Herd immunity

Valuations of private school assets are set to recalibrate due to the coronavirus conundrum. But attrition will not be spread evenly across the sector, as school groups will emerge from the pandemic stronger than ever, often at the expense of stand-alone institutions, writes **Josh O'Neill**

Now is not a comfortable time to be the proprietor of a stand-alone private school. Consultancy EY-Parthenon says that the British private school market could shrink by 7% due to the Covid-19 pandemic, putting at risk as many as 180 institutions. More conservative forecasts predict that 100 will be wiped out if a 3% contraction occurs.

Similar predictions are echoed in other parts of the world, as enrolments of international students have fallen sharply while domestic parents have lost jobs and income, spurring transfers of pupils to state schools and cheaper private alternatives. Most at-risk are institutions with relatively low student numbers – think of a family-owned village prep school – and boarding schools whose margins are supplemented by lots of international pupils paying higher fees.

So far, at least nine British independent schools have folded. As many as 30 more are said to be on the brink of insolvency. Fast approaching administration, some school owners have drafted in advisors to explore quick-fire sales. With distress and uncertainty plaguing the K12 market, in which valuations have arguably been toppy in recent years, some say that a correction to pricing is inevitable (and perhaps overdue). While this may be true for some schools, it is certainly not for all. Compelling arguments – and evidence – suggest that while price-to-earnings multiples paid for single-site schools will diminish, valuations of school groups will remain robust.

Ashwin Assomull, a partner at L.E.K. Consulting's global education practice, says that school groups are better capitalised and have wider access to funding than single-site institutions. This means they are more likely to be comfortable absorbing the kind of losses that could wipe out single-site schools. A shrewd investor will tell you that diversification is key when it comes to picking stocks. The same can be said of private schools and weathering a pandemic.

"Pushed to the wall by Covid, so many single-site schools will be available at lower multiples," says Assomull, who estimates that the top-eight global private school operators will expand their market share by 5-10% over the next five years, due in part to coronavirus-induced consolidation. "Even well-reputed family-run schools might struggle to sustain a 10-15% drop in enrolments.

"Meanwhile, investors will see that 'big is beautiful' amid the distress. There will be a flight to quality. School platforms will become more sought-after, and [price-to-earnings] multiples at which they trade will remain strong."

Evidence supporting this theory can be found in recent transactions.

Singapore's Canadian International School, which although not technically a group has 3,500 students enrolled across two campuses, was bought in June at the height of the pandemic by China-based operator Maple Leaf for £386 million, equal to 14-times its annual earnings. Auctioneers had been asking for between 15- and 17-times EBITDA, so, coronavirus considered, the price paid to Southern Capital, the school's former private equity owner, was enviable.

Premium schools group Inspired Education, whose chief executive this publication interviews on pages 22-25, was valued at €3.05 billion – 20-times its EBITDA – on receiving a €350 million investment from GIC, a Singaporean sovereign wealth fund, in exchange for a 15% stake. The deal was agreed with terms unchanged in March, by when Inspired's schools in Italy, Spain, Bahrain, Vietnam, New Zealand, Australia and South Africa had closed down in response to lockdown measures.

Meanwhile, a UK prep school which taught Prime Minister Boris Johnson couldn't leverage its Eton-feeding credentials to secure a future once the coronavirus infected its balance sheet. Tom Beardmore-Gray, chief executive of the Cothill Trust, which owns Ashdown House, said that he expected the 177-year-old school to be less than a third full come September. "Closing the school is the only remaining option," he said in June. Hundreds of private school proprietors in the UK – and thousands worldwide – will almost certainly be forced to do the same. That, or offload their cash-strapped schools for the value of the property (if owned outright, that is). It is difficult to run a competitive auction based on a multiple of earnings if they are in – or heading towards – negative territory. If a school lacks tangible assets and simultaneously is undersubscribed, there may not be much of a business to sell. ▶

Insulated, but not immune

Still, school groups are by no means immune to the financial effects of the coronavirus. Most have eaten into margins by creating hardship funds, issuing refunds and discounts, rolling out new technology and maintaining staff salaries in the face of falling enrolments.

"I don't know of any school group that won't take a hit to profits of at least 10-20% this year," says an M&A advisor to private school proprietors. "Any that say they won't take a hit are lying."

Indeed, some schools belonging to groups have already fallen victim to Covid-19. GEMS Education, the United Arab Emirates' largest private school chain, which is backed by CVC Capital Partners, announced in June that it would close one of its schools in Dubai, which taught 1,500 students. The move came after ratings agency Moody's downgraded its outlook on the $5 billion operator to 'negative', reflecting the risk that the pandemic would negatively affect cash flows and could "jeopardise" GEMS' ability to reduce its debt burden. Moody's estimated that GEMS, which runs more than 60 schools worldwide, would require around $40 million of additional working capital this year to cover shortfalls in tuition fees.

Shelter from the storm

Despite warnings that some require large sums of cash, it is accepted that school groups are better insulated from economic turbulence than stand-alones. Schools belonging to GEMS, Cognita, Nord Anglia, ISP and Inspired Education, for example, can fall back on shared resources and expertise. They can learn more quickly from the experience of sister schools in other countries where lockdowns have eased and reopening is permitted. If a school owned by a group is forced to close down, its students can often transfer to a nearby sister school, alleviating some of the social distress imposed on pupils while keeping parents sweet. Groups also tend to have "better marketing and student-recruitment machines", says Assomull.

Recent corporate ploys by school groups signal a reliance on investors' confidence in the long-term prospects of the K12 sector. They also highlight the efficiency with which they can raise large sums of money – and at reasonable rates.

In June, Hong Kong-based premium school operator Nord Anglia was reported to be looking to raise €150 million of debt via Deutsche Bank, HSBC and J.P. Morgan. According to a source familiar with the group's strategy, the money would "mainly" be used to fund expansion through acquisitions of schools, many of which will be distressed. Considering the current economic environment, paying interest of 325 basis points – or 3.25% – on notes maturing in four years' time seems like a pretty good deal for Nord Anglia. Commenting on the premium, one corporate lawyer says: "It's pretty low, assuming the debt is secured. I bet it won't be provided by old-school investors."

In nearby Foshan, China, one of the mainland's biggest bilingual school operators could be preparing to expand its international footprint. Bright Scholar, which is listed in New York, last year spent nearly £200 million on CATS Colleges, an international network of independent schools, and a pair of private schools in the UK, after taking its first steps outside China in 2018, when it bought Bournemouth Collegiate School on the English south coast. According to Fitch Ratings, Bright Scholar's finances will "remain solid" despite the pandemic, which, it says, could prompt the organisation to scoop up schools overseas at cheaper-than-usual prices. Fitch notes that Bright Scholar's cash flow is "particularly strong" and suggests that the group may "seek overseas expansion as more opportunities arise" amid distress.

Bright Scholar and other large Chinese school groups, as well as mainland private investors, will continue to target deals in the UK, experts agree, where most private schools hold charitable status. Some British independent schools that folded either during or before the pandemic have already been resuscitated by Eastern saviours. In April, KSI Education, which is bankrolled by China First Capital, bought Heathfield Knoll in Worcestershire. The same month, a consortium of

Ashwin Assomull, L.E.K. Consulting

Ross Barfoot, Clyde & Co

John Hayes, Rothschild & Co

Chinese investors acquired a closed-down private school in Staffordshire, with plans to reopen it in due course. According to Venture Education, a China-based consultancy, 17 British schools are now owned by Chinese entities.

Risk premium

In certain regions, so-called premium private schools, which charge high fees, could be at greater risk of insolvency and therefore experience significant value erosion.

Dubai, the United Arab Emirates' biggest city, in which private schools comprise more than three-quarters of the market, is awash with expensive international schools, many of which were operating at low capacity prior to the pandemic. According to local experts, many premium operators had already discounted fees heavily prior to Covid-19 in a bid to increase enrolments. For some, this tactic worked: North London Collegiate School – Dubai more than tripled enrolments to 800 within three years of launching. But for others, further discounts – at a time when enrolments are tumbling as the uncertain futures of expatriate families have prompted many to flee – may not be sustainable. In addition, many premium school operators rent their properties, exacerbating financial risk as buildings cannot be sold off to generate liquidity. Commenting on the post-Covid prospects of half-empty premium schools in Dubai, one local advisor says: "They're f***ed."

Ross Barfoot, a UAE-based partner at Clyde & Co, says his law firm has been approached by a number of private equity-backed school operators on the hunt for potential acquisitions at attractive prices. "They've got war chests to spend and they are waiting patiently to see whether there are some good assets coming up at good prices. We're expecting a lot of consolidation and aggregation" – mergers, in other words – "and I think there will be a lot of opportunities to pick up individual sites or small, family-run schools." In June, two American-curriculum schools in Sharjah announced a tie-up to reduce operational costs – a testament to the economies of scale achieved by clustering schools.

Cashing in on consolidation

What kind of investors will bankroll – and reap the rewards of – the next wave of consolidation in the private school arena?

Private equity, which is sitting atop a collective $2.5 trillion of 'dry powder' – unspent capital – will almost certainly benefit. Buyout funds do not earn fees for managing institutional investors' money unless they spend it on businesses and later sell them for a profit. They will continue to be a driving force in the lower-to-mid-market, in which there are countless private equity-backed school operators.

Scaled school groups will continue to fall into the hands of financial sponsors with longer investment horizons and deeper pockets. The bigger an organisation becomes, the harder it is to expand at pace. Therefore, investors seeking to get in and out within five years – as private equity typically does – will struggle to generate satisfactory returns – especially in light of Covid-19, which is widely expected to extend holding periods.

John Hayes, director at Rothschild & Co in Singapore, who advises on education M&A transactions, expects so-called 'patient' investors – such as sovereign wealth funds, pension funds and family offices – to increase their exposure to K12 assets in the wake of the pandemic. This would accelerate an existing trend: Cognita is owned by Jacobs Holding, a Swiss family office; Inspired Education is backed by a mix of private equity, sovereign wealth and family office capital; Nord Anglia is co-owned by a Canadian pension fund and Asian buyout group.

"I think there could be a recalibration of long-term investment portfolios to more defensive sectors, like education," says Hayes. "This opens the door quite nicely for sovereign wealth funds and family offices – and even social infrastructure funds – to do more within the K12 sector."