INSIGHT.

The Journal of the American Chamber of Commerce in Shanghai - Insight November/December 2021

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INTO NEW TERRITORY

China is driving ahead with changes to a wide swath of its economy, from real estate to auto and education.

What do the changes mean for American companies?

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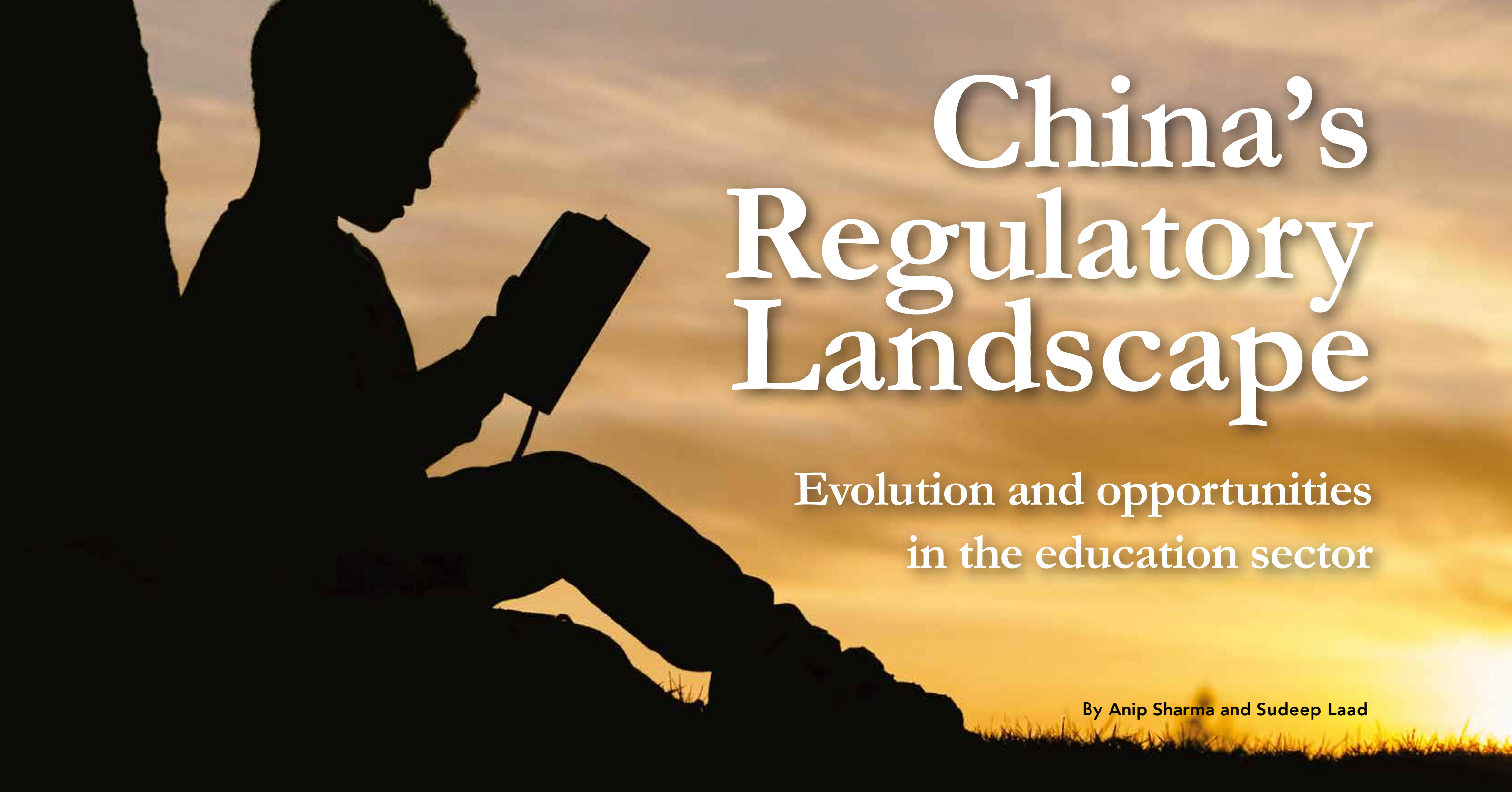

China's Regulatory Landscape

Evolution and opportunities in the education sector

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China's education sector is one of the largest, deepest and fastest growing in the world. However, overnight regulatory changes are impacting stakeholders in significant ways. Is this the end of the road for investment opportunities in Chinese education? Or are there segments that offer potential for new investors and existing operators with legacy investments in the sector?

Background

China has one of the largest education markets in the world, with an estimated $300 billion in annual revenue. The landscape broadly includes three sectors: formal education, supplementary education and education services. **Formal education** covers kindergarten, primary and secondary school, high school, secondary vocational education and training and higher education focused on adults. **Supplementary education** covers early childhood enrichment and care, K-12 academic tutoring, K-12 enrichment, junior English language training (ELT), foreign counselling and test prep, skill-based vocational training, white collar professional development, adult tertiary programs and corporate training. Finally, **education services** include education software (including LMS, SaaS, etc.), education content, education supplies and online program management.

Education spending in China is driven by a large population with parents who are increasingly pursuing an agenda of premium and high-quality education *(Figure 1)*.

In addition to growing K-12 spending, parents are also spending on upskilling, vocational training, corporate training and continuous learning. This has created massive demand for high-quality private education offerings (all recent sectoral growth has been in the private rather than public education sector). As of 2019, approximately 19 million children in China were enrolled in K-12 private education, 10% of the total K-12 student population.

Thematically, the three important and dominant trends in the Chinese education sector are:

Internationalization: Overseas education continues to be a priority for Chinese parents, with the US as a top destination choice. This is driving demand for English language and test prep training. Even young Chinese who remain at home for higher studies and work regard English as a "must have" skill. They're also increasingly seeking international professional certifications from foreign universities and content providers, which they believe can improve career prospects.

Premiumization: Rising per capita disposable income in urban China and the emergence of education as "the ultimate

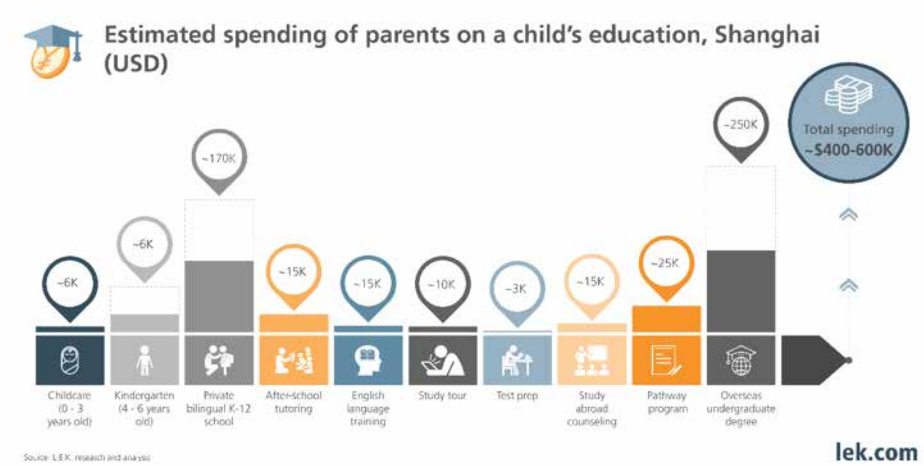

Figure 1

consumer good" has driven demand for premium education. Bilingual schools are growing at 15-20%, with the premium segment growing the fastest. This willingness to spend more for higher quality is driven by perception of value, success rate for outcomes including acceptance to top-tier foreign universities, expectations on outcomes and brand reputation, especially in English proficiency, where legacy brands like Harrow International School, Dulwich College and Westminster School are in demand.

Digitization: Chinese consumers, who traditionally display an "online first" eagerness, are willing to engage with digital education, driving the proliferation of online models. China has 250 million school-age children and an internet penetration level of approximately 60%. These 150 million 'online children' collectively consume nearly 280 million hours of screen time daily and, of this, almost 45% — or 120 million hours a day — is educational. Additionally, growing device proliferation plus internet penetration means that a large pool of untapped learners in tier three to five tier Chinese cities are skipping offline training centers and going directly online. A growing integration of online and offline learning methods has been observed, which represents a substantial opportunity for providers offering tutoring and enrichment programs in either mode.

Regulatory headwinds

Current regulatory conditions have called into question investable opportunities in China's compulsory education space, where regulatory intervention was already high. Recent regulations however have made even the afterschool and ELT segments a challenging space for both investors and operators *(Figure 2)*. The challenge for investors centers around the inability to invest in key, high growth sectors of Chinese education

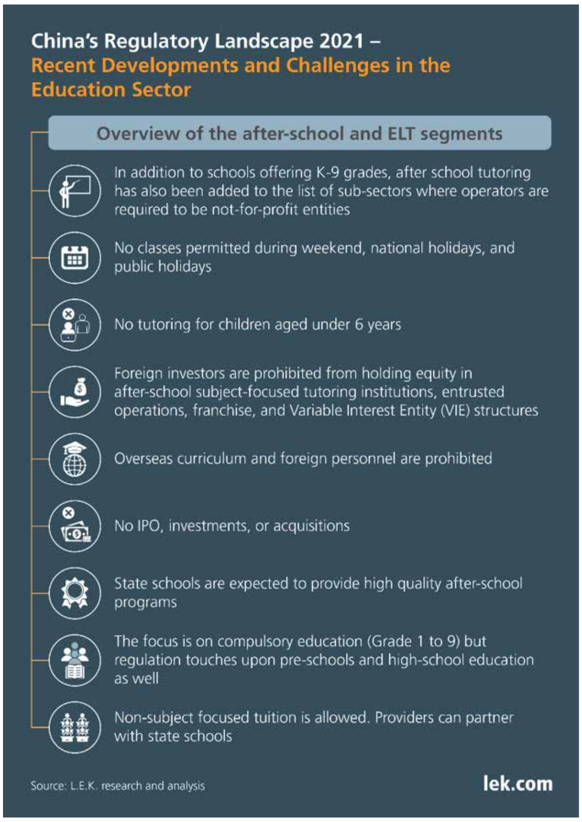

Figure 2

while for operators in segments with high regulatory overhang, the main challenge is access to growth capital.

The impact of these regulatory headwinds is evident in the stock price performance of listed education companies, particularly those in afterschool tutoring and some K-12 players, such as Tianli Education and Lixiang Education. Continued regulatory tightening is creating downward pressure on stock prices in these segments, on top of already softening Chinese equity markets. Of the 30 largest listed global education companies, only seven are Chinese – down from nine in 2019. In contrast, post-IPO stock prices for higher education and vocational training space players have been more resilient.

Historically, the story of the regulatory environment in China has been one of overreach (tightening) and subsequent relaxation (loosening). This is evidenced by:

- The Chinese higher education sector grew rapidly through private participation for over two decades after the economy opened, until a crackdown in the last decade, primarily to weed out low quality operators and unaccredited foreign institutions.
- Similarly, the international student counselling market has seen the progressive tightening and loosening of requirements for study abroad agencies, resulting in an alternating cycle of consolidation and fragmentation. The ELT sector has witnessed a similar pattern.

Implications and opportunities going forward

Despite these regulatory burdens, China remains one of the world's most vibrant education markets and presents a range of opportunities for investors *(Figure 3)*. While demand-side drivers will remain strong, regulatory headwinds will be greater for operators and investors in some segments, some others will be relatively immune and yet others may even see tailwinds. The fast-growing ELT industry, for example, may bear some of the most negative impacts, especially due to restrictions on recruitment of foreign teachers, since most premium online and offline providers rely on native English-speaking tutors. The ideal opportunities for investors will lie in the following areas.

Areas outside regulatory purview

Early years enrichment and care

Early Childhood Education (ECE) is likely to sustain its current growth. This is driven by multiple factors, including the relaxations of China's one child policy, growing ECE affordability and the growing popularity of more holistic and well-rounded ECE beyond just childcare. Given these factors, leading providers are in a position to further consolidate the market. Childcare offers higher margins and slightly better growth prospects than the enrichment segment. Critical success factors for ECE players will be market coverage, brand impact, innovation and cost effectiveness. Major players include children's fitness center chain MyGym and clothing store brand Gymboree (both offering enrichment products), as well as RYB (offering childcare + enrichment). While the childcare sector has lower rates per hour and enrollments compared to enrichment, its average margins are much higher (30-40% EBITDA margins, versus 20-25% for enrichment).

White collar professional development and upskilling

Increased competition in the domestic job market and growing demand for professional upskilling across industries will continue to drive high growth rates in this segment. Barring civil service test prep, other segments are fragmented and offer consolidation opportunities. Critical success factors include increasing teacher utilization/reducing teacher churn, reducing customer acquisition cost (CAC), and upselling/cross-selling. Globally, this is a fast-growing segment and it has emerged as a large industry in itself with providers like Great Learning, Emeritus and Upgrad all securing multiple rounds of funding. These and other local providers are showing great traction in Asia, Europe and Latin America in high demand areas like IT, data science, leadership and analytics. Major players in China include ITCast, Tarena (both IT focused) and Golden Finance (certification test prep for courses like CPA, CFA, CMA, ACCA).

Education software and services

At-home consumption of educational content is likely to see growth given recent regulatory changes. With this, the education software market in China is expected to grow at more than 20% annually for the next few years; large system integrators, such as Jia Fa IE, with their higher profit margins, and vertical providers, such as Seentao, with strong product advantages are likely to win. Impetus from Covid-19, industry consolidation, wider service offerings (K-12 players such as Yuanfudao and Zhangmen are expanding into the logic and coding tutoring business), and growth opportunities in third to fifth tier cities will drive growth. Critical success factors for companies will be end-to-end offerings that can capture a larger market share, the ability to develop and tailor products that cater to a larger consumer base and strong partner distribution networks that lower CAC and widen the user base.

Figure 3

Tutoring in non-subject areas

Tailwinds exist for non-subject focused enrichment providers in areas such as art, coding, music and sports and other supplementary education products. Besides these, opportunities exist in Technical and Vocational Education and Training (TVET), lifelong learning and adult education. Subject-oriented sectors including logic, coding, Chinese and arts and music are also very popular. Top firms such as Huohua, VipThink and Zhangmen have taken over 80% of market share in this segment and have raised multiple rounds of funding.

Outbound opportunities

Incumbents can look at regional and international expansion and focus on outbound opportunities, while leveraging the infrastructure and capabilities they have developed in China.

Overseas education demand is likely to grow rapidly. In response, some K-12 providers such as Maple Leaf, which acquired CIS in Singapore, as well as Bright Scholar, are increasingly looking at acquisition and expansion opportunities outside China. Tutoring and ELT companies could potentially look at adjacent markets in Southeast Asia, India and beyond where demand for similar products is robust. ELT companies could also diversify into teaching Mandarin outside China, given the huge global interest in China. Lingo Bus (a part of VIPKID) is an online learning platform that has enrolled 4-to-15-year-olds from several countries in its Mandarin learning programs.

Conclusion

The current regulatory conditions are painful and will likely persist. This calls for a shift in focus by existing operators and investors. In the early childhood and K-12 space, operators will need to consider global or regional expansion owing to greater regulatory overhang. Service providers would do well to review their offerings and disengage their better protected enrichment offerings from school performance. Instead, they should develop more 'at home' digital learning products, with a focus on online higher education and continuous education. Meanwhile, the most attractive segments from regulatory and economic opportunity points of view are likely to be early childhood enrichment and care, higher education, TVET and the continuing education space. I