COMPANY RESEARCH | Initiation

Maybank Kim Eng

November 18, 2015

Tree House Education & Accessories (THEAL IN)

Share Price: INR251	MCap (USD): 161M	India	BUY (New)
Target Price: INR458 (+82%)	ADTV (USD): 0.4M	Consumer Disc.	

Big boy of pre-school business

- Initiate with BUY & TP of INR458, based on 20x FY17F PER. Largest player in self-operated pre-schools in India with 720 centres (611 self- operated, 5th ranked globally).
- EPS to increase 28-30% pa in FY16-18. Optimization of newly opened centres (34% of total) will expand EBITDA margin by 85-118bps in FY16-18, supporting EPS growth.
- TP implies 20x FY17 PER (10% discount to historical average of 22x). Expect catalysts from increase in penetration of organised pre-schools and foray into Tier II and III cities and day care activity.

Well placed to capitalise on pre-school potential

We forecast THEAL's pre-school revenue (88% of total) to increase 21-29% pa in FY16-18, backed by 12-30% pa increases in students to 74,338. Further, we forecast K12 revenue (10% of total) to increase 10-12% pa in FY16-18. Organised pre-school industry in India is estimated to grow at 26% pa to INR42.7b for FY13-18 vs overall pre-school industry growth of 20% pa to INR164.7b. This will lead to an increase in organised pre-school penetration from 20% in FY13 to 26% in FY18. This shift to organized pre-schools will be driven by rising urbanisation, increase in the middle class and in working women, and higher aspirations for quality education.

Improving FCF, ROCE to drive re-rating

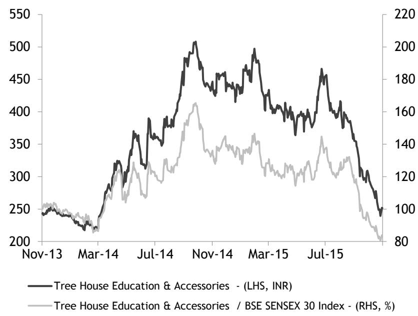
In the last 12 months, THEAL's stock is down 43% due to concerns over rising debtors. It trades at 11.0x FY17 PER, a 50% discount to historical PER of 22x. We expect the stock to rerate due to better control on debtors and positive FCF generation from FY16. Further, we expect ROCE to expand consistently in the next 3 years from 15% in FY15 to 18% in FY17 and 20% in FY18, led by a) improving profitability in pre-schools b) control on working capital and c) reduction in capital employed in the K-12 business. K-12's low ROCE of 3-4% has depressed the benefit of high ROCE +25% in the pre-school business.

FYE Mar (INR m)	FY14A	FY15A	FY16E	FY17E	FY18E
Revenue	1,576.4	2,074.5	2,680.3	3,384.7	4,083.7
EBITDA	892.2	1,187.1	1,565.6	2,005.7	2,462.7
Core net profit	439.2	577.3	749.4	968.7	1,237.1
Core EPS (INR)	10	14	18	23	29
Core EPS growth (%)	31.7	31.4	29.8	29.3	27.7
Net DPS (INR)	1	2	3	3	4
Core P/E (x)	24.2	18.4	14.2	11.0	8.6
P/BV (x)	2.3	1.7	1.5	1.3	1.2
Net dividend yield (%)	0.5	0.8	1.3	1.3	1.6
ROAE (%)	11.8	11.0	10.9	12.6	14.4
ROAA (%)	9.0	8.7	8.7	10.1	11.6
EV/EBITDA (x)	13.1	13.7	6.3	4.9	3.8
Net debt/equity (%)	17.9	net cash	net cash	net cash	net cash

Key Data

52w high/low (INR)	497/240
3m avg turnover (USDm)	0.4
Free float (%)	38.6
Issued shares (m)	42
Market capitalization	INR10.6B
Major shareholders:	
-BHATIA GEETA RAJESH	21.2%
-Matrix Management Corp.	12.0%
-BHATIA RAJESH DAULATRAM	8.5%

Share Price Performance



	1 Mth	3 Mth	12 Mth
Absolute(%)	(18.7)	(38.2)	(43.4)
Relative to index (%)	(14.4)	(33.4)	(38.3)

Maybank vs Market

	Positive	Neutral	Negative
Market Recs	3	0	0
	Maybank	Consensus	% +/-
Target Price (INR)	458	469	(2.4)
'16 PATMI (INRm)	749	740	1.3
'17 PATMI (INRm)	969	1,030	(6.0)

Source: FactSet; Maybank

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Executive Summary

Strategically positioned to benefit from growth in India's pre-school segment

Tree House Education and Accessories Ltd (THEAL) is the largest self-operated pre-school chain in India with 15% share in organised pre-school industry. We believe a number of enabling factors such as rising urbanisation, increase in middle class population and working women, and higher disposable income would power growth of India's pre-school segment. THEAL has established a reputation underpinned by qualified and experienced teachers, standardized curriculum, and quality education. This places it well to capitalise on the immense potential of organized pre-school industry in India. Further, divestment of non-core assets and receipt of security deposits provided for building the K12 business will improve ROCE over the next 3-4 years. FCF generation, which was a hiccup, should correct as the company turns FCF positive in FY16. We expect the stock to rerate underpinned by positive FCF, lighter balance sheet, and strong growth in earnings of 28-30% pa in FY16-18.

Largest self-operated pre-school chain in India

THEAL had 612 centres with 505 self-operated centres as of FY15. By 30 September 2015, the company had 720 pre-school centres with 611 self-operated pre-schools. A high proportion of self-operated centres vs. peers will help THEAL to maintain quality of teaching staff, engage better with parents, control costs, and standardize infrastructure. THEAL's self-operated centres have increased from 62% of total pre-school centres in FY11 to 83% in FY15. We forecast this to increase further to 88% in FY17.

Strong growth drivers in place

The Indian pre-school industry has immense long-term growth potential. Market penetration in the country is poor with 1.1% enrolment compared with 100% enrolment in France. The organized pre-school segment in India is estimated to grow at 26% per annum vs 20% growth for the overall pre-school sector. Higher penetration will help the organized pre-school segment to grow from 20% in FY13 to 26% by FY18. Rising urbanisation, increase in middle class population, rising number of working women and higher aspiration for quality education will be the main factors driving growth in the segment. Further, expansion by organised players into tier II and tier III cities will accelerate growth.

Expansion and higher mature centres to drive pre-school earnings

THEAL's centre expansion will drive its earnings growth in FY16-18. The company plans to open 150 self-operated pre-school centres per annum in FY16 and FY17. The expansion will be largely in Delhi, the National Capital Region (NCR), and Tier II & Tier III cities in India. Additionally higher number of mature and profitable centres will drive profitability in the next two years. We expect share of mature centres to rise from 21% of total self-operated centres in FY15 to 43% in FY18 while profitable centres will increase from 65% in FY15 to 71% in FY18.

Unwinding of capital intensive K12 to aid ROCE

With capital employed of INR2.5b (43% of total capital employed ex-cash) K-12 school business attracts a sub optimal ROCE of 3-4%, which depresses the high ROCEs (25%) of the pre-school business. Therefore going ahead with the reduction in capital employed, ROCEs of K-12 should improve, which in turn will lead to overall improvement in ROCE of THEAL.

Low ROCE in K-12 has depressed overall ROCEs

FY15	Pre-school	K-12	Total
Capital Invested (ex-cash) (INRm)	3,389	2,507	5,896
EBIT (ex-other income) (INRm)	830	89	919
ROCE %	24.5	3.5	15.6

Source: KESI

The company plans to divest its owned properties in K-12 comprising four schools and a piece of land involving a total investment of INR1.04b under K-12. In FY15 it has already sold a school in Vadodara (Gujarat) for INR171m in FY15 and has signed an MOU (Memorandum of Understanding) for the sale of land and a building in Vadodara at INR525m (to be accounted in FY16). The company plans to sell the residual properties (book value – INR640m) until FY18. **This initiative coupled with the improving profitability will facilitate improvements in ROCE.** We expect ROCE to expand consistently in the next 3 years from 15% in FY15 to 18% in FY17 and 20% in FY18.

Capital employed - K-12 (FY15)	INRm
Land and building	870
Security deposits to educational trusts	1,400
Business commercial rights	237
Total	**2,507**

Source: KESI

To turn free cash flow positive in FY16

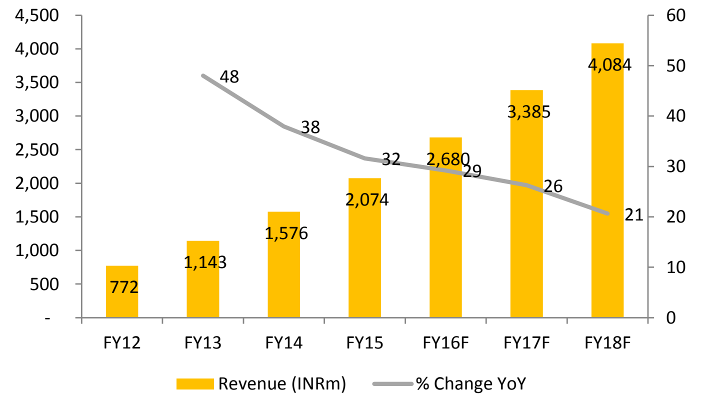
We forecast positive free cash flows in FY16 and FY17 led by control on receivables and receipt of security deposits paid under the K12 business. This will play a key role in the re-rating of the stock.

Expect re-rating backed by better FCF and ROCE

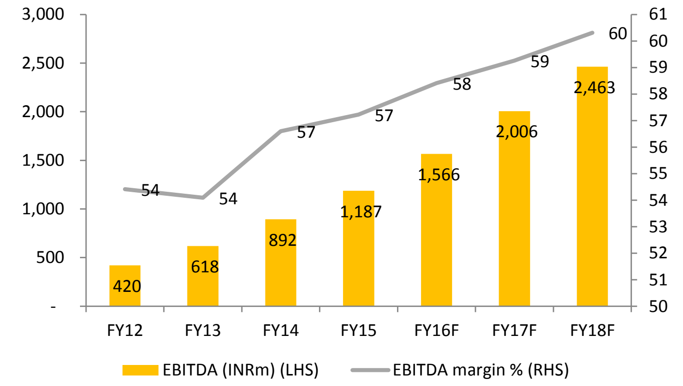
We expect a re-rating of the stock in the next 12 months on the back of control on debtors, positive free cash flow generation and improving return ratios. The stock has traded at 22x PER in the past four years. However, concerns on rising debtors have led to a temporary de-rating of the stock. We believe the scenario will reverse by FY16, thus leading to re-rating of the stock. Additionally, reduction of non-core capital employed under K-12 and improvement in the K12 business through student additions will boost ROCE of the overall business. We expect ROCE to expand consistently in the next 3 years from 15% in FY15 to 18% in FY17 and 20% in FY18. Therefore, we initiate coverage on the stock with a TP of INR458, valuing the stock at 20x FY17F PER (in line with global peer average for FY17F and 10% discount to its historical multiple).

Investment thesis in charts

Revenue and revenue growth (%)
Revenue performance to be driven by pre-school expansion

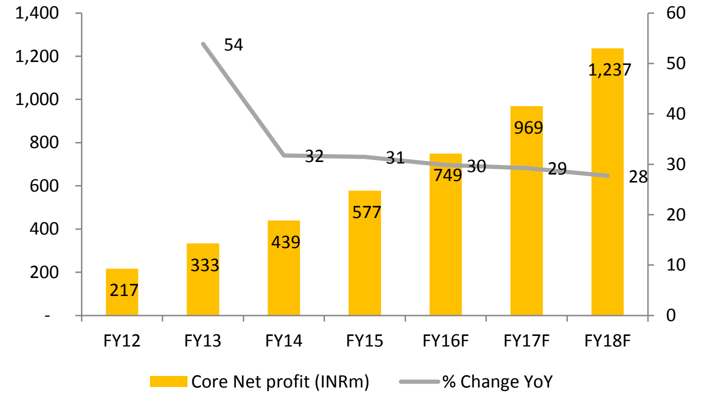


EBITDA and EBITDA margin (%)
Rising share of profitable pre-school centres to aid margins

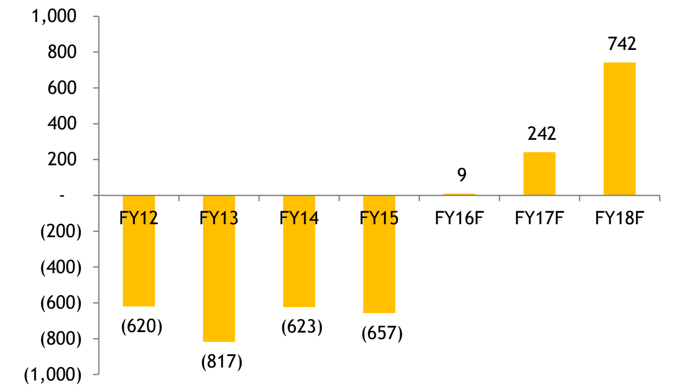


Source: Company, KESI

Core Net profit growth (%)



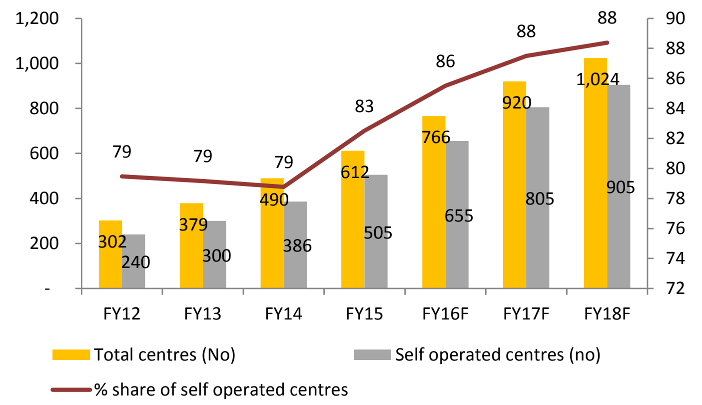
Free cash flow (INRm)
Control on debtors, loans & advances and lower investments in K-12 to aid free cash flow



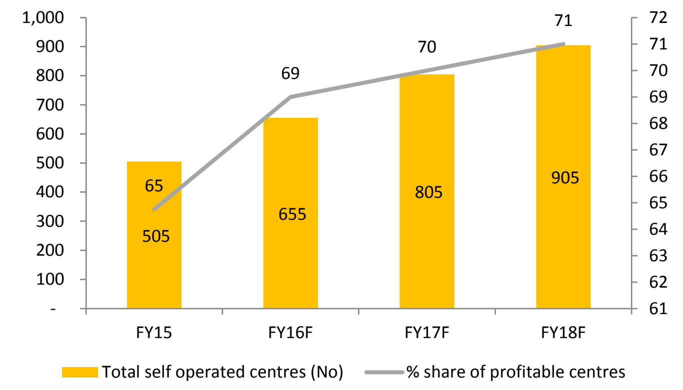
Source: Company, KESI

**** FY15 student enrolments are KESI estimates based on INR45000 average fees/charges per student per annum*

Rising share of self-operated centres (%)
Higher number of self-operated centres will improve quality of services and better branding

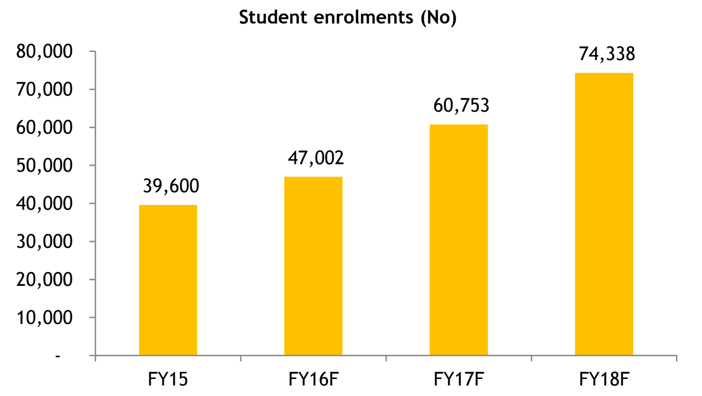


Rising share of profitable centres (No)
Higher number of profitable pre-school centres will improve profit margins

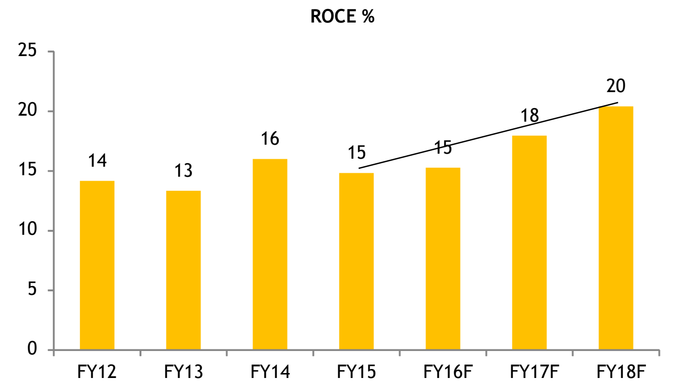


Source: Company, KESI

Student enrolments in THEAL Pre-school
Higher number of mature centres and additions in pre-schools would drive enrolments



Improvement in ROCE (%)
Divestment of K-12 assets, control on receivables & higher profitability in pre-school will drive ROCE improvement



Source: Company, KESI

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Company Background

Tree House (THEAL), formed in 2003 in Mumbai (India), completed its initial public offer of INR1.12b in August 2011. It operates in the pre-school education space and owns 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. As of March 31, 2015, it had 612 centres across 88 cities and 20 states in India. The company had 505 self-operated pre-schools in India. As of 30 September 2015, THEAL has 720 pre-school centres (611 self-operated centres) across 103 cities in India. THEAL is a leading player in the western region, especially in Mumbai, Pune, and Ahmedabad. It has also expanded to major metros such as Kolkata, Bengaluru, and Hyderabad. With 257 pre-schools, which form 40% of its 612 pre-school centres, THEAL enjoys a dominant position in Maharashtra.

The company plans to expand its operations in Delhi, National Capital Region, and in Tier II and Tier III cities.

THEAL acquired the pre-school business of Global Champs in September 2012. Under the brand of Global Champs, they provide low-cost quality pre-primary education in six centres across India. In June 2013, it acquired "Brainworks" as a running business and integrated operations.

Further, in FY14, the company started day care facilities in Mumbai, Pune, Bangalore, and Hyderabad.

THEAL marked its initial foray into the K12 business in FY09. Under this business, the company provides school management services to 24 K12 schools located in Maharashtra, Gujarat, and Rajasthan. It provides a range of educational services to K12 schools, including designing curriculum and teaching aid, supplying methods for imparting education, and organising extracurricular activities for students and teacher training.

The key revenue streams include: 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 K12 schools.

The company has strong funding support from venture capitalists. In December 2014, THEAL raised INR2b through the Qualified Institutional Placement (QIP) route to fund its pre-school expansion and reduce debt. THEAL concluded the issue with an allotment of 4.55m equity shares at an issue price of INR440/ share. The key investors in this QIP are Macquarie Asia, Mondrian Emerging Market Small Cap Fund, Japan Trustee Services Bank LTD, and Swedbank Robur Global Emerging Markets.

2. Competitive landscape and positioning

The pre-school market remains highly fragmented and regional due to its unregulated nature. Organised schools have a share of 20% of the industry. Therefore, there are many opportunities for organized pre-school players, including THEAL, to grow. The company is a predominantly self-operated pre-school player and therefore has an edge over its competitors because the latter continues to focus on a franchisee model that scales up operations and ends up compromising on quality as a result. The self-operated model helps the company maintain high quality standards across all its centres.

2.1 Key players in organized pre-school

THEAL's main competitors are the national players in the organised pre-school industry. Based on their size of operations (number of centres including franchisees), Kidzee, Bachpan, and EuroKids are the largest with +1500, 1000, and 884 centres, whereas THEAL is the fourth largest with 612 centres as of FY15. However, THEAL is the largest self-operated pre-school at 505 centres (as on 31 March 2015). The other three leading players primarily operate through the franchisee model.

Profile of key Pre-school players in India

Name	Centres	Model	Fees charged per student per annum (INR)	Primary presence
Kidzee	1500	Primarily franchisee	35,000-45,000	Pan India presence (550 cities). +60% centres in South and North India
Bachpan	1000	Primarily franchisee	15,000-25,000	Presence in 22 states (40% of centres in North India)
Euro Kids	884	Primarily franchisee	35,000-45,000	Pan India presence (350 cities)
THEAL	612	83% Self operated	35,000-45,000	Western states (Maharashtra and Gujarat - 103 cities)
Shemrock	425	Primarily franchisee	30,000-40,000	North India (Delhi, Haryana and Uttar Pradesh), 175 cities
Hello Kids	350	Primarily franchisee	20,000-30,000	
Little Millennium	250	Primarily franchisee	35,000-45,000	Western India (65 cities)
Podar jumbo kids	200	60% Franchisee	40,000-50,000	Western India
Time Kids	170	Mix of franchisee and SOP	30,000-40,000	South India
Kangaroo kids	100	Primarily franchisee	45,000-55,000	Mumbai

Source: www.enrolmentdesk.com

Kidzee: Kidzee, the largest pre-school player was established in 2003 as part of the media group, Zee. The company is present in the pre-school and higher secondary school segments. Kidzee has the widest network of pre-schools across India and has a presence in more than 550 cities, and in the K12 segment. It has been the most aggressive among other players in terms of expanding its network. The company operates solely through the franchisee model and the fee is at a slight discount compared with THEAL. Kidzee conducts regular audits across its centres to ensure conformity with quality benchmarks. However, we believe that the audits conducted by THEAL are more effective and dependable as the centres are self-operated.

Bachpan: Bachpan, the second biggest player in terms of network, commenced its operations in 1994 through a vocational education venture, focussed on computer and fashion technology. Its pre-school venture started in 2004, spreads across 22 states in India. The company is primarily expanding through the franchisee model and it focuses on Tier-III cities. This has provided it with an advantage of less competition from its national competitors, who primarily focus on metropolitan and Tier-I cities. The company's fees are at a 40-50% discount compared with its national organised pre-school competitors, which has helped bolster its presence in Tier III cities.

Euro Kids: Euro kids, the largest player in the market, was established in 1997 as a joint venture between the Indian daily newspaper group Indian Express and Egmont to operate in the children-publishing domain. In 2001, Egmont International Holdings, Denmark bought back shares of Indian Express in the JV and started a preschool chain. In 2004, Egmont exited Euro Kids; later in 2008, the company entered into a strategic and financial tie-up with Educomp Solutions Ltd. Euro Kids has a widespread network across 350 cities. However, it primarily operates through the franchisee model. This strengthens our argument that THEAL has an advantage over the others in terms of quality. In terms of fees, it is at a slight discount to THEAL.

Shemrock: A Delhi-based family established Shemrock in 1989. Majority (about 70%) of its centres are located in North India, especially Delhi, Haryana, and Uttar Pradesh. The fees charged are close to that of THEAL.

Hello Kids: Targets the large middle-income population of India. Hello Kids has secured quality standard certification (ISO 9001:2008) for establishing itself as a house focused on quality.

Little Millennium: Launched by the education services provider, Educomp in 2006. This school follows a differentiated approach by following innovative methods like multiple intelligence and thematics.

Podar Jumbo Kids: Formed in 1927, it has a strong presence in primary, secondary, and higher secondary education in major cities. It follows a mix of franchisee (60% of total) and self-operated (40% of total) models. The pre-school has a strong branding in K12, but has a relatively smaller presence in pre-school.

Time Kids: Started by a corporate house, Time Pvt Ltd in Hyderabad has extended operations to major cities of India. The pre-school follows a mix of franchisee and self-operated models.

Kangaroo Kids: A premium pre-school located in the western suburbs of Mumbai and is expanding to the rest of Mumbai. The pre-school, formed in 1993, has also marked its presence in the K12 segment through Billabong High School.

2.2 Low entry barriers due to unregulated nature of pre-schools

Pre-schools are a part of the non-formal education system, which stood at an estimated INR97.2b in FY15. The pre-school market is highly fragmented and unorganized, owing to low entry barriers, minimal investment requirement, and lack of a regulatory body. Pre-schools are allowed to make profits, unlike schools, colleges, and higher educational institutions, which are barred by law from becoming for-profit ventures. The unorganised nature of the pre-school market provides a strong opportunity for organised players, including THEAL, to increase their penetration and beat industry growth. Consequently, the organised pre-school industry is expected to increase to 26% of the total pre-school industry by FY18 from 20% in FY13.

2.3 Self-operated model provides an edge

In our view, as THEAL's model is based on self-operated centres, it enjoys an edge over its organised pre-school competitors. Majority of the organised pre-school players in India are adopting the franchisee model over the self-operated model to achieve better scalability. However, we prefer the self-operated model, as we believe it is important for pre-schools dealing with children falling in the age group of 2-6 years. Self-operated pre-schools have many advantages over pre-schools with a franchisee model. These include: a) standardized teacher training; b) uniform hygiene conditions across centres; c) focus on security norms; d) higher margins in self-operated pre-schools due to better control on cost efficiency and lack of royalty payment; e) rising use of multimedia, particularly in self-operated pre-schools; f) planning and organisation of infrastructure; g) transferability of students from one city to another; and h) higher bargaining power, given it is a large player.

2.3.1 Record of nil closures in self-operated Pre-school centres

THEAL's strong control on operations stems from its self-operated pre-school centres. Zero closure of any of its self-operated centres in the past five years is a clear reflection of this control. In our view, this factor proves the primary advantage of following the self-operating system in pre-school operations. The company carries out an in-depth study of the proposed location relative to the target population and the number of local pre-schools in the vicinity (signifying the acceptability of pre-schools). It also ascertains the availability of property within 1-2km of the target population before setting up a pre-school centre.

2.3.2 Cost advantage due to scale

The company, due to its largely self-operated model, enjoys a cost advantage over its peers, who mainly follow the franchisee route. The huge scale of self-operated schools lends strong bargaining power to THEAL and helps it in managing costs better than unorganised players and franchisees of organised players. As property owners prefer to rent out their property to a company rather than to an individual running a business, THEAL enjoys higher bargaining power than an individual player does. The company also purchases equipment on a much larger scale than any single franchisee, which further reduces THEAL's operating cost. A franchisee purchases student's kits from the franchisor charging high margins.

2.3.3 Strong quality control measures due to own management

The company keeps a check on the quality to maintain its brand image, and maintains a common infrastructure for all preschools. It conducts regular audits and liaises with franchisee owners. The size of the audit team is more than 30 members; the audit team visits at least once every three months to ensure quality maintenance and following of curriculum instructions across all its pre-school centres. The team also meets parents to take feedback from them, and it ensures that the infrastructure is keeping pace with the advances in technology, and performs basic commercial checks.

2.3.4 Standardized curriculum and teacher training classes

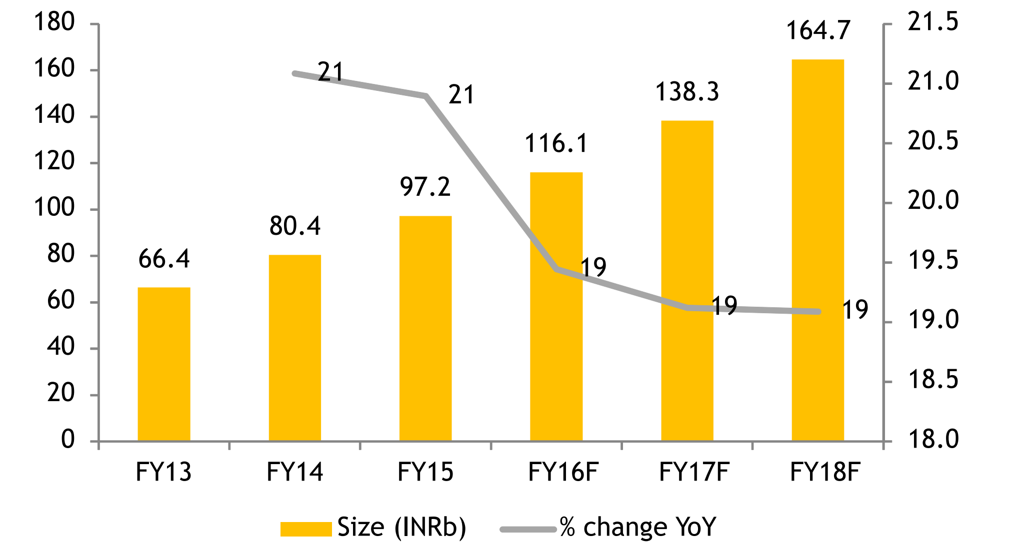
The company's standardized curriculum and pool of teachers from its own teacher-training unit should help in its expansion plans. THEAL has developed its own course curriculum prepared by its expert education committee, which brings its global experience, and is accommodating the views of parents with relevant experience on early childhood care. The expert education committee includes M.Sc. (Human Development) graduates. THEAL designs the course curriculum to impart quality learning through practical methods in a structured way. THEAL's curriculum incorporates a combination of Playway and Montessori methods to strike a balance between education and fun. It caters to the need of each child in a customised way to aid in physical and intellectual growth. Since 2008, THEAL has run its own preschool teacher training programme that helps in getting well-trained teachers, thus contributing to the company's revenue. THEAL conducts the classes in the self-operated pre-school premises, which helps it to realize better margins. As of FY15, THEAL has 34 teacher-training centres and 2117 teachers. As of 30 September 2015, the total teachers in workforce increased to 2,453.

3. Growth Drivers

3.1 Higher penetration of organized pre-schools

CRISIL (Credit Rating Information Services of India Limited) expects the pre-school industry in India to increase by 20% pa to INR165b in FY18 from INR66.4b in FY13.

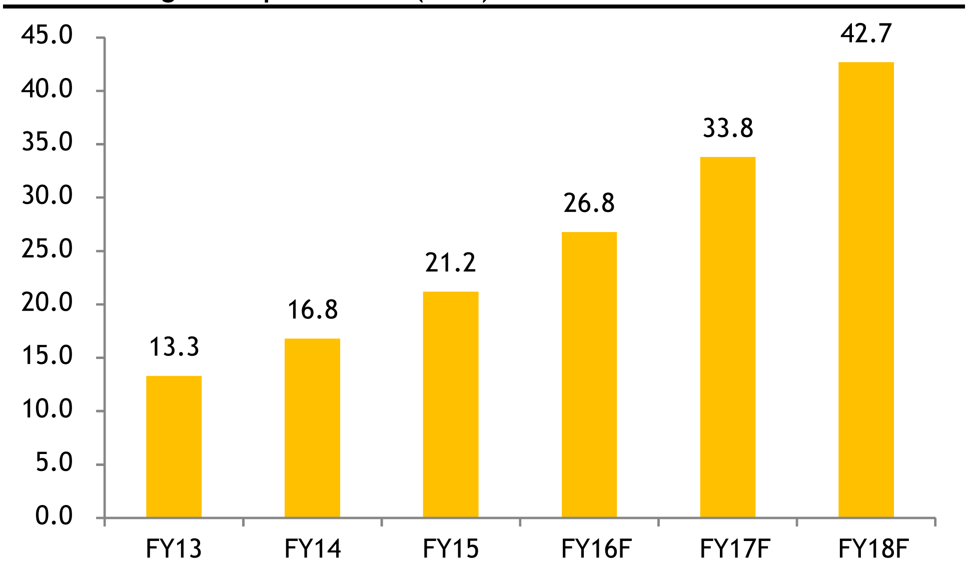
Pre-schools (Organised + Unorganised)



Source: KESI, Industry

Rising urbanization, increase in female workforce, and low penetration of pre-schools in the country will aid in overall growth. In addition, the lack of regulations in regards to pre-schools and minimal supporting infrastructure is providing momentum for a ramp-up of operations. Currently only 10–15% of the total urban population in the 2-4 years age bracket enrol in pre-schools in India. However, with a greater thrust in education and increasing awareness about the necessity of quality pre-school education, the penetration level is set to rise, thus resulting in growth of the pre-school industry.

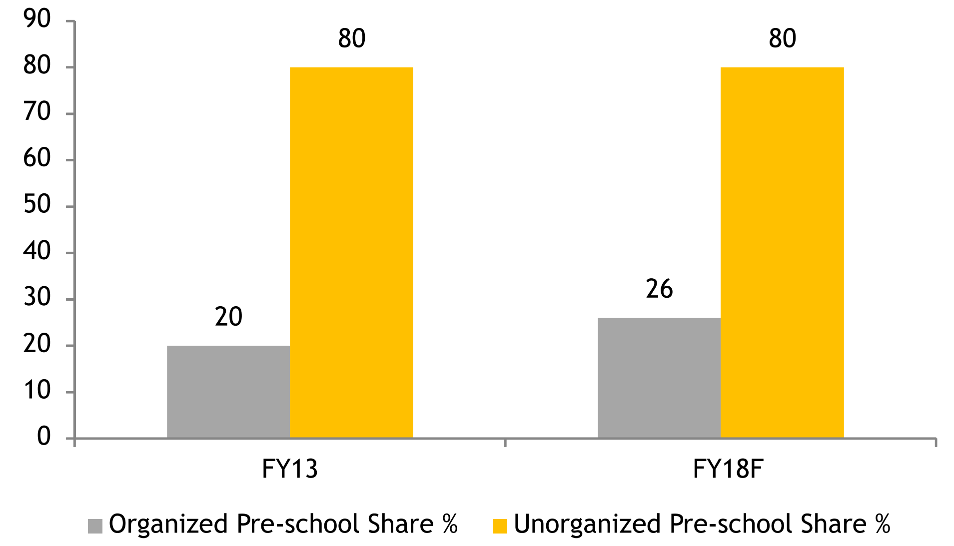
Trend in Organised pre-schools (INRb)



Source: KESI, Industry

Rising awareness of quality pre-school education, ramp-up of operations by existing organised players, and entry of new organised players will support the outperformance of organised players. The growth in Tier-II and Tier-III cities will be higher in this period due to lower penetration rates of pre-schools in these markets.

Changing composition of pre-school industry (FY13-FY18)



Source: KESI, Industry

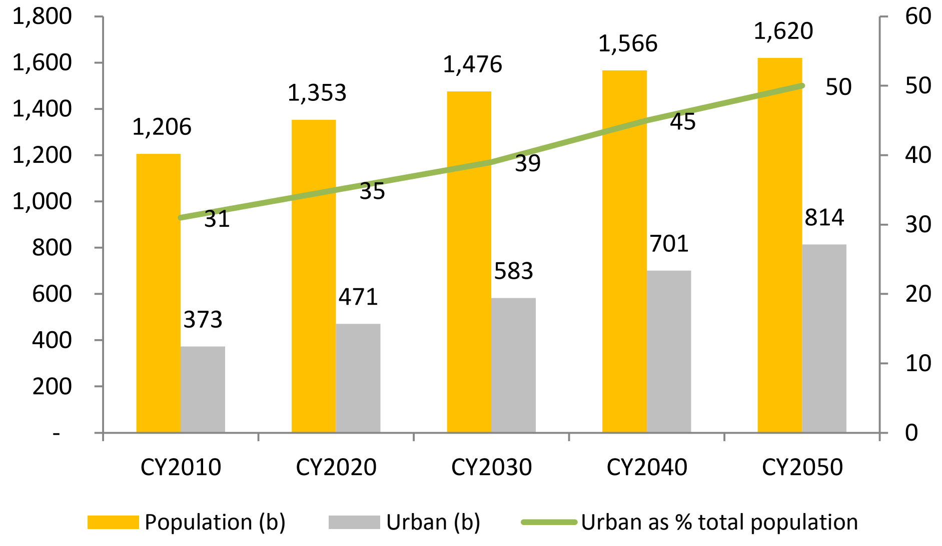
We believe that THEAL with about a 15% market share will capitalise on the opportunity in the organised pre-school segment, backed by its self-operated centre model. The self-operated centre model of the company has helped the company build a strong brand and achieve consistent quality standards across all centres. Further, as highlighted earlier, its in-depth understanding of probable pre-school locations ensures a high success rate. Consequently, it has created a dominant presence in one of the most quality conscious markets including Mumbai. With about 130 centres, THEAL runs 57% of the total pre-school centres in Mumbai. It has a 60% share of total pre-school centres in another key metropolitan city, Kolkata. We are confident that THEAL will successfully gain share in other metros, and in Tier-II and Tier-III cities.

3.2 Favourable demographics

Increase in working women is also one of the driving factors for pre-school education. The number of women working is estimated to increase four fold to 45-50m in the age group of 20-40 years in urban India by 2020. By 2020, working women population will reach 158m and earn USD900b with per capita income of USD5792 compared to 134m working women with earnings USD280b and per capita income of USD2089 in 2010. Increasing urbanization is also one of the drivers for the education sector. India accounts for more than 10% of the world's total urban population. India has the largest rural population (857m), followed by China (635m). India, China, and Nigeria together are predicted to account for 37% of the projected growth of the world's urban population between 2014 and 2050, to nearly 2.5b people by 2050. Between 2014 and 2050, Indian projected urban occupants will grow by 404m, followed by China with 292m.

Increasing urbanization would be one of the key drivers for the education sector. In the next five years, India is expected to add about 100m people to the urban population. About 100m more people will join the urban population in the next 10 years. Between 2014 and 2050, Indian projected urban occupants will grow by +40m, followed by China with 292m.

Rising urbanisation



Source: KESI, Industry

3.3 Pre-school expansion

THEAL plans to focus on Delhi, National Capital Region (NCR), Tier-II, and tier-III cities for expansion of its self-operated pre-school chain in the next two years. In the next five years, THEAL plans to expand its Pre-school network in Delhi to levels of Mumbai (THEAL's largest region in terms of number of pre-schools). In the last one year, THEAL has entered 25 new cities and has set up 122 new centres.

We forecast centre addition of 150 per annum, which would mean addition of 30% in FY16 and 22% in FY17 to its total self-operated pre-school capacity. This will increase its self-operated pre-school centres to 805 in FY17 from 505 in FY15, increasing the proportion of self-operated schools to THEAL's total pre-school chain to 88% in FY17 from 83% in FY15. **We forecast students in its self-operated pre-school centres at 60,753 by FY17. We have estimated 39,600 students in FY15 across its 505 centres based on an average fees/ charges per student of INR45,000 per annum**. Further, we have factored in addition of 50 centres per annum in Delhi and NCR in the next two years, while the tier II and tier III cities will witness the opening of 100 centres per annum. We have factored in marginal centre addition of 2% per annum through the franchisee route.

In 1HFY16, THEAL added about 106 centres out of the 150 centres per annum planned in FY16. The company has forayed into tier II and III cities of India like Solapur, Sangli, Akola, Aurangabad, Satara, Amravati, Ahmednagar, Jalgaon and Ratnagiri (Maharashtra), Bareilly and Noida (Uttar Pradesh), Gurgaon (Haryana) and Goa. Post the additions by 1HFY16 THEAL has 720 centres (612 centres in FY15) with 611 self-operated centres (505 self-operated centres in FY15). Its presence has expanded to 103 cities now vs 88 cities in FY15.

Based on our analysis, we believe that Delhi and National Capital Region has the potential to absorb 50 pre-school centres per annum as planned by THEAL. Delhi has currently about 140-145 pre-school centres, of which 50-55% are organised players, while Gurgaon (a part of the National Capital Region, NCR) has about 45-50 pre-schools with a low organised share of 30-35%.

We are confident that a) low penetration of organised pre-schools in Delhi, NCR and Tier II & Tier III cities and b) relatively modest rentals (due to a muted real estate industry in Delhi, NCR and low rentals in tier II and III cities), will aid early breakeven of the scheduled expansion in the next 3 years.

Geographical break-up of THEAL's Pre-schools (as of 31 Mar 2015)

State	No of Pre-schools	% of total
Maharashtra	259	42.3
Uttar Pradesh	55	9.0
Rajasthan	49	8.0
West Bengal	43	7.0
Madhya Pradesh	36	5.9
Telangana	33	5.4
Gujarat	26	4.2
Karnataka	26	4.2
Jharkhand	19	3.1
Bihar	14	2.3
Orissa	9	1.5
Chhattisgarh	8	1.3
Tamil Nadu	8	1.3
Kerala	8	1.3
Assam	7	1.1
Punjab	4	0.7
Andhra Pradesh	4	0.7
Delhi	2	0.3
Jammu & Kashmir	1	0.2
Daman & Diu	1	0.2
Total	**612**	

Source: Company, KESI

3.4 Higher number of profitable and mature centres

We believe that higher number of profitable and mature centres will contribute to better profitability in the next 3 years.

3.4.1 Break-even analysis

Our analysis suggests that THEAL achieves profitability at the EBITDA level per centre on enrolment of 36 students while it achieves optimum profitability and strong return on capital employed (40%) at 100 students. It takes about 18-24 months to get the required 36 students to achieve profitability. As per the management after achieving enrolment of 35-40 students, it takes another 6-12 months to ramp up the number of students in a particular centre to profitable levels of 80 students. We assume the average revenue per student per annum at INR45,000 per annum (however, it ranges from INR25,000 to INR75,000 depending on the location and the rental). The key cost components are rentals (16-17% of centre revenue), centre head (1 per center), teachers (one teacher for every 14 students), and maids (3 maids per center). Currently about 65% (327) of the self-operated centres are profitable, which we forecast will increase to 71% in FY17.

Break-Even Analysis of Pre-school centres

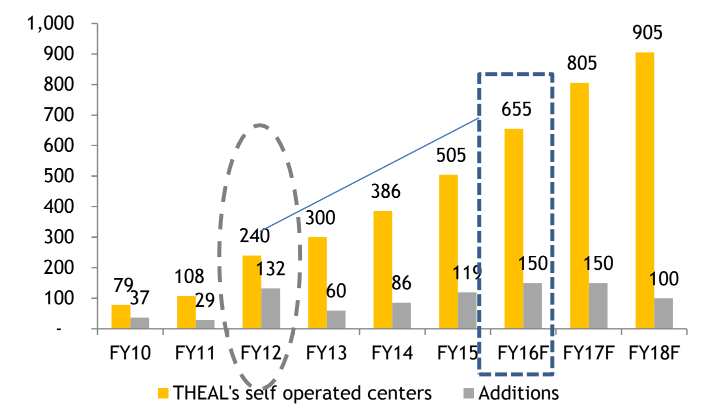
Revenue model of Pre-school (per center)	Students (no)	Fees per annum (INR)	Mature Pre-school Amount (INR)	Break-even point Amount (INR)
Students (Number)			**100**	**36**
Annual revenue		45,000	4,500,000	1,620,000
Rental expenses			716,861	716,861
Student/ Teacher ratio (14/1)			7	3
7 Teachers (INR7,000 per month)	7	84,000	588,000	216,000
Center head - 1	1	180,000	180,000	180,000
Maids (INR3,000 per month)	3	36,000	108,000	108,000
Security (INR6,000 per month)	1	72,000	72,000	72,000
Utilities (INR2,000 per month)		24,000	24,000	24,000
Consumables/events/miscellaneous			300,000	300,000
Total operating expense			**1,988,861**	**1,616,861**
Center EBITDA INR			2,511,139	3,139
Center EBITDA margin %			56	0.2
Centre EBIT INR			**2,011,139**	**3,139**
Centre EBIT margin%			**45**	**0**
Unit level Investment			5,000,000	
ROCE %			**40**	

Source: KESI

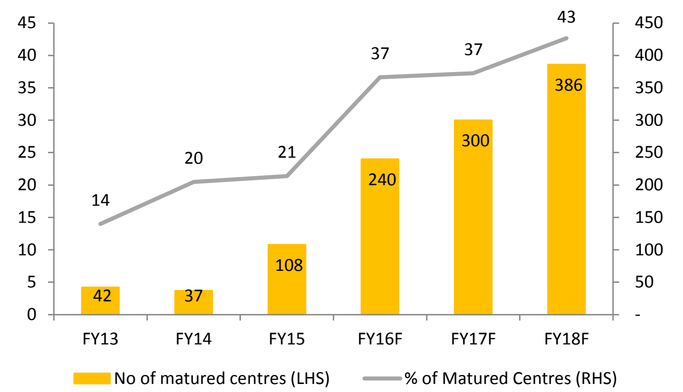
3.4.2 Better profitability from more mature centres

As per our understanding, pre-schools attain optimum utilisation levels and maturity in the third and fourth year of operations depending on the location and the related rentals. In the case of THEAL, it started expanding aggressively from FY12, when it added about 132 centres in a single year. As per our analysis, assuming pre-schools reach optimum utilisation and profitability levels in their fourth year of operation, **THEAL will witness consistent increases in mature self-operated centres in the next 3 years. We expect the share of mature centres to rise from 21% of total self-operated centres in FY15 to 43% in FY18.** The company will have 240 pre-school centres in FY16, 300 centres in FY17 and 386 centres in the maturity phase as compared to its 108 centres in FY15.

Trend in THEAL's self-operated centres (No)



Rising share of mature centres (%)



Source: Company, KESI

3.5 Unwinding of capital intensive K-12 to aid ROCE

In the high gestation period (5-7 year) business K-12, THEAL has invested 42% (INR2.5b) of its total capital employed, which includes mandatory upfront investments for 30-year business commercial rights and interest free security deposits (total INR1.5b) required to start the business. The company has also made discretionary investments in land and buildings (book value INR1.02b) and provided the same as education infrastructure to four K-12 schools. The total capital employed in K-12 has been yielding extremely low ROCE of 3-4%, which has been depressing the overall company-level ROCE.

Low ROCE in K-12 has depressed overall ROCEs

FY15	Pre-school	K-12	Total
Capital Invested (ex-cash) (INRm)	3,389	2,507	5,896
EBIT (ex-other income) (INRm)	830	89	919
ROCE %	24.5	3.5	15.6

Source: KESI

Capital employed - K-12 (FY15)	INRm
Land and building	870
Security deposits to educational trusts	1,400
Business commercial rights	237
Total	**2,507**

Source: KESI

Currently, THEAL is in the process of selling the land and building, which will reduce its capital employed in K-12 by 41%. THEAL has already sold a part of the assets and plans to execute the total asset sale by FY18. Therefore, there is fair visibility on the reduction in capital employed in K-12. Additionally higher utilization of the existing capacity in its K-12 schools will drive revenue and aid re-payment of the INR1.4b interest free security deposit over the next 5 years. Therefore reduction in non-core capital employed and higher revenues will drive ROCEs of the K-12 business and in turn THEAL's total ROCE.

3.5.1 Regulations make K-12 business capital intensive

THEAL forayed into the formal education industry through K-12 in FY08. The company established its K-12 operations in known geographies of Maharashtra, Gujarat, and Rajasthan, where it already had a strong branding backed by its chain of pre-schools.

K-12 institutes form a part of the formal education system in India. K-12 schools are required to be not-for-profit institutions operated by trusts, societies or companies under section-25 of the Indian Companies Act. These institutions have to depend on donations from various entities to fund their capital requirement as they are restricted from distributing dividends. However K-12 has huge funding requirements for the construction of school infrastructure and working capital till it becomes self-sufficient. To address this challenge, it is common practice in the industry that these K-12 institutions will tie-up with investors and the surplus profits are distributed to the investors in the form of school management expenses. In line with this practice, THEAL entered into long-term (30-year) service agreements with such institutions owning K-12 schools. As per the arrangement, THEAL had to pay one time fixed fee to the non-profit educational trust/society towards such exclusive rights called 'Business Commercial Rights' (forming a part of its intangible assets) and interest free refundable security deposits. Additionally, THEAL produces curriculum for these K-12 schools. Under the K-12 business, THEAL provides services like admission, administration, examination, school bus, laboratory, recruitment, and content management. In certain cases, it also provides infrastructure to the educational trusts. In return, it generates revenues in the form of School Management Fees (included in consultancy fees) and rental income from education infrastructure.

In addition to the payments made towards business commercial rights and refundable security deposits and expenses incurred on preparing curriculum content for these institutes (total INR1.5b), THEAL provided education infrastructure in four schools. THEAL has direct ownership of the land & buildings in 3 schools and 1 through a 50% joint venture. The total investment in this education infrastructure has been to the tune of INR1.04b.

3.5.2 Divestment of non-core K-12 investments already initiated

THEAL has initiated efforts to divest its owned properties in the K-12 business. It has sold a school in Vadodara (Gujarat) for INR171m and has signed a MOU (Memorandum of Understanding) for sale of land and building in Vadodara (Gujarat) at INR525m. The company expects INR1.50b from the total sale of these assets by March 2017 (including the transactions already announced). The divestment of these assets will substantially reduce the capital employed in K-12 and lead to improvement of its ROCE.

3.5.3 Increase in utilization rates to drive K-12 revenue

For the revenue stream of school management fees in K12, THEAL has 24 schools. The company currently has utilised 15,000 seats leading to a 32% utilisation rate. We expect THEAL to increase the seat utilisation rates to 43% by FY18. We understand that it takes 5-7 years to establish the K12 school business. We forecast K12 to record revenue of INR218m in FY16 and INR240m in FY17 against INR195m in FY15. We have considered average school management fees at 21% of the school revenues. Further, in view of the divestment of the properties under K-12, we estimate marginal rental income from education infrastructure going ahead.

In the K12 business, THEAL has witnessed success in two destinations Virar and Baroda. These schools have 700-800 students within 2 years of opening. In the Virar School, THEAL expects to increase students by 400 to 1200 by the end of FY16.

Calculation of revenue from K1-2

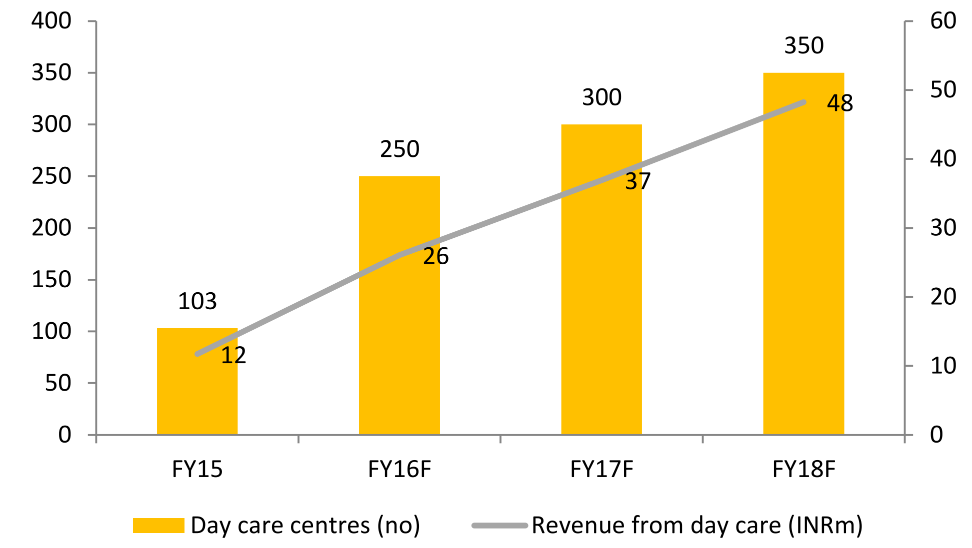
	2015e	2016F	2017F	2018F
Number of K12 schools	24	24	24	24
Total students (no)	15,000	16,800	18,480	20,328
Utilisation %	**32**	**36**	**39**	**43**
Fees/Charges per student	62,000	62,000	62,000	62,000
Revenue to Trust (INRm)	930	1042	1146	1260
% contribution to Tree house	21	21	21	21
Revenue (INRm)	**195**	**218**	**240**	**264**

Source: KESI

3.6 Ramp-up of day-care centres

THEAL commenced day-care services in FY08 under the brand name Muskaan within the premises of its pre-school centres. Initially the services were limited to THEAL's pre-school children. In FY14, they decided to expand this service aggressively as it enables the company to have optimal utility of its assets post pre-school hours. Currently day care services are offered across Bangalore, Pune, Mumbai, Hyderabad, Kolkata, and Nagpur. According to the company, initial response from parents is encouraging. It has entered into tie-ups with large employers in the IT, ITES, banking, and consulting space to provide day-care services for their employees. In FY15, the day care business recorded revenue of INR11.7m with about 103 centres. We forecast day care revenue to touch INR26m in FY16 and INR37m in FY17. However in the next 5 years, the company plans to substantially scale day care centres, which we believe will lead to higher utilization of the existing pre-school centres and consequent improvement in margins for the company. Importantly, its day care centre business will earn higher EBITDA margin of 70-75% (against EBITDA margin of 58% in pre-school) as the rental cost will be effectively zero for the division. In 1HFY16, THEAL has a total of 250 day care centres.

Trend in THEAL's day care centres



Source: KESI, Industry

4. Financial Analysis

Detailed Income statement

Income Statement (INRm)	FY14	FY15	FY16F	FY17F	FY18F
Revenue (+)	**1,576**	**2,074**	**2,680**	**3,385**	**4,084**
- Sale of education kits	15	15	16	16	16
- Consultancy income	347	204	218	240	264
- Income from early childhood education	1,148	1,794	2,406	3,087	3,760
- Income from early childhood training course	15	13	14	14	14
- Other operating income	0	1	1	1	1
- Rent income from education infrastructure	31	28	6	7	7
- Royalty income	20	20	20	21	21
Rent	(267)	(319)	(383)	(462)	(525)
% of revenue	17.0	15.4	14.3	13.7	12.9
Other center operating expenses	(128)	(152)	(188)	(232)	(273)
% of revenue	8.1	7.3	7.0	6.8	6.7
Staff cost	(174)	(239)	(310)	(392)	(459)
% of revenue	11.0	11.5	11.6	11.6	11.2
Advertisement and publicity expenses	(59)	(102)	(138)	(172)	(215)
% of revenue	3.7	4.9	5.1	5.1	5.3
Other expenses	(56)	(75)	(97)	(121)	(149)
% of revenue	3.6	3.6	3.6	3.6	3.6
Total expenses	**(684)**	**(887)**	**(1,115)**	**(1,379)**	**(1,621)**
EBITDA	892	1,187	1,566	2,006	2,463
EBITDA margin %	56.6	57.2	58.4	59.3	60.3
Depreciation & amortization (-)	(170)	(268)	(351)	(426)	(478)
EBIT	723	919	1,215	1,580	1,985
EBIT margin %	45.8	44.3	45.3	46.7	48.6
Net interest income /(exp) (+/-)	(76)	(153)	(171)	(171)	(166)
Exceptionals (+/-)					
- Profit on sale of assets	0	31	239	0	0
Other pretax income (+/-)	13	40	90	57	53
Pretax profit	660	837	1,372	1,465	1,872
Income tax (-)	(221)	(229)	(384)	(497)	(634)
Reported net income	439	609	988	969	1,237
Core net income	439	577	749	969	1,237

**** Consultancy income (FY15) includes INR8.92m of one time license fees charged from franchisees under the pre-school business*

Source: Company, KESI

Detailed balance sheet statement

Balance sheet (INRm)	FY14	FY15	FY16F	FY17F	FY18F
Assets					
Total current assets	**2399.2**	**4460.2**	**5394.7**	**5770.8**	**6749.8**
Cash & short term investments	108.1	1613.7	1937.4	1903.1	2325.5
Accounts receivable	290.0	429.7	550.7	695.5	839.1
Inventory	56.2	52.1	63.1	76.8	88.3
Long term loans and advances	1870.8	2310.2	2788.9	3041.0	3442.5
- Capital advances	463.9	639.9	861.8	883.7	1081.6
- Security deposits	1356.5	1643.6	1900.4	2130.7	2334.2
- Other loans and advances	50.4	26.7	26.7	26.7	26.7
Short term loans and advances	74.0	52.2	52.2	52.2	52.2
Other current assets	0.1	2.2	2.2	2.2	2.2
Total non-current assets	**2868.1**	**3584.9**	**3754.2**	**4328.5**	**4550.3**
Gross block					
Tangible assets	2543.4	3548.3	4068.3	5068.3	5768.3
Less : Depreciation	387.7	613.2	926.7	1315.2	1756.2
Tangible assets (net)	2155.7	2935.1	3141.6	3753.1	4012.1
Intangible assets	387.4	387.4	387.4	387.4	387.4
Less : Amortization	74.7	112.5	149.7	186.9	224.1
Intangible assets (net)	312.7	274.9	237.7	200.5	163.3
WIP	274.0	251.6	251.6	251.6	251.6
Intangible assets under development	10.9	10.9	10.9	10.9	10.9
Investments - Other	114.8	112.4	112.4	112.4	112.4
Total assets	**5267.3**	**8045.1**	**9148.9**	**10099.4**	**11300.2**
Liabilities and shareholders equity					
Total current liabilities	381.1	535.4	754.3	897.7	1067.8
Accounts payable	273.9	314.0	420.0	488.9	562.2
Income taxes payable	107.3	221.4	334.2	408.8	505.6
Total non-current liabilities	877.4	1062.4	1124.2	1124.2	1124.2
Long term debt	826.3	1058.2	1120.0	1120.0	1120.0
Deferred taxes - liability	51.1	4.2	4.2	4.2	4.2
Total liabilities	1258.5	1597.8	1878.5	2021.9	2192.0
Total common equity	4008.8	6447.2	7270.4	8077.4	9108.2
Common stock/ordinary capital	371.7	423.1	423.1	423.1	423.1
Share premium	2688.3	4602.8	4602.8	4602.8	4602.8
Retained earnings	948.8	1421.3	2244.4	3051.5	4082.2
Shareholders equity	4008.8	6447.2	7270.4	8077.4	9108.2
Total liabilities & shareholders equity	**5267.3**	**8045.1**	**9148.9**	**10099.4**	**11300.2**

Source: Company, KESI

Detailed cash flow statement

Cash flow statement (INRm)	FY14	FY15	FY16F	FY17F	FY18F
Operating					
Pretax profit	**660.2**	**837.3**	**1372.3**	**1465.5**	**1871.5**
Depreciation & amortization	169.6	268.2	350.7	425.7	478.2
Adj net interest (income) / expenses	**62.5**	**113.1**	**81.1**	**114.6**	**113.0**
Cash taxes paid (-)	(221.0)	(228.6)	(384.3)	(496.8)	(634.4)
Deferred taxes (+/-)	**7.5**	**(46.8)**	**(0.0)**	**0.0**	**0.0**
Other non-cash items (+/-)	0.0	0.0	0.0	0.0	0.0
Funds from operating activities	**678.9**	**943.2**	**1419.7**	**1508.9**	**1828.3**
Profit from sale of assets	0.0	(31.5)	(238.5)	0.0	0.0
Rent equaliser provision reversed	0.0	(32.2)	0.0	0.0	0.0
Adjustment of depreciation as per transitional provisions	0.0	(1.6)	0.0	0.0	0.0
Dividend provision relating to previous year	0.0	(0.9)	0.0	0.0	0.0
Higher depreciation charged in profit and loss account	(6.7)	(4.9)	0.0	0.0	0.0
Change in working capital (+/-)	**(300.4)**	**(401.1)**	**(391.9)**	**(267.1)**	**(386.5)**
- Accounts receivable (+)	(221.2)	(139.7)	(121.1)	(144.7)	(143.6)
- Inventory (+)	(10.2)	4.1	(11.0)	(13.6)	(11.6)
- Long term loans and advances	(177.5)	(439.5)	(478.7)	(252.1)	(401.4)
- Short term loans and advances	(1.2)	21.8	0.0	0.0	0.0
- Other current assets	28.5	(2.1)	0.0	0.0	0.0
- Trade & notes payable	19.6	14.9	17.4	20.2	19.5
- Others	14.4	25.2	88.7	48.7	53.8
- Provisions	47.3	114.2	112.8	74.6	96.8
Cash flow from operations	371.8	471.1	789.4	1241.9	1441.7
Investing					
Capex (-)	(995.2)	(1128.5)	(780.0)	(1000.0)	(700.0)
Increase in investments	(15.0)	2.4	0.0	0.0	0.0
Disposal of fixed assets (+)	26.8	177.4	498.5	0.0	0.0
Interest income (+)	13.3	40.0	90.0	56.5	52.5
Net cash flow from investments	(970.0)	(908.6)	(191.5)	(943.5)	(647.5)
Financing					
Dividends paid (-)	(65.2)	(101.5)	(164.8)	(161.6)	(206.4)
Change in debt (+/-)	159.2	231.9	61.8	0.0	0.0
Equity raised / (purchased) (+/-)	201.2	1965.9	(0.0)	0.0	0.0
Interest expense (-)	(75.9)	(153.1)	(171.1)	(171.1)	(165.5)
Other financial activities (+/-)	(0.1)	0.0	0.0	0.0	0.0
Net cash flow from financing	219.2	1943.2	(274.1)	(332.7)	(371.9)
Effect of exchange rate changes (+/-)	0.0	0.0	0.0	0.0	0.0
Net cash flow	(379.1)	1505.6	323.7	(34.3)	422.4
Cash beginning	487.2	108.1	1613.7	1937.4	1903.1
Cash ending	108.1	1613.7	1937.4	1903.1	2325.5
Free cash flow	(623.4)	(657.4)	9.4	241.9	741.7

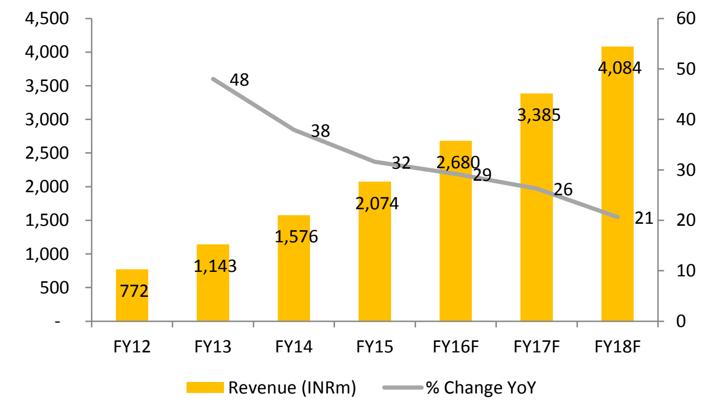
Source: Company, KESI

4.1 2016-18 forecasts

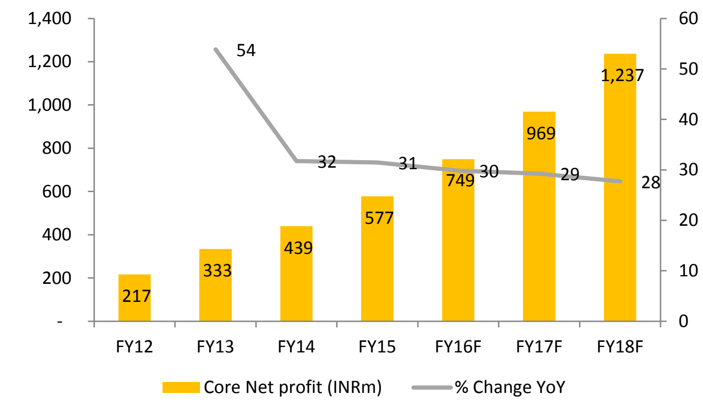
We forecast THEAL's revenue to increase by 21-29% pa in FY16-18 aided by higher enrolments in existing schools, opening of new pre-school centres and ramp up in day care centres. We expect earnings to increase by 28-30% pa in FY16-18 backed by margin expansion.

In 2011-15, revenue and net profits increased at 52% and 61% pa respectively. Net profit grew faster than revenue, thanks to consistent increases in profitable pre-school centres. We expect Ebitda margin will expand by 308bps to 60% by FY18 from 57% in FY15, thanks to the increasing proportion of mature as well as profitable centres.

Revenue and revenue trends



Core Net profit trend



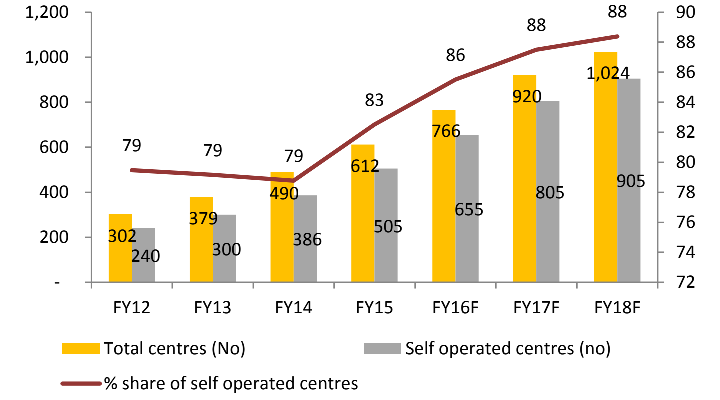
Source: Company, KESI

4.2 Centre openings and student enrolments

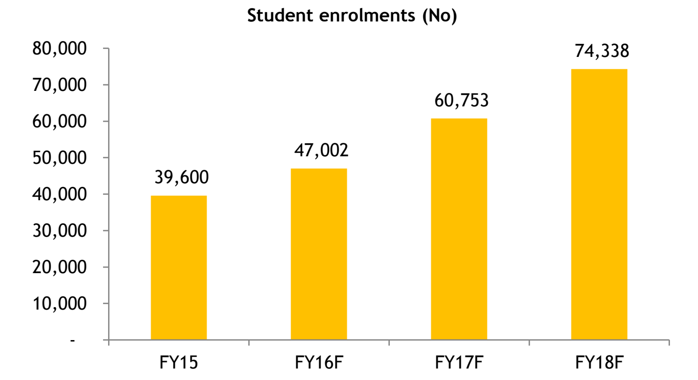
As of September 2015, THEAL has 720 pre-school centres with self-operated centres at 611 and 109 franchisees. The company plans to open another 44 centres by the end of FY16 (March 2016). At-least 50 of the new pre-school centres will be in Delhi and National Capital Region, while the rest will be in tier II and tier III cities. In FY17, we forecast the opening of 150 centres with 50 centres in Delhi and National Capital Region and the remaining 100 in tier II and tier III cities. We forecast the addition of 100 pre-school centres in FY18.

We forecast the number of students under self-operated pre-schools to increase 18-22% pa in FY16-18. We expect students in pre-schools to increase to 47,002 in FY16 and 60,753 in FY17, from an estimated 39,600 in FY15. In FY18, we forecast the number of students to touch 74,338.

Trend in centre openings



Trend in Student enrolments



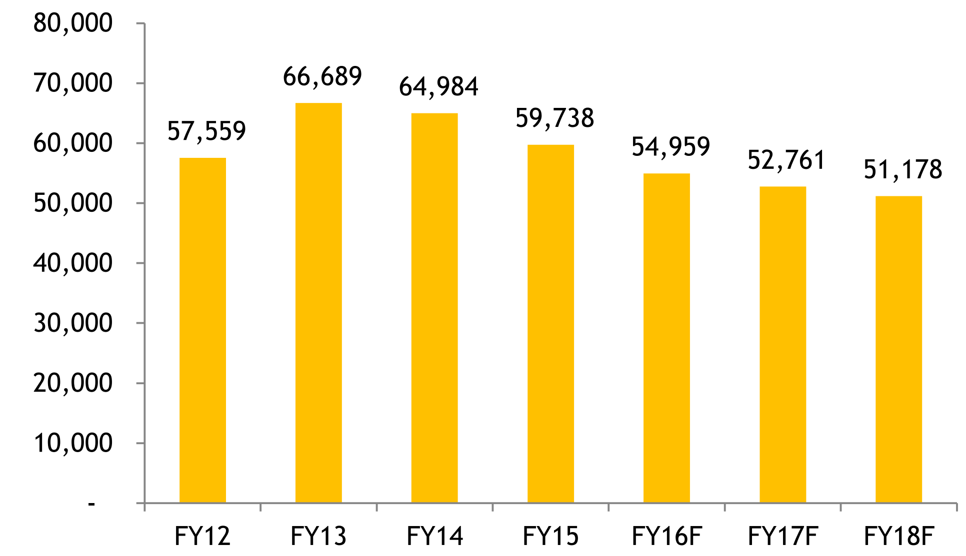
Source: Company, KESI

**** FY15 student enrolments are KESI estimates based on INR45000 average revenue per student per annum*

4.3 Moderation in rentals to aid profitability

We expect incremental rental to be lower over the current rentals paid by the company. This will be due to its expansion in low-rental locations like tier-II and tier-III cities and drop in rentals with moderation in the real estate sector. We believe that THEAL will primarily witness benefits of moderation in rentals in Delhi and NCR. We forecast average rentals per centre per month to drop by 8% to INR54,959 in FY16 and by 4% to INR52,761 in FY17. The average rent paid per centre in FY15 was at INR59,738 in FY15.

Forecast drop in average rentals per centre per annum (INR)



Source: KESI, Industry

4.4. Better control on debtors, loans, and advances

We expect improvements in working capital position in the next 3 years led by control on debtors and reduction in loans and advances. We expect that THEAL will receive payments towards curriculum content developed for its K-12 schools to the tune of INR125m by FY17. Further, with the improvement in utilisation levels of K-12 schools (refer to 3.5 unwinding of capital intensive K-12), the company will receive higher payments towards school management fees in the next 3-5 years booked in profit and loss account on an accrual basis.

Break up of Debtors

Debtors (INRm)	FY15
Pre-schools	75
Franchisee royalty	3
More than 6 months	
Curriculum content (K-12)	125
Education trust - Vidyabharati Sansthan	52
Less than 6 months (K-12)	175
Total debtors	**430**

Additionally, the company has forwarded deposits to the tune of INR1.4b to the school trusts of K-12. THEAL expects to secure a repayment of 35-40% of the deposits (INR400m) in the next three years by FY18.

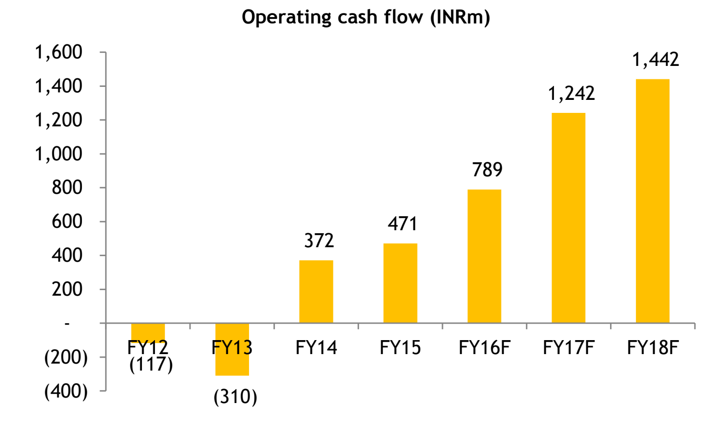
Current status of receivables (INRm)

Particulars	As on 31 Mar 2015 (Gross)	Invoiced in 1HFY16	Received in 1HFY16	Balance as on 30 Sept 2015	Subsequent collections (till 7 Nov 2015)
Pre-school	75.2	1,045.4	892.3	228.3	183.6
Franchisees	3.1	27.5	13.1	17.5	14.5
K-12	351.4	180.8	152.0	380.3	113.5
Total	**429.7**	**1,253.7**	**1,057.3**	**626.1**	**311.6**

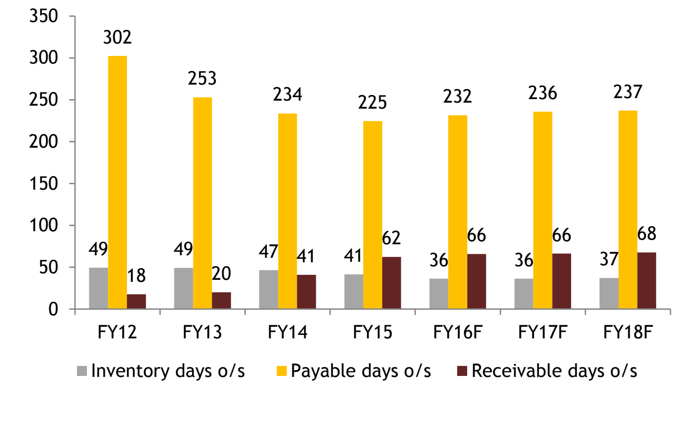
4.5. Expect positive FCF from FY16

We expect THEAL to generate positive free-cash-flow from FY16 backed by steady growth in cash from operations, control on debtors and loans and advances. We expect payable days to increase for the next three years due to a) rise in advance fees (include collections from higher mature pre-school centres and ramp up in pre-school centres in the next two years), and b) rise in sundry creditors for services and expenses from the sharp increase in marketing spends to support expansion in new geographies. From a negative free cash flow of INR657m in FY15, we expect the company to generate a positive free cash flow of INR9m in FY16 and INR242m in FY17 and to maintain dividend payout at the FY15 level of 14%.

Operating cash flow to improve consistently

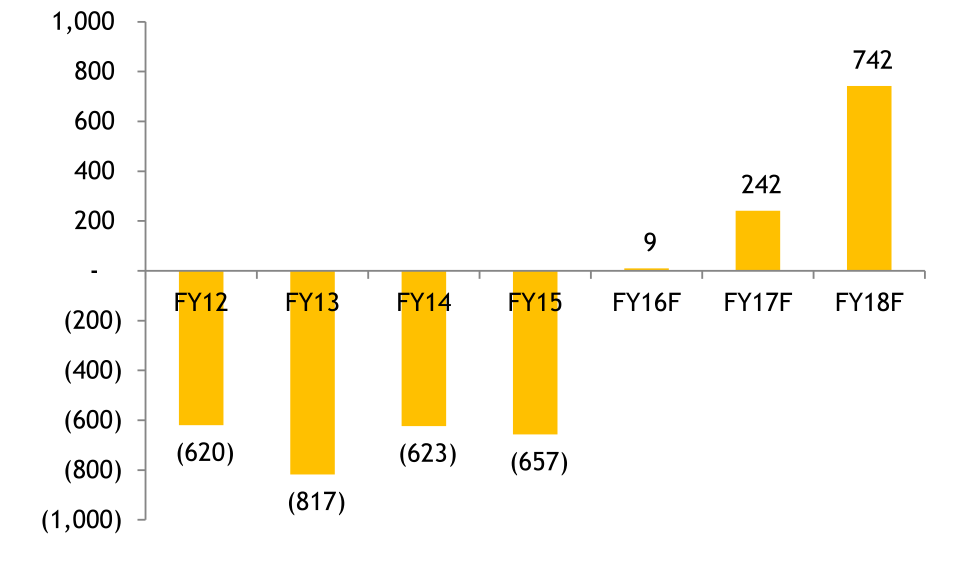


Receivable days to be kept under control



Source: Company, KESI

Forecast rise in FCF generation from FY16 (INRm)



Source: KESI, Company

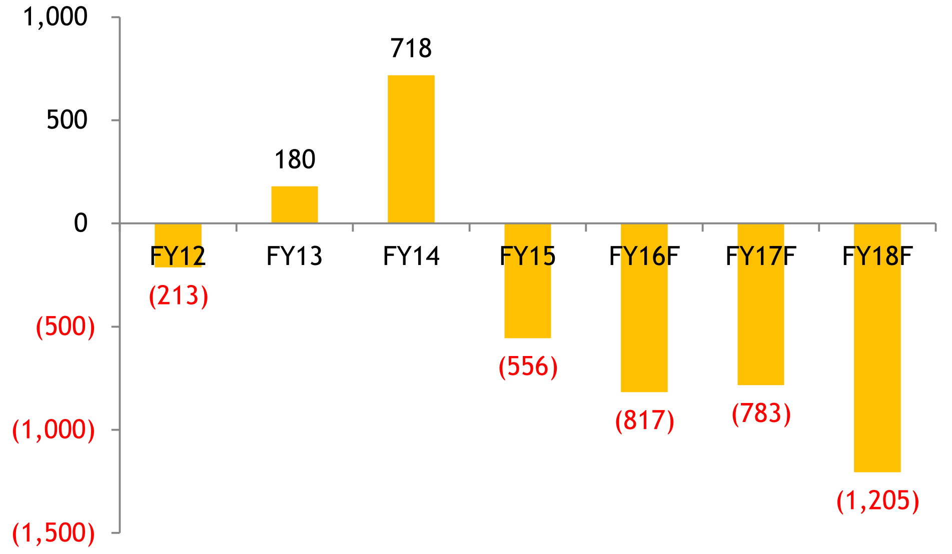
4.6. Capital expenditure

The company will incur a capex of INR780m-INR1b per annum for the next two years for expansion of self-operated pre-school by 150 centres per annum. The company has executed a QIP (qualified institutional placement) of INR2b in FY15 for this expansion. Therefore, the company is well equipped to fund the total capex of INR1.5-2b for the next two years FY15-17.

4.7 Turned net cash from FY15

THEAL has initiated efforts to divest its owned properties comprising four schools and one land involving a total investment of INR1.04b in the K-12 business. It has already sold a school in Vadodara for INR171m and has signed a MOU (Memorandum of Understanding) for sale of land and building in Vadodara at INR525m. The company expects INR1.50b from the total sale of these assets by March 2017 (including the transactions already announced). It will utilize proceeds from this divestment of assets primarily for debt reduction, which in turn will reduce interest payable in the next three years. We forecast the net cash to improve consistently over the next three years.

Improving trend in net cash levels (INRm)

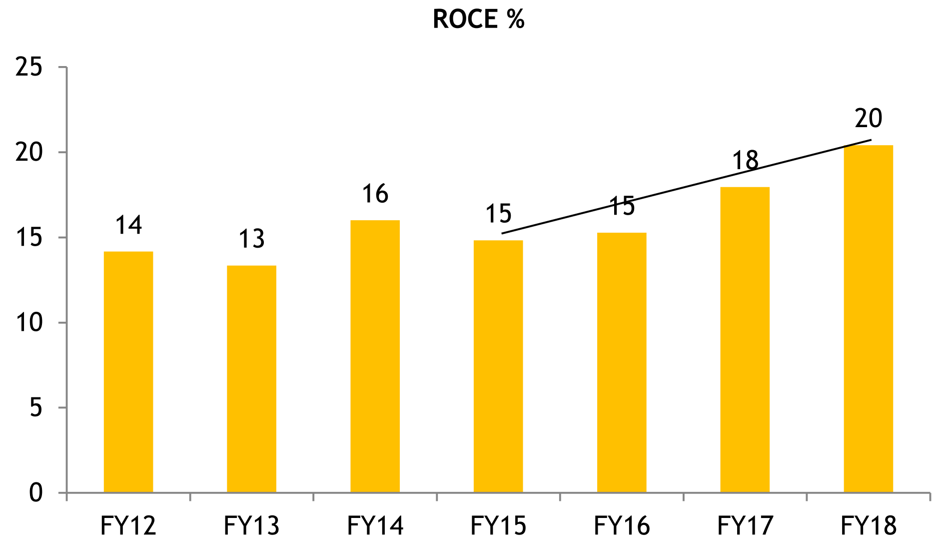


Source: KESI, Company

4.8 ROCE expansion

We expect ROCE to expand consistently in the next 3 years from 15% in FY15 to 18% in FY17 and 20% in FY18, backed by strong growth in earnings and divestment of land and building under the K-12 business (already executed/announced). ROCE can expand further to 20% by FY18, if sale of the residual land and building (book value – INR640m) materializes.

ROCE to expand consistently in the next 3 years



Source: KESI, Company

5. Valuation and TP

THEAL trades at 11x FY17 PER, a 50% discount to its historical average PER of 22x. We initiate coverage of THEAL with a BUY. In the last 12 months, THEAL's stock is down 43% due to concerns over higher receivables. However, we believe that they will be kept under control going ahead. We forecast that EPS will grow 28-30% pa in FY16-18, mainly from pre-school centre expansion and better margins.

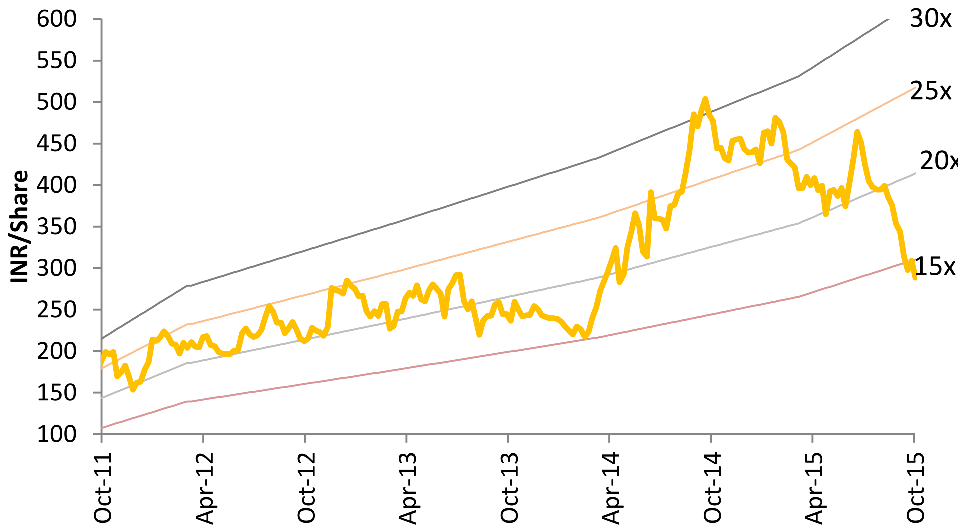
Our TP of INR458 is based on 20x FY17F PER, in line with its global peer average and a 10% discount to its historical PER of 22x (four year average PER). We believe THEAL deserves a re-rating in valuations due to positive FCF generation from FY16 and improvements in ROCE from 15% in FY15 to 20% in FY18.

Comparative valuations

Company	BB Code	Mkt Cap	PER			EV/EBITDA			ROE (%)	2 year EPS
		(USD m)	FY15	FY16F	FY17F	FY15	FY16F	FY17F	FY15	CAGR %
Tree House Education and Accessories Ltd	THEAL IN	177.8	18.4	14.2	11.0	13.7	6.3	4.9	11.0	29.5
SEG International	SYS MK	231.6	36.5	28.8	25.1	25.7	15.6	13.6	12.5	19.5
Prestariang BHD	PRES MK	263.0	33.0	23.9	17.6	27.7	19.8	15.7	11.8	77.4
China Distan-ADR	DL US	528.3	20.9	22.5	17.2	10.8	15.5	12.5	29.5	12.6
TAL Educatio-ADR	XRS US	3040.7	37.5	29.2	24.3	27.7	25.4	17.5	30.9	38.1
New Oriental - ADR	EDU US	4339.4	19.4	18.9	15.7	12.9	14.4	11.7	17.1	20.0
Peer Average					**20.0**			**14.2**		

Source - Bloomberg consensus, KESI

One year forward PER band chart



Source: KESI, Bloomberg

6. Risks

Introduction of regulations in the pre-school industry

Pre-school education forms a part of the informal education of the Indian education industry. There is no regulatory body currently supervising the functioning of the pre-school market in India. Unlike schools, colleges and other educational institutions, pre-schools are allowed to make profits. Therefore, the introduction of regulations and control on the pre-school industry could adversely affect industry players.

Competition from organised players

The pre-school business has low entry barriers with no government regulations and low capital investments. Therefore, competition from an increasing number of domestic and international organised players exists. With the rise in the number of organised players, the requirement of quality teaching staff is set to increase. This could lead to a poaching of quality teaching staff from established pre-school chains like THEAL. Therefore in such a scenario, the retention of quality teaching could emerge as a key risk and could lead to increase in staff cost as well.

Higher than expected time for establishing K-12

THEAL has provided interest-free security deposits of INR1.4b to the educational trusts. Additionally, the company earns school management fees from the K-12 educational trusts for managing their institutions. Therefore, if the K-12 institutions take a longer than expected time to reach break-even student enrolments, the same will affect the repayment of security deposits and affect their revenues as well.

Geographical concentration risk

THEAL has more than 40% of its current chain of pre-schools located in Maharashtra with the majority of them in Mumbai and its peripheries. Any rise in competition from organised players in this geography is a potential risk to the company.

Annex I: Education Industry in India

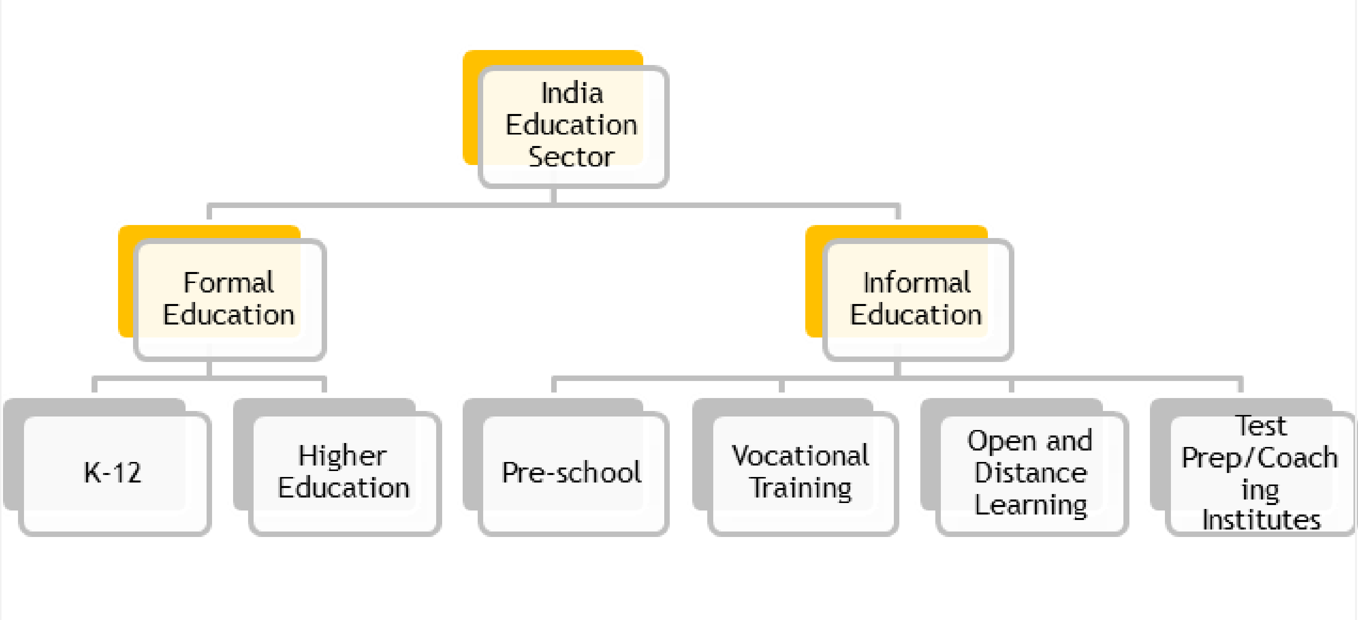
India spends an average 3.8% of its gross domestic product on education, which has resulted in a growth of 9.2% in its average literate population, with its literacy rate being 74% in 2011.

A majority of its population (585m) is in the 0-24 age bracket, while 158.8m is in the 0-6 age group. Consequently, India has the advantage of being the third largest education system and largest education market.

Legislative powers related to the education sector in India governing the sector are distributed between the Centre and the State. Further, educational institutions in India have to be run as not-for-profit entities, as either trusts, societies, or companies under Section 25 of the Indian Companies Act. Consequently, any surplus that is generated cannot be withdrawn but will have to be utilised for the development of the institution(s). However, recently, a slight modification was made to the rules, wherein the trusts can now transfer the surplus made by one institution to a sister concern under the umbrella of the same trust.

India's education sector can be broadly classified into three categories: formal, vocational, and informal. While, all levels of formal education are highly regulated and fall under the purview of the Ministry of Human Resource Development, non-formal education is non-regulated and presents a lucrative opportunity for private players to manage capacity and charge fees.

Structure of the education industry in India



Source: KESI, Company

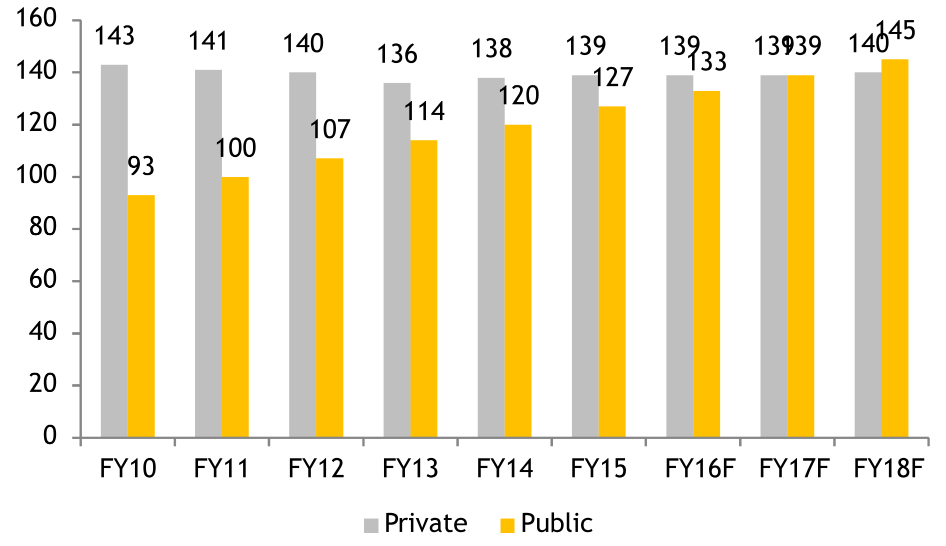
Pre-schools

Pre-schools or playschools typically cater to the 2-4 years age group. Various scientific studies indicate that human beings grasp the most until the age of four and it is during this time that children learn to assimilate information, express interest, and develop cognitive and emotional skills. Hence, pre-schools play a large role in the development of a child's cognitive skills and intelligence. Increasing awareness among parents (about the benefits of quality preschool education) coupled with rising disposable income have boosted and will continue to boost the penetration levels in the segment. However, it still largely remains an urban phenomenon.

Prospects of K-12

K-12 education is the term used to describe the primary and secondary phases of a school life where 'K' stands for kindergarten and '12' for the 12th standard. Therefore, the expression is used to connote a system that covers education from kindergarten until the 12th grade. The concept is slowly gaining importance in India with the Government introducing new schemes to impart knowledge like free and compulsory primary schooling throughout the country. The prospect of the K-12 segment remains strong with higher growth owing to private spending because of a constant shift towards private schooling in the country. CRISIL Research estimates that 0.21m K-12 institutions will be set up during 2012-13 to 2017-18 as against an estimated 0.2m set up during 2007-08 to 2012-13. The average enrolments per institution stood at 157 in 2013-14. The presence of private players in the K-12 segment has been increasing due to the necessity for good facilities of education and better infrastructure, which are found lacking in several government-owned institutions. The share of private K-12 centres will gradually rise to 30% in 2017-18 from 28% in 2013-14. However, their share in total enrolments is predicted to rise at a much faster pace to 51% in 2017-18 from 47% in 2013-14. The sector's attraction for participation from private entities remains intact due to the annuity style of income that it provides.

Rising share of private schools (INRm)



Source: KESI, Bloomberg

Annex II: Management Team

Name	Title	Experience	Education	Other Ventures
Mr.Sanjaya Kulkarni	Chairman and Independent Director	Over 30 years in financial services	MBA from Indian Institute of Management, Ahmedabad	-
			Bachelor of Technology from Indian Institute of Technology (IIT) Mumbai	-
Mr. Rajesh Bhatia	Managing Director	12 years in the field of education	Bachelor of Engineering from MS univeristy, Baroda	-
			MBA from Pune University	
Mr Vishal Shah	Executive Director	-	MMS from Narsee Monjee Institute of Management studies	-
			Bachelor of Commerce from Mumbai University	-
Mrs. Geeta Bhatia	Non-Executive Director	+10 years in the field of education	Bachelor of Commerce from Mumbai University	-
Mr. T. S Sarangpani	Independent Director	35 years in financial services	Bachelor of Engineering	-
			MBA from the University of Madras	-
Mr. Parantap Dave	Independent Director	28 years of experience in finance, banking, accounts, audit,taxation and general management	Qualified Chartered Accountant	-
Mr. Rishi Navani	Nominee Director	+ 10 years of investing in Indian capital markets	MBA from Wharton School at the University of Pennsylvania	Co-founder and Managing Director of Matrix India Asset Advisors Private Limited
			Bachelor of Arts Degree from North-western University	-

Source: Company, KESI

Annex III: Milestones

Year	Milestones
FY03	Incorporated the first pre-school in Mumbai
FY06	Established six pre-schools
FY07	Converted to a private limited company
FY08	Launched Teachers Training programme Received investments of INR350m from Matrix partners India Investment Holdings LLC
FY09	Entered K-12 segment and started Day care centres - 'Muskaan'
FY10	Received a further investment of INR150m from Martrix partners India Investment Holdings LLC
FY11	Converted to a Public limited company Received an investment of INR400m (INR310m from FC VI India Venture (Mauritius) Ltd and INR90m from Matrix partners India Investment Holdings LLC
FY12	Received an investment of INR189m :INR42m from Matrix partners India Investment Holdings LLC :INR14m from FC VI India Venture (Mauritius) Ltd and :INR133m from ON Mauritius Completed Initial Public Offer of INR1.12b in August 2011
FY13	Acquired pre-school business 'Global Champs' in September 2012 Received an invesment of INR411.81m by issuing equity shares to ON Mauritius and to Aditya Birla Trustee on preferential basis Issued warrants to promoters, Mr. Rajesh Bhatia & Mrs. Geeta Bhatia to be converted in to equity shares aggregating INR400.68m Launched pre-schools for underprivileged children under the brand name 'Global Champs'
FY14	Acquired Brainworks chain in 2013
FY15	Raised INR2b through QIP Monetized investments in physical assets of K-12 schools worth INR171m Signed MOU for sale of land and building located in Gujarat for INR525m Started new day care centres in Mumbai, Pune, Hyderabad and Bangalore Inaugurated Global Champs in Dharavi, Mumbai

Source: Company, KESI

Annex IV: Teaching methodologies followed by Indian Pre-schools

Montessori Method - This methodology involves teaching students using concepts, i.e., students move from simple concept to complex concept, where they learn by didactic approach working with materials instead of direct instructions.

Playway method - This is a child-centric methodology which follows informal teaching method, to suit the child's interest. Children learn through play concepts.

Reggio Emilio method - This is an approach involving the participation of child, teacher and community. The child is encouraged to make new relationships that will allow him or her to reach a higher level of understanding and development.

Waldorf method - The method lays an emphasis on children in learning through teamwork and sharing; they are also encouraged to use their imagination for storytelling, drawings, and arts and crafts. They learn in natural environment. All materials are made up of natural things.

Annexure V: Courses offered by THEAL

Courses offered	Age group	Skills
Playgroup	1.5 - 2.5 years	Fun activities are conducted to impart and build skills of language, math, gross and fine motor skills, and social, emotional, aesthetic and creative abilities. Value education also forms a crucial part of the education offerings in the playgroups.
Nursery	2.5 - 3.5 years	Programme teaches students the workings of letters, concepts of math and everyday social skills. All elements of the programme facilitate prekindergarten learning. Value education forms a crucial aspect of this. Other key areas and skill sets comprise language, writing, reading, and math, gross and fine motor, social, emotional, and environmental awareness. Other abilities developed are cognitive - conceptual and mathematical, sensory and general knowledge, and aesthetics and creative.
Junior KG	3.5 - 4.5 years	Skills developed at this stage are value education, those of language, reading, writing, math, general knowledge, environmental studies, science, and Hindi. Other abilities honed are emotional and cognitive skills, and creative and aesthetic expression
Senior KG	3.5 - 4.5 years	This course develops skills that help children to interact with their peers and hone abilities of complex co-ordination. Children begin to better their abilities of language and writing, math, general knowledge, environmental studies, science, Hindi, value education, aesthetics, and creative thinking. They also improve upon their social, emotional and cognitive talents
Day care services	1.5 years onwards	Children get an opportunity to grow in an enriching environment, which boosts their self-esteem and makes them ready for the future.
Hobby/Activity class	3 years to 8 years	This program is designed to encourage physical, emotional, social, and mental growth of the child.

Source: Company, KESI

FYE 31 Mar	FY14A	FY15A	FY16E	FY17E	FY18E
Key Metrics					
P/E (reported) (x)	24.2	17.5	10.8	11.0	8.6
Core P/E (x)	24.2	18.4	14.2	11.0	8.6
P/BV (x)	2.3	1.7	1.5	1.3	1.2
P/NTA (x)	2.7	1.7	1.5	1.3	1.2
Net dividend yield (%)	0.5	0.8	1.3	1.3	1.6
FCF yield (%)	nm	nm	0.1	2.3	7.0
EV/EBITDA (x)	13.1	13.7	6.3	4.9	3.8
EV/EBIT (x)	16.1	17.7	8.1	6.2	4.8
INCOME STATEMENT (INR m)					
Revenue	1,576.4	2,074.5	2,680.3	3,384.7	4,083.7
Gross profit	1,011.2	1,335.2	1,759.1	2,265.3	2,807.2
EBITDA	892.2	1,187.1	1,565.6	2,005.7	2,462.7
Depreciation	(169.6)	(268.2)	(350.7)	(425.7)	(478.2)
Amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	722.6	918.9	1,214.9	1,580.1	1,984.5
Net interest income /(exp)	(75.9)	(153.1)	(171.1)	(171.1)	(165.5)
Associates & JV	0.0	0.0	0.0	0.0	0.0
Exceptionals	0.0	31.5	238.5	0.0	0.0
Other pretax income	13.4	40.0	90.0	56.5	52.5
Pretax profit	660.2	837.3	1,372.3	1,465.5	1,871.5
Income tax	(221.0)	(228.6)	(384.3)	(496.8)	(634.4)
Minorities	0.0	0.0	0.0	0.0	0.0
Perpetual securities	0.0	0.0	0.0	0.0	0.0
Discontinued operations	0.0	0.0	0.0	0.0	0.0
Reported net profit	439.2	608.7	987.9	968.7	1,237.1
Core net profit	439.2	577.3	749.4	968.7	1,237.1
BALANCE SHEET (INR m)					
Cash & Short Term Investments	108.1	1,613.7	1,937.4	1,903.1	2,325.5
Accounts receivable	290.0	429.7	550.7	695.5	839.1
Inventory	56.2	52.1	63.1	76.8	88.3
Reinsurance assets	0.0	0.0	0.0	0.0	0.0
Property, Plant & Equip (net)	2,429.7	3,186.7	3,393.2	4,004.7	4,263.7
Intangible assets	323.6	285.8	248.6	211.4	174.2
Investment in Associates & JVs	0.0	0.0	0.0	0.0	0.0
Other assets	2,059.7	2,477.1	2,955.8	3,207.9	3,609.3
Total assets	**5,267.3**	**8,045.1**	**9,148.9**	**10,099.4**	**11,300.2**
ST interest bearing debt	0.0	0.0	0.0	0.0	0.0
Accounts payable	273.9	314.0	420.0	488.9	562.2
Insurance contract liabilities	0.0	0.0	0.0	0.0	0.0
LT interest bearing debt	826.3	1,058.2	1,120.0	1,120.0	1,120.0
Other liabilities	158.0	226.0	338.0	413.0	510.0
Total Liabilities	**1,258.5**	**1,597.8**	**1,878.5**	**2,021.9**	**2,192.0**
Shareholders Equity	4,008.8	6,447.2	7,270.4	8,077.4	9,108.2
Minority Interest	0.0	0.0	0.0	0.0	0.0
Total shareholder equity	**4,008.8**	**6,447.2**	**7,270.4**	**8,077.4**	**9,108.2**
Perpetual securities	0.0	0.0	0.0	0.0	0.0
Total liabilities and equity	**5,267.3**	**8,045.1**	**9,148.9**	**10,099.4**	**11,300.2**
CASH FLOW (INR m)					
Pretax profit	660.2	837.3	1,372.3	1,465.5	1,871.5
Depreciation & amortisation	169.6	268.2	350.7	425.7	478.2
Adj net interest (income)/exp	62.5	113.1	81.1	114.6	113.0
Change in working capital	(300.4)	(401.1)	(391.9)	(267.1)	(386.5)
Cash taxes paid	(221.0)	(228.6)	(384.3)	(496.8)	(634.4)
Other operating cash flow	7.5	(78.3)	(238.5)	0.0	0.0
Cash flow from operations	371.8	471.1	789.4	1,241.9	1,441.7
Capex	(995.2)	(1,128.5)	(780.0)	(1,000.0)	(700.0)
Free cash flow	(623.4)	(657.4)	9.4	241.9	741.7
Dividends paid	(65.2)	(101.5)	(164.8)	(161.6)	(206.4)
Equity raised / (purchased)	201.2	1,965.9	(0.0)	0.0	0.0
Perpetual securities	0.0	0.0	0.0	0.0	0.0
Change in Debt	159.2	231.9	61.8	0.0	0.0
Perpetual securities distribution	0.0	0.0	0.0	0.0	0.0
Other invest/financing cash flow	(50.8)	66.7	417.4	(114.6)	(113.0)
Effect of exch rate changes	0.0	0.0	0.0	0.0	0.0
Net cash flow	(379.1)	1,505.6	323.7	(34.3)	422.4

FYE 31 Mar	FY14A	FY15A	FY16E	FY17E	FY18E
Key Ratios					
Growth ratios (%)					
Revenue growth	37.9	31.6	29.2	26.3	20.7
EBITDA growth	44.3	33.1	31.9	28.1	22.8
EBIT growth	49.2	27.2	32.2	30.1	25.6
Pretax growth	35.1	26.8	63.9	6.8	27.7
Reported net profit growth	31.7	38.6	62.3	(1.9)	27.7
Core net profit growth	31.7	31.4	29.8	29.3	27.7
Profitability ratios (%)					
EBITDA margin	56.6	57.2	58.4	59.3	60.3
EBIT margin	45.8	44.3	45.3	46.7	48.6
Pretax profit margin	41.9	40.4	51.2	43.3	45.8
Payout ratio	12.7	13.9	13.9	13.9	13.9
DuPont analysis					
Net profit margin (%)	27.9	29.3	36.9	28.6	30.3
Revenue/Assets (x)	0.3	0.3	0.3	0.3	0.4
Assets/Equity (x)	1.3	1.2	1.3	1.3	1.2
ROAE (%)	11.8	11.0	10.9	12.6	14.4
ROAA (%)	9.0	8.7	8.7	10.1	11.6
Liquidity & Efficiency					
Cash conversion cycle	(146.3)	(120.8)	(129.4)	(133.3)	(132.1)
Days receivable outstanding	41.0	62.4	65.8	66.3	67.6
Days inventory outstanding	46.5	41.4	36.4	36.3	37.2
Days payables outstanding	233.8	224.6	231.6	235.8	237.0
Dividend cover (x)	7.9	7.2	7.2	7.2	7.2
Current ratio (x)	6.3	8.3	7.2	6.4	6.3
Leverage & Expense Analysis					
Asset/Liability (x)	4.2	5.0	4.9	5.0	5.2
Net debt/equity (%)	17.9	net cash	net cash	net cash	net cash
Net interest cover (x)	9.5	6.0	7.1	9.2	12.0
Debt/EBITDA (x)	0.9	0.9	0.7	0.6	0.5
Capex/revenue (%)	63.1	54.4	29.1	29.5	17.1
Net debt/ (net cash)	718.2	(555.5)	(817.4)	(783.1)	(1,205.5)

Source: Company; Maybank

Research Offices

REGIONAL

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