March 25, 2013

Tree House

Spreading Branches

Tree House Education and Accessories Ltd (THEAL) is the largest self-operated pre-school education provider in India. THEAL has 349 pre-school centres of which 278 centers are self-owned schools (SOS) while 71 centers are franchisees (as of December 2012). THEAL has also entered into the K-12 schools segment (in regions where it has strong pre-school presence) which is a logical extension from its existing pre-school business. THEAL has advantage over other players since it has feeders from its pre-school segment. It offers school management services to K-12 schools through a trust and currently has 23 operational schools under this arrangement. With rising need for quality education and changing lifestyles, THEAL is expected to grow at a robust pace with its established brand. We initiate coverage on THEAL and recommend Buy with a target price of ₹275.

Investment rationale

Budding pre-school segment to boost top-line: The concept of imparting education to young toddlers is catching up fast today. With a current size of ₹5,000cr, the pre-school segment is expected to grow to ₹13,300cr in 2015 as per CRISIL Research. Considering an urbanization rate of 40%, the demand for the segment is expected to maintain its momentum. In addition the expected growth in average household disposable income in India to ~₹239,000 in 2030 (from ~₹60,000 in 2008; CAGR of 6.4%) is expected to drive growth for THEAL.

Unique business model to provide competitive edge: THEAL operates its pre-schools on a dual business model, ie operating SOS in metro cities and adopting the franchise model in tier 3 & 4 cities. This model facilitates the company to maintain its quality of education and maximize the profit through SOS; and widen its reach through franchisees.

Moreover, 'Tree House' being an established and trusted brand in the pre-school segment has taken a logical step to enter the K-12 segment and benefit from its brand and experience of providing quality education. Both, Pre-schools and K-12 are complimentary to each other with pre-school acting as a feeder to the K-12.

Outlook and valuation: Given the growth opportunities in the pre-school segment coupled with its consistent expansion of pre-schools and K-12 schools, we expect THEAL's top-line to grow at a CAGR of 35.3% and net profit to grow at a CAGR of 39.4% respectively over FY2012-15E to ₹192cr and ₹58cr in FY2015E. The stock is currently trading at a PE of 13.9x its FY2015E earnings. Considering the nascent stage of pre-school segment with high potential growth prospects and unique business model of THEAL, **we initiate coverage on THEAL and recommend Buy with a target price of ₹275 based on target PE of 17x for its FY2015E earnings.**

Key financials

THEAL	Net sales (₹ cr)	OPM (%)	PAT (₹ cr)	EPS (₹)	ROE (%)	P/E (x)	P/BV (x)	EV/ EBITDA (x)
FY2013E	110	53.4	33	9.1	8.1	24.8	2.0	12.6
FY2014E	150	52.6	46	12.8	10.0	17.5	1.7	9.4
FY2015E	192	52.5	58	16.2	11.1	13.9	1.5	7.2

Source: Company, Angel Research

BUY

CMP	₹225
Target Price	₹275
Investment Period	12 Months

Stock Info	
Sector	Educational Services
Market Cap (₹ cr)	809
Net Debt	11.7
Beta	1.0
52 Week High / Low	259 / 190
Avg. Daily Volume	28,834
Face Value (₹)	10
BSE Sensex	18,681
Nifty	5,633
Reuters Code	THEA.BO
Bloomberg Code	THEAL.IN

Shareholding Pattern (%)	
Promoters	27.8
MF / Banks / Indian FIs	17.1
FII / NRIs / OCBs	39.4
Indian Public / Others	15.8

Abs.(%)	3m	1yr
Sensex	(3.0)	8.6
THEAL	(18.1)	11.1

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Investment arguments

Unique business model and strong brand to provide competitive edge

THEAL is the largest self-operated pre-school provider in India. It operates pre-schools on a dual business model, ie operating SOS (~80% of total centres) in metro cities and adopting the franchise model in tier 3 & 4 cities. This model facilitates the company to maintain its quality of education and maximize profits through SOS; and widen the reach through franchisees. In franchisees, the quality of education is maintained by adopting standardization of curriculum and teacher training programmes.

Strong brand and assured quality of education act as differentiating pillars for THEAL. With an average teacher : student ratio of 1:14, teachers trained in-house, supervisors and quality control team to monitor services, and competent curriculum designers, the quality is an assured aspect for THEAL, which provides it a competitive edge over other pre-school operators.

K-12 to be logical extension, pre-school being the potential feeder

'Tree House' being an established and trusted brand in the pre-school segment has taken a logical step to enter the K-12 segment and benefit from its brand and experience of providing quality education. K-12 schools are established only where the company has strong pre-school presence, which minimizes the marketing cost. The company currently provides consultancy and management services to 20 schools and is in the process of developing 3 self-owned K-12 school buildings, for which major capex has already been undertaken. Revenue comes in by way of service or consultancy fees which are usually based on factors which include (i) per child admitted to the school (for services forming part of service agreement) and (ii) lumpsum basis (for services beyond the scope of service agreement). Both, Pre-schools and K-12 are complimentary to each other with pre-school acting as a feeder to the K-12. We expect the K-12 segment to post a CAGR of 60% over FY2012-15 to ₹23cr in FY2015.

Potential growth in pre-school segment- key growth driver

- Niche but growing addressable market: India is the second largely populated country in the world with ~54cr in the age bracket of 0-24 years, which forms the addressable segment for education. With a current size of ₹5,000cr, the pre-school segment is expected to grow to ₹13,300cr in 2015 as per CRISIL Research. To capitalize on such opportunities, THEAL intends to establish and expand the number of its pre-schools in various cities and towns in India and proposes to open an additional 120 pre- schools across India by FY2014.

- Rapid urbanization and transition in income bracket of people: According to Mckinsey Global Institute's recent research study, India's urban population is expected to rise from 34cr in 2008 to 59cr in 2030, ie an urbanization rate of 40% (lower than seen in most Asian countries due to strict definition of Indian Census). The average household disposable income in urban areas is expected to grow at a CAGR of 6.4% from ~₹60,000 in 2008 to ~₹239,000 in 2030 considering a GDP growth rate of 7.4%. Thus, such a rise in disposable incomes provides strong growth visibility for the education market.

- **Changing lifestyles with need for quality education:** With the changing demographics, the lifestyle of the people has changed drastically. Women who used to be home-makers previously are now joining the workforce and that too at an increasing rate. Also, there is increased awareness about the role of education in a competitive market ('Think tank'). Moreover, with awareness of the fact that 40% of a person's ability to learn is shaped during the first four years of his life, pre-schools have secured a vital place in the education system.

'Brainworks Learning' acquisition to compliment THEAL's reach

THEAL has plans to acquire a pre-school brand 'Brainworks Learning' (BL) which is expected to be finalised by the end of this fiscal year (FY2013). BL centres are present mainly in the areas where THEAL is yet to establish its foothold. The proposed acquisition is hence expected to widen the reach of THEAL. Of the 70 centres of BL, 13 are self owned and will be converted to 'Tree House' brand post acquisition. Rest of the centres, which are franchisee based, will be given an option to convert to THEAL's brand or else continue with BL's brand. This inorganic growth is thus expected to boost the top-line, while simultaneously extending the reach.

Financials

Exhibit 1: Key Assumptions

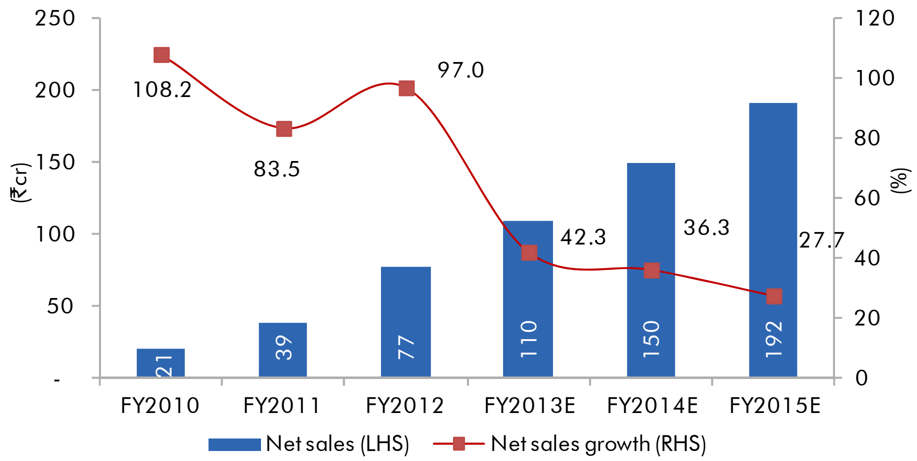
	FY2012	FY2013E	FY2014E	FY2015E
Total no of pre-school centres	302	382	492	622
SOS	*237*	*297*	*382*	*482*
Franchisee	*65*	*85*	*110*	*140*
Total Revenue (₹ cr)	77	110	150	192
Pre-school Revenue (₹ cr)	72	98	132	169
SOS	*68*	*92*	*123*	*158*
Franchisee	*1*	*2*	*3*	*4*
Teacher training programme	*3*	*4*	*6*	*7*
K-12 Revenue (₹ cr)	6	12	18	23

Source: Company, Angel Research

Expansion plans to lead to top-line CAGR of 35.3% over FY2012-15E

THEAL, an established and trusted brand in the pre-schools segment owns 349 pre-schools as on December 2012. Also, the company has ventured into the K-12 schools segment and currently possesses school management rights for 23 schools. The top-line, following the expansion plans of the company, is expected to grow at a CAGR of 35.3% over FY2012-15 to ₹192cr in FY2015.

Exhibit 2: Pre-school and K-12 expansion plans to drive top-line

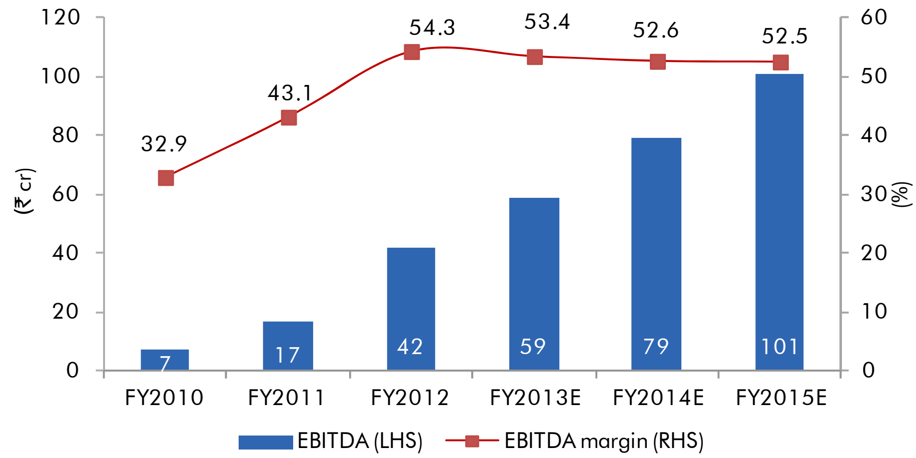


Source: Company, Angel Research

EBITDA to grow at a CAGR of 33.8% over FY2012-15E

On the back of a robust estimated top-line growth of 35.3% (CAGR), the company's EBITDA is expected to grow at a CAGR of 33.8% over FY2012-15E, from ₹42cr in FY2012 to ₹101cr in FY2015. The EBITDA margin is expected to stabilize ~52-53% over FY2012-15.

Exhibit 3: EBITDA to normalise at higher levels

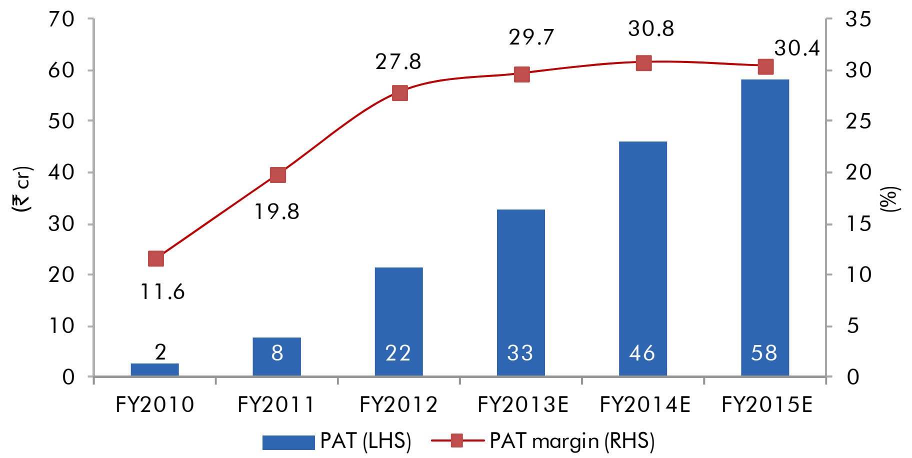


Source: Company, Angel Research

Net profit to grow at a CAGR of 39.4% over FY2012-15E

On back of a robust estimated top-line coupled with a healthy and stable operating performance, the PAT is expected to grow at a CAGR of 39.4% to ₹58cr in FY2015 with a PAT margin of ~30.0% in FY2014 and FY2015.

Exhibit 4: PAT margins to trend higher owing to lower interest costs



Source: Company, Angel Research

Risks

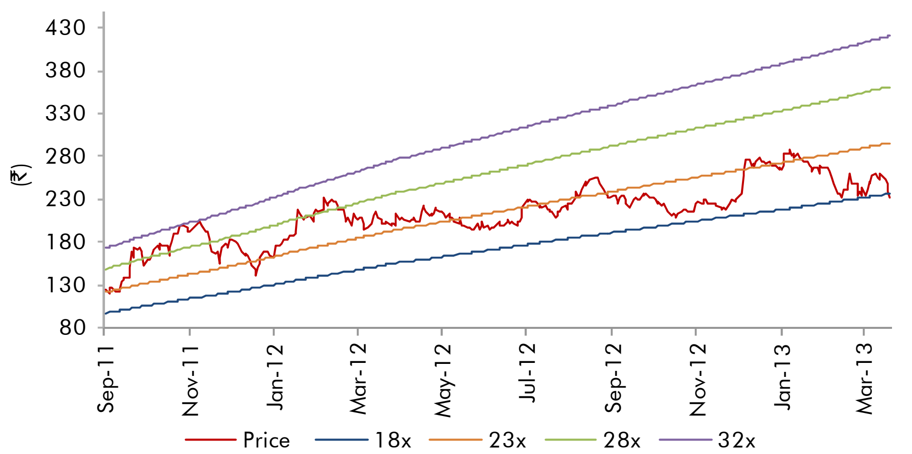
Geographical concentration: Of the total 349 pre-schools, ~147 centers are located in and around Mumbai metropolitan. This suggests a geographical concentration risk to the company.

Regulations pertaining to K-12 segment: Operating pre-schools and providing educational services to K-12 schools are currently unregulated, but the government may introduce a regulatory framework in future. Any such government regulation, and THEAL's inability to comply with the same, may adversely affect its revenue.

Outlook and Valuation

THEAL is in a position to capitalize on the growth opportunities emerging in the pre-schools segment. It is consistently expanding its network of pre-schools and K-12 schools pan-India. The top-line of the company is expected to grow at a 35.3% CAGR over FY2012-15 to ₹192cr in FY2015. The EBITDA for the company is expected to grow from ₹42cr in FY2012 to ₹101cr in FY2015, at a 33.8% CAGR. Owing to a robust top-line and healthy EBITDA, the net profit for the company is expected to grow at a CAGR of 39.4% over FY2012-15 to ₹58cr in FY2015. At the current market price of ₹225, the stock is trading at a PE of 13.9x its FY2015E earnings. Considering the nascent stage of pre-school segment with high potential growth prospects and unique model of THEAL, **we initiate coverage on THEAL and recommend Buy with a target price of ₹275, based on target PE of 17x for its FY2015E earnings.**

Exhibit 5: One-year forward PE



Source: Company, Angel Research

Relative Valuation

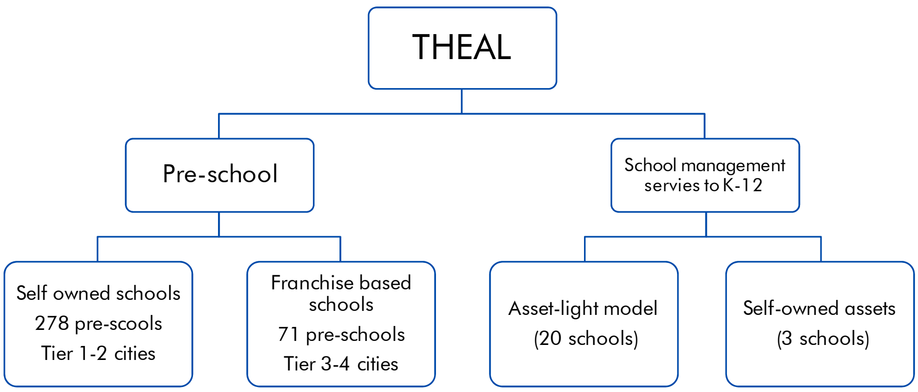
The education sector in India is largely unorganized and the business of pre-schools is highly fragmented and competitive. In addition to competition from unorganized players in the pre-schools business, THEAL faces a lot of competition from organized players in the market where it competes with various pre-schools like Kidzee, Euro Kids and Roots to Wings (operated by Educomp Solutions).

Leading self-operated pre-school provider- THEAL

Dual business model enables profitability & extended reach: THEAL operates its pre-schools on a dual business model, ie operating SOS and following the franchise model suitably. Of the total 349 centers, 278 centers (~80%) are self owned while 71 centers are franchisee operated as of December 2012. SOS are mainly set-up in tier 1 and 2 cities while the franchise route covers tier 3 and 4 cities. In SOS the company enters into leave and license agreements or lease agreements for the premises, usually for a period of 5 years. While in case of franchise, all the costs are borne by the franchisee. The franchisee is allowed to use the brand name of 'Tree House', and is provided with curriculum and training for teachers, so as to standardize the quality of education across SOS and franchisees. Thus, the dual model enables the company in maximizing profits through SOS and widening reach through franchisees; with standardization in curriculum, and quality of education, both intact.

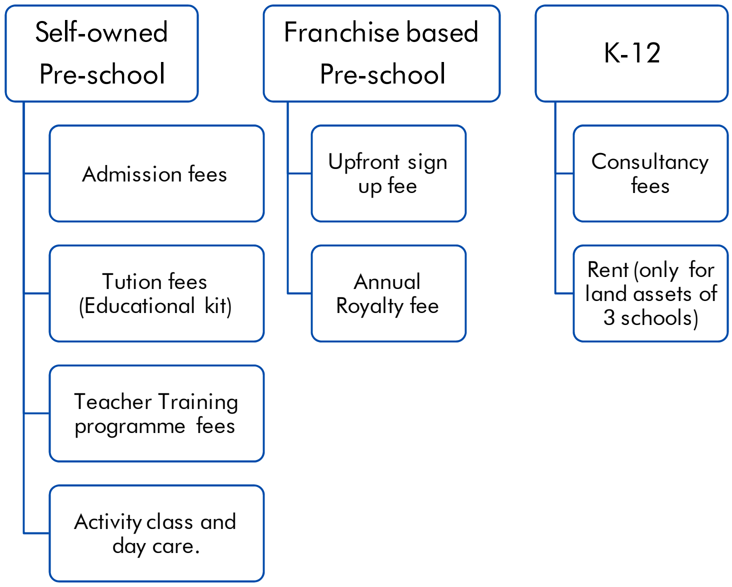
THEAL follows a standard design and architecture across all pre-schools and follows a central procurement process for furniture, toys and teaching aids. Thus, the central procuring model assists it in economizing costs and maintaining uniformity across SOS and franchisees, which aids in making their business scalable.

Exhibit 6: Company Structure



Source: Company

Exhibit 7: Revenue Stream



Source: Company

K-12 a logical extension, with pre-school being the potential feeder:

THEAL has proficiently imparted quality education at the pre-school level and has the skill to handle and develop every individual child. After having successfully operated pre-schools and enabled children to fill other K-12 schools, it is a logical extension for the company to enter the K-12 segment and benefit from its brand name established in the pre-school segment. Thus pre-school segment (students) is seen as a potential feeder for K-12 schools.

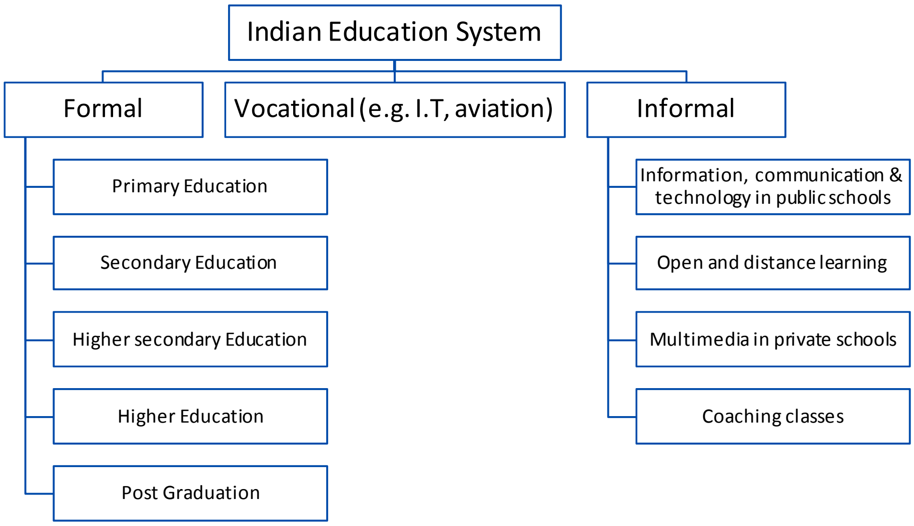
The company currently provides consultancy and management services to 20 schools mainly in the western belt of India. For these schools, THEAL has bought business commercial rights (BCR) by paying a one-time upfront fee. These BCR enable the company to provide consultancy services to these schools for a period of 30 years for a share of the surplus cash flow generated by the school. THEAL is in the process of developing 3 self-owned K-12 school buildings for which major capex has already been undertaken.

The company provides a wide variety of educational services to these K-12 schools which include designing curriculum and providing teaching aids, supplying methods for imparting education, organizing extra-curricular activities for students and training teachers.

Education Industry

India is one of the world's youngest nations with a majority of its population (585mn) in the age bracket of 0-24 years, according to a *CRISIL* report released in December 2010. The Indian education system comprises of formal, vocational and informal approach of education. All the levels of formal education are highly regulated by the Ministry of Human Resource Development (MHRD), while informal education is out of the regulation ambit.

Exhibit 8: Indian Education System Structure



Source: CRISIL

Growth drivers:

a) **Increased spend by government on education sector:** India spends nearly 3.5% of its gross domestic product on education (Source: NSSO Report: Education in India 2007-08). The central government has been investing in promoting literacy and education (Source: *CRISIL report- Dec 2010*). However its efforts remain largely focused on elementary schooling, thus providing scope of growth for pre-schools and K-12 schools.

b) **Transition in income brackets of people:** Structural changes in the Indian economy such as urbanization, and rising disposable incomes coupled with increasing emphasis on education by parents are expected to accelerate the household expenditure on education. By 2012-13, of a total of 6.9cr households in urban areas, nearly 5.2cr are expected to belong to the ₹0.01-0.05cr income bracket as compared to 2.1cr households in 2001-02. During the same period, in rural areas, nearly 5cr households are expected to be in the addressable income bracket as compared to 1.6cr in 2001-02 (Source: *CRISIL* report- Dec 2010). This transition of households from lower income to higher income bracket will provide an impetus to spend on education by private households.

c) **Increased private sector investment:** The presence of private players in the K-12 sector has been increasing due to the need for quality education and better infrastructure, which are found lacking in several government-owned institutions. The number of private institutions grew at a CAGR of 10.2% over 2001-2008. Further, *CRISIL* report- Dec 2010, projects the total number of private institutes to reach 0.043cr by 2015-16 and private sector enrolments to touch 12.7cr during that period. The share of private institutions in the K-12 segment will gradually rise to 26% in FY2015 from 19% in FY2005. However, *CRISIL* report- Dec 2010, projects that their share of enrolments will rise at a much faster pace to touch 46% in FY2015 from 36% in FY2005.

d) Increasing penetration level in pre-school industry: The pre-school industry currently has a low penetration level, with only 10–15% of the urban population in the 2–4 years age bracket enrolled in pre-schools in the country. (Source: *CRISIL* report- Dec 2010) However, with greater thrust on 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. The pre-primary gross enrollment ratio (GER) of India is low when compared to other major countries in the world.

Profit and loss statement (Standalone)

Y/E March (₹ cr)	FY2011	FY2012	FY2013E	FY2014E	FY2015E
Gross sales	39	77	110	150	192
Less: Excise duty	-	-	-	-	-
Net Sales	39	77	110	150	192
Other operating income	-	-	-	-	-
Total operating income	**39**	**77**	**110**	**150**	**192**
% chg	*83.5*	*97.0*	*42.3*	*36.3*	*27.7*
Other operating costs	4	16	25	34	44
% chg	*103.1*	*306.5*	*53.4*	*38.8*	*27.7*
Personnel	5	13	16	22	30
% chg	*86.0*	*166.8*	*19.2*	*38.5*	*40.2*
Other	13	6	11	15	17
% chg	*35.6*	*(51.3)*	*77.5*	*38.4*	*11.6*
Total Expenditure	22	35	51	71	91
EBITDA	**17**	**42**	**59**	**79**	**101**
% chg	*140.8*	*148.0*	*40.0*	*34.3*	*27.4*
(% of Net Sales)	*43.1*	*54.3*	*53.4*	*52.6*	*52.5*
Depreciation & Amortization	4	8	11	14	15
EBIT	**13**	**34**	**47**	**65**	**86**
% chg	*216.3*	*163.5*	*38.7*	*37.5*	*31.3*
(% of Net Sales)	*33.1*	*44.2*	*43.1*	*43.5*	*44.7*
Interest & other charges	1	7	5	5	5
Other Income	0	4	6	8	6
(% of Net Sales)	*1.2*	*4.9*	*5.5*	*5.5*	*3.0*
PBT (reported)	**12**	**31**	**48**	**68**	**86**
Tax	4	10	16	22	28
(% of PBT)	*36.3*	*31.6*	*32.4*	*32.4*	*32.4*
PAT (reported)	**8**	**22**	**33**	**46**	**58**
PAT after MI (reported)	**8**	**22**	**33**	**46**	**58**
ADJ. PAT	**8**	**22**	**33**	**46**	**58**
% chg	*212.4*	*176.7*	*51.6*	*41.4*	*26.3*
(% of Net Sales)	*19.8*	*27.8*	*29.7*	*30.8*	*30.4*
Basic EPS (₹)	**3.1**	**6.4**	**9.1**	**12.8**	**16.2**
Fully Diluted EPS (₹)	**3.1**	**6.4**	**9.1**	**12.8**	**16.2**
% chg	*212.4*	*107.5*	*42.1*	*41.4*	*26.3*

Balance sheet (Standalone)

Y/E March (₹ cr)	FY2011	FY2012	FY2013E	FY2014E	FY2015E
SOURCES OF FUNDS					
Equity Share Capital	24	34	36	38	38
Reserves& Surplus	99	223	365	425	489
Shareholders' Funds	**123**	**256**	**401**	**463**	**527**
Total Loans	48	51	41	41	41
Long term Provision	-	0	0	0	0
Other long term liabilities	0	1	1	1	1
Net Deferred Tax Liability	1.8	3.3	3.3	3.3	3.3
Total Liabilities	**172**	**312**	**447**	**509**	**573**
APPLICATION OF FUNDS					
Gross Block	72	131	191	231	251
Less: Acc. Depreciation	10	17	29	42	57
Net Block	**62**	**114**	**162**	**188**	**194**
Capital Work-in-Progress	52	14	21	21	13
Lease adjustment	-	-	-	-	-
Goodwill	-	30	28	27	25
Investments	**3**	**31**	**12**	**12**	**40**
Other non-current assets	34	85	121	165	211
Current Assets	36	64	131	136	142
Cash	29	48	99	92	89
Loans & Advances	3	5	10	13	17
Inventory	1	4	9	12	15
Debtor	2	6	12	16	21
Other current assets		2	2	2	0
Current liabilities	14	25	29	40	52
Net Current Assets	**22**	**39**	**102**	**95**	**91**
Misc. Exp. not written off	-	-	-	-	-
Total Assets	**172**	**312**	**447**	**509**	**573**

Cash flow statement **(Standalone)**

Y/E March (₹ cr)	FY2011	FY2012	FY2013E	FY2014E	FY2015E
Profit Before Tax	12	31	48	68	86
Depreciation	4	8	11	14	15
Other Income	(0)	(4)	(6)	(8)	(6)
Change in WC	13	(0)	(17)	(3)	(2)
Direct taxes paid	(4)	(10)	(16)	(22)	(28)
Cash Flow from Operations	**24**	**25**	**21**	**49**	**65**
(Inc.)/ Dec. in Fixed Assets	(88)	(73)	(101)	(83)	(56)
(Inc.)/Dec. In Investments	(2)	(28)	19	0	(28)
Other Income	0	4	6	8	6
Cash Flow from Investing	**(89)**	**(97)**	**(76)**	**(75)**	**(78)**
Issue of Equity/Preference	7	10	104	38	0
Inc./(Dec.) in Debt	37	6	(10)	0	0
Dividend Paid (Incl. Tax)	0	(3)	(4)	(4)	(4)
Others	40	78	17.3	(15.0)	13.3
Cash Flow from Financing	**83**	**91**	**107**	**19**	**9**
Inc./(Dec.) In Cash	19	19	51	(7)	(3)
Opening Cash balance	**10**	**29**	**48**	**99**	**92**
Closing cash balance	**29**	**48**	**99**	**92**	**89**

Key ratios

Y/E March	FY2011	FY2012	FY2013E	FY2014E	FY2015E
Valuation Ratio (x)					
P/E (on FDEPS)	104.0	37.6	24.8	17.5	13.9
P/CEPS	68.9	27.6	18.4	13.5	11.1
P/BV	6.6	3.2	2.0	1.7	1.5
Dividend yield (%)	-	0.4	0.5	0.5	0.5
EV/Net sales	21.0	10.1	6.7	5.0	3.8
EV/EBITDA	48.7	18.6	12.6	9.4	7.2
EV / Total Assets	4.8	2.5	1.7	1.5	1.3
Per Share Data (₹)					
EPS (Basic)	3.1	6.4	9.1	12.8	16.2
EPS (fully diluted)	3.1	6.4	9.1	12.8	16.2
Cash EPS	4.6	8.7	12.2	16.7	20.4
DPS	-	0.2	0.2	0.2	0.2
Book Value	48.5	76.0	111.5	128.7	146.5
DuPont Analysis					
EBIT margin	33.1	44.2	43.1	43.5	44.7
Tax retention ratio	0.6	0.7	0.7	0.7	0.7
Asset turnover (x)	0.4	0.4	0.4	0.4	0.5
ROIC (Post-tax)	9.3	12.3	11.2	12.4	14.3
Cost of Debt (Post Tax)	1.7	8.7	8.5	8.5	8.5
Leverage (x)	0.1	(0.1)	(0.2)	(0.1)	(0.2)
Operating ROE	10.3	11.9	10.7	11.8	13.3
Returns (%)					
ROCE (Pre-tax)	7.5	10.9	10.6	12.8	15.0
Angel ROIC (Pre-tax)	14.6	18.0	16.6	18.3	21.1
ROE	6.3	8.4	8.1	10.0	11.1
Turnover ratios (x)					
Asset TO (Gross Block)	4.3	0.6	0.6	0.6	0.8
Inventory / Net sales (days)	8	12	21	25	47
Receivables (days)	41	18	30	35	35
Payables (days)	156	130	130	130	130
WC cycle (ex-cash) (days)	1	1	10	7	3
Solvency ratios (x)					
Net debt to Equity	0.1	(0.1)	(0.2)	(0.1)	(0.2)
Net debt to EBITDA	1.0	(0.7)	(1.2)	(0.8)	(0.9)
Int. Coverage (EBIT/ Int.)	10.4	5.3	9.1	12.5	16.5

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Disclosure of Interest Statement	**Tree House**
1. Analyst ownership of the stock	No
2. Angel and its Group companies ownership of the stock	No
3. Angel and its Group companies' Directors ownership of the stock	No
4. Broking relationship with company covered	No

Note: We have not considered any Exposure below ₹1 lakh for Angel, its Group companies and Directors

Ratings (Returns):	*Buy (> 15%)*	*Accumulate (5% to 15%)*	*Neutral (-5 to 5%)*
	Reduce (-5% to -15%)	Sell (< -15%)	

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