Services Group
Knowledge Services

India

Educomp Solutions (BSE: EDSL IN)

Initiating Coverage: Price Discovery in Progress - Undervalued

Initiating Coverage

Investment Summary

EDSL is India's largest market-listed technology-aided education company. The size of India's addressable market, favorable demography, growing acceptance of technology-aided learning, and EDSL's diverse, innovative and quality product suites should enable rapid growth. Its business model is scalable to international markets.

Rating:	BUY
Price:	INR1,380.70
Price Target:	INR1,784.00
Bloomberg:	BSE: EDSL IN

Market Data

52-Week Range:	INR1,454.45-INR291.00
Total Entprs. Value (MM):	INR22,026.9
Market Cap. (MM):	INR22,063.6
Insider Ownership:	64.0%
Institutional Ownership:	16.0%
Shares Out. (MM):	15.98
Float (MM):	4.3
Float (%):	27.0%
Avg. Daily Vol.:	34,622

Financial Summary

Book Value (MM):	INR1404.20
Book Value/Share:	INR56.11
Net Debt (MM):	(INR36.70)
Return on Avg. Equity:	30.8%
Long-Term Debt (MM):	INR965.40
LTD/Cap:	68.8%
Dividend Yield:	0.1%

INR	2006A	2007E	2008E	2009E
Rev. (MM)	555.0	1113.0	2548.0	3835.0
EV/Rev.	39.7x	19.8x	8.6x	5.7x
EPS				
Jun	4.24	—	—	—
Sep	1.18	—	—	—
Dec	3.17	—	—	—
Mar	5.10	—	—	—
FY Mar	**11.16**	**22.08**	**46.47**	**70.66**
FY P/E	NM	62.5x	29.7x	19.5x

The Fiscal Year of the Company is Apr to Mar. Annual EPS estimates are for the respective fiscal years.

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Event

We are initiating coverage on Educomp Solutions Ltd. with a Buy rating. We expect Educomp to experience fast-paced (early-phase "S curve") growth ahead.

Key Points

- **Education is set to emerge as an attractive investment theme** in India, with the population's median age below 25 years, and with a perceptible shift in mass mindset towards spending for education.
- Educomp has a **unique scalable business model** and broad product range, with virtually no direct competition in the local Indian market. Further, superior profitability margins and a rich content bank provide sizable opportunities for the company in markets within and outside India.
- The company's **multi-pronged strategy** to address government, private schools, and pre-schools, and content delivery in English as well as 10 regional languages to capture geographic spread should drive revenue growth, ensuring increasing returns to scale.
- The **momentum of an early start**, a proprietary library of 10,000+ content modules, aggressive additions to marketing headcounts, and strategic marketing tie-ups should ensure Educomp's leadership position in a rapidly emerging technology-aided learning market.
- **Educomp should see strong growth ahead.** Revenues should grow at CAGR 90.5% over FY2006–09E, resulting in 85% rise in EPS during the same period, in our view. Educomp's operating EBITDA margins and net margins projected to improve to 63.4% and 29.8%, respectively, by FY09.
- Educomp is a **classic example of "S curve"** – innovation/decay business model in early phase of discovery. Projected revenue growth tapers off to 50% YoY in 2010 and to 23% YoY in 2011.

Valuation/Risks

We believe that a **DCF valuation method** is more appropriate for EDSL. Currently, EDSL's stock is trading at a 30.3x and 20.1x multiple to Mar 2008 and Mar 2009 earnings, respectively. Our DCF-based valuation method results in a fair value of INR1784 for EDSL's stock. At current market price of INR1381, the stock offers a potential 29% upside, in our view. Risks include pricing pressure due to convertible bond conversion, as well as the new and innovative nature of the product, which is still a ways off from broad acceptance.

Executive Summary

The Market Is Huge, and Rapidly Expanding. India's US$970bn economy spends only around 4%, or US$39bn, on education. The country's education process is still dominated by the public education system with more than 1 million publicly run educational institutions. However, there are more than 50,000 private schools in the country, and that segment is experiencing rapid growth. With growing awareness of the benefits of education, education's share of the wallet will rise, and that is already apparent. According to National Sample Surveys, spending on education in urban areas has risen from 2.1% of per capita income in 1983 to 6.3% in 2003.

Education: An Emerging Investment Theme in India. We have highlighted in our recent India Strategy note that India is experiencing constructive educational reforms at the grassroots levels. EDSL's business model is unique, virtually with no competition, and its addressable market size, as mentioned above, is huge. Educomp's target business segment in the domestic market could be as large as US$4bn/yr, in our view. A 10% market penetration thereof results in US$400mn/yr revenue potential. With the momentum of an early start, and armed with an extensive content library, the company's current annual revenue of US$26mn leaves opportunity for rapid growth in coming years.

The "Bloomberg" of Education. The 2006 Annual Report highlights the business concept that Educomp wants to be *"The Bloomberg of Education."* Indeed, Educomp's Flagship Product Smart_Class is expensive. Smart_Class charges INR150 (US$3.6) per month per student. The product is expensive in the Indian context, and restricts the size of EDSL's addressable market. We believe that out of India's more than 50,000 (and growing) private schools, only 5,000 elite private schools are potential subscribers to Smart_Class. With subscription strength of 300 schools, Smart_Class already has a 6% penetration. We expect the product's penetration level to grow rapidly in coming years and plateau at 22% levels, as EDSL strengthens its market presence and leadership. We expect subscription growth to taper off to below-25% YoY levels by 2012, with market saturation and competition.

We Expect Competition to Emerge. Educomp has developed its content over 12 years, but the company is unlikely to have spent more than US$25mn to develop its content. A robust content library and the momentum of an early start provide the only credible entry barriers to EDSL's business. However, given the high profitability and prospects of the business, and the low cost of content development locally, we expect competition to emerge in coming years, nevertheless. The momentum of an early start, innovation, and adaptability should help EDSL maintain its leadership position in the market, in our opinion.

Valuation

Financial projections factoring a one- to three-year growth horizon, using P/E or growth-adjusted P/E multiples (PEG) for valuations could be misleading, in our view. We believe that beyond the initial nascent stage of high growth, EDSL's growth will taper off over a multi-year horizon. Further, it is inappropriate to benchmark EDSL against software companies or software training companies, as its target market segment, potential, and business risks are quite different. To that effect, we view a longer-term DCF valuation as more holistic and appropriate than comparative EV/EBITDA, P/E or PEG valuation measures. In order to project cash flows, we have estimated revenues and expenses of each of EDSL's key business segments going forward. We made assumptions on future market size and appropriate target segments for each of EDSL's key products. The projections are essentially a result of a marriage of top-down and bottom-up analyses.

Investment Risks

We note that the company's products are new and innovative, and still a long way from *broad levels* of acceptance. Note that only 300 schools have subscribed to EDSL's Smart_Class, out of more than 50,000 private schools in the country. An argument against scalability of its products would be obsolescence of content presentation style with availability of richer animations and formats, hence the requirement for continuous investments in content upgrades. Further, the company has a high accounts receivable collection period of 163 days (FY2007), largely due to the ICT product, which is sold to government educational institutions. The company's aggressive scaling up target of ICT subscriptions from December 06's 1,833 to 3,000–3,500 in FY07 may pose cash flow management challenges, and also put pressure on profit margins. We note that EDSL's stock price (at INR1380.7, closing price April 23, 2007) has jumped fully 42% since April 4. Pressure on the stock price due to the possible conversion of US$21mn outstanding convertible bonds and profit-booking by short-term traders pose some immediate-term downside price risks. We recommend buying on such dips with a 12-month investment horizon.

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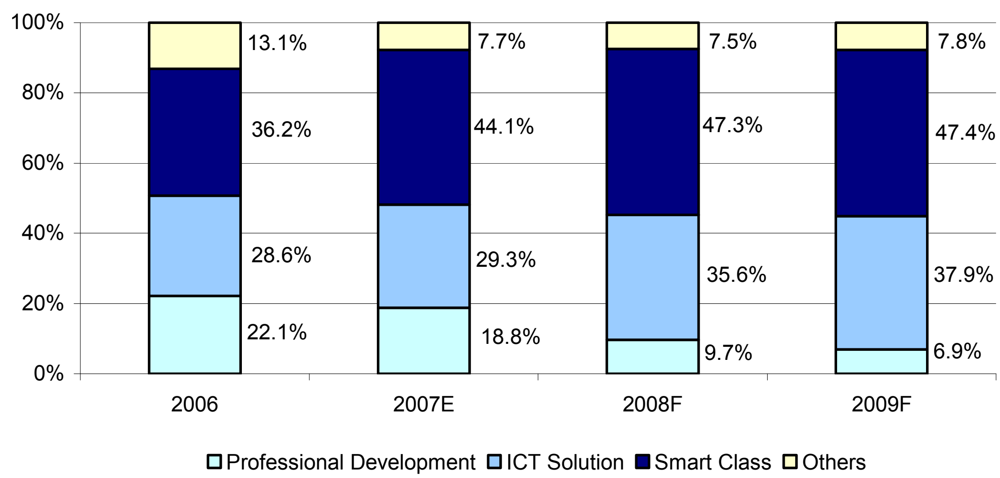
Educomp's Business Model, Products and Revenues

Currently EDSL has three main business segments, and at least a couple of new and innovative product initiatives. EDSL's revenue model is mainly based on long-term contracts and annual subscriptions, which provides predictability to the company's revenue. The company has established a track record of constant product innovation. We have browsed through EDSL's product suites, and also visited Bal Bharti School in Delhi where EDSL has implemented its product — Smart_Class. The visually engaging content makes the course material more interesting, in our opinion. However, the content is not interactive, nor does it have step-up attributes to address needs of advanced students. There is room for further innovation and upgrades, but the beginning is indeed encouraging.

Chart 1: Educomp's Revenue Composition



Source: Jefferies Research; Company Data.

Smart_Class: Offers animated content for school curriculum. The product is designed to assist and complement teachers, and the content uses visual effects to help students understand abstract and often drab course materials. India's school curriculum is textbook-oriented, bound by syllabus guidelines (CBSE and CISCE are the two most popular national standards, besides numerous state-level grades). EDSL provides end-to-end solutions and wires up content delivery infrastructure in the classroom subscribed for the Smart_Class platform. The company charges INR150 (US$3.6) per student per month, and a typical subscribing school signs up for 20–30 classes with an approximate enrolment of around 900 students, and payments are obtained on a quarterly basis. The contracts are typically for three to five years, based on a build-own-operate-transfer (BOOT) model. For schools, opting to bear the cost of wiring the classrooms themselves, EDSL charges INR75 (US$1.79) per student per month under the Smart_Class program.

Smart_Class is EDSL's largest, and currently fastest growing, business segment. The segment's revenues rose 107.7% YoY to INR216.4mn (US$5.2mn) during the first three quarters of FY07, entirely driven by volume growth over a low base. The segment earned profits (EBIT) of INR127.2mn (US$3mn), up 57.8% YoY during the same period. The company's increased marketing efforts and wider geographic focus yielded results, and the number of schools under Smart_Class rose to 228 by the end of December 2006 from 26 in March 2005. The company expects further growth in school subscriptions to 300 by March 2007. Currently the company engages 50 marketing executives and 18 partners targeting to reach out to 55 cities by March 2007. Initial infrastructure setup cost is around INR150,000 (US$3570) per class, and the fee structure ensures net-of-depreciation capital recovery in about 13–15 months.

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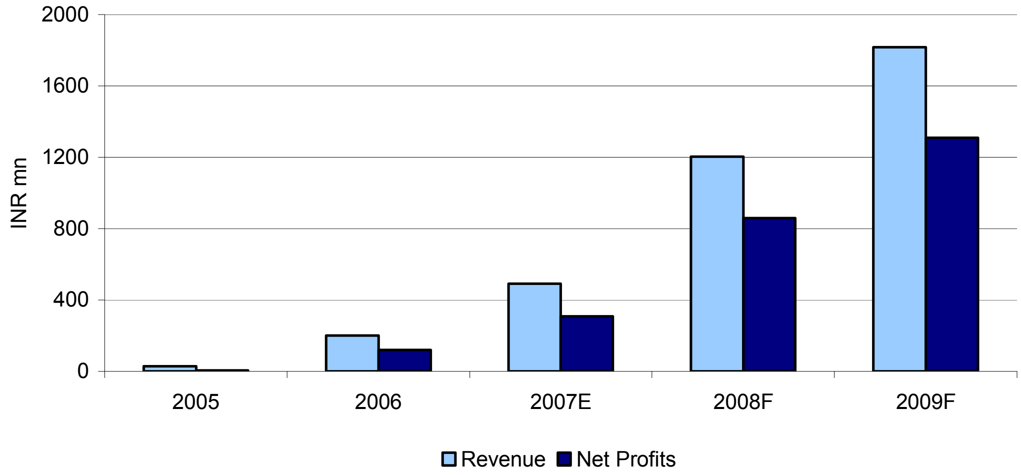
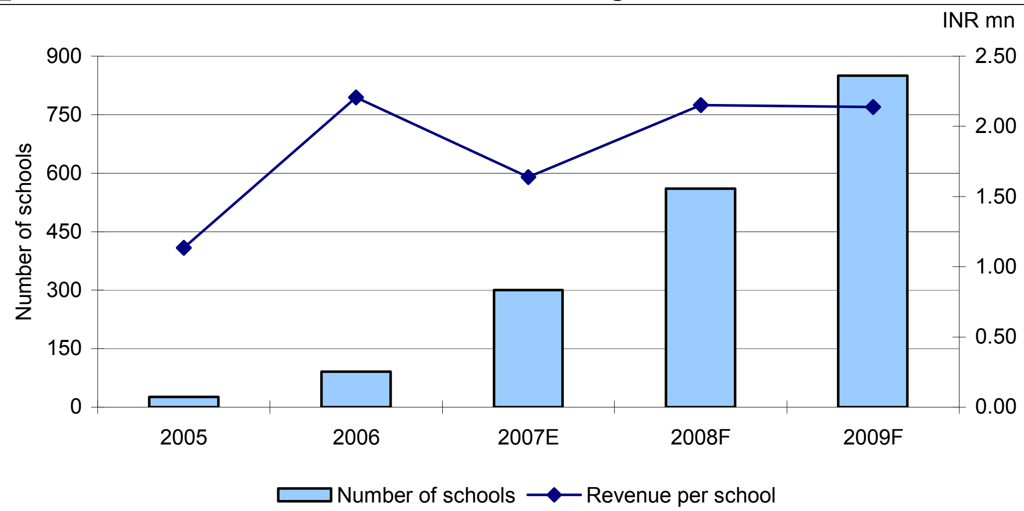
Chart 2: Smart_Class Revenues, Net Profits



Source: Jefferies Research; Company Data.

Chart 3: Smart_Class Number of Schools and Per-School Billing



Source: Jefferies Research; Company Data.

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Table 1: Selected Prestigious Schools Subscribing to Smart_Class

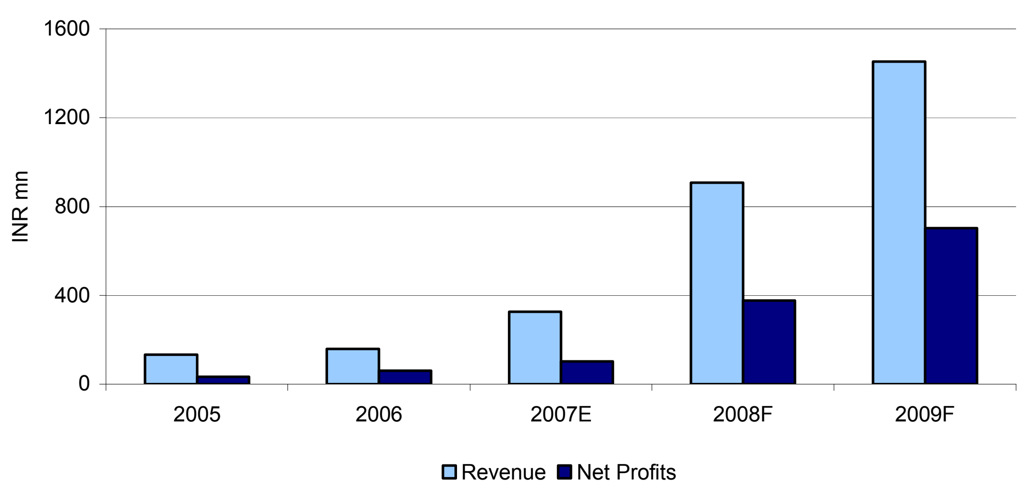
Bal Bharti Public School, Pitampura, Delhi
DOON Public School, Delhi
Delhi Public School, RK Puram, Delhi
Bal Bharti Public School, Navi Mumbai
Queen Mary, Delhi
Padma Shrishadri School, Chennai
Poilan Public School , Kolkatta
Delhi Public School, Agra
Sanskriti, The Gurukul, Guwahati
Choithram International School, Indore
Bharti Vidya Bhawan, Indore
Carmel High School, Bangalore
Campion School, Trichy

Source: Jefferies Research; Company Data.

ICT Program: This is a basic computer literacy program, lower value-added, and targets government-funded literacy drive projects and initiatives to lessen the "digital divide." EDSL provides the hardware infrastructure and digital content. Contracts are usually longer — typically five years or more. The projects under the ICT segment are also run under the BOOT model. Government schools are the target market for this product.

ICT is EDSL's fastest growing business segment. ICT program's revenues and profits jumped 239.0% YoY and 33.6% YoY, respectively, during April–December 2006, with fully 1,833 government schools registered under the program. EDSL won six-year contracts with 650 schools in West Bengal and 500 schools in Gujarat and five-year contracts with 70 schools in UP. The company also has a qualified order pipeline of 100 schools in Assam and 264 schools in Karnataka for ICT solutions. The company is targeting a scaling up of ICT subscriptions to 3,000–3,500 schools by March 2007. Each school is typically wired up with one classroom for this program, and the implementation cost of the infrastructure is around INR125,000 (US$2976) for a computer lab with five computers. The typical capital recovery period for the ICT program is around 18-19 months per subscription.

Chart 4: ICT Program's Revenues and Net Profits



Source: Jefferies Research; Company Data.

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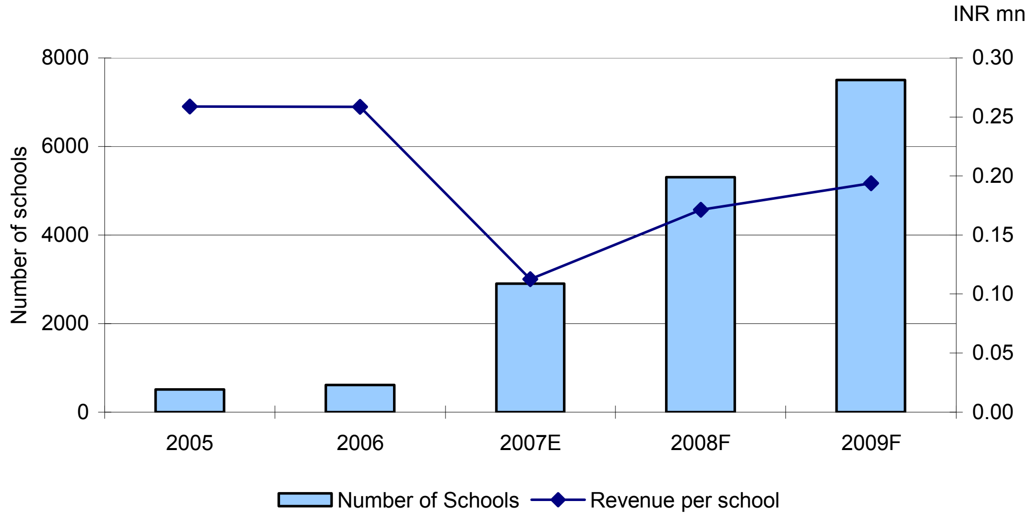
Chart 5: Number of Schools and Per-School Billing in ICT



Source: Jefferies Research; Company Data.

Presently, EDSL's ICT programme is being implemented in seven states, including the addition of the state of Assam in 1Q08. Besides the above, ICT has been implemented in Delhi, where the infrastructure has already been transferred to the government. In our view, the potential target states for ICT include Chandigarh, Goa, Maharashtra, Himachal Pradesh, Kerala, Uttaranchal, Meghalaya, Rajasthan and Andhra Pradesh.

Table 2: States Subscribing to ICT, and States that Are Potential Targets for ICT

State Education Boards Subscribing to ICT	Per Capita Income
West Bengal	22,497
Uttar Pradesh	11,477
Tripura	n.a
Orissa	13,601
Karnataka	23,945
Gujarat	28,355
Delhi*	53,976
Assam#	13,633

States not Subscribing to ICT	Per Capita Income
Chandigarh	67,370
Goa	58,184
Maharashtra	32,170
Himachal Pradesh	27,486
Kerala	27,048
Andhra Pradesh	23,153
Uttaranchal	19,652
Meghalaya	19,572
Rajasthan	16,212

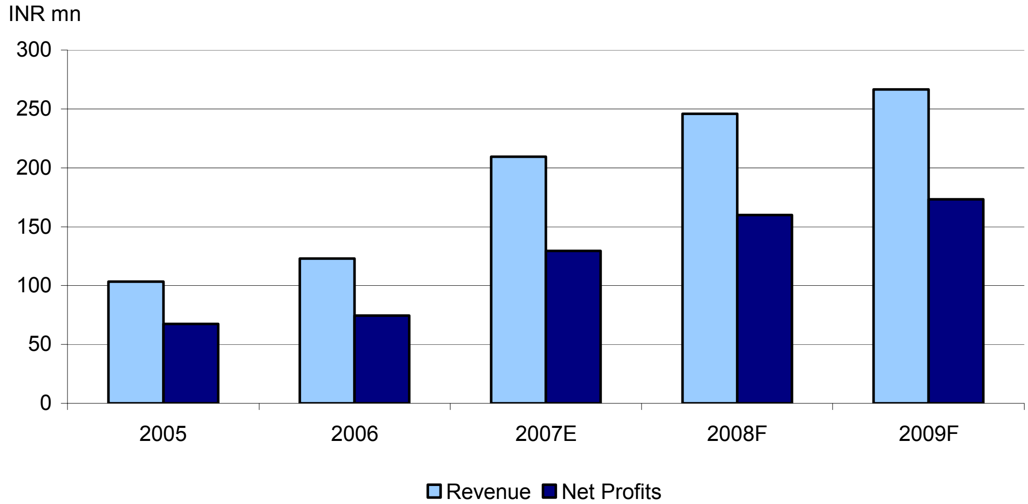
Source: Jefferies Research; State Finances, RBI; Economic Survey 2006-07, Government of India.

** ICT programme is already implemented; # 100 schools subscribed in April 08.*

Professional Development: The program organizes cognitive learning workshops for teachers. The program targets students and parents and provides technology-aided learning and development. The company has established partnerships with Microsoft, Wipro, Worldlinks and Azim Premji Foundation, several state governments, Ministry of Education, and Ministry of IT to promote the product.

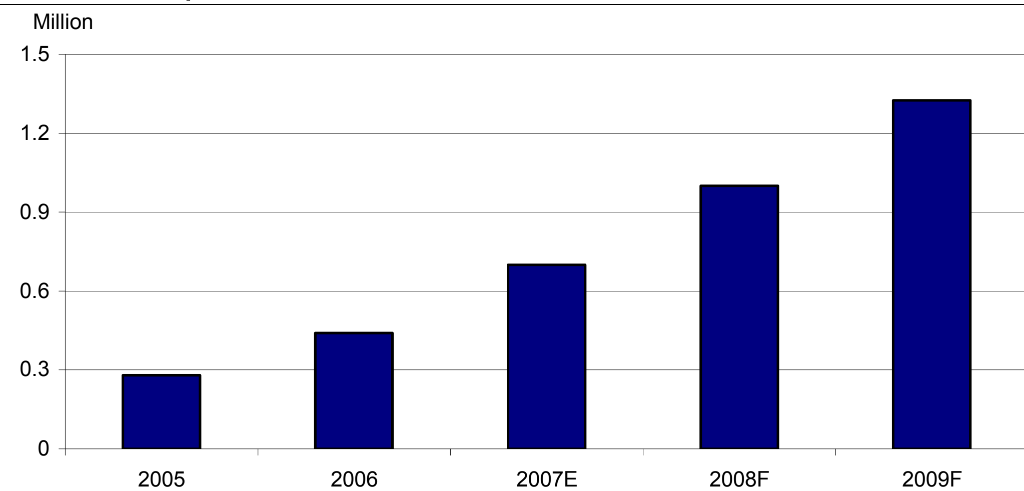
EDSL has trained 0.6 million teachers under the Professional Development program thus far. The company earned revenues of INR133.7mn (US$3.2mn, up 74.8% YoY) and profits of INR80.3mn (US$1.9mn, up 60.6% YoY) during the first three quarters of FY07 in this segment.

Chart 6: Professional Development Program Revenues and Net Profits



Source: Jefferies Research; Company Data.

Chart 7: Professional Development: Number of Teachers Trained



Source: Jefferies Research; Company Data.

New Innovative End-User Focused (B-to-C) Products: EDSL's three flagship products discussed above may be viewed as B-to-B business models from a marketing perspective with clients being private school chains, states or large companies. Besides these, EDSL has also launched two innovative products targeting (a) the pre-school market, which is fragmented and often run by mom-and-pop setups, and (b) private tutoring market — directly reaching out to end-users:

Roots to Wings: The company launched its own brand of pre-schools called "**Roots to Wings**." It launched its first pre-school in Delhi with 150 students in 2006 and targets to open two more schools by March 2007. EDSL charges INR2500 (US$59.5) per student per month and plans to open 10 more pre-schools by FY08 to be run primarily on the franchise model from 2009 onwards. The company has created over 100,000 pages of content for this.

Mathguru.com: In July 2006, a web-based retail initiative was launched through the creation of the **"Mathguru.com**." The online delivery model provides on-demand homework help to grades 6–12 students in mathematics. The portal is supported by a team of 40 professionals and has developed over 12,000 content modules. Fully 4,431 students were registered at mathguru as of end-December 2006, targeted to touch fully

75,000 by March 2008. The company expects to have 8,000 paid subscribers by March 2007, with an annual subscription fee of INR1200 (US$30). With Mathguru.com, the company is also targeting a pie of the US$4bn US online tutoring industry. EDSL's other segments mainly comprise of retail products like educational aids and CD ROMs in over 250 retail outlets across the country through its distribution channels. This segment contributed 13.1% to the total revenues and reported profit of INR18.8mn (US$0.45mn) in 2006.

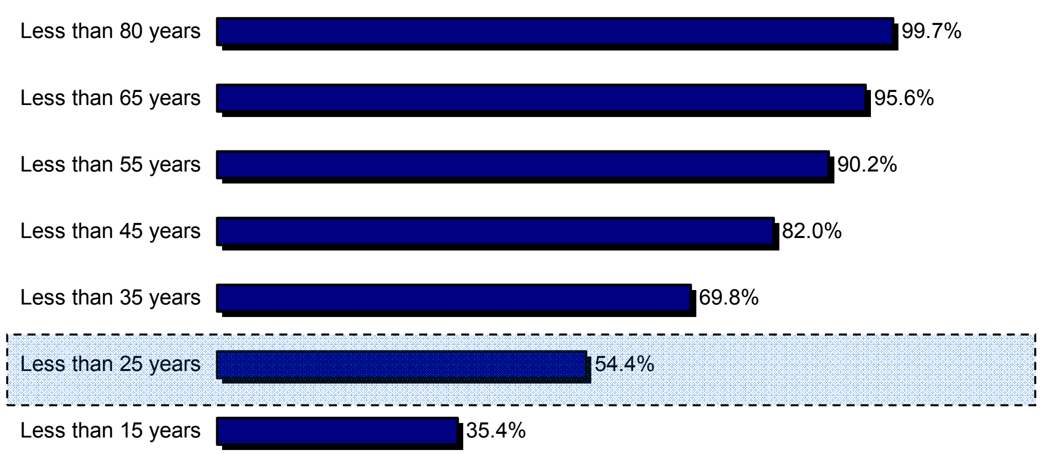
Acquisition of Threebrix E-Services: In April 2007, the company acquired a 76% stake in a software firm, Threebrix E-Services, which owns online education portal Learninghour.com. The company paid INR 25 million (all cash) for this acquisition, which is expected to strengthen its tutoring portfolio.

Expanding International Presence: EDSL is expanding its presence in the international education market. The company has set up an office in United States and an office in Singapore, and plans to open offices in Malaysia and Thailand by 2008. In 2006 fiscal EDSL earned US$2.1mn revenues from the U.S. market.

Addressable Market, Innovation and Product Adaptability

India is the largest education market in the world in terms of number of students, with over 220 million students already accessing the formal education system and an additional 100 million students leveraging informal education sources.[1] There are more than 975,000 government-recognized schools in the country.[2] Of these, about 50,000 are private schools, and that number is growing rapidly. Hardly 2% of the schools are IT-enabled, and the awareness of the need is spreading fast. Further, there are more than five million teachers who need training on IT and related pedagogy.

Chart 8: Population Distribution in India



Source: Jefferies Research; National Census Data 2001.

Quest for Quality Education Driving Fast Growth of Private Schools: India's 50,000+ private schools vary widely in terms of endowments, quality, and costs. While it is hard to get data on tuition fees of private schools, disaggregate city authority data and independent studies reveal that there are more than 5,000 private schools in the country currently charging more than INR2000 (US$48) per month per student in tuition and miscellaneous fees (miscellaneous one-time fees and development fees are often significant). In our view, that would be EDSL's target population for the Smart_Class product; with subscription strength of 300 schools, it has a current market penetration of 6% (assuming target market size of 5000 schools[3]). Note that the number of private schools with fees entering the affordability band for Smart_Class product is also growing fast.

[1] Selected Education Statistics of the Dept. of Education, Government of India indicates that there are 177mn students officially enrolled in registered schools between grades 1–8.
[2] Annual Report 2005–06, Department of Education, Ministry of Human Resource Development, Government of India
[3] The company believes that the current target market size could be more than 10,000 private schools

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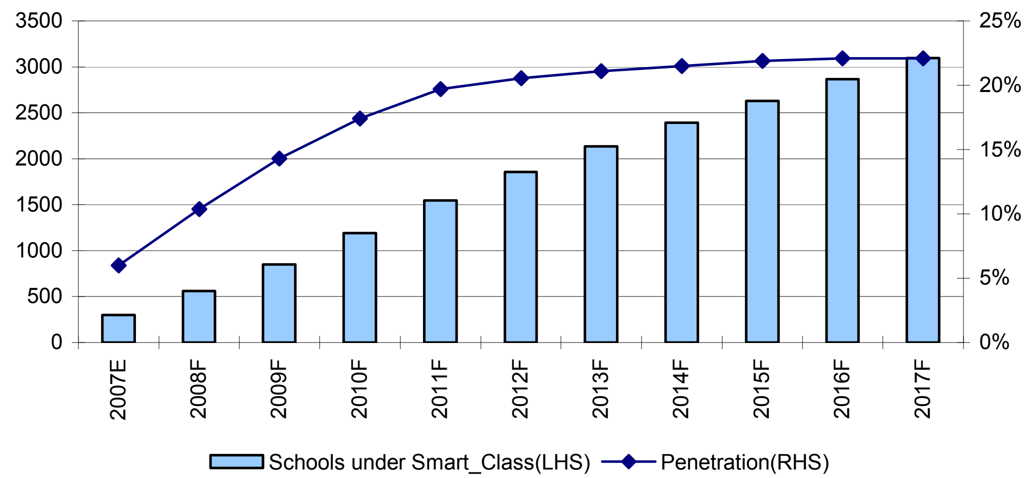
Several independent studies in recent years have highlighted the growing importance of private schools even among India's poor. These are unregistered and privately run rudimentary primary and secondary school facilities catering to the poor population — typically charging monthly fees in the range of $2–5. Eminent economist Jean Drèze, who led India's national assessment of education project in 1999, had commented that public schools in India are on a path of slow extinction. A recent sample study[4] in the slums of Hyderabad, in Andhra Pradesh, found that out of a sample of 1,000 schools, around 750 were private. Stress on English language and better teacher attendance are key reasons cited for their growing popularity. Another factor driving growth of private education is the rapid pace of urbanization led by urban jobs growth. India's urban population as a percentage of total population has gone up to 28.7% in 2005 from 17.3% in 1950. According to National Sample Surveys, spending on education in urban areas has risen from 2.1% of per capita income in 1983 to 6.3% in 2003.

We expect Smart_Class to experience accelerated growth on a relatively small base over the near to medium term, fuelled by growth in private schools, the innovative nature of its products and their potential utility to teachers in a market where the curriculum is well-defined — and achieve a penetration level of 17.4% by the year 2010. However, we expect competition to challenge EDSL's revenue growth prospects over a multi-year horizon. Further, while Smart_Class is rapidly gaining acceptance in the Indian markets supported by the textbook-defined nature of local curriculum, we believe that its prospects in the U.S. market would be challenged by the more open syllabi and unstructured school curriculum followed by most U.S. schools and teachers.

Chart 9: Projected Growth of the Smart_Class Segment



Source: Jefferies Research; Company Data.

Public Schools: Government Spending to Increase: India has an extensive public school system. While public schools are typically undercapitalized, boasting shoddy infrastructure and inadequate facilities — recent initiatives of the government highlight renewed spending initiatives. Combined government expenditure on education (states and federal) has increased at a CAGR 11.6% over the past six years to INR1178.12 billion in FY2006/07[5]. It is important to note that revenue collections via 2% "education cess" on direct and indirect Central Government taxes specifically lends equity to the government's education spending plans. The government, through its political agenda of implementing the National Common Minimum Programme (NCMP), is committed to increase public expenditure on education to around 6% of GDP over the medium term, from the current level of a little below 3% of GDP[6]. EDSL's ICT and Professional Development business segments can benefit from the various spending initiatives and literacy awareness programs of the government in the coming years. Further, we believe that given the government's preference for public-private-partnership (PPP) models to promote education, EDSL is well positioned to access available public funds under various state and central government schemes through effective program partnerships with the public educational authorities. Notably, the company expects approximately 30–35% of its revenues to start coming in the form of PPP models over the near to medium term.

4 Private Schools for the Poor: A Case Study from India by James Tooley, a professor of Education Policy at the University of Newcastle in England
5 Budget Estimate
6 Economic Survey 2006–07

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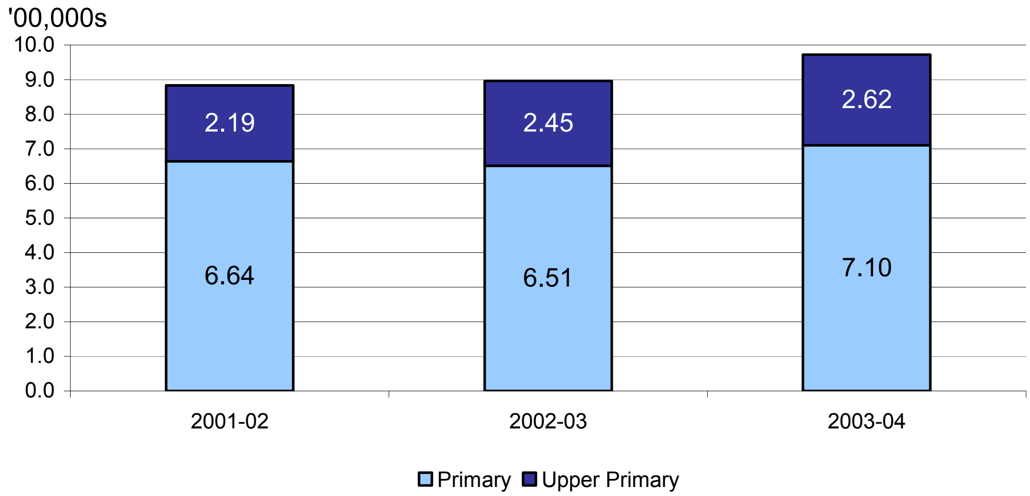
Chart 10: Total Number of Registered Schools in the Country



Source: Jefferies Research; Annual Report of the Department of Education 2005–06, Government of India.

Table 3: Government's Recent Initiatives on Education

Government's Education Programmes and Initiatives	
Sarva Shiksha Abhiyan (SSA)	SSA is an effort to universalize elementary education to all children in the 6–14 age group by 2010.
Mid-Day Meal (MDM) Scheme.	Implemented by all states and UTs, under this scheme, mid day meal is served to students studying at primary levels in government, government-aided and local body schools.
National Programme for Education of girls at Elementary Education	This programme started in July 2003 aims at setting up a model school in every cluster for enhancing girls education
Total Literacy Campaign	This is an adult education programme covering 101 districts targeting age group of 15–35 for providing basic literacy to non-literates.
Kasturba Gandhi Balika Vidyalaya (KGBV) Scheme	KGBV, launched in July2004 aims to set up residential schools at upper primary level for girls belonging predominantly to the SC, ST, OBC and minority communities.
Education Initiatives in Union Budget 2007-08	
Provision for strengthening teachers training institutions to be increased from 1.62 billion to 4.5 billion with 200,000 more teachers to be appointed and 500,000 more class rooms to be constructed.	
Mid-day Meal Scheme to be provided Rs.73.2 billion; children in upper primary classes in 3,427 educationally backward blocks to be also covered	
National Means-cum-Merit Scholarship Scheme to be introduced to arrest dropout ratio	
An additional cess of 1% on all taxes to be levied to fund secondary education and higher education and the expansion of capacity by 54% for reservation for socially and educationally backward classes	

Source: Jefferies Research; Union Budget Highlights, Ministry of Finance.

Emerging Online Tutoring Market: U.S. online tutoring is currently estimated to be a US$4bn business. India offers significant cost advantages with quality services, and online tutoring is fast emerging as a remotely deliverable service industry. Against U.S. hourly tutoring rates of US$40–100, Indian online tutorial service providers charge US$5–20/hour. Apart from EDSL, there are many companies like TutorVista, Growing Stars and Career Launcher gearing up to tap the opportunities in this nascent industry. EDSL's U.S. subsidiary Edumatics Corporation markets online tutoring in the United States, and is presently targeting the vast non-resident Indian (NRI) community United States. It has already tied up with Google for marketing its online tutoring service for mathematics.

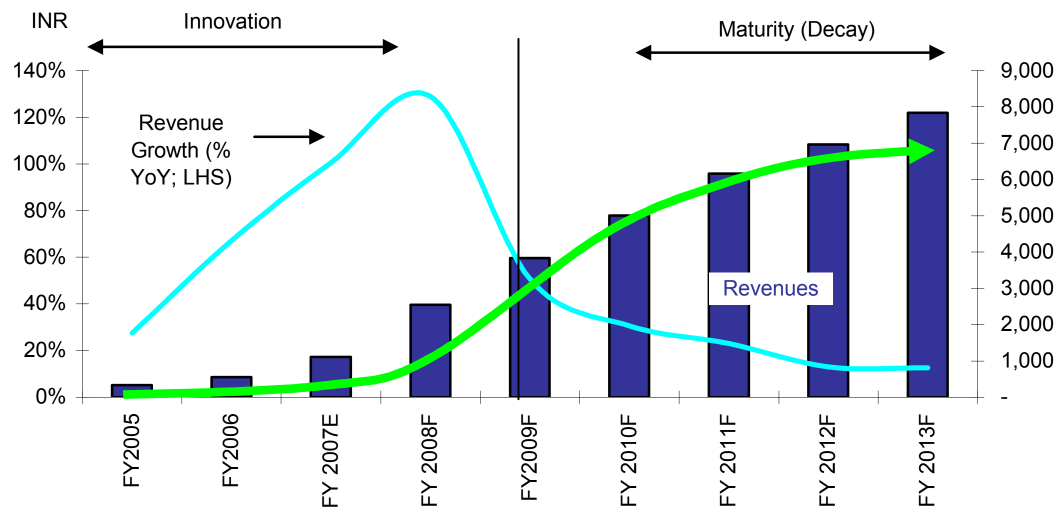
Opportunities in the U.S. market: Smart_Class may have limited scope in the U.S. education system, but online tutoring indeed has huge potential. EDSL entered the U.S. education market by setting up a U.S. subsidiary Edumatics

Corporation in 2002, which is marketing its smart class and online tutoring services. It also successfully completed a pilot with Santa Barbara School District in 2004. Needless to state that the U.S. education market is huge: U.S expenditure on elementary and secondary education topped US$536bn in 2005, up 5.6% CAGR during 1991–2005.

Valuation Methodology

EDSL Is Still at an Early Phase of Growth. Educomp's products are truly innovative and unconventional. We maintain that Educomp is a classic example of "S curve" — innovation/decay business model, in the early phase of discovery. We view a longer-term DCF valuation is more holistic and appropriate than comparative EV/EBITDA, P/E or PEG valuation measures.

Chart 11: Educomp Experiencing Initial Phase "S-Curve" Effect



Source: Jefferies Research; Company Data.

DCF Valuation: In order to project cash flows, we have estimated revenues and expenses of each of EDSL's key business segments going forward. We made assumptions on future market size and appropriate target segments for each of EDSL's key products. The projections are essentially a result of a marriage of top-down and bottom-up analyses. Our projections are based on conservative estimates on market share and penetration for EDSL's Smart_Class and ICT products. We believe that the company's other initiatives like online tutoring can take off in a few years, with increased internet penetration in the country. On the other hand, competition and product obsolescence are real challenges that the company would have to encounter with continuous innovation and adaptability. For our valuation projections, we have not factored in growth in online tutoring at this stage.

We have used Discounted Cash Flow (DCF) as the valuation methodology to arrive at a fair value of the EDSL stock. Our DCF valuation is based on the free cash flow to equity estimated over financial years 2008 to 2017. With FY2017 as the terminal year, we discount the free cash flows and terminal value to present value with the company's weighted average cost of capital (WACC). We have made the following assumptions in our calculations, to arrive at the equity value of EDSL:

- Weighted average cost of capital of 13.9%
- Risk free rate of 8.1 (current 10-yr Government of India bond yields).
- Equity cost of 13.9%
- Beta of 1.01 for EDSL
- Perpetual growth rate (PGR) of 11.5%

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Valuation Methodology (Contd.)

Table 4: Educomp Valuation – DCF Calculations

(INR million)	2008 E	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F
EBIT after tax	763	1151	1362	1665	1877	2168	2447	2557	2783	2993
+ Depreciation & Amortization	409	643	1087	1325	1446	1554	1592	1728	1767	1811
- Capital Expenditure	-1405	-1562	-1481	-2061	-1819	-1887	-1708	-2147	-1886	-1949
- Increase in working capital	-316	-268	-325	-265	-176	-178	-145	-140	-139	-144
- Interest	-12	-10	-10	-10	-5	0	0	0	0	0
Free Cash Flow	-561	-45	633	655	1323	1657	2187	1998	2525	2711
Discount Factor	1	1	1	1	1	0	0	0	0	0
NPV of FCF	**-492**	**-35**	**428**	**389**	**690**	**759**	**879**	**706**	**783**	**738**

Total NPV	**29669**
Enterprise Value	29669
Net Debt	-989.5
Market Capitalization	30658
Fully diluted shares outstanding (mn)	17
Estimated fair value/ share	**1780**
Share price (04/20/07)	**1381**
Potential upside	**26.5%**
* Assuming a perpetual growth rate of 11%	

WACC Calculations	
Market risk premium	5.7%
Beta	1.0
Cost of equity	13.93%
After tax cost of debt	8.0%
WACC	13.90%

Source: Jefferies Research, Bloomberg.

The following table summarizes the sensitivity of EDSL's "fair value" to different assumptions on Perpetual Growth Rate/terminal growth rate (PGR) and WACC estimates, according to our model. We have assumed 13.9% WACC and 11% PRG. Assumptions of India's long-term real GDP growth of above 6% and inflation of 5% keep our terminal growth rate assumption conservative. Our DCF-based fair price target for EDSL is INR1,784.

Table 5: Educomp Valuation – Sensitivity Analysis

Sensitivity Analysis

Share Price		Perpetual Growth Rate				
	1,780	9.0%	10.0%	11.0%	12.0%	13.0%
WACC	11.89%	2,104	3,040	6,076	(46,831)	(4,284)
	12.89%	1,520	1,937	2,793	5,570	(42,832)
	13.89%	1,178	1,403	1,784	2,568	5,111
	14.89%	954	1,090	1,296	1,646	2,364
	15.89%	796	885	1,010	1,199	1,519

Source: Jefferies Research.

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Financials

Table 6: Educomp – Key Ratios

	FY2005	FY2006	FY 2007E	FY 2008F	FY2009F
Revenue Growth (y-o-y)(%)	27.6%	67.1%	100.4%	128.9%	50.5%
Operating EBITDA margin	47.2%	48.2%	59.2%	62.1%	63.4%
Net profit margin (%)	20.2%	25.1%	31.9%	29.5%	29.8%
COGS/ Total Revenue(%)	10.2%	17.2%	13.7%	13.7%	13.7%
Personnel expenses/Total revenue (%)	20.4%	16.4%	9.8%	7.3%	7.4%
Personnel expense (y-o-y)	18.2%	34.3%	20.2%	69.2%	54.0%
Administration and other expenses/Total Revenue (%)	22.2%	18.2%	17.0%	16.0%	15.0%
Administration and other expenses (y-o-y)	11.9%	36.7%	87.6%	115.5%	41.1%
Depreciation % of revenue	15.5%	10.1%	10.3%	16.1%	16.8%
Asset Turnover (X)	0.96	0.68	0.57	0.78	0.85
Debt to Equity (X)	0.20	0.12	0.69	0.45	0.29
Debt to Op EBITDA (X)	0.29	0.41	1.47	0.60	0.39
Return on Equity (%)	34.8%	24.8%	30.8%	42.5%	42.5%
Return on Assets (%)	19.3%	17.1%	18.0%	23.1%	25.3%

Source: Jefferies Research; Company Data.

Table 7: Educomp's Key Business Segments

Smart Class	**2005**	**2006**	**2007E**	**2008F**	**2009F**
Revenue (INR mn)	29	201	491	1204	1818
Revenue Growth (% YoY)		**581%**	**145%**	**145%**	**51%**
Net Profits (INR mn)	6	120	308	859	1309
Net Profits Growth (% YoY))		1813%	156%	179%	52%
Number of schools	26	91	300	560	850
Revenue per school	1.13	2.21	1.64	2.15	2.14
ICT Solution	**2005**	**2006**	**2007E**	**2008F**	**2009F**
Revenue (INR mn)	132.6	158.61	326.4063	906.87	1452.99
Revenue Growth (% YoY)		**20%**	**106%**	**178%**	**60%**
Net Profits (INR mn)	32.59	60.17	102.19	376.87	702.99
Net Profits Growth (% YoY))		85%	70%	269%	87%
Number of schools	**512**	**613**	**2900**	**5300**	**7500**
Revenue per school	**0.259**	**0.259**	**0.113**	**0.171**	**0.194**
Professional Development	**2005**	**2006**	**2007E**	**2008F**	**2009F**
Revenue (INR mn)	103.37	122.95	209.386	246	266.5
Revenue Growth (% YoY)		**19%**	**70%**	**17%**	**8%**
Net Profits (INR mn)	67.42	74.62	129.52	159.90	173.23
Net Profits Growth (% YoY))		11%	74%	23%	8%
Total Number of Teachers Trained (mn)	0.28	0.44	0.70	1.00	1.33

Source: Jefferies Research; Company Data.

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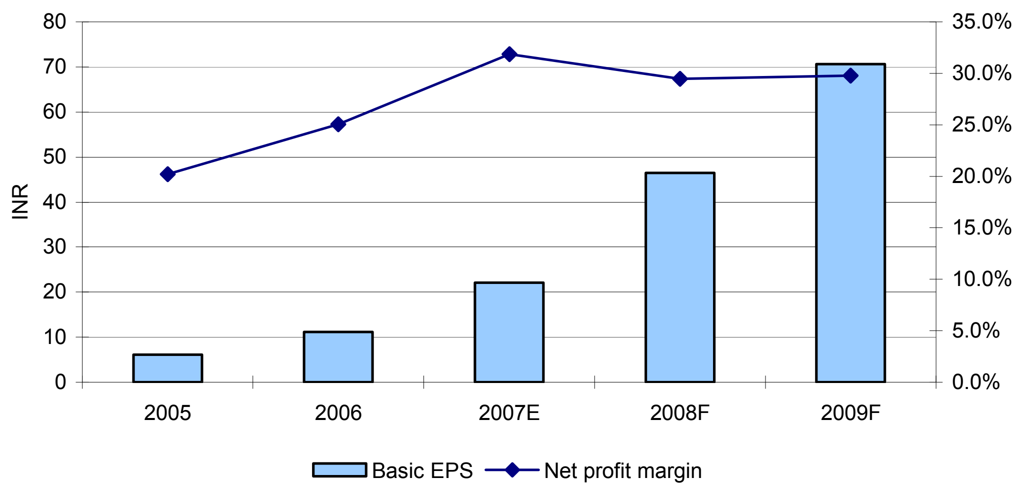
Table 8: Income Statement – Key Items

INR million	2005	2006	2007E	2008F	2009F	2010F
Revenue	332	555	1,113	2,548	3,835	5,008
y-o-y growth (%)		*67.1%*	*100.4%*	*128.9%*	*50.5%*	*30.6%*
Cost of goods sold	34	95	155	373	542	690
Gross profit	298	460	957	2,175	3,293	4,318
Gross profit margin	*89.8%*	*82.8%*	*86.0%*	*85.4%*	*85.9%*	*86.2%*
Total operating expense	197	255	424	1,015	1,514	2,204
Operating EBITDA	157	267	658	1,581	2,432	3,211
Operating EBITDA margin	*47.2%*	*48.2%*	*59.2%*	*62.1%*	*63.4%*	*64.1%*
Profit before tax	114	220	562	1,189	1,808	2,143
Tax	45	79	208	438	666	791
Profit after tax	67	139	355	751	1,142	1,352
Net margin	*20.2%*	*25.1%*	*31.9%*	*29.5%*	*29.8%*	*27.0%*
Basic EPS	6.1	11.2	22.1	46.5	70.7	83.7
Basis EPS y-o-y growth (%)		*82.2%*	*97.9%*	*110.5%*	*52.0%*	*18.4%*
Diluted EPS	4.2	8.7	20.6	43.6	66.3	78.5
Diluted EPS y-o-y growth (%)		*107.3%*	*136.2%*	*111.8%*	*52.0%*	*18.4%*

Source: Jefferies Research; Company Data.

Chart 12: EPS Growth and Net Profit Margins (%, RHS)



Source: Jefferies Research; Company Data.

Economies of Scale. Educomp should reap benefits of economies of scale, particularly FY2008 onwards. Its Operating EBITDA margins should steadily improve from 47.2% in March 2005 to 64.1% in March 2010, according to our model. Essentially, the content library has a long shelf life, and the company recovers fixed costs in 13–15 months for Smart_Class and in 18–19 months for ICT program. Length of contract and freed-up cash from business would lend latitude to Educomps ability to (a) innovate and invest, and (b) fight competition.

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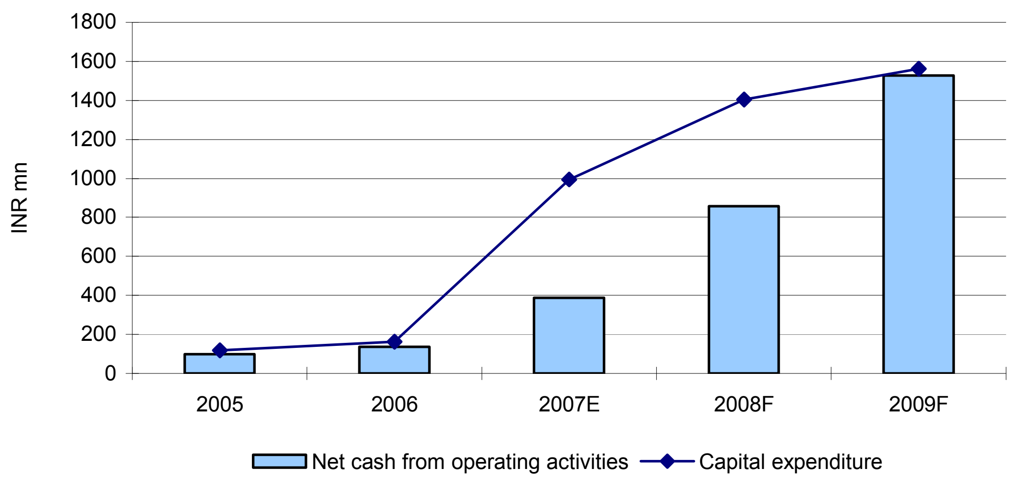
Table 9: Cash Flow Statement – Key Items

INR million	2005	2006	2007E	2008F	2009F	2010F
Net profit before tax	114	221	562	1,189	1,808	2,143
Net cash from operating activities	98	137	387	857	1,527	2,124
y-o-y growth (%)		*39.4%*	*183.0%*	*121.6%*	*78.2%*	*39.1%*
Capital expenditure	118	162	994	1,405	1,562	1,481
Capex as a % of revenue	*35.7%*	*29.2%*	*89.3%*	*55.2%*	*40.7%*	*29.6%*
Net cash used in investing activities	-98	-167	-994	-1,405	-1,562	-1,481
Net cash from financing activities	12	616	1,000	-52	-37	-37
Net increase in cash and cash equivalents	12	586	393	-600	-72	605
Closing cash and cash equivalents	23	609	1,002	402	329	935
Free cash flow	-7	10	-607	-548	-36	633
y-o-y growth (%)		*-240.8%*	*-6182.6%*	*-9.7%*	*-93.5%*	*-1880.8%*

Source: Jefferies Research; Company Data.

Chart 13: Capital Expenditure and Net Cash from Operating Activities



Source: Jefferies Research; Company Data.

Funding Growth Through Internal Accruals. Educomp expects to free up enough cash for future investments. The company's cash & bank balances are expected to top INR1bn by Mar 2007 (primarily with the proceeds of the US$25mn FCCBs). Between March 2007 and March 2009, we estimate investments worth US$70mn by the company—completely funded by internal accruals. Given its comfortable cash position, we do not expect EDSL to raise debt or equity funding in the medium term.

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Table 10: Balance Sheet – Key Items

INR million	2005	2006	2007E	2008F	2009F	2010F
Shareholders equity	226	895	1,404	2,128	3,242	4,567
Total debt	45	110	965	953	953	953
Net debt	22	-499	-37	551	624	18
Current liabilities	125	187	338	689	1,019	1,239
Fixed assets	146	252	1,130	2,126	3,044	3,439
Total debtors	191	260	496	1,135	1,709	2,231
Current assets	257	935	1,573	1,639	2,165	3,315
Working capital	132	748	1,235	950	1,146	2,077
Total assets	417	1,210	2,726	3,787	5,232	6,776
Debt to equity	*20.2%*	*12.3%*	*68.7%*	*44.8%*	*29.4%*	*20.9%*
Return on equity	*34.8%*	*24.8%*	*30.8%*	*42.5%*	*42.5%*	*34.6%*
Return on assets	*19.3%*	*17.1%*	*18.0%*	*23.1%*	*25.3%*	*22.5%*
Current ratio	*2.1*	*5.0*	*4.7*	*2.4*	*2.1*	*2.7*
Total debt/Operating EBITDA	*0.29*	*0.41*	*1.47*	*0.60*	*0.39*	*0.30*

Source: Jefferies Research; Company Data.

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Appendix

Company Profile

EDSL was established in 1994. It provides animated and innovative education products for K–12 segments aimed to aid the teaching in private schools and offers computer literacy programme in government schools. It has presence in 51 cities in India, with nine offices across the country and one office each in U.S. and Singapore. It operates through four business segments:

- Smart Class – Offers animated content designed as per the text books for K–12 segments of private schools
- ICT – Offers computer literacy program to government schools which involves setting up of a computer lab in each school and running the project on BOOT model
- Professional Development – Offers cognitive learning workshop for teachers, students and parents
- Retail/Others – Markets CD ROMs and education aids contents, also includes new initiatives like mathguru portal and own branded pre schools "Roots to Wings"

The company became a public limited company in 2000 and is listed on NSE and BSE since 2006.

Management Profile:

Board of Directors	Age	Designation	Qualification	Profile
Shantanu Prakash	40	Managing Director	B.Com (H) (SRCC), MBA (IIM-Ahmedabad)	Founder of the company
Gopal Jain	34	Director	B.Tech (IIT Delhi)	Managing Director of Gaja Capital Partners (a private equity firm)
Shonu Chandra	40	Director	MA in Mass Communication (Mass Communication Research Centre, JMI), Post Graduate Diploma CYD (Institute of Social Science, the Hague, Netherlands)	Executive Producer and Director in Waves Communications Pvt Limited, associated with Waves for the past 17 years
Sankalp Srivastava	40	Director	B.E. (Electronics and Communication Engineering) (University of Roorkee)	Founder of Mark and Space, which is engaged in design, development and manufacture of micro-processor based telecom, power-control and energy management system
Jagdish Prakash	70	Director	M.Com (Agra University)	Worked with Steel Authority of India as Chief Material Manager

Source: Company website

Key Investors	% Holding
Shantanu Prakash	57.78
Bhanshali Roopchand	6.26
Morgan Stanley & Co Intl	5.43
Anjlee Prakash	4.71
Goldman Sachs	4.68
Citigroup GLBL	4.34
Gaja Advisors	2.50

Source: Bloomberg

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Educomp Solutions Limited

Consolidated Income Statement INR million except per share data	FY2004 A	FY2005 A	FY2006 A	FY 2007 E	FY 2008 F	FY2009 F	FY 2010 F	FY 2011 F	FY 2012 F	FY 2013 F	FY 2014 F	FY 2015 F	FY 2016 F	FY 2017 F
Income														
Sales	260	332	555	1113	2548	3835	5008	6161	6960	7840	8634	9130	9828	10518
Revenue	**260**	**332**	**555**	**1113**	**2548**	**3835**	**5008**	**6161**	**6960**	**7840**	**8634**	**9130**	**9828**	**10518**
Cost of goods sold	70	34	95	155	373	542	690	849	961	1043	1148	1168	1257	1344
Decrease/(Increase) in stock in trade	0	0	0											
Purchases	0	0	0											
Gross Profit	**190**	**298**	**460**	**957**	**2175**	**3293**	**4318**	**5312**	**5999**	**6797**	**7487**	**7962**	**8571**	**9174**
Operating Expense														
Personnel expenses	57	68	91	109	185	285	381	493	610	716	821	921	1033	1158
Administration and other expenses	66	74	101	189	408	575	726	887	995	1113	1217	1278	1376	1472
Finance charges	4	4	6	10	12	10	10	10	5	0	0	0	0	0
Depreciation	38	51	56	115	409	643	1087	1325	1446	1554	1592	1728	1767	1811
Miscellaneous Expenditure written off	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Total Operating Expense	**165**	**197**	**255**	**424**	**1015**	**1514**	**2204**	**2716**	**3057**	**3384**	**3630**	**3927**	**4175**	**4442**
Opearting Income	**25**	**102**	**205**	**534**	**1160**	**1779**	**2114**	**2596**	**2943**	**3413**	**3857**	**4035**	**4396**	**4732**
Other income	13	13	15	29	29	29	29	29	29	29	29	29	29	29
Profit before tax and prior period items(3)	38	114	220	562	1189	1808	2143	2625	2971	3442	3885	4064	4424	4761
Provision for income tax														
Current	8	40	80	204	431	656	778	952	1078	1249	1410	1474	1605	1727
Deferred	8	5	-4	0	0	0								
Fringe benefit	0	0	3	4	7	10	13	17	21	25	29	32	36	41
Profit after tax and before prior period items	22	69	141	355	751	1142	1352	1656	1872	2168	2447	2557	2783	2993
Prior period Items	0	0	-1	0	0	0	0	0	0	0	0	0	0	0
Provision for income tax for previous years	4	0	2	0	0	0	0	0	0	0	0	0	0	0
Profit after tax before minority interest & pre-acquisition (	18	69	140	355	751	1142	1352	1656	1872	2168	2447	2557	2783	2993
Pre-acquisition profits	0	1	0	0	0	0	0	0	0	0	0	0	0	0
Minority interest	0	1	1	0	0	0	0	0	0	0	0	0	0	0
Net Profit	**18**	**67**	**139**	**355**	**751**	**1142**	**1352**	**1656**	**1872**	**2168**	**2447**	**2557**	**2783**	**2993**
Weighted Average number of equity shares outstanding	4.5	11.0	12.5	16.1	16.2	16.2	16.2							
Outstanding Share at the end of FY			16.0	16.2	16.2	16.2	16.2							
Outstanding Diluted Number of shares		16.0	16.0	17.2	17.2	17.2	17.2							
Basic Earning per Share of Rs 10 each (in Rupees)	4.0	6.1	11.2	22.1	46.5	70.7	83.7							
Diluted EPS		4.2	8.7	20.6	43.6	66.3	78.5							
						0.9								

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Company Description

Educomp is India's largest market-listed technology-aided education company.

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I, Anindya Chatterjee, certify that all of the views expressed in this research report accurately reflect my personal views about the subject security(ies) and subject company(ies). I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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In November 2006, Jefferies acted as lead manager in a convertible notes offering for Educomp Solutions Limited.

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Our focus on mid-capitalization and growth companies implies that many of the companies we cover are typically more volatile than the overall stock market, which can be amplified for companies with an average stock price consistently below $10. For companies in this category only, the expected total return (price appreciation plus yield) for Buy rated stocks is 20% or more within a 12-month period. For Hold rated stocks with an average stock price consistently below $10, the expected total return (price appreciation plus yield) is plus or minus 20% within a 12-month period. For Underperform rated stocks with an average stock price consistently below $10, the expected total return (price appreciation plus yield) is minus 20% within a 12-month period.

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Risk which may impede the achievement of our Price Target

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Rating and Price Target History for: Educomp Solutions Ltd. (EDSL IN) as of 04-24-2007

Created by BlueMatrix

Distribution of Ratings

Rating	Count	Percent	IB Serv./Past 12 Mos. Count	IB Serv./Past 12 Mos. Percent
BUY [BUY/SB]	430	53.42	60	13.95
HOLD [HOLD]	344	42.73	29	8.43
SELL [UNPF/SU]	31	3.85	6	19.35

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