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India Research

Sector: Indian Education

Call Report

Educomp Solutions Ltd. (EDSL.IN) (EDSO.BO)

(CMP: Rs. 1815 Mkt. Cap: Rs. 29.04 bn, $ 0.72 bn, May 30, '07)
Relevant Index: S & P CNX Nifty: 4249.65, May 25,'07

Very high debtor days, at 170 days, is a cause for great concern. This crimps Educomp's cashflows significantly. What's more, management is unwilling to elaborate on the reasons for this, save for giving a bland: "This figure will always remain high". And the arithmetic of these high debtor days doesn't add up (see inside). Something doesn't make sense here. When a young growth company refuses to explain this, we have never found this to be a good sign

Educomp has never had even a SINGLE year of positive free cash. Nor will it, even in the next some years. We thought businesses of this kind were supposed to be cash positive…and lastly, there is no good reason why its valuation should be that much above NIIT's. The gap has to narrow.

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IMPORTANT DISCLOSURES CAN BE FOUND AT THE END OF THIS REPORT.

Financial Snapshot

Key Financials							
(YE Mar 31st) (Rs. mn)	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Net Sales	**105**	**177**	**207**	**248**	**311**	**523**	**1,065**
Sales Growth (Y-o-Y)		*69%*	*17%*	*20%*	*26%*	*68%*	*104%*
Other Operating Income	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Op. Inc.Growth (Y-o-Y)							
Total Revenue	**105**	**177**	**207**	**248**	**311**	**523**	**1,065**
Revenue Growth (Y-o-Y)		*69%*	*17%*	*20%*	*26%*	*68%*	*104%*
EBIDTA	**11**	**37**	**58**	**63.50**	**146**	**260**	**503**
EBIDTA Growth (Y-o-Y)		*248%*	*59%*	*9%*	*130%*	*78%*	*93%*
Net Profit	**11**	**13**	**18**	**19**	**63**	**139**	**283**
Net Profit Growth (Y-o-Y)		*11%*	*40%*	*7%*	*235%*	*120%*	*103%*
Net Profit (Excl. Extra-ordinaries)	**11**	**13**	**18**	**19**	**56**	**139**	**283**
Net Profit (Excl. Extra-ordinaries) Growth (Y-o-Y)		*11%*	*40%*	*7%*	*196%*	*149%*	*103%*
Shareholders Equity	**126**	**143**	**156**	**171**	**234**	**903**	**1,152**
Number of Diluted shares (mn)	4	11	9	4	11	12	16
Key Operating Ratios							
(YE Mar 31st)	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Diluted EPS (Rs) (Excl. Extra-Ordinaries)	**2.55**	**1.15**	**1.97**	**4.23**	**5.10**	**11.15**	**17.68**
EPS Growth (Y-o-Y)		*-54.9%*	*71.2%*	*114.8%*	*20.6%*	*118.6%*	*58.6%*
CEPS (Rs.) (Excl. Extra-Ordinaries)	3.4	3.2	5.3	12.6	9.6	15.4	23.71
EBIDTA (%)	10.0%	20.6%	28.1%	25.7%	46.9%	49.8%	47.2%
NPM (%)	**10.8%**	**7.1%**	**8.5%**	**7.6%**	**18.0%**	**26.6%**	**26.6%**
RoE (%)	18.1%	9.4%	11.8%	11.6%	27.6%	23.9%	27.2%
RoCE (%)	18.1%	9.1%	10.6%	9.6%	21.9%	20.8%	N.A.
Book Value per share (Rs.)	28.2	13.0	17.4	38.2	21.3	72.4	72.0
Debt/Equity (x)	**0.00**	**0.06**	**0.09**	**0.17**	**0.19**	**0.11**	N.A.
Valuation Ratios							
(YE Mar 31st)	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
P/E (x)							104.6
P/BV (x)							26
P/CEPS (x)							78
EV/EBIDTA (x)							N.A.
Market Cap./ Sales (x)							27.8
DuPont Model							
(YE Mar 31st)	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
EBIDTA/Sales (%)	10%	21%	28%	26%	47%	50%	47%
Sales/Operating Assets (x)	**2.3**	**1.5**	**1.3**	**1.3**	**1.3**	**1.5**	N.A.
EBIDTA/Operating Assets (%)	**23.2%**	**31.4%**	**37.3%**	**34.0%**	**61.6%**	**74.9%**	N.A.
Operating Assets/ Net Assets (x)	0.7	0.8	0.9	0.9	0.9	0.5	N.A.
Net Earnings/ EBIDTA (%)	109%	35%	30%	30%	38%	53%	56.22%
Net Assets/ Equity (x)	1.0	1.0	1.1	1.2	1.3	1.2	N.A.
Return on Equity (%)	**18.1%**	**9.4%**	**11.8%**	**11.6%**	**27.6%**	**24.5%**	**27.2%**

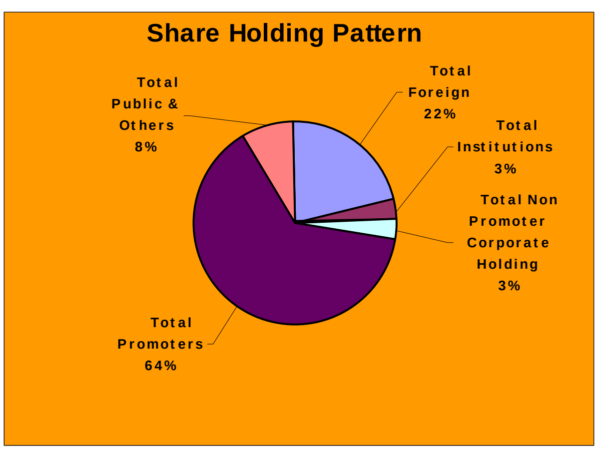
Free Cash flow – standalone basis							
(YE Mar 31st) (Rs. mn)	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007E**
EBITA	**7**	**14**	**28**	**26**	**97**	**207**	**407**
Less: Adjusted Taxes	1	3	9	12	37	73	164
NOPLAT	**6**	**11**	**19**	**14**	**60**	**134**	**242**
Plus: Depreciation	4	22	30	37	49	53	97
Gross Cashflow	**10**	**34**	**49**	**51**	**109**	**187**	**339**
Less: Increase in Working Capital	40	30	7	25	72	127	224
Operating Cashflow	**-30**	**4**	**42**	**26**	**38**	**60**	**115**
Less: Net Capex	54	44	51	46	84	151	640*
Less: Increase in Net Other Assets	0	0	-10	-6	-42	-65	0
FCF From Operation	**-84**	**-40**	**1**	**-14**	**-4**	**-27**	**-525**
Less: Inc./(Dec.) in Investment	22	-14	1	2	6	-2	0
FCF after Investment	**-107**	**-26**	**0**	**-16**	**-10**	**-25**	**-525**
Plus: Gain/(loss) on Extraordinary Items	0	0	0	0	5	0	0
Plus: Foreign currency Translation Effect	0	0	0	0	0	0	0
Total FCF	**-107**	**-26**	**0**	**-16**	**-6**	**-25**	**-525**

** Management has disclosed FY 07 capex of Rs.640 mn*

Common Sized Profit & Loss Account							
(YE Mar 31st)	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total Revenues	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Operating expenses	23.6%	20.8%	21.4%	27.7%	12.6%	19.3%	29%
Personnel Expenses	24.0%	30.6%	26.7%	22.2%	19.5%	13.7%	10%
S G & A Expenses	42.4%	27.7%	23.9%	24.4%	19.4%	15.7%	14%
Miscelleaneous Exp	0.0%	0.3%	0.0%	0.0%	1.5%	1.5%	0%
EBITDA	10.0%	20.6%	28.1%	25.7%	46.9%	49.8%	47%
Depreciation and Amortization	3.8%	12.6%	14.6%	15.1%	15.7%	10.2%	9%
Interest	0.4%	1.2%	1.5%	1.5%	1.8%	1.4%	1%
PAT	10.8%	7.1%	8.5%	7.6%	20.3%	26.6%	27%
PAT(Excl.Extra-ordinaries)	10.8%	7.1%	8.5%	7.6%	18.0%	26.6%	27%

*Key Statistics**

Share Holding Pattern As on 31st March 2007



Industry:	**Computer Sector**
52 Week Hi:Lo:	Rs.1999 / 269.20
CMP:	Rs.1851
Avg Daily Vol (20 days):	0.34 mn
Avg Daily Val (20 days):	Rs.609.20 mn
Performance over 52 weeks:	
EDUCOMP:	Up 374.1%
Nifty:	Up 33.4%

Educomp Solutions Ltd.'s Business in Pictures… (FY07)

Operations/ Value added
Net Revenues: Rs. 1065 mn (100%)

COGS: Rs. 304 mn (28.5%)

Selling, General &Administrative Expenses:
Rs. 153 mn
(14.36%%)
Personnel Expenses:
Rs. 105 mn (9.86%)

Finished Products:
1) Smart_Class Rs.465.7mn
2) Instructional Computing Technology Rs. 301.2mn
3) Professional Development Rs.175.4mn
4) Others like portals and preschools Rs. 122.8mn

Markets
Domestic & Foreign

EBIDTA
Rs. 503 mn
(47.2%)

Below Operating Line

Interest: Rs. 13 mn (1.2%)
Depreciation: Rs. 97 mn (9.1%)

Domestic Customers: Indian Private Schools, Public Schools, Teachers, Pre School going children's.

Global Customers: Partnership Agreements Educomp receives Licensing Fee.

Profit Before Tax
Rs. 442 mn (41.50%)

Taxes
Rs. 160 mn (15.02%)

Profit After Tax
Rs. 282 mn (26.48%)

Assets

Balance Sheet (FY06)
Rs. 1180 mn (100%)

Liabilities

Fixed Assets: Rs. 167 mn (14.15%)
CWIP: Rs..67(5.68%)
Investments: Rs.16(1.36%)
L& A: Rs. 55 mn (4.67%)
Debtors: Rs. 257 mn (21.78%),
Inventory: Rs. 17 mn (1.44%)
Cash: Rs. 600 mn (50.85%)
Miscellaneous: Rs. 1mn (0.08%)

Equity: Rs. 160 mn (13.56%)
Reserves: Rs. 744 mn (63.05%)
Debt: Rs.99 mn (8.39%)
Sundry Liabilities: Rs. 21.5 mn (1.82%)
Current Liability: Rs. 141.5 (12%)
Deferred Tax Liability: Rs.14mn (1.19%)

Call Report

(in the interest of timeliness, this report is largely unedited)

Date: May 28, 2007

People met: Ms. Sangeeta Gulati, Vice President (Finance) Educomp Solutions Ltd.

Following Main points were discussed in the meeting:-

- **Future Plans for e.g. expanding in country like China.**
- **Competitive nature of the industry.**
- **Scope for margin improvements.**
- **Detail Revenue Break-up.**
- **Future Guidance.**
- **Discussion on issues like negative free cash flows, seasonal behaviour of revenues etc.**

Brief Overview of Educomp Solutions Ltd.

Educomp is a niche player in the Indian education space catering to the K12 (Kindergarten to class 12th) market segment and has different products catering to various segments:

1) **Smart_Class (44% of Revenues in FY07):** Under this product, Educomp provides infrastructure, content, and teachers training to private schools on Build, Own, Operate, & Transfer basis, wherein the contract usually runs for 3-5 years.

   Schools have two options after the termination of the contract - either to renew the contract, in which case Educomp provides the school with the latest technology, or not to renew the contract, in which case, Educomp takes back the content from the school (so far, the company has witnessed a 100% renewable rate).

   The current charges are Rs.150 p.m. per student in case hardware is provided by Educomp, or the charges are Rs.75 p.m. per student. Currently, the company serves 331 schools, out of which 10% are not obtaining the hardware facilities. Going forward, management expects to cover 450 more schools in FY08, representing a growth of around 136% Y-o-Y.

   Payments are received by the company on quarterly basis. It expects an improvement in the operating margin in this segment from the current 58% to 65% in 3-4 years. In FY07, the contribution of smart _class to the total revenue was 43.72%.

   Currently company enjoys monopoly like situation under this segment.

2) **Instructional Computing Technology (28% of Revenues in FY07):** Under this product, Educomp provides the infrastructure, content, and teachers training to government schools on a B.O.O.T basis, wherein the contracts are run for a period of 3-5 years. The company transfers all the infrastructure and content at the end of the period. ***The company faces stiff competition from N.I.I.T technologies in this segment, although it is limited due to entry barriers in the form of minimum qualifications required in order to win the project from the government***.

   Educomp has so far covered 2,808 schools until FY07 and expects this figure to reach to 4000 by FY08. The current charges are Rs.17,000-20,000 per month per school. The segment's operating margin hovers around 32% and it contributed to about 28.26% of the total revenues in FY07.

   Payments are generally received in about 160-180 days, although payment is assured on account of government backing.

3) **Professional Development:** Under this product, Educomp provides training to teachers in association with partners, such as Intel, Wipro, etc. The company charges around Rs.800 per teacher for 2-3 weeks training and 6,65,000 teachers have received training under this programme so far. Management expects the company to provide training to an additional 3,00,000 professionals next year (FY 08). The segment's operating margin was around 60% in FY07 and it contributed 16.43% of the total revenues.

4) **Other revenue sources:**

   a) Portal www.mathguru.com - Under this product, the company helps students of classes VI to XII in solving all kinds of arithmetic problems. In FY07, the total number of subscribers were 10000 and the fees per subscriber was Rs.1200. Management expects the number of subscribers to reach 25000 by next year and the company has already increased its annual fees to Rs.1800 per month. The segment has an operating margin of around 47%.

   b) Pre School Initiatives: The company began pre schools under its brand "Roots to Wings." Until FY07, three schools were operational and management expects to add another 12 schools by FY08. The fee per student is around Rs.2500 per month and 150-200 students are enrolled in one pre school, with break-even achieved at around 45 students.

Future Plans…

In India, there are 50,000 private schools and 950,000 government schools. Educomp currently caters to only 331 private schools and 2808 government schools, thus leaving tremendous scope for growth in the domestic market. In addition to this, the company also earns licensing revenues from countries, such as Singapore and the US, by providing content to schools. It has recently acquired ThreeBrix E-Services Pvt. Ltd. through which it intends to expand its operations in the Middle East.

The company faces stiff competition only in the I.C.T market from N.I.I.T and management does not expect competition to intensify further in the I.C.T segment due to entry barriers.

EBIDTA margin to improve

Although Educomp's EBIDTA margin declined from 49.2% to 47.2%, management expects it to improve to around 54-56% in a couple of years, as more revenues begin kicking in from high margin products, such as licensing revenues, smart_class, etc. For FY08, the company has also provided a topline guidance of Rs.2100 mn, marking a growth of around 100%, and a bottomline guidance of Rs.550 mn, marking a growth of 95% Y-o-Y.

The key problem area: very high (and unexplained) debtor days.

Educomp suffers from a very high receivables period of around 170 days, which requires a large amount of investment in working capital. As a result, the company's internal accruals are insufficient to fund its capex requirements. We tried doing the math on these receivable. The smart_class segment (47% of revenues) runs at 90-95 days of receivables. The government school segment, Instructional Education, 28% of Revenues, runs at 160-180 days approx. All other segments run at around 10-20 days approx. So how on earth does the company exhibit 170 days of debtors, overall? Management is giving no explanation, and this, for a young, growth company, is always a bad sign. If everything is kosher, managements have to be more open and willing to explain. Going forward, management is considering taking the capex off the company's balance sheet, i.e. it will try to avoid raising debt or equity for financing capex.

The company also faces seasonality in revenues. For instance, 9% of its total revenues are booked in Q1, 17-18% in Q2, 25-27% in Q3, and the remaining 40-47% in Q4. According to management, this seasonality occurs because the government invites tenders in Q3 or Q4, as it is required to spend the budget allocations before March 31. The private schools contracts also leads to seasonality as due to summer vacations contracts generally get entered into after Q1. As Educomp is adding a large number of new schools year after year, the seasonality in revenues will persist.

Indian comparative Valuations

	Year	P/E		P/S		P/BV		EV/Sales		EV/EBITDA		EBITDA		RoE	RoCE	Annual EPS Growth	Annual Sales Growth
Company	**End**	**FY08E**	**FY 09E**	**FY08E**	**FY 09E**	**FY08E**	**FY 09E**	**FY08E**	**FY 09E**	**FY08E**	**FY 09E**	**FY 08E**	**FY 09E**	**FY 08E**	**FY 07E**	**(09/08)**	**(09/08)**
Educomp Solutions Ltd	**Mar**	52.8	30.8	13.8	7.9	16.7	11.9	13.5	7.8	25.0	13.8	54.2%	56.3%	41.71%	N.A.	71.6%	74.2%
NIIT LTD.	**Mar**	7.6	15.5	1.9	1.7	4.7	3.8	2.0	1.8	14.8	11.3	13.5%	15.8%	24.33%	N.A.	42.2%	11.8%

Sources: Consensus Estimates.

IMPORTANT DISCLOSURES

Price Target

Price targets (if any) are derived from a subjective and/or quantitative analysis of financial and non-financial data of the concerned company using a combination of P/E, P/Sales, earnings growth, discounted cash flow (DCF) and its stock price history.

The risks that may impede achievement of the price target/investment thesis are -

- Product Obsolescence.
- Increased competition in the domestic market.
- Delays & Risk of payment defaults by schools.

Rating system of First Global

Our rating system consists of three categories of ratings: Positive, Neutral and Negative. Within each of these categories, the rating may be absolute or relative. When assigning an absolute rating, the price target, if any, and the time period for the achievement of this price target, are given in the report. Similarly when assigning a relative rating, it will be with respect to certain market/sector index and for a certain period of time, both of which are specified in the report.

Rating in this report is relative to: S&P CNX Nifty Index

Positive Ratings

(i) Buy (B) *– This rating means that we expect the stock price to move up and achieve our specified price target, if any, over the specified time period.*

(ii) Buy at Declines (BD) *– This rating means that we expect the stock to provide a better (lower) entry price and then move up and achieve our specified price target, if any, over the specified time period.*

(ii) Outperform (OP) *– This is a relative rating, which means that we expect the stock price to outperform the specified market/sector index over the specified time period.*

Neutral Ratings

(i) Hold (H) *– This rating means that we expect no substantial move in the stock price over the specified time period.*

(ii) Marketperform (MP) *– This is a relative rating, which means that we expect the stock price to perform in line with the performance of the specified market/sector index over the specified time period.*

Negative Ratings

(i) Sell (S) *– This rating means that we expect the stock price to go down and achieve our specified price target, if any, over the specified time period.*

(ii) Sell into Strength (SS) *– This rating means that we expect the stock to provide a better (higher) exit price in the short term, by going up. Thereafter, we expect it to move down and achieve our specified price target, if any, over the specified time period.*

(iii) Underperform (UP) *– This is a relative rating, which means that we expect the stock price to underperform the specified market/sector index over the specified time period.*

(iv) Avoid (A) *– This rating means that the valuation concerns and/or the risks and uncertainties related to the stock are such that we do not recommend considering the stock for investment purposes.*

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