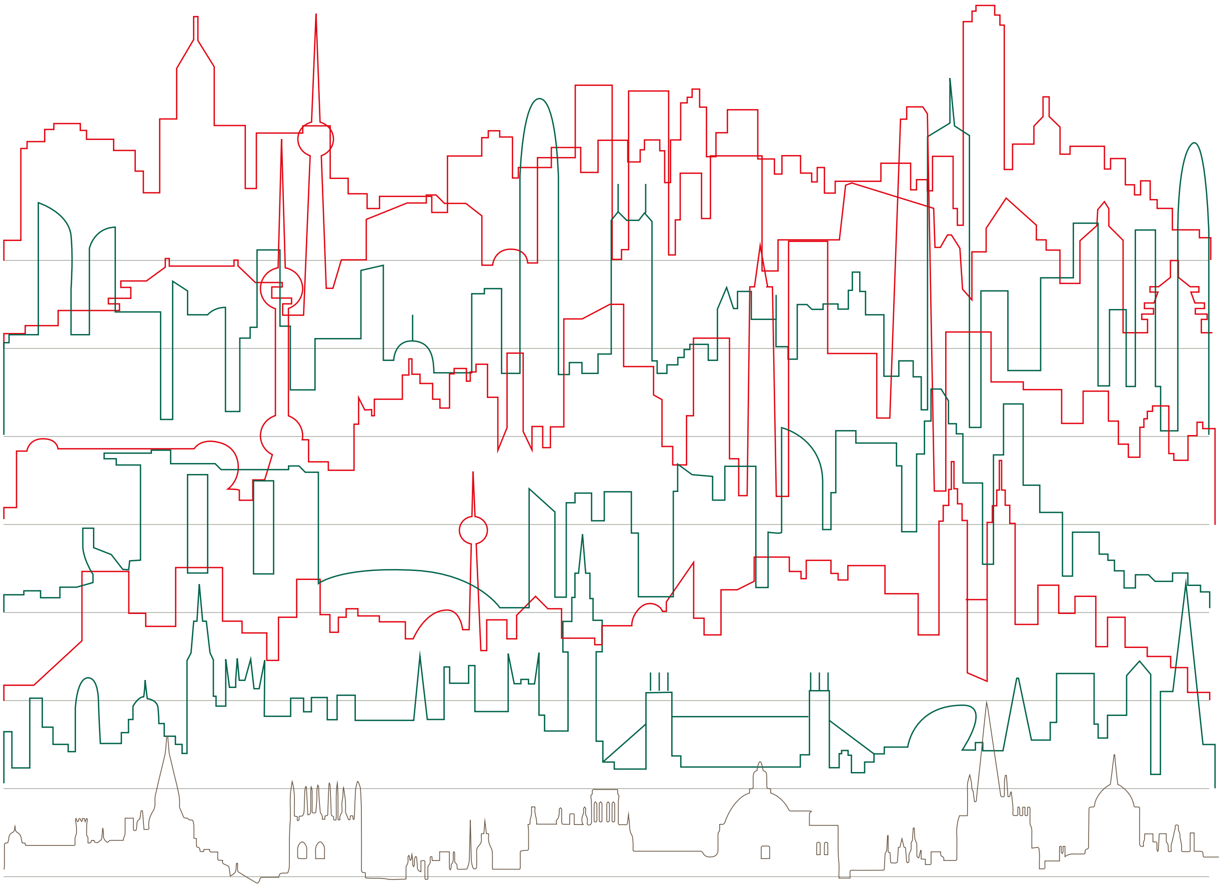
Value Partners
Investing through discipline

CHINA HIGHER EDUCATION UNLOCKING THE VALUE



OXFORD METRICA

INVESTMENT INSIGHTS 01 / 2020

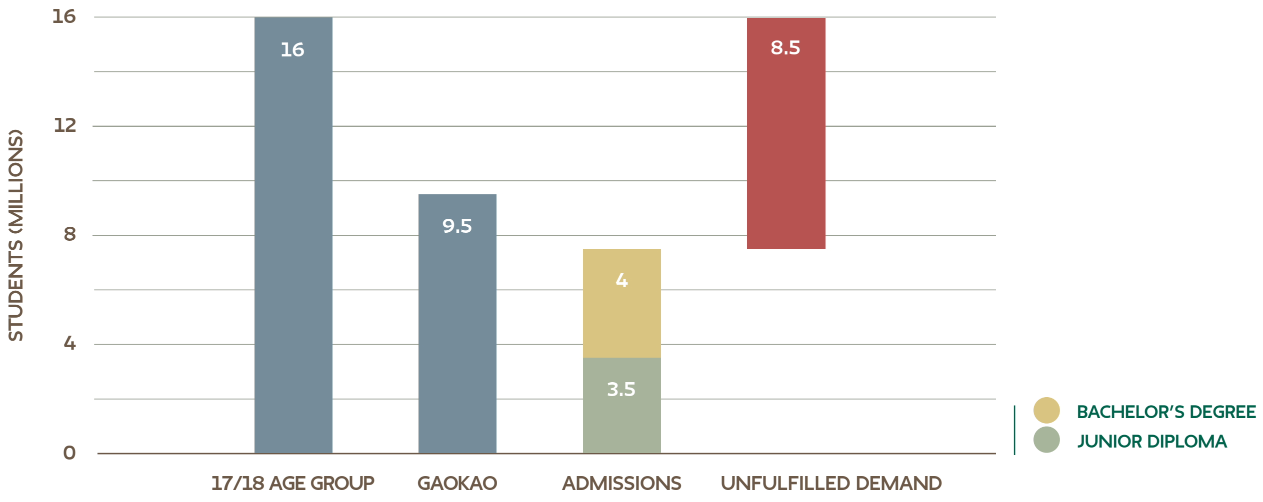
CHINA HIGHER EDUCATION: A NEW ECOSYSTEM EMERGES

Education is one of the most powerful forces driving modernization in China, playing a key part in creating a high value economy built around consumption and services, advanced technology and sophisticated labour skills. Reflecting this, higher education, and in particular the opportunities to expand the role of private institutions, offer some of the most inviting and potentially lucrative destinations for domestic and foreign capital in China today. Conscious of higher education's vital economic contribution, and responding to changing demographic developments such as the nation's emerging and increasingly affluent middle class, China is estimated to have a middle income population of 777 million[1], the Chinese government has markedly also changed direction since 2017. New policies and greater regulatory freedom are unrolling a new roadmap for education in China at all levels from kindergartens to colleges and universities. As part of its initiative the government is pursuing a far more open and liberal approach in its dealings with private education operators. The draft rules of the Private Education Promotion Law, for instance, offer a raft of fresh incentives to spur growth in this area, in the process greatly clarifying the role for private enterprises and foreign investment and strengthening support for them.

MINDING THE GAP

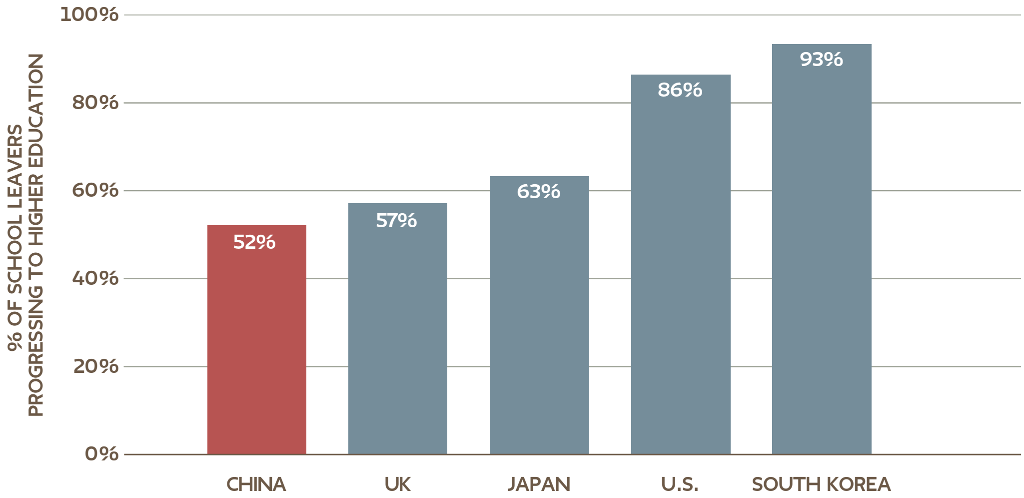
As well as the recent switch in the government's education priorities a number of other key features mark out the higher education landscape in China. An outstanding is the yawning gap between demand and supply.

FIGURE 1: Insufficient supply



Currently there are only 7.5 million places in higher education for the 16 million Chinese school leavers. The 9.5 million candidates for the national high school exam (Gaokao) exceeds the places by some 2 million a year. In its most recent five-year plan the 50% target China's Ministry of Education (MOE) set for participation in higher education, was achieved in 2019 with 52% participation[2]. Looking even further ahead, the China Association of Higher Education has stated that the government intends to achieve a 60% university enrolment by 2030. This requires approximately 2.1 million places in new capacity in the next 10 years. For reference, the largest private higher education operator in China operating ten schools in total has added only 6,000-10,000 new places per year over the last three years, this excludes places added through acquisitions and mergers with other operators. Evidently the rate of growth will have to significantly increase to acheive the target set by the Ministry of Education for 2030.

To cope with spiralling student demand, several regions have already been forced to up their quotas, for instance, Guangdong will be increasing its quota by 80,000 over the next three years[3]. Sichuan has pursued a different strategy, simply extending its submission period in order to allow students more time to apply. In addition, the Chinese government has announced numerous policies to support higher education to ameliorate the effects of Covid-19 including the relaxation of enrolment quotas to help alleviate the nationwide employment pressures caused by the pandemic.



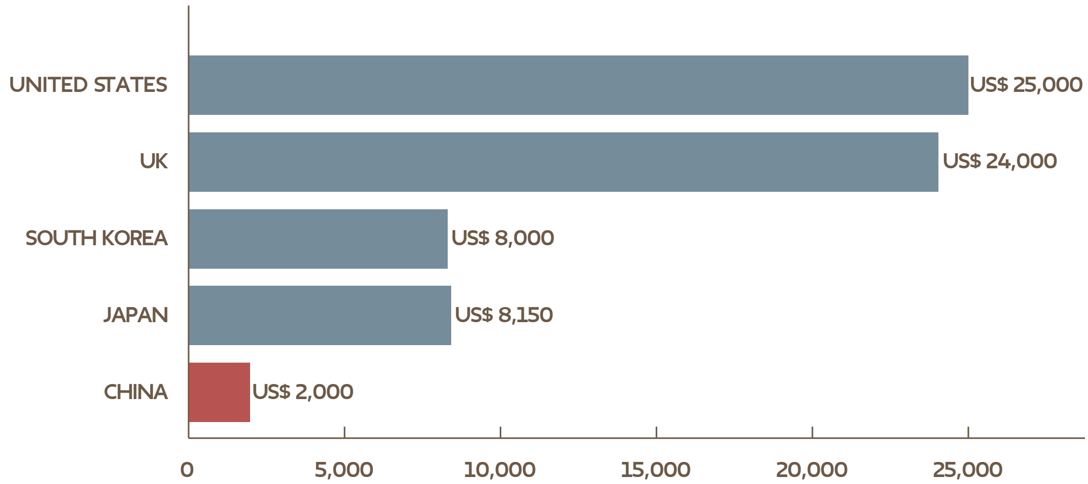
| FIGURE 2: Comparative enrolments (2017)

FEES: BREAKING THE LOW CEILING

Another feature of higher education in China involves the extremely low levels of fees currently being charged by Chinese institutions. Average tuition fees in China are at rock-bottom in global terms. As shown in the figure below, they are not only significantly below those in, say, South Korea but some twelve times lower than those in the US. Major opportunities exist therefore to generate additional fee revenue.

The case for higher fees is particularly strong in the private sector given its flexibility and versatility vis-a-vis the public sector. It is far better equipped to provide on a timely basis the tailored products and services needed to generate the high value technical and vocational skills required to create an innovative and fast moving economy. In terms of the attractiveness of private higher education institutions a virtuous circle would result: graduates of private institutions would be correspondingly sought after by employers, and in turn, these institutions would increasingly become the destinations of choice for ambitious, career-minded students who bear their future employment prospects in mind.

| FIGURE 3: Average tuition fees per student



THE POLICY FRAMEWORK OPENS UP

The Chinese government has struck a new, more open note in higher education, encouraging more private operators in order to upgrade the system. The draft implementation rules of the Private Education Promotion Law clarify support for private enterprises and foreign investments and offer incentives to spur growth in this area all of which augurs well for future value creation in the private education sector.

The government has rolled out a range of policies to support the sector in the post-COVID-19 environment in addition to the relaxation of the enrolment quotas referred to earlier. As well as encouraging undergraduates to obtain a second bachelor's degree, this year's National People's Congress set targets to expand vocational degree enrolment by over 40%.

The MOE has also released a document, 'Implementation to accelerate independent colleges' transformation' which aims to put those independent schools owned by public institutions on a new and more autonomous footing. This transformation and expansion of independent colleges, while still remaining under public university branding, will also enhance profitability generally in the sector thanks to the reductions in management fees then made possible for their parent public universities. Chinese higher education is also set to benefit from the new freedom and flexibility offered by private higher education institutions in the vocational training sphere. In contrast to public institutions which are often hampered by lack of resources and government regulations, private education institutions enjoy greater versatility and agility to adjust their curriculums in order to supply the skills that students will actually need in today's fast-moving workplace. Graduates of private institutions would consequently find themselves more employable, and this in turn would make private institutions even more attractive as destinations for students.

HUNGER FOR NEW CAPITAL

It is clear that in order to expand fully and effectively tertiary education in China desperately needs the injection of fresh and innovative private capital. Already a number of private higher education operators, as shown in the table below, are seeking to tap capital markets via public listing. The initial outlay required to establish educational start-ups and develop the necessary infrastructure can seem daunting. It has been estimated that simply to fulfil official land-to student ratios could cost as much as one billion RMB. The scale of these outlays and the time needed to build credible track records will call for solid commitment and strong financial experience on the part of investors in private education institutions. Although existing players will have to contend with the vagaries of any future government amendments, they will enjoy incumbent advantage. Over time, it may be possible that consolidation between major players becomes more common. However, there will always remain room for the energetic and innovative. None of these concerns and caveats deny the realities of the solid, long-term opportunities offered by the sector.

TABLE 1: Recent Chinese higher education IPOs

COMPANY	DATE	PROCEEDS RAISED (BILLIONS HKD)
China Kepei Education Group	25/01/2019	0.9
Hope Education Group	03/08/2018	3.1
21st Century Education Group*	29/05/2018	0.4
China Xinhua Education Group	26/03/2018	1.3
China Education Group	15/12/2017	3.2
China New Higher Education Group	19/04/2017	0.8
Minsheng Education Group	22/03/2017	1.4
China Yuhua Education Group*	28/02/2017	1.5

* Provide K-12 education in addition to higher education

WHAT ARE THE REVENUE PROSPECTS?

Stable, sustainable annual revenue growth in China's higher education sector can be projected at a highly attractive level of 8-10%, as shown in the graph below. On average, tuition fees in China can be projected to continue to rise by 5% - 6 % per annum in line with annual growth in per capita GDP. However, the freedom of private as opposed to public education institutions to set tuition fees will allow them far greater scope to increase revenue. They will of course be subject to corporate taxes and may lose out subsidies or favourable pricing when acquiring land to expand. However, Value Partners do not believe that any of these factors will significantly check the onward march of private institutional involvement in Chinese higher education. This is especially the case when one takes into account the growing affluence of the middle class in China and the increasing likelihood of Chinese students choosing the more cost-effective option of studying locally rather than going abroad. Moreover, any potential drawbacks should be set against the independence and autonomy of private managements, their access to sources of investment and their ability to respond flexibly and creatively to challenges, for example by expanding capacity by means of mergers and acquisitions.

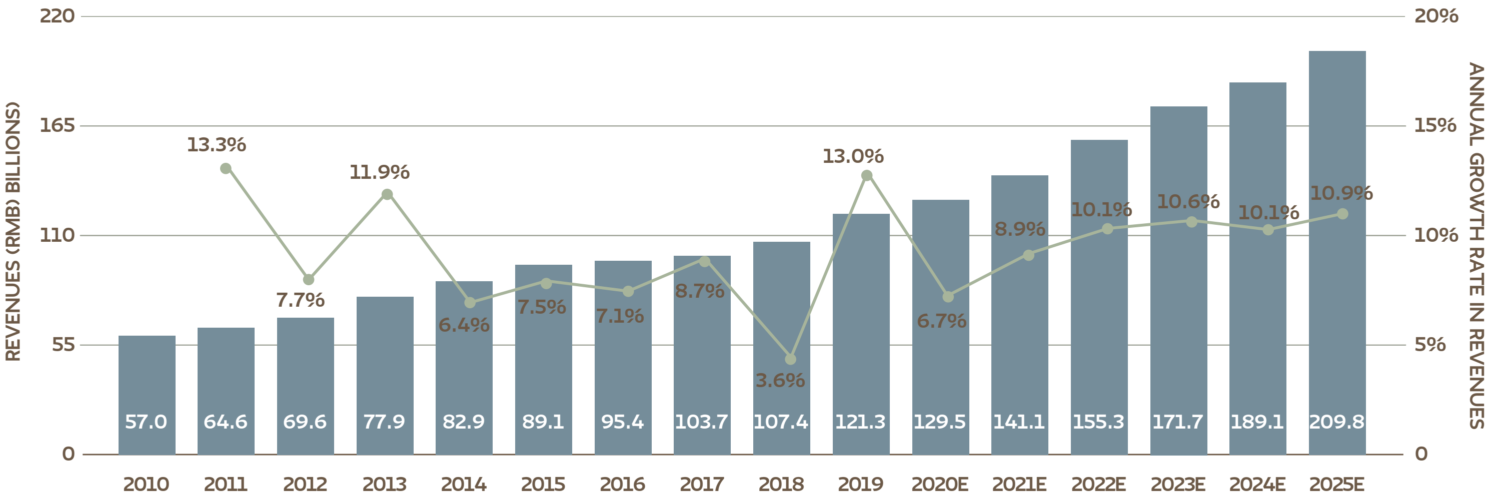


FIGURE 4: Revenue growth prospects

A VALUE OPPORTUNITY: THE CHINA EDUCATION GROUP (CEG)

Looking at the range of private players in Chinese higher education, Value Partners feel particularly bullish about China Education Group Holdings Co., Ltd. (CEG). The largest private operator in its field, CEG focuses its activities in Guangdong, Shandong and Jiangxi provinces. These locations have impressive potential to expand student intake. In addition, the large populations of these regions coupled with their relatively high per capita GDP provide a positive environment for CEG to expand its future operations.

CEG benefits from a strong funding position, having launched an IPO in 2017 (see Table 1) as well as enjoying highly favourable rates in the credit package it has secured from the World Bank. These rates in turn are helping boost its net profit margin, currently 30%. Its recent acquisitions are listed in table 2 below.

Internally, CEG has put together a dedicated finance team to ensure it gets the maximum value out of its acquisitions. It continues to make active efforts to expand its networks within schools and to increase its market penetration in chosen strategic locations across China, thereby both diversifying regionally as well as increasing student enrolments.On an individual basis CEG appears particularly well placed to capitalise on its opportunities to strengthen its position in the higher education sector, steadily increasing its presence in the industry through acquisitions and through the skillfull management of its financial resources. But it is by no means an unrepresentative example.

	TARGET ACQUISITION	LOCATION	NO. OF STUDENTS AT AUGUST 2019	NO. OF STUDENTS AT ACQUISITION	DATE OF ACQUISITION
1	Chongqing Nanfang Translators College	Chongqing	13,238	13,000	July 2019
2	Quancheng University	Shandong	8,488	8,500	March 2019
3	Chongqing Nanfang Translators College	Guangzhou	12,709	8,700	June 2018
4	Zhengzhou Transit School	Henan	27,046	23,700	March 2018
5	Xi'an Railway College	Xi'an	27,221	20,000	March 2018

TABLE 2: Recent acquisitions by CEG

We at Value Partners are firmly convinced that higher education in China is poised on the brink of an exciting boom. With accelerating domestic demand and increasing regulatory freedom the future for education providers in China has never looked brighter, and especially for private providers and for all those who have the vision and resources to invest in their potential.

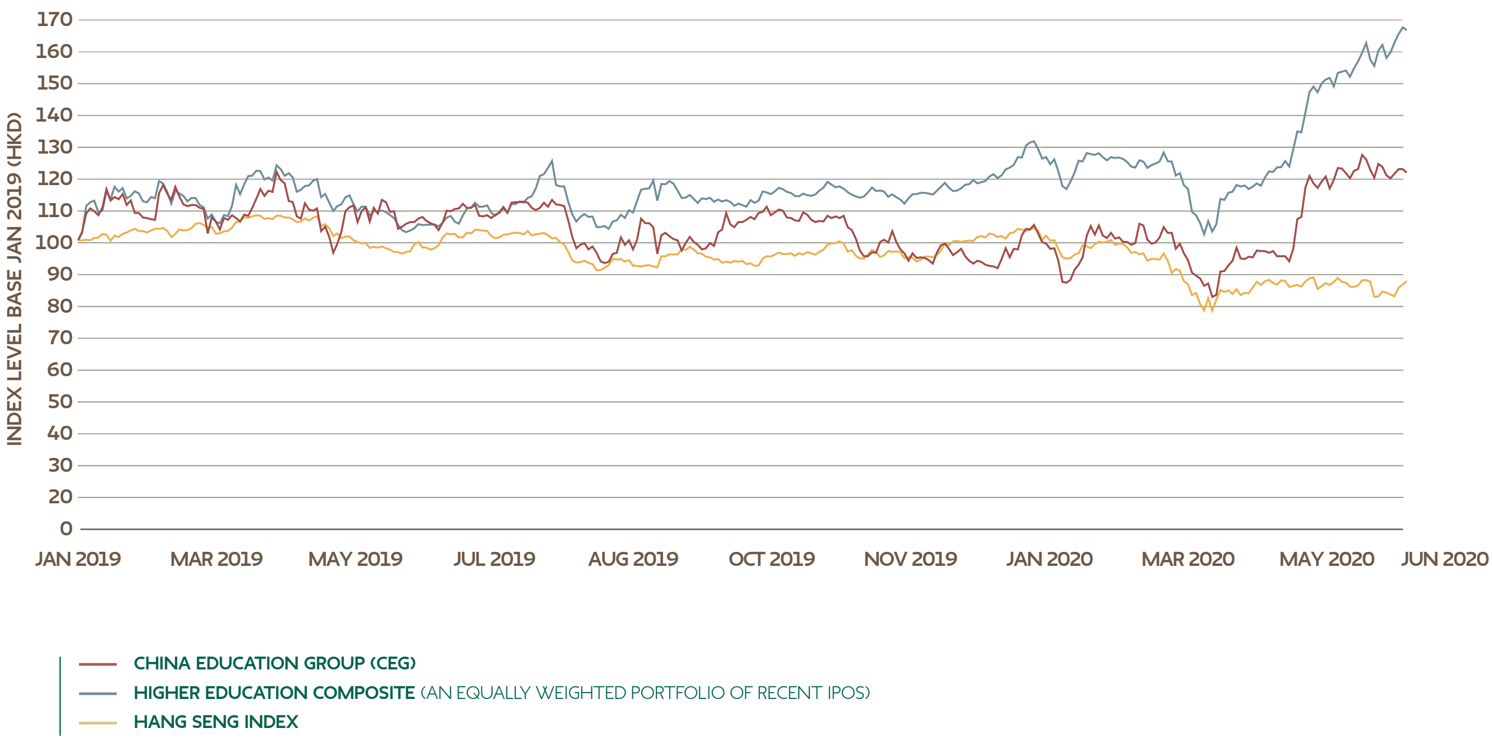
MARKET STATISTICS

TOP 5 LISTED CHINESE HIGHER EDUCATION COMPANIES

FIVE LARGEST CHINESE HIGHER EDUCATION COMPANIES	MARKET CAPITALISATION (BN HKD)	REVENUE (BN HKD)	EXCHANGE
China Education Group	25.8	2.6	HKEX
China Yuhua Education Group	22.5	2.4	HKEX
Hope Education Group	15.3	1.5	HKEX
China Kepei Education Group	12.6	0.8	HKEX
China New Higher Education Group	6.6	1.2	HKEX

SOURCE FINANCIAL TIMES, JUNE 2020

RECENT PRICE PERFORMANCE OF CHINESE HIGHER EDUCATION STOCKS



SOURCE OM LAB OXFORD METRICA

SOURCES

FOOTNOTE 1: POPULATION PYRAMID, MORGAN STANLEY, MAY 2020. (MIDDLE INCOME IS RMB 13K TO 67K PER ANNUM)
FOOTNOTE 2: MINISTRY OF EDUCATION (MOE), JULY 2018. CHINA STATE COUNCIL INFORMATION OFFICE, MAY 2020
FOOTNOTE 3: GUANGDONG PROVINCE, DEPARTMENT OF EDUCATION, MAY 2019

FIGURE 1: CSCI RESEARCH, FROST AND SULLIVAN, MORGAN STANLEY
FIGURE 2: MOE, WORLD BANK, TRADING ECONOMICS, GOLDMAN SACHS GLOBAL INVESTMENT RESEARCH, OCTOBER 2019
FIGURE 3: UNIPAGE, VALUE PARTNERS, 2018/2019.
FIGURE 4: UBS-S RESEARCH, JANUARY 2019

TABLE 1: HONG KONG STOCK EXCHANGES, JULY 2019
TABLE 2: CHINA EDUCATION GROUP, JULY 2019

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Established in 1993, Value Partners is one of Asia's largest independent asset management firms offering world-class investment services and products for institutional and individual clients internationally. In addition to its Hong Kong headquarters, it operates in Shanghai, Shenzhen, Kuala Lumpur, Singapore and London, and has representative offices in Beijing and Boston. Value Partners was the first and only asset management firm listed on the Main Board of the Hong Kong Stock Exchange (stock code: 806 HK) after it went public in 2007. It offers a diversified asset management portfolio for both institutional and individual clients in Asia Pacific, Europe and North America, covering: equities and fixed income, alternatives, multi-asset and quantitative investment solutions

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