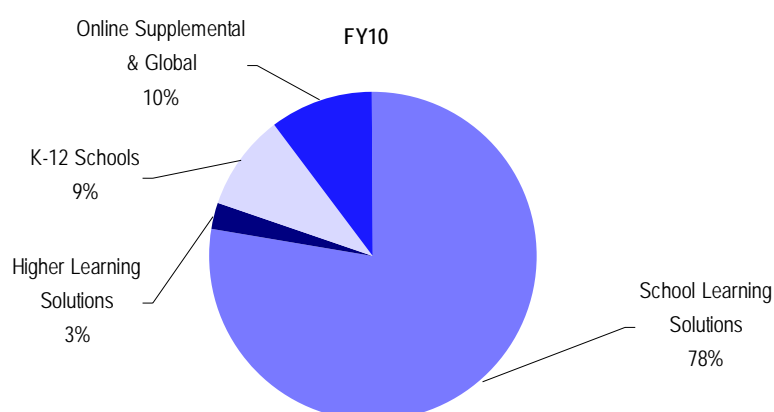
**Table 2: Educomp is set to increase market share in its key segments**

	2010E	2015E
<b>Multimedia content</b>		
Total private schools (number)	249,920	253,837
Assumed penetration (%)	3.00%	15.00%
Schools adopting multimedia content (number)	7,498	38,076
Classroom using multimedia content (number per school)	8	10
Total classrooms (number)	59,981	380,756
Revenue per classroom (Rs)	300,000	330,000
Educomp's market share (%)	44.09%	56.98%
<b>K-12 schools</b>		
Total private schools (number)	249,920	253,837
Educomp schools (number)	43	156
Educomp's market share (%)	0.02%	0.06%

We expect Educomp to increase its market share in fast growing segments within India's education sector

Source: National Council of Educational Research and Training (NCERT), Company data, UBS estimates

Chart 1: Educomp—revenue breakdown



Note: School Learning Solutions includes *smartclass* and ICT.

Source: Company data

■ **Move to asset light model to extend growth trajectory.** Educomp has moved to an upfront license-fee-based sales model in *smartclass* and to an increasingly franchisee-based model in K-12 schools. We expect capex requirements to ease due to the transition from a capex-intensive to capex-light model in both its key segments over the past one to two years. We expect the company to start turning free cash flow positive in H2 FY11 and believe strong cash generation post FY11 will help fuel growth in the K-12 schools business (43% over FY10-12). We expect growth in *smartclass* to remain steady at 20% over the same period. We forecast FY12-15 earnings growth of 35% backed by sales growth of 28% as a result of these efforts.

Educomp's new asset light model should help ease capex requirements and sustain longer term growth

Table 3: We expect lower capex and improved cash flow from FY11

	FY07	FY08	FY09	FY10E*	FY11E	FY12E
Free cash flow (Rs m)	-510	-1,719	-3,892	-5,252	-87	1,975
Capex/sales (%)	61%	78%	98%	46%	28%	24%

Note: \*Estimate as the company has not yet published the actual numbers

Source: Company data, UBS estimates

## Risks

We believe that the key risks for Educomp are:

- Company specific: 1) a lack of clarity on the ownership and functioning of EduSmart—the third party implementation partner for *smartclass*; 2) a slower-than-expected ramp up in *smartclass*; and 3) a lack of sufficient management personnel as the company embarks on a fast ramp up schedule.
- Industry specific: 1) changes in regulations in the K-12 segment, 2) long sales cycles that could derail growth expectations for government schools, and 3) a slowdown in economic growth affecting spending on education.

## Valuation and basis for our price target

**DCF based price target of Rs775.00.** We derive our price target from a DCF based methodology and explicitly forecast long-term valuation drivers using UBS's VCAM tool. We assume a WACC of 13.3%, based on beta of 1.18, a risk free rate of 7.8%, an equity risk premium of 5%, and a debt/equity ratio of 6.2%.

**Our price target implies PE of 25.0x FY11E and 18.8x FY12E.** Our price target implied PE is at a 33% discount to Educomp's three-year historical trading average, which we believe adequately factors in the growth maturity. Due to a lack of comparable listed entities, we compare Educomp's target PE with Indian and Asian peers, although we note that the business dynamics are very different in India than in other countries in the region.

Price target implied PE multiple of 25.0x/18.8x FY11/12E is at a 30% discount to 3-year trading average

## UBS versus consensus

Our earnings forecasts are lower than consensus estimates by 11%/5% in FY11/12, which we believe is because the consensus estimates are not very up to date. However, we are in line with the lower end of the company's guidance on earnings for FY11. We forecast a 20% earnings CAGR in FY10-12, and 35% earnings growth in FY12-15 as the effects of the business model change in FY10-11 even out.

Our estimates are in line with management guidance, but below consensus; we believe there is upside potential to our earnings estimates

We remain conservative in our forecasts given the recent change in business model, which we believe will depress earnings growth in the near term (due to the high base in FY10), but help sustain stronger medium-to-long-term growth. We believe this leaves room for potential upside to our estimates.

Table 4: UBS estimates versus consensus

(Rs m)	FY11E	FY12E
<b>Revenue</b>		
UBS	12,792	15,503
Consensus	14,181	17,315
Difference	-9.8%	-10.5%
<b>EBITDA</b>		
UBS	6,180	7,727
Consensus	6,800	8,203
Difference	-9.1%	-5.8%
<b>PAT</b>		
UBS	3,071	4,089
Consensus	3,445	4,297
Difference	-10.8%	-4.8%

Source: Bloomberg, UBS estimates

## Sensitivity analysis

We believe the key variables impacting Educomp's earnings are 1) the number of *smartclass* classrooms added, 2) fees per classroom charged for *smartclass*, 3) the number of students added per school in K-12, and 4) annual fees per student charged for K-12. Our earnings forecasts are most sensitive to changes in assumptions for *smartclass* (both classroom additions and fees) given the high revenue contribution from this segment (62% in FY11E).

**Table 5: Scenario analysis—limited share price downside potential from current levels**

	Worst case	Base case	Best case
Revenue—FY12E (Rs m)	12,176	15,503	18,225
Revenue CAGR FY10-12E (%)	17.0	22.1	32.3
EPS—FY12E (Rs)	36.7	43.1	53.4
EPS CAGR (FY10-12E) (%)	13.3	20.2	33.8
Price target (Rs)	475	800	1,100

Source: UBS estimates

Our scenario analysis indicates little stock downside potential from current levels

**Table 6: Sensitivity analysis to key forecast assumptions**

Changes to <i>smartclass</i> additions forecast (FY11)	-10%	-5%	0%	5%	10%
Impact on earnings forecast (FY11)	-5.2%	-2.5%	0.0%	2.8%	5.6%
Changes to <i>smartclass</i> fees (FY11)	-10%	-5%	0%	5%	10%
Impact on earnings forecast (FY11)	-6.2%	-3.1%	0.0%	3.4%	6.8%
Changes to number of students per school in K-12 (FY11)	-10%	-5%	0%	5%	10%
Impact on earnings forecast (FY11)	-1.2%	-0.6%	0.0%	0.9%	1.5%
Changes to K-12 school fees (FY11)	-10%	-5%	0%	5%	10%
Impact on earnings forecast (FY11)	-0.9%	-0.3%	0.0%	0.6%	1.2%

Source: UBS estimates

## Corporate governance

Educomp's corporate governance came under question in mid-2009 following a complaint filed to the Delhi police of falsification of accounts. Educomp has since appointed Grant Thornton as internal auditor and Haribhakti & Co. as joint statutory auditors, in addition to Anupam Bhansal & Co., to address the issue. The company has also expanded its board and added two non-executive independent directors to improve corporate governance standards. In June 2009, Educomp was assigned a credit rating of A for its long term and PR1 for its short term bank facilities by CARE (Credit Analysis & Research Ltd.). CARE is a credit rating agency with includes leading public sector banks in India such as State Bank of India, IDBI Bank and Canara Bank as key stakeholders.

# Risk analysis

## Industry risks

### Changes in regulations governing K-12 schools

Regulations stipulate that private schools in India should be governed by non-profit institutions. Most private education companies, including Educomp, act as service providers to a non-profit 'trust' which collects fees and pays its service providers. There is no regulation on school fees at present, but any imposed ceiling could impact the profitability of companies such as Educomp.

Regulatory changes could impact the education sector

### Long decision-making cycles in government projects

While government spending on education provides significant growth opportunities, decision-making cycles are long and could impact growth projections in this segment.

### Slowdown in economic growth

Any slowdown in the broader economy could affect spending levels on education, preventing companies from increasing school fees, and leading to lower spending on out-of-school instruction. This, in turn, could impact revenue growth and profitability for the sector.

## Company specific risks

### Lack of adequate clarity on EduSmart

We believe the business model for EduSmart, the implementation partner for Educomp's *smartclass* is not yet proven. Further, although EduSmart is a third-party entity, Educomp has guaranteed the funding for securitising the *smartclass* assets, and any collection issues at EduSmart might therefore flow back to Educomp.

The viability of EduSmart's business model is untested

### Slower-than-expected ramp up in *smartclass*

We have factored in steady growth in *smartclass* additions over the next few years on the basis that the market is underpenetrated and provides strong growth potential. A slower-than-expected ramp up in this segment would impact our revenue and profit assumptions.

### Management bandwidth

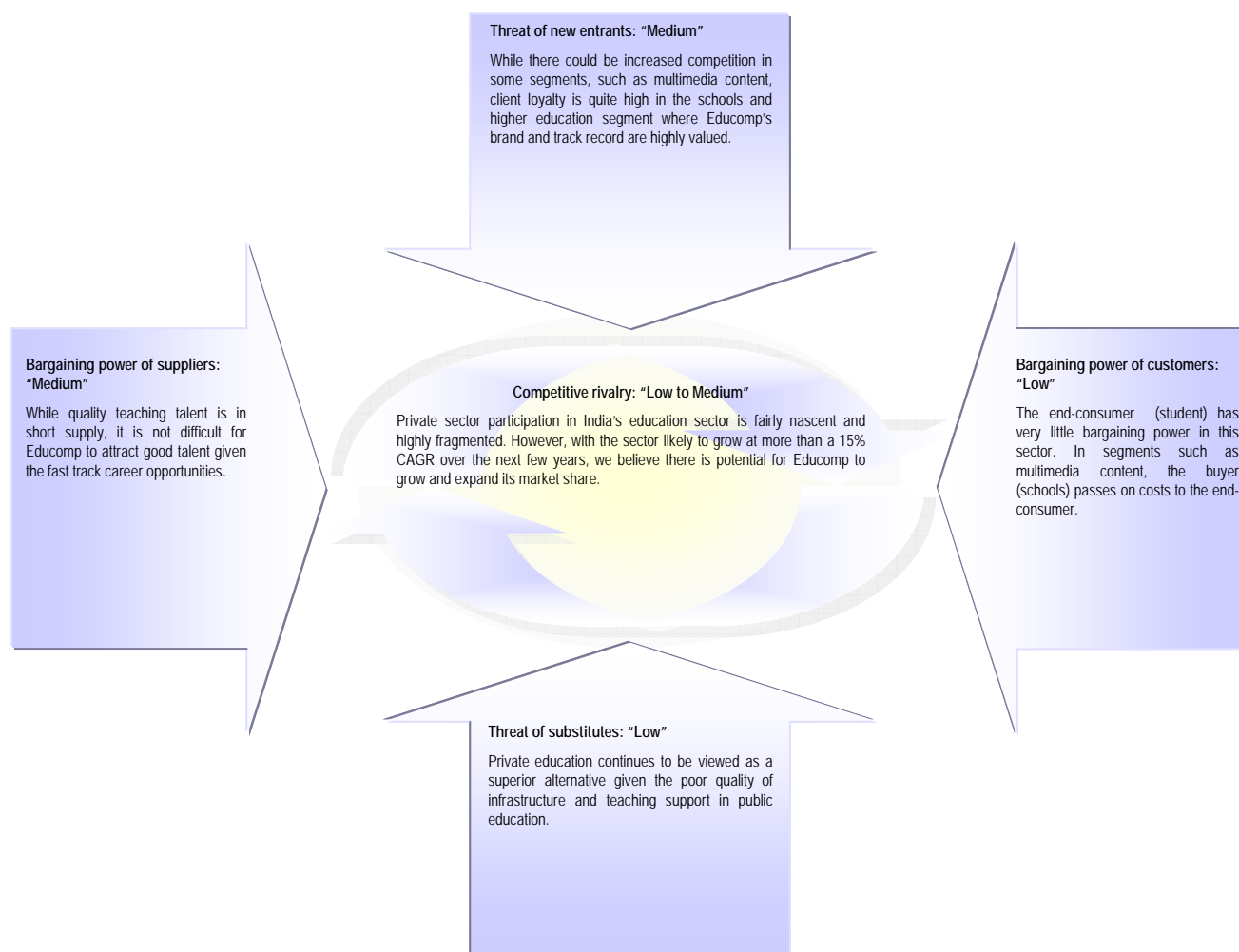
As the company embarks on a fast ramp up schedule, lack of sufficient management personnel might prove to be an obstacle. Educomp has recruited several business heads over the past 1-2 years to address this issue, although it remains to be seen how the organisation adapts to the fast growth in segments such as K-12 and higher education.



# Competitive analysis

## Assessment of industry attractiveness

Figure 1: Porter's analysis



Source: Michael Porter, UBS

## Competitive strengths

### First-mover advantage in multimedia content in schools

Educomp was an early entrant in the multimedia course content for schools space with its successful product *smartclass*. Educomp's private schools' portfolio grew more than 10 times in FY06-10, which we believe is evidence of *smartclass*'s increasing adoption in schools. Educomp, with a proven product and virtually no established competition, can focus on scaling up its market share with an aggressive sales strategy. The company has nearly doubled its *smartclass* sales force from 60 staff in FY07 to more than 220 at present. We believe this should help it stay ahead of its competitors, which are still at the early stages of market penetration.

**Educomp is the market leader in providing multimedia course content to schools**

Table 7: *smartclass* is the leader in multimedia content

Parameter	Educomp	NIIT	Everonn
Product name	<i>smartclass</i>	<i>e-Guru</i>	<i>iSchool</i>
Interactivity (1-Lowest, 5-Highest)	4	5	3
Model used	Content +Hardware (through 3rd party)	Mainly content	VSAT+ Hardware+Content
Syllabus covered	CBSE/ICSE	NA	CBSE/ICSE
Schools installed	3,294	1,532	1,017

Source: Company data, UBS estimates

## Track record in existing K-12 schools to help future expansion

Educomp entered the K-12 segment by setting up state-of-the-art schools in Chennai and Gurgaon. The company currently has 43 schools operating under various brand names (*Millennium*, *Takshila*, and *Vidya Prabhat*) and is on track to add another 23 schools in FY11 alone. We estimate that more than 20,000 additional urban schools will be required in India by 2015, and that more than 4,000 of these will be added by the private sector. We also believe schools can be very profitable, with a well managed school making a 50-60% EBIT margin on a steady state basis.

Educomp has successfully established its own brand name through its tie-ups with reputed local schools (such as PSBB and Don Bosco) across the country. We think Educomp can leverage its expertise from these tie-ups and expand rapidly in this segment. The lack of significant pan-India school chains (with the exception of missionary schools and Delhi Public Schools) offers an opportunity for Educomp to set up pan-Indian school chains. While others (such as Zee Education) have similar plans, we believe they lack Educomp's execution track record in this segment.

### Pre-school business to supplement the K-12 business

Educomp has a presence in the pre-schools segment under the *Roots to Wings* and *EuroKids* brands. We estimate that the pre-school market will grow from US\$300m in FY08 to almost US\$2bn by 2015 (a 29% CAGR). Educomp has more than 600 pre-schools operating under its brands across the country, and expects to rapidly expand its presence in the next few years. We expect the pre-school business to act as feeder into the K-12 business as well as leverage off the more successful K-12 schools for Educomp.

## Management strategy

### *smartclass* moved to an upfront licensing model

Educomp derived nearly 80% of revenue and all of its profits from *smartclass* in FY10 due to a change in business model to reflect an asset light strategy. As part of this strategy, the company has started to sell its content on an upfront basis to private schools, while EduSmart, a third party entity, will provide implementation and maintenance services. This approach is different from the build, own, operate, transfer (BOOT) model it adopted earlier, which required Educomp to invest Rs200,000 per classroom upfront and collect revenue on a quarterly basis.

Educomp's track record with existing schools is likely to help its future expansion

Educomp also has a large pre-school network

Educomp will now use a third-party implementation partner for *smartclass*, which will reduce capex requirements in this segment

Table 8: *smartclass*—new revenue model

Total contract value (Rs)	394,000	
Revenue accruing to EduSmart (Rs)	98,500	25% of contract value
Revenue accruing to Educomp - Year 1 (Rs)	206,850	30% of contract value for hardware + 22.5% for content
Revenue accruing to Educomp - Year 2 (Rs)	88,650	22.5% of contract value for content

Source: Company data

The change in business model resulted in the company's School Learning Solutions division (*smartclass* + ICT) contributing close to 80% of revenue and nearly all of the company's profit in FY10. This change should result in more subdued revenue growth in this segment in FY10-12 (20% compared with 100%-plus previously). However, we expect it to improve cash flow significantly and free up capex for other investments.

*Smartclass* contributed to 99% of pre-tax profit in FY10 due to the business model change

Table 9: *smartclass* contributes to bulk of revenue and profit

Business segment	FY09	FY10
Revenue contribution (%)		
School Learning Solutions	67.9	77.5
Higher Learning Solutions	4.8	2.7
K-12 Schools	9.8	9.4
Online Supplemental & Global	17.5	10.3
PBIT Contribution (%)		
School Learning Solutions	78.4	98.7
Higher Learning Solutions	3.5	(2.4)
K-12 Schools	11.4	7.3
Online Supplemental & Global	6.7	(3.7)

Source: Company data

### Improved cash flow to help drive investments in K-12

With the change to an asset-light model in *smartclass*, Educomp now expects to focus on driving faster growth in the K-12 segments, where growth has been slower than expected due to rising land/construction costs and a lack of capital. While the initial capex for schools owned by the company is high, at nearly US\$4m per school; operating margins can be as high as 50-55% once the school reaches steady state. The company has adopted a strategy comprising: 1) owned schools; 2) JVs with land owners; and 3) management contracts, in order to fast-track growth in this segment.

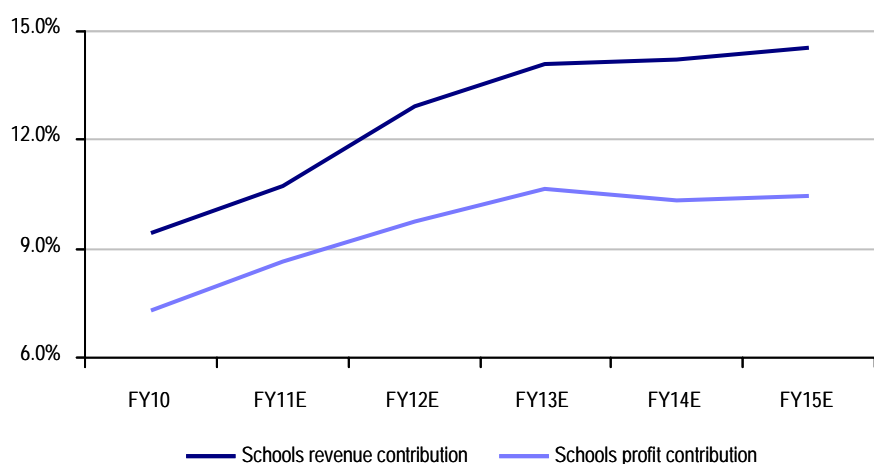
Table 10: Financials of a standalone school (fully owned)

Year	1	2	3	4	5	6	7	8	9	10	11	12
Grades	KG- 6th	KG- 8th	KG- 10th	KG- 12th	KG- 12th	KG- 12th	KG- 12th	KG- 12th	KG- 12th	KG- 12th	KG- 12th	KG- 12th
Students	392	792	1,144	1,560	1,768	1,768	1,768	1,768	1,768	1,768	1,768	1,768
Utilisation (%)	35.0%	55.0%	65.0%	75.0%	85.0%	85.0%	85.0%	85.0%	85.0%	85.0%	85.0%	85.0%
Tuition fees pm (Rs)	2,000	2,100	2,205	2,315	2,431	2,553	2,680	2,814	2,955	3,103	3,258	3,421
Admission fees pa (Rs)	15,000	15,750	16,538	17,364	18,233	19,144	20,101	21,107	22,162	23,270	24,433	25,655
Revenue from tuition fees-recurring (Rs m)	9.4	20.0	30.3	43.3	51.6	54.2	56.9	59.7	62.7	65.8	69.1	72.6
Revenue from admission fees-one time (Rs m)	5.9	6.3	5.8	7.2	3.8	3.4	3.6	3.7	3.9	4.1	4.3	4.5
Total revenue from tuition and admission fees (Rs m)	15.3	26.3	36.1	50.6	55.4	57.5	60.4	63.4	66.6	69.9	73.4	77.1
Ancillary revenue (Rs m)	3.6	7.4	10.8	15.0	17.2	17.4	17.7	18.0	18.2	18.5	18.8	19.1
Total revenue (Rs m)	18.9	33.6	46.9	65.5	72.6	75.0	78.1	81.4	84.9	88.5	92.3	96.2
Teacher salaries (Rs m)	2.3	4.7	7.1	10.5	10.9	11.4	11.8	12.3	12.8	13.3	13.9	14.4
% of revenue	12.0%	14.1%	15.2%	16.1%	15.1%	15.2%	15.2%	15.1%	15.1%	15.1%	15.0%	15.0%
Support staff salaries (Rs m)	0.3	0.7	1.0	1.4	1.5	1.5	1.6	1.6	1.6	1.7	1.7	1.8
% of revenue	1.7%	1.9%	2.1%	2.2%	2.0%	2.0%	2.0%	2.0%	1.9%	1.9%	1.9%	1.9%
Electricity charges (Rs m)	0.8	1.1	1.4	1.7	1.8	1.9	2.0	2.0	2.2	2.3	2.4	2.5
% of revenue	4.1%	3.1%	2.9%	2.6%	2.4%	2.5%	2.5%	2.5%	2.5%	2.6%	2.6%	2.6%
Ancillary costs (Rs m)	2.5	5.2	7.6	10.5	12.0	12.2	12.4	12.6	12.8	13.0	13.2	13.4
% of revenue	13.4%	15.4%	16.1%	16.0%	16.6%	16.3%	15.9%	15.5%	15.1%	14.7%	14.3%	13.9%
Other overheads (Rs m)	0.9	1.3	1.4	2.0	2.2	2.2	2.3	2.4	1.7	1.8	1.8	1.9
% of revenue	5.0%	4.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	2.0%	2.0%	2.0%	2.0%
Total operating costs (Rs m)	6.8	13.0	18.4	26.1	28.4	29.2	30.1	31.0	31.1	32.0	33.0	34.0
% of revenue	36.1%	38.6%	39.3%	39.8%	39.1%	39.0%	38.5%	38.1%	36.6%	36.2%	35.8%	35.3%
EBITDA (Rs m)	12.1	20.7	28.5	39.5	44.2	45.8	48.0	50.4	53.8	56.5	59.3	62.2
% of revenue	63.9%	61.4%	60.7%	60.2%	60.9%	61.0%	61.5%	61.9%	63.4%	63.8%	64.2%	64.7%
Depreciation (Rs m)	5.3	6.9	7.1	7.1	7.1	7.3	7.3	7.3	7.6	7.6	7.6	7.8
EBIT (Rs m)	6.8	13.8	21.4	32.4	37.1	38.5	40.7	43.1	46.2	48.9	51.7	54.4
% of revenue	36.0%	41.1%	45.6%	49.4%	51.1%	51.3%	52.1%	52.9%	54.5%	55.3%	56.1%	56.6%

Source: UBS estimates

We expect the revenue and profit contribution from the schools segment (K-12 and preschools) to increase sharply over the next five years, as a result of increased management focus to grow this business.

Chart 2: 12 revenue and profit contribution is set to increase



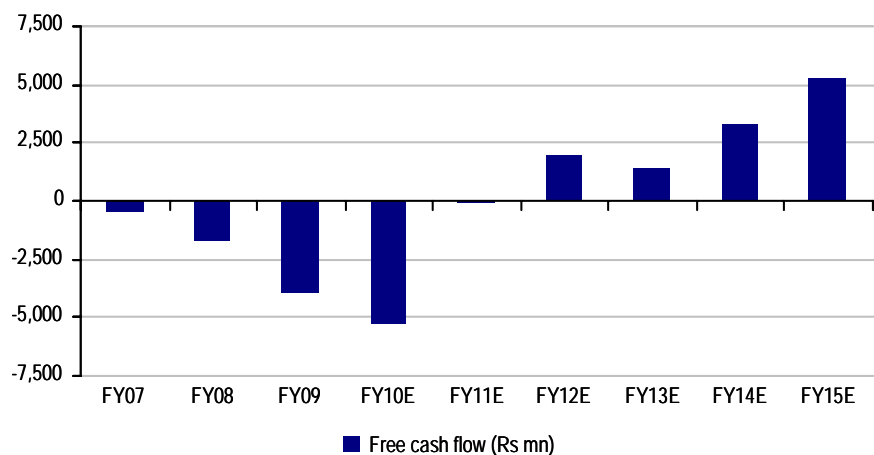
Source: Company data, UBS estimates

### Cash flow likely to turn positive by H2 FY11

Having turned cautious on investing in capex-heavy segments such as ICT, and moving to an asset-light model in both *smartclass* and K-12, Educomp management expects the company to turn free cash flow positive in FY11. While we expect full-year free cash flow to remain negative (negative Rs87m) in FY11, we believe Educomp should turn free cash flow positive in H2 FY11 and report positive cash flow in FY12.

Asset light model should help cash flow turn positive by H2 FY11

Chart 3: Educomp likely to turn free cash flow positive in FY12



Source: Company data, UBS estimates

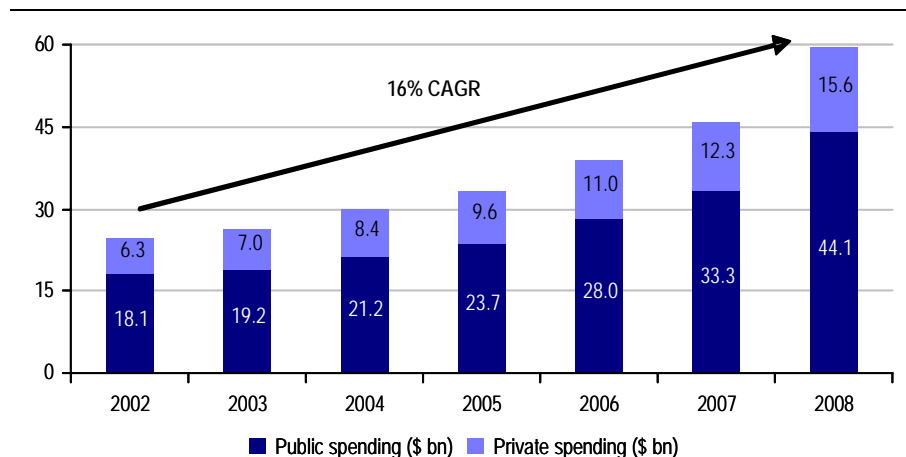
# Industry analysis

## Large market with ample opportunity for growth

We estimate that the private education sector in India will grow to a US\$42bn market, representing a three-fold growth CAGR in 2008-15. This is consistent with the growth forecasts by McKinsey Global Institute (in its report *The 'bird of gold': The rise of India's consumer market*, published May 2007) and Euromonitor. We expect the strong growth in the sector to be led by increasing spending on private schooling and higher education as well as the increased participation of private enterprises in government spending.

We estimate a 15% CAGR for the Indian education sector by 2015

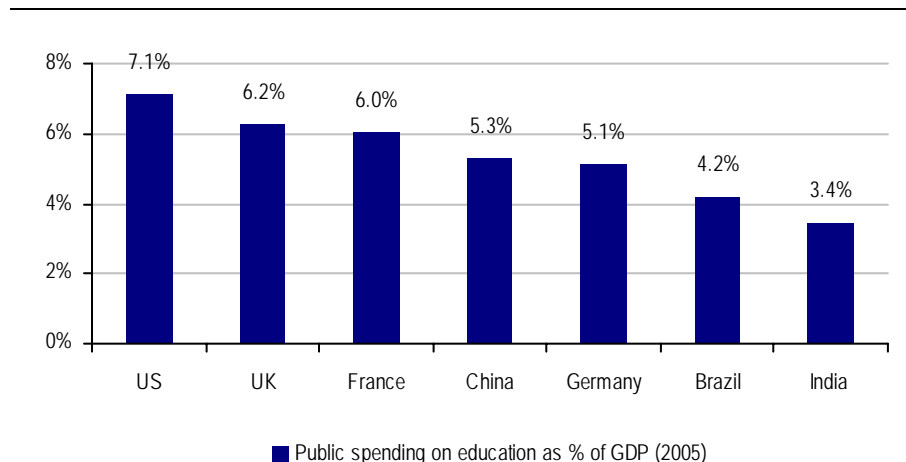
Chart 4: India is a US\$60bn market for education



Source: Centre for Monitoring Indian Economy (CMIE), Ministry of Human Resource Development

While India spends close to 5% of its GDP on education, literacy remain low at 62-63% of the adult population, compared to 90-95% in other emerging markets such as China and Brazil.

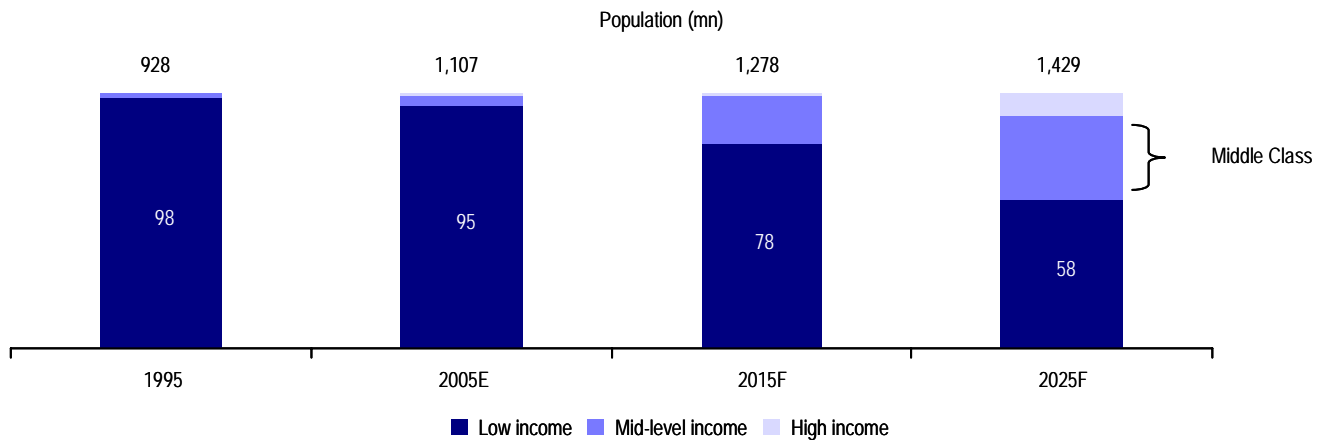
Chart 5: India has scope for increasing education spending



Source: UNESCO

## Booming middle class population to lead to increased private spending on education

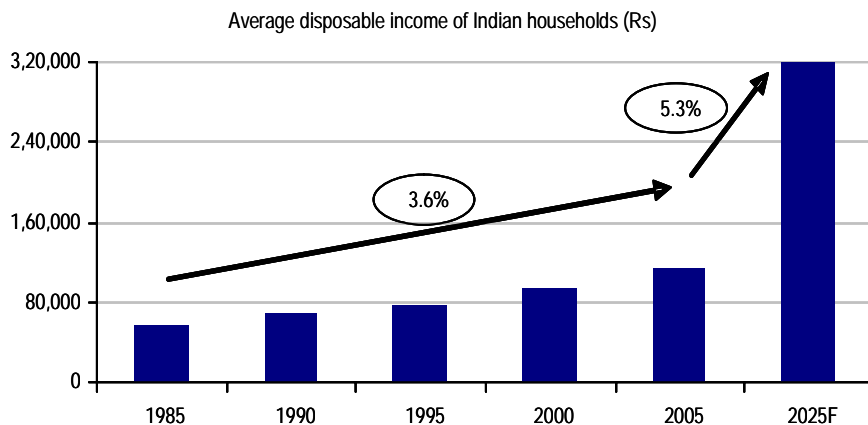
Chart 6: Income levels in India are expected to rise sharply over the next decade



Source: McKinsey Global Institute

According to McKinsey Global Institute (MGI) estimates, average real household disposable income in India will increase at a CAGR of 5.3% in 2005-25 to Rs318,896 (US\$7,000). This would be higher than the 3.6% annual growth rates previously, and result in a population with mid-level and high incomes of 614m by 2025, representing 43% of India's total population. This segment will also account for a significant proportion of spending on education at 89% by 2015, according to MGI, up from 58% in 2005.

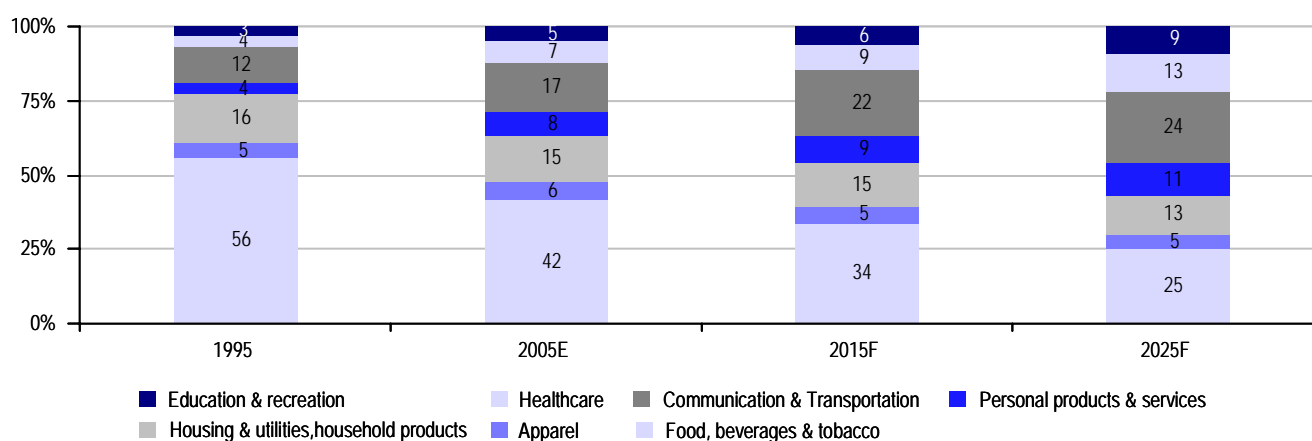
Chart 7: Income levels in India are set to rise



Source: McKinsey Global Institute

Rising income levels in India are conducive to greater spending on education

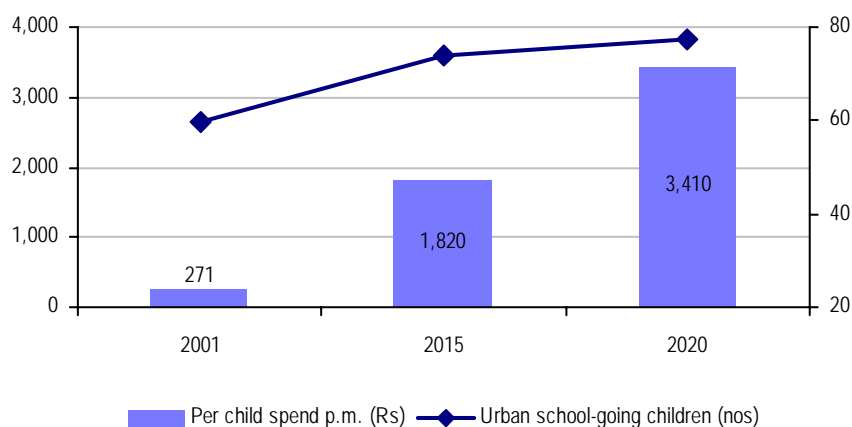
Households in India spend less than 5% of disposable income on education compared to 12% in the US, and 15% in China. However, household spending on education has grown rapidly, increasing at a CAGR of 16.3% in 2002-08 to US\$15.6bn. We expect this segment to grow at a faster pace in FY10-25, driven by favourable demographics and rising income levels.

**Chart 8: Private spending on education is expected to increase**

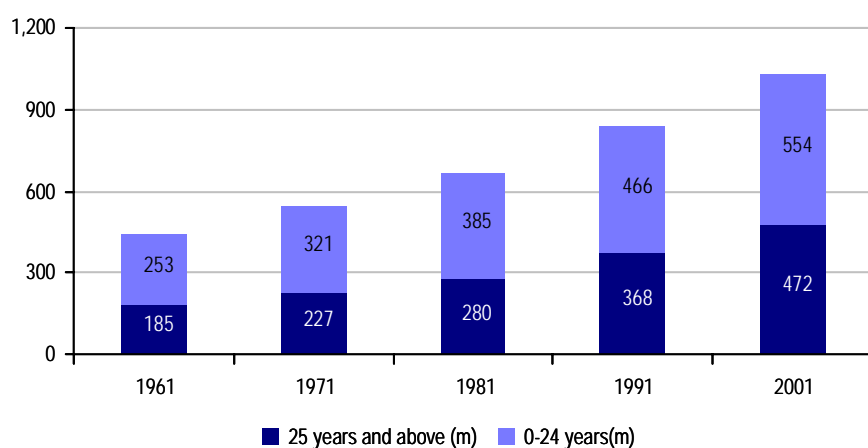
Source: McKinsey Global Institute

**Chart 9: Per capita spending on education is likely to increase sharply**

We forecast a sharp increase in per capita spending on education



Source: CMIE, UBS estimates

**Chart 10: Demographics are also conducive to greater spending on education**

Source: Census of India



## Demand for private schools set to increase

According to NCERT, in 2001 there were 78,290 schools in urban areas with an average enrolment of 660 students per school. Based on the government's population growth estimates, more than 14m children will join the education system by 2015 in urban areas alone. We estimate this will lead to demand for more than 20,000 schools over the next few years. We estimate that the private school segment in India is a US\$20bn market, which will expand at a 15% CAGR over the next 10 years.

We estimate demand for more than 20,000 new urban schools by 2015

Table 11: More than 20,000 urban new schools will be needed by 2015

	2001	2015
School-going urban children (m)	59.8	73.9
Urban schools	78,290	98,433
Additional urban schools required		20,143

Source: NCERT, UBS estimates

At least 4,000 new schools needed in the private sector

Table 12: Private schools make up 20% of total schools in India

	2009
Government schools	1,035,178
Private schools	249,920
Private as % of total	19.4%

Source: District Information System for Education (DISE)

At least 4,000 new schools are likely to be added in the private sector by 2015

We believe that the rapid growth in the middle income bracket population will fuel growth in private education. We believe the career aspirations of this segment of the Indian population will boost demand for private schools, as parents seek superior alternatives to the public education system. Currently, private schools make up about 20% of the total in the country, and we expect this proportion to increase over the next few years.

Table 13: Private schools—a US\$20bn potential market

	2015
Total private schools	249,920
Additions expected	3,917
Total private schools	253,837
Students per school	650
Fees per month (Rs)	500
Total revenue (US\$ m)	21,063

Source: NCERT, UBS estimates

Private schools—a US\$20bn potential market

## Content in private schools also provides growth potential

Multimedia-based course content has gained significant traction over the last few years as a means to increase the effectiveness of classroom curricula. We believe this segment is still in the early stages of adoption, with less than 3% of the market penetrated so far. As product awareness and income levels increase, we estimate a 25% CAGR in the market for such products in 2010-25.

Multimedia content in private schools is in the early stages of adoption

**Table 14: Multimedia content in schools offer strong growth opportunity**

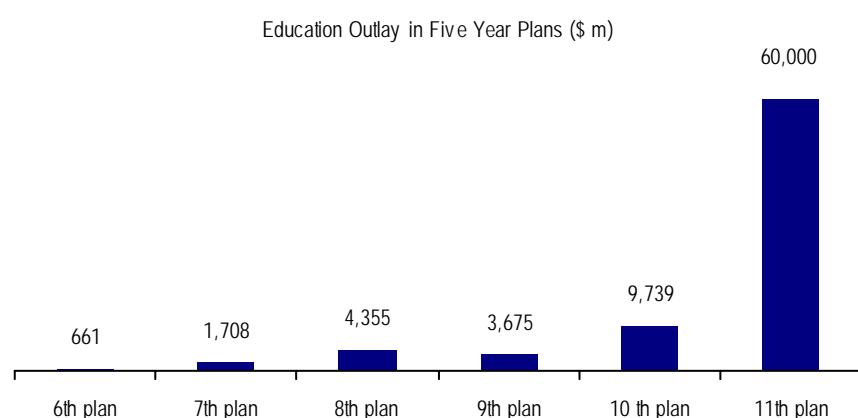
	2010E	2015E	2025E
Total number of private schools	249,920	253,837	257,713
Assumed penetration	3%	15%	30%
Schools adopting content	6,248	38,076	77,314
Classrooms using content (number per school)	5	8	10
Total number of classrooms	31,240	304,605	773,138
Revenue per classroom (Rs)	300,000	330,000	363,000
Total revenue (US\$ m)	208	2,234	6,237
Revenue CAGR (2010-25E)			25.4%

Source: DISE, Company data, UBS estimates

## Government increasingly engaging with private sector

Government spending on education is set to increase from 7.7% of gross budgetary support in the 10th [Five Year] Plan, to more than 19% in the 11th Plan. This translates to a five-fold rise in education outlay in the next five years. Under the 'ICT in Schools' programme, the government will support States/Union Territories in education funding in the ratio of 55:45 in FY11 and 50:50 thereafter (compared with 60:40 in FY10).

**Chart 11: Government spending on education is set to increase sharply**



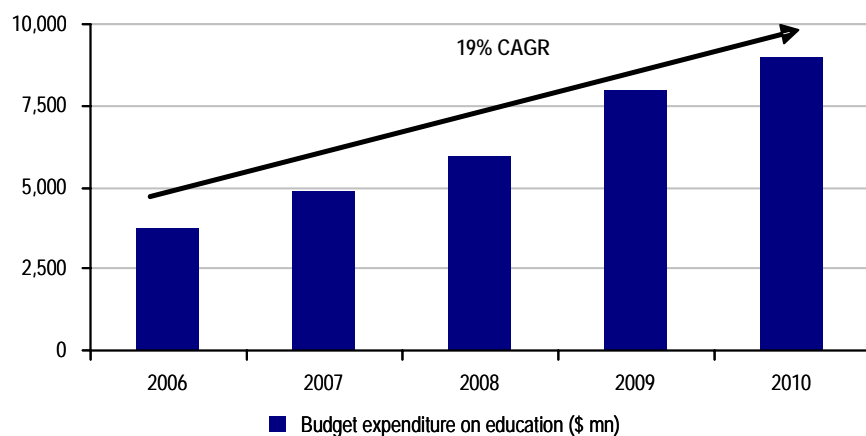
Source: Planning Commission of India

### PPP opportunity could expand the addressable market

Currently, most private education services companies provide largely IT-related services on a BOOT basis to the government under the 'ICT in Schools' scheme, which restricts their scope in government spending. Recently, India's government announced plans to set up over 2,500 model and 200 central schools on a PPP basis in the next two years. We believe this could open up more of the US\$9bn government spending on education to private enterprises.

Private-public partnership (PPP) could expand the addressable market for private service providers such as Educomp

Chart 12: Budget allocation for education has increased sharply



Source: Ministry of Finance, India

# Financials

## Profit and loss

- We forecast revenue of Rs12.8/15.5bn in FY11/12 implying a CAGR of 22.1% for Educomp in FY10-12, driven by strong growth across multiple business segments. We forecast FY12-15 earnings growth of 35% backed by sales growth of 28% as the effects of the business model change in FY10-11 are smoothed out.
- We expect the company's K-12 division to record the fastest revenue growth, at a 42.8% CAGR in FY10-12, and its School Learning Solutions division (comprising *smartclass* and ICT) to record a 20.4% CAGR over the same period.
- We expect margins to improve in FY11 and FY12, because of the margin improvement in K-12 and *smartclass*, as well as a greater revenue contribution from these segments.
- We expect tax rates to remain stable at 35-37% as the company pays the full tax rate in India.

Revenue CAGR of 22.1% in FY10-12 driven by strong growth across multiple segments

Table 15: Profit and loss statement

(Rs m)	FY07	FY08	FY09	FY10	FY11E	FY12E	FY13E	FY14E
Revenue	1,101	2,861	6,371	10,405	12,792	15,503	20,865	26,147
Cost of goods sold	(430)	(1,286)	(2,283)	(3,413)	(3,798)	(4,288)	(5,736)	(7,007)
Gross profit	671	1,575	4,088	6,992	8,994	11,215	15,128	19,140
SGA	(261)	(641)	(1,875)	(3,271)	(4,086)	(4,854)	(6,154)	(7,433)
Other core income	-	-	-	-	-	-	-	-
EBIT	410	935	2,212	3,721	4,908	6,361	8,974	11,707
Income from associates	-	(3)	(8)	(6)	-	-	-	-
Other investment income	-	-	-	-	-	-	-	-
Pension	-	-	-	-	-	-	-	-
Abnormal items (pre-tax)	(23)	(50)	-	-	-	-	-	-
Interest	(14)	(48)	(268)	(489)	(648)	(784)	(750)	(854)
Other pre-tax non-operating	59	178	227	1,167	640	853	1,252	1,569
Goodwill	-	-	-	-	-	-	-	-
Profit before taxes	432	1,011	2,164	4,393	4,899	6,429	9,476	12,422
Taxes	(170)	(351)	(773)	(1,626)	(1,764)	(2,250)	(3,317)	(4,348)
Profit after tax	262	660	1,391	2,767	3,135	4,179	6,159	8,074
Minorities	(1)	(3)	(68)	(54)	(64)	(90)	(124)	(164)
Preferred dividends	-	-	-	-	-	-	-	-
Abnormal items (post-tax)	4	(2)	2	-	-	-	-	-
Net income	265	655	1,324	2,713	3,071	4,089	6,035	7,910
Revenue growth	NA	160%	123%	63%	23%	21%	35%	25%
EBIT margin	37%	33%	35%	36%	38%	41%	43%	45%
EBIT growth	NA	128%	137%	68%	32%	30%	41%	30%
Net profit growth	NA	148%	102%	105%	13%	33%	48%	31%

Source: Company data, UBS estimates

Table 16: Segmental revenue projections

(Rs m)	FY09	FY10	FY11E	FY12E	FY13E	FY14E	FY15E
School Learning Solutions	4,303	8,065	9,944	11,685	15,739	19,800	24,451
Higher Learning Solutions	306	285	342	462	623	841	1,136
K-12 Schools	623	983	1,330	2,004	2,947	3,716	4,699
Online Supplemental & Global	1,109	1,072	1,176	1,353	1,556	1,789	2,057
<b>Total</b>	<b>6,342</b>	<b>10,405</b>	<b>12,792</b>	<b>15,503</b>	<b>20,865</b>	<b>26,147</b>	<b>32,343</b>
<b>Segmental growth</b>							
School Learning Solutions	NA	87.4%	23.3%	17.5%	34.7%	25.8%	23.5%
Higher Learning Solutions	NA	-6.9%	20.0%	35.0%	35.0%	35.0%	35.0%
K-12 Schools	NA	57.8%	35.3%	50.7%	47.0%	26.1%	26.4%
Online Supplemental & Global	NA	-3.4%	9.8%	15.0%	15.0%	15.0%	15.0%
<b>Total</b>	<b>122.7%</b>	<b>64.1%</b>	<b>22.9%</b>	<b>21.2%</b>	<b>34.6%</b>	<b>25.3%</b>	<b>23.7%</b>

Source: Company data, UBS estimates

Table 17: Segmental revenue contribution

(%)	FY09	FY10	FY11E	FY12E	FY13E	FY14E	FY15E
School Learning Solutions	67.9	77.5	77.7	75.4	75.4	75.7	75.6
Higher Learning Solutions	4.8	2.7	2.7	3.0	3.0	3.2	3.5
K-12 Schools	9.8	9.4	10.4	12.9	14.1	14.2	14.5
Online Supplemental & Global	17.5	10.3	9.2	8.7	7.5	6.8	6.4

Source: Company data, UBS estimates

### Margin assumptions

We estimate operating margins will expand from 46.7% in FY10 to 49.8% in FY12. We expect segmental margins in School Learning Solutions and K-12 to increase steadily over FY10-15, driven by a stabilisation in investments and strong revenue growth. However, we believe losses in the Higher Learning Solutions and Online/Supplemental business segments are likely to increase in FY11. We expect these businesses to remain in investment mode and turn positive only by 2014-15.

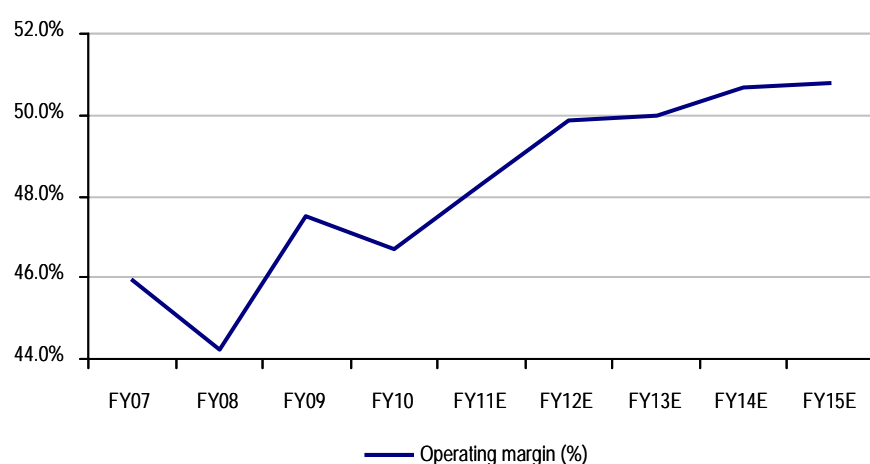
We expect margins to improve led by improved profitability in *smartclass* and K-12

Table 18: Segmental profitability

(Rs m)	FY09	FY10	FY11E	FY12E	FY13E	FY14E	FY15E
School Learning Solutions	2,101	4,483	5,469	6,543	8,814	11,286	13,937
Higher Learning Solutions	95	-107	-330	-200	-100	-50	0
K-12 Schools	306	331	465	701	1,090	1,375	1,739
Online Supplemental & Global	179	-167	-200	-125	-60	0	20
<b>Total</b>	<b>2,681</b>	<b>4,540</b>	<b>5,405</b>	<b>6,920</b>	<b>9,744</b>	<b>12,611</b>	<b>15,696</b>
<b>Segmental PBIT Margin</b>							
School Learning Solutions	48.8%	55.6%	55.0%	56.0%	56.0%	57.0%	57.0%
Higher Learning Solutions	30.9%	-37.5%	-96.5%	-43.3%	-16.0%	-5.9%	0.0%
K-12 Schools	49.1%	33.6%	35.0%	35.0%	37.0%	37.0%	37.0%
Online Supplemental & Global	16.2%	-15.5%	-17.0%	-9.2%	-3.9%	0.0%	1.0%
<b>Total</b>	<b>42.3%</b>	<b>43.6%</b>	<b>42.3%</b>	<b>44.6%</b>	<b>46.7%</b>	<b>48.2%</b>	<b>48.5%</b>

Source: Company data, UBS estimates

Chart 13: Operating margins are likely to increase



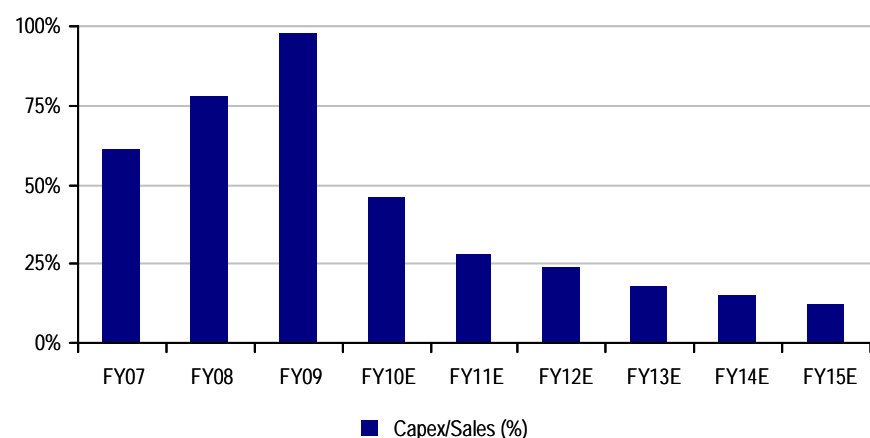
Source: Company data, UBS estimates

## Balance sheet

- Educomp had net debt of Rs2.18bn, or a net debt-to-equity ratio of 13.5% in FY10. We forecast this to reduce to a net debt position of Rs495m, or debt-to-equity ratio of 2.2% by FY12, following the impact of its conversion to an asset-light business model and the consequent improvement in cash flow.
- Given the company's recent move to a less capital intensive business model, we forecast a sharp reduction in capex to sales over the next five years.
- We expect Educomp to return to a net-cash position in FY13, with net cash of Rs2.15bn.
- Receivable days were at 195 in FY10 due to the higher receivables in the government business (six to nine months) and higher receivables in the hardware resale component of *smartclass* (30% of revenue per sale). We expect this to reduce to 175 by FY12 due to a lower revenue contribution from government business.

Balance sheet leverage is likely to reduce as cash flow improve

Chart 14: Capex-to-sales ratio is likely to decline sharply



Note: FY10 reflects UBS estimates since the company is yet to publish the actual data.

Source: Company data, UBS estimates

Table 19: Balance sheet

(Rs m)	FY07	FY08	FY09	FY10E	FY11E	FY12E	FY13E	FY14E
Net tangible fixed assets	831	2,714	8,126	11,794	14,107	16,455	18,814	21,141
Net intangible fixed assets	138	281	1,584	1,237	1,237	1,237	1,237	1,237
Net working capital	1,621	4,047	4,302	14,557	18,047	18,009	23,214	31,741
Other long-term liabilities	(59)	(210)	(439)	(439)	(807)	(1,289)	(2,000)	(2,931)
Total invested capital	2,532	6,832	13,573	27,149	32,584	34,412	41,265	51,188
Investments/other assets	-	19.0	329.3	329.3	329.3	329.3	329.3	329.3
Total capital employed	2,532	6,851	13,903	27,478	32,914	34,742	41,595	51,517
Net (cash)/debt	1,255	3,773	8,895	10,475	13,094	11,039	12,052	14,219
Provisions	-	-	-	-	-	-	-	-
Minority Interests	128	194	804	858	922	1,012	1,136	1,300
Shareholders' funds	1,148	2,884	4,203	16,145	18,897	22,691	28,406	35,997
Net pension assets	-	-	-	-	-	-	-	-
Total capital employed	2,532	6,851	13,903	27,478	32,914	34,742	41,595	51,517
Fixed asset growth	NA	227%	199%	45%	20%	17%	14%	12%
Working capital growth	NA	150%	6%	238%	24%	0%	29%	37%
Capital employed growth	NA	171%	103%	98%	20%	6%	20%	24%

Note: FY10 reflects UBS estimates since the company is yet to publish the actual data.

Source: Company data, UBS estimates

Table 20: Net working capital

(Rs m)	FY07	FY08	FY09	FY10E	FY11E	FY12E	FY13E	FY14E
Accounts receivable	496	1,157	2,765	5,565	6,775	7,307	9,748	12,166
Inventory	33	18	316	1,041	1,279	1,550	2,086	2,615
Other current assets	1,334	3,481	3,472	11,189	13,902	13,984	17,823	24,877
Accounts payable	(76)	(415)	(599)	(883)	(939)	(1,269)	(1,703)	(2,022)
Other short term liabilities	(166)	(195)	(1,651)	(2,354)	(2,970)	(3,563)	(4,740)	(5,895)
Net working capital	1,621	4,047	4,302	14,557	18,047	18,009	23,214	31,741
Days of receivables	165	148	158	195	193	172	171	170
Days of Inventory	28	5	51	111	123	132	133	136
Days of payables	65	118	96	94	90	108	108	105
Days of NWC	538	516	247	511	515	424	406	443

Note: FY10 reflects UBS estimates as the company has yet to publish the actual data

Source: Company data, UBS estimates

## Cash flow

Educomp reported negative free cash flow in FY10. While we expect full year free cash flow to remain negative (-Rs87m) in FY11, we believe Educomp should be able to turn free cash flow positive in H2 FY11 and report positive cash flow in FY12.

**We expect Educomp to turn free cash flow positive in FY12**

**Table 21: Cash flow**

(Rs m)	FY07	FY08	FY09	FY10E	FY11E	FY12E	FY13E	FY14E
EBIT	410	935	2,212	3,721	4,908	6,361	8,974	11,707
Depreciation	96	331	814	1,138	1,272	1,366	1,459	1,550
Change in working cap	(225)	(730)	(1,023)	(3,934)	(1,244)	(231)	(2,570)	(2,654)
Other operating	72	201	950	802	594	704	649	709
Operating cash flow	353	737	2,954	1,726	5,530	8,200	8,512	11,312
Interest	(14)	(48)	(268)	(489)	(648)	(784)	(750)	(854)
Taxes paid	(174)	(184)	(329)	(1,685)	(1,383)	(1,727)	(2,524)	(3,337)
Capex	(675)	(2,219)	(6,227)	(4,805)	(3,585)	(3,714)	(3,818)	(3,877)
Investment in affiliates	-	-	-	-	-	-	-	-
Free cash flow	(510)	(1,714)	(3,870)	(5,252)	(87)	1,975	1,420	3,244
Net acquisitions/disposals	-	-	-	-	-	-	-	-
Dividends (common)	(27)	(40)	(58)	(51)	(109)	(224)	(224)	(224)
Dividends (preferred)	-	-	-	-	-	-	-	-
Share issues/buybacks	-	-	-	9,496	-	24	-	-
Other	NA	(764)	(1,194)	(5,772)	(2,424)	281	(2,209)	(5,188)
Cash flow (inc)/dec in net debt	NA	(2,518)	(5,122)	(1,580)	(2,619)	2,056	(1,013)	(2,168)
Free cash flow yield	-5.1%	-3.4%	-8.1%	-7.9%	-0.2%	3.8%	2.7%	6.2%
Dividend yield	0.1%	0.1%	0.1%	#N/A	0.4%	0.4%	0.4%	0.4%
Capex/sales	61.3%	77.6%	97.8%	46.2%	28.0%	24.0%	18.3%	14.8%
Net debt to equity	109.4%	130.8%	211.6%	64.9%	69.3%	48.6%	42.4%	39.5%

Note: FY10 reflects UBS estimates since the company is yet to publish the actual data.

Source: Company data, UBS estimates



## Return on capital

We forecast Educomp's ROE to decline to 17.5% in FY11 due to investments in higher learning and online and supplemental business as well as the full-year impact of equity dilution in FY10. However, we expect this to pick up to 24% by 2014 as a result of faster growth in K-12.

Return ratios are also likely to pick up

Table 22: ROCE/ROE decomposition

	FY07	FY08	FY09	FY10E	FY11E	FY12E	FY13E	FY14E
Asset turnover	43.5%	61.1%	62.4%	51.1%	42.8%	46.3%	55.1%	56.6%
EBIT margin	37.2%	32.7%	34.7%	35.8%	38.4%	41.0%	43.0%	44.8%
EBIT ROIC	16.2%	20.0%	21.7%	18.3%	16.4%	19.0%	23.7%	25.3%
Taxes	60.7%	65.3%	64.3%	63.0%	64.0%	65.0%	65.0%	65.0%
Returns on invested capital	9.8%	13.0%	13.9%	11.5%	10.5%	12.3%	15.4%	16.5%
IC as % of capital employed	100.0%	99.8%	98.3%	98.4%	98.9%	99.0%	99.1%	99.3%
Returns on other invested capital	-	857.5%	81.0%	222.0%	124.3%	168.3%	247.1%	309.7%
Other assets/CE	-	0.2%	1.7%	1.6%	1.1%	1.0%	0.9%	0.7%
Returns on capital employed	-	14.7%	15.1%	14.9%	11.8%	13.9%	17.4%	18.5%
Leverage	193.9%	204.2%	217.5%	165.9%	141.9%	135.6%	130.2%	127.7%
Minorities	111.2%	108.0%	114.1%	108.2%	105.1%	104.7%	104.2%	103.8%
Exceptionals	101.4%	99.7%	100.1%	100.0%	100.0%	100.0%	100.0%	100.0%
ROE	NA	32.4%	37.4%	26.7%	17.5%	19.7%	23.6%	24.6%
ROE (adjusted)	NA	34.1%	37.4%	26.7%	17.5%	19.7%	23.6%	24.6%

Note: FY10 reflects UBS estimates since the company has not yet published the actual data.

Source: Company data, UBS estimates

# Valuation

## Price target derivation

### VCAM is a DCF and an economic profit model

VCAM is a discounted cash flow (DCF) and economic profit analysis (EPA) valuation methodology, which calculates economic profit along with free cash flow each year.

- It assumes that a company's DCF Value = Current earnings [NOPAT] valued in perpetuity + present value of all future incremental economic profit.
- The accompanying economic profit forecast indicates whether or not free cash flow is value-added and it is economic profit growth that justifies an intrinsic value greater than the company's current earnings valued in perpetuity.
- A key assumption in the VCAM model is the value creation horizon (VCH), which refers to the number of future years a company is expected to generate *incremental* economic profits. At the end of the VCH, we value the NOPAT into perpetuity to calculate terminal value.
- The major subjective drivers of our VCAM price targets are long-term margin assumptions and the weighted average cost of capital (WACC).

Our sensitivity and valuation tables come directly from VCAM and clients are free to modify the data and/or use their own assumptions on our website ([www.ubs.com/investmentresearch](http://www.ubs.com/investmentresearch)). The site also has a number of tools including sensitivity analysis, long-term trends, and a goal seeker, and an extensive VCAM user guide.

### VCAM assumptions

Value creation horizon is one of the key assumptions in VCAM. We believe Educomp can continue to generate incremental economic profit over the next 25 years given the strong potential for growth in the Indian education market.

- WACC—we assume a WACC of 13.3% based on a 7.8% risk-free rate, a 5% equity risk premium and 1.18 beta.
- Sales growth—we estimate medium-term sales growth of 15%, and a 5% terminal growth rate.
- Margin—we assume margins of 33% over the long term, which we believe are sustainable.
- Tax—we expect tax rates to remain steady at 35% over the long term.
- Working capital—we expect the increase in working capital to be lower in FY12 as a result of the change in business model, which would lead to higher increases in FY10 and FY11. We expect this normalise from FY13 onwards.

Table 23: UBS VCM Valuation Summary for Educomp [EDSO.BO]

Relative year	+1E	+2E	+3E	+4E	+5E	+6E	+7E	+8E	+9E	+10E
Fiscal year	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
EBIT	4,908	6,361	8,974	11,707	14,725	15,525	18,090	20,850	23,765	26,787
D&A*	1,272	1,366	1,460	1,550	1,697	1,941	2,304	2,708	3,148	3,620
Capex	(3,585)	(3,714)	(3,818)	(3,877)	(3,877)	(3,881)	(4,609)	(5,415)	(6,295)	(7,240)
Chg. in wkg. cap.	(1,392)	(473)	(2,543)	(2,628)	(2,874)	(2,949)	(3,564)	(3,970)	(4,353)	(4,696)
Tax (operating)	(1,767)	(2,227)	(3,141)	(4,098)	(5,154)	(4,843)	(5,643)	(6,504)	(7,414)	(8,356)
Other	(72)	(81)	(161)	(158)	(186)	(785)	(907)	(1,035)	(1,168)	(1,302)
Free Cash Flow	(636)	1,232	771	2,496	4,331	5,007	5,672	6,633	7,683	8,812
<i>growth</i>		<i>NM</i>	<i>-37.4%</i>	<i>223.9%</i>	<i>73.5%</i>	<i>15.6%</i>	<i>13.3%</i>	<i>16.9%</i>	<i>15.8%</i>	<i>14.7%</i>

Valuation	
PV of explicit cash flow	29,550
PV of terminal value (yr. 15)	34,204
<b>Enterprise Value</b>	<b>63,754</b>
<i>% terminal</i>	<i>54%</i>
Associates & other	329
- Minority interests	870
Surplus cash**	8,005
- Debt***	3,403
<b>Equity value</b>	<b>67,815</b>
Shares outstanding	99.3
<b>Equity per share (Rs/sh)</b>	<b>683.03</b>
Cost of equity	13.69%
Dividend yield	0.37%
<b>1-year Price Target (Rs/sh)</b>	<b>774.02</b>

Long Term Assumptions			
Relative year	+10E	+15E	+25E
Sales growth	15.0%	10.0%	5.0%
EBIT margin	37.0%	32.0%	29.0%
Capex/sales	10.0%	10.0%	10.0%
ROIC	25.8%	19.8%	12.5%

Valuation-Implied Metrics			
Fiscal year	2011E	2012E	1-yr Fwd.
EV / EBITDA	10.3x	8.3x	9.9x
EV / EBIT	13.0x	10.0x	12.3x
FCF Yield	NM	1.9%	NM
P / E (PV)	22.1x	16.6x	20.8x
P / E (Target)	25.0x	18.8x	23.5x

WACC	
Risk free rate	7.80%
ERP	5.0%
Beta	1.18
Debt / equity***	6.2%
Marg. tax rate	32.5%
Cost of equity	13.69%
Cost of debt	9.80%
<b>WACC</b>	<b>13.28%</b>

Terminal Assumptions	
VCH (years)	15
Impl. FCF gr.	6.2%
Incr. ROIC	13.1%

Figures in Rs m, unless noted otherwise.

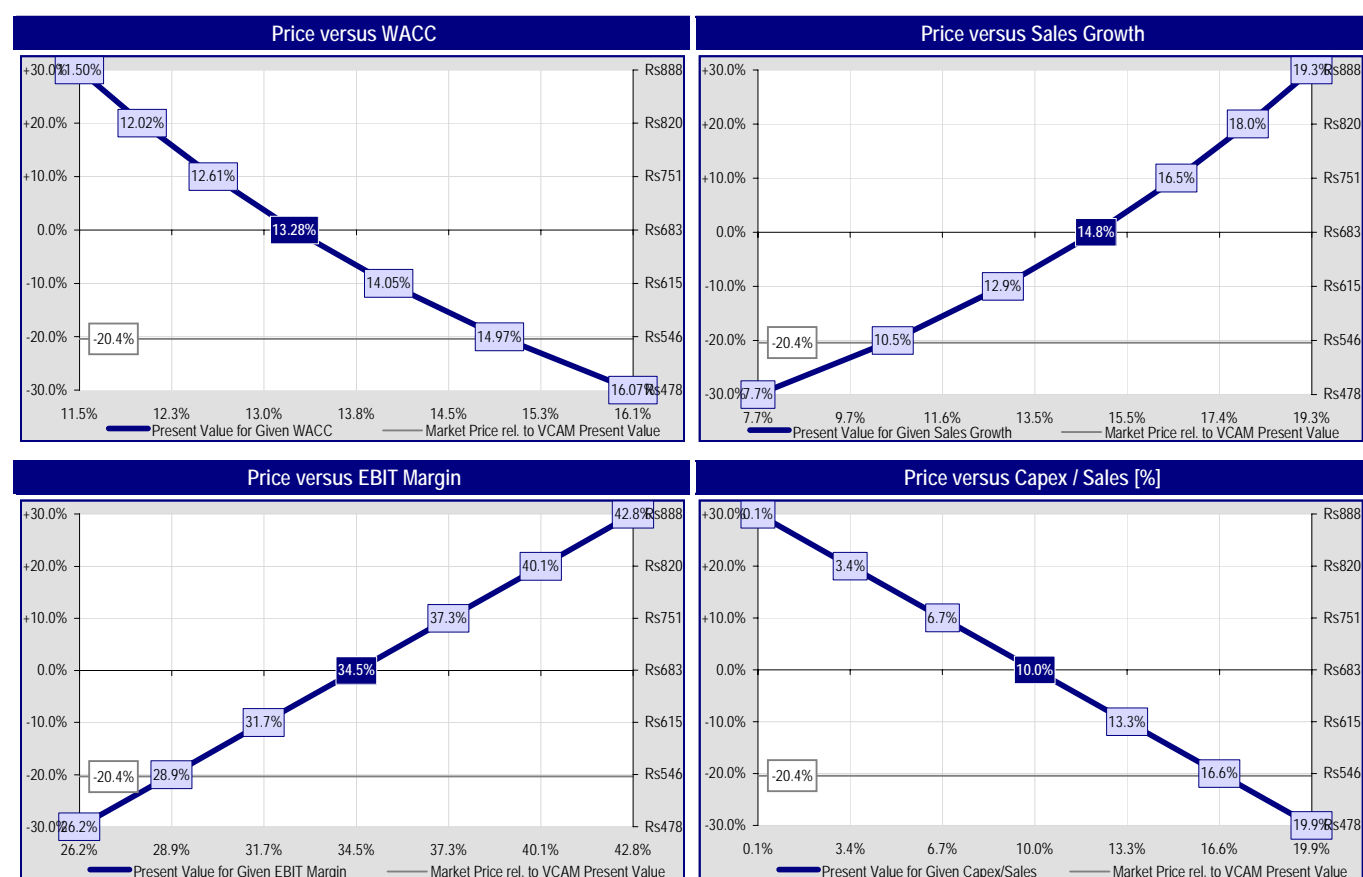
\* Depreciation and non-goodwill amortization

\*\* The portion of cash not required to maintain operations

\*\*\* Assumes market value of equity and includes market value/seasonal adjustments for debt and debt-deemed obligations.

Source: UBS VCM

Chart 15: UBS VCAM Sensitivities for Educomp [EDSO.BO]



Notes: Sensitivities are derived from assuming Sales Growth, EBIT Margin, or Capex / Sales is flat annually for years 4 through the VCH. Explicit estimates in years 1 through 5 do not vary, and always represent the assumptions on the Inputs Page. For each chart, one parameter is varied while the others are held constant. Those held constant are set as they appear on the Inputs Page.

Source: UBS VCAM

## Comparables

Educomp is trading at a premium to regional peers

We compared Educomp's target PE with Indian and Asian peers, although we note that the business dynamics are very different in India as compared to other countries in the region. We believe Educomp continues to command a premium to other education stocks in India given its industry leadership in multimedia content and K-12.

Table 24: Valuation comparison

	Market cap (US\$ m)	FY11E PE (x)	FY11E ROE (%)	FY10 revenue (US\$ m)	FY10 net income (US\$ m)
Educomp	1,098	18.6	17.5	221	58
NIIT	214	10.6	17.3	255	15
Everonn	113	9.6	21.7	62	10
Raffles Education	538	10.9	14.2	143	36
Navitas Limited	1,248	14.7	67.6	457	50

Note: Raffles Education FY end-June; Navitas Limited FY end-December, others FY end-March

Source: Bloomberg data, UBS estimates

# Appendix

## Company background

Educomp is a leading provider of education services in India, with interests in schools, pre-schools, multimedia learning aids, higher education, vocational training and online tutoring.

**Table 25: Company history**

1994	Started operations by setting up computer laboratories under BOOT model in government and private schools
2000	Strategic investment by Carlyle of US\$2.1m for a 15% stake
2002	Entered e-learning space with its Learning Mate division
2003	Launched <i>smartclass</i> Content solutions
2004	Launched online tutoring for teaching mathematics to US students
2005	Carlyle exited by selling stake to promoters in return for the promoters relinquishing their stake in Learning Mate Solutions Pvt. Ltd.
2006	MathGuru.com - Online 24/7 math help program launched. Three pre-schools under the brand name <i>Roots to Wings</i> launched. Set up of Edu Infra and Edu Manage subsidiaries for K-12
2007	Acquisition of 76% stake in ThreeBrix services; 100% in ASKnLearn; 70.05% stake in Savvica, 51% stake in AuthorGen Technologies, Launch of 'Millennium' schools
2008	Tie-up with Ansals API for real estate for K-12, Acquired 51% stake in Learning.com, JV with Singapore-based Raffles Education
2009	JV with Perason for vocation training
2010	Acquired studyplaces.com

Source: Company data

# Educomp Solutions

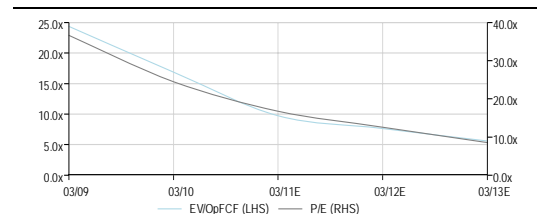
Income statement (Rsm)	-	03/07	03/08	03/09	03/10	03/11E	% ch	03/12E	% ch	03/13E	% ch
Revenues	-	1,101	2,861	6,371	10,405	12,792	22.9	15,503	21.2	20,865	34.6
Operating expenses (ex depn)	-	(595)	(1,595)	(3,344)	(5,546)	(6,613)	19.2	(7,776)	17.6	(10,431)	34.1
EBITDA (UBS)	-	506	1,266	3,027	4,859	6,180	27.2	7,727	25.0	10,434	35.0
Depreciation	-	(96)	(331)	(814)	(1,138)	(1,272)	11.8	(1,366)	7.4	(1,459)	6.8
Operating income (EBIT, UBS)	-	410	935	2,212	3,721	4,908	31.9	6,361	29.6	8,974	41.1
Other income & associates	-	59	175	220	1,161	640	-44.9	853	33.3	1,252	46.8
Net interest	-	(14)	(48)	(268)	(489)	(648)	32.6	(784)	21.0	(750)	-4.3
Abnormal items (pre-tax)	-	(23)	(50)	0	0	0	-	0	-	0	-
Profit before tax	-	432	1,011	2,164	4,393	4,899	11.5	6,429	31.2	9,476	47.4
Tax	-	(170)	(351)	(773)	(1,626)	(1,764)	8.5	(2,250)	27.6	(3,317)	47.4
Profit after tax	-	262	660	1,391	2,767	3,135	13.3	4,179	33.3	6,159	47.4
Abnormal items (post-tax)	-	4	(2)	2	0	0	-	0	-	0	-
Minorities / pref dividends	-	(1)	(3)	(68)	(54)	(64)	19.0	(90)	40.4	(124)	37.8
Net income (local GAAP)	-	265	655	1,324	2,713	3,071	13.2	4,089	33.1	6,035	47.6
Net Income (UBS)	-	283	708	1,322	2,713	3,071	13.2	4,089	33.1	6,035	47.6
Tax rate (%)	-	39	35	36	37	36	-2.7	35	-2.8	35	0.0
Pre-abnormal tax rate (%)	-	37	33	36	37	36	-2.6	35	-2.8	35	0.0
Per share (Rs)	-	03/07	03/08	03/09	03/10	03/11E	% ch	03/12E	% ch	03/13E	% ch
EPS (local GAAP)	-	3.31	7.74	15.23	29.33	32.34	13.2	43.06	33.1	63.55	47.6
EPS (UBS)	-	3.55	8.35	15.21	29.33	32.34	10.3	43.06	33.1	63.55	47.6
Net DPS	-	0.48	0.60	0.70	1.00	2.00	100.0	2.00	0.0	2.00	0.0
Cash EPS	-	4.75	12.27	24.58	41.63	45.73	9.8	57.44	25.6	78.92	37.4
BVPS	-	14.38	33.54	48.87	170.16	199.17	17.0	239.15	20.1	299.39	25.2
Balance sheet (Rsm)	-	03/07	03/08	03/09	03/10	03/11E	% ch	03/12E	% ch	03/13E	% ch
Net tangible fixed assets	-	831	2,714	8,126	11,794	14,107	19.6	16,455	16.6	18,814	14.3
Net intangible fixed assets	-	138	281	1,584	1,237	1,237	0.0	1,237	0.0	1,237	0.0
Net working capital (incl. other assets)	-	1,621	4,047	4,302	14,557	18,047	24.0	18,009	-0.2	23,214	28.9
Other liabilities	-	(59)	(210)	(439)	(439)	(807)	83.6	(1,289)	59.8	(2,000)	55.1
Operating invested capital	-	2,532	6,832	13,573	27,149	32,584	20.0	34,412	5.6	41,265	19.9
Investments	-	0	19	329	329	329	0.0	329	0.0	329	0.0
Total capital employed	-	2,532	6,851	13,903	27,478	32,914	19.8	34,742	5.6	41,595	19.7
Shareholders' equity	-	1,148	2,884	4,203	16,145	18,897	17.0	22,691	20.1	28,406	25.2
Minority interests	-	128	194	804	858	922	7.5	1,012	9.8	1,136	12.3
Total equity	-	1,276	3,078	5,007	17,003	19,819	16.6	23,703	19.6	29,543	24.6
Net debt / (cash)	-	1,255	3,773	8,895	10,475	13,094	25.0	11,039	-15.7	12,052	9.2
Debt deemed provisions	-	0	0	0	0	0	-	0	-	0	-
Total capital employed	-	2,532	6,851	13,903	27,478	32,914	19.8	34,742	5.6	41,595	19.7
Cash flow (Rsm)	-	03/07	03/08	03/09	03/10	03/11E	% ch	03/12E	% ch	03/13E	% ch
Operating income (EBIT, UBS)	-	410	935	2,212	3,721	4,908	31.9	6,361	29.6	8,974	41.1
Depreciation	-	96	331	814	1,138	1,272	11.8	1,366	7.4	1,459	6.8
Net change in working capital	-	(225)	(730)	(1,023)	(3,934)	(1,244)	-68.4	(231)	-81.4	(2,570)	1013.8
Other (operating)	-	72	201	950	802	594	-26.0	704	18.6	649	-7.9
Operating cash flow	-	353	737	2,954	1,726	5,530	220.3	8,200	48.3	8,512	3.8
Net interest received / (paid)	-	(14)	(48)	(268)	(489)	(648)	32.6	(784)	21.0	(750)	-4.3
Dividends paid	-	(27)	(40)	(58)	(51)	(109)	115.5	(224)	105.3	(224)	0.0
Tax paid	-	(174)	(184)	(329)	(1,685)	(1,383)	-17.9	(1,727)	24.9	(2,524)	46.1
Capital expenditure	-	(675)	(2,219)	(6,227)	(4,805)	(3,585)	-25.4	(3,714)	3.6	(3,818)	2.8
Net (acquisitions) / disposals	-	0	0	0	0	0	-	0	-	0	-
Other	-	-	69	(1,255)	372	56	-85.0	158	184.8	626	294.9
Share issues	-	0	0	0	9,496	0	-	24	-	0	-
Cash flow (inc)/dec in net debt	-	(596)	(1,685)	(5,183)	4,564	(140)	-	1,933	-	1,822	-5.8
FX / non cash items	-	-	(832)	61	(6,144)	(2,479)	-59.7	123	-	(2,835)	-
Balance sheet (inc)/dec in net debt	-	-	(2,518)	(5,122)	(1,580)	(2,619)	65.8	2,056	-	(1,013)	-
Core EBITDA	-	506	1,266	3,027	4,859	6,180	27.2	7,727	25.0	10,434	35.0
Maintenance capital expenditure	-	(101)	(334)	(937)	(721)	(538)	-25.4	(557)	3.6	(573)	2.8
Maintenance net working capital	-	0	0	0	0	0	-	0	-	0	-
Operating free cash flow, pre-tax	-	405	932	2,089	4,138	5,642	36.3	7,170	27.1	9,861	37.5

Source: Company accounts, UBS estimates. (UBS) valuations are stated before goodwill, exceptionals and other special items. Note: For some companies, the data represents an extract of the full company accounts.

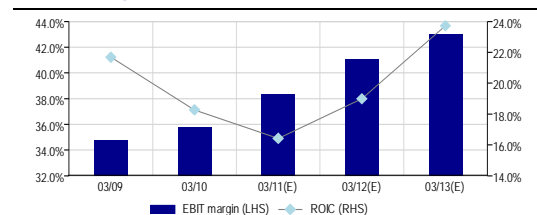
## Company profile

Educomp Solutions (Educomp) is India's leading provider of multimedia course content to private schools, as well as a leading education services provider to the public education system. The company also has presence in the kindergarten to twelfth grade and pre-school segments, with more than 40 schools operating under multiple brand names. The company has recently entered the higher education segment through its tie-up with Raffles Education Corp, a Singapore-based provider of educational services. In addition to the above, Educomp has also has interests in online tutoring and vocational training.

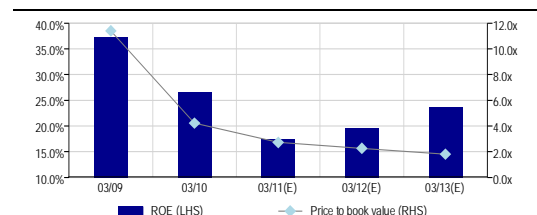
## Value (EV/OpFCF & P/E)



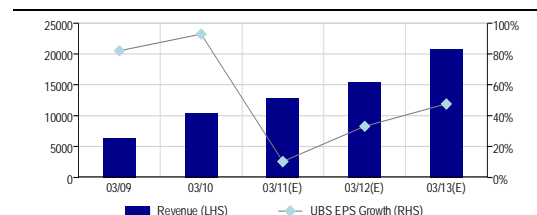
## Profitability



## ROE v Price to book value



## Growth (UBS EPS)



# Educomp Solutions

Valuation (x)	5Yr Avg	03/09	03/10	03/11E	03/12E	03/13E
P/E (local GAAP)	-	39.5	26.3	17.5	13.2	8.9
P/E (UBS)	-	36.6	24.5	16.8	12.6	8.5
P/CEPS	-	22.7	17.3	11.8	9.4	6.9
Net dividend yield (%)	-	0.1	0.1	0.4	0.4	0.4
P/BV	-	11.4	4.2	2.7	2.3	1.8
EV/revenue (core)	-	8.0	6.7	4.3	3.5	2.6
EV/EBITDA (core)	-	16.8	14.4	8.9	7.1	5.3
EV/EBIT (core)	-	23.0	18.8	11.2	8.6	6.1
EV/OpFCF (core)	-	24.4	16.9	9.7	7.7	5.6
EV/op. invested capital	-	5.0	3.4	1.8	1.6	1.5

Enterprise value (Rsm)	03/09	03/10	03/11E	03/12E	03/13E
Average market cap	47,893	66,755	51,718	51,718	51,718
+ minority interests	804	858	922	1,012	1,136
+ average net debt (cash)	2,514	2,514	2,514	2,514	2,514
+ pension obligations and other	0	0	0	0	0
- non-core asset value	(329)	(329)	(329)	(329)	(329)
Core enterprise value	50,882	69,798	54,826	54,916	55,040

Growth (%)	5Yr Avg	03/09	03/10	03/11E	03/12E	03/13E
Revenue	-	122.7	63.3	22.9	21.2	34.6
EBITDA (UBS)	-	139.1	60.5	27.2	25.0	35.0
EBIT (UBS)	-	136.7	68.2	31.9	29.6	41.1
EPS (UBS)	-	82.0	92.9	10.3	33.1	47.6
Cash EPS	-	100.4	69.4	9.8	25.6	37.4
Net DPS	-	17.1	43.1	100.0	0.0	0.0
BVPS	-	45.7	NM	17.0	20.1	25.2

Margins (%)	5Yr Avg	03/09	03/10	03/11E	03/12E	03/13E
EBITDA / revenue	-	47.5	46.7	48.3	49.8	50.0
EBIT / revenue	-	34.7	35.8	38.4	41.0	43.0
Net profit (UBS) / revenue	-	20.8	26.1	24.0	26.4	28.9

Return on capital (%)	5Yr Avg	03/09	03/10	03/11E	03/12E	03/13E
EBIT ROIC (UBS)	-	21.7	18.3	16.4	19.0	23.7
ROIC post tax	-	14.0	11.5	10.5	12.3	15.4
Net ROE	-	37.3	26.7	17.5	19.7	23.6

Coverage ratios (x)	5Yr Avg	03/09	03/10	03/11E	03/12E	03/13E
EBIT / net interest	-	8.2	7.6	7.6	8.1	12.0
Dividend cover (UBS EPS)	-	21.8	29.3	16.2	21.5	NM
Div. payout ratio (% , UBS EPS)	-	4.6	3.4	6.2	4.6	3.1
Net debt / EBITDA	-	2.9	2.2	2.1	1.4	1.2

Efficiency ratios (x)	5Yr Avg	03/09	03/10	03/11E	03/12E	03/13E
Revenue / op. invested capital	-	0.6	0.5	0.4	0.5	0.6
Revenue / fixed assets	-	1.0	0.9	0.9	0.9	1.1
Revenue / net working capital	-	1.5	1.1	0.8	0.9	1.0

Investment ratios (x)	5Yr Avg	03/09	03/10	03/11E	03/12E	03/13E
OpFCF / EBIT	-	0.9	1.1	1.1	1.1	1.1
Capex / revenue (%)	-	NM	NM	28.0	24.0	18.3
Capex / depreciation	-	7.6	4.2	2.8	2.7	2.6

Capital structure (%)	5Yr Avg	03/09	03/10	03/11E	03/12E	03/13E
Net debt / total equity	-	NM	64.9	69.3	48.6	42.4
Net debt / (net debt + equity)	-	67.9	39.4	40.9	32.7	29.8
Net debt (core) / EV	-	4.9	3.6	4.6	4.6	4.6

Source: Company accounts, UBS estimates. (UBS) valuations are stated before goodwill, exceptionals and other special items.

Valuations: based on an average share price that year, (E): based on a share price of Rs541.95 on 08 Jun 2010 23:39 HKT Market cap(E) may include forecast share issues/buybacks.

## Diviya Nagarajan

Analyst

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## ■ Educomp Solutions

Educomp Solutions (Educomp) is India's leading provider of multimedia course content to private schools, as well as a leading education services provider to the public education system. The company also has presence in the kindergarten to twelfth grade and pre-school segments, with more than 40 schools operating under multiple brand names. The company has recently entered the higher education segment through its tie-up with Raffles Education Corp, a Singapore-based provider of educational services. In addition to the above, Educomp has also has interests in online tutoring and vocational training.

## ■ Statement of Risk

The key company specific risks are: 1) a lack of clarity on the ownership and functioning of EduSmart—the third party implementation partner for smartclass; 2) a slower-than-expected ramp up in smartclass; and 3) a lack of sufficient management personnel as the company embarks on a fast ramp up schedule. The key industry specific risks are: 1) changes in regulations in the K-12 segment, 2) long sales cycles that could derail growth expectations for government schools, and 3) a slowdown in economic growth affecting spending on education.

## ■ Analyst Certification

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### UBS Investment Research: Global Equity Rating Allocations

UBS 12-Month Rating	Rating Category	Coverage <sup>1</sup>	IB Services <sup>2</sup>
Buy	Buy	50%	39%
Neutral	Hold/Neutral	40%	33%
Sell	Sell	11%	24%
UBS Short-Term Rating	Rating Category	Coverage <sup>3</sup>	IB Services <sup>4</sup>
Buy	Buy	less than 1%	29%
Sell	Sell	less than 1%	0%

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 31 March 2010.

### UBS Investment Research: Global Equity Rating Definitions

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.
UBS Short-Term Rating	Definition
Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
Sell	Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.

## KEY DEFINITIONS

**Forecast Stock Return (FSR)** is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

**Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).

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**Equity Price Targets** have an investment horizon of 12 months.

## EXCEPTIONS AND SPECIAL CASES

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**UBS Securities India Private Ltd:** Diviya Nagarajan.

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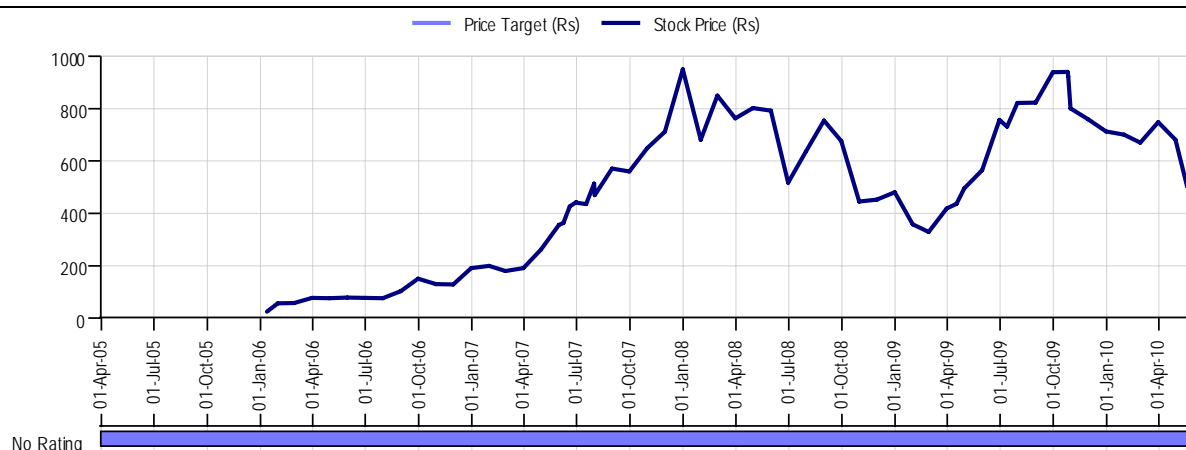
Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
Educomp Solutions	EDSO.BO	Not Rated	N/A	Rs541.95	08 Jun 2010

Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

## Educomp Solutions (Rs)



Source: UBS; as of 08 Jun 2010



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