December 15, 2010

Indian Education

AMBIT
Acumen at work

INITIATING COVERAGE

Unloved flowers or weeds?

Listed education players have substantially underperformed the broader market over the last two years and now trade at a significant discount to the unlisted sector's deal valuations. Although the sector continues to enjoy secular growth drivers, the ground realities for the listed participants are deteriorating in their core segments due to: (a) rising competition, (b) adverse regulation, and (c) emerging scalability challenges. In light of this, current valuations do not promise attractive long term value.

The investment opportunity in Indian Education can primarily be split into three primary sub-segments. We choose to distinguish between these based on capital intensity, ROI potential and sustainability of returns:

- **Short term opportunities (Allied services: pre-school, test-prep and tutoring, vocational training):** These segments tend to enjoy lighter regulation, low capital intensity and shorter pay back periods (or ROI velocity), but suffer from lower barriers to entry and scalability challenges. The typical IRR/ROEs in these businesses range from 17-43% and the typical payback period ranges from 2.5-8 years. Listed plays in this segment are Aptech, CareerPoint, NIIT and Everonn.

- **Medium term opportunities (IT suppliers to schools: multimedia content, ICT@School):** This segment not only has relatively higher capital intensity (given the nature of contracts), but also higher barriers to entry and returns (ROE>20%). However, given that the premium end of the market seems to have reached a saturation point, further penetration depends on Tier2/3 cities and that is likely to entail falling price points and lower classroom adoption. Listed plays in this segment are Educomp, Everonn and NIIT.

- **Longer term opportunities (Brick and mortar K-12 schools and college ownership/management):** The market opportunity for the K-12 and Higher Education segments is undoubtedly attractive given the substantial unmet demand, sustainable competitive advantage and defensive recurring revenues. Successfully run schools are highly lucrative with ~23% IRRs. That said, challenges remain in terms of execution capability and operating in a backdrop of regulatory controls. Listed plays in this segment are Educomp and Everonn.

While the education sector has several catalysts (E.g. low penetration of high quality education and growing demand for educated workers), our analysis of the key segments in which listed players operate suggest that specific challenges persist that makes sustainability of returns doubtful. The only segments that promise sustainable competitive advantages with a large addressable market size are the brick & mortar K-12 and college businesses. However, the sector has a short and chequered history of successful ramping up brick and mortar institutions that create ROI in a reasonable time frame in the face of regulation. We would wait and watch before dipping toes into this opportunity. We initiate with a **Sell** recommendation on **Educomp** (28% downside) and **Everonn** (10% downside).

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Educomp- SELL

CMP:	Rs517
Target Price :	**Rs372**
Downside (%):	***28***
EPS (FY11E):	Rs34.7
Variance from consensus (%):	*5%*
Mkt cap:	Rs49bn/US$1,095mn
ADV	Rs757mn/US$16.8mn

Everonn - SELL

CMP:	Rs597
Target Price:	**Rs535**
Downside (%):	***10***
EPS (FY11E):	Rs36.4
Variance from consensus (%):	*-1*
Mkt cap:	Rs9bn/US$200mn
ADV	US$6.1mn / Rs276mn

Other stocks mentioned in this report

Company:	**Aptech (APTR.IN)**
Mkt cap:	Rs6,058mn/US$135mn
ADV:	Rs144mn/$3.2mn
Company:	**NIIT (NIIT.IN)**
Mkt cap:	Rs8,882mn/US$197mn
ADV:	Rs53mn/$1.2mn
Company:	**Career Point (CRPT.IN)**
Mkt cap:	Rs6,679mn/US$148mn
ADV:	Rs625mn/$14mn
Company:	**Core Projects (CPTL.IN)**
Mkt cap:	Rs29,788mn/US$662mn
ADV:	Rs534mn/$11.8mn

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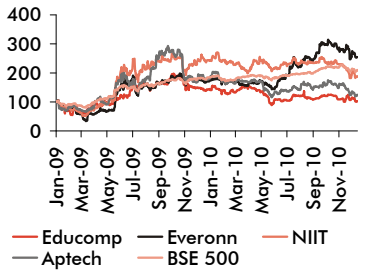
CONTENT

SECTOR

COMPANIES

Does CY11 promise better tidings for this battered sector?

Exhibit 1: Education stocks have relatively underperformed the BSE500



Source: Ambit Capital research, Bloomberg

Stocks of education firms were stock market darlings two years ago but have now lost their coveted position as the companies have underperformed their initial inflated expectations. Although the share prices have recovered from their 2008-9 nadir, the sector (with the exception of Everonn) has underperformed the BSE 500 Index by 31% YTD and now trades at an average FY12 EV/Sales of 2.2x, P/E of 13.7x and EV/EVITDA of 7.1x. In contrast, private equity deals for unlisted firms point to substantially higher valuations. While specific deal valuations are not available publicly, anecdotal evidence from our meetings at the recent VCCircle Education Summit suggest that deals have been placed at 6-12x Price/Sales. Private money is clearly chasing a limited number of attractive unlisted education businesses aggressively.

Does this point to an attractive entry point for public market investors into the much touted "secular growth" education sector? We think not. While the education sector still promises strong growth driven by unmet demand for high quality education, the ground realities in the core segments (that the listed players currently operate in such as multimedia content in schools, K-12 and pre-schools) are changing with rising competition, falling differentiation and regulatory pressures. Moreover, valuations when seen in the context of company specific issues do not look exciting.

Exhibit 2: Deal activity in the private space (figures in US$mn)

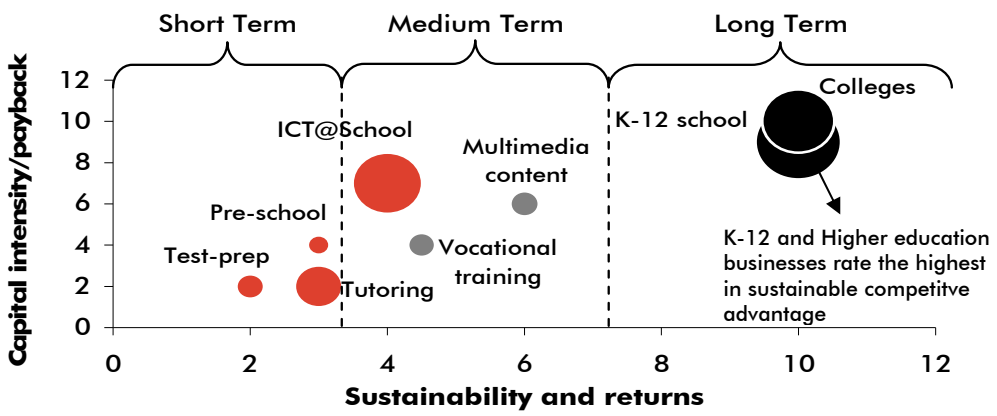
PE firm involved	Particulars	Deal value
India Venture Partnership	Your Kids 'R' Our Kids	2.2
Reliance Capital	Pathways school	22
Sequoia / Song Advisors	K12 Techno Services	15
India 2020	iDiscoveri	10
Venture East	Orion Edutech	na
Premji invest	Manipal K-12	43
Milestone	Resonance	13
India Alternatives	The Framboxx-IIFM	6

Source: Industry, VCCircle.

Investment opportunities in the Indian education sector

We believe that the education sector can be sliced into three categories: short term, medium term and long term opportunities. These opportunities also chart the typical lifecycle of most education companies that begin with businesses in the "Short term" and "Medium term" opportunities categories and then invest cash flows from these businesses into "Long term" opportunities to transform their businesses into more sustainable franchises with stronger recurring revenues. Exhibit 3 highlights our view on the education landscape in this context:

Exhibit 3: Sustainability v/s capital intensity



*Source: Industry, Ambit Capital research; Note: * size of the bubble indicates the size of the addressable market; ^colour of the bubble indicates competition: Red- High, Grey- Medium, Black- Low.*

Short Term Opportunities

Exhibit 4: Allied services revenue % for listed players

% of consol. revenue	FY09	FY10
Educomp	4%	5%
Everonn	33%*	41%*
NIIT	38%	38%
Aptech	100%	100%
Career Point	100%	100%
Core Projects	nil	nil

Source: Company. Note: includes College, Retail and Toppers Tutorial revenues.*

Exhibit 5: Key players in testprep/tutoring

Players	Revenue (Rsmn)	Centres
IMS Learning	~1,500	na
Career Launcher	~1,500	na
Career Point	620	31
Mahesh Tutorials	~1,000	160
Brilliants	200-250	40
Kalrashukla	200-250	35
Resonance	600-800	25

Source: Industry

Exhibit 6: Career Point's revenue and net income

Rs mn	FY06	FY10	CAGR (%)
Revenue	54	617	83.5
PAT	15	199	91.6
PAT margin	27.1%	32.2%	

Source: Company

Allied services: pre-school, test-prep and tutoring, vocational training

Summary: Currently the allied segments contribute significantly to listed players revenues (with the exception of Educomp). These segments tend to enjoy the advantage of low regulations, low capital intensity and shorter pay back periods (also called "ROI velocity"). For example, barriers to entry are particularly very low in the tutoring and in the test prep segment where, firstly, scalability is a severe issue given the highly fragmented nature of the market and, secondly, student enrolments and pricing power is dependant on the success of the students in the previous batch. Whilst the vocational training market is attractive, it has not been able achieve scale outside IT training. Furthermore, most of the sub-segments in the vocational training market are still nascent and unproven. However, stickiness of revenues and barriers to entry are low in this segment. This impacts long term margins and ROE.

1. Test preparation and Tutoring: These are supplementary businesses which run parallel to mainstream education. Firms catering to this segment tend to focus on the important public exams (class 10 & 12) and professional college entrance exams (CAT, GMAT, CET, IIT-JEE, AIEEE, etc).

Drivers: (a) Increasing enrolment in private schools and higher education, (b) no regulatory restrictions on profitability, (c) high price inelasticity for well established brands, (d) low capital intensity (capex only on furniture and fit outs, a typical tutoring centre with 240 students capacity would involve capex of only ~Rs3 mn), and (e) quick payback period (~2.5-3 years).

Challenges: While the segment enjoys strong growth drivers, it suffers from specific challenges: (a) a highly fragmented market (one of the largest players in this segment, IMS Learning despite being established since 1977 has a revenue base of only ~Rs1.5 bn; source: industry), (b) strong local preferences making it difficult to break regional shackles, (c) high dependence on star teachers who are prone to attrition which can then dent enrolment, and (d) low barriers to entry as capital intensity is low.

The initial success of listed diversified firms, Educomp and Everonn, in this segment has been mixed. Both the firms have grown inorganically by buying existing franchises. While Everonn has been able to successfully scale up its test prep business (Toppers Tutorial; revenues of Rs131mn in FY10 and PAT margin of 8.3%), Educomp has struggled to grow its acquired businesses (Learning Hour: revenues of Rs12 mn grew only by 16% YoY in FY10 with a PAT loss of Rs33 mn). Barring Career Launcher and IMS, firms in this segment do not have a proven and scaled up business model. Industry sources indicate that revenues for a large player in the MBA test prep market fell 30% YoY. We believe that the industry seems ripe for consolidation as firms are finding it increasingly difficult to scale.

Career Point, a recently listed firm, is a test prep pure play that provides IIT-JEE, AIEEE, AIPM, AIPDT training. As on July 2010, the company had 17 owned and 16 franchisee Centres. A significant portion of its revenues (58%) is derived from the company owned Kota centre. While the company has registered robust growth in the past, we believe that the business model is unsustainable in the long term given: (a) high exposure to a single segment (IIT-JEE training), where government legislation could place the entire business model under threat, and (b) scalability for the largest revenue contributor (Kota centre) could be a limiting factor as rise in competition in the same region can lead to market share loss.

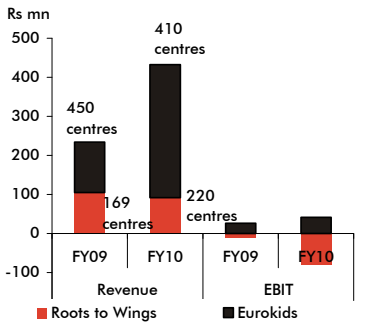
2. Pre-school: The pre-school market (early age training between 18-48 months) is dominated by the unorganized players. Listed market firms (Educomp and Everonn) have tried to enter this market with branded chains using better pedagogy and resources

Exhibit 7: Key players in pre-school

Players	Centers
Kidszee	700
Eurokids	410
Roots to Wings	220
Treehouse	140
Kangaroo kids	98
Shemrock	130
Hellokids	76

Source: Industry

Exhibit 8: Educomp's pre-school business



Source: Company

Drivers: (a) attractive market potential (~11% of Indian population is in the 0-4 age group and ~94% enrolments are at the primary level), (b) increasing importance placed by parents on early age training, (c) the rising proportion of working women, and (d) no regulatory restrictions on profitability.

Challenges: Whilst pre-schools remain an attractive opportunity, it faces the following issues: (a) competition with low priced local mom-&-pop shops, (b) scalability remains restricted to the local neighbourhood due to travel constraints for small children, (c) low attractiveness for pre-schools, which do not have tie ups with K-12 schools, and (d) successfully managing a franchisee model as quality tends to get diluted with growth.

While a successful pre-school would have attractive IRRs of ~17%, scaling up and managing a successful franchisee model appears to be challenging. Educomp has had issues in its own brand Roots to Wings (RTW), as well as in its acquired business, Eurokids (50% stake). Despite increasing franchisee centres by 30% in FY10, RTW reported a revenue decline of 13% YoY and loss of Rs81.8 mn at the EBIT level indicating falling realizations per centre, which reflects rising competitive intensity. On the other hand, Eurokids grew by 21% YoY in FY10 (adjusted for acquisition) with a decline in total centres from 450 in FY09 to 410 in FY10 and EBIT margins dipped from 20% in FY09 to 12% in FY10. This points to the fact that success ratio of franchisee centres remains low even for well established brands such as Eurokids (the second largest player in the market).

3. **Vocational training:** The Vocation training market can be broadly divided into formal and informal training. The informal vocational training market is a more attractive segment for private players. Indeed, training in IT, multimedia, insurance, retail etc are attracting significant private sector participation.

Drivers: (a) attractive market potential as 1/3rd of the population is in the 15–29 years age band and only 7% have received any form of vocational training, and (b) lack of business regulation regarding profitability.

Challenges: While the overall market opportunity looks enticing, there are certain issues associated with operating in this segment: (a) highly fragmented market as there is stiff competition from mom-and pop players particularly in the generic skills training such as English language training, personality development, (b) apart from IT training, no other segment has seen large scale plays, (c) some areas such as insurance, retail training are still at a nascent stage, and (d) students seek job guarantees for specialized courses and hence corporate tie-ups are critical.

Exhibit 9: Vocational training revenue % for listed players

	Revenue proportion
Everonn	a. 13% of revenue in FY10; derived from providing employability skills training in colleges. b. To spend Rs300 mn to set up 100 ITI's to deliver formal vocational training over the next 18 months
Educomp	a. 0.2% of revenue in FY10; derived from the Pearson JV b. Plans 600 centres, focused on finance, retail, IT and insurance
NIIT	38% of revenue from IT/BPO training, BFSI and management training
Aptech	100% revenues from IT training, airhostess training and technology based testing.

Source: Company

Amongst the listed firms NIIT and Aptech, have proven, scaled-up business model for the IT training segment. However, IT training is the most well penetrated segment in vocational training and is highly cyclical in nature. Given the strong recovery in the Indian IT industry, these firms are likely to benefit from the recovery in hiring activity in the short term. Given their experience in running large and successful IT training businesses, these firms are also theoretically more likely to run other vocational businesses better than newer entrants into this space. However, success in non-IT training has been limited to animation training for Aptech.

In the non-IT vocational training segment, Everonn has a large presence (13% of revenues in FY10) where it offers employability skills training (primarily generic skills) to college students within the institute's premises. However, Everonn's current business model in the colleges segment suffers from low revenue visibility as there is no revenue guarantees from the colleges.

Everonn and Educomp have set ambitious targets in the vocational training space wherein they plan to offer specialized courses (refer exhibit 9). However, these businesses are yet to take off and we believe that a established player in the IT training space, which has the experience of operating a proven franchisee model and corporate tie-ups for placements might have a better chance of succeeding in such ventures. Moreover, for Everonn and Educomp it is a move away from their core competence and hence the likelihood of success at the current stage seems low.

Medium Term Opportunities

IT suppliers to schools: Multimedia content, ICT@School

This segment has relatively higher capital intensity given the nature of BOOT contracts and hence higher barriers to entry.

Summary: The market opportunity for the multimedia content market looks attractive in terms of size (>US$1 bn). However, given that the premium end of the market seems to have reached a saturation point, further penetration depends on Tier2/3 cities. This in turn entails falling price points and lower classroom adoption implying a substantial decline in revenue growth for the leading players with compression of margins and return ratios. Whilst the ICT business has a high annuity revenue component, higher receivable days (~180-240 days), lumpiness in contract wins and lower IRRs (~10%) denote negative NPVs for such contracts (assuming a reasonable cost of equity such as 15%).

Multimedia content in schools

Multimedia content for schools is currently the largest revenue pie for listed core players in the education space. Such multimedia content enables teachers to use digital resources (such as graphics, animations and video clips) in addition to the chalk & talk methods of teaching. This, according to the multimedia vendors, improves teacher productivity as well as provides multisensory learning experience to the student thus improving learning outcomes.

Exhibit 10: Key players in multimedia content for schools

	Schools (No.)	Price per classroom (Rs, p.m)
Educomp	4,532	5,400-6,300
Everonn	1,195	5,400-5,850
NIIT	300	6,000-7,000
Manipal K-12	400	4,500-5,400

Source: Company, Industry

Exhibit 11: Multimedia revenue and EBITDA margins

	Educomp		Everonn	
	FY09	FY10	FY09	FY10
Revenue (Rs mn)	3,141	6,445	274	314
% of total revenue	49.3	62.0	18.9	10.7
EBITDA margin *(%)	68.3	69.5	60.6	63.9

*Source: Company, Ambit Capital research. Note: * Estimates*

Drivers: (a) With around 175,885 unaided private schools in India (Source: Education World) and the target market for multimedia content at ~50,000 schools (fees of above Rs800 per student/month) the market size for multimedia content is above US$1 bn per annum, (b) Given the difficulty of finding good teachers in the Indian job market, multimedia content is increasingly gaining popularity with schools, which want to differentiate from the neighbourhood competition. In fact, the multimedia vendors now find it easier selling in Tier2/3 cities than in Tier1 cities where the product is no longer a novelty.

The primary sources of competitive advantage in this segment are:

- **First mover advantage:** Educomp was the amongst the first players in this space and consequently was the first to capture the premium schools segment that have become a strong reference base (Delhi Public School RK Puram, PSBB Chennai, etc).
- **Distribution:** The ability to reach more schools and convince sceptical school principals/management is crucial in this business. The strength of a firm's sales team is a crude estimate of distribution. Unsurprisingly, market leader, Educomp currently leads the pack with the largest marketing team (340 sales reps). There remains a large gap between Educomp and the marketing strength of the second player, Everonn, which has ~180 sales reps.
- **Content:** Content quality and breadth of coverage (in terms of types of syllabi, subjects and grades covered) are key success factors in this space. Our industry discussions and competitor checks suggest that Educomp's content is more dynamic, visually appealing and compelling. Moreover, Educomp's 400 strong content development team and exclusive tie ups for syndicating animated content from leading content publishers (DesignMate, Crocodile Clips and Discovery Channel) help it maintain this edge. In terms of content coverage,

Educomp and Manipal K-12, rate the highest with content mapping for grades 1-12 for entire CBSE/ICSE curricula and few state/IB boards.

Exhibit 12: Product comparison for key players

	Educomp	Everonn	NIIT	Edurite	Navneet	Hurix/ HCL Infosystems*
Installed base/first mover advantage	●	◕	◔	◑	◔	◔
Marketing muscle	●	◕	◔	◕	◔	●
Content mapping: CBSE/ICSE Boards	●	◕	◑	●	○	◕
Content mapping : IB/State Boards	◕	◑	○	●	◔	◑
Quality of content	●	◑	◕	●	◑	●

Source: Industry, Ambit Capital research. Note: HCL Infosystems has an arrangement with Hurix Systems for content development on a revenue share basis. Rating:* ● 4 (highest); ◕ 3(above average.); ◑ 2 (average); ◔ 1 (lowest); ○ (no exposure)

Eroding competitve advantages for listed players

- **Premium schools segment saturating, lower classroom adoption rate and price points in tier2/3 city schools:** While Educomp did have a first mover advantage, the market for premium schools appears to have saturated forcing Educomp and other players to focus on the Tier2/3 cities. The outcome of making inroads into Tier2/3 cities is that the number of classrooms added per school has started trending downwards given the lower purchasing power of these schools. For instance, the number of classrooms added per school has come down from 20 to 8 for Educomp. Secondly, given the lower paying propensity of these schools and given aggressive increasing newer entrants such as Manipal K-12 and Next Education (described below), price points are on a downward trend.

- **Increasing number of newer entrants:** While Educomp had a strong foothold in this space until FY09, it's becoming weaker with increasing competition. Manipal K-12 (known as Edurite earlier), a privately held competitor, which was 1/10th of Educomp's size in 2008 has grown to 1/4th its size (giving some indication of the extent of the market share loss for Educomp).Furthermore, newer players-Hurix/HCL Infosystems, Next Education (earlier known as Helix) and Navneet are making inroads into this space, which will further pressurize the pricing realization. We have also begun to see collaborations between established MNC education content brands such as Harcourt Mifflin Houghton partner with leading domestic publishers such as S Chand offering similar solutions. Discussions with Educomp's current schools also indicate that while they are satisfied with the current product, they are willing to consider competitive products for the additional classrooms which they intend to wire. Thus, the current installed base for vendors is likely to witness higher churn and rising competitive intensity when these schools come up for renewal. Stickiness to Educomp's Smart_Class business will be put to test in FY12 when a meaningful chunk of its schools come up for renewal.

- **Competition is aggressively building on its distribution strength:** We understand that competitors are also aggressively ramping up their marketing teams. For instance, Manipal K-12 has increased its sales team from 55 people in FY09 to 138 currently. Moreover, the entry of strong players such as Hurix/HCL Infosystems is likely to further intensify competition. HCL Infosystems has a formidable marketing presence through its computer hardware business where it also sells to schools directly. Given more than two decades of operations in the hardware business, HCL Infosystems has developed extensive relationships with schools (at least 10,000) enabling it to penetrate this segment quickly. Furthermore, it has the potential to offer low price points due to its operating leverage from its hardware business.

- **Basis of competition shifting to content could lower barriers to entry:** Most of the players have been primarily selling hardware and content on a BOOT basis. However, we believe that in the contract renewal cycle, schools

might choose not to invest in new hardware and continue with their existing assets. In such a scenario, the basis of competition would primarily shift to content. This would lower the barriers to entry for newer players whose weak balance sheet strength restricts their ability to take on BOOT contracts. Further, newer players have begun to catch up on the quality of content and depth of coverage. For instance, Manipal K-12's content coverage (CBSE/ICSE/IB and six State Boards) is as good as Educomp. While a part of the industry is convinced that a branding strategy would help in the longer term, we believe that branding is not an answer to commodisation. This is because the product is primarily a B2B business where the buying centre for the product is the principal/school management (not students or parents who might be influenced by TV advertising).

Government schools -ICT@school

Exhibit 13: Key players in ICT segment

	Schools(No.)	Rev. (Rsmn)	% of total rev.
Educomp ^	13,814	1,252	13
Everonn ^	6,628	825	24
NIIT	~11,200	~2000	17
Manipal K-12	7,100*	na	na

*Source: Company, Industry, 1H FY11 annualized revenues. *includes 5,000 schools from Punjab which have contracted only for content*

Summary: Several education firms, working as Government contractors, are setting up computer laboratories in government schools under a Government sponsored program, ICT@School. Although the ICT business improves revenue visibility (given the annuity revenue component), it comes with its own vagaries: (a) higher receivable days (~180-240 days) as state governments tend to be sluggish in making payments, (b) higher lumpiness as order wins are dependant on the timing of the contract bids, and (c) lower IRRs (~10%) and negative NPVs. Given these low return ratios, we prefer firms with low exposure to ICT.

Current ground realities spell more worries

Intensifying competition and pricing pressure: Despite the poor contract level economics of these contracts, most firms view this space more from a strategic perspective and as a means for revenue growth. Our channel checks suggest that the competition has been building up in this segment with aggressive bidding from both listed and unlisted entities as highlighted in Exhibit 14 below. Indeed, margins in the ICT segment have been falling over the last few years, and fresh competition is likely to further compress margins for the listed players (Educomp, Everonn, NIIT) on the incremental wins.

Exhibit 14: Competition is heating up in the ICT space

Company name	No. of schools	State	Order size
Core Projects	645	Gujarat	Rs264 mn
Compucom	836	Rajasthan	Rs104 mn
Edurite/Manipal K-12	1,600	Rajasthan	Rs200 mn
Edurite/Manipal K-12	450	Rajasthan	Rs 280 mn
Edurite/Manipal K-12	5,000	Punjab	Rs 50mn; only content

Source: Ambit Capital research, Industry

Reduced funding from the Central government is likely to stretch working capital requirements: The XIth five year plan indicates that Central Government funding for ICT contracts is likely to reduce to 50% from FY11. This is likely to further stretch the already long debtor days in this business (180+ days), as state governments tend to be slower paymasters.

Exhibit 15: ICT margins for listed players has been reducing

Margins (%)	FY07	FY08	FY09	FY10
Educomp*	33%	29%	22%	na*
Everonn ^	na	17%	21%	20%

*Source: Ambit Capital research, Company; Note: not available due to change in reporting segments; * EBIT margins; ^ PBT margins.*

While most of the listed players began life as ICT contractors to government schools, their contribution from this segment has been waning with listed firms espousing intentions of de-focusing from this segment going forward. However, we worryingly hear from private competitors that listed firms continue to bid for new contracts on unfavourable terms. This suggests desperation for new sources of growth on the part of some of the listed players.

Long Term Opportunities

Exhibit 16: Key players in K-12 schools segment

Firms	Plans
Educomp	69 in FY12, 150 by June 2013
Everonn	10 in FY12, 350 over next 5 years
GEMS	100 by 2014
Manipal K-12	100 over next 5 years
Birla Edutech	200 over next few years
Essel Group	300 by 2015

Source: Company, Industry

Summary: The market opportunity for the K-12 and Higher Education segments is undoubtedly attractive given the substantial unmet demand, stronger sustainable competitive advantages, high switching costs and defensive recurring revenues. Successfully run schools are highly lucrative with ~23% IRRs while colleges can offer as high as 25%. We prefer the owned school model v/s the managed one as it offers higher sustainable competitive advantages and absolute profits. That said, challenges remain in terms of execution capability and operating against a backdrop of regulatory controls.

K-12 /Higher education- Owning and managing brick and mortar schools and colleges:

Private entrepreneurs are turning governmental failure into an opportunity: The Government's inability to deliver high quality formal education in India is well known. However, the expansion in the middle/upper class population, (which wants to fulfil its aspirations through education), and rise in per capita spending by this segment is likely to fuel growth in private education. This coupled with the dearth of high quality private schools and attractive economics of running a school is leading to entrepreneurs making a beeline for setting up school chains. Amongst listed players, Educomp ventured into this space in FY08 and currently has 46 operational schools while Everonn has announced its plans for the K-12 segment recently and intends to have 10 schools operational in FY12.

Drivers for dry school management model:

(a)Cases where the next generation promoters given their lack of interest in the business might look at external options for school management

(b)Increase in revenue and profitability for an existing school as a well established school management chain could change the former's market positioning significantly.

Various models for running schools: Given that most Indian states do not allow schools to be operated on a 'for profit' basis, private firms have overcome the regulatory barrier by developing innovative multi-tier structures. This involves creating separate entities which act as suppliers of goods and services to the school trust/society.

Private players adopt one of the following business models in the K-12 space:

- **Owned schools:** This is a greenfield approach where the land and building leased to the schools is owned by them. Different strategies within this model have evolved: (a) *Lease arrangement with real estate players* as owning land comes at premium prices, (b) *Co-branding where the company forges tie-ups with established brands* to ensure initial ramp up in return for royalties to the schools for lending their brand.
- **Dry management:** The dry school management model, in our view, is similar to managing branded hotel chains. Under this, companies render school management services and typically earn a revenue share. This model can work with both existing and greenfield schools.

Exhibit 17: Comparison of owned vs dry school model

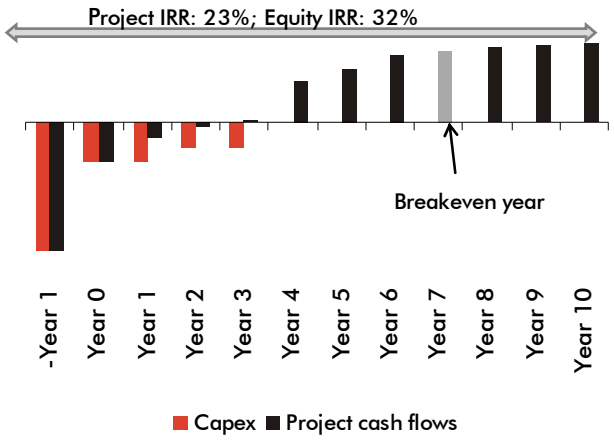
Characteristics	Owned	Managed
Scalability	Gradual	Quick
Absolute profits	High	Medium
Sustainable competitive advantage	High	Low
NPV of a successful K-12 school	Rs137mn	Rs68mn

Source: Ambit Capital research

We prefer the owned model v/s dry management model: The dry management strategy is the quickest way to build scale and profit margins in this model are also high. However, the owned model which has gradual scalability, rates the highest on sustainable competitive advantages and absolute profits.

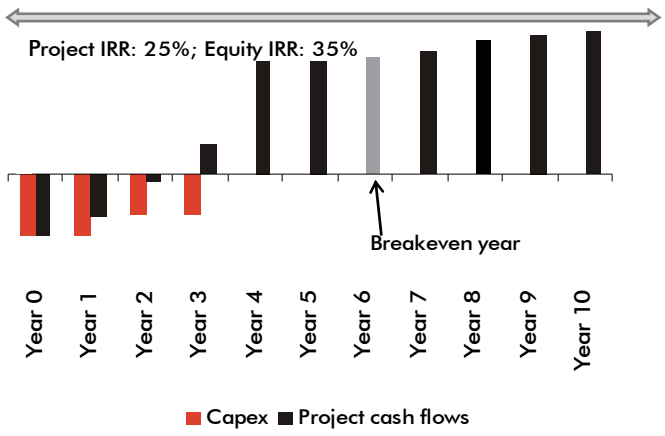
Running schools and colleges can be an attractive opportunity. Successfully run school can have IRRs of ~23% while a successful Business School can have even higher IRRs of 25%. The willingness to spend for professional courses is higher than the K-12 segment given the quicker ROI to the student.

Exhibit 18: Attractive cash flow profile for a successful K-12 school



Source: Ambit Capital research, Industry

Exhibit 19: Attractive cash flow profile for a successful Business School



Source: Ambit Capital research, Industry

Sensitivity analysis: We believe that two main factors are crucial to the school's profitability and IRRs: (a) Time taken to reach full capacity; and (b) Teacher's salaries.

Exhibit 21: IRR sensitivity to the year of achieving full capacity

Full capacity	Year 4	Year 5	Year 6	Year 7	Year 8
IRR	25.4%	24.2%	23.4%	22.4%	21.8%

Source:, Ambit Capital research, Industry

Exhibit 22: Sensitivity to teacher's salaries and fee hike

		Teacher's salaries (Rs, p.m)				
		25,000	27,500	30,000	32,500	35,000
Avg. fees (Rs, p.a)	36,000	22.4%	21.4%	20.4%	19.3%	18.1%
	37,800	23.9%	23.0%	22.0%	21.0%	20.0%
	39,600	25.3%	24.5%	23.6%	22.6%	21.7%
	41,400	26.7%	25.9%	25.0%	24.2%	23.3%
	43,200	27.9%	27.2%	26.4%	25.6%	24.7%

Source: Ambit Capital research, Industry

Exhibit 20: Educomp's ramp up in Millennium schools

Millennium schools	Starting year	Students/ Capacity	Std.
Mohali	Apr '07	540/1000	K-9
Bhatinda	Apr '10	225/700	K-6
Lucknow	Apr '09	800/2000*	K-8
Jalandhar^	Mar '10	380/NA	K-12
Kurkshetra	Apr '10	200/3000*	K-6
Panipat	Apr '09	400/1300	K-8
Noida	Apr '08	500/900	K-8
Meerut	Jun '10	80/250	K-6
Takshila schools			
Gaya	Apr '09	400/2000*	K-8
Hoshiarpur	Apr '09	165/2000*	K-8
Bhuneswar	Jun '10	85/500	K-5

Source: Industry, Ambit Capital research
*^JV with an existing school, earlier was known as Ambika Modern School; *Indicates full capacity, rest current capacity.*

Challenges in the K-12 segment: There are three main critical success factors for achieving success in the K-12 segment: (a) reputation, (b) location, and (c) time taken to execute. While the economics of operating a K-12 school looks attractive there are several challenges in achieving this.

- **Achieving full capacity takes time as the gestation period for building reputation is long:** Successful schools chains are built over time by word of mouth and are based on the ranks of the previous graduating batch in public examinations (Class 1O & 12). Our primary data checks with Educomp's Millennium schools indicate that ramp ups have been less-than-ideal. For instance, the Mohali school despite being operational since for the last 3 years currently only has 540 students.
- **Delay in execution has significant impact on IRRs:** The time taken to execute (right from land acquisition to construction to being ready for operations) is crucial for IRRs. This is because once the capex is invested upfront, the interest gets capitalized until the school starts operations. For instance, a delay of few months could mean missing the academic year; a one year delay would mean IRRs falling to 20% v/s 22.4% (for on-time execution schedule).

Provisions in the RTE Act, 2009 which have investment implications for private unaided schools.

a) Under s.13 there is a ban on lump sum admission (capitation) fees and any screening procedures to filter students.

b) Under s.12(c) private unaided schools are obliged to admit poor neighborhood children upto 25% of capacity in class I. The tuition fees for such students will be reimbursed by the state to the schools on the basis of its per capita expenditure per student. Alternatively, the Act provides for an opportunity of establishing an equal opportunity school which provides the same quality of education at a fraction of the cost.

- **Regulation is the elephant in the room:** Regulation is the biggest hurdle for private institutions, the case in point being the recent Righ to Education (RTE) Act 2009. The RTE Act 2009 has raised the thorny constitutional issues relating to the administrative autonomy of private unaided schools. The main cause of worry for the private schools is the s.12 (c) clause as such a move could have a drastic impact where IRRs could slip to 19% (v/s 23% in the pre-RTE world).

- **Pricing power for even well established schools is restricted:** While a well established school enjoys considerable pricing power, laws regarding the fee charging capacity of a school remain unclear. Further, the tolerance level of states to fee hike varies widely (Andhra Pradesh is considered to be a friendly state towards private institutions while Tamilnadu and Maharashtra are known to be less tolerant). Judicial interventions in the past have been contradictory which add to the ambiguity.

Exhibit 23: Key judicial judgments in the K-12 space

Year	Parties involved	Context	Ruling: For or against private unaided institution
2005	P.A. Inamdar vs. State of Maharashtra	State reservation policy for private unaided colleges	For
2004	Modern School vs Union of India	Right to hike fees by private unaided school	Against
2003	Islamic Academy vs Union of India	Regulation of admissions and tuition fees by private unaided professional colleges	Against
2002	TMA Pai vs State of Karnataka	Right to determine admissions and fee structures by private unaided colleges	For
1993	Unni Krishnan vs State of Andhra Pradesh	State governments right to administer and regulate admission for privately promoted institutions	Against
1992	Mohini Jain vs State of Karnataka	Right to charge higher fees than government seats by private unaided college and issue of capitation fee	Against

Source: Industry

As education is a social issue, delivering high quality education at an affordable price point that creates a reasonable return on capital is crucial for private institutions. However, what makes this more complex is doing this in the face of regulation and within a reasonable time frame as patient capital from investors is scarce.

Educomp: Given the above highlighted challenges, we find Educomp's target of 150 operational schools by June 2013 (currently 46 since operations began in FY08) on the ambitious side. We expect Educomp to scale up to 150 schools only by FY16 and accord a value of Rs161 per share (43% of our overall valuation of the company) or total value of US$339 mn to this business.

Everonn: Everonn has announced an ambitious target of 350 schools over the next 3 years, we find it too early to ascribe any value to this business as: (a) Everonn has practically no operational experience in this space, and (b) Educomp, a much earlier entrant into this space, has had a chequered experience in this segment. That said, the option value we would ascribe to this business, should Everonn successfully create a franchise of 100 schools (assuming 50% owned, 50% dry management model) by FY20 would be Rs344 per share or US$145 mn.

Conclusion: Investment banker's friends for now

While the education sector has several drivers at the macro level (viz. unmet demand for high quality education and growing demand for educated workers in a service led economy growing at 8%), our analysis on the core segments (Multimedia content, ICT, K-12 and Vocational training) in which the listed players operate in point to rising competition, dwindling differentiation and price erosion. The only segment that exudes the characteristics of sustainable competitive advantages with a large addressable market size is the brick & mortar K-12 and college businesses. However, even this sector has had a short and chequered history of successful ramping up brick and mortar institutions that create ROI in a reasonable time frame in the face of tricky regulation. Hence, we believe that it is too early to ascribe substantial valuations to the ambitious plans set by the main players in this market (Educomp and Everonn). We initiate with **SELL** recommendations on **Educomp** (28% downside) and **Everonn** (10% downside).

We have analyzed the Indian players in the education space in terms of: (a) relative valuation to global peers, (b) accounting quality vs. BSEE 5OO, IT/ITES and Housing related companies, and (c) comparative analysis amongst the Indian listed players.

Exhibit 24: Dupont Analysis of listed players

	Educomp			Everonn			NIIT			Career point		
	FY08	FY09	FY10	FY08	FY09	FY10	FY08	FY09	FY10	FY08	FY09	FY10
Profit margin (Adj PAT/Sales)	24.7	20.8	20.9	15.1	15.3	15.5	7.5	5.4	5.9	32.9	39.2	41.2
Total Asset turnover (Sales/TA)	0.6	0.8	0.6	1.5	1.6	2.5	2.1	2.1	1.8	1.4	1.1	0.9
Equity multiplier (TA/TE)	2.3	2.6	1.8	0.9	0.6	0.5	1.3	1.2	1.4	0.8	0.9	0.7
RoAE	35.8	40.7	21.7	21.0	14.3	19.4	21.2	14.2	14.5	38.5	35.4	26.5

Source: Company, Ambit Capital research

a) Relative Valuation

A look at Exhibit 25 suggests that on comparative valuation multiples in conjunction with growth estimates, Indian listed players look cheaper when compared to developing markets (Brazil, South East Asia) while developed markets (US, UK) trade at cheaper valuations to Indian players given their lower growth profile. That said, we remain worried about the inferior accounting quality and aggressive revenue recognition followed by some of the listed education players in India.

Amongst the Indian listed players, Educomp currently trades at a PE of 13.3x on CY11E EPS, a 9% premium to the sector average of 12.1x (excluding Aptech). Educomp's ROEs have fallen substantially and the quality of ROE generation has been poor with declining asset turnover (see exhibit 24). Thus, when viewed against a slower EPS growth going forward (15% adj. EPS CAGR over FY10-13E v/s 85% over FY08-10), the stock looks expensive.

Everonn trades at a PE of 13.3x on CY11E EPS, a premium of 9% premium to the sector average (excluding Aptech). Everonn has been the most efficient player in terms of quality of ROE generation with an increase in asset turnover and decrease in financial leverage. However, we believe that slower EPS growth going forward (28% EPS CAGR over FY10-12E v/s 79% over FY08-10) and relatively weaker positioning in core segments to market leader Educomp justifies a discount to the latter than the similar multiple it currently enjoys.

Exhibit 25: Relative valuations

	Mkt Cap (in local currency)	RoE		Sales CAGR (CY09-11)	EV/Sales (x)		EBITDA CAGR (CY09-11)	EV/EBITDA (x)		EPS CAGR (CY09-11)	P/E (x)	
		CY08	CY09		CY10	CY11		CY10	CY11		CY10	CY11
India Peers												
Educomp Solutions *	49,406	38%	27%	29%	4.8	3.9	15%	10.5	8.8	22%	15.4	13.3
Everonn Education *	9,033	14%	19%	42%	2.5	1.8	48%	6.8	4.9	31%	17.4	13.3
NIIT *	8,874	16%	14%	9%	1.0	0.9	20%	6.9	5.8	22%	10.5	8.4
Aptech *	6,089	22%	NA	16%	2.1	1.7	26%	11.3	8.7	NA	43.8	21.3
Navneet Publications *	13,531	23%	23%	12%	2.5	2.1	NA	NA	NA	33%	17.3	12.3
Core Projects *	29,653	29%	23%	26%	3.2	2.7	24%	9.5	NA	9%	15.0	13.4
Career Point Infosystems *	6,688	32%	20%	NA	NA	NA	NA	NA	NA	NA	NA	NA
Median				**21%**	**2.5**	**2.0**	**24%**	**9.5**	**7.3**	**22%**	**16.3**	**13.3**
Mean				**22%**	**2.7**	**2.2**	**26%**	**9.0**	**7.1**	**23%**	**19.9**	**13.7**
Developed Countries (US, UK)												
American Public Education $	608	37%	35%	28%	2.6	2.2	23%	9.3	7.6	12%	22.1	17.7
Apollo Group Inc-Cl A $	5,713	60%	44%	12%	1.0	1.1	10%	3.5	4.0	10%	7.7	8.7
Blackboard Inc $	1,450	-1%	3%	16%	3.4	3.0	27%	14.1	11.3	51%	26.3	21.7
Capella Education Co $	1,029	19%	26%	19%	2.0	1.8	22%	7.5	7.3	10%	17.1	14.9
Career Education $	1,636	7%	9%	10%	0.6	0.5	21%	2.8	2.8	-1%	7.1	7.0
Corinthian Colleges $	372	15%	24%	13%	0.3	0.3	-6%	2.0	2.9	-17%	3.3	6.0
Devry $	3,165	20%	27%	24%	1.3	1.2	31%	5.3	4.7	27%	10.4	9.5
ITT Educational Services $	1,988	165%	182%	9%	1.2	1.2	6%	2.9	3.3	1%	5.6	5.7
K12 Inc $	837	7%	11%	32%	2.0	1.7	39%	13.4	10.6	209%	41.3	35.4
Lincoln Educational Services $	342	12%	25%	6%	0.6	0.6	2%	2.5	3.1	-9%	5.8	7.1
Princeton Review $	60	-45%	-39%	28%	1.2	1.2	102%	10.4	7.5	-34%	-1.2	-3.1
Strayer Education $	2,156	44%	57%	20%	3.2	2.8	19%	8.7	7.7	9%	16.5	14.4
RM #	144	21%	29%	-3%	0.4	0.4	-13%	4.8	4.8	-6%	9.4	9.2
Promethean World #	115	NA	NA	3%	0.4	0.4	-9%	3.5	3.5	NA	6.7	8.1
Median				**14%**	**1.2**	**1.2**	**20%**	**5.0**	**4.7**	**9%**	**8.5**	**9.0**
Mean				**15%**	**1.4**	**1.3**	**20%**	**6.5**	**5.8**	**20%**	**12.7**	**11.6**
South East Asia												
Credu Corp ^	384,420	8%	7%	6%	5.2	4.5	34%	46.5	35.8	26%	60.2	45.3
Daekyo Co ^	544,639	3%	9%	4%	0.5	0.5	4%	3.8	3.7	-3%	13.2	11.5
Megastudy Co ^	1,169,853	31%	34%	8%	4.1	3.6	8%	11.0	9.6	10%	16.4	14.0
Benesse Corp **	402,548	6%	13%	4%	0.7	0.7	8%	5.3	5.1	9%	16.1	15.1
Raffles Education ~	643	11%	10%	4%	3.8	3.6	-10%	8.8	9.6	-26%	14.0	14.0
New Oriental Education $	3,909	19%	20%	39%	7.9	6.1	42%	29.0	24.1	31%	43.8	34.2
Median				**5%**	**3.9**	**3.6**	**8%**	**9.9**	**9.6**	**9%**	**16.3**	**14.6**
Mean				**11%**	**3.7**	**3.2**	**14%**	**17.4**	**14.6**	**8%**	**27.3**	**22.4**
Brazil												
Anhanguera Educacional @	4,881	-4%	7%	18%	4.8	3.9	35%	16.1	16.1	302%	37.6	23.0
Kroton Educacional @	1,302	7%	-1%	42%	2.1	1.8	272%	12.3	12.3	-7%	120.7	22.8
Mean				**30%**	**3.5**	**2.9**	**154%**	**14.2**	**14.2**	**147%**	**79.1**	**22.9**
Australia												
Navitas ^ ^	1,366	51%	63%	19%	2.3	2.1	22%	11.9	10.8	21%	20.6	18.6

*Source: Bloomberg Note: * INR; $ USD; #GBP; ^ KRW; **JPY; ~SGD; @ BRL; ^ ^ AUD*

b) Inferior accounting policies of the education sector

In our recently released Indian Accounting thematic (*'Accounting Quality Matters!'*, dated 30 Nov 2010) our analyst Bhargav Buddhadev, has scored the BSE 500 companies based on their accounting quality determined by nine financial ratios (using consolidated financials for FY07, FY08, FY09 and FY10). A high aggregate score indicates good accounting quality while a low one corresponds to weaker accounting quality.

We have used this analysis to compare the education sector scores to IT/ITES and construction/housing sector. This is because most education firms are in the: (a) business of providing multimedia content to schools or setting up computer labs in government schools; and/or (b) K-12 business which involves owning brick- and mortar schools. Our sector analysis is limited to three companies present in this space in BSE 500 - Educomp, NIIT and Aptech. Everonn has been excluded due to the short listing and reporting history. Our analysis points to the following:

- The education sector's average score is far below the IT sector while it is marginally above the construction/housing sector reflecting the weaker accounting quality of the firms in this sector.
- Within the sector, Educomp's aggregate scores at 153 is far below the other two comparables NIIT (194) and Aptech (185). In terms of individual metrics, Educomp rates the lowest in terms of debtor days, contingent liabilities as % of net worth, audit fees % of revenue and average advances recoverable cash or kind/revenue.

Exhibit 26: Scores based on accounting policies

Average score	CFO/ EBITDA	Depr. as % of gross block	Misc exp as a % of revenue	Other loans & advances / Networth	Avg. advances recoverable /revenue	Provisions as a % of gross debtors	Debtors days	Contingent liabilities / networth	Audit fees as a % of revenue	Overall score
Education sector	205	139	182	300	90	269		138	184	177
IT/ITES	218	128	160	339	181	209	128	230	208	200
Housing related	64	204	277	310	169	67	87	131	217	170
BSE 500	180	181	181	306	181	181	181	181	195	196
Education companies										
Educomp Sol.	171	359	294	360	25	103	20	38	4	**153**
NIIT	185	31	230	360	141	347	89	173	187	**194**
Aptech	258	27	23	180	103	358	156	202	360	**185**

Source: Company, Ambit Capital research. Note: 1 is the lowest and 360 is the highest possible score; A high score indicates good accounting quality while a low one corresponds to weaker accounting; based on standalone financials from Capitalline.

Revenue recognition for Educomp and Everonn is aggressive

Everonn: Everonn recognises its iSchool business revenues under the following pattern: (a) Product License fees: ~35% of revenues for a single classroom contract) is recognised on installation while incremental license revenues recognised for >1 classrooms is ~Rs30K per classroom. (b) Equipment and Services fees: ~65% of revenues are recognised over the period of the contract.

Our issue lies in the fact that Everonn's payments from schools are on a quarterly basis in equal monthly instalments. As a result, Everonn books 36-48% of revenues in the first year (depending on the number of classrooms a school wires up), although it is only paid 20% of the revenues in that year.

Educomp: While Educomp used to recognize the entire revenues for its Smart_Class business over the period of the BOOT contract, it changed its revenue recognition policy during FY10. Under the new model, Educomp has begun securitising its Smart_Class receivables through Edu Smart (an SPV).

Educomp now books 75% of revenues for the total signed classrooms during the quarter in two tranches, while 25% is passed on the vendor. Out of the 75% revenues, 52.5% of is recognized upfront during the particular quarter while 22.5% is booked in the successive year same quarter. Since Educomp has an economic obligation to provide content updates, Educomp has decided to recognize the content revenues over a two year period. Under the earlier model, Educomp was recognizing only 20% of revenues of the total contact value in any quarter. Management's view is that since Educomp is selling content and hardware on a non-refundable basis to Edu Smart, it is in-line with the accounting standard requirements. Furthermore, since it is a hardware sale to a third party vendor Educomp does not have to invest in capital expenditure and has the benefit of faster cash recovery given the upfront payment made by Edu Smart. Although the entire arrangement inflates profitability in early years and makes Educomp's balance sheet look optically light, a deeper look at it points to inconsistencies. Despite having created a separate entity, business/operational linkages for Edu Smart and Educomp remain high and the corporate guarantee given by Educomp for Edu Smart's securitization arrangement makes it liable to banks in the event of default by Edu Smart or any breach in the securitisation covenants. For more details, please refer to our in-depth section on Educomp.

Overall, we find the revenue recognition policies of both the companies to be aggressive as it allows for upfront booking of revenues while service/maintenance agreements are to be provided over the period of the BOOT contract. We believe that while upfronting revenues will boost current financials, it would suppress it in the medium term, particularly against the backdrop of slowing revenue growth for these players in most segments.

Exhibit 27: Competitive analysis

Company	Revenue Growth	Liquidity Strength	Capital intensity	Quality of Mgmt	Exposure to promising verticals	Leadership in any business	Overall	Comments
Aptech	○	●	◐	◐	○	◐	○	Aptech revenue growth prospects are contingent on its Chinese JV. Its exposure to certain non-IT training initiatives are in multimedia, hardware and aviation - each of which are cyclical.
Educomp	●	◐	◐	●	●	●	●	Educomp seems to be best placed in terms of first mover advantage in the multimedia content space but changing ground realities for the space suggest tapering growth. While K-12 is an attractive segment, the target of 150 schools by June 2013 seems ambitious.
Everonn	●	◐	◐	◐	●	○	◐	Everonn lacks leadership in any of its business segments. New sales model for the colleges segment shows limited success. Too early ascribe value to its K-12 business plans.
NIIT	◐	◐	●	◐	○	●	◐	NIIT has an impressive lead in IT training in India that has not been replicated in other verticals. Its business is highly exposed to the business cycle. Relatively low success in the multimedia content market.
Career Point	●	●	◐	◐	◐	◐	◕	Business model seems exposed in the longer term given that CareerPoint's exposure is limited to the IIT Test prep segment which is a highly fragmented market. Government regulations could place this business model under threat.

Source: Ambit Capital research; Rating: - ● relatively strong ; ◕ Strong; ◐ average ; ○ relatively weak position
Our ranks on liquidity strength are based on CFO/EBITDA, Net Debt/Equity and NWC/Sales and Capital intensity based on % Change in EBITDA/% Change in Avg Gross Block, Change in Asset Turnover and NWC Turnover.

c) Competitive analysis of business models

Our comparative analysis of listed players suggest that Aptech is positioned the weakest in terms of **revenue growth** while Educomp, Everonn and Career Point stand out as the strongest. However, we believe that Career Point's business model is unsustainable in the longer term given scalability issues in its core business. In terms of **liquidity strength**, Aptech and Career Point rate the highest given their low capital intensity. Everonn is positioned the weakest in terms of **leadership in core segments** in which it operates in. Although Educomp's **quality of returns** (as highlighted in exhibit 24) and accounting quality (as highlighted in exhibit 26) is poor, our analysis of competitive advantage indicates that it has a leadership positioning in the core segments it operates in coupled with superior position in promising verticals backed by a good management bandwidth. Thus, it remains a superior franchisee relative to other players.

Exhibit 28: Porter's analysis of Indian Education Sector

Supplier power (Low)

- **ICT:** Suppliers for government contracts are likely to get discounts on large orders. However, increasing competitive intensity and commoditised services has killed return ratios to below cost of capital.
- **Multimedia content:** With increasing newer entrants, differentiation based on content offering and pricing power is deteriorating.
- **K-12/Higher education:** A well established school has a pricing owner and parents have no option but to accept the fee hike.

Intensity of rivalry (Medium)

- The number of players in this industry is beginning to increase in most segments. Currently players are focussed on 2-3 segments and are likely to transgress into other segments in search of profitable growth opportunities.
- Rivalry is increasing in all segments except K-12 where competition is restricted to the neighbourhood schools. Rivalry is highest in allied services and ICT segment with the competitive intensity starting to increase in the multimedia content for schools as well.

Buyer power (Medium)

- **ICT:** The government holds the bargaining power because of numerous players and the nature of the tendering process.
- **Multimedia content:** In urban areas schools 'buying power' is increasing with rising competition amongst vendors.

Substitute products (Low)

- **Multimedia content for schools:** The high costs involved in developing multimedia content would make it unviable for schools to develop it in house.
- **K-12/Higher education:** There is no substitute for schools and switching costs for the students is very high.
- **Allied opportunities:** High quality formal education can eliminate the need for parallel education. However, this is no where in sight.

Barriers to entry (Medium)

- **Multimedia content for schools:** Barriers to entry in the classroom software segment are relatively high as players need to have reasonable balance strength to take on BOOT contracts and invest in content development. However, with the basis of competition likely to change to content in a few years the entry barriers would be significantly lowered.
- **ICT:** Given the large size of the contracts players with reasonable balance sheet strength have a higher chance of winning contracts. Smaller players do not qualify for large contracts.
- **K-12/Higher education:** Building brick and mortar schools and colleges requires significant capital investment.
- **Allied opportunities:** Low capital intensity and student enrolments, pricing power is dependant on the success of students in the previous batch.

Industry outlook (Negative)

- Strong macro growth drivers in terms of burgeoning middle class with increasing income levels, unmet demand for quality education and favourable demographics for India's population.
- Rising competition in ICT and multimedia content for schools and saturation of premium schools segment in the latter leading to lower price points for existing players.
- Falling differentiation for players in multimedia for schools with new entrants possessing strong distribution strength and quality content.
- Regulatory pressure in terms of fee charging capacity and legislative acts threatening the autonomy of private schools/colleges is a challenge.

Improving

Unchanged

Deteriorating

Source: Ambit Capital research

Educomp Solutions

AMBIT Acumen at work

Bloomberg: EDSL IN Equity
Reuters: EDSO.BO

SELL **INITIATING COVERAGE**

Scarcity Value No More

Whilst Educomp is taking the right steps towards high quality long term opportunities such as brick & mortar schools and colleges, the sustainability of its core Smart_Class business is threatened by saturation in the premium end of the market and eroding competitiveness in the mass-market. We remain sceptical of the indicated like-for-like numbers and are worried by falling profitability until clean numbers emerge.

Educomp has underperformed the BSE 500 Index by 35% on a YTD basis driven by its lack of clarity on clean like-for-like financials and emerging competitive and regulatory issues. With the business now trading below historical averages are all concerns in the price? We think not.

Weakening Smart_Class franchise hidden by EduSmart: Educomp's Smart_Class business continues to face rising competition and deteriorating economics due to the saturation of demand in the premium end of the market. We expect revenues to start declining from FY12 due to these trends. This business faces a key litmus test when ~300 legacy customers come up for renewal in FY12 and when clean like-for-like numbers for Q3 and Q4FY11 are published.

Edu Smart will continue to need equity infusion from Educomp: Our analysis highlights questions around whether Edu Smart can be run as a standalone business. Our estimates point to further equity infusion by Educomp into Edu Smart as Edu Smart is likely to be substantially FCF negative (by ~10-13% of the contract values) in years 2/3/4 of operation. We estimate that Edu Smart will need a further ~Rs1bn equity infusion as its repayments accelerate combined with the need to pay Educomp. We also note that as per our model EduSmart's NPV is negligible, making it unattractive for genuine third party players to sign such an agreement with Educomp.

Slow ramp-up in K-12 business: Educomp's K-12 business is running substantially behind management's earlier aspiration with just 43 schools implemented by FY10 compared to 150 earlier indicated. We also find that some of the schools have less than ideal ramp-ups and substantial revenues are driven by acquisitions and JVs rather than by organically set up schools.

Valuation - Difficult to spot value: Although, Educomp looks superficially attractive at 15x FY11 P/E, its weakening core businesses, scaling challenges in K-12 and its deteriorating balance sheet (rising leverage & contingent liabilities) worries us. Our DCF based valuation points to a valuation of Rs372, 28% downside. This implies a FY12 earnings multiple of 12x.

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Recommendation

CMP:	Rs517
Target Price :	**Rs372**
Downside (%):	***28***
EPS (FY11E):	Rs34.7
Change from previous (%):	*NA*
Variance from consensus (%):	*5%*

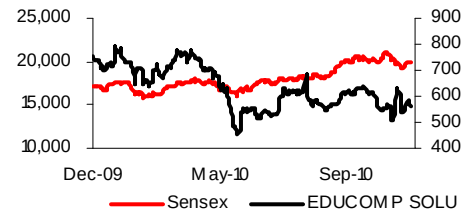
Stock Information

Mkt cap:	Rs49bn/US$1,095mn
52-wk H/L:	Rs876/440
3M Avg. daily val.:	Rs757mn/US$16.8mn
Beta:	1.3x
BSE Sensex:	19,799
Nifty:	5,944

Stock Performance (%)

	1M	3M	12M	YTD
Absolute	1.0	-9.0	-29.8	-27.5
Rel. to Sensex	2.8	-11.3	-45.6	-40.9

Performance (%)



Source: Bloomberg, Ambit Capital research

Exhibit 1: Key financials

Year to March	FY09	FY10	FY11E	FY12E	FY13E
Operating income	6,371	10,394	13,247	13,805	15,592
EBITDA	3,078	4,911	6,135	5,896	7,210
EBITDA (%)	48.3%	47.2%	46.3%	42.7%	46.2%
EPS (Rs)	15.0	27.3	34.7	32.7	41.0
RoE (%)	37%	27%	17%	13%	14%
RoCE (%)	13%	10%	10%	8%	9%
P/E (x)	34.4	18.9	14.9	15.8	12.6

Source: Company, Ambit Capital research

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Please refer to disclaimer section on the last page for further important disclaimer.

Company Financial Snapshot

Profit and Loss (consolidated)

	FY10	FY11E	FY12E
Net sales	10,394	13,247	13,805
Optg. Exp(Adj for OI.)	5,483	7,112	7,909
EBIDTA	4,911	6,135	5,896
Depreciation	1,142	713	850
Interest Expense	590	890	1,028
PBT	3,526	5,054	4,802
Tax	1,584	1,718	1,632
Adj. PAT	2,175	3,295	3,110
Profit and Loss Ratios			
EBIDTA Margin %	47.2%	46.3%	42.7%
Adj Net Margin %	20.9%	24.9%	22.5%
P/E (X)	19.0	15.0	15.9
EV/EBIDTA (X)	12.0	9.6	10.0
Dividend Yield (%)	0%	1%	1%

Company Background

Educomp is a provider of technology-based education products and services for kindergarten to twelfth grade (K-12) education. Educomp provides technology enabled products and services to both public and private schools, including Smart_Class, instructional and computing technology solutions (ICT solutions) and runs a network of brick and mortar K-12 schools. It has also diversified into online initiatives (like Mathguru and Learning Hour), running pre-schools (Eurokids, Roots to Wings), colleges (Raffles Millenium International) and vocational training (IndiaCan). However, Smart_Class remains the core revenue and profit contributor to the business.

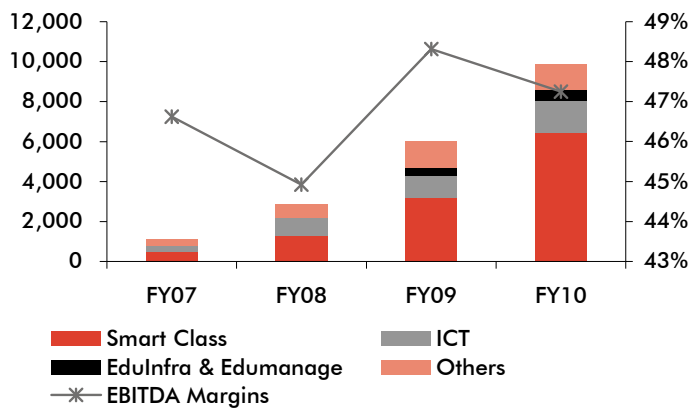
Balance Sheet (consolidated)

	FY10	FY11E	FY12E
Total Assets			
Net Fixed Assets	13948	16333	18984
Current Assets	15,816	22,072	24,862
Other Assets	7,887	10,717	14,180
Total Liabilities			
Networth	16,328	22,691	25,547
Debt	10,478	12,836	15,412
Current Liabilities	3,963	3,510	3,536
Balance Sheet Ratios			
ROE %	17%	13%	14%
ROCE %	10%	8%	9%

Cash Flow (consolidated)

	FY10	FY11E	FY12E
PBT	4392	5054	4802
Depreciation	1142	713	850
Change in Wkg Cap	(1910)	42	338
CF from Operations	2195	4623	4713
Capex	(6855)	(3500)	(3208)
FCF	(4659)	1123	1505
Interest/dividend received	(2)	522	784
Cash flow from investing	(3722)	(2978)	(2425)
Long term borrowings	1,854	2,358	2,577
Interest paid	(411)	(890)	(1,028)
Dividends paid (incl. tax)	(166)	(282)	(374)
Cash flow from financing	7,462	1,185	1,174
Net change in cash	5,936	2,830	3,463

Revenue Breakdown



While ROEs have been improving, we expect it to decline over the long term

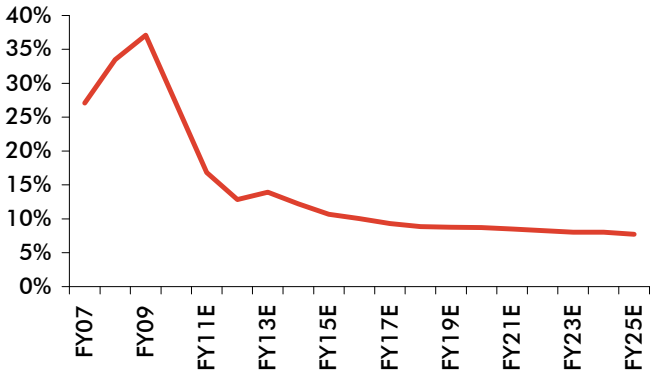


Exhibit 2: SWOT analysis

Strengths	Weaknesses
▪ First mover in technology enabled teaching aides ▪ Presence across the complete spectrum of education sector in India ▪ Largest software content across the entire K-12 range coupled with strong relations with top-notch K-12 schools in India	▪ Inability to create any recurring cash generative businesses with sustainable business models ▪ Inability to profitably scale up new investments in newer segments (vocational training and colleges) where the company does not have a track record ▪ Autonomy given to subsidiaries seems to sometimes come at the cost of financial discipline
Opportunities	**Threats**
▪ Evolving its current short to medium term opportunity businesses into quality longer term businesses with sustainable businesses with recurring cashflows ▪ Huge demand for high quality K-12 schools ▪ Opportunity to expand in the bricks & mortar coaching space	▪ High margins in the education sector in India has attracted many new players ▪ Regulatory risk as schools in India are supposed to operate on a non-profit basis ▪ Long cash collection cycle in the government facing side of the business ▪ Scalability challenges in loss making businesses are a drain on the balance sheet

Source: Ambit Capital research

Key issues facing the business

Educomp's business can be broken into three key areas:

- Multimedia based teaching aides (Smart_Class, 62% of FY10 revenues)
- ICT (15% of FY10 revenues)
- K-12 schools (5% of FY10 revenues)
- Nascent businesses (18% of FY10 revenues): Online and Supplemental businesses (pre-schools, Test Prep, Tutoring, Vocational training and Colleges).

However, the key drivers of value are Smart_Class and K-12 schools. Despite the impressive revenue FY07-10 CAGR of 110% and a strong competitive position in key growth areas as highlighted earlier in this thematic, Educomp faces three key issues:

Educomp's view on the maturity of the Smart_Class market:

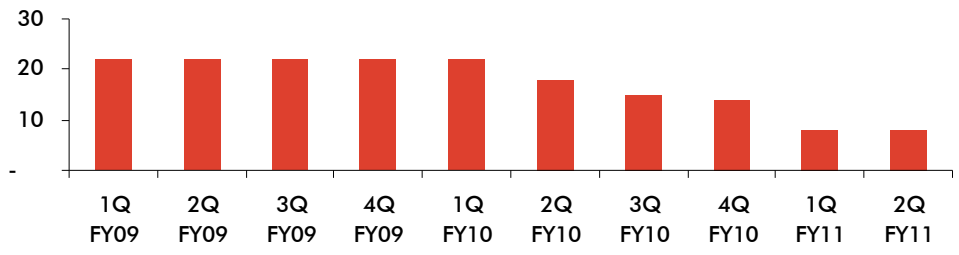
"There are 75,000 private schools in India, which we believe is the market for Smart_Class, and we have reached only 4,585 schools. Even in tier 1 cities like Delhi and Mumbai, market is far from saturation. By opening up multiple channels of sales in tier 2 and tier 3 cities, we are not only growing in tier 1 cities, but are capturing the demand coming in from lower tier cities as well, at the same price per classroom as tier 1 cities. Based on our experience in the market, we have given a guidance that we will grow this business to 20,000 schools and 300,000 classrooms in the next 5-6 years."

Source: Educomp

1. Smart_Class business saturating

Weakening Smart_Class franchise hidden by EduSmart: Educomp's Smart_Class business continues to face rising competition and deteriorating economics due to saturation of demand in the premium end of the market as described in the thematic section of this note. We expect revenues to start declining from FY12 due to these trends. This business faces a key litmus test when ~300 legacy customers come up for renewal in FY12 and when reporting clean like for like numbers for Q3 and Q4FY11. We note that management indicate that Educomp's first 91 schools have seen close to 100% renewals and management report that it has been able to hold up pricing even in Tier 2/3 cities. However, given rising competition particularly at the lower end of the spectrum, we expect pricing pressure.

Exhibit 3: Falling classroom penetration



Source: Company, Ambit Capital research

Do reported numbers reflect a slowdown? In a welcome move, Educomp management has begun giving guidance for Smart_Class on a per classroom basis, moving away from the previous practice of sharing only school level data. Using this metric management has guided to adding 25-30K classrooms in FY11 and growing the business to 20K schools and 300K classrooms in the next 5-6 years (FY16-17). However, as the table below shows the number of classrooms per school and incremental students reached per quarter has slowed down.

Exhibit 4: Slowdown in incremental students reached

	Q308	Q408	Q109	Q209	Q309	Q409	Q110	Q210	Q310	Q410	Q111	Q211
Total Students reached (000)	709	990	1100	1363	1708	1980	2190	2500	2900	3100	3400	3600
Incremental Students reached (000) QoQ		282	110	263	346	272	210	310	400	200	300	200
Incremental Schools QoQ		263	103	238	200	251	173	309	355	503	844	664
Students per incremental school reached			1064	1104	1728	1083	1214	1003	1127	398	355	301
Incremental Classrooms (Including upfront H/W schools)		6515	2410	5852	7620	9130	3460	5682	5590	4038	6750	5309
Classrooms per school		25	23	25	38	36	20	18	16	8	8	8

Source: Company reports, Ambit Capital Estimates

Edu Smart will continue to need equity infusion from Educomp: Whilst Edu Smart is a distinct legal entity from the listed company Educomp, what is debatable is whether in practical terms Edu Smart is a distinct business functioning independent of Educomp.

Our analysis suggests that it might be increasingy difficult to run Edu Smart as a standalone business without further equity infusions into Edu Smart's balance sheet by Educomp. Our estimates point to the following:

- Edu Smart's balance sheet could fall short of cash by ~10-13% of the contract values in the years 2,3 and 4 of the contract.
- Edu Smart could need a further Rs1.2bn (13% of ~Rs.13bn worth existing contracts transferred) equity infusion as its repayments accelerate combined with the need to repay Educomp.

The estimates highlighted above are based on analyzing the P&L and cash profile of a typical Educomp contract assuming a contract size of Rs. 100 as elaborated in Exhibit 4 below. The Exhibit assumes a funding of 54% of the contract value and repayment schedule and interest rates as mentioned in Educomp's agreement with the consortium of banks. We assume Edu Smart earns revenues equal to the contract size of Rs.100 over 5 years and pays Educomp 58.2% in the first year and 16.8% over the remaining five years as agreed in EduSmart's agreement with the banks. Our analysis suggests that such contractual terms could be unfavourable for a third party receivables buyer given the relatively low net present value of this contract.

Management's view on the Educomp/EduSmart relationship

"EduSmart is run on a standalone basis and its business evaluation is done by various leading banks which form an independent consortium including PSU banks. Till date the total disbursed/sanctioned amount is to the tune of Rs915cr. These banks have carried out a detailed due diligence before lending"

Source: Educomp

Exhibit 5: Cash flow analysis of a typical Edu Smart contract

	Existing Schools					New Schools				
	FY1	FY2	FY3	FY4	FY5	FY1	FY2	FY3	FY4	FY5
Loan amount	54.0					54.0				
% principal repaid	21.0	28.0	28.0	17.0	6.0	13.5	18.0	21.0	23.5	24.0
Prinicpal repaid	11.3	15.1	15.1	9.2	3.2	7.3	9.7	11.3	12.7	13.0
Principal O/S	42.7	27.5	12.4	3.2	0.0	46.7	37	25.7	13.0	0.0
Avg loan for the year	48.3	35.1	20	7.8	1.6	50.4	41.9	31.3	19.3	6.5
Int rate (%)	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5	11.5
Int paid	5.6	4.0	2.3	0.9	0.2	5.8	4.8	3.6	2.2	0.7
Edu Smart Financials										
Revenues	**20**	**20**	**20**	**20**	**20**	**20**	**20**	**20**	**20**	**20**
Opex	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8
EBIT	18.2	18.2	18.2	18.2	18.2	18.2	18.2	18.2	18.2	18.2
Interest	-5.6	-4.0	-2.3	-0.9	-0.2	-5.8	-4.8	-3.6	-2.2	-0.7
Depreciation	-11.6	-12.7	-14.1	-16.2	-20.4	-11.6	-12.7	-14.1	-16.2	-20.4
PBT	1.0	1.5	1.8	1.1	-2.4	0.8	0.7	0.5	-0.2	-2.9
Tax	-0.3	-0.5	-0.6	-0.4	0.0	-0.3	-0.2	-0.2	0.0	0.0
PAT	**0.7**	**1.0**	**1.2**	**0.7**	**-2.4**	**0.5**	**0.5**	**0.3**	**-0.2**	**-2.9**
Interest	5.6	4.0	2.3	0.9	0.2	11.6	12.7	14.1	16.2	20.4
Depreciation	11.6	12.7	14.1	16.2	20.4	5.8	4.8	3.6	2.2	0.7
CFO	**17.9**	**17.7**	**17.6**	**17.8**	**18.2**	**17.9**	**18.0**	**18.0**	**18.2**	**18.2**
Capex	**-58.2**	**-4.2**	**-4.2**	**-4.2**	**-4.2**	**-58.2**	**-4.2**	**-4.2**	**-4.2**	**-4.2**
CFBF	**-40.3**	**13.5**	**13.4**	**13.6**	**14.0**	**-40.3**	**13.8**	**13.8**	**14.0**	**14.0**
Net borrowing	42.7	-15.1	-15.1	-9.2	-3.2	46.7	-9.7	-11.3	-12.7	-13.0
Interest paid	-5.6	-4.0	-2.3	-0.9	-0.2	-5.8	-4.8	-3.6	-2.2	-0.7
Net change in cash	-3.2	-5.6	-4.0	3.6	10.6	0.7	-0.8	-1.1	-0.9	0.3
EOP cash balance	**-3.2**	**-8.9**	**-12.9**	**-9.3**	**1.3**	**0.7**	**-0.1**	**-1.2**	**-2.1**	**-1.8**
FCFE	**-45.9**	**9.5**	**11.1**	**12.7**	**13.8**	**-46.0**	**9.0**	**10.2**	**11.8**	**13.3**
NPV (15% CoE)	**-11.3**					**-13.2**				

Source: Company, Ambit Capital research

Heavy covenants attached under the current agreements: Despite having created a separate entity, Educomp continues to remain liable to banks in the event of default by EduSmart and any breach in securitisation covenants will result in the liability falling on Educomp. For instance:

- A rating down grade of two notches or above for Educomp or a change in ownership and/or management would be construed an event of default by Edu Smart and would entail immediate repayment of the principal.
- Educomp has to maintain a minimum DSCR >= 1.50 and the Ratio of Net Debt to Equity shall not exceed 4.0 times. (DSCR stands for Debt Service Coverage Ratio or Net Income/ (principal repayment+interest)).
- Educomp's share of contracts cannot exceed 75% but it can go below 75%. Furthermore, Educomp cannot afford to let EduSmart default on repayment of dues or interest because if EduSmart defaults, the liability falls on Educomp's shoulders. Hence, if the debt on EduSmart books increases with new schools being securitised and pricing per classroom continues to fall impacting its Cash flow from Operations, Educomp will have to sacrifice on its share of revenues to ensure EduSmart has enough cash to meet its obligations.

Lowering corporate guarantee to 20% is unlikely to reduce liabilities: Edu Smart began life with a 100% corporate guarantee from Educomp, thus making its debt a contingent liability (off balance sheet item) for Educomp.

Management admits that in light of the market's concerns of this 100% corporate guarantee it has moved to reduce the corporate guarantee to 20% with the recently announced agreement with ICICI Bank for Rs3bn that was disbursed in Oct 2010 (with a 20% guarantee from Educomp). However, in our view, this is unlikely to change ground realities for Educomp, as in the case of a potential default by Edu Smart, banks are likely to turn to Educomp to fund the shortfall.

Would the Edu Smart structure impact Educomp's debt rating?: In our mind this really is the critical question for equity investors in Educomp who are trying to get their heads around this Edu Smart structure. The answer to this question will only emerge halfway through CY11 when the rating agencies take a view on this subject.

Ahead of such an announcement from the rating agencies we note the following:

- From a practical perspective it is difficult for us to distinguish between Educomp and Edu Smart's businesses. To us they appear to be two sides of the balance sheets of the same business.
- Furthermore, business/operational linkages between EduSmart and Educomp seem to be high.
- Finally, in the event of Educomp's business facing challenges it's hard to envisage a scenario that will not have an adverse effect on EduSmart's standing.

In light of these concerns, we have our apprehensions about the extent to which credit rating agencies will buy into the Educomp/Edu Smart demarcation that management is presenting to the market.

2. Slow ramp-up in K-12 business

Educomp's view of ramp-up in its K-12 business:

"…we have never given out any guidance in terms of number of schools for FY10. It is our aspiration to set up 150 schools by FY13. This aspiration has to be seen more from the perspective of an ambitious vision rather than a financial target. And this aspiration stands unchanged. In a short span of 3 years we have set up a franchise that covers a visibility of 79 schools, of which 46 are operational currently. …all [our] schools have been built over 3 years which we believe is a landmark achievement from our perspective."

Source: Educomp

Educomp's K-12 business is running substantially behind management's earlier aspiration with just 43 schools implemented by FY10 compared to 150 earlier indicated. We also find that some of the schools have failed to ramp-up and substantial revenues are driven by acquired franchises rather than organically set up schools.

Although Educomp began its K-12 business in FY09 with a target of achieving 100 schools by FY10 and 150 schools by FY12, it has only been able to operate 46 schools by Dec 2010 and has visibility on 33 new schools (where the land has been purchased or construction has begun). Further while the earlier strategy focused on owning and managing the schools themselves, the current portfolio consists of a mixture of models – franchisee and dry management. While the latter ones ensure a quicker ROI with low capital on Educomp's books, we believe that owning the schools would have given the company the best sustainable competitive advantage.

Exhibit 6: Educomp's stake increase in EISML implies a valuation of Rs16.3 bn for the entity

Educomp's earlier stake in EISML	**69.4%**
Increase in stake	8.8%
Educomp's current stake in EISML	78.2%
No. incremental shares issued to Educomp (mn)	7.4
Total amount paid for the incremental stake by Educomp (mn)	4,898
Value per share (Rs)	662
EISML total no. of O/S shares (mn)	25
Implied valuation for EISML (bn)	16.3

Source: Ambit Capital research, Company

Exhibit 7: Educomp's ramp up in Millennium schools

Millennium schools	Starting year	Students Capacity
Mohali	Apr '07	540/1000
Bhatinda	Apr '10	225/700
Lucknow+	Apr '09	800/2000
Jalandhar*	Mar '10	380/NA
Kurkshetra+	Apr '10	200/3000
Panipat	Apr '09	400/1300
Noida	Apr '08	500/900
Meerut	Jun '10	80/250
Takshila schools		
Gaya+	Apr '09	400/2000
Hoshiarpur+	Apr '09	165/2000
Bhuvneswar	Jun '10	85/500

Source: Industry, Ambit Capital Research
**JV with Ambika Modern, a seven year old school*
+Capacity indicates full capacity in these schools. All other schools indicate current capacity

Ramp-up in own brand schools has been weak: Educomp had begun with a co-branding strategy wherein it tied up with PSBB brand in Chennai and set up co branded 2 co branded schools –PSBB Millennium in Chennai (OMR and Porur). The initial student ramp-up with these schools were high given that PSBB was an established brand in South India. For instance, PSBB Millennium Porur had a first year student intake of ~950 students. However, most of the Millennium schools do not appear to have match this trend and the first year student intake for Millennium schools has ranged between 80-400 students. Exhibit 6 on the right indicates the ramp-up in Educomp's Millenium and Takshila schools.

Management's view is that school ramp-ups are on-track and as planned. Since by law schools can only open in staggered phases. In the 1st year the operator can only open a school from K-5. In the 2nd year it ramps up to Grade 8, then in the subsequent year until Grade 10 and so on.

We appreciate that school ramp-ups are slowed down by these legal restrictions. However, we note that in schools like Millenium Mohali and Jalandhar (see Exhibit 6) the capacity utilization appears sub-par even after factoring in such legal restrictions.

Substantial growth has come from acquired and JV schools: Out of the capex of ~Rs2.7 bn for K-12 in FY10 ~Rs1 bn was spent on acquiring the Musoorie International school. Furthemore, we find from channel checks that the Millenium Jalandhar JV school has been operational as an existing Ambika Modern School brand for seven years with ~400 students.

Portfolio mix is tilting towards the lower end schools: Educomp had earlier started out with the strategy of building schools under the Millennium brand focused on the high end segment. However, it has since then changed it strategy to venture into the mid (Takshila) and low (Universal) segment schools as well. Further, Educomp has decided to take the franchisee route for newer schools within the Takshila brand. While we understand that the K-12 market is still a nascent one, we are discomfited by the frequent change in strategies for the K-12 business. We continue to believe that owning and managing the schools generates the maximum sustainable advantage. Further, the budget school model (Universal) is still unproven in the market as most schools run into sever operational issues such as inability to find good teachers and longer ROI.

The 150 schools target seems ambitious: Educomp has now moved the goal post for its target of running 150 schools to FY13. Given the delay in ramping up green field own schools as highlighted above, we expect Educomp may try to reach this number by signing up contracts for dry management and franchising. However, we remain sceptical of the target being achieved by FY13 and assume that Educomp will only reach this number by FY16.

Management's view on growth in Loans & Advances

"Loans and advances have increased in line with the business model. The business model of EISML is such that in the first year of operations, the schools are FCF negative. This is in line with industry practice as no business is FCF positive in the first year of operations. Every business has a cycle time and similarly schools have a cycle time of 3 years. We have given adequate disclosures detailing the degree of EBITDA losses that each of our school brands are likely to make in the 1st year of operations in our investor update."

Source: Educomp

3. Persistent accounting issues and inadequate disclosures

- **Loans and advances** have increased from Rs1.89bn as on March 2010 to Rs3.28bn as on 30 Sep 2010 despite schools visibility having increased from only 69 to 79. Management noted that these are pertaining to the loans which were given by EISML to the school trusts.
- **Negative FCF:** Even management admits that the Educomp SPV has been created to make Educomp FCF positive. In spite of that Educomp had a negative free cash flow of ~Rs5bn in FY10. This is despite the new accounting model in Smart_Class where it recognises a portion of debt raised through an associate third party company as operating cashflow. We find Educomp's negative FCF puzzling especially since management says that it has not changed its accounting policies in the wake of EduSmart's creation.
- **Management discretion on revenue recognition in Smart_Class:** We understand that the substantial negative cashflow for Educomp in FY10 has partly been caused by the delay of securitisation of a tranche of ~1000

schools due to a delay in the release of funds by a consortium of banks for Educomp's existing and new schools (Smart_Class) in FY10. Based on our reading of documents on the Ministry of Corporate Affairs website (contract signed with a consortium of banks on March 12 2010), we understand that future funding for Edu Smart (which Edu Smart will use to pay Educomp for its receivables) would be contingent on meeting certain norms and would only be released after September 30. We think this and Educomp's negotiations for reducing its corporate guarantee could be some of the reasons for the delay in disbursement. Whilst the delay in securing funding is understandable, we find it surprising that management booked revenues despite a delay of ~6 months in the disbursal of loans to Edu Smart and hence of payment by Edu Smart to Educomp. We appreciate that Educomp's management has the discretion to recognize revenues in advance of actual payments to it by Edu Smart but we struggle to feel comfortable with such revenue recognition methods.

- **Less-than-ideal disclosure:**
  - **Promoter allotted warrants:** Educomp increased the stake in Educomp Infrastructure and School Management Ltd (EISML) from 69.4% to 78.2% at Rs4.89 bn. This gives EISML an implied valuation of Rs16.42 bn. However, the promoter (MD of Educomp) has recently been awarded 800K warrants at the same valuation as Educomp, over six months after the Educomp's equity infusion according to filings to the Ministry of Corporate Affairs. We find the lack of disclosure on this front unsettling although we recognize that the law might not require Educomp to make such a disclosure.
  - **Undisclosed JV with an existing school:** Educomp established a JV with an existing school called the Ambika Modern school in Jalandhar that has now been rebranded as Millenium Jalandhar. We find it intriguing that management has not disclosed this explicitly.

Educomp's shares have traded at a premium to the sector over the last three years due to the seemingly strong recurring revenues from Smart_Class, the growth potential of its Smart_Class and K-12 businesses and scarcity of high quality alternate plays on the sector. With rising questions on the sustainability of momentum in Smart_Class beyond the next few years, slower than expected ramping up of K-12 schools and persistent inadequacy in accounting and disclosure levels we believe that such a premium is no longer warranted.

Key assumptions & estimates

Exhibit 8: Key assumptions and estimates for EDSL (all figures in Rsmn unless otherwise mentioned)

	FY09	FY10	FY11E	FY12E	FY13E	Comments
Assumptions						
Smart_Class Schools	1684	3024	6086	9420	13286	We model strong school addition. However, the classroom addition is slower due to dilution in classroom penetration per school given lower demand on a school level in Tier 2/3 towns that forms a substantial part of Educomp's growth.
Classes Added	17717	18385	24916	27103	30134	
ICT	15004	24824	23931	27161	29711	
EduInfraManage	20	43	69	99	119	We model a reasonable addition of schools given the current visibility and ramp-up
Key Outputs (YoY growth)						
Revenue growth						
Smart_Class	148%	103%	34%	-10%	8%	We model a decline in FY12 revenues as FY11 benefits from a higher recognition of schools transferred to EduSmart in FY10 (Rs. 3441m recognised) than FY11. This normalises in FY12
ICT	22%	39%	-20%	9%	6%	We model a slow growth in the business after a decline in FY11.
EduInfraManage	NA	50%	44%	56%	80%	We model strong revenue growth driven by ramping up of schools in the K-12 business.

Source: Ambit Capital research

Ambit versus consensus

Exhibit 9: Ambit v/s consensus

(Rs m)	Consensus	Ambit	% change
Total Income			
FY11E	13,267	13,247	0%
FY12E	16,190	13,805	-15%
EPS (Rs)			
FY11E	34.8	34.7	0%
FY12E	39.6	32.7	-17%

Source: Bloomberg, Ambit Capital research

Our FY11 numbers are broadly inline with consensus. Our FY12 revenues are substantially below consensus as we model slow increase in Smart_Class sales due to decline in per school penetration and pricing pressure as a result of competition. We also model a more modest growth in K-12 school revenues given our observations of slow organic ramp-up. This is reflected in our lower margins and earnings.

Valuation

We have valued Educomp using a sum-of-the-parts (SOTP) model with a DCF valuation for its standalone business (primarily Smart_Class), K-12 schools and new ventures.

Based on the assumptions shown above and assuming; a) cost of equity at 15%; and b) terminal growth at 5%, our FCFE model values Educomp's Standalone business at Rs184 per share and K-12 business at Rs161 per share. We value the sum of Educomp's other businesses at Rs28 per share.

Hence we arrive at a total valuation for the company at Rs372 per share (implied FY11 P/E of 11x and FY11 EV/EBITDA of 7x), implying 29% downside from current levels.

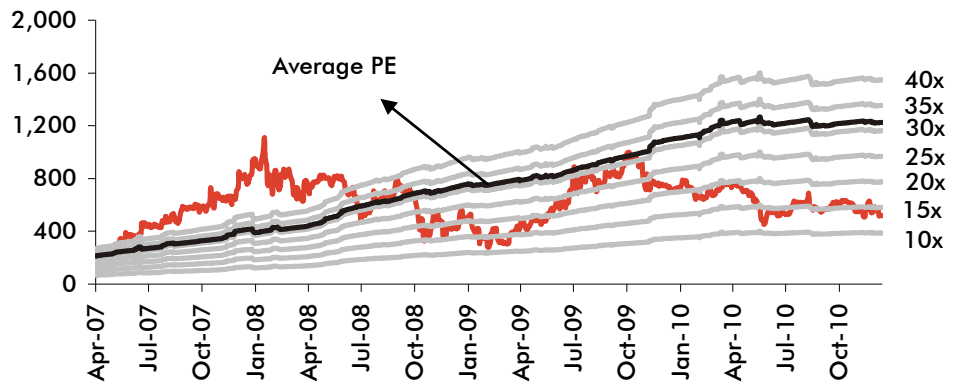
The key downside risks to our SELL stance are:

- Better than expected renewal of existing schools in FY12
- Strong uptake of Smart_Class and ability to hold pricing and increase penetration in Tier 2/3 cities
- Stronger than expected ramp-up in existing K-12 schools and faster organic execution of proposed schools

Cross Cycle Valuation

EDSL is trading at a forward PE of 15x (on consensus estimates) which is at a 50% discount to its long term average forward PE of ~32x (calculated based on the period from Sep-07 to Nov-10). However, this chart could be misleading as its FY10-FY11 earnings seem to be flattered by recent changes in revenue recognition.

Exhibit 10: Educomp is trading at a discount to its long term average PE



Source: Bloomberg

Exhibit 10: Balance sheet

Year to March (Rs mn)	FYO9	FY10	FY11E	FY12E	FY13E
Equity Share Capital	173	190	190	190	190
Reserves & Surplus	3,539	16,138	22,501	25,357	30,071
Net Worth	**3,712**	**16,328**	**22,691**	**25,547**	**30,261**
TOTAL debt excl FCCB	4,896	6,934	9,292	11,869	13,803
Total debt	8,895	10,478	12,836	15,412	17,346
Capital Employed	**13,996**	**28,894**	**35,798**	**41,278**	**47,803**
Net Block	**6,388**	**13,948**	**16,333**	**18,984**	**21,246**
Capital Work in Progress	2,962	2,739	548	614	561
Total Current Assets	**6,153**	**15,816**	**22,072**	**24,862**	**29,249**
Cash and Bank Balance	1,902	7,887	10,717	14,180	18,377
Total Current Liabilties	2,251	3,963	3,510	3,536	3,607
Total Assets	**13,995**	**28,894**	**35,798**	**41,278**	**47,803**
Net debt (ex-FCCBs)	2,594	(984)	(1,457)	(2,343)	(4,607)
Net debt (incl. FCCBs)	6,137	2,559	2,087	1,200	(1,063)

Source: Company, Ambit Capital research

Exhibit 11: Income statement

Year to March (Rs mn)	FYO9	FY10	FY11E	FY12E	FY13E
Smart Class	3,172	6,445	8,831	8,443	8,750
ICT	1,137	1,583	1,269	1,386	1,464
Professional development	287	200	136	129	123
Retail and consulting	416	403	513	646	794
EduInfra & Edumanage	377	564	812	1,267	2,280
Others	637	653	695	739	782
Net income	**6,371**	**10,394**	**13,247**	**13,805**	**15,592**
Total expenses	3,292	5,483	7,112	7,909	8,381
EBITDA	**3,078**	**4,911**	**6,135**	**5,896**	**7,210**
Depreciation	814	1,142	713	850	946
EBIT	**2,263**	**3,767**	**5,422**	**5,046**	**6,264**
Interest & financial exp	302	590	890	1,028	1,134
Other income	227	348	522	784	1,019
PBT (before EO)	2,189	3,526	5,054	4,802	6,149
Provision for Tax	773	1,584	1,718	1,632	2,090
Adjusted PAT	1,403	2,819	3,336	3,170	4,059
Reported PAT	**1,327**	**2,175**	**3,295**	**3,110**	**3,898**
Shares outstanding (net) (mn)	89	95	95	95	95
Adjusted EPS (Rs)	**15.0**	**27.3**	**34.7**	**32.7**	**41.0**

Source: Company, Ambit Capital research

Exhibit 12: Cash flow statement

Year to March (Rs mn)	FYO9	FY10	FY11E	FY12E	FY13E
PBT	**2108**	**4392**	**5054**	**4802**	**6149**
Depreciation & amortisations	814	1142	713	850	946
Dividend and Other income	(128)	(307)	(522)	(784)	(1019)
Interest expense	268	411	890	1028	1134
Cash flow before WC changes	3721	5044	6198	5959	7273
WC changes	(1023)	(1910)	42	338	(101)
Cash flow from operations	**2357**	**2195**	**4623**	**4713**	**4959**
Capex	**(6249)**	**(6855)**	**(3500)**	**(3208)**	**(2208)**
Free Cash Flow	**(3892)**	**(4659)**	**1123**	**1505**	**2752**
Interest/dividend received	128	(2)	522	784	1019
Cash flow from investing	**(7215)**	**(3722)**	**(2978)**	**(2425)**	**(1189)**
Long term borrowings	4,000	1,854	2,358	2,577	1,934
Interest paid	(268)	(411)	(890)	(1,028)	(1,134)
Dividends paid (incl. tax)	(58)	(166)	(282)	(374)	(373)
Cash flow from financing	**3,846**	**7,462**	**1,185**	**1,174**	**427**
Net change in cash	**(1,011)**	**5,936**	**2,830**	**3,463**	**4,197**

Source: Company, Ambit Capital research

Exhibit 13: Ratio analysis

Year to March (%)	FYO9	FY10	FY11E	FY12E	FY13E
Year on year growth					
Smart Class	148%	103%	37%	-4%	4%
ICT	22%	39%	-20%	9%	6%
Professional development	12%	-30%	-32%	-5%	-5%
Retail and consulting	171%	-3%	27%	26%	23%
Net income	123%	63%	27%	4%	13%
EBITDA growth	140%	60%	25%	-4%	22%
Op. profit growth	138%	66%	44%	-7%	24%
EPS growth	-57%	82%	27%	-6%	25%
Margins					
EBITDA margin	48.3%	47.2%	46.3%	42.7%	46.2%
Operating/EBIT margin	35.5%	36.2%	40.9%	36.6%	40.2%
Net margin	20.8%	20.9%	24.9%	22.5%	25.0%
Returns					
ROCE	13%	10%	10%	8%	9%
ROE	37%	27%	17%	13%	14%

Source: Company, Ambit Capital research

Exhibit 14: Valuation parameters

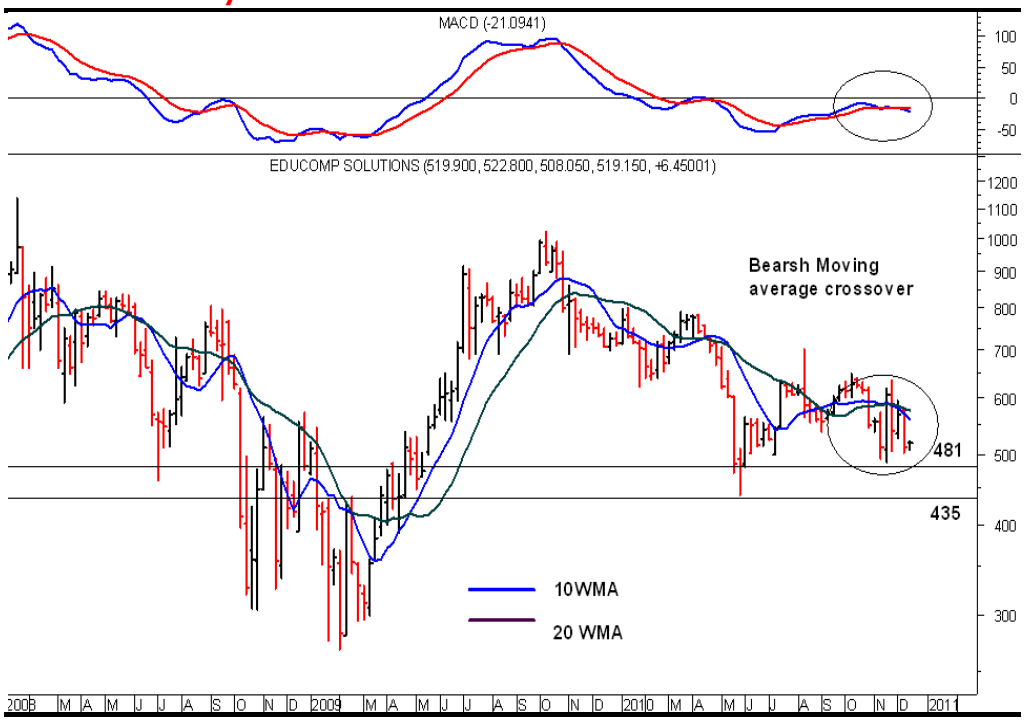
Year to March (Rs mn)	FYO9	FY10	FY11E	FY12E	FY13E
Diluted EPS (Rs)	**15.0**	**27.3**	**34.7**	**32.7**	**41.0**
Dividend per share (Rs)	0.6	2.5	3.4	3.4	4.6
P/E (x)	34.4	18.9	14.9	15.8	12.6
EV/EBITDA (x)	19.0	11.9	9.6	9.9	8.1
EV/EBIT (x)	25.9	15.6	10.8	11.6	9.4
EV/Sales (x)	9.2	5.6	4.4	4.2	3.8

Source: Company, Ambit Capital research

Technical View (3 months view)

Educomp Solutions: Bearish Weekly Averages Crossover

Exhibit 11: Weekly chart



Source: MetaStock

- Educomp on weekly chart has witnessed bearish moving average crossover as 10WMA cuts the 20WMA from the up signaling upside is limited till the averages.
- The daily and weekly MACD are in sell mode signaling the stock would witness lot of selling pressure in coming weeks.
- On the upside resistance will be near averages and also the reversal point for the current downtrend.
- The stock has also broken the neckline of head and shoulder and in the downside the stock to target Rs435 before that Educomp has minor support at Rs481.
- Therefore we advise to sell the stock with reversal above Rs570.

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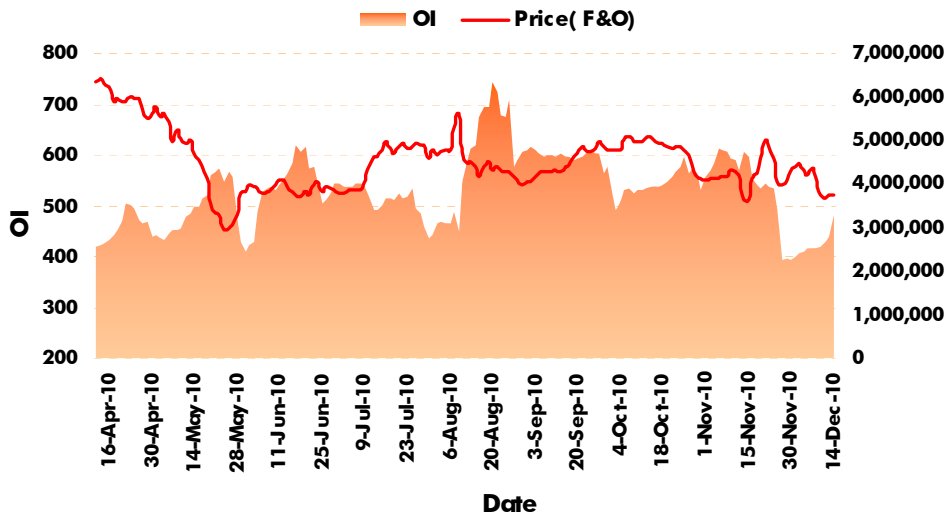
Derivative View

Exhibit 12: Open interest



Source: Ambit Capital research

Post some aggressive short build-up and subsequent covering in November, open interest this series has remained on the lower side for Educomp. However, the counter has seen some open interest accumulation over the last few days (around 28% addition in the last 3 sessions) while prices have remained almost unchanged. The cost of carry in the process has widened from 29 bps to 71 bps now. This can be a sign of accumulation for a bounceback. On the way up the stock is likely to face stiff resistance around the 550 mark. We think, around 500-510 is a very good support region for the stock. One should look to short only on a break below 500. On a break below 500 the stock can likely fall down to 450 levels.

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Everonn Education

AMBIT Acumen at work

Bloomberg: EEDU IN Equity
Reuters: EVED.BO

SELL INITIATING COVERAGE

Pricing in too many positives

Everonn has outperformed the Sensex and BSE500 by 32% in FY11 YTD backed by strong performance in the iSchools segment, grandiose plans for the K-12 segment and fund infusion by SKIL Infrastructure. However, the structural challenges that threaten the sustainability of its core businesses, such as revenue lumpiness and limited differentiation, keep us worried. We also find it too early to ascribe option value to its plans for setting up brick & mortar institutions given the lack of operational experience. With far too many positives priced in we initiate with a SELL. Potential earnings dilution from the recently concluded revised open offer could be a hangover over the near term.

New go-to-market strategy in the college business yet to fructify: Everonn's new sales model which was targeted at improved adoption rates and revenue visibility has met with limited success. Currently, we believe that only ~20 colleges have registered for this model. Further, most of the courses taken by students are restricted to short term ones (English language, personality development) and average price realization per student still remains low at ~Rs1,100.

Rising competition in iSchools (11% of revenue): Everonn's differentiated strategy has helped the firm establish itself firmly in the schools multimedia market despite not having an early mover advantage. While classroom penetration has been increasing for Everonn (unlike the trend witnessed in Educomp), increasing newer entrants and market leader Educomp resorting to price cuts could accentuate pricing pressure.

Too early to assign any value to the K-12 business: Everonn has announced an ambitious target of 350 schools in the K-12 segment over the next 3 years. We find it too early to ascribe any value to this given that: (a) Everonn has practically no operational experience in this space; and (b) Educomp, which was amongst the early entrants in this space, has ramped up to only 46 schools since the announcement of its plans in FY08. That said, should Everonn successfully create a franchise of 100 schools by FY20 (50% owned; 50% managed) we would ascribe a value accretion of ~US$145 mn/Rs344 per share (assuming dilution from SKIL Infra) from this venture.

The market has rewarded Everonn shares for impressive classroom penetration and strong growth in its college business. However, structural challenges that threaten the sustainability of its business model remain with rising competition and lumpy revenues. We also find it too early to ascribe any value to its ambitious K-12 plans given lack of operational experience in running/managing schools. We initiate coverage on Everonn with a SELL recommendation and a DCF based target price of Rs535.

Exhibit 1: Key financials

Year to March (Rsmn)	FY09	FY10	FY11E	FY12E	FY13E
Operating income	1,447	2,938	3,861	5,100	6,390
EBITDA	512	1,014	1,363	1,919	2,519
EBITDA margin (%)	35.4	34.5	35.3	37.6	39.4
EPS (Rs)	14.1	30.1	37.5	50.9	67.7
RoE (%)	13.2	19.4	18.4	19.2	20.8
RoCE (%)	11.8	16.9	15.8	15.9	17.0
P/E (x)	42.4	19.8	15.9	11.7	8.8

Source: Company, Ambit Capital research

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Recommendation

CMP:	Rs597
Target Price:	**Rs535**
Downside (%):	***10***
EPS (FY11E):	Rs36.4
Change from previous (%):	*NA*
Variance from consensus (%):	*-1*

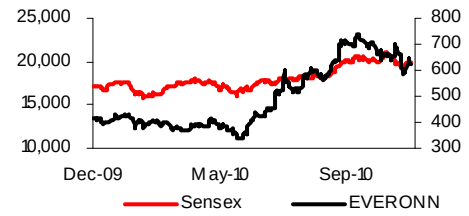
Stock Information

Mkt cap:	Rs9bn/US$200mn
52-wk H/L:	Rs756/332
3M Avg. daily val.:	US$6.1mn / Rs276mn
Beta:	1.7x
BSE Sensex:	19,799
Nifty:	5,944

Stock Performance (%)

	1M	3M	12M	YTD
Absolute	-6.6	-6.1	43.4	45.4
Rel. to Sensex	-4.9	-8.5	27.6	32.1

Performance (%)



Source: Bloomberg, Ambit Capital research

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Company Financial Snapshot

Profit and Loss (consolidated)

	FY10	FY11E	FY12E
Net Sales	**3,861**	**5,100**	**6,390**
Operating Exp	2,498	3,181	3,871
EBITDA	**1,363**	**1,919**	**2,519**
Depreciation	313	450	571
Other income	18	35	35
Interest expenses	215	344	440
PBT	854	1,160	1,543
Tax	284	385	513
PAT	**570**	**775**	**1,030**

Company Background

Everonn, incorporated in 2000 and has since become a leading Indian education service provider. It operates in two major segments – ICT that accounted for 25% and ViTELS (iSchools, Colleges, Retail) that accounted for 47% of revenues in FY10. The remaining 28% of revenue is contributed by its two subsidiaries EDURES and Toppers Tutorial. While the company started off with a focus on ICT, Everonn has established itself by offering digital curricula for schools and non-curriculum courses for colleges based on a VSAT based model. Everonn has recently ventured into the business of setting up K12 schools on a brick and mortar model and business schools over the next three years.

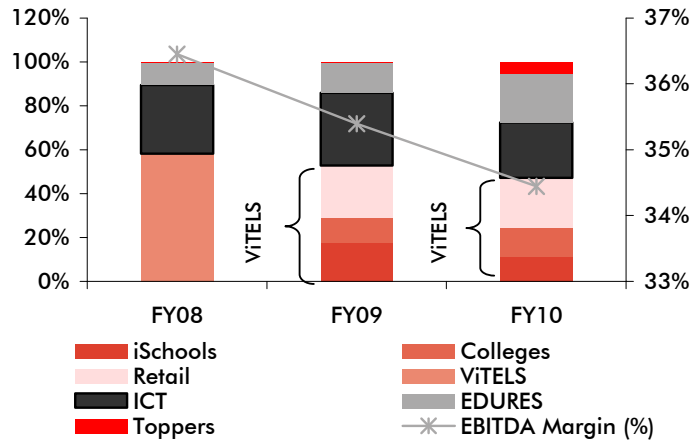
Balance Sheet (consolidated)

	FY10	FY11E	FY12E
Total Assets	**6,185**	**7,675**	**9,400**
Fixed Assets	2,477	3,385	4,407
Current Assets	2,912	3,566	4,469
Goodwill	5	5	5
Cash and Bank	557	485	286
Investments	235	235	235
Total Liabilities	**6,185**	**7,675**	**9,400**
Total Net Worth	3,645	4,426	5,457
Total Debt	1839	2439	3039
Current Liabilities	700	809	904

Ratios

	FY10	FY11E	FY12E
RoE (%)	18.4	19.2	20.8
RoCE (%)	15.8	15.9	17.0
EV/Sales (x)	2.3	1.7	1.4
EV/EBITDA (x)	6.5	4.6	3.5
EV/EBIT (x)	6.6	5.2	4.3
P/E (x)	15.8	11.7	8.8
P/B (x)	2.5	2.0	1.7

Revenue Breakdown



While ROEs have been improving, we expect it to decline over the long term

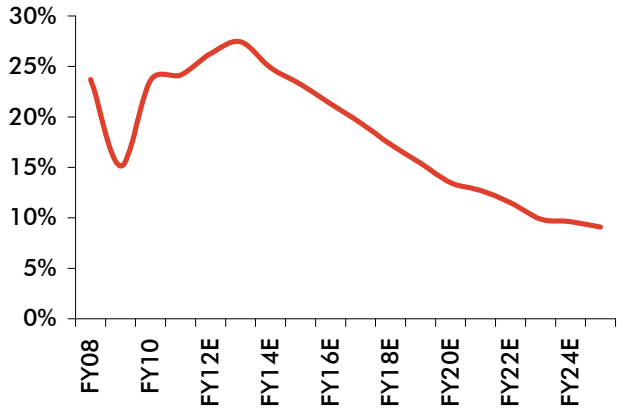


Exhibit 2: Everonn's SWOT Analysis

Strengths	Weaknesses
▪ Leading player in setting up and managing schools and colleges on a VSAT based model ▪ Relatively early entrant in the multimedia content for schools market and has a reasonable referenceable installed base ▪ Strong relationship with state governments through ICT contracts.	▪ Relatively higher dependence on ICT for annuity revenues resulting in stretched cash flows. ▪ Increasing proportion of revenues from non core business (EDURES) where margins are in the range of 5%. ▪ Increasing proportion from relatively commoditised Retail business with low operational disclosures. ▪ No past experience in setting up and managing K-12 schools and Business schools
Opportunities	**Threats**
▪ Increasing classroom penetration for iSchools (Currently 2.5 classes per school vs Educomp's 8 classes per school). ▪ New business model in college business (tie up with colleges instead of students) would ensure revenue guarantee and reduce the lumpiness in the revenues of this segment. ▪ Has recently ventured into the attractive K-12/ Higher education segment which provides the highest sustainable competitive advantage.	▪ Rising competition in ICT could drive the company to bid aggressively for contracts which would impact return ratios and cash flows. ▪ Decline in pricing for iSchools given increasing new entrants and price cuts by market leader, Educomp. ▪ Failure of the recently implemented new business model in the college segment will have Everonn following the older model in which revenues continue to be unpredictable. ▪ Failure to execute on the K-12/Business school plans

Source: Ambit Capital research

New go-to-market strategy in the college business yet to fructify

Everonn's VSAT based non-curriculum courses for colleges met with stupendous initial success with revenues growing by 163% YoY in FY10. However, the business is faced with structural problems as these courses are sold directly under a retail model to students with no minimum revenue guarantee from colleges.

Under the new college model, colleges have to ensure minimum enrolment of 200 students without which Everonn will not invest in setting up the VSAT classrooms.

New model in colleges targets improved adoption rates and revenue visibility...

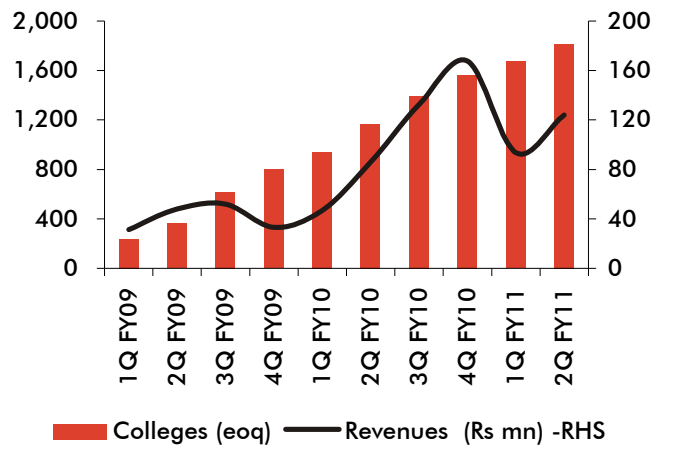
Everonn initiated a change in early 2010 whereby:

- Firstly, it changed the sales model from employing Everonn's direct employees to using channel based distribution to ensure quicker scalability. Under this model, the channel partner is paid approximately ~15% revenue share (the colleges continue to get revenue share of ~15% as in the earlier model).
- Secondly, efforts were initiated to convert the business model from Business-to-Consumer (B2C) to Business-to Business (B2B) where the customers would be colleges who in turn would ensure minimum student enrolments for these courses.

...but unpredictable performance suggests that model has not fructified

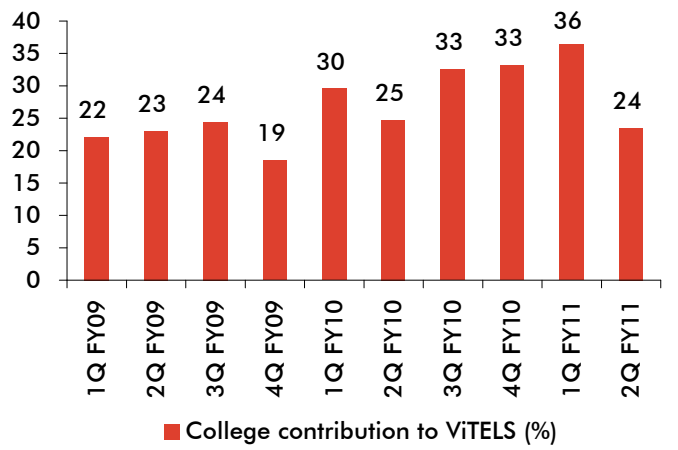
While Everonn's entire college business operates on a channel distribution model currently, the efforts of selling it to institutions directly has met with limited success. Currently, we believe that only ~20 colleges have registered for this model. Hence, the college segment still continues to be unpredictable as revenues are prone to lumpiness from student enrolments in a particular quarter. Furthermore, most of the courses taken are restricted to short term ones (English language, personality development) where the price points and student tenure remains low. While Everonn's courses are priced between Rs350-25,000, average price realization per student still remains low at ~Rs1,100. Further, despite meaningful contribution of college business (15% of revenue in FY10), management disclosures for the business remain unsatisfactory.

Exhibit 3: Revenue performance for the college segment continues to be unpredictable



Source: Company, Ambit Capital research

Exhibit 4: Despite meaningful contribution to ViTELS, disclosure for college business remains unsatisfactory



Source: Company, Ambit Capital research

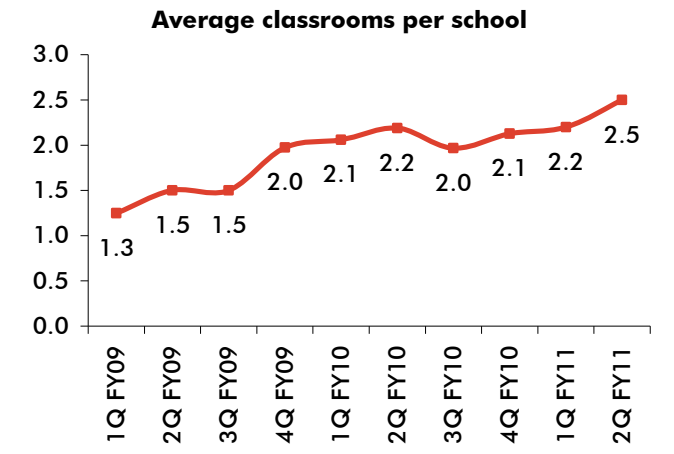
Increased competitive intensity to increase pricing pressure

Differentiated strategy helped Everonn in the first leg of growth...

Given that Everonn was a relatively late entrant in this market, it adopted a differentiated strategy vis a vis Educomp. Everonn's primary focus was: (a) the middle/lower segment of the schools market where Educomp did not have meaningful presence then; and (b) to gain entry into the school first and to do this it was willing to install iSchool even in schools which wanted to start with a couple of classes (unlike Educomp which would then add schools with only 10 or more classes).

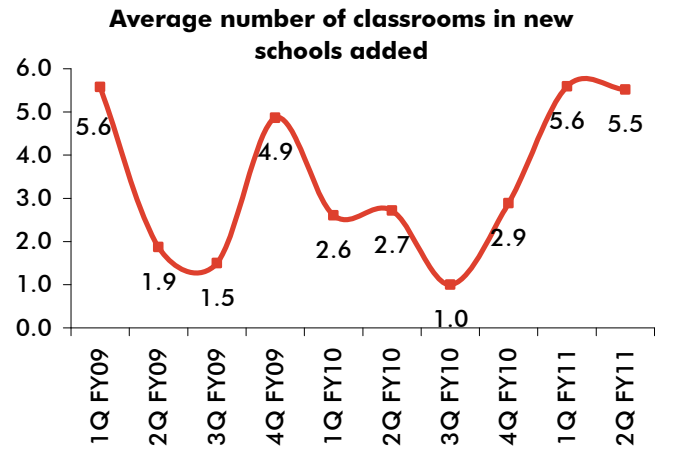
This worked well for Everonn as with schools becoming comfortable with the product, penetration within existing schools has been on an rising trend (average classroom per school stood at 2.5 in 2Q FY11 vs 1.3 in 1Q FY09). This is in contrast to Educomp which was earlier focused on the premium segment and now, with that space beginning to get saturated, has shifted the focus to Tier2/3 cities. Consequently, average classroom penetration has fallen for Educomp from 15 in FY10 to 8 in 2Q FY11.

Exhibit 5: Average classroom penetration for iSchools has been increasing



Source: Company

Exhibit 6: Average classroom additions for iSchools for incremental schools has been increasing



Source: Company

...but changing market realities could mean pressure on pricing

However, as highlighted in the earlier part of this report, the ground realities in the multimedia content market are changing. While in the early part, Everonn's strategy has worked well, increased competitive intensity could mean increased pressure on price points for Everonn, particularly when Educomp as a market leader is resorting to price cuts and newer entrants are coming in with better quality content.

K-12 business – Too early to assign value

Everonn has been retracing Educomp's steps in the K-12 space. While Everonn has suggested its preference for a low capital intensive model, we suspect that the recent fund infusion from the new promoter entity, SKIL Infrastructure, could encourage the management to explore the greenfield option as well. We view the K-12 business as an attractive opportunity and see a good potential value addition. Should Everonn successfully create a franchise of 100 schools by FY20 (50% owned; 50% managed) we would ascribe a value accretion of ~US$145 mn/Rs344 per share (assuming dilution from SKIL Infra) from this venture. However, we have some issues with this business:

In July 2010, SKIL Infra structure acquired 20.9% stake in Everonn and was designated as a co-promoter. Everonn issued 4 mn optionally convertible debentures amounting to Rs2.1bn (Rs521 per share).

1. Firstly, we find that the target of 350 schools over a period of 5 years too ambitious. Educomp, the only other listed player in the K-12 space, currently has 46 operational schools after working for three years in this space.
2. Secondly, Everonn has practically no operational experience in this space making it difficult for us to assign a value for this business. That said we have presented the potential value it could derive from more realistic targets.

Initiate coverage with SELL

Everonn faces rising competition in its schools business and teething problems in its nascent K-12 business. Furthermore, stickiness in the college business remains unproven as the new sales strategy has had limited success. EPS is expected to grow only at 31% CAGR FY10-13E (79% CAGR FY08-10). Our 3-stage DCF points to Rs 535, 10% downside (refer to Pg 7 for further details).

Everonn's revised open offer at Rs587 was scheduled for 2 November 2010 to 27 November 2010. However, only 88,500 shares were tendered during the offer (0.6% dilution on the current equity share capital). Assuming that the rest of 3.9 mn shares are issued to SKIL infrastructure at Rs521 per share, we believe that the potential EPS dilution would be 19.5% for FY11E and 10% for FY12E. We believe that potential dilution could be a hangover on the stock for the near term.

Valuation

We have valued Everonn using a three stage DCF model. Our FCFE model has three distinct phases:

- **FY10-FY13**: We model each year and broadly assume that revenues will grow at 29% CAGR and EBITDA margins will grow to 40% by FY13 vs. 36% in FY11.
- **FY14-18**: We fade the revenue growth gradually so that by FY18 the revenue growth is 7% and EBITDA margins is at 38%.
- From **FY20** FCFE grows at a CAGR of 10%.

Based on the assumptions shown above and assuming; a) WACC at 14% (cost of equity at 15%; cost of debt at 13% and long term debt/equity ratio of 1:1) b) terminal growth at 5%, our FCFE model values Everonn's business at Rs535 per share (implied FY12 P/E of 11x) implying 10% downside.

Exhibit 7: Valuation sensitivity to key assumptions

	High Case	Base Case	Low Case
Revenue	We model revenues to grow at a faster CAGR of 31% over FY10 - FY13 driven by increased classroom penetration for iSchools product and higher adoption of the new business model for colleges. We also assume that Everonn competes better with competition resulting in lower attrition in the schools in the renewal cycle. Our FY14–18 growth rate is 15%.	We model revenue CAGR of 29% over FY10-FY13 driven by strong growth in ViTELS. We model this to moderate to 13% revenue CAGR for FY14-FY18 driven by the assumption of slower market growth rates and price erosion due to increasing competition.	We assume slower revenue growth of 26% CAGR over FY10-FY13 as Everonn faces higher price erosion and lower classroom penetration for iSchools. Similarly our longer term growth rates are 11% for FY14-FY18 as we model higher attrition from older schools and colleges.
EBITDA	We model EBITDA margins to be higher by 100 bps annually over FY11-FY13 driven by higher classroom penetration for iSchools and lower price erosion. We expect margins to moderate to 38% and subsequently taper to 29% driven by rising competition and need to invest higher in sales and marketing.	We model EBITDA margins to expand from 34% in FY10 to 39% in FY13 driven by the increasing proportion of higher margin iSchool business and operational efficiencies from the new business model in College business. We model this margin to moderate to 37% in FY18 and subsequently to 29% at the end of the forecast period driven by rising competition.	We model EBITDA margins to be lower by 50 bps annually over FY11-FY13 due to slower than expected adoption of iSchools and lower success of the new business model in colleges. Post FY18, we model margins to gradually fade until 29% due to rising competition.
Fair value-(Rs)	**Rs673**	**Rs535**	**Rs318**
Upside	Upside of 13%	Downside of 10%	Downside of 47%

Source: Ambit Capital research

The key risks to our SELL stance are: (a) Everonn being able to hold on to its pricing power in the schools business; (b) faster than expected ramp up in the new model in the colleges business which would infuse higher revenue guarantee and student stickiness; and (c) faster than expected ramp up in the K-12 business.

Exhibit 8: Key assumptions and estimates (all figures are in Rs mn unless otherwise stated)

	FY10	FY11E	FY12E	FY13E	Comments
ICT					
Ending Schools (No)	5,862	7,731	9,760	10,248	Assumed sequential addition of 8% in the number of schools for 2H FY11, 6% in FY12, 5% in FY13.
Revenues	689	890	1,119	1,350	Revenue growth in FY12 mainly driven by Himachal Pradesh (282 schools) and Maharashtra (206 schools) contracts.
EBITDA	328	384	463	549	Pressure on EBITDA margins due to rising competition
ViTELS - Schools					
Ending Schools (No)	1,017	1,498	2,197	2,382	Assumed sequential addition of 12% in number of schools for 2H FY11, 10% in FY12, 9% in FY13.
Revenues	314	375	581	871	Revenue growth faster than school addition due to increase in average classroom penetration from 2.5 currently to 3.8 in FY12 and 4.5 in FY13
EBITDA	204	210	349	534	Operating margins improves as classroom penetration per school rises
ViTELS - Colleges					
Ending Colleges (No)	1,427	2,338	3,511	3,806	Assumed 13% sequential growth in colleges under old model in 2H FY11, 10% in FY12 and 8% in FY13. 30 college addition per quarter in new model for FY12 and FY13
Revenues	434	564	959	1,380	Revenue buoyancy driven by new model in colleges
EBITDA	170	291	493	694	
ViTELS - Retail					
Ending Centres (No)	46	58	66	68	
Revenues	671	760	842	1,005	Revenue growth driven by addition of new centres and more tests conducted
EBITDA	298	330	366	437	
EDURES					
Revenues	698	1,041	1,193	1,325	Revenue growth driven by increased contribution from corporates (38% in FY13 vs 32% in FY11)
EBITDA	45	39	44	71	
Toppers Tutorial					
Revenues	131	230	406	460	29 centres at the end of FY11, 35 in FY12 and 43 in FY13
EBITDA	-	102	208	262	
Consolidated Revenues	2,937	3,861	5,100	6,390	Revenue growth driven primarily by schools and colleges segment
Consolidated EBITDA	1,014	1,363	1,919	2,519	Margins driven by increased contribution from schools and colleges business
Depreciation	253	313	450	571	
Consolidated EBIT	761	1,050	1,469	1,948	
PBT	659	854	1,160	1,543	
PAT	456	570	775	1,030	
PAT Margin (%)	15.5%	14.8%	15.2%	16.1%	
Fully Diluted EPS (Rs)	30.1	37.5	50.9	67.7	
Change in working Capital	(564)	(969)	(546)	(807)	
Capex	(779)	(1,083)	(1,358)	(1,593)	Majority of the capex is for schools and colleges business
CFO	252	128	1,023	1,234	
CFI	(555)	(1,307)	(1,358)	(1,593)	
FCF	(527)	(955)	(335)	(359)	

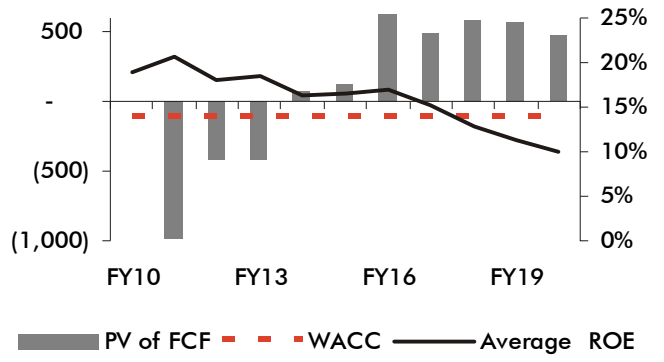
Source: Company, Ambit Capital research

Exhibit 9: Comparison with consensus

	Ambit	Consensus	% difference
Revenue (Rs mn)			
FY11	3,861	3,833	1%
FY12	5,100	5,130	-1%
EBITDA (Rs mn)			
FY11	1,363	1,364	0%
FY12	1,919	1,884	2%
EPS (Rs)			
FY11	37.5	36.9	2%
FY12	50.9	51.8	-2%

Source: Bloomberg, Ambit Capital research

Exhibit 10: FCF cash flow profile (Rs mn)

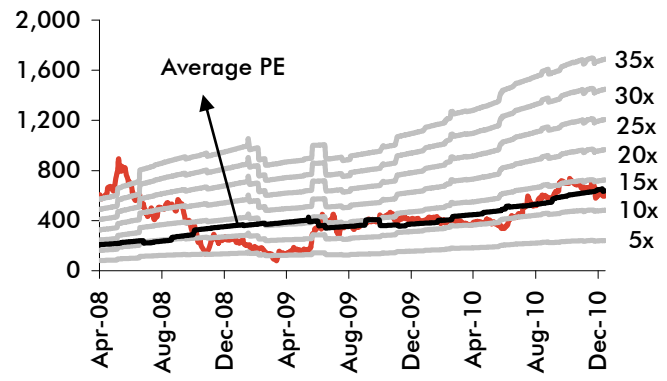


Source: Bloomberg, Ambit Capital research

Relative valuation

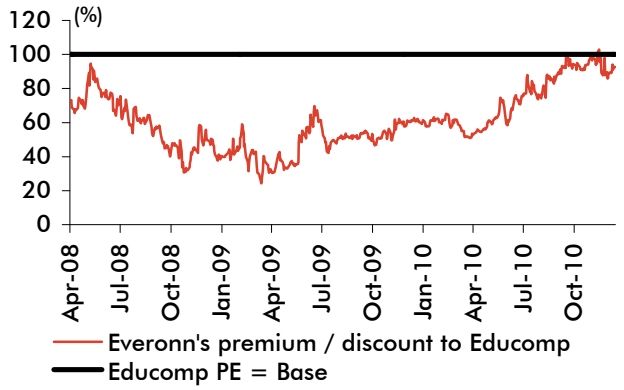
Everonn has traded at an average discount of 29% to Educomp since listing. This discount had widened to 50% during FY09 when Everonn missed its guidance by a large amount and investors had lost faith in the business model. Subsequently improved operational performance in FY10, announcement of K-12 plans and entry of SKIL as a co-promoter saw the discount to Educomp reduce substantially to 20% since April 2010. Currently, Everonn trades at only 9% discount to Educomp. Given Everonn's lower exposure to promising businesses (Multimedia, K-12 and colleges) and relatively weaker competitive position in its leading business, it deserves to trade at a discount to Educomp.

Exhibit 11: Everonn's 1 year forward PE band



Source: Ambit Capital research, Bloomberg

Exhibit 12: Everonn's discount/premium to Educomp



Source: Ambit Capital research, Bloomberg

We build in revenue CAGR of 30% over FY10-13E primarily driven by addition in schools and colleges.

Exhibit 13: Consolidated income statement

Y/E Mar (Rsmn)	2009A	2010A	2011E	2012E	2013E
ICT	471	690	890	1,119	1,350
ViTELS - Schools	274	314	375	581	871
ViTELS - Colleges	164	434	564	959	1,380
ViTELS - Retail	304	671	760	842	1,005
Edures	229	698	1,041	1,193	1,325
Toppers Tutorial	4	131	230	406	460
Net income	**1,447**	**2,938**	**3,861**	**5,100**	**6,390**
Total expenses	935	1,924	2,498	3,181	3,871
EBITDA	**512**	**1,014**	**1,363**	**1,919**	**2,519**
Depreciation	159	253	313	450	571
EBIT	354	761	1,050	1,469	1,948
Interest & financial exp	68	107	215	344	440
Other income	39	5	18	35	35
PBT (before EO)	324	659	854	1,160	1,543
Provision for Tax	120	204	284	385	513
Reported PAT	**204**	**456**	**570**	**775**	**1,030**
Adjusted PAT	204	456	570	775	1,030
Weighted avg shares (mn)	15	15	15	15	15
Adjusted EPS (Rs)	**14.1**	**30.1**	**37.5**	**50.9**	**67.7**
Adjusted EPS post dilution (Rs)	14.1	30.1	31.4	46.3	59.7

Source: Ambit Capital research, Company

We estimate debt to increase from Rs839 mn in FY10 to Rs3 bn in FY13E to fund its growth in the ViTELs segment.

Exhibit 14: Consolidated balance sheet

Y/E Mar (Rsmn)	2009A	2010A	2011E	2012E	2013E
Equity Share Capital	151	151	151	151	151
Reserves & Surplus	1,986	2,408	3,494	4,275	5,306
Net Worth	2,137	2,559	3,645	4,426	5,457
TOTAL debt	487	839	1,839	2,439	3,039
Capital Employed	**2,624**	**3,399**	**5,485**	**6,866**	**8,496**
Net Block	926	1,456	2,227	3,135	4,157
Capital Work in Progress	250	246	250	250	250
Goodwill	5	5	5	5	5
Investments	235	11	235	235	235
Total Current Assets	1,340	1,777	2,912	3,566	4,469
Cash and Bank Balance	403	439	557	485	286
Total Current Liabilities	534	535	700	809	904
Total Assets	**2,624**	**3,399**	**5,485**	**6,866**	**8,496**

Source: Ambit Capital research, Company

We do not expect Everonn to turn FCF positive by FY13

Exhibit 15: Consolidated cash flow statement

	2009A	2010A	2011E	2012E	2013E
Pre-tax profits before EO items	341	659	854	1,160	1,543
Depreciation & amortisations	159	252	313	450	571
Dividend and Other income	39	5	18	35	35
Others	(12)	11	197	309	405
Cash flow before WC changes	526	927	1,381	1,954	2,554
WC changes	(585)	(564)	(969)	(546)	(807)
Taxes paid	(31)	(111)	(284)	(385)	(513)
Cash flow from operations	**(90)**	**252**	**128**	**1,023**	**1,234**
Capex	(710)	(779)	(1083)	(1358)	(1593)
FCF	(799)	(527)	(955)	(335)	(359)
Interest/dividend received	39	5	18	35	35
Cash flow from investing	**(858)**	**(555)**	**(1,307)**	**(1,358)**	**(1,593)**
Long term borrowings	29	358	1,000	600	600
Interest paid	(68)	(107)	(215)	(344)	(440)
Dividends paid (incl. tax)	0	0	0	0	0
Cash flow from financing	**(39)**	**251**	**785**	**256**	**160**
Net change in cash	(987)	(52)	(394)	(79)	(199)

Source: Company, Ambit Capital research

EBITDA margins to increase by 490 bps over FY10-13E primarily driven by higher classroom penetration per school in the iSchools

Exhibit 16: Key ratios

	2009A	2010A	2011E	2012E	2013E
Year on year growth					
ICT		46%	29%	26%	21%
ViTELS - Schools		15%	19%	55%	50%
ViTELS - Colleges		164%	30%	70%	44%
ViTELS - Retail		121%	13%	11%	19%
Net income	58%	103%	31%	32%	25%
EBITDA growth	53%	98%	34%	41%	31%
Op. profit growth	50%	115%	38%	40%	33%
EPS growth	49%	114%	24%	36%	33%
Margins					
EBITDA margin	35.4%	34.5%	35.3%	37.6%	39.4%
Operating/EBIT margin	24.4%	25.9%	27.2%	28.8%	30.5%
Net margin	14.1%	15.5%	14.8%	15.2%	16.1%
Returns					
ROCE (%)	11.8%	16.9%	15.8%	15.9%	17.0%
ROE (%)	13.2%	19.4%	18.4%	19.2%	20.8%
Equity value					
P/E (x)	42.4	19.8	15.9	11.7	8.8
Enterprise value					
EV/Sales (x)	6.1	3.0	2.3	1.7	1.4
EV/EBITDA (x)	17.3	8.8	6.5	4.6	3.5
EV/EBIT (x)	16.3	8.0	6.6	5.2	4.3

Source: Company, Ambit Capital research

Technical View (3 months view)

Everonn Systems: Sell with downside target of Rs507

Exhibit 17: Weekly chart

Source: MetaStock

- Everonn is trading in upward channel but not able to close above the upper end of the Raff regression trend line.
- The stock is not able to breakout from the original channel to new trading zone suggesting lot of selling pressure at higher levels.
- Even the daily and weekly MACD and RSI are in sell mode and this would help the stock to dip toward the lower end of the channel which's at Rs507.
- We would recommend selling the stock until it not breaks out the upper end of the channel which is at Rs600.

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Explanation of Investment Rating

Investment Rating	Expected return (over 12-month period from date of initial rating)
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Hold	5% to 15%
Sell	<5%

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