Drawing the dividing line

Tumultuous times lie ahead for school operators in China as regulators take aim at structures widely used by overseas investors to extract earnings from non-profit education businesses. What impact will the proposals have on industry incumbents, market entrants and their investors? **Josh O'Neill** investigates

Chinese education groups could face major operational shake-ups over the next year as regulators tighten their grip on activity in compulsory grades, contractual agreements with offshore entities and M&A ventures, experts have warned.

In August, China's Ministry of Justice published a draft of revised regulations related to private education on the mainland. Of 68 points listed in the 22-page document, L.E.K., the global consultancy, extracted the following "key" articles: five, seven, 12 and 45.

Article five states: "Foreign companies or social organisations controlled by foreign entities cannot establish or control private G1-9 (compulsory education) schools."

Under current legislation, all schools teaching G1-9 must be not-for-profit, while foreign investors can take a maximum 49% stake in G10-12 operations. However, many overseas organisations and investors use variable interest entity (VIE) structures to sidestep China's stringent foreign investment laws, according to Michael Cripps, consultant to global law firm Clyde & Co, who specialises in China cross-border M&A, joint ventures and corporate financing.

The VIE structure was devised nearly two decades ago to enable Chinese firms operating in industries with tight restrictions on foreign ownership to list overseas. It involves a China-based entity (in this case, a school or schools group); an overseas firm listed offshore (foreign schools group or investor); and, typically, a Chinese shell company (service provider) wholly-owned by said offshore firm. The China-based schools operator enters into contractual agreements stipulating the transfer of profits to the service provider in the form of fees and royalties, thus enabling the parent of the latter group to extract earnings. Although the offshore entity does not hold an equity stake in the Chinese group or have direct access to its assets, clauses are often written into contracts granting it control, in some cases, "of all operational aspects," Cripps explains.

"The degree of control can be extraordinary," he says.

However, article five places VIE arrangements in jeopardy, according to Cripps. He says "assuming the regulations enter into force in their current format" – which he expects they will, judging by past regulatory introductions – "they will completely abolish VIE structures".

Michael Cripps, consultant to global law firm Clyde & Co

Mariana Kou, head of China education, CLSA

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In addition, article 45 suggests authorities will more closely scrutinise partnerships arrangements and deals. It states: "Transactions between private schools and relevant parties will be audited by the Ministry of Education/ Human Resource and Social Security Department." In light of this, Cripps expects regulators to take a "hardline" retrospective view on VIE structures already in place, suggesting "they will simply unwind them, giving a grace period of around a year in my guess".

"It's going to cause considerable unhappiness," he says.

In fact, it already has.

On 13 August, three days after the revisions were published, shares in K12-focsued education groups Wisdom Education, Tianli Education and Maple Leaf plummeted 40%, 37% and 31%, respectively, causing the market segment to "collapse," according to Mariana Kou, head of China education at CLSA, the investment bank. Fast forward over a month, and investors were still unnerved due to the groups' "high exposure to compulsory grades," she adds, noting that almost 80% of Wisdom's pupils are in G1-9, compared with around 60% of Maple Leaf's. Prompting further concern, both utilise VIE structures. On September 14, both firms' share prices were still down more than 42%.

"Stock prices are reflecting concerns the market has," Kou says. "I don't know when it will recover."

In a bid to reassure investors, Wisdom chairman Liu Xuebin issued a statement: "The group has not been affected by the draft amendments in any material respect as at the date of this announcement (14 August), and the company currently does not expect that the draft amendments will have any material negative impact on the group based on its preliminary assessment." ▶

However, many may fail to find solace in his remarks due to the implications of article 12, which states: "Education groups cannot control non-profit schools through M&A, franchise, or contractual controls." Kou points out that this amendment would inherently prohibit purchases of G1-9 schools as they cannot be for-profit, essentially limiting the purchasing power of Wisdom and its rivals.

"Looking forward, expansion in G1-9 may not possible, so companies may just have to focus on high schools (G10-12)," she says.

Still, this isn't necessarily a "doomsday scenario," Anip Sharma, partner at L.E.K., tells *EducationInvestor Global*, because "50% of demand in the dual-curriculum market is in G10-12".

"Operators can still build very scalable, profitable businesses in that space," he says.

Nevertheless, Sharma says the deal-making process in all sub-sectors could become "cumbersome" under article 12, as "potential non-profit targets would first have to be converted to for-profit", which would, in turn, drive up acquisition costs. As a result, "the investor pool would shrink," he adds, because "the structure is complicated, requiring parties to jump through more hoops".

In Sharma's opinion, the language used in article 12 is "ambiguous" and open to interpretation, as it is unclear what constitutes an "education group". It "simply isn't clear," he adds, questioning whether an organisation must operate more than one business to qualify as a group.

Article seven, on the other hand, is clear-cut in his opinion. It states: "Public schools are not allowed to run, or participate in the running of, for-profit schools and cannot profit through the licensing of their brand." This, Sharma says, will terminate the trend of less reputable private schools in lower tier cities borrowing the brand of esteemed public counterparts and paying them a fee to do so.

"Those with such partnerships will have to lose them, and this could spark consolidation as those without a reputed brand are bought by those which do," he continues.

Anip Sharma, partner, L.E.K.

Allan Walker, director of international schools, Malvern College Chengdu

Certain operators may have no choice but to restructure, breaking up businesses into separate entities to ensure compliance, according to Cripps. This would cause major headaches for publicly-listed players and potentially all-through private schools, should regulators forcibly unwind VIE structures. Sharma says "it's hard to say" what the outcome for international private schools will be, "but they may well be asked to change their structure in some ways and amend contracts" so relationships with Chinese partners are "more arm's length".

Malvern College Chengdu, a British international secondary boarding school, is currently developing a bilingual primary curriculum to bolster its offering, despite the impending raft of regulatory changes, Allan Walker, director of international schools, tells *EducationInvestor Global*. While article five would prevent foreign entities from establishing or controlling private compulsory education offerings, Walker says Malvern's will be compliant as the curriculum "will be based around local curriculum requirements... and its development will be driven by the in-country management team, with appropriate input and advice from the UK". Walker declines to say whether Malvern employs a VIE structure with its Chinese partner, Babylon Education, but is "confident that our management arrangements are compliant with regulations", as they fall "under the provisions of a brand licence".

David Yung, chief financial officer of Dulwich College International, the overseas division of the UK private school which has four campuses across China, tells *EducationInvestor Global* "we are still evaluating what the impact will be and what interpretations we can get" from the revised regulations.

On paper, the revisions rightly warrant concern from industry incumbents. In reality, though, authorities at the local level tasked with implementing a final version of the

regulations could find policing them a challenge due to constraints on budgets and resource, according to Sharma.

"Practically speaking, in how many provinces would the education bureau be sophisticated enough to police this?", he asks. "Beijing, Shanghai and the likes could, but what about tier two and three cities?"

Sharma also points to potential ramifications for other Chinese industries, should regulators throw the book at VIE structures.

"What the Chinese government doesn't want is chaos," he says. "Dismantling VIEs would have implications on the wider industry in China. Even Alibaba," the $500 billion e-commerce giant, "is structured as a VIE".

One certain outcome, Cripps says, is "the historically blurred dividing line between for-profit and non-profit" will be sharpened as regulators "draw an absolutely clear distinction", requiring operators to "nominate which way to go throughout 2019".

He continues: "The state's saying: you're either for-profit or non-profit, not a mix of both with 'behind the scenes' structures facilitating dividends payments while enjoying a raft of government subsidies. Once operators have decided, they'll be licensed accordingly and, more importantly, will be allocated appropriate subsidies and state funding." CLSA's Kou points out that Tianli Education, which floated on the Hong Kong Stock Exchange in July, received ¥70 million (£7.8 million) in government grants related to salaries and wages in 2017, equal to more than half of its overall net profit of ¥131 million.

"Once the decision is made, there will be zero scope to convert back," Cripps adds. "It's going to be a huge space to watch as institutions begin to clean themselves up."

In the meantime, Sharma, Cripps and Kou all agree we're likely to see a slowdown in M&A activity and listings, as the market factors in risk and operators carefully calculate their next steps. According to Cripps, regulators have indicated there will be no new operational licences granted until the end of 2019, when he expects the regulation to officially transpose into law.

"They're not interested in looking at new entrants until all this is sorted out," he says.

In Sharma's opinion, "it's going to be a multi-year affair" as operators gauge "how close they can come to the knife's edge" in terms of compliance while the dust settles in the background. However, he's already seen "six or seven" education groups' plans for public listings shelved in response to the amendments, as future growth through M&A in compulsory years hangs in the balance.

Tianli chairman Luo Shi sought to reinsure investors in his newly-listed organisation, saying: "The draft amendment law is not a final draft and has not been approved or has not taken effect yet." Still, in times of tumult, there is little else those in his position can do other than put on a brave face and ride out market ruts.

With not a whisper on the matter from government since the consultation period closed on 10 September, Sharma says: "It's certainly a case of wait and watch for the moment."