K12 Inc. (LRN)
Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

				FY Jun	2013A	2014E	2015E
Price ($) (5/20/14):	**22.85**	**Rating:**	**Neutral**	Q1	0.11A	(0.13)A	
52WK H-L ($) :	**38 - 17**	**Suitability:**	**Higher Risk**	Q2	0.24A	0.36A	
Market Cap (mil):	**905**	**Price Target ($) :**	**24**	Q3	0.31A	0.40A	
Shares Out (mil):	39.6	L-Term Rev. Gr Rate Est:	7%	Q4	0.06A	0.18E	
Float (mil):	32.0	L-Term EPS Gr Rate Est:	10%	**Total**	**0.72A**	**0.83E**	**1.01E**
Avg. Daily Vol (mil):	323,930	Debt/Cap:	6.4%	FY P/E	31.7x	27.5x	22.6x
Dividend ($) :	0.00	ROE:	5.0%	**EPS (Cal)**	**0.59A**	**0.95E**	
Yield (%):	0.0	Insider Holdings:	18.1%	P/E (Cal)	38.7x	24.1x	

Headquartered	**IPO/Founded**
Herndon, VA	2007/2000

Management

Executive Chairman & CEO:	Nathaniel Davis
President & COO:	Timothy Murray
CFO:	James Rhyu
VP-Investor Relations:	Mike Kraft

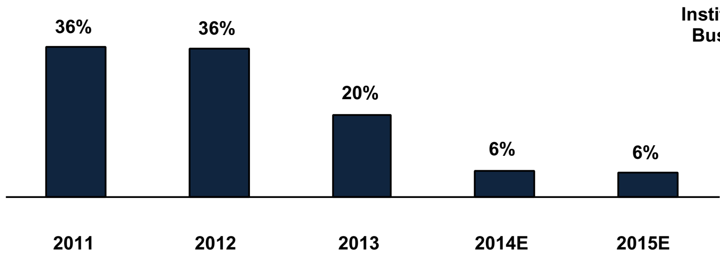
Jun	**2013A**	**2014E**	**2015E**
Revenue (Mil)	848.2	908.0	960.9
% Growth	19.7%	7.1%	5.8%
Operating Margin	5.4%	5.8%	6.9%
EBITDA Margin	13.1%	13.6%	14.5%
EV/EBITDA	6.9x	6.3x	5.5x

Company Description

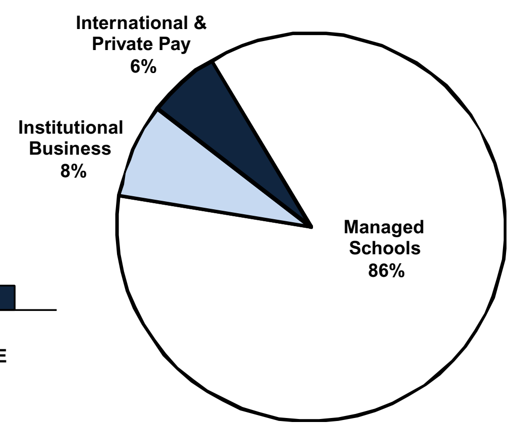
K12 Inc., founded in 2000 and headquartered in Herndon, Virginia, is a technology-based education company that offers proprietary curriculum, software, and management services predominately for online delivery to students in kindergarten through 12th grade, or K-12. The company's primary market focus is the virtual or online public school industry. As of March 31, K12 enrolled approximately 125,000 students across 33 states and D.C. in its managed public school business. K12 also sells its proprietary curriculum to school districts, schools, and home school families, and operates a number of private schools.

Revenue Profile

Revenue (% Change) Trend



F2013 Revenue Breakdown



Source: Company reports and Robert W. Baird & Co. estimates.

Competition

Virtual school competition includes:

- **For-Profit Virtual Schools** including Connections Academy (owned by PSO), Advanced Academics (owned by DV within discontinued operations), and White Hat Management.
- **State-operated Virtual Schools**
- **Traditional Public Schools, Private Schools, and Charter Schools**

Institutional business competition includes:

- **Online curriculum providers** including Apex Learning, Compass Learning, edmentum, OdysseyWare, and Renaissance Learning.
- **Traditional textbook publishers** including McGraw-Hill, Pearson, and Houghton Mifflin Harcourt.

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Quick Summary

Our Neutral rating is based on the following:

- **FQ3 solid quarter, clean beat** driven by a combination of good expense management and upside vs. our estimate in managed public schools revenue per enrollment. Revenue and EBIT both met the high end of managment's guidance range. Notably, SG&A expense was actually down slightly y/y despite 8% revenue growth, driven by a full quarter of expense savings from the Q2 expense/restructuring actions coupled with comping against a period when LRN was ramping its capacity in anticipation of an enrollment level that was greater than ultimately materialized.
- **Question of growth likely to linger until beginning of 2014-15 school year.** We believe a wide range of outcomes are possible (including a potential enrollment decline, although that is not our "base case") as management tries to strike a balance of improving educational outcomes (its self-described number one priority), improving its operational processes and marketing that facilitate enrollment, driving enrollment growth, and achieving profitability.
- **Valuation screens attractive, but lacks catalyst, in our view.** While a current ~6x EV/EBITDA multiple may attract investors, especially given LRN's longer-term historical track record, in our view, valuation is not as attractive as it may appear given the capex-intensive nature of LRNs's business model. Additionally, any significant growth acceleration is unlikely to materialize over F'14, given the full-year impact of the company's key fall enrollment period, and in our view, back-end loaded F'14 guidance appears at risk.

Our $24 price target reflects 5.8x EV/our NTM EBITDA estimate, near the low end of LRN's historical multiple (5.4x-12.5x over last two years) given its slowing growth and our view of significant risks to returning to its prior growth trajectory, and reflects ~20x our F'15 EPS estimate ex. net cash per share (ex. capital leases).

Other valuation thoughts. While a current ~6x EV/EBITDA multiple may attract investors, especially given LRN’s longer-term historical track record, in our view, valuation is not as attractive as it may appear given the capex-intensive nature of LRN’s business model. Guidance calls for $75mn-$85mn of “all-in” capex, which using the mid-point against our F’14 EBITDA estimate implies $43mn in EBITDA less capex, against which LRN shares trade at 18.9x EV/(EBITDA less capex). We were previously more comfortable with an elevated EV/(EBITDA less capex) multiple given that LRN has started to achieve strong capex leverage (capex was roughly flat yoy in F’13 on 28% EBITDA growth) and given that we previously expected strong EBITDA growth to continue intermediate term. However, with our new downwardly revised EBITDA growth estimate, we now also expect materially slower “normalized” FCF growth (normalizing for the working capital intensive nature of LRN’s business model, which requires a working capital investment for growth, but for which A/R write-offs have historically been immaterial). Consequently, on a FCF/DCF basis (based on our current estimates/outlook), we do not believe that the shares appear as attractive as it may appear as if one uses EBITDA as a short-hand proxy for cash flow. That said, we also recognize that LRN shares often appear to “trade on” EV/EBITDA multiples.

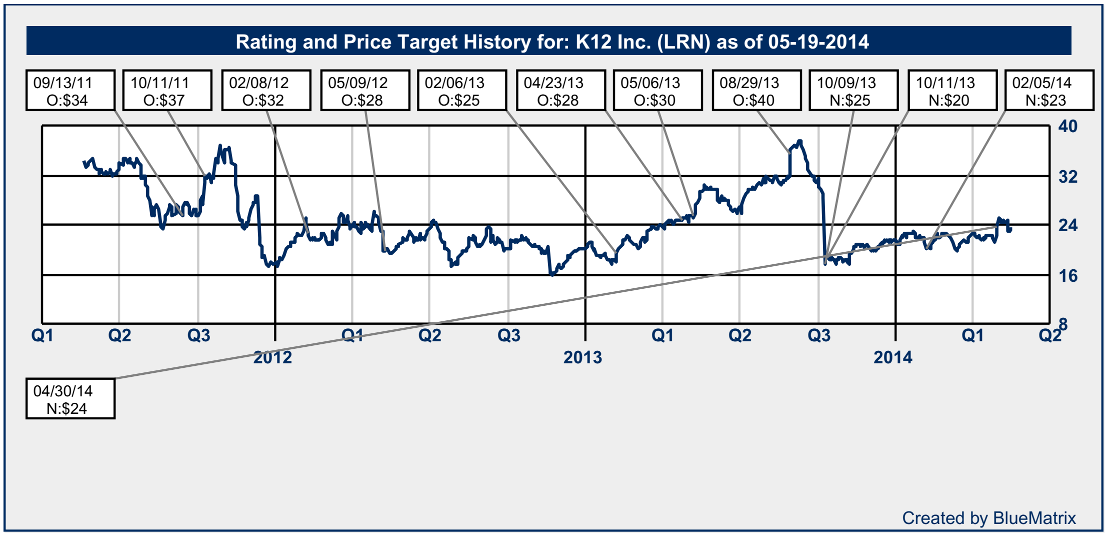
Investment Thesis

Solid growth opportunity. K12 expects to drive growth through enrollment growth at existing schools, expanding to new states, selling curriculum to traditional schools for in-class use, and increasing direct-to-consumer sales. According to the National Center for Education Statistics (NCES), there were nearly 50 million students in K-12 public schools during the 2010-11 school year. In addition, approximately two million students are home schooled and approximately six million students are enrolled in private schools. Capturing just two million (3.5%) of the addressable market yields a market opportunity of approximately $12 billion. Over the next three years, we believe that the company is capable of 7%+ organic revenue growth with modest margin expansion.
Market leader in market with barriers to entry. K12 enrolled its first students in September 2001 and currently enrolls approximately 125,000 students in its managed public schools, more than K12's three largest competitors combined. LRN continues to widen its leadership position in a secular growth market, enabling it to invest materially more than competitors in systems/curriculum, etc., further enhancing its competitive advantage.
Scalable financial model. LRN is the scale provider in what should be a solid incremental margin business (operating leverage on systems and curriculum), and per pupil funding appears to be stabilizing on an apples-for-apples basis as state tax collections improve.
Proprietary curriculum/technology. We believe K12's proprietary curriculum and technology are a key point of differentiation for the company. Approximately 90% of K12's curriculum was developed in-house and contains more than 700 courses and over 100,000 hours of instructional content, which combine technology, such as flash animation and interactivity, with text books and other offline course materials. K12 has invested over $350 million in the development of its curriculum and systems.
Competency in lobbying in new states. Another key point of differentiation is K12's success in working closely with state policymakers and school districts to enable the expansion of virtual schools into new states or districts. The company has years of experience in successfully lobbying to get legislation passed to allow virtual schools to operate. It is also one of only a handful of providers with first-mover advantage in a market where state-by-state approvals are key.

Risks & Caveats

Regulatory issues. K12's schools are subject to state government regulations and licensing requirements. Failure of any school to comply with the requirements could result in sanctions, fines, probation, or in severe cases, revocation of its license.
Competition. The market for primary and secondary education is competitive. K12 competes against other virtual schools, charter schools, and public schools as well as private schools and home schooling.
K-12 funding cyclicality. K-12 funding is tied to state budgets and tax revenues, which are impacted by economic cycles. Funding generally lags broader economic trends. Average per-pupil funding has been reduced over the last several years.
Delay in opening new states. K12 spends time and money lobbying state legislators to create and vote for bills that would permit and fund the virtual charter schools. Potential delays or lack of success could impact potential growth.
Teacher unions. K12 has faced opposition from teacher unions while lobbying for legislation and unions may continue to resist the company's efforts to operate or expand. The company was previously involved in two lawsuits concerning virtual charter school laws, both involving teachers unions, which were resolved in favor of the company.
Concentration. We estimate that the company's 10 largest states account for roughly 75% of total managed school enrollment, including roughly 40% in its three largest states. Future revenue could be significantly impacted by any decline in the funding levels or in enrollment, the loss of a contract, or a legal challenge to one of its key schools/states.
Cash collections. DSO is inherently high in LRN's business model. However, bad debt expense has historically been minimal for LRN, and the quality of its receivables appears high given that it is primarily cash due from states.
Accounting/systems risks. LRN recently implemented a new ERP system, which contributed to a delay in the company's F'11 10-K filing and F1Q12 10-Q filing, which constituted a material weakness in internal controls. However, the material weakness has since been remediated and recent 10-Qs and the most recent 10-K have been filed without delay.

Appendix - Important Disclosures and Analyst Certification



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