

Tree House Education & Accessories Ltd

CRISIL IPO Grade 3/5 (Average)

May 10, 2011

Grading summary

CRISIL has assigned a CRISIL IPO grade of '3/5' (pronounced "three on five") to the proposed IPO of Tree House Education & Accessories Limited (Tree House). This grade indicates that the fundamentals of the IPO are 'average' relative to the other listed equity securities in India. However, this grade is not an opinion on whether the issue price is appropriate in relation to the issue fundamentals. The grade is not a recommendation to buy, sell or hold the graded instrument, its future market price or suitability for a particular investor.

The assigned grade reflects the benefit Tree House will derive, given its strong position, from the expected robust growth in the preschool industry. CRISIL Research expects the highly underpenetrated preschool industry to increase at a CAGR of 21% to Rs 133 bn by FY15. The company, which has an established track record of expanding branches - from 12 in FY07 to 177 as on December 31 2010, is poised for further expansion. Unlike other organised players, Tree House's expansion has been largely through self-operated branches, which has enabled it to ensure quality measures and helped in brand building. The grade also considers the company's bargaining power as a large player due to the large number of self-operated branches as it leads to cost advantages compared to other players who mainly operate through the franchisee route. The grade is further supported by the company's entry into the K-12 (Kindergarten to Class 12) segment, teacher training and other ancillary services, which also have strong business prospects with the expected domestic economic growth and increasing government participation in the K-12 segment.

However, the grade is moderated by an expected increase in competition from other players who are also in the expansion mode. Also, Tree House's aggressive expansion plans face execution challenges. Its major expansion plans cover new geographical areas where it does not have a presence and is therefore, not conversant with local market risks. The preschool industry is marked by low entry barriers which pose a risk to the player's profitability. In preschool industry, word of mouth marketing plays an important role, so any negative publicity can damage the company's brand value. Hence, the grade also takes into account the quality dilution risk given Tree House's aggressive expansion plans. It plans to spend a major part of the IPO proceeds on the K-12 business where it has a limited operating track record.

For the nine months ended December 2010, Tree House reported revenues of Rs 291 mn and a net profit of Rs 71 mn. The 9MFY11 EPS was Rs 2.9 per share with 5.7% RoE.

Contacts:

Media

Mitu Samar
Head, Market Development & Communications

CRISIL Limited
Phone: +91-22-3342 1838
Mobile: +91-9820061934
Fax: +91-22-3342 3001
Email: msamar@crisil.com

Analytical

Tarun Bhatia
Director – Capital Markets
Phone: +91-22-3342 3226
Email: tbhatia@crisil.com

Chetan Majithia
Head, CRISIL Equities
Phone: + 91-22-3342 4148
Email: chetanmajithia@crisil.com

CRISIL Limited
Phone: +91-22-3342 3000
Fax: +91-22 -3342 3501

Client - servicing

Client servicing
Phone: +91-22-3342 3561
Email: clientservicing@crisil.com

About the company

Tree House Education & Accessories Ltd (Tree House) is the largest self-operated preschool education provider in India. It was originally incorporated in 2003 as a proprietorship firm - M/s Tree House - by Rajesh Bhatia and his wife Geeta Bhatia. They started with one preschool in Mumbai. Between 2003 and 2006, the promoters gathered hands-on knowledge and experience to run preschools and gradually increased the total number of preschools run by them in the Mumbai region.

In 2007, the proprietorship firm was acquired by Tree House Education & Accessories Pvt Ltd and started to expand the preschool business. In August 2008, they received the first round of funding from Matrix Partners, a PE investor. This was followed by funding from Foundation Capital in May 2010. As on December 31 2010, Tree House operates 177 centres across 23 cities, out of which 108 are self operated. The company's branches are concentrated in western India, which accounts for more than 72% of all the branches, of which 80% is concentrated in Mumbai. The company has also ventured into ancillary services like preschool teacher training, day care etc. In 2009, the company ventured into the K-12 school segment and manages 12 such schools as on December 31 2010.

Issue details

Shares offered to public	9,696,343*
As per cent of post issue equity	28%
Object of the issue	<ul style="list-style-type: none"> Expansion in preschool business Procurement of exclusivity rights and construction of educational complexes Funding the repayment of the debt availed by the company General corporate purposes
Amount proposed to be raised	Not available at the time of grading
Price band	Not available at the time of grading
Lead managers	JM Financial Consultants Private Ltd and Motilal Oswal Investment Advisors Private Ltd

Source: DRHP

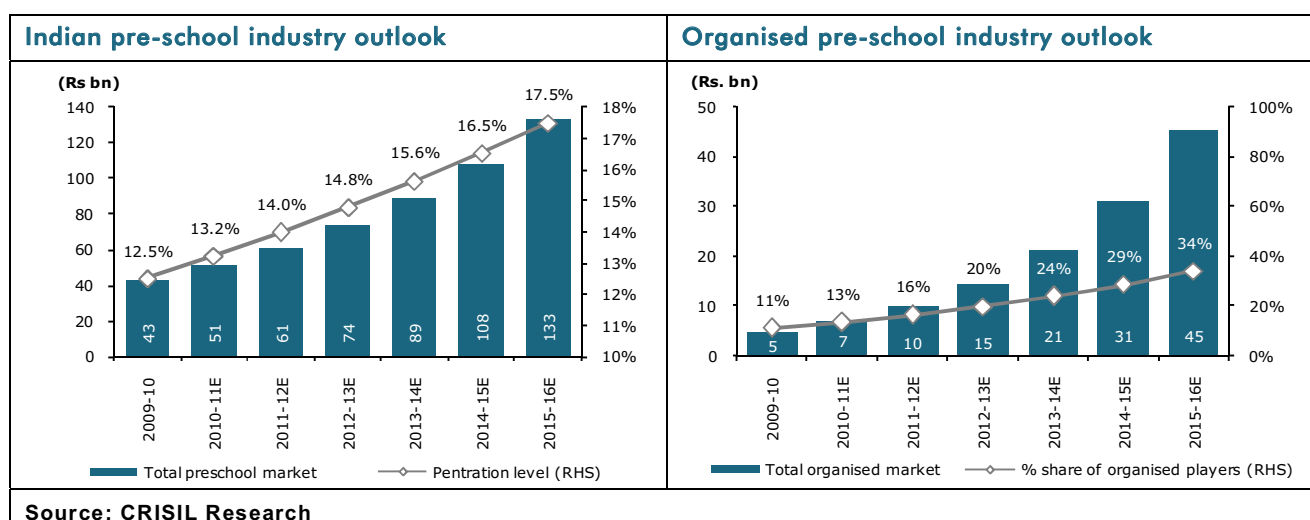
*includes Pre-IPO placement

Detailed Grading Rationale

A. Business Prospects

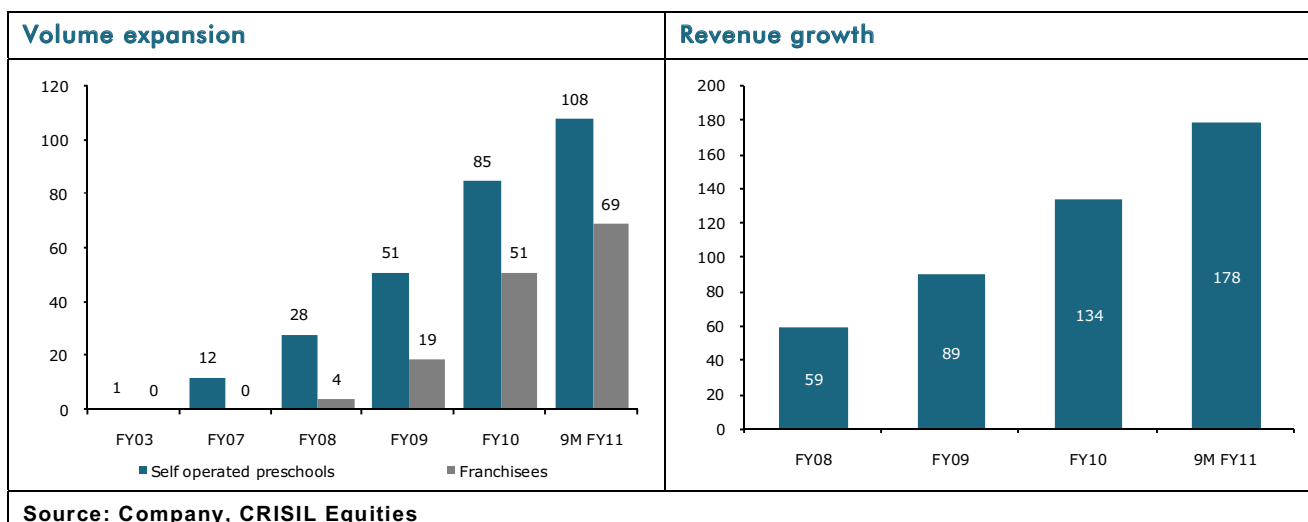
- Robust growth in underpenetrated preschool industry*

The pre-school segment is a part of the informal education category which caters to children between two and four years. The Indian preschool market is highly fragmented and unorganised with only 8-10 organised players operating currently. This is because of low entry barriers and low investment required in the segment. Although the preschool concept is relatively new in India, increasing awareness among parents about the benefits of quality preschool education has been driving the penetration levels in the segment. CRISIL Research expects the preschool market to grow at a CAGR of 20.6% to reach Rs 133 bn in FY15 from Rs 43 bn in FY10. CRISIL Research also expects the share of the organised market to increase from 11% in FY10 to 34% in FY16 on the back of the rising awareness about quality pre-school education, big expansion plans of existing players and the entry of more organised players in the pre-school segment.



- Tree House expanded significantly over the past 4-5 years*

Tree House has scaled up its preschool business at a rapid pace. The number of preschool branches has scaled up from 12 in FY07 to 177 as on December 31, 2010. The company follows a judicious mix of both owned branches and franchisees. The company's branches are concentrated in western India, which accounts for more than 72% of all the branches and out of this 80% is concentrated in Mumbai. The company has also ventured into the K-12 segment and currently provides educational services to 12 K-12 schools.



- Mix of both self-operated and franchised schools helping quality and scalability*

Unlike other players in the preschool segment, Tree House follows both business models seen in this field – self-operated and franchise. Out of the 177 branches, 108 are self operated and 69 are franchisees. While the self-operated model allows better administrative and quality control, it largely lacks the scalability seen in the franchise model. Since preschool caters to children in the two-four year group, quality control is very important as a lack of it may lead to brand dilution. The company follows a judicious mix of both the models to service the franchisees at an optimum cost level.

Self operated vis-à-vis franchisee

Criteria	Self operated	Franchisee
Business elements	Moderate scalability High control on quality No payment related issues	Very High scalability Low control on quality Payment issues High churning ratio
Revenue stream to company	Fee collected from students	One time franchisee fees Royalty fee as a share in revenue Student's kit fees
Cost stream to company	Initial setup cost Operational cost Marketing and advertising expenses	Marketing and advertising expenses Teacher training cost Equipment/Toys cost

Source: CRISIL Research

- Competitive 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 gives Tree House a strong bargaining power and help in managing costs better than both unorganised players and franchisees of the organised players. As property owners prefer to rent out their property to a company rather than to an individual running a business, Tree House enjoys relatively more bargaining power compared to an individual player. The company also purchases equipment on a much larger scale compared to any single franchisee, which further reduces Tree House's operating cost. A franchisee purchases student's kits from the franchisor who charges huge margins, which adds to the overall spend of the franchisee. So Tree House has a lower per branch cost as compared to a franchisee which enables it to maintain a discount in the fees, without hampering margins.

- *Close tab on quality has helped in brand building*

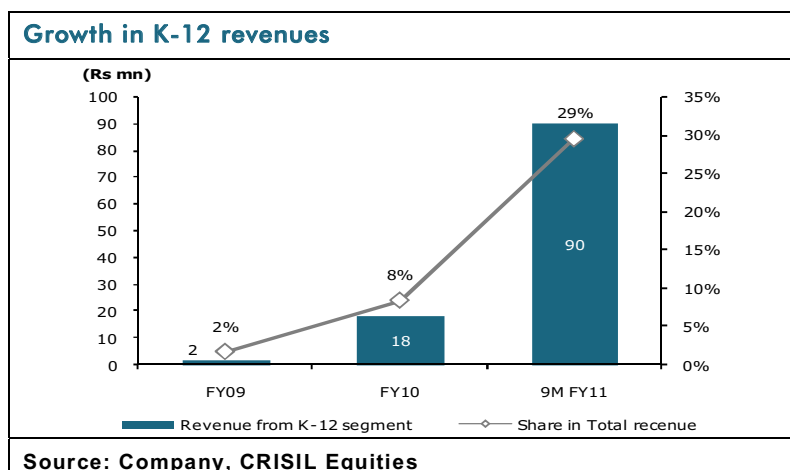
In a short span of time, Tree House has been able to build its brand image in the organised preschool segment to become the largest self-operated preschool chain in the country. To maintain its brand image, the company keeps a check on the quality. It maintains a common infrastructure for all the preschools. It also conducts regular audits and has a close liaison with franchisee owners.

- *Standardised curriculum and teacher training classes*

The company's standardised curriculum and pool of teachers from its own teacher training unit is expected to help in its expansion plans. Tree House has developed its own course curriculum with the help of a team of M.Sc. (Human Development) graduates. The course curriculum is designed to impart quality learning through practical methods in a very structured way. Since 2008, Tree House is running its own preschool teacher training programme which helps in meeting the need for well-trained teachers and also contribute to the company's topline. The classes are conducted in the self-operated preschool's premises, which help the company to enjoy very high margins.

- *Venture in K-12 and other ancillary services*

Tree House entered the K-12 segment in 2009 and currently operates 12 schools as on December 31 2010. For these schools, the company has entered into an exclusive rights arrangement with the schools by paying upfront fees to them. Only for one school in Vadodara, the company has bought the land and building from the builder. The K-12 segment is the second largest contributor to the company's overall revenue.



- *Huge expansion plans on the anvil*

With the help of the IPO proceeds and internal accruals, the company plans to further expand in the preschool segment by opening another 120 preschools by FY14. In the K-12 segment, the company plans to acquire exclusivity rights from seven K-12 schools and construct two brick and mortar educational complexes, one each in Rajasthan and Gujarat. From the IPO proceeds, the company plans to spend Rs 413 mn in preschool expansion and Rs 556 mn for K-12 business expansion. The company has a proven track record of successful expansions – having increased the number of branches from 12 in FY07 to more than 177 branches as on December 31, 2010. So long, the company was largely focusing on western India (especially Mumbai) but is

now planning to expand into new geographical areas. But the lack of knowledge of local market dynamics may pose challenges as the company expands in areas which are currently dominated by other players.

- *Low entry barrier; competition from existing and new players...*

Due to the low capital requirement and lack of regulations, the preschool industry has very low entry barriers. Interested players are already moving in to capture the growth potential in the preschool segment. Most of the players have chosen to operate through the franchisee model in their urgency to grab market share. There are 8-10 organised players (Eurokids, Kidzee, Apple Kids, Shemrock etc) in the segment and a few more - like Camlin and Birla - are expected to enter the segment. We expect the segment-wide competition to increase as most of the players have lined up rapid expansion strategies. However, considering the growing market and low penetration level of the organised players, we believe the field is big enough for each player to grow. We expect players like Tree House to grow faster as it is ahead in the learning curve compared to other players due to its ability to manage both self operated and franchise models unlike many other players.

- *... and from existing K-12 schools*

Most of the K-12 schools have already started preschools in their campuses. The only comfort which they offer to parents is continuing schooling from preschool to secondary classes. Parents do not have to worry for admission in kindergarten once their child takes admission in the preschool. However, this comfort comes at the cost of quality learning. A preschool requires specialised skills and a different social environment – especially in terms of children of the same age group learning in an age-conducive atmosphere. But K-12 schools cater to many students of different age groups. So a preschool in a K-12 school cannot offer the same ambience as that offered by a specialised preschool. But considering the growing parental awareness about early childhood development, we believe there is considerably less threat from K-12 schools entering the preschool segment.

- *Rapid expansion poses a risk of brand dilution in preschool segment*

Tree House plans to expand rapidly through both self-operated and franchised centres. Maintaining a high standard with a growing number of schools and an increasing geographical presence will be a big challenge for Tree House. In preschools, word of mouth marketing plays an important role, so any negative instance - for example failure to meet parental expectations - can damage the brand of the company. Unless the company is able to keep a strict control over quality issues, an aggressive expansion poses a risk to quality and brand presence.

- *Limited operating track record in the K-12 poses a challenge*

Tree House entered the K-12 segment in 2008 and has a limited track record. Using IPO proceeds, the company plans to build brick and mortar schools, which are highly capital-intensive projects. Inability to timely execute and understand the market dynamics could pose challenges in the K-12 expansion plans.

B. Financial Performance

Tree House's revenues have increased at a CAGR of 99% from Rs 54.2 mn in FY08 to Rs 213.75 mn in FY10, primarily on account of expansions in the preschool and the K-12 segments. EBITDA margins expanded from 16% in FY08 to 35% in FY10 due to the increase in the number of students. However, the company reported net profits of Rs 26 mn in FY10 as compared to a loss of Rs 1.9 mn. For the nine-month ended December 2011, the company posted revenues of Rs 291 mn and profits of Rs 71 mn, a 36% and 172% increase over FY10 revenues and profits, respectively. EBITDA margin was 50% whereas PAT margin was 24%.

The company's operating margin is expected to be adversely impacted due to alignment of the lease rentals (effective December 2010) to market rates for 21 properties (out of the 108 self operated) leased by the promoter to the company. However, margin would be supported by increasing scale of operations from the newly opened branches and a higher share of K-12 revenues.

Financial performance snapshot

Particulars	2008	2009	2010	9M FY11
Revenue from operations	54.17	102.65	213.75	290.78
Other income	0.09	3.82	4.96	14.95
Total income	54.26	106.47	218.71	305.73
Centre operating expenses	18.33	33.27	63.13	72.17
Employee cost	7.84	16.67	29.36	34.54
Administrative and other expenses	19.47	32.03	51.06	54.17
EBITDA	8.62	24.5	75.16	144.85
Finance charges	-	0.42	5.76	4.74
Depreciation and amortization	9.4	18.74	29.27	34.69
Profit / (Loss) before tax	-0.78	5.34	40.13	105.42
Provision for taxation	1.13	0.22	14.14	34.64
Net profit / (loss)	-1.91	5.12	25.99	70.78
EBITDA margin	16%	24%	35%	50%
PAT margin	-4%	5%	12%	24%
EPS	nm	0.33	1.5	2.9
ROE	nm	1.1%	3.7%	5.7%

Source: DRHP

C. Management Capabilities and Corporate Governance

- *Capable top management*

Mr. Rajesh Bhatia, promoter and managing director, is an engineer (computer science) and MBA. He worked for 10 years with different companies in financial services prior to his current entrepreneurship. After its learning phase from 2003 to 2006, the company has seen tremendous growth in terms of number of centres as well as revenues. Starting with one centre in 2003, the company has expanded to 177 centres across 23 cities in India. Of the 177 branches, 108 are self operated (the highest in India) and the rest are franchised centres. The management has proven their ability to handle rapid expansions, manage competition as well as operate in cost-intensive areas, especially Mumbai (with high rental costs). The pre school curriculum has been mostly institutionalised leading to uniform and high quality of education across all branches. The management has also set up a teacher training institute which provides additional source of revenue as well meets the need for well-trained teachers. The company has also ventured into the K-12 education segment and currently provides educational services to 12 such schools.

- *Strong second line of management*

The company has a strong second line to support the management. Two key management personnel Mr. Vishal Shah (executive director) and Mr. Utsav Shrivastava (CFO) have been part of the company's growth phase in the past three-four years. The company has recruited a few more key people in the past one year to realign the second line of management with its expansion strategy. The second line of management also includes Mr. Hiren Shah (Chief Finance Controller), Mr. Ravi Warriar (Chief Operating Officer- South India) and Mr. V. Sridhar (Chief Operating Officer- K-12 schools division). We believe that the company will be required to create more bandwidth in line with its expansion plans while retaining employees in the expanding market will be a challenging task.

- *Experienced and reputed independent directors*

The company has qualified independent directors with vast experience in areas of finance and management. The board is chaired by an independent director, Mr. Sanjaya Kulkarni, promoter of 20th Century Finance Corporation. In accordance with our conversation with two of the independent directors, we feel that they are aware of their roles and responsibilities in the company. They have a good understanding about the company's ongoing developments. All the three independent directors have been associated with the company for the past three years. The board also consists of one nominee director each from Martix Partners and Foundation Capital.

- *Adequacy of governance systems & processes*

As per our discussion with the independent directors, we feel that the governance practices are good. Agenda papers for board meeting are generally sent 5-7 days in advance. The presence of private equity investors has also improved the company's system and processes. In 2009, there was a delay in the payment of direct taxes due to inadequate systems. However, the company has rectified its system and processes and plans to implement an ERP system for better control for increasing scale of operations.

Annexure I

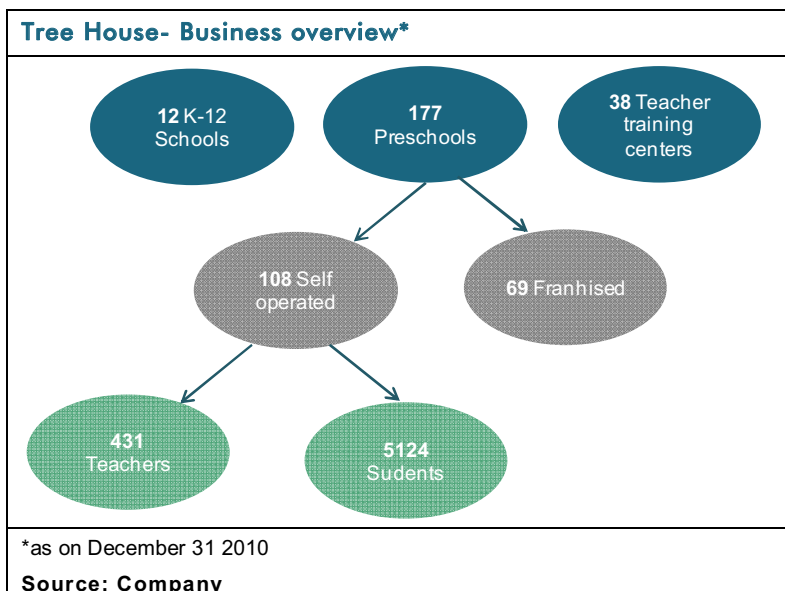
Business Profile

• *Business overview*

Mumbai-based Tree House runs 177 preschools and provides services to 12 K-12 schools in India. Out of the 177 centres, the company runs 108 self-operated schools and the rest are franchises. Tree House also provides preschool teacher training and day care centres under the brand Muskaan.

Key milestones

2003	Set up its first self owned preschool in Mumbai
2006	Set up 6 more pre schools
2007	<ul style="list-style-type: none"> Acquired proprietorship firm M/s Tree House Launched first franchised pre-school
2008	Launched preschool teacher training programme
2009	<ul style="list-style-type: none"> Roped Matrix Partners India Investment Holdings, LLC as an investor with investment of Rs. 350 mn Ventured in K-12 schools segment by providing educational services Started day care centres under the name 'Muskaan'
2010	Received further investment of Rs. 150 mn from Matrix Partners Investment Holding, LLC
2011	Received further investment of Rs. 310 million and Rs. 90 million from FC VI India Venture (Mauritius) Limited and Matrix Partners Investment Holding, LLC, respectively



• *Preschools and other ancillary services*

The preschool segment caters to children aged two to four years. A preschool provides learning using various known methodologies like the Play Way method, Montessori method, etc. Usually schools run batches in two shifts per day of two hours each. Unlike most other industry players, Tree House runs a mix of both self operated and franchised centres in the preschool segment. The company follows the strategy of having self operated preschools in Tier 1 and Tier 2 cities and franchisees in other cities. As a result, most of the self-

operated centres are located in cities like Mumbai, Bangalore, Hyderabad and Ahmedabad. This helps the company to have a strict control over the quality of course curriculum, infrastructure and teachers.

Tree House has developed a standard curriculum which is strictly followed by all self operated and franchised centres. Course curriculum is framed considering various prevailing methodologies followed by preschools in India and abroad. The course has been further standardised day-wise and minute-wise. Tree House also provides teacher training for preschool teachers which fulfills its teachers requirements and also provides additional source of revenue. The company has a strong team of trainers who are Masters in Science in subjects like human development and early childhood care. These trainers have been entrusted with the regular task of updating curriculum as well as quality control of branches. Some centres of Tree House also provide day care centre facility under the name Muskaan, which is being managed by the centre head of the school.

• *K-12 schools*

The K-12 segment represents education from kindergarten to higher secondary. Tree House provides education services to 12 such schools in India. Its services consist of infrastructure development, marketing and brand building, course curriculum aids etc. The company plans to develop educational complexes in Jhunjhunu, Rajasthan and Vadodara, Gujarat. These educational complexes will include classrooms, living accommodation for students, library, computer, laboratory and primary health centre along with indoor and outdoor recreation.

Name of the trust	No. of Schools	Location
Dixit Education Trust	2	Thane, Kalyan (Maharashtra)
Mira Education Trust	2	Vadodara (Gujarat)
Bhartiya Vidhya Mandir Samiti	2	Jhunjhunu (Rajasthan)
Vidya Bharti Sansthan	6	Sikar (Rajasthan)
Total	12	

The company operates the K-12 segment through two business models:

Exclusivity rights

In this model, the company pays an upfront fee towards exclusivity rights, which entitles the company to provide facilitation services to schools for 30 years against which the company is entitled to a share of the revenue or a minimum guaranteed payment, whichever is higher. This arrangement is common across the industry.

Brick and mortar schools

In the second model, the company owns the land and constructs a school. The company is setting up two educational complexes with seating capacities for 3,000 and 1,200 students in Jhunjhunu, Rajasthan and Vadodara, Gujarat, respectively. These educational complexes will consist of classrooms and also facilities such as accommodation for students, library, computer laboratory, science laboratory, guest house for visiting faculty, staff quarters, provision for utilities like departmental store, bank facilities etc. Total cost of setting up these educational complexes is expected to be ~ Rs. 402.7 mn.

Annexure II: Profile of the Directors

Name	Designation	Age	Qualification	Yrs of Experience	Previous Employment	Directorships / partnership in other entities
Mr. Sanjaya Kulkarni	Non- Executive Independent Chairman	61	B.Tech. (IIT-Mumbai), PGDM (IIM-A)	30	Promoted 20th Century Finance Corporation Ltd, worked with Citibank	UTV Global Broadcasting Ltd, UTV Software Communications Ltd, Time Technoplast Ltd, Agro Tech Foods Ltd
Mr. Rajesh Bhatia	Managing Director	41	BE (MS University, Baroda), MBA (Pune University)	18	Worked with 20th Century Finance Corporation , Motilal Oswal and Indsec Securities Ltd	Madhav Education and Research Institute India Private Ltd, Khemi Investments and Consultancy Private Ltd
Mr. Vishal Shah	Executive Director	39	B.Com (Mumbai University), PDGM (NMIMS)	16	Worked with Apple Finance Ltd, Indsec Securities Ltd	Dhiranand Engineers Private Ltd
Mrs. Geeta Bhatia	Non Executive Director	37	B.Com (Mumbai University)	7	No previous experience	Madhav Education and Research Institute India Private Ltd, Khemi Investments and Consultancy Private Ltd
Mr. T.S. Sarangpani	Independent Director	62	BE and MBA (University of Madras)	32	Worked with 20th Century Venture Capital, TAIB Bank in Bahrain and West Merchant Bank at London	NA
Mr. Parantap Dave	Independent Director	49	B.Com., CA	25	Independent consultant in the area of finance, banking, accounts, audit, taxation, legal, project and general management and commercial matters.	Mas Service Ltd, Spectrum International Private Ltd and Dhanipa Management Services Private Ltd
Mr. Ashu Garg	Nominee Director (FC VI India Venture (Mauritius) Ltd)	40	B.Tech. (IIT-Delhi), PGDM (IIM-B)	15	Worked with McKinsey & Company and Hindustan Unilever. Co-founded Aptech Internet, in partnership with Aptech Ltd.	Vienova Technology Private Ltd, Agni Property Services Private Ltd
Mr. Rishi Navani	Nominee Director (Matrix Partners India Investment Holdings)	37	B.A. (Northwestern University), MBA (Wharton School, University of Pennsylvania)	10	Worked as MD at West Bridge Capital Partners. Also worked in management consulting at A.T. Kearney and McKinsey & Company;	FIITJEE Ltd, Brand Marketing (India) Private Ltd, Matrix India Asset Advisors Private Ltd

Source: DRHP

Disclaimer

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