Special Report

The Ultimate Consumer Good

Education Trends in China

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Introduction

Boasting the world's largest population, its longest-ever run of sustained growth, and its second-largest economy, China is also emerging as the world's education powerhouse. Government reform has played an essential role, propelling the country's leading universities into the global rankings and its Tier 1 city schools to the top of the K-12 league tables.

Private education in China is also improving in quality and availability, driven by an increasingly affluent, urban and cosmopolitan population that is demanding world-class education, with all that implies: bilingual and English-language offerings, access to international opportunities, job-oriented training, and top-notch tutoring and supplementary education to give students an edge.

An education investment "frenzy"

China's private education market is large and growing quickly, at $260 billion (RMB1.6 trillion), and set to grow at 9% year-on-year until 2020.[1] It is also underpenetrated versus other global private education markets; if it had the same relative size as the U.S. market, it would be at least $500 billion.[2]

Moreover, China's education landscape has been rapidly consolidating and maturing within the past five to 10 years, spurring a "frenzy"[3] of education investment activity over the past two to three years, with approximately 75 deals and $7 billion deployed for the two-year period 2016-17.[4] More than 40 deals are projected for 2018 alone, valued at a total of some $3.5 billion (see Figure 1).[5]

Core segments of education (early years, K-12 schools, and higher education) continue to dominate deal flow. Three principal trends have been observed in investment activity over the past two to three years:

1) Continued growth in education investments as China-listed companies increase their exposure to the sector
2) A flurry of activity in higher education acquisitions, as newly publicly listed providers seek rapid growth
3) Education technology (edtech) emerging as a key investment theme: 30-40% of investments across subsectors are in edtech, and in segments such as English language training (ELT) they were among the top two largest deals

A period of capital deployment in high-growth companies eight to 10 years ago helped them gain scale and is now resulting in a boom in IPOs. The world's two largest listed education companies, TAL and New Oriental, are Chinese, and eight of the world's 15 largest listed education companies are Chinese (see Figure 2). Five years ago, only two Chinese companies were among this group.

Figure 1
Total value of education deals in China (2011-18F)

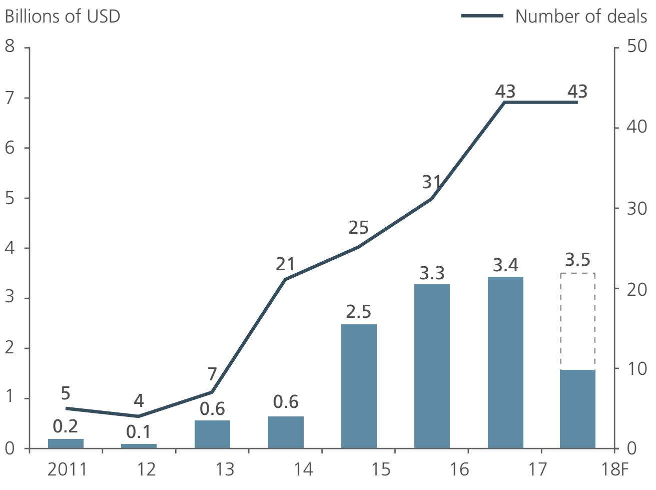
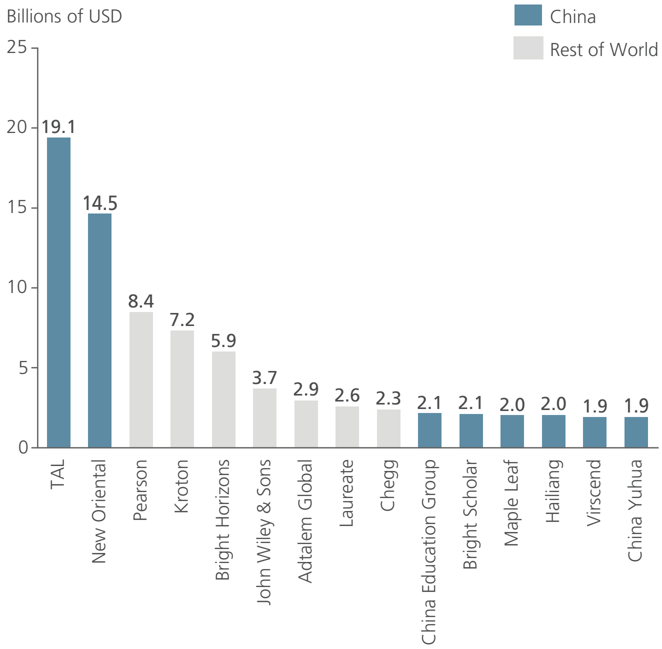


Figure 2
Market capitalization of
15 largest listed education companies (2018)



[1] L.E.K. Consulting research and analysis.

[2] The U.S. private education market is approximately $140 billion on a population base one-quarter the size of China's. U.S. education market size data source is BMO Capital Markets, adjusted for missing segments based on observed ratios in other markets.

[3] *Education Investor*, February 2018.

[4] Mergermarket. For reference, the U.S. had approximately 180 deals in 2016-17 with a total deal value of $23 billion.

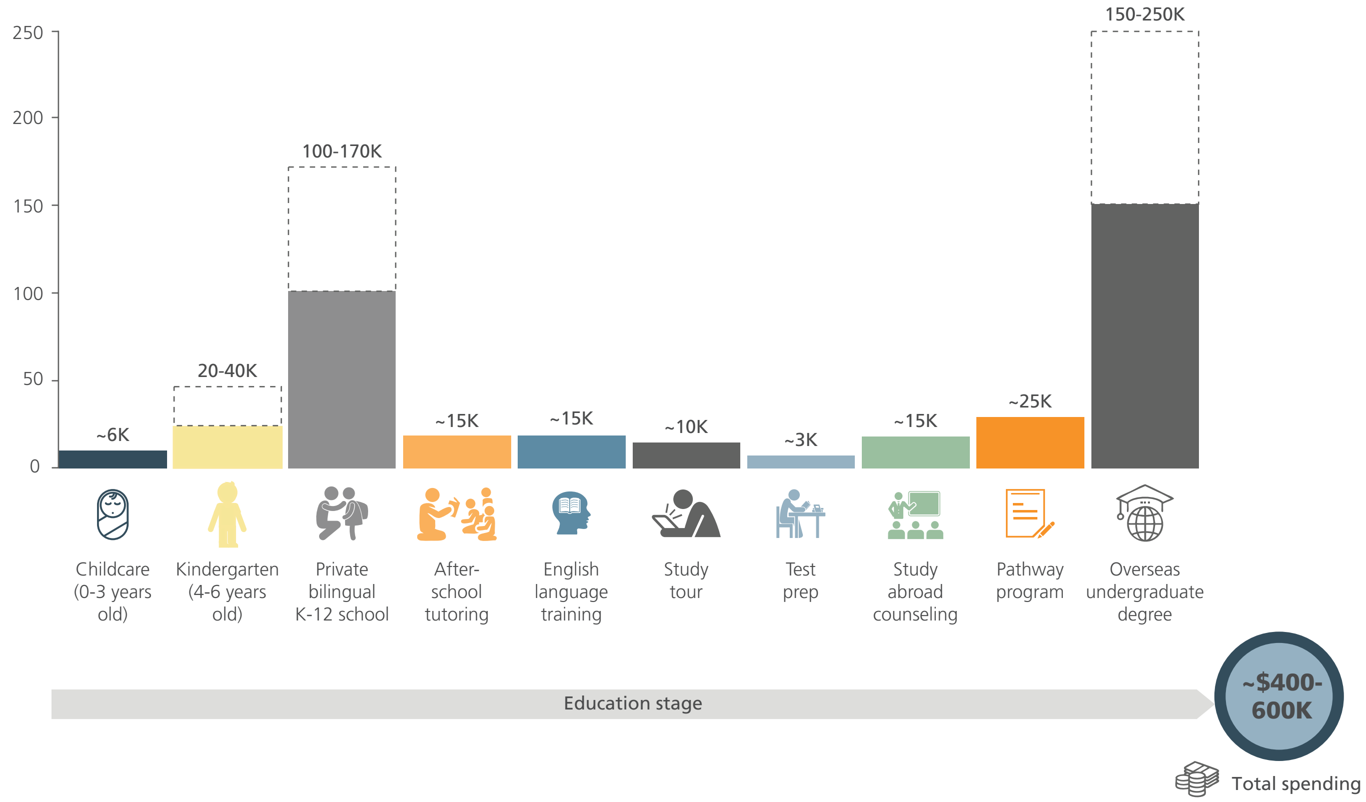
[5] Mergermarket. 2018 forecast is projected based on historical trend of deals to date versus total deals annually.

The ultimate consumer good

Across the world, education has moved from a niche to a mainstream investment theme, and China's education sector growth is the most dynamic of all. However, the country's demand drivers are distinctive: In China, with its brand-conscious, aspirational consumers, education is the ultimate consumer good.

Nearly 9% of Chinese household spending is on education, compared with approximately 4% for other emerging markets[6] — despite the fact that Chinese households have one or two fewer children than their counterparts in similar economies, and that public education is free. Affluent Chinese parents may spend as much as $400,000-$600,000 (RMB 2.5M-3.8M)[7] on a child's education from early years to university (see Figure 3).

Figure 3
Estimated spending of affluent parents on a child's education, by education stage, Shanghai (in thousands of USD)



[6] Oxford Economics, L.E.K. research and analysis.

[7] Education spending is calculated based on typical spending on a child who attends private kindergarten, private bilingual school in Shanghai and American university.

Three key demand drivers for Chinese consumers of education

Advantage seeking

The Chinese education sector is highly competitive, with 9.4 million students sitting each year for the *gaokao*[8] and C9 universities[9] selecting as few as one in 50,000 students.[10] University places are seen as essential, but getting a place at the "right" university is just as important; graduate unemployment in China is estimated at about 15%,[11] while one in four new graduates earns wages commensurate with migrant workers.[12] As such, Chinese students and their parents are advantage seeking, with hypercompetition (sometimes characterized as an "arms race") from pre-primary school, particularly among affluent groups. Chinese families are willing to spend to get an edge, and education subsectors that particularly benefit are tutoring, test prep, K-12 schools, and ELT. Private higher education providers offering job-oriented education also benefit.

Internationally minded

Chinese students are the largest cohort of international students, with 500,000 students initiating international study each year,[13] comprising approximately 20% of all international students. The hunger for transnational education (TNE) continues to grow, at approximately 5% per year.[14] These international ambitions require significant preparation and spend, from test prep and tutoring to enrichment and ELT. Bilingual and premium K-12 schools teaching the national curriculum with foreign elements are also important for internationally minded Chinese consumers. TNE businesses such as pathway programs, study abroad counseling, and other student services are key beneficiaries of this trend.

Premium preferring

Chinese consumers have a strong preference for premium branded goods. While this trend is well-established in the global premium luxury segment, a preference for premium also permeates wider consumer behavior: Approximately 50% of Chinese consumers report they will always buy the most expensive product across categories.[15] This is affecting a range of education subsectors with premium options, including early years, K-12, and higher education. It is also driving demand for high-priced, exclusive options in supplementary education segments such as tutoring, test prep, and enrichment.

These factors are driving the emergence of a hyperconsumerization of education in China, where what has traditionally been seen only as a social good is now also a consumer good. This has deep implications for investors and operators as they seek opportunities in the education sector.

[8] The *gaokao* is the National Higher Education Entrance Examination, a standardized test offered annually and required for entry to almost all undergraduate institutions.

[9] The C9 League is an official alliance of the nine most prestigious universities in China. The League was established in 1998 by the government as part of reforms aimed at driving more of China's universities into the global elite. The C9 institutions account for 30% of Chinese research citations.

[10] L.E.K. research and analysis.

[11] Six-month unemployment rate for new graduates, reported in *BBC News*.

[12] *The Conversation*.

[13] Ministry of Education, China.

[14] UIS.

[15] L.E.K. research and analysis

Trends and disruptions in Chinese education

Figure 4
Three trends to watch in Chinese education

Against this backdrop, investors and operators keen to expand in China should be aware of three key trends to watch (see Figure 4).

Trend 1: Brands do battle

Because education is not a "try-before-you-buy" service, parents and students across markets look to education providers' reputations in the selection process. Brand becomes shorthand for reputation and a promise of quality.

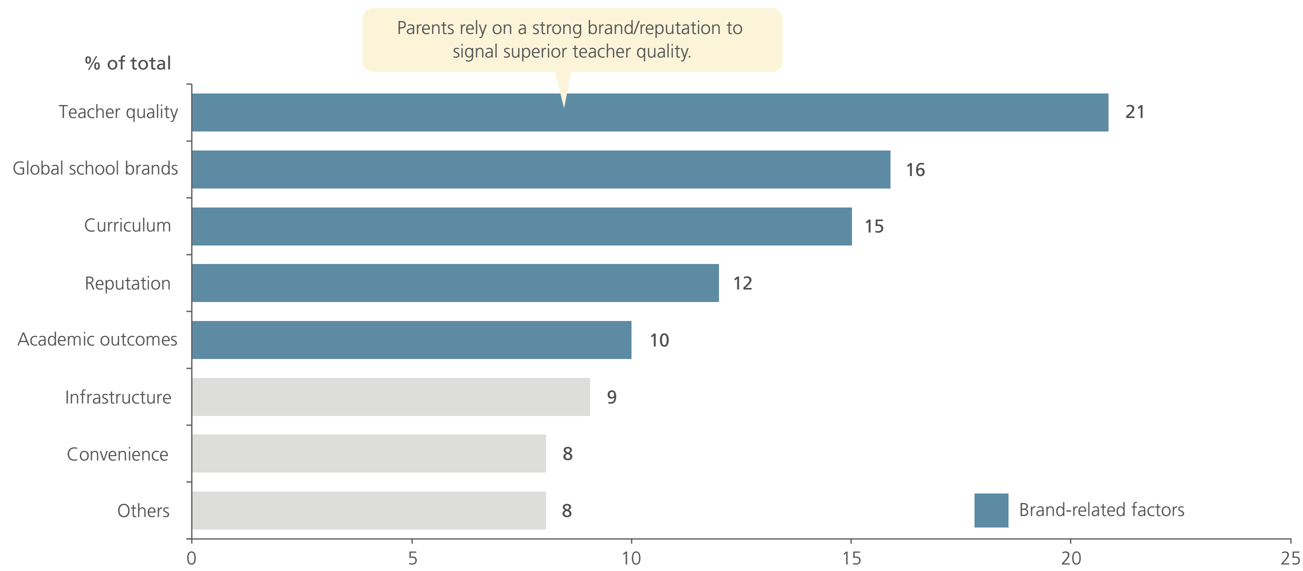
In China, as elsewhere, about three-quarters of parents choose education for their children based on brand-related factors.[16]

These factors can include selection based on pure brand recognition and reputation, as well as factors for which brand can be a proxy (particularly in the absence of a long track record), such as academic outcomes and teacher quality (see Figure 5).

Typically, in education it can take decades to build a premium brand, given that reputation is tied to results. What differentiates the Chinese education landscape is how providers have established education brands without the advantage of time.

Moreover, Chinese education companies trade on prestige and legacy to drive customer perception by "borrowing" brands. Legacy and international brands, particularly where they use

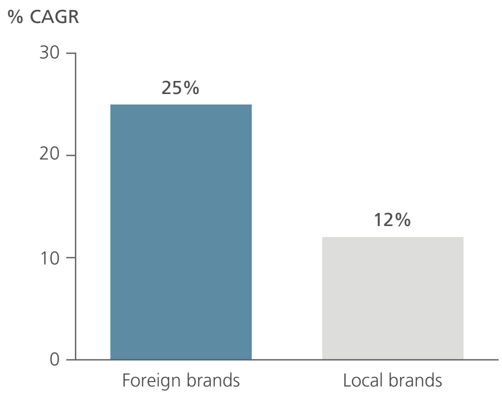
Figure 5
Top 3 most important criteria for selecting a K-12 school



[16] L.E.K. surveys of parents in China and other markets, 2018.

established foreign names, have an advantage. For example, in the premium K-12 segment, foreign brands typically grow twice as fast as local brands (see Figure 6).[17]

Figure 6
Growth rate of premium K-12 schools, foreign vs. local brands



For local companies to compete in the battle of the brands without the benefit of international names or legacy associations, they need to become known in one of two ways:

- Solving local problems in an innovative way, for example in segments such as after-school K-12 tutoring. Companies like Gaosi have traded on the credentials of "star" teachers to differentiate their offering and signal quality.
- Gaining market share quickly in subsectors with less legacy and international competition (such as online junior ELT, where all five of the largest companies are homegrown). In this subsegment most of the key players have also built their reputations in five years.

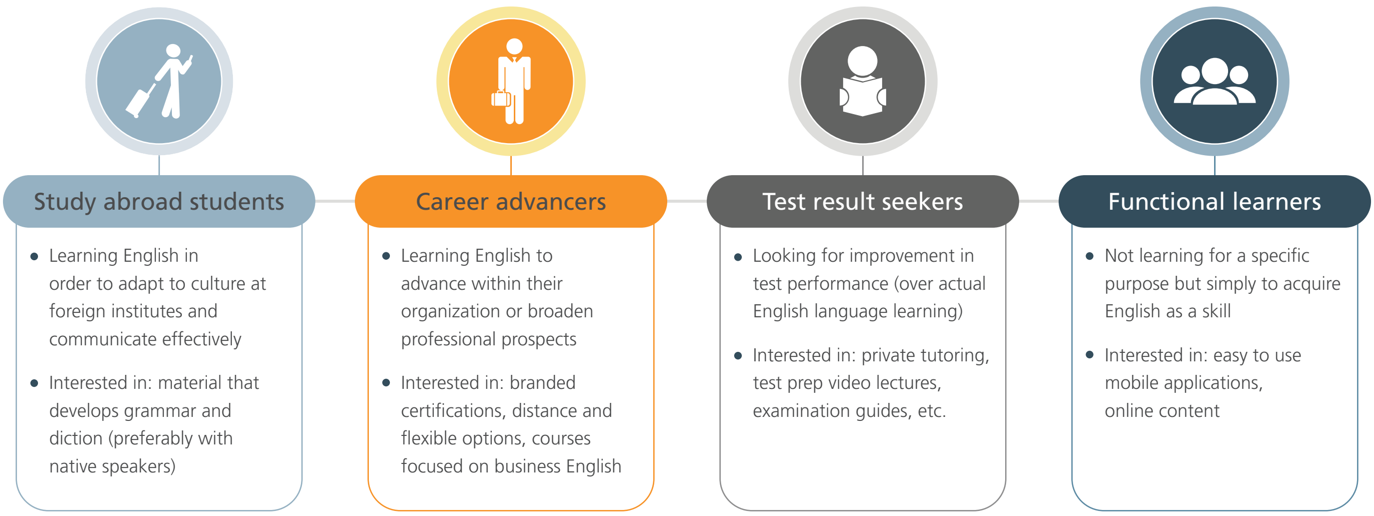
Investors must therefore align themselves with premium and international brands in order to secure a foothold, or pick segments where offerings are distinctive or unique to China and leverage homegrown brands.

Trend 2: The niche goes mainstream

Beyond focusing on building brand, education companies are taking advantage of new opportunities in the Chinese market. As the education ecosystem rapidly matures, what were once niche groups of consumers are now viable segments for core business strategy.

For example, ELT is already a well-established, approximately $12 billion sector in China, growing at 15%[18] per annum with a range of in-classroom and supplementary provision for children and offerings for adults. Where the sector was once limited to in-person tutoring and classes, there is now a profusion of offerings catering to a variety of learner types, such as career advancers, test result seekers, functional learners and study abroad students (see Figure 7).

Figure 7
English language training — key student segments



[17] L.E.K. research and analysis.
[18] L.E.K. market knowledge

Study abroad students are an ELT niche market but now account for an estimated $2-3 billion in revenues. This segment can therefore support targeted, scale business offerings. For example, ELT providers now offer specialized content to advanced students who want top-tier business and academic English, with immersive subject learning (e.g., science and math).

It is likely that other niches will themselves become viable segments for investors and operators, for example in further diversification of TNE, differentiated K-12 offerings, and after-school enrichment (see Figure 8).

Trend 3: Online cracks open China

Tier 1 and Tier 2 cities have been gravitational centers for education, pulling in talent and money, but 1.1 billion[19] Chinese people live outside these cities, presenting an addressable market of 165 million affluent and middle-class consumers.[20] They have aspirations for the same things as other Chinese — a top-tier university place, international education and English proficiency — but access to the private education offerings that support such aspirations has traditionally been limited.

Figure 8
Potential future viable segments

[19] *Euromonitor*.

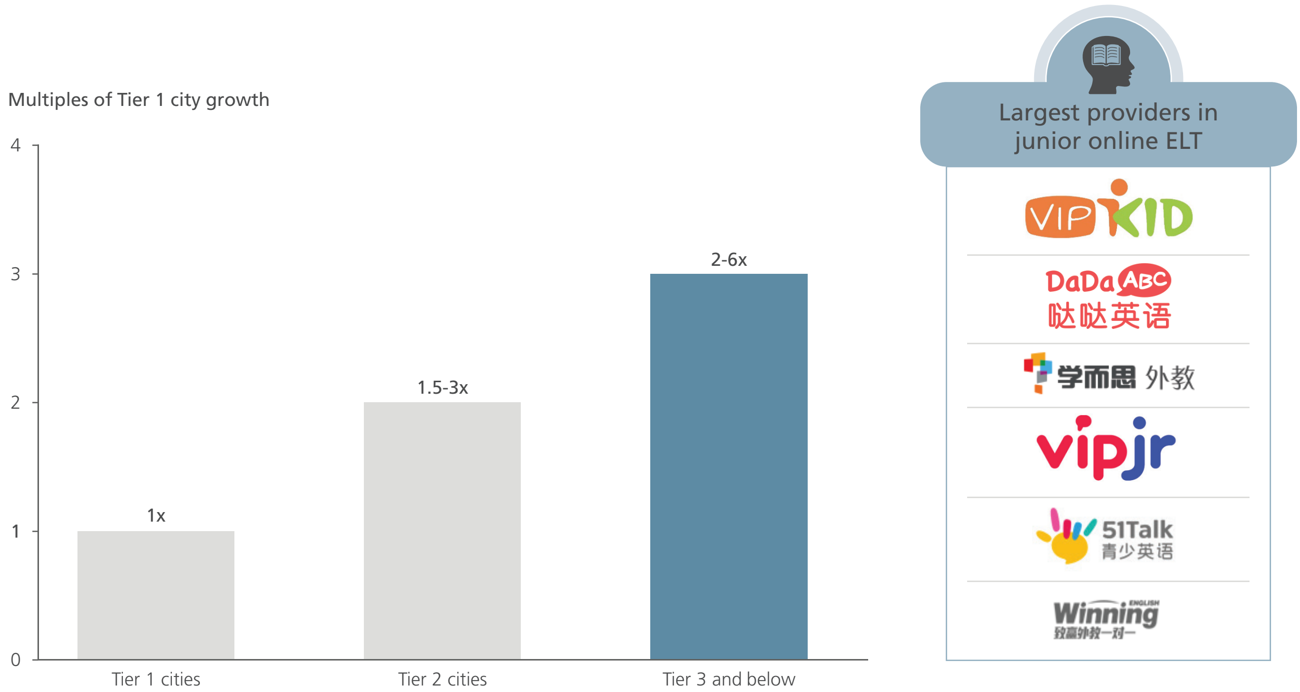
[20] Affluent and middle-class consumers are in households with income of $10,000 and above. Analysis based on Oxford Economics data.

Education technology is driving access in regions previously unreached by big-city offerings, with these regions growing faster than Tier 1 and Tier 2 cities (see Figure 9). This is particularly relevant for mass-market products with a relatively lower price point such as online ELT and tutoring. There are 600 million[21] people still living outside cities, and education quality, access, and relevance are all lower in rural than in urban areas.

Potentially, as in other emerging markets, in China online education can help level the playing field for students across the population.

For education companies with mass market products, a pan-China and online strategy is essential for rapidly gaining scale beyond big cities. However, they will have to adapt their products to the needs of consumers in less developed education ecosystems. Moreover, premium offerings, particularly in brick-and-mortar-dominated segments, will continue to do best in the wealthiest 30 cities.

Figure 9
Enrollment growth of online English language training by city tier



[21] National Bureau of Statistics, China.

Looking ahead

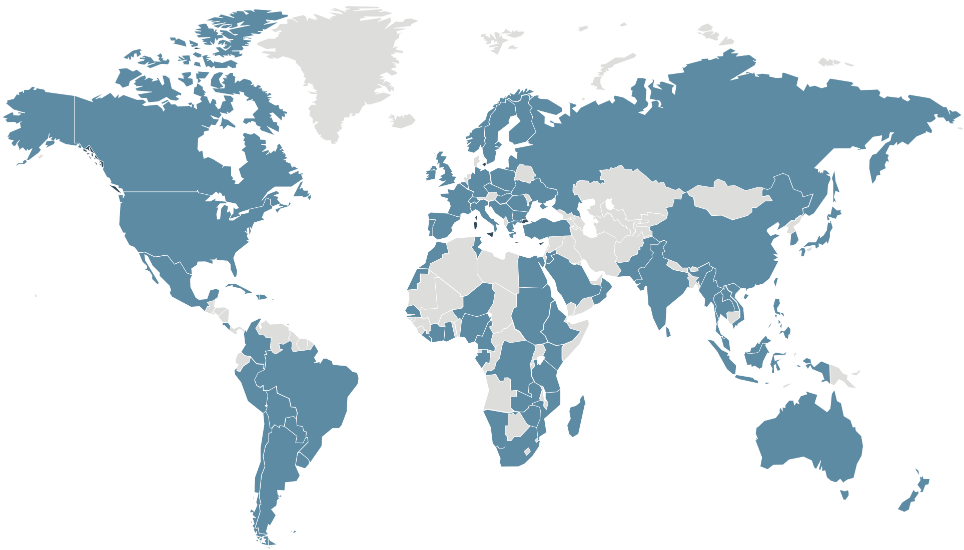
Alongside these three key trends, there are other emerging themes for investors and operators to watch in the months and years ahead:

- **Edtech is only getting started:** As online provision becomes the norm across education segments and for population groups across China, the urgent questions for operators and investors are "What's next, and when?" Artificial intelligence is already shaking up personalized language learning, for example on apps such as Liulishuo. The personalization and flexibility promised by edtech could transform other segments. Key opportunities are likely to be in test prep and tutoring, as well as services to K-12 and higher education.
- **Public higher education will become a major consumer of private services:** The number of *gaokao* takers is declining, and reskilling and employability are on the agenda of corporates and government alike. This context will put pressure on Chinese universities to recruit from and serve nontraditional student segments. In the United States, where public and nonprofit universities have faced a similar challenge, the online program management market has mushroomed, transforming the market in services for universities. Chinese universities are likely to adopt this know-how in their quest to be competitive, reduce costs and drive relevance for new student groups.
- **China goes global:** Chinese companies, and foreign operators in China, are developing unique operating capabilities and innovations. Key opportunities are likely to be in segments where China has a distinct scale or capability advantage. For example, some premium K-12 brands are pioneering fully bilingual schools in China catering to Chinese parents — a model with potential applications abroad. Homegrown companies, which so far have been able to grow quickly without looking beyond their borders, are also likely to begin to expand operations abroad. For example, ELT providers with scale technology platforms are likely in the near term to look to neighboring markets in Southeast Asia with similar underlying demand characteristics.
- **Universities abroad adapt:** Chinese students are becoming an ever more common sight on college campuses from Sydney to South Bend. While this has been positive for university bottom lines and student experience across destination markets, the presence of so many Chinese students will present new challenges for university leaders. These include developing support services that can ensure Chinese students are successful at host universities and managing student experience to ensure that both Chinese and domestic students are satisfied with campus life. Key segments likely to grow will include pathway providers offering student support and counseling, alongside "micro" TNE provision that meets student demand for international experiences while anchoring students at universities in China itself.

The technology sector in China is said to have a "9-9-6" working culture: 9 a.m. to 9 p.m., six days a week — a notion that captures the dynamism and growth potential of the market. Given the opportunity in China's education sector, operators and investors may wish to adopt a similar approach.

About the Global Education Practice

The L.E.K. Global Education Practice (GEP) is a specialist international team whose members have experience in more than 600 education sector engagements across 90+ countries. This dedicated group of 40+ consultants and four partners and principals is based in Singapore and serves a global client base from China to Chile. Our experts bring insights on education businesses, investment opportunities, market dynamics and impact across education subsectors from K-12 to edtech. GEP leaders have served CXOs and boards of some of the world's largest education sector businesses and advised on most major deals over $200 million since 2010.



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