PRATIBHUTI

March 14, 2014

Aptech Limited.

CMP(14/3/2014)	Intrinsic Value Range(14/3/2014)	Recommendation
INR 70.6	INR 110.0	BUY

- Aptech has a strong balance sheet with positive cash (and equivalent) balances and current assets. The price multiples based on these (price/ current asset of 3x and price/ cash asset value of 5.3) clearly indicate undervaluation of Aptech's operating assets. Net EV/ EBITA of just 2x for a zero debt business with strong balance sheet is another indication of an undervalued stock.
- ROIC excluding goodwill and intangibles of about 50% can be attributed to good asset productivity ratios (Revenues/ Invested Capital ratio of 5) resulting in good asset utilization. We attribute good asset productivity ratio to franchise based business model, where capital expenditures are borne by the Aptech's business partners and Aptech provides training material and courseware in return for franchise fee.
- Aptech has consistently generated good gross and free cash flows (INR 12.19cr, 22.98cr and 7.99cr in FY12, FY13 and 1H14 respectively), primarily by opting for asset light business model that ensures minimal investment in capacity by partnering with business entities through franchises, or maintaining 10-40% equity in Aptech centres. Sufficient FCF and non-operating income has ensured that Aptech paid good dividends in the past 2.5 years. For FY14, we expect dividend yield of 6.4% for the stock on CMP of INR70.6.

Investment conclusion: *In view of strong operating fundamentals, we believe that Aptech is undervalued and deserves a higher valuation. Considering the strong balance sheet, and operating leverage, we find that the company is undervalued at current levels. We expect that Aptech's earnings growth will improve as IT industry demand continues to improve, with a recovery in the USA. Aptech has already recorded YoY revenue growth rates of 9%, 9.7% and 3.6% over the past three quarters respectively and we expect 8-10% YoY revenue growth rates in the next four quarters with average net income margin of 15%. We value Aptech at 1.8x of its book value (INR 62/share at end of FY14E) and 16.4x of its FY14E EPS of INR 6.73 for stock price of INR 110/share, which also means target Net EV/ EBITA of 7.*

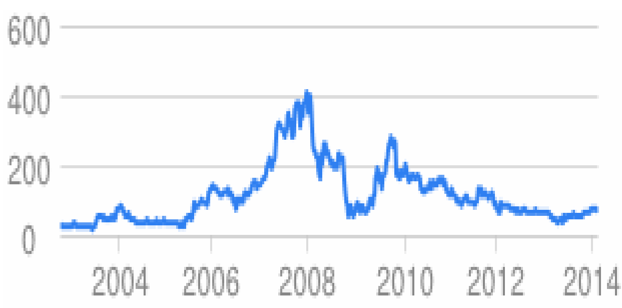
Aptech's business is classified into two categories, viz. Individual Training (or Retail) and Enterprise Business (or Non-retail). Individual Training segment comprises of vocational, certification and skill upgrade courses to individual students. Enterprise Business segment addresses content development, training and assessment related needs of government, institutional and corporate customers. Mr. Rakesh Jhunjhunwala, promoter and chairman, along with Rare Equity Pvt. Ltd owned 30.48% of Aptech's equity at end of FY13.

EPS - FY11	EPS - FY12	EPS - FY13	EPS - FY14E
INR 9.21	INR 15.46	INR 6.41	INR 6.73

Market Profile

BSE	NSE	BLOOMBERG	REUTERS
532475	APTECHT	APTR:IN	APTA.NS

52 week price range	INR 40.25- 89.45
Average Volume	371,848
Beta	1.45
Dividend yield	6.4%
Shares outstanding (mn)	40.3
Market cap (INR bn)	2.8
Float	37.4%
% Institutional Holdings	7.9%
% Public and Others	29.5%
Borrowings/ Assets	0.0%
Return on equity (LTM)	10.4%
Return on assets (LTM)	9.0%



Attractive valuation supported by good fundamentals

Aptech has consistently generated good free cash flows, primarily by opting for asset light business model.

We note that Aptech is trading at 1.1x times of its 1H14 end book value (BVPS of INR62.1). Even if Aptech reports flat earnings for FY15, Aptech is trading at 1.15x times its FY15 book value (BVPS of INR65.5 assuming 50% dividend payout for FY15). As such, the valuation seems attractive at CMP of INR70.6. However, we inspect Aptech's fundamentals before we form an opinion on Aptech's intrinsic value.

Aptech has consistently generated good gross and free cash flows, primarily by opting for asset light business model that ensures minimal investment in capacity by partnering with business entities through franchises or maintaining 10-40% equity in Aptech centers. High investment in operating assets in 2011 was due to acquisition of MAAC. Sufficient FCF and non-operating income has ensured that Aptech paid good dividends in the past 2.5 years. In the future, we expect Aptech to maintain 25-50% dividend payout ratios. For FY14, we expect dividend yield of over 6% for the stock on CMP of INR70.6.

Figure 1: Positive free cash flow is sustainable given Aptech's business model

in INR lakhs	2011	2012	2013	1H14
Noplat	1,892	2,444	2,085	1,077
Gross cash flow	2,318	2,573	2,404	1,240
Less: Gross investment in operating assets	-5,206	-1,354	-106	-440
Free cash flow (FCF)	-2,888	1,219	2,298	799
Non operating income	1,707	1,330	-484	1,480
Total cash flow	**-1,181**	**2,549**	**1,814**	**2,279**
Cash flow to debt holders	2,830	444	29	12
Cash flow to equity holders	-3,813	2,167	1,786	2,267
Cash flow to minority interest holders	-197	-62	-	-

Source: Company documents, Analyst's estimates

Note: Non-operating income arises due to interest and dividend income, change in loans and advances, non-current investments and excess cash

Strong balance sheet reduces earnings volatility

Aptech is well financed and currently has outstanding loans. Other liabilities such as employee defined benefit plans and operating working capital related liabilities, are only 13.5% of total assets.

Aptech is well financed and currently has no outstanding loans. Other liabilities such as employee defined benefit plans and operating working capital related liabilities, are only 13.5% of total assets. Elimination of fixed financial costs offers has reduced earnings volatility in the past three years, whereas organic revenue growth has remained volatile.

Figure 2: Good financing structure

in INR lakhs	2011	2012	2013	1H14
Borrowings (includes operating lease)	376	-	-	-
Other debt	1,905	1,391	1,831	1,769
Operating working capital related liabilities	3,602	2,890	3,481	3,401
Total borrowings/ Total assets	1%	0%	0%	0%
Total liabilities/Total assets	18%	11%	13%	13%

Source: Company documents, Analyst's estimates

ROIC excluding goodwill and intangibles of about 50% can be attributed to good asset productivity ratios (Revenues/ Invested Capital ratio of 5)

Figure 1 indicates that Aptech has been able to fund its dividend payments through FCF, non-operating income (dividend and interest receipts) and cash/ current investments. We believe that FCF generated by Aptech should be able to support at least 50% dividend payout ratio in the future. ROIC excluding goodwill and intangibles (Figure 3) is about 50%, and a major source of good FCF generation is the asset productivity of Aptech. For e.g. Revenues/ Invested Capital (without goodwill and intangibles) ratio of 5x indicates that less capital is required to generate incremental revenues. We attribute good asset productivity ratio to franchise based business model, where capital expenditures are borne by the Aptech's business partners and Aptech provides training material and courseware in return for franchise fee.

Figure 3: Good asset productivity ratios produce good ROIC

in INR lakhs	2011	2012	2013	1H14
ROIC excluding goodwill and intangibles	39.0%	60.9%	51.1%	58.2%
ROIC including goodwill and intangibles	12.0%	13.1%	10.9%	11.2%
Operating cash tax rate	2.6%	2.4%	25.7%	23.8%
Pretax ROIC excluding goodwill and intangibles	40.0%	62.3%	68.7%	76.4%
Pretax ROIC including goodwill and intangibles	12.3%	13.4%	14.7%	14.8%
Operating margin	10.1%	14.1%	16.2%	15.1%
Revenues/Invested Capital without goodwill and acquired intangibles	4.0	4.4	4.2	5.1
Revenues/Invested Capital with goodwill and acquired intangibles	1.2	0.9	0.9	1.0

Source: Company documents, Analyst's estimates

Aptech acquired MAAC, a high end provider of multimedia and animation courses, in FY11 and paid a high premium for it (INR68cr of goodwill). As a result, Aptech's ROIC with goodwill and intangibles is just 11.2% and recent earnings volatility has kept this measure of ROIC lower. However, we are yet to see substantial growth in revenues from MAAC and ARENA (low cost provider of multimedia and animation courses) to justify the high premium paid for MAAC acquisition. In fact, management indicated that MAAC revenues have been adjusted lower in FY13 as a result of some accounting adjustments, which has put pressure on top line in past one and half years. We believe that high premium paid for MAAC and subsequent lack of clarity on income from animation and multimedia division has been an overhang on the stock price.

Aptech has been able to report positive net income in the past 14 quarters

Even though MAAC revenue has been adjusted downward due to changes in accounting conventions, Aptech has been able to report positive net income in the past 14 quarters (Figure 4). We believe that consistently positive net income in the future (INR 2,708 lakhs in FY14E) will ultimately result in appreciation of book value and with revenue improving due to better economic conditions, leading to an appreciation in the stock price.

Figure 4: Aptech has reported positive net income in the past 14 quarters

in INR lakhs	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14
Sales	5,395	4,711	4,450	4,644	4,742	3,979	4,078	3,857	4,522	3,674	4,858	4,248	4,960	3,722
Net income	547	334	3,325	5,366	662	594	982	377	596	604	1,554	472	868	552
Net income margin	10.1%	7.1%	74.7%	115.5%	14.0%	14.9%	24.1%	9.8%	13.2%	16.4%	32.0%	11.1%	17.5%	14.8%

Source: Bloomberg

Aptech has better operating fundamentals compared to those of its peers, NIIT and Tree House

Aptech has high ROIC and enough excess cash to fund its working capital requirements. In fact, Aptech is in middle of share buyback program that should increase its EPS and should be beneficial for existing shareholders.

We compare Aptech's ROIC (Figure 5) to that of its peers in the education sector, NIIT and Tree House. Aptech's ROIC, in excess of 50%, is substantially higher than that of NIIT and Treehouse and is primarily driven by its asset light business model. As can be seen in Figure 6, good asset productivity ratio (Revenue/ Invested capital) of Aptech is the main driver of its ROIC (58.2% at end of 1H14) and is the result of low working capital and nil operating leases. Even if Aptech utilizes its excess cash reserves to fund working capital liabilities and maintains working capital to 36% (similar to NIIT) of its invested capital, it can easily command a ROIC in excess of 40% compared to 6% for NIIT. On other hand, Tree House, which is in preschools segment, will have a reduced ROIC of 10.7% (Figure 7) if it maintains operating working capital at 36% of its invested capital. In fact, Tree house will have to fund its operating liabilities by raising more debt or equity as it does not has excess cash or other non-operating assets that can fund its operating working capital requirements. Hence, a big risk for Tree House exists in equity dilution if earnings growth stagnates due to increasing competition in the preschool segment from small players and Tree House continues to grow its asset base at a high rate. No such risk exists for Aptech as it has high ROIC and enough excess cash to fund its working capital requirements. In fact, Aptech is in middle of share buyback program that should increase its EPS and should be beneficial for continuing shareholders.

Figure 5: Consistently better ROIC (excluding goodwill and intangibles) means Aptech's asset light business model is better than that of its peers

	2011	2012	2013	1H14
Aptech	39.0%	60.9%	51.1%	58.2%
NIIT Ltd	24.4%	-1.9%	6.3%	NA
Tree House	11.6%	15.1%	12.6%	13.9%

Source: Company documents

Figure 6: Good asset productivity ratio (Revenues/ Invested capital) is the main driver of Aptech's ROIC

	2011	2012	2013	1H14
Aptech	4.0	4.4	4.2	5.1
NIIT Ltd	2.2	2.1	1.5	
Tree House	0.3	0.4	0.3	0.4

Source: Company documents

Figure 7: Normalized ROIC (excluding goodwill and intangibles) also justifies Aptech's strong operating fundamentals

	Aptech	NIIT Ltd	Tree House
Normalized ROIC	45.0%	6.3%	10.7%

Source: Company documents

Figure 8: Aptech can fund its working capital requirements from internal accruals vs Tree House that has to rely on equity/debt funding

INR lakhs	Aptech	Tree House
Operating working capital (A)	-65	903
PPE and other operating assets (B)	3,786	48,147
Invested capital (C=A+B)	3,720	49,050
Goodwill and intangibles (D)	15,575	3,066
Invested capital including goodwill and intangibles (E=C+D)	19,295	52,117
Excess cash (F)	10,341	-
Other non operating assets (G)	13,470	1,128
Total funds invested (E+F+G)	43,107	53,245

Source: Company documents

Note: Figures as of end of 1H14

Figure 9: EBITDAR/ (Interest + Rentals) - Aptech has substantial cushion against earnings volatility

	2011	2012	2013	1H14
Aptech	5.9	40.6	109.7	131.4
NIIT Ltd	2.1	1.9	1.2	
Tree House	2.5	2.4	2.4	2.7

Source: Company documents

Aptech is undervalued based on fundamentals

In view of strong operating fundamentals, we believe that Aptech is undervalued and deserves a higher valuation. We value Aptech at 1.8x of its book value (INR 62/share at end of FY14E) and 16.4x of its FY14E EPS of INR 6.73 for stock price of INR 110/share, which also means target Net EV/ EBITA of 7.

In view of strong operating fundamentals, we believe that Aptech is undervalued and deserves a higher valuation. We note that Aptech has a strong balance sheet with positive current and cash asset value, and price multiples based on them (Figure 10) clearly indicates undervaluation of its operating assets. Net EV/ EBITA of just 2x for zero debt business with strong balance sheet is another indication of a stock that is undervalued. We believe that Aptech's earnings growth will improve as IT industry demand continues to improve with recovery in US. Aptech has already recorded YoY revenue growth rates of 9%, 9.7% and 3.6% over the past three quarters respectively and we expect 8-10% YoY revenue growth rates in the next four quarters with average net income margin of 15%. We value Aptech at 1.8x of its book value (INR 62/share at end of FY14E) and 16.4x of its FY14E EPS of INR 6.73 for stock price of INR 110/share, which also means target Net EV/ EBITA of 7.

Figure 10: Aptech's price multiples indicate undervaluation

	Aptech
Price to Book value	1.1
Price to current asset value	3.0
Price to cash asset value	5.3
Earnings/Share	6.7
Price/Earnings	10.5
Price/ Average of three year EPS	11.3
Earnings yield	9.5%
Net EV/EBITA	2.0
Dividend yield	6.4%

Source: Google finance, Company documents, Analyst's estimates

Note: EPS has been adjusted for common shares, extraordinary earnings/costs and tax effects

Net EV excludes value of non-operating assets, such as excess cash, investments and loans and advances. EBITA excludes non-operating costs related to defined benefit plans and non-operating income, such as dividend and interest income.

Current asset value and cash asset value are calculated after deducting all liabilities ahead of common stock.

We identify some risk factors that may lead to short term downside in Aptech's stock price:

1) New acquisitions at premium prices can depress ROIC (including goodwill and intangibles) below 10%, rendering the stock unattractive for long term investors. However we believe that Aptech has very little scope for new acquisitions as it has already overpaid for MAAC.
2) IT industry reporting below par growth rates will affect demand for Aptech's course enrolment rate.
3) Continued underperformance from Multimedia and Animation division would mean lower returns than anticipated from Aptech's acquisition of MAAC .

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Contact Details

PRATIBHUTI

Pratibhuti

Regd. & Adm. Off:
3rd Floor, 28 Rajabahadur Mansion,
Mumbai Samachar Marg, Fort,
Mumbai – 400 001. India.
Tel: +91 22 61485300
Fax: +91 22 2265 6905

Corporate Off:
Gr. Floor, 11, Raheja Centre,
Free Press Marg, Nariman Point,
Mumbai – 400 021. India.
Tel: +91 22 6148 5700
Fax: +91 22 6148 5750

E-mail: **onlinehelp@pratibhuti.com**
Website: **www.pratibhuti.com**