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Learning curve

There is no shortage of demand for services or investment opportunity in India's education sector, but negotiating overcrowding and heavy regulation requires a clear strategy

"ALL PARENTS WANT IS THE BEST FOR their children," says Gary Ng, a managing director with CLSA Capital Partners, "and many are willing to commit quite a handsome portion of their income to put kids into the top colleges."

It is an apt description of the dynamic at work in India's middle class, which is expanding rapidly and populated by families keen to use their wealth to secure the prosperity and social status of the next generation. This was the rationale for CLSA's $22 million investment in Resonance Eduventures, just one of a number of forays by private equity investors into India's education space in recent times.

Alongside healthcare, education has benefited considerably from India's growth story – plus it is regarded as non-cyclical and far better insulated from economic shocks. As of 2012, the country's education market was worth around $120 billion, with 46% of that sum entering the private sector, compared to 47% for the public sector and 7% for foreign education.

At first glance, the case for investing in India's education space makes a lot of sense. Kaizen Private Equity was the first to go all in, reaching a final close of $98 million on the country's first-ever dedicated education fund in 2009. At that time, the market was growing at around 20% year-on-year and private equity more than matched this. According to AVCJ Research, PE investment in Indian education more than quadrupled to around $170 million between 2008 and 2010. Deal volume more than doubled.

Despite the clear need for services and these impressive headline numbers, finding deals has not been plain sailing. "When we started raising our first fund we thought we wanted to raise a $150 million," says Sandeep Aneja, CEO of Kaizen. "We thought that India had the ability to absorb such an amount of capital into high quality companies – but it was not the case."

The problem is not that the space has been capital starved, rather that it is has been deal starved. The issue for private equity, then, is not whether there are investment opportunities but how to find them and where GPs are better off putting their money.

While the sector as a whole still saw compound annual growth (CAGR) of 14.9% in 2012, private equity activity over the last two years appears to have dropped off. Deal flow has been steady, but the amount being invested is closer to 2008 levels, indicating that transaction size has shrunk.

A broad spectrum

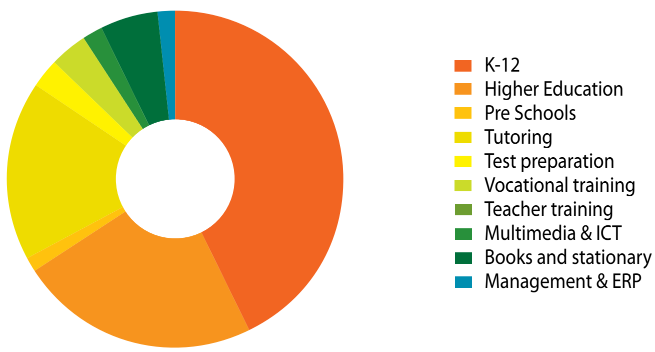
The education sector represents a broad spectrum of businesses, but it is generally divided into three areas. First, the core segments: K-12 (from kindergarten to Year 12) and higher education. Heavily regulated, these represented more than half of India's $56 billion private education sector in 2012. Second, parallel businesses operating in areas with far less regulatory oversight: pre-school, test preparation, tutoring and vocational training. Third, ancillary businesses such as school books, stationery, multimedia, IT and management.

"The challenge tends to be that a lot of the pockets that one could invest in are regulated, so there is a mismatch between potential demand on one side and the more limited investment opportunities based on regulation, on the other," explains Rishi Navani, co-founder and managing director at Matrix Partners.

As a result of these restrictions, the K-12 segment has experienced less investment from private equity than elsewhere. At the same time, though K-12 and higher education comprises the lion's share of the market, growth has been more subdued, with a CAGR of 14% and 13%, respectively. Compare this to expansion in pre-school (a CAGR of 30%), multimedia and ICT (30%), test preparation (25%) and vocational training (25%), and the rationale for investing in businesses beyond standard regulatory jurisdictions is clear.

One of the most significant areas targeted by PE to date has been the test preparation space. Gaja Capital's portfolio includes Career Launcher, which provides test preparatory and vocational training services to over 60,000 students. The company initially helped students prepare for tests to enter the Indian Institute of Management but later expanded its offering to include school and college students seeking admission to a broad range of professional courses.

India education segment market share (US$b)



Source: Kaizen private equity

CLSA's investment in Resonance is another example. The company coaches students who are undertaking college or equivalent entrance examinations in the fields of engineering and medical science.

"Every year over one million students sit for the various entrance exams to gain entry into Indian Institutes of Technology (IITs), medical colleges and engineering schools," says Ng, who notes that test preparation is attractive because it is less capital intensive than most education investments. "That is the big difference compared with building a hospital or school – you do not need a lot of capital expenditure and therefore the margins are much better."

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The relative ease of entering this asset-light space has meant that areas like test preparation and vocational training have become highly fragmented. As such, PE can add value through consolidation and standardization. "While you may have a lot of mom and pop shops offering different forms of training, test preparation and pre-schooling, the organized chain that gives you the same service in multiple locations is all but missing," explains Rahul Chowdhri, a director with Helion Venture Partners.

One of the these chains to make a consolidation play is Tree House, which received INR410 million from Aditya Birla in December last year. The pre-school management provider is now the largest cap education company in India, having previously acquired Brainworks Learning Systems, a national chain of pre-schools.

As much as it has been fragmented, the education space is also crowded, as companies and their PE-backers scramble to address the affluent urban demographic. This has led some to look further afield, providing capital to companies operating outside the middle-class.

Lok Capital, for example, focuses on base of the pyramid (BoP) businesses serving low income markets. It recently invested in Hippocampus Learning Centers, a company that provides pre-school and primary education coaching in rural areas. The company currently operates in 80 villages in the Karnataka region in South West India, running morning Kindergarten classes along with afternoon English and math classes for children aged 5-8.

"We are likely to do more investments in the Kindergarten sector. There is too much competition for the middle class consumer, but not much in the rural side that Hippocampus targets," say Vishal Mehta, co-founder and partner at Lok. He adds that, while the margins remain slim in this segment, the potential is there for businesses to scale up.

Technology play

Another significant way in which education investments have crossed over into other sectors has been with early-stage tech-focused investments. Kaizen led a $4 million Series B round for Educomp Solution's subsidiary authorGen, which produces online education platform WizIQ. Educomp acquired a 51% stake in authorGen in 2007 in order to consolidate its position on the online tutoring space, later increasing its holding to more than 75%.

"Regulation is much less relevant in the tech-enabled sector. The issue is free content versus paid content, whether there are enough smart phones and tablets and whether the market is large enough," says Matrix's Navani.

Despite the limitations of hardware, some are in little doubt of the potential of technology in education. Helion, for example, invested in Attano, a provider of interactive ebooks and rich media learning resources for the classroom. Chowdri notes that students are comfortable using technology while, at least in the metropolitan areas, consumers are much more demanding. Technology can therefore serve as a differentiator as schools compete for pupils.

There also have been venture capital investments in software alone. Voicetap, a technology start-up that allows students to access educational content and counseling services via a mobile platform, received $1 million last May from CCube Angels, Frontline Strategy and other angel investors.

> **"We thought that India had the ability to absorb $150 million into high quality companies – but it was not the case"** – Sandeep Aneja

Matrix's Navani cautions that the volume of free content material in online and mobile learning makes it difficult to devise a business based on premium content, but this is counterbalanced by the potential for the expansion of technologies and software into overseas markets. An international strategy can also open up a range of new options on exit as secondary and strategic players are drawn to companies with proven cross-border potential. With this in mind, Kaizen has been courting strategic investors in Europe and the US for a potential sale WizIQ.

"Education businesses that are technology-enabled have got the potential to be a global players so we are looking actively at technology enabled in various forms as it mitigates country risk," explains Kaizen's Aneja. "Long term companies such as WizIQ will have a global footprint opportunity."

Regulation: Where private capital can and cannot go

Education in India is a large and fragmented sector that can be divided into formal and non-formal segments.

The formal education system comprises K-12 (from kindergarten to Year 12) and Higher Education Institutes (HEI). These are regulated so they cannot be run for profit, which the scope for private investment, although there are privately-run institutions in the sector. As such, India's schools can only be operated by the government or non-profit charitable public trusts or societies that are prohibited from taking out any surplus money.

Section 25 of the Companies Act stipulates that an entity falling under Section 25 – which includes educational trusts – "apply its profits, if any, or other income in promoting its objects, and to prohibit the payment of any dividend to its members."

However, privately run schools can use certain structures to circumvent regulatory restrictions. For example, a legal structure can be created whereby a trust runs the educational institute and another company owns all the assets such as land, infrastructure, management and technology.

These assets can be leased to the trust for a fee.

Despite these loopholes, few private equity players have been tempted into the space. "We avoided the K12 segment because it is regulated and any investment would have to be into a management company which charges the non-profit trust," says Gary Ng, a managing director with CLSA Capital Partners. "We are concerned about whether such a structure would pass the regulator's approval."

Even so, the state has recognized the need for additional investment in the K-12 segment. India's 11th Five-Year Plan, which outlined policy objectives for 2007-2012, identified a resource gap of INR2.2 trillion ($25 billion) that needs to be filled by private funding.

The Human Resource Development ministry has short-listed 65 private organizations, including PE-backed Everonn Education and Educomp Solutions for public-private partnerships to open schools. Under the scheme, private companies will procure the land and design, develop, operate and manage the schools. The government will offer a 25% infrastructure grant and the recurring cost of education for students sponsored by it.