

Tree House – BUY

18 February 2015

Initiating coverage



Poised for growth

We initiate coverage on Tree House with BUY and TP of Rs579. Tree House runs one of India's largest self-operated pre-school chains. With just 1.1% enrolment in pre-schools in India, increase in penetration presents a significant opportunity. Tree House is well positioned to benefit from this penetration considering its strong brand recall. Tree House owns the land and building in five K-12 schools, which it plans to monetise by March 2017 (the company has already sold one, entered an MoU to sell another and we build in land and building sale in the others by March 2017). If this materialises, ROCE should increase from the current 16% to ~25%.

Market leader in self-operated pre-schools: Tree House had 562 centres as of December 31, 2014 across 80 cities out of which 459 were self-operated pre-schools. According to the company, advantages of self-operated schools include higher engagement with parents, better cost efficiency, and better branding. Tree House also provides school management services to 24 K-12 schools. The pre-school segment contributed 86% to FY14 revenue.

The company targets 1100 self-operated pre-schools in the next three years: Low barriers to entry along with the increasing awareness, popularity, and propensity of young working professionals to pay are likely to drive growth for the pre-school market. According to industry estimates, this market is expected to grow at 26% Cagr over five years. Tree House spends Rs3.5m-7m per school on capex. Schools turn Ebitda positive at ~30 students. Within 24 months, if a location has been chosen well, Ebitda margin exceeds 50%. We are building in 804 self-operated pre-schools by end-FY17.

We estimate 31% EPS Cagr over FY15-17ii; BUY with Rs579 TP: In five of the 24 K-12 schools, Tree House owns the land and building. This has resulted in Rs1.1bn capital employed on its books. The company targets to sell all five (one has been sold and the MoU for sale of another has been announced) by March 2017. The company states that security deposits worth Rs1.2bn made to K-12 school trusts would also be repaid by FY18. The stock is trading at 26x one-year forward PE vs. 22x historical average. Our Rs579 TP is based on 24x multiple.

Company update

CMP	Rs499
12-mth TP (Rs)	579 (16%)
Market cap (US\$m)	341
Enterprise value(US\$m)	313
Bloomberg	THEAL IN
Sector	Education

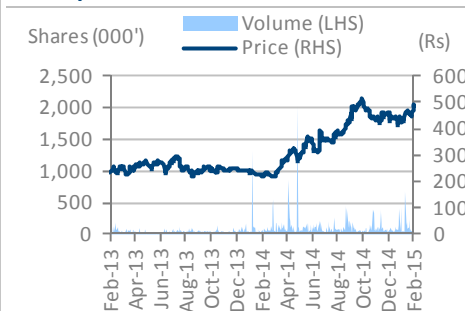
Shareholding pattern (%)

Promoters	28.9
FII	20.2
DII	4.3
Others	46.5
52Wk High/Low (Rs)	559/214
Shares o/s (m)	42
Daily volume (US\$ m)	0.8
Dividend yield FY15ii (%)	0.3
Free float (%)	71.1

Price performance (%)

	1M	3M	1Y
Absolute (Rs)	8.9	10.0	113.4
Absolute (US\$)	8.8	8.9	115.1
Rel. to Sensex	2.8	5.9	69.3
Cagr (%)	3 yrs	5 yrs	
EPS	42.4	120.8	

Stock performance



Financial summary (Rs m)

Y/e 31 Mar, Consolidated	FY13A	FY14A	FY15ii	FY16ii	FY17ii
Revenues (Rs m)	1,143	1,576	2,125	2,806	3,657
<i>Ebitda margins (%)</i>	<i>54.1</i>	<i>56.6</i>	<i>60.5</i>	<i>58.1</i>	<i>57.0</i>
Pre-exceptional PAT (Rs m)	333	439	595	806	1,022
Reported PAT (Rs m)	333	439	614	806	1,180
Pre-exceptional EPS (Rs)	9.3	11.8	14.1	19.0	24.1
<i>Growth (%)</i>	<i>44.2</i>	<i>27.4</i>	<i>19.0</i>	<i>35.5</i>	<i>26.8</i>
<i>IIFL vs consensus (%)</i>			<i>(13.0)</i>	<i>(10.4)</i>	<i>(19.8)</i>
PER (x)	53.8	42.2	35.5	26.2	20.7
<i>ROE (%)</i>	<i>11.1</i>	<i>11.7</i>	<i>11.0</i>	<i>11.4</i>	<i>12.8</i>
Net debt/equity (x)	0.1	0.2	(0.1)	0.0	(0.1)
EV/Ebitda (x)	29.3	21.6	15.6	12.7	9.7
Price/book (x)	5.2	4.6	3.1	2.8	2.5

Source: Company, IIFL Research. Priced as on 16 February 2015

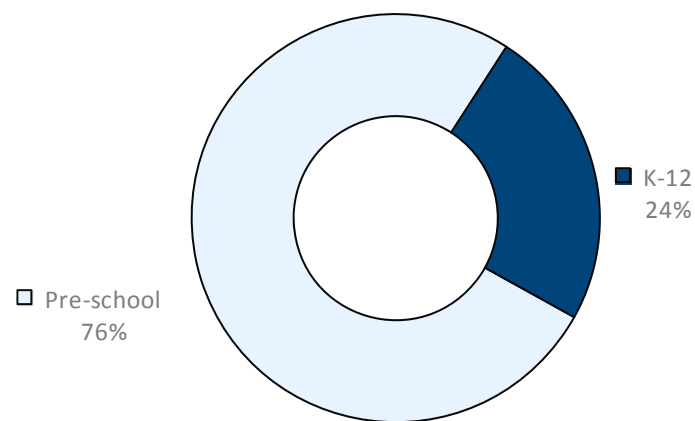
Company snapshot

Tree House is a player in the pre-school education space and has one of India's largest self-operated pre-school chains. Tree House offers playgroup, nursery, junior KG, senior KG, day care services, teacher training, summer camp and activity/hobby class services. It had 562 centres as of December 31, 2014 across 80 cities out of which 459 were self-operated pre-schools. It added 72 centres in 9MFY15. Total staff strength stood at 2,179 and the company operated 21 teacher-training centres.

Tree House also provides school management services to 24 K-12 schools. It provides a range of educational services to K-12 schools, which include designing curriculum and providing teaching aids, supplying methods for imparting education, organising extracurricular activities for students and teacher training.

The streams of revenue are: 1) admission and tuition fee in self-operated pre-schools; 2) one-time upfront fee and annual service fee in franchise-run pre-schools; and 3) service/consultancy fee based on admission in K-12 schools.

Figure 1: Revenue break-up for FY14



Source: Company, IIFL Research; Note that K-12 segment had one-time curriculum development fee but for which its contribution would have been 14%

Figure 2: Operating and financial snapshot

	FY11	FY12	FY13	FY14
Self-operated preschools	110	240	300	386
Franchisee preschools	68	62	79	104
Total preschools	178	302	379	490
Preschool revenue (Rs m)	273	699	1,012	1,198
K-12 schools	12	17	24	24
K-12 revenue (Rs m)	119	72	130	377
Total revenue (Rs m)	392	772	1,143	1,576
Ebitda (Rs m)	169	420	618	892
PAT (Rs m)	92	217	333	439
ROE	9.6%	11.4%	11.1%	11.7%
ROCE	11.7%	15.8%	15.3%	16.2%

Source: Company, IIFL Research

Background

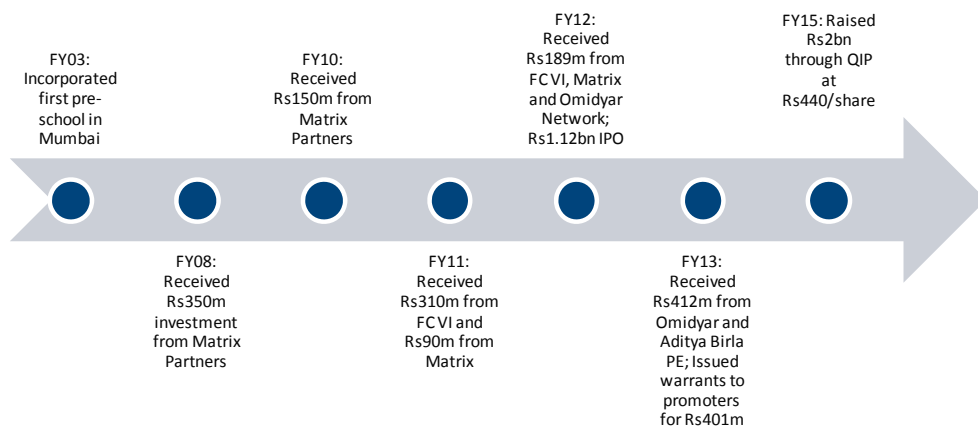
Rajesh Bhatia, who previously worked in financial services and consulting, promoted Tree House. The first school was set up in Mumbai in FY03. In FY09, Tree House entered the K-12 segment and started day care centres. It went public in August 2011 through an IPO of Rs1.12bn. In FY13, it issued Rs412m equity to Omidyar Network and Aditya Birla Private Equity. In FY14, it acquired Brainworks, a player in the pre-school space, for Rs50m. In December 2014, it raised Rs2bn through a QIP.

Figure 3: Details of December 2014 QIP

Item	Value
Total proceeds (Rs m)	2,000
Issue price (Rs)	440
Number of shares issued (m)	4.55
Number of shares prior to QIP (m)	37.77
% dilution	12.0%

Source: Company, IIFL Research

Figure 4: Company history



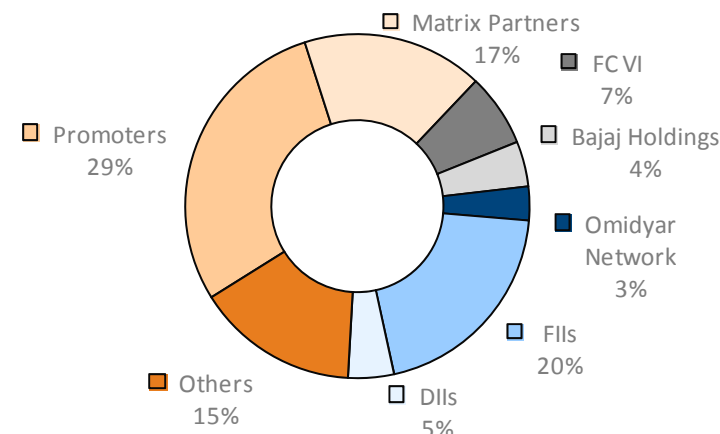
Source: Company, IIFL Research

Figure 5: Management profile

Name	Designation	Description
Sanjaya Kulkarni	Non Executive Chairman	30 years + experience in financial services' PGDM (IIM-A), B. Tech (IIT-D)
Rajesh Bhatia	Promoter - Managing Director	Previously worked in financial services and consulting; started Tree House in 2003
Geeta Bhatia	Non-Executive Director	

Source: Company, IIFL Research

Figure 6: Shareholding pattern as of Dec 31, 2014



Source: Bloomberg, IIFL Research

Market leader in self-operated pre-schools

Pre-school market expected to grow at 26% Cagr over five years: The Indian pre-school market is experiencing rapid growth due to rising number of working mothers, increasing trend of nuclear families, and escalating demand for high quality pre-school education for toddlers. The pre-school industry has low market penetration with 1.1% enrolment in India compared with France with 100% enrolment. Low barriers to entry along with the increasing awareness, popularity, and propensity of young working professionals to pay are likely to drive growth for the pre-school market.

CRISIL expects the share of organised pre-schools to increase from 20% in FY13 to 26% in FY18. This implies that organised pre-school market is expected to grow at 26% Cagr from Rs13.3 billion to Rs42.8 billion over this period.

Tree House focuses on self-operated schools unlike peers: More than 80% of Tree House's 562 pre-schools are self-operated and the rest are through franchisees. This is in sharp contrast to competitors such as Zee Learn (1300 schools) and Bachpan that have adopted the

franchise model for most of their schools. According to the company, the advantages of self-operated schools are higher engagement with parents, better cost efficiency, and better branding. The franchisee model is limited to places with difficult access.

Tree House achieves Ebitda break even in 12-14 months: The economics of self-operated pre-schools are as follows

- Tree House maintains 14:1 student to teacher ratio.
- The average annual fee comes to Rs40,000-Rs45,000 per student.
- The key cost items are rental costs (all pre-schools operate on rented premises), wages paid to teachers and maids, and utility costs, all of which are fixed.
- Tree House spends Rs3.5 to Rs7m per school on capex.

Schools turn Ebitda positive at ~30 students. Within 24 months, if location has been chosen well, Ebitda margin exceeds 50%.

The table below summarises the P&L of a school with 75 students and capex of Rs5m.

Figure 7: Sample P&L for Tree House’s self-operated pre-school

Item	Value
Students per pre-school	75
Annual fee per student (Rs)	40,000
Annual fee revenue (Rs)	3,000,000
Annual utility + rental+ admin costs (Rs)	1,100,000
Student teacher ratio*	20
Number of teachers	4
Cost per teacher per annum (Rs)	84,000
Teacher salary bill (Rs)	336,000
Total wage bill (Rs) (adding another 10% for support staff)	369,600
Ebitda (Rs)	1,540,400
Ebitda %	51%
Capital employed (Rs)	5,000,000
Depreciation (assuming 10 years useful life) (Rs)	500,000
Ebit (Rs)	1,040,000
ROCE	21%

Source: Company, IIFL Research; *we take student teacher ratio of 20:1 vs. 14:1 to account for double shifts in many schools

Fee per student in franchisee schools is ~50% that of self-operated schools. Franchisees pay one-time licence fee of Rs700k-Rs1.5m + 15-20% royalty only on tuition fee to Tree House.

We build in 300 self-owned pre-school additions in FY16 and FY17 and 30% revenue Cagr: Tree House intends to take self-operated pre-school count to 1100 over the next three years. We estimate self-operated pre-schools to increase from the current 459 to 804 by end-FY17. This would entail 30% revenue Cagr over FY15-17.

Figure 8: We build in 30% pre-school revenue Cagr over FY15-17

	FY13	FY14	FY15	FY16	FY17
Number of self-operated preschools	300	386	509	657	804
Number of students	28,116	33,840	41,678	53,764	65,850
Revenue (Rs m) – A	970	1,163	1,837	2,407	3,110
% YoY growth		20%	58%	31%	29%
Number of franchise schools	79	104	106	113	121
Revenue (Rs m) – B	42	35	44	53	64
% YoY growth		-16%	25%	20%	21%
Total Pre-school revenue – A+B	1,012	1,198	1,881	2,460	3,174
% YoY growth		18%	57%	31%	29%

Source: Company, IIFL Research

K-12 school count to be held constant; land to be sold

Tree House has 24 K-12 schools - 19 without land, 5 with land:

Tree House decided to expand into K-12 segment in 2008 with its pre-schools serving as feeders to these schools. It has since expanded to 24 schools. In five of these schools, Tree House owns land and building. In all 24 schools, it receives school management fee.

The number of K-12 schools is not going to increase in the near future as Tree House has created sufficient capacity for now. It has 15,000 students in its K-12 schools vs. 46,000 capacity. It will take some time for this to ramp up as students gradually move up to higher grades.

The services rendered include admission, administration, examination, school bus, laboratory, recruitment, and content management. Though the actual fee may be depend on the paying ability of the trust, the location of the school, etc. Tree House receives ~22% of the trust's revenue (which itself consists of admission, tuition and school bus fee

paid by students). With each support service being chargeable, this may increase to 28-30% of trust revenue over time.

Land to be sold and capital employed to be brought down: Tree House has invested ~Rs300m for refurbishment of schools. It has extended Rs1.2bn as security deposits to the school trusts. The land and building for five schools worth Rs1.1bn on its books. All this resulted in ~Rs2.5bn capital employed in the K-12 business (>50% of the total capital employed).

Figure 9: K-12 segment has Rs2.5bn capital employed...

Item (FY14)	Rs m
Business Commercial Rights	275
Land and building	1,040
Security deposits made to trusts	1,230
K-12 Capital employed	2,545

Source: Company, IIFL Research

Figure 10: ...which has suppressed ROCE

Rs m	Pre-school	K-12	Total
Ebit	480	243	723
Total capital employed	2,407	2,545	4,952
ROCE	19.9%	9.5%	16.2%

Source: Company, IIFL Research

Tree House aims to sell land and building in all five schools by end-FY17:

Out of five schools, land and building in one has already been sold in January 2015 for ~Rs170m (vs. Rs140m book value). It has announced MoU for sale of land and building pertaining to another school for Rs525m. The company expects to sell land and building in the remaining four schools in the next two years that is expected to yield ~Rs1.4bn (including Rs170m from the one already sold). We build in sale of land and building by end of FY17. Security deposits worth Rs1.2bn would also be repaid by FY18 according to the company.

Our assumptions and projections are as follows:

Figure 11: We estimate 40%+ revenue Cagr for K-12 segment

	FY13	FY14	FY15	FY16	FY17
Number of K-12 schools	24	24	24	24	24
Total students			16,800	21,840	28,392
Revenue per student (Rs '000)			60,000	63,000	66,150
Revenue to trust (Rs m)			1,008	1,376	1,878
% contribution to Tree House			22%	23%	24%
Revenue (Rs m)	118	157	222	316	451
% YoY growth		33%	41%	43%	42%

Source: Company, IIFL Research

We build in 31% EPS Cagr over FY15-17; Initiate with BUY and Rs579 TP

Figure 12: We build in 31% total revenue Cagr over FY15-17

Revenue Projections (Rs m)	FY13	FY14	FY15	FY16	FY17
Pre-school	1,012	1,198	1,881	2,460	3,174
K-12	118	157	222	316	451
Total	1,143	1,576	2,125	2,806	3,657
% YoY growth		38%	35%	32%	30%

Source: Company, IIFL Research

Figure 13: Overall projections; sharp jump in FY16 PAT is on account of interest income on Rs2bn QIP proceeds; PAT estimates and FCF are adjusted for sale of land and building pertaining to one school in FY15, and others by end-FY17

Rs m	FY13	FY14	FY15	FY16	FY17
Ebitda	618	892	1,287	1,632	2,086
Ebitda%	54.1%	56.6%	60.5%	58.1%	57.0%
% YoY growth		44.4%	44.2%	26.8%	27.8%
Reported PAT	333	439	614	806	1,180
% YoY growth		31.7%	39.9%	31.1%	46.4%
Adjusted PAT	333	439	595	806	1,022
% YoY growth		31.7%	35.4%	35.5%	26.8%
FCF	(962)	(694)	(232)	(567)	686
FCF adj for land and building sale	(962)	(694)	(402)	(567)	(514)

Source: Company, IIFL Research

We value Tree House at 24x one-year forward PE: Tree House has traded historically at average one-year forward PE of 22x. It is currently trading at 26x. Our March 2016 TP is based on 24x multiple that translates into Rs579 and 17% total return. Initiate with BUY.

Figure 14: Our March 2016 TP is based on 24x PE target multiple

Item	Value
Target PER	24.0
2 yr fwd PAT(Rs m)	1,022
M-cap (Rs m)	24,519
#shares (m)	42
TP (Rs)	579
CMP (Rs)	499
Upside	16.1%
Dividend per share (Rs)	2.2
Total Return	16.6%

Source: Company, IIFL Research

Figure 15: One-year forward PE: Historical average is 22x and the stock currently trades at 26x



Source: Bloomberg, IIFL Research

Figure 16: Sector valuation matrix

	CMP (Rs)	M-Cap (US\$m)	PE		EV/Ebitda		PB		FY15-17 Cagr		ROE	1 yr return
			FY16	FY17	FY16	FY17	FY16	FY17	EPS	Ebitda	FY16	
Tree House*	499	340	26.2	20.7	15.6	12.7	3.1	2.8	31.1%	27.3%	11.4%	118.0%
Navneet Education*	106	407	15.0	12.9	8.5	7.5	3.8	3.3	20.1%	17.3%	27.7%	102.5%
MT Educare	109	69	11.1	8.7	NA	NA	NA	NA	25.8%	NA	NA	39.1%
Zee Learn	34	176	NA	NA	NA	NA	NA	NA	NA	NA	NA	29.4%
Educomp	24	47	NA	NA	NA	NA	NA	NA	NA	NA	NA	5.8%
Core Education and Technologies	10	18	NA	NA	NA	NA	NA	NA	NA	NA	NA	-43.8%

Source: Bloomberg, IIFL Research; * indicates IIFL estimates

Background: Tree House is a player in the pre-school education space and has one of India's largest self-operated pre-school chains. Tree House offers playgroup, nursery, junior KG, senior KG, day care services, teacher training, summer camp and activity/hobby class services. It had 562 centres as of December 31, 2014 across 80 cities out of which 459 were self-operated pre-schools. Tree House also provides school management services to 24 K-12 schools. It provides a range of educational services to K-12 schools, which include designing curriculum and providing teaching aids, supplying methods for imparting education, organising extracurricular activities for students and teacher training.

Management

Name	Designation
Sanjaya Kulkarni	Non-Executive Chairman
Rajesh Bhatia	Promoter- MD
Vishal Shah	Executive Director

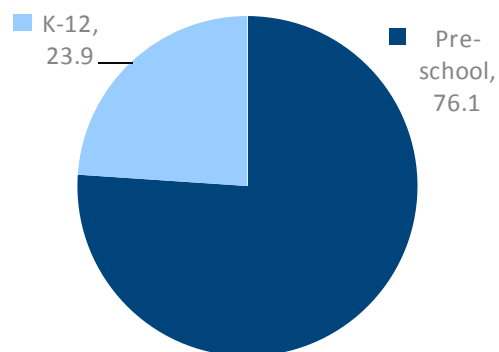
Competition: Kidzee, Eurokids:

Assumptions

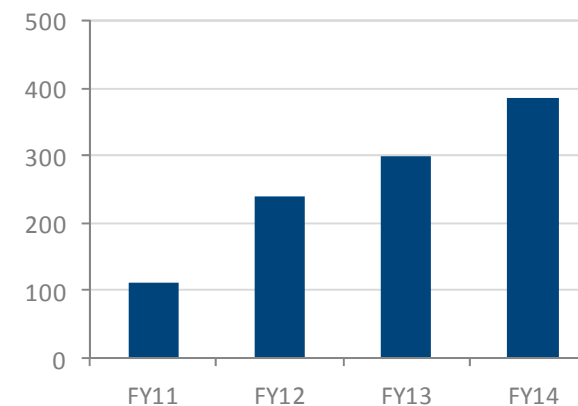
Y/e 31 Mar, Consolidated	FY13A	FY14A	FY15ii	FY16ii	FY17ii
Total number of pre-schools	379	490	615	769	925
Number of self-owned preschools	300	386	509	657	804
Number of K-12 schools	24.0	24.0	24.0	24.0	24.0
Number of teachers	1,562	1,880	2,316	2,987	3,658
Capex (Rs m)	786	1,011	752	880	920
Employee costs (%)	11.6	11.0	11.4	12.6	13.4

Source: Company data, IIFL Research

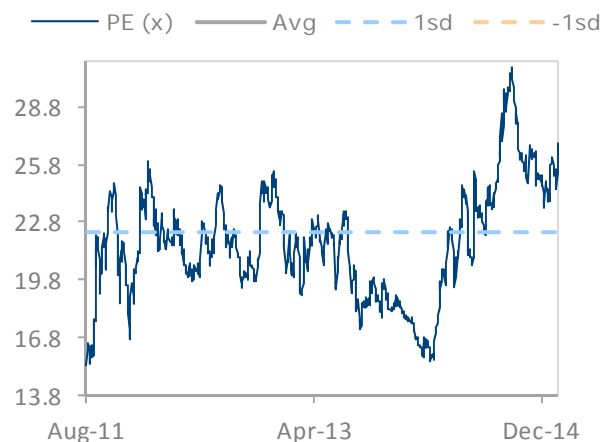
Revenue Break-up (%) - FY14



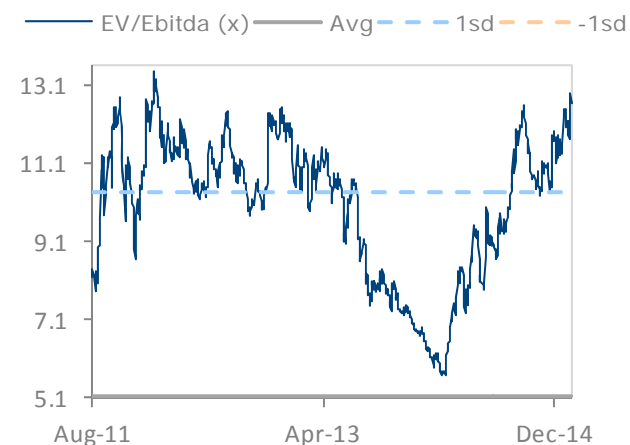
Number of self-operated pre schools



PE chart



EV/Ebitda



Financial summary

Income statement summary (Rs m)

Y/e 31 Mar, Consolidated	FY13A	FY14A	FY15ii	FY16ii	FY17ii
Revenues	1,143	1,576	2,125	2,806	3,657
Ebitda	618	892	1,287	1,632	2,086
Depreciation and amortisation	(134)	(170)	(268)	(347)	(432)
Ebit	484	723	1,019	1,284	1,653
Non-operating income	71	13	42	109	67
Financial expense	(66)	(76)	(162)	(172)	(172)
PBT	489	660	899	1,221	1,548
Exceptionals	0	0	30	0	240
Reported PBT	489	660	929	1,221	1,788
Tax expense	(155)	(221)	(315)	(415)	(608)
PAT	333	439	614	806	1,180
Minorities, Associates etc.	0	0	0	0	0
Attributable PAT	333	439	614	806	1,180

Ratio analysis

Y/e 31 Mar, Consolidated	FY13A	FY14A	FY15ii	FY16ii	FY17ii
Per share data (Rs)					
Pre-exceptional EPS	9.3	11.8	14.1	19.0	24.1
DPS	0.9	1.2	1.5	2.2	2.9
BVPS	95.5	109.6	158.8	175.7	200.7
Growth ratios (%)					
Revenues	48.0	37.9	34.8	32.1	30.3
Ebitda	47.1	44.4	44.2	26.8	27.8
EPS	44.2	27.4	19.0	35.5	26.8
Profitability ratios (%)					
Ebitda margin	54.1	56.6	60.5	58.1	57.0
Ebit margin	42.4	45.8	48.0	45.8	45.2
Tax rate	31.8	33.5	33.9	34.0	34.0
Net profit margin	29.2	27.9	28.9	28.7	32.3
Return ratios (%)					
ROE	11.1	11.7	11.0	11.4	12.8
ROCE	15.3	16.2	16.4	16.7	18.6
Solvency ratios (x)					
Net debt-equity	0.1	0.2	(0.1)	0.0	(0.1)
Net debt to Ebitda	0.3	0.8	(0.8)	(0.2)	(0.4)
Interest coverage	7.3	9.5	6.3	7.4	9.6

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar, Consolidated	FY13A	FY14A	FY15ii	FY16ii	FY17ii
Cash & cash equivalents	487	108	2,222	1,564	2,129
Inventories	46	56	76	100	130
Receivables	69	290	390	515	671
Other current assets	1,795	1,945	2,521	3,349	4,299
Creditors	38	57	77	102	132
Other current liabilities	262	259	349	461	600
Net current assets	2,097	2,083	4,784	4,965	6,497
Fixed assets	1,676	2,430	2,775	3,307	2,834
Intangibles	271	324	324	324	324
Investments	100	115	117	117	117
Other long-term assets	0	0	0	0	0
Total net assets	4,145	4,951	7,999	8,713	9,772
Borrowings	667	826	1,231	1,231	1,231
Other long-term liabilities	44	51	49	49	49
Shareholders' equity	3,434	4,074	6,719	7,433	8,492
Total liabilities	4,145	4,952	7,999	8,713	9,772

Cash flow summary (Rs m)

Y/e 31 Mar, Consolidated	FY13A	FY14A	FY15ii	FY16ii	FY17ii
Ebit	484	723	1,019	1,284	1,653
Tax paid	(176)	(189)	(315)	(415)	(608)
Depreciation and amortization	134	170	268	347	432
Net working capital change	(583)	(352)	(586)	(840)	(966)
Other operating items	3	1	0	0	0
Operating cash flow before interest	(139)	352	386	376	511
Financial expense	(66)	(76)	(162)	(172)	(172)
Non-operating income	71	13	42	109	67
Operating cash flow after interest	(134)	290	266	313	406
Capital expenditure	(786)	(1,011)	(752)	(880)	(920)
Long-term investments	(38)	(15)	138	0	960
Others	(4)	42	117	0	240
Free cash flow	(962)	(694)	(232)	(567)	686
Equity raising	603	201	2,006	0	0
Borrowings	153	159	405	0	0
Dividend	(34)	(45)	(65)	(92)	(121)
Net chg in cash and equivalents	(240)	(379)	2,114	(659)	566

Source: Company data, IIFL Research

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